



MPHIL (DEVF) MODULAR 2013

Session 5:

Regulating the modern Banking Sector (part 2)
EU Crisis



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In this session



- We will be discussing the factors that caused the **turmoil in Europe**.
- **Readers relevant to this session include:**
- <http://www.npr.org/blogs/money/2012/06/04/154282337/the-crisis-in-europe-explained>
- http://www.georgesoros.com/interviews-speeches/entry/remarks_at_the_festival_of_economics_trento_italy/
- <http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications>
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Consider this little Gem:



- http://www.youtube.com/watch?v=M_3T-Af57Pg



From the clip...



- **A little gem of a line appears in the clip we just saw:**
- “You don’t need to afford the things you’re buying – you only **need to afford the interest** on the money that you need to borrow in order to buy them”
- In the US this was clearly the belief from banks that incurred unsustainable debts to seem more profitable than they truly are.
- **In the EU crisis – this was true not only for banks, but for the different economies as well**



The EURO crisis



- After the dust settled following the Global Financial Crisis in 2008 – 2009, and it seemed like the Fed and ECB spending spree had sufficiently dealt with the problems – **fresh problems started to emerge in the Euro area.**
- After it was discovered that Greece had cooked their books and was far more indebted than initially thought, questions started to emerge as to the sustainability of other, similarly indebted EU countries that now:
 - **1) had high debt levels and**
 - **2) a lingering recession** (slow-down in GDP growth)
 - – making it hard for these countries to raise the taxes to repay their debt obligations...
- **BUT Authorities for a long time did not understand the true nature of the crisis – thinking wrongly that it was a fiscal problem.**



The EURO crisis



- Added to their wrong thinking that it was a fiscal problem that needed to be addressed, they also applied the wrong remedy to the wrong problem – ***greatly exacerbating the real problem in the first place:***

As Soros argues: ***you cannot reduce a country's debt burden by shrinking the economy through austerity programs.***

- In actual fact, as we will see today, the problem is a dual one:
- The Euro crisis is both a **sovereign debt crisis** and a **banking crisis** – and untangling the two is more tricky than you might think...



European Crisis: Background



- Let's consider first the background:
- Formed in 1999, the EU was a mesh of diverse nations: formed with a common goal in mind of facilitating trade and relations.
- The problem, though, was that at the one end there was advanced, developed countries – while at the other end there were countries still finding their feet.
- Using a common currency, and promising to uphold their unity: the EU embarked on a decade of **fast growth** and **easy lending**.



The Euro crisis



- What makes the crisis in Europe different from that of the US: is that **sovereign indebtedness** is at the heart of the problem.
- Following concessions by member states, certain “**peripheral**” **countries** (such as Greece, Ireland, Portugal) were granted leeway to spend more than initially agreed upon, in order to let them **catch up** to the larger economies.
 - This **makes complete sense**, as the **EU** was **striving towards unity**, so allowing certain countries to spend more in an effort to grow made perfect sense... That is until it landed them in deep trouble!



Public Spending



- Before we carry on, let's consider the concept of Public Spending.
 - In contrast to the **bad publicity** it has been getting of late, **public spending** has some **serious positives**:
- It allows spending on **infrastructural-** and **socio economic development** (such as education), while **nurturing growing industries...**
 - **This will benefit an economy in the long run** (just ask **South Korea**): by **stimulating production** and **employment**.



Public Spending



- Public financing occurs through two main channels:

I. Raising Taxes

2. Borrowing money (Public Debt)

- **While taxes limit economic growth...**
- **Public Debt** can make use of the wonder of **Leverage** (Yes that technique that the US banks used so extensively)
 - Which helps the economy grow to its full potential, while allowing the larger economy (higher GDP thanks to the debt-funded public spending programs) to pay off debts in the future through increased taxes.



Back to the EU:

- So the peripheral countries, in a world of cheap and easy debt, managed to incur large amounts of public debt – motivated by their efforts to ***catch up***.
 - It was expected at the time that **future economic growth** would **justify** the high current public expenditures.
 - The investors and banks, meanwhile, firmly believed in the **credibility** of the continued joint backing of the EU pact – leaving no one behind.



Euro Crisis



