

Future Risks and Fragilities for Financial Stability

Report on the ICFR-SUERF conference held in London on 8th March, 2012



By Stefano Pagliari, ICFR, London



Richard Reid (ICFR)



David Llewellyn (SUERF)



Michael Saunders (Citigroup)

Richard Reid, Director of Research at ICFR welcomed the speakers and participants at the conference held in Friends House, Euston Road, London and expressed his enthusiasm for the ICFR/SUERF partnership in organising this important conference on the key issue of financial stability. Explaining the reason for the conference he suggested that the regulatory response to a crisis may have the effect of setting the parameters for the next. It is starting from this insight that this conference, organised jointly by the ICFR and SUERF, on “Future Risks and Fragilities for Financial Stability,” explored what the next pressure points for financial stability might be, how these may arise from the response to the last financial crisis, and how the industry and the regulators can prepare for them.

In order to discuss this theme, the conference brought together a select group of academics, industry practitioners and policymakers to discuss a range of connected issues, mainly incentives and market discipline, regulation, competition and shadow banking, and size and structure of business models.

The paper presented by **Clive Briault** (Senior Adviser, KPMG) discussed the role of incentive structures in driving the conduct of the financial sector in the run-up to the crisis. During this period, the financial sector frequently responded to incentives originating outside the

financial sector itself, such as global imbalances, loose monetary policies, and loose fiscal policies, as well as tax incentives. These external incentives interacted with, and were magnified by, incentives internal to the financial system, such as the targeting of return on equity and a reliance on short-term remuneration packages. The crisis also demonstrated how the impact of these incentives within financial institutions can survive the combined scrutiny of management, internal control systems, internal audit, as well as the discipline imposed by financial markets, for a significant length of time. Briault discussed different approaches to strengthen those incentives faced by financial firms and their management that seemed to have gone missing ahead of the crisis, as well as ways to encourage firms to internalise their negative externalities. The final part of Briault’s presentation discussed the regulatory response to the crisis and highlighted how there is significant scope for well-intended regulatory initiatives to generate perverse incentives. These are already visible in the reaction of banking institutions seeking to implement Basel III, but also in the conduct of regulators who tend to be excessively risk-averse in order to meet their statutory objective.

The second paper, presented by Professor **Alistair Milne** (Professor of Financial Economics, Loughborough Uni-

versity) suggested a more hopeful view of the role that market discipline can play in promoting the safety and soundness of the financial sector. According to Milne, the failure of market discipline in the lead-up to the crisis could be attributed to the failure in making information available to investors in an appropriate form. Existing international accounting standards fail to provide a complete view of the situation of firms as complex as major international banks, while the performance measures upon which investors rely to assess the performance of financial institutions, such as return on equity and related techniques of economic capital allocation, have proved to be inadequate.

Building upon this analysis, Milne discussed the need to supplement international accounting standards and existing performance measures with additional disclosures to allow investors to better understand the internal functioning of banks. More specifically, Milne advocated the creation of an “open-source” banking system, allowing investors to request, and to obtain on demand, complete information on bank exposures along any appropriate dimension so as to enable comparison to be made between different financial institutions. In order to achieve this objective, Milne endorsed the shift towards “contingent reporting”, expecting banks to be responsible for providing relevant information at reasonably short notice to either regulators or to investors, as well as the establishment of a private sector disclosure council to determine such contingent disclosures, and regular stress testing as demanded by the same investors.

Patricia Jackson (Ernst & Young LLP) discussed the implications that Basel III and other recent regulatory reforms have on the “shadow banking” sector. Jackson argued that the request for banks to increase the quantity and quality of equity capital against different activities will have deep behavioural impacts in the business models of banks, which are already meeting their new obligations by retreating from different lending activities. Conversely, with banks capital constrained, hedge funds are already moving into lending activities alongside private equity firms, asset manager and lending between companies. Jackson raised the issue of the extent to which this expansion in financial intermediation occurring within the shadow banking sector is sustainable. While macroeconomic or regulatory changes may force a contraction in some lending channels, this shortfall in the shadow banking sector will not necessarily be met by an expansion in the balance sheet of banks, which remain

constrained by the newly-imposed capital and leverage ratios, as well as by the new liquidity ratios. This reduction in the provision of credit to the economy may negatively affect the real economy.

