SUERF/Central Bank of Iceland Conference

Post-Crisis Recovery and the Reconstruction of the Financial Sector

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Conference Report

Findings from a SUERF/Central Bank of Iceland Conference in Reykjavik.[1]

By Ernest Gnan, Secretary General, SUERF

Seven years after the onset of the financial crisis, economic recovery is uneven and in many countries lacklustre. Although many reforms of banking and financial system regulation and supervision have been undertaken, key issues remain unsolved regarding the structure of the banking system, cross-border banking activity and post-crisis business models. Important questions remain to be answered regarding the "new normal" and post-crisis potential output growth, as well as how we can build a sustainable financial system that serves the real economy. Against this background, this conference brought together top academics, senior policy makers and financial industry leaders to take stock of these issues and discuss strategies to promote post-crisis economic recovery and the reconstruction of the financial sector. Possible stumbling blocks as well as linkages between real and financial recovery were given special attention.

Már Gudmundsson, Central Bank of Iceland, opened the conference, recalling that at the last joint SUERF-Central Bank of Ireland conference on the topic of *"The interaction of monetary policy and financial stability in small open economies"* worries about mounting imbalances and risks for financial stability were articulated. The discussion then about what instruments to use against emerging imbalances has meanwhile been answered by the creation of macro-prudential policy. But the financial crisis eventually turned out much more severe than expected or feared. Iceland experienced the biggest financial crisis in the country's history, as the internationally very active Icelandic banks, which had grown rapidly and become very big compared to the economy of their home country, were hit hard by the panic in international banking and financial markets. Forceful crisis management by central banks contributed towards successfully avoiding another Great Depression, but the recovery is lacklustre. The risk of secular stagnation is not off the table, and is attributable to a combination of demand and supply side factors; unresolved legacy issues including high debt levels and fragile banking systems are certainly important. While banks are currently very actively adjusting to the tightened regulatory framework

[1] *The conference presentations can be found on the SUERF website http://www.suerf.org/index.php?option=com_k2&view=item&id=497&Itemid=170, with the password being "Harpa2014".*

and reinforcing their capital levels, the aim of re-establishing a reliable financial system that serves the real economy is far from being achieved. The too-big-to fail problem is yet to be solved. The deeply flawed framework for cross-border banking is still pending to be satisfactorily reformed. The optimal interplay of the financial sector with regulation and safety nets still needs to be studied more deeply.

Iceland's crisis featured, for one thing, a traditional credit boom fuelled by international capital inflows, which at some point stopped suddenly. For another, it was a collapse of three major banks with huge foreign exchange exposure and maturity mismatch, which lacked an adequate backstop given their huge size compared to Iceland's economy. This latter aspect was quite unprecedented. Given the huge shock, the resulting recession was comparatively modest, given the costs of the banking crisis were largely borne by other countries and that the crisis hit mostly the financial and construction sectors, while exports were boosted by a low real exchange rate. The recovery since 2011 has been quite vigorous, with economic slack disappearing and unemployment having fallen to 5%, and inflation being slightly below the central bank's inflation target. Private, public and foreign debt levels, while still very high, are on a declining trend. The biggest challenge yet to be solved are the comprehensive capital controls which turn out to become an increasing impediment for economic development.

Barry Eichengreen University of California, Berkeley, delivered the Keynote speech on the topic of *"Designing a financial system for the post-crisis period: a view from economic history"*. The economic literature on the link between financial development and economic growth is rather technical, large and yet inconclusive. The recent financial crisis prompted further questions on such link. The Asian financial crisis raised the issue that bank-based financial systems may maximise forced capital accumulation at the cost of efficiency and stability, and thus led to a push towards securitisation. The 2008/2009 financial and economic crisis in turn cast doubts on securities markets as efficient allocators of resources and on the efficacy of universal banks that combine commercial and investment banking functions. Currently, the issue arises whether China is pursuing a similarly hazardous road as it liberalizes its financial markets, facilitating the growth of shadow banking and liberalising its capital account with the aim of internationalising the renminbi.

