Emerging from the Ashes: Prospects for European Wholesale Banking in the Wake of the Crisis

2009 Annual Conference Report

31 March 2009 - De Warande, Brussels

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The ongoing financial crisis is whittling down the whole financial sector, calling into question the future prospects of the European wholesale banking industry. The 2009 ECMI Annual Conference held on March 31 in Brussels brought together important players in the global financial industry to discuss how the European banking system and financial markets will evolve.

Firstly, the debate looked at the current state of the financial system, delving into the causes of the meltdown of the crisis and its impact on global financial stability. In the last years, most of the risk capacity[1] moved from a micro level (conflict of interests, market frauds and so on) to a macro level (excessive liquidity in the financial system), inflating the bubble in several apparently not-linked sectors.

The second panel analysed the micro aspects of the financial crisis in regard to the impact of state aids on competition and the integrity of the European single market. In addition, experts and academics focused on the state ownership of the banking system and how this development would affect the efficiency of the present banking model.

In the second half of the day, speakers discussed ways to improve the efficiency and governance of the back office (post-trading infrastructure) and how to re-establish the credibility of the front office (fund management industry). It emerged that the primary objective is the reduction of access fees and the overhaul of the investor confidence.

The dinner debate shed new light on the future of European capital markets. On the one hand, the downsizing of the financial sector brings the industry back to its fundamental size, testing the efficiency of post-trading services to contain the worsening of the crisis. On the other, the shrinkage of financial markets and their fragmentation leads the European Union at a crossroad: should we go on with improving enforcement and supervision at the European level or retrench to national markets and jeopardise the European project?

[1] Risk capacity defines micro or macro sectors potentially capable to accumulate risk that directly or indirectly affects market stability and efficiency. This indicator does not provide markets with enough information to be easily detected, basically due to its ability to quickly move across disparate financial or not financial sectors.

OPENING SESSION
The Banking Sector: Going Down the Drain?

Speakers:
Jan Loeys, Chief Market Strategist, JPMorgan
Avinash Persaud, Chairman, Intelligence Capital Limited
Moderator:
René Karsenti, Chairman of ECMI

Markets and economies need to be constantly re-optimized and adapted to a changing environment. Structures change because we learn from mistakes. However, human beings' bounded rationality does not support a collective wisdom, frequently driving people to do same (wrong) thing at the same time (herd behaviours). This often causes manias, panics and crashes in financial markets. It is possible to draw three lessons from the present recession: markets can break and cease to exist; the world is instable; and liquidity is not a free good.


Loeys, Persaud and Karsenti

Market failure can be retraced to several causes, all affecting the three main categories of the balance sheet: assets, debt and equity. Against a background of stable global GDP growth and a prolonged period of price stability starting from the middle 80s, markets experienced an underpricing of risk, on the assets side, while supervisory mechanisms at the macro and micro level were relaxed. In consequence, low default rates and a general sense of euphoria helped to lower credit risk and drastically reducing the cost of debt (low real yields). On the other hand, the "dot.com" bubble in equity markets at the turn of the century increased the costs of equity (high equity risk premium), except for financials.

The unusual mixture of these variables contributed to the build up of leverage in the financial sector and to diminishing household savings rates[2]. Market participants and consumers underestimated the risks of this strategy. The risk capacity quickly moved on the excess of liquidity. In effect, it moved from a micro level (conflict of interests, market frauds [Enron, WorldCom, Parmalat, etc] and so on) to a macro level (excessive liquidity in the financial system), inflating the bubble in several apparently not-linked sectors. The hypothesis of perfect risk diversification was wrong. We can spread the risk but we cannot eliminate it. An incredible amount of resources has been transferred to illiquid assets until the bubble of these risky sectors has burst, pushing down investments in alternatives and global equities markets. The high opportunity cost of having no liquidity is consistent with soaring saving rates and distrust of the banking system. On financial markets side, OTC products, mutual and hedge funds are facing liquidity issues, while there is a slight switch on fiduciary investment (UCITS-based). In

[2] Emerging Asian countries, after the crisis of the middle 90s', understood the risk of high leveraging and lower savings and since 1999 they aimed at deleveraging, increasing savings (CA surplus) and investing in liquid assets (reserves).

addition, for the first time in 200 years, US Treasuries outperformed equities over the past 20 years. Therefore, the assumption that equity investment will achieve higher returns than bonds in the long run because of higher volatility has broken down. The equity market thus is also facing a cultural crisis.

From this time of intense difficulty, we can draw some conclusions on the regulatory framework. High-regulated institutions have been strongly hit by the crisis, thus we do not need more regulation but better regulation. We should also shed new lights on the risks of "bad" regulation.