The proposal presented by Jackson to avoid this outcome is to regenerate the securitisation market around stricter rules and standardised structures to prevent the failures that characterised these markets in the past. However, according to Jackson, measures to restart the securitisation markets are unlikely to succeed without the intervention of regulatory authorities, for instance by allowing financial institutions to count securitisation as part of the liquidity pool under Basel III.

Vicky Pryce (FTI Consulting) discussed the issue of competition in the financial system, and the extent to which this will be affected by recent regulatory reforms. Increasing competition within the financial sector was one of the explicit goals that informed the work of the UK’s Independent Commission on Banking, which identified different measures to enhance the level of competition in the UK. According to Pryce the impact of these measures on the level of competition is uncertain and the level of competition within the UK banking sector may not change significantly over the next few years.

According to Pryce, the outcome is not necessarily a negative one. While the promotion of competition is generally associated with greater efficiency of markets, in the case of finance this objective needs to be weighed against other concerns such as ensuring the stability of vital functions, services and the protection of consumers. At the present moment, allowing existing financial institutions to recover may be a greater priority. Moreover, according to Pryce, both theory and empirical evidence remain ambiguous regarding the nature of the payoff between financial stability and competition, and some countries with heavily concentrated banking sectors have weathered the financial crisis better than other less concentrated countries. Indeed, the level of concentration in the financial sector should not be equated with the lack of competition, which still remains possible amongst a small number of incumbents.

The paper presented by Professor **David Llewellyn** (Loughborough University and the Vienna University of Economics and Business) explored the evolution of bank business models before and after the crisis. Indeed, a complex two-way causation exists between business models and regulatory policies where the change in business

models over time is influenced by, and in turn influences, the content of regulatory policies. This is the ‘endogeneity’ problem. Regulatory policies such as the original Basel Agreement, together with other factors, contributed to an important evolution in bank business models, creating incentives for banks in the years before the crisis, including the movement of assets off their balance sheet, and an increasing reliance on securitisation and on credit risk shifting instruments, and a departure from the traditional business model where banks accept originated loans and accept the risk in their balance sheet. Some of the by-products of this change in business models, such as an over-reliance on wholesale funding and increased gearing into higher risk assets, have been closely associated with the origin of the financial crisis.

According to Llewellyn, the financial crisis has generated new pressures upon banks to further adjust their business models. The unique conditions in the markets generated by the financial crisis, as well as changes in the regulatory environment, have generated a massive tightening in credit conditions and a contraction in the inter-bank markets, and forced the European Central Bank (ECB) to become a semi-permanent financier of commercial banks in Europe. According to Llewellyn this model is unsustainable. Indeed, while it is still unclear how the adjustment process will take place, Llewellyn argues that the crisis will be transformational although banks are unlikely to converge on a single business model: diversity in business models will continue.

Other challenges for financial stability that may emerge from the crisis were discussed by a panel including **David Lascelles** (Centre for the Study of Financial Innovation), **Emil Levendoğlu** (HM Treasury) and **Thorsten Beck** (Tilburg University). In his discussion, Beck pointed to the risks emerging from the growth in the size of the financial sector relative to the rest of the economy, arguing that there may be no additional benefit from the growth of financial lending after a certain level. According to Beck, regulatory policies should not be designed with the objective of avoiding bank failure, but rather of ensuring that bank failures do not create significant costs for the rest of the economy. Finally, Beck discussed the benefits of cross-border banking, and argued that to preserve financial stability policymakers may be forced to choose between increasing the international coordination of regulatory policies and segmenting cross-border banking activities.

Emil Levendoğlu discussed the reforms being introduced to redesign the British regulatory architecture. Levendoğlu highlighted how the novelty of certain regulatory measures (such as the implementation of macro-prudential frameworks) should lead policymakers to be cautious and avoid running too quickly before having ensured the development of the right tools. Similarly, in the design of a new regulatory framework it is important to keep in mind how overly detailed prescriptions could create the wrong incentives.

Lascelles in his remarks discussed what the major sources of future risks are as perceived by the banking community. While the macroeconomic environment and the Eurozone crisis are perceived as the major present risks, followed by the sovereign and consumer credit risk, regulation also continues to be perceived by banks as a high risk area given the costs it imposes and the competition issues it generates. However, this perception is not shared by market players outside of the banking community which continue have a more positive view of regulation.