Eichengreen drew four lessons from economic history for the design of the post-crisis financial system: First, history casts a long shadow, financial systems reflect other economic circumstances and policy decisions in the past, they are networks and are also for this reason hard to change. So, while history is not destiny, policy makers seeking to change the financial system should build on history rather than ignoring it. Second, major events can shock financial systems out of an established equilibrium. Historically, such shocks were associated with wars and their financing needs, but also financial crises that worked to discredit inherited structures and motivated fundamental financial reforms. One will see whether the recent financial crisis will act as such a trigger. Third, the close connection between government and finance is unavoidable, as much as some would like it otherwise. Governments fulfil an essential role in creating the institutional framework and a level playing field, within which financial institutions and markets develop. It is naive to think that financial institutions and markets develop spontaneously. Government regulation can help or hinder the development of an efficient financial structure, suited to the needs of the economy. Regulation can also serve mechanisms through which incumbents maximize their rents, deter entry and slow the adaptation of the financial system to changing economic circumstances. Finally, the distinction between Anglo-Saxon market-based and bank-based financial systems à la Germany and Japan has been given more weight than it deserves. Banks and securities markets are complements, not substitutes. A deep and liquid financial market can enhance the efficiency of the banking system. Banks and securities markets have different comparative advantages in dealing with different customer segments and in carrying out different functions. Banks matter most where relationships matter, financial markets meet the needs of large borrowers better and are good at financing uncertain, competing technologies. The question for Asia or Europe is, thus, not banks or jump-starting securities markets.

In the following discussion, he forecast that ultimately the European Central Bank would conduct more outright securities purchase; for lack of sufficient volumes of other paper, this will imply more buying of government bonds. Regarding corporate governance of financial institutions, economic history studies confirm that this matters very much for financial and economic outcomes. For example, outside directors in boards can greatly improve communication of financial institutions with the public. He suggested that banks would, without active or passive encouragement by governments, for mere reasons of economies of scale or scope, not become as large as they did in history.

Session 1, devoted to *"Post crisis economic recovery: challenges and remedies"*, was chaired by **Arnor Sighvatsson,** Central Bank of Ireland. **Athanasios Orphanides**, MIT Sloan School of Management, opened the session with a presentation on *"Reconstructing Europe: Beyond the Politics of Disintegration"*. He argued that over the past decade, particularly since the onset of the economic and financial crisis, Europe's share of world GDP has continuously declined. While the Great Recession hit the US and the Euro Area alike, the Euro Area recovery has been lagging behind since 2012, and is forecast to do so over the remainder of the current decade. While, according to OECD estimates, between 2007 and 2015 the US will have lost 5% in the level of potential output, Euro Area countries except Germany will have lost up to one third (Greece and Ireland; Spain: 22%, Finland: 19%, Portugal: 14%, Italy 12%). Germany, by contrast, will have lost a mere 3% (followed by Austria: 7%, Belgium, France and the Netherlands with 9%); indeed Germany's GDP per capita growth has been outperforming that of the US since 2011, while the rest of the Euro Area has stagnated. The divergence in the trend of unemployment mirrors this economic divergence.

A key question in the context of economic crises is, who pays for the costs of economic crises? Proper crisis management minimizes the total cost of financial crises and ensures a fair burden sharing. The euro deprived individual member countries of crisis management tools, while not ensuring the necessary political structure to encourage solidarity and cooperation in crisis management. National politics led governments to focus on shifting losses to others. Massive destruction in some member states and a much higher than unavoidable total cost for Europe as a whole resulted. As examples for this proposition, the author asked who had benefited from forcing the Irish government to accept all losses from the banks, who benefited from the postponement of the resolution and by the injection of credit risk into euro area sovereign debt by the introduction of private sector involvement, in the context of Greece's sovereign debt crisis? The timing and sequencing of crisis-related policy decisions had important distributional consequences among member states. Orphanides concluded by stating that the status quo of the euro area is unsustainable, the euro in its present form poses a threat to European integration. A reshuffling of political power is thus necessary to move beyond the politics of disintegration. If this proves impossible, plans to unwind the euro should be advanced to preserve the European project.

Stephen G. Cecchetti, Brandeis International Business School, talked about "Debt, growth and recovery". He started out by pointing out the different developments of public and private debt since 2007 among advanced and emerging economies (EMEs). In the former, public debt rose by 35 percentage points to 112% until 2013, while corporate debt stagnated at around 90% and for private households it fell by 7 percentage points to 75%. By contrast, in EMEs, public and private household debt rose moderately by 5 and 8 percentage points to 43% and 30% respectively, while corporate debt increased sharply by 34 percentage points to 92%. As a result, total public and private sector debt to GDP has sharply increased in most advanced economies (Ireland, Portugal, Greece, Spain, France, UK, US) and in several emerging economies (China, Hong Kong, Singapore). Despite methodological difficulties, empirical studies tend to show non-linear effects in the sense that at low debt levels, higher economic growth is associated with higher debt, while very high debt levels are associated with lower growth. Thresholds for the latter effect are empirically found at around debt ratios of 80-100%. A number of countries are above this threshold now. The economic rationale for such non-linear effect is that up to a certain point, debt allows the smoothing of consumption, investment and production, it enables capital deepening and improves allocative efficiency. Too high debt ratios result in a debt overhang and trigger financial crises. While high public debt seems to hamper economic recoveries, there is no such empirical relationship for private debt.

Tjörvi Ólafsson, Central Bank of Iceland, talked about *"Post crisis recoveries: the role of cross-border credit and sectoral misallocation"*. The fact that the post-crisis recovery has been slow and uneven despite extraordinary and long monetary accommodation reflects the nature of boom-bust cycles, where resource misallocations and debt overhangs built up during the boom need to be painfully corrected in the following bust phase. In small open economies, domestic financial cycles were lengthened and amplified by interactions with global cycles, spill-overs, foreign funding of credit booms and protracted real exchange rate misalignments, particularly in the late stage of the boom, thereby magnifying resource and credit misallocation to be corrected in the aftermath of the bust. Recovery thus requires, first, resource reallocation in the real economy and, second, balance sheet repair in the financial sector.

Iceland used capital controls to limit the damage of the bust, to re-establish macroeconomic stability and to create breathing space for needed structural adjustments. It was stressed from the outset that capital controls should not postpone the needed adjustments. Iceland's recovery was primarily export-driven, while former boom sectors (in particular banking and construction) shrank, with labour being reallocated in a large scale to more sustainable and competitive sectors. The fact that the capital stock is still contracting reflects the excessive corporate debt accumulation during the boom, the correction of which takes a long time. The extensive debt restructuring has strengthened private balance sheets, so that households' and firms' equity position is now similar to the pre-boom period. However, given continued high debt levels, the economic recovery has been credit-less, and the process of balance sheet repair is going to continue. It is vital that post-crisis economies stay clear of "hysteresis" effects. Labour market flexibility, the availability of finance and the creation of confidence are conducive to post-crisis reform processes, while conversely temptation to delay reforms, rigid labour markets, credit constraints and uncertainty pose threats to reforms and to the economic recovery. Central banks face serious communication challenges and have to operate within complex broader policy frameworks with increased political economy risks.

Session 2, chaired by **Ernest Gnan**, Oesterreichische Nationalbank and SUERF, dealt with the topic of *"Reconstructing the financial sector to serve the recovery"*. **Adrian Blundell-Wignall**, OECD, started the session with a presentation on *"Post crisis recovery and the finance sector"*, which addressed some major challenges currently facing global financial stability and economic growth. The Asian industrial revolution is based on state capitalism and supply chain management of importing to re-export to the West. Beggar-thy-neighbour exchange rate targeting supported by capital controls have made the world exchange rate regime dysfunctional. The huge Asian current account surpluses have to be recycled through capital outflows; but these outflows do not necessarily go to where asset prices have fallen the most, and are not used for example to recapitalize European banks or to lend to sovereigns. Instead they are invested in destinations to secure future food and resource supply. Asian state-owned enterprises benefit from subsidized cost of capital for these FDIs. To offset damage in the traded goods sector, industrialised countries have responded with ultra-easy monetary policies, which are for example reflected by very low real US bond rates since the start of the millenium. Given the close empirical relation between saving and investment in emerging market economies, and given their strongly rising share in world GDP, their model of export-led growth cannot go on indefinitely. Either economic policies will trigger the necessary adjustments, or it will happen through major financial disruption in a future crisis.

Prior to the crisis, the financial sector made up far too big a share of market capitalisations and earnings in the economy. In the future, banking and finance will need to undergo very far-reaching adjustments. Basel equity requirements are far too complex, allowing banks to reduce the ratio of risk-weighted assets to total assets through various "optimization" techniques, and thus to maximize their return on equity. In any case, there is no ex ante reasonable capital rule that is enough in a major crisis. Basel III has not addressed banks' business model issues that are at the heart of the too-big-to-fail related under-pricing of risk. Moving derivatives towards exchanges and CCBs will alleviate the need for banks to hold capital. Global derivatives volumes have reached levels of 12 times global GDP, and have hardly declined since then. Banks' gross credit exposure reached USD 5,000 bn in 2008, representing a huge margin call on all exposed banks, compared to which equity volumes were far too small. Commercial banking thus subsidises investment banking through implicit state guarantees for systemically important, too-big-to-fail banks. This is why the OECD supports initiatives to separate commercial from investment banking activities.

Shadow banks, or in the OECD's terminology: non-bank intermediaries, which comprise e.g. investment funds, pension funds, insurance companies, sovereign wealth funds, private equity funds, hedge funds, and exchange-traded funds, have become very important. They will gain even more weight in the future, as banks come under regulatory pressure, and as the financing of long-term investment and large pension savings in a low-inflation, low-interest rates world need to be matched. Price discovery in securities markets is being hampered by the spreading of passive fund management, index products etc. Small and medium-sized companies face a shortage of equity, since investors no longer make the effort to discover and research such companies.

In the euro area, the asset quality review will remain the big issue in 2014: US banks show much safer distance to default than many euro area banks. This problem is reflected in falling credit volumes in many Euro Area countries, which is not conducive to an economic recovery. The euro implies loss of individual, national monetary and exchange rate policies. But it also implies that, contrary to countries with their own currencies, individual euro area countries can indeed fail; this is reflected in sovereign risk premiums, as compared for example to Japan, the US or the UK. As the euro is, for political reasons, not going to break up, the only other choice is to move towards fiscal union. Otherwise, peripheral euro area countries might face a long period of stagnation and emigration towards more prosperous countries, as had been the case in Ireland in the late 19th century.

Patricia Jackson, Ernst & Young and SUERF, asked *"Have the lessons from the crisis been learnt?"* In her assessment, much of the focus of reregulation of recent years was on capital and liquidity buffers, but not on the actual failures that led to the crisis. First, large opaque securitisation markets were a major source of the crisis. In the run-up to the crisis, as the market grew, disclosure was not sufficient to show the market's fundamental change between 2004 and 2005 towards lower lending standards and reduced due diligence. As the quality of underlying loans deteriorated, tranching, the use of credit enhancement and a range of new instruments (such as CDOs) proliferated; prospectuses were long and difficult to understand. Given the opacity of the markets and instruments, prices reacted too slowly to changing default rates. Similar problems could occur in the same or different global markets in the future, e.g. with assets generated by shadow banks. Regulation has so far not addressed core problems in securitisation. Ways forward to develop these useful markets would be to trade these securities on exchanges in order to encourage transparency and enhance liquidity. This would for example entail a standardisation of prospectuses as well as standards for, and oversight of, rating models. Recently, shadow banking momentum has been growing, leading to different types of structures and relying less on underlying credit assessment.

Second, risk transparency within financial firms needs to be substantially improved. Metrics must reflect risks and lean against disaster myopia, they must reflect true risk and not disguise it. Point in time calculation and assessment of risk created wrong risk perceptions. Value at risk (VaR) models for trading books under-read risk because a mere one-year data history was accepted; thus, VaR measures compress in low-volatility periods and expand too late when volatility rises. This has been addressed by stress VaR and proposed expected shortfall. But a general principle of through-the-cycle (rather than point-in-time) metrics has not been adopted. The point-in-time modelling of PDs (probabilities of default) carries the same risks. Instead, PD estimates should be scaled into through the cycle.

The third failure leading to the crisis was risk concentration and risk culture in financial firms. There was a mix of "disaster myopia" and "false sense of security". Regulators should in the future focus on concentrated exposures to underlying risk factors. As a response to the crisis, financial firms have changed their internal frameworks for risk governance: the Chief Risk Officer (CRO) now usually holds a senior position within firms and the board is involved. By contrast, more work is still needed to embed risk appetite explicitly in the corporate culture and governance and to enhance risk transparency. Risk culture comprises the attitudes and behaviours of an organisation's people that influence risks and affect outcomes. A firm's culture is shaped by the way corporate values are translated into desired behaviours and by fundamental enablers. Risk culture is also influenced by external factors such as regulation. Summing up, Jackson urged regulators to study more thoroughly the true causes of the crisis. Misunderstanding the drivers creates the potential for wrong and ineffective solutions.

Cyrus Ardalan, Barclays PLC, offered a talk on *"The Private Sector Perspective: Financial sector developments and reform"*. The financial crisis has led to the biggest regulatory overhaul of the industry ever undertaken, addressing resilience, resolvability, market structure, governance and transparency, and an institutional revamping of supervision. In Europe, re-regulation has been even more intense with the creation of the European Banking Union. Overall, reregulation serves to strengthen the financial sector and will contribute to the economic recovery. Between 2007 and 2013,

banks have strongly increased their CET1 (core equity tier 1) ratios – mostly through the issuing of equity, given that the return on equity of banks has been quite weak in recent years. However, the magnitude and speed of change has raised a number of issues surrounding global consistency, extraterritoriality, adequacy, cumulative impact and business models.

According to the EU Commission, while substantial progress has been made in the area of financial regulation, outstanding issues are structural economic reforms, the regulation of shadow banking, non-bank recovery and resolution frameworks, and better satisfaction of long-term financing needs. Risks identified by the Commission include regulatory arbitrage, risk concentration, growing asset encumbrance, disorderly deleveraging and excessive complexity of post-crisis regulation. IOSCO's 2014 *"Survey of Securities Markets Risk Trends"* has identified regulatory uncertainty, banking vulnerabilities and volatile cross-border capital flows as major risks for banks; further risks include corporate governance issues, financial risk disclosure, shadow banking, search for yield, resolution and resolvability plans, central counterparties ("CCPs"), market fragmentation, and cyber crime. Ardalan also mentioned uncertainty about future macro prudential policy tools as a risk for banking. A critical review of the growth impact of reregulation is required. Given ongoing deleveraging in European banking, non-bank lending and capital market financing should be expanded in Europe. The biggest current challenge is shifting the focus from financial stability towards growth. Without growth, financial stability will be undermined by the public and private debt overhang as well as by unemployment and social dislocation.

The conference concluded with a panel, chaired by Gillian Tett, Financial Times, as well as **Már Gudmundsson**, Central Bank of Iceland, **David Llewellyn,** Loughborough University and SUERF, and **Fridrik Már Baldursson**, University of Reykjavik, as panellists. The panel focused, inter alia, on the strategic way forward for regulation, on the role of, and experience with, capital controls, and the pros and cons, in the context of the financial crisis, of being inside or outside the euro area.[2]

Baldursson called for higher capital and better cross-border resolution. Cross-border resolution of banks has been a major problem during the crisis and still is not satisfactorily solved. This was and is also at the heart of the Icelandic banking crisis. The world should study and learn from the Icelandic experience. It is not clear that higher capital requirements for banks will result in higher borrowing costs. Aside from capital controls, both capital outflows and inflows may also be addressed under the aspect of macro-prudential measures. While capital controls were effective during the Icelandic crisis, they cannot stay forever. Many high-tech companies in Iceland are reacting to the capital controls by relocating their production. Regarding the issue of who should bear the cost of banking crisis, the Irish experience of the taxpayer possibly footing all or most of the bill contrasts with the Icelandic approach, where creditors had to take a substantial share of the burden.

Llewellyn noted that – existing, quite comprehensive and detailed - regulation did not manage to prevent the crisis. Did it fail because there were fault lines in the details of regulation, or because there were fundamental flaws in regulation? Llewellyn suggested both reasons were relevant, but mostly the latter, because banks will always react to regulation. Regulation has two objectives: a) to reduce the probability of bank failure, b) to reduce the social cost if bank failures occur. Reducing the probability of bank failure to zero would basically imply a bank system that no longer serves its functions and would thus become useless. Optimal regulation bears in mind costs from regulation (which ultimately end up with consumers) in relation to their benefits. Also, regulatory escalation should be avoided. So, further work should focus on resolution, ring-fencing etc. The aim must be to bring the social cost of bank failure reasonably close to zero, otherwise resolution regimes will not be credible. Capital controls, while possibly useful in acute crisis situations, ultimately in the long run do not work, because they trigger circumvention. There is no simple answer or rule on how to deal with a banking crisis such as the Icelandic one: a proper cost-benefit analysis needs to be done on a case-by-case basis to determine the optimal burden sharing and the sequencing of measures.

Gudmundsson recalled that banking systems are the result of developments and decisions in the past. It is time, to actively ask whether our fractional banking system is the best one. This would not imply the abolition of a financial system altogether. But as long as we have the present system, it will never function without a safety net, which in turn creates moral hazard. Capital requirements on banks are the price to pay for this safety net. The roots of the crisis were too little capital in international banks and regulatory arbitrage. As long as resolution and backstops are not installed at an international level, banks from small countries need to observe limits on their international activity with respect to maturity transformation, foreign currency mismatch, and the collection of deposits at foreign branches. Their international activity should focus on serving foreign activities of the companies of the respective country. Specific risks need to be addressed by appropriate measures, even if this may be regarded as "sand in the wheels" by some. Iceland has for example reacted by imposing strict liquidity ratios and limits on foreign currency exposure on banks. The abolition of Icelandic capital controls needs to be done step by step, in line with the unwinding of problem banks and a solution to dealing with the stock of foreign claims against Iceland. Having one's own currency, as opposed to being part of a monetary union, can be both a problem in a financial crisis and facilitate macroeconomic adjustment. We need a new and better growth model which is less debt driven and more globally balanced. The world will suffer from low growth for several years, bearing the risk of vicious spirals.

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[2] *A full video stream of the panel discussion can be found on the SUERF website: http://www.suerf.org/index.php?option=com_k2&view=item&id=497&Itemid=170*

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At the end of the day, the over 100 participants left with a better understanding of the core issues currently at stake, and of the different perspectives of financial practitioners, academics and policy makers. The conference highlighted that the reconstruction of the financial sector and the restoration of economic growth are mutually conditional. So, economic policy needs to address them simultaneously and as part of a comprehensive, consistent package. Financial crises are possible triggers for substantial reforms. But it is yet to be seen whether the recent financial crisis will act as such a trigger. The close connection between government and finance is unavoidable, if only since it is Governments that set the rules and incentives for financial institutions to operate, and Governments are thus also – at least partly - responsible for the outcome. The re-regulation of the banking and financial industry so far achieved is widely considered to be conducive to contributing to greater financial stability in the future. At the same time, it was criticized by some as being incomplete, not necessarily optimally targeted at the areas truly critical for financial stability, while others saw it as having reached a point beyond which the costs of further regulation might outweigh the benefits. For the euro area to function smoothly in the future and to restore growth also in the peripheral countries, many held the view that the hitherto observed continued focus on national interests needs to give way to a more fundamental and far-reaching reform of governance and of burden sharing. Substantial new financial stability risks are looming from global exchange rate distortions, and the resulting current account imbalances, mispricing of various asset classes and financial exposures.