Lastly, we can make some predictions about the future. At government level, while tax revenues are collapsing, the excessive use of fiscal policies and government bonds[3] will trigger the explosion of public debt (e.g. in UK, in the next years, the debt will achieve up to 150% of GDP).

At market level, the banking system will be repressed and downsized (more banking regulation and capital requirements). A stricter regulation will affect cross-border operational activities of banks. Banks are usually more national "in death".

However, it is a good moment for the European banking system since the regulatory fragmentation between member states paradoxically helped to avoid a worse situation.

The question thus will be: from where the liquidity will move in the future? The increasing savings rate will create a better environment for safe and simple institutions as retail and cooperative banks. This new solid positioning in the market will generate stronger competition between the private and public sector in the bond market. The ownership of banks is going to be more seductive for governments because it will be the best access point to savings and liquidity.

FOCUS SESSION 1
The State-Run Banking Model: Impact on Capital Markets

Speakers:
Christoph Walkner, State Aid Unit, DG Competition
Fabrice Demarigny, Partner, Mazars
Rod Carlton, Partner, Freshfields
Florencio Lopez de Silanes, Professor, Duisenberg school of finance
Moderator:
Jan Wouters, Professor, University of Leuven

Different kinds of state aid (liquidity injections, full guarantee on deposits or government ownership) across the world are shaping a new banking business model in which governments are more frequently in control[4]. In addition, especially in US, a big flow of fresh resources is supporting industrial companies as well. This aspect may affect fair global competition leading to the revamp of nationalism in Europe that is a big threat for the single market. The European Commission will intervene to preserve the

[3] In recession, the supply of Government bonds is usually not a problem.

[4] "The Government must be prepared to hold whatever proportion of equity capital turns out to be necessary", Mervyn king, Bank of England, 17 March 2009.

basic principles of competition[5] but with more flexibility. It will allow partial aid for tackling the crisis at a national level as long as it will be limited intervention to help proper market functioning, to maintain a level playing field and to favour restructuring plans[6]. There should be a better involvement of international institutions, for example the World Trade Organization (WTO) for the control on state aids, the Financial Stability Forum (FSF) for prudential regulation and new standards, and the International Accounting Standards Board (IASB) for the definition of new accounting standards and new changes in the governance practices.

Demarigny and Wouters

However, many concerns emerge around the governance and the efficiency of the government ownership of the banks (GoB):
- What is the role of the State as controlling shareholders?
- Will it pursue the maximization of shareholders or stakeholders value?
- Why are governments investing in bank equity?

If the first question is hard to answer, the second question follows the usual pattern: providing additional core tier 1 capital to further strengthen banks' capital, enabling them to absorb expected losses and to restructure their balance sheets. The consequences of the government bailouts of banks can seriously affect the efficiency of the whole banking system. The GoB negatively and significantly affects[7]:

- Growth of private credit;
- Growth of liquid liabilities;
- Growth of claims on private sector;
- Growth of quasi-liquid liabilities;
- Growth of GDP and GNP per-capita;
- Growth of the productivity.

GoB is associated with a misallocation of resources in the economy that gradually impact on the variables mentioned above. Finally, data shows that the GoB increases default rates on loans, while the overall recovery rate is drastically reduced. In the long run, increasing risks of politicisation of resource allocation can delay financial and economic development. Some argue that an excessive flow of resources has been dedicated to this sector. So, it is important, at least in the long run, to safeguard and

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[5] Monopoly can be harmful (Dead Weight Loss - DWL) if it is not result of the competition between firms or of the impossibility for competitors to replicate the same level of marginal costs that one player can structurally have in the market. Therefore, it is strongly desirable that monopolistic solutions, outside these two exceptions, would represent only a short-term solution.

[6] See European Commission, Temporary Community framework for State aid measures to support access to finance in the current financial and economic crisis, COM 2009/C 16/01, 22 January 2009, available at http://ec.europa.eu/competition/state_aid/legislation/horizontal.html.

[7] Regressions data and results (time period 1960-95) provided by Prof. Florencio Lopez de Silanes.

promote a competitive banking sector to preserve an efficient allocation of resources.

FOCUS SESSION 2
The Prospects for Europe's Market Infrastructure

Speakers:
Helmut Wacket, Head of Section, ECB
Mattias Levin, Financial Markets Infrastructure Unit, DG Internal Market
Mark Yallop, Global COO, ICAP
Moderator:
Godfried de Vidts, ECMI Board Member

Since 1999, when the Giovannini Group began to work on the subject, Europe is trying to produce a harmonised regulatory framework and an integrated infrastructure for clearing and settlement. However, European securities and derivatives markets are still too fragmented and inefficient to achieve such objectives and the 15 barriers[8] have only been partially overcome.

The current action is focusing on three aspects:

- Target 2 Securities (T2S);
- Code of Conduct;
- OTC derivatives markets

Concerning Target 2 Securities, the ECB considers this project as a part of Europe's future post-trade infrastructure, which aims at stimulating competition in services related to settlement, harmonisation of rules and a single pool of securities (in line with the Lisbon Agenda). T2S will bring on one technical platform the settlement of securities transactions and cash accounts in central bank money in the Euro area. It will start operating in 2013. The objectives of T2S are: reducing cross-border settlement fees, decreasing users' collateral/liquidity needs, and creating new opportunities for competition. Even though market players have some concerns, the ECB will push again for this project with the signature by Central Securities Depositories (CSDs) of the memorandum in June 2009.

Levin and Yallop

The code of conduct[9] initially played a positive role, but it is currently limited by insufficient price comparability (limited use of conversion tables and simulators), barriers to links between depositories and doubts on the efficacy of unbundling and separation measures.

Lastly, the financial crisis shifted the focus from clearing and settlement of cash equity

[8] The Giovannini Group, Cross-Border Clearing and Settlement Arrangements in the European Union, Brussels, November 2001; Second report on EU Clearing and Settlement Arrangements, April 2003.

[9] European Code of Conduct for Clearing and Settlement, November 2006, available at http://ec.europa.eu/internal_market/financial-markets/docs/code/code_en.pdf.

markets to derivatives and OTC markets, especially on credit default swaps (whose share is only $38 trn over a total size of OTC markets of $680 trn[10]). Bear Sterns, Lehman Brothers and AIG are only a part of the bigger market failure related to the uncertainty on size and distribution of losses as well as effect on counterparties. The uncertainty moreover helps the liquidity drying up and so the market paralysis. A central counterparty (CCP) clearing is the most immediate way to mitigate risks and to reduce uncertainty, improving market liquidity, information asymmetries and operational efficiencies (economies of scale and scope). In effect, many actions are redundant and they might be reduced with CCPs. A European infrastructure (single point of failure) for derivatives clearing should be implemented. However, the number of trades already cleared on CCPs is still low[11].


Helmut Wacket, ECB

Then, many concerns are related to the dynamic inefficiency[12] of a static infrastructure and the regulatory differences that affect the cross-border transactions. In the current crisis the concerns are amplified by limits to access central bank emergency liquidity provision beyond the currency area and legal risks in case of default (especially to access the assets).

FOCUS SESSION 3
Re-establishing the Fund Management Industry

Speakers:
Philippe Ricard, Head of Fund Services, BNP Paribas
Marcus Weigl, Director, Superfund
Luis Correia da Silva, Managing Director, Oxera
Moderator:
Jaap Winter, Duisenberg School of Finance

The fund management industry has been subject to massive capital outflows[13]. There is a clear need to restore capital inflows, investor confidence and profitability.

There is a growing trend in banking groups to merge funds activities, while retail and institutional demands are converging. In the next months, the assets management will be more competitive and the reduced complexity will make it easier and in some way more profitable. The sector will go back to growth in a relatively short period.

[10] Data provided by Mr Mattias Levin, European Commission.
[11] In 2007 the trades credit, rates, commodity and equity derivatives in OTC markets cleared through CCPs was 11.7 mln; data provided by Mr. Mark Yallop.
[12] In term of reduced innovation and market development.
[13] In 2008, the net assets of European Investment Funds is €4,593 bln for UCITS and €1,549 bln for NO UCITS, respectively 25% and 12% less than 2007; data provided by Mr. Mark Weigl.

On a regulatory side, the forthcoming UCITS IV[14] is going to have an impact on:

- Industry efficiency;
- Cross-border distribution;
- Investor protection.

The master-feeder structure, fund mergers and the management company passport with the use of a single platform will permit economies of scale and costs reduction, increasing the efficiency in the industry. The

European passport for UCITS will speed the notification procedures, reducing delays and favouring the development of the cross-border distribution. Finally, the key investor document will simplify and harmonise the information released for investors, strengthening investor protection. In addition, non-UCITS funds should be harmonised to avoid the risk for investors to access "dangerous" products.

In regard to product innovation, from 1990 to 2009, managed futures funds have outperformed bonds and stocks (574.48% versus respectively 275.59% and 32.35%)[15]. They allow also a better diversification of the portfolio with a more stable return of investment. Therefore, there are still opportunities to "safely" innovate products, assuring the return to profitability for the entire sector. UCITS IV in fact should be open to innovative products, taking into consideration the low risk of broadening to new "market-proven" and "non sophisticated" asset classes. In conclusion, for the future, we need more financial education, better governance rules, and clearer valuation techniques for assets (with specific rules for certain investment vehicles).

Up to this day, we have been completely dependent upon investment managers: they have avoided any type of governance regulation. However, in the fund management industry, there is a strong principal-agent problem, whereby the principal is affected by rational apathy and lack of expertise, and the agent faces very weak monitoring. Moreover, agents are affected by multiple conflicts of interest: their interests versus their clients'; and between clients themselves. This situation involves different breaches of the fiduciary duty: late trading, churning, bad IPO dumped into managed funds, and multiple funds. The fees structure is also largely inappropriate and drastically in favour of managers. We need more transparency in fund governance if we are to restore investor confidence. We should also consider that overregulation can divert responsibility from behaviours (real responsibility) to compliance. A behavioural-based solution would be to establish a trustee overseeing asset managers.

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[14] The draft of the proposal, approved in January 2009 by the European Parliament, is available at http://ec.europa.eu/internal_market/investment/ucits_directive_en.htm.

[15] Data from Mr. Markus Weigl.

DINNER DEBATE
The Prospects for European Capital Markets and Europe's Financial Centres

Speakers:
H. Onno Ruding, Chairman of CEPS
Ignace R. Combes, Deputy CEO, Euroclear
Olivier Lefebvre, ECMI Board Member, Member of Lamfalussy Group
Robin Fransman, Deputy Director, Holland Financial Centre
Moderator:
John Rega, Journalist, Bloomberg

The downsizing of the financial sector across Europe is bringing back the sector to fundamentals, involving new prospects for European capital markets and its financial institutions. When the dust will settle, we are going to face overcapacity in the European wholesale banking industry. The financial sector in fact has grown too much in the last years and it is just going back to normal[16]. New stricter rules for capital requirements and stronger supervision[17] will constrain banks' balance sheet (returns on capital will be drastically reduced). We are rightly concerned about the "too big to fail" financial institutions, but going back to a new Glass-Steagall regulation is not the solution. We need less risk-taking banks but, at the same time, we should preserve financial innovation. For instance, credit derivatives and securitisation should continue to exist in a different way that should not affect the risk exposure of banks and other financial institutions.

Olivier Lefebvre, ECMI Board Member, Lamfalussy Group Member

There are also positive elements to be taken from the financial crisis. The post-trading sector and market services in general performed quite well, facilitating capital flows and servicing a large amount of transactions due to the crisis. However, markets ask for more liquidity and confidence. Reduced liquidity and increased banks' exposure begs for the redemption of assets into cash as soon as possible. If banks do not take note quickly, we are going to face serious consequences on the availability of collateral.

The entire financial infrastructure needs to be improved, especially in the post-trading space. The consolidation process that will follow will achieve costs reduction and lower fees (economies of scale and scope; benefits on the increasing collateral with few CCPs). The broker-dealer business is shrinking, and consolidation will easily happen when benefits will be clearly

16 For instance, the weight of Financials in global equity markets is returning back to historical norms (around 20%); Mr Loeys' data.

17 As stated by De Larosière Group; The high-level group on financial supervision in the EU, *Report,* p. 10, with special focus on proprietary trading transactions, available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

delivered to counterparties. However, conflicts of interests are a big concern of this process. For the future, we need more implementation and uniformity for market services rules and infrastructures. A harmonised bankruptcy regulation across Member states is also essential. In effect, the implementation of the Financial Services Action Plan produced a positive process of integration of European capital markets, but it lacked answers on the governance and supervisory sides.

The responses that have so far emerged from the international debate give reasonable hope that the future regulatory and supervisory architecture will be strengthened. However, compromises between states will leave many concerns unanswered. On the supervisory side, there are still doubts on how to improve the macro stability supervision through the ECB and how to proceed with better implementation of level 3 committees. How will the systemic risk regulator access the macro data? Or will it blocked by national interests? The concentration of macro supervision at a supra-national level can involve discrimination of small countries and their financial stability in favor of bigger and more influential countries. We still have no responses on this issue. On the other hand, the risk of prevailing nationalism can hamper the enforcement of this new financial architecture. On the regulatory side, the risk of overregulation is always present. Currently, we do not know enough to address the banking model for the future. In addition, FSAP (especially MiFID) split liquidity through strong competition between market players. At moment, we need liquidity, transparency and a uniform CCP: in short we need more centralisation. However, there is also higher risk of supervisory arbitrages instead of regulatory ones. The De Larosière Report proposes bold solutions so that financial markets can finally return to be an efficient tool to support the economic and financial prosperity and development across the world.

The Head Table at the ECMI Dinner Debate (clockwise from bottom left): Barbara Matthews, René Karsenti, Robin Fransman, Ignace R. Combes, John Rega, Olivier Lefebvre, Fabrice Demarigny, Ieke van der Burg (MEP), H. Onno Ruding