In conclusion to the conference, **Michael Saunders** (Citigroup) spoke on the challenges for financial stability that are emerging in this phase from the overall economic outlook. The global economic outlook is currently threatened by the interaction of three different processes: the deleveraging taking place in the private sector, the deleveraging by the public sector, and the existing weaknesses in the banking system. Indeed, the extent of these challenges is clearly tied to the size of the credit boom before the crisis, a process whose origins can be found in the regulatory policies introduced over that period.

Given the major costs that credit boom/bust cycles pose in terms of bank recapitalisation costs, as lost jobs, business failures, and public spending, Saunders concludes that one of the major aims of economic and regulatory policies should be that of dampening credit cycles and of minimising the losses that result from them.

According to Saunders policymakers need to pay close attention to credit, housing and balance sheets during the boom. Sharp rises in debt and leverage are warning signs that should not be overlooked. Policy makers need to act to dampen this through monetary tools, as well as through the use of different macroprudential regulatory tools such as variable capital weights and LTV ratios, as well as through traditional monetary policy instruments. Saunders also called for ending the tax advantages of debt finance. However, these lessons have not been fully

learnt yet. In his concluding remarks, Saunders called on policymakers to be more forceful in demanding banks to recognise their losses and recapitalise in a timely manner, while not allowing them to aggressively deleverage to meet capital targets.

The conference was concluded by **Barbara Ridpath**, Chief Executive of ICFR, and **Catherine Lubochinsky**,

President of SUERF. They thanked the speakers, chairpersons and the participants for their contributions to a very interesting event. Catherine Lubochinsky expressed the hope that this successful joint venture between the two organisations would lead to further collaboration in the future.

30th SUERF Colloquium

States, Banks and the Financing of the Economy

sponsored by UBS,
Bank Julius Baer, the Department of Banking and Finance, University of Zürich,
NCCR FinRisk, the Swiss Finance Institute and KOF ETHZ
University of Zürich, Rämistrasse 74, CH-8032 Zürich
on 5–6 September 2012

OUTLINE PROGRAMME

Wednesday 5 September, 2012

- 08.30 **Opening and Welcome**
Urs W. Birchler, University of Zürich, SUERF President
Plenary Session – Keynote Speakers
Jean Pierre-Danthine* Vice-President
Schweizerische Nationalbank
Axel Weber*, Vice Chairman, UBS
Jean-Charles Rochet*, Prof. of Banking, Uni. Zurich & Toulouse
- 11.00 *Coffee Break*
- 11.30 **Commission Work – Session 1**
1: The role of monetary and fiscal policy
2: Bank lending, alternative financing, capital structure and growth
3: Resolution of banks or states, bail outs and contagion
- 13.00 *Lunch*
- 14.00 **Commission Work – Session 2**
1: The sovereign debt crisis and Eurobonds
2: Government bonds: risk, performance and liquidity
3: Bank ownership, performance and supply of credit
- 15.30 *Coffee Break*
- 16.00 **SUERF Marjolin Lecture**
Chairperson: Urs W. Birchler
Money and Banking in Times of Crisis
Lorenzo Bini Smaghi*, formerly ECB
Followed by Q&A
- 17.30 **SUERF General Assembly**
- 19.30 *Official Colloquium Dinner*
Dinner Speaker: Axel Weber, Vice Chairman, UBS

Thursday 6 September, 2012

- 09.00 **Commission Work – Session 3**
1: Monetary and fiscal policy
2: State owned vs privately owned banks and firms
3: Safety nets and government intervention
- 10.30 *Coffee Break*
- 11.00 **Commission Work – Session 4**
1: Taxation issues
2: Cross border issues in a global economy
3: Independence of policymakers and supervisors in times of crisis
- 12.30 *Lunch*
- 13.30 **Commission Summaries – Chairmen of the Commissions**
Closing Plenary Session
Benoît Coeuré, European Central Bank
D. Wilson Ervin, Crédit Suisse
Yves Robert-Charrue*, CEO, Bank Julius Baer
Stephen Cecchetti*, Chief Economist, BIS
Haig Simonian*, Correspondent Switzerland/Austria, FT
- 15:45 **Presentation of the Marjolin Prize by SUERF President**
- 16:00 *End of Colloquium*
- Further information & programmes to follow and appearing on the 30th SUERF Colloquium microsite: www.suerf.org/c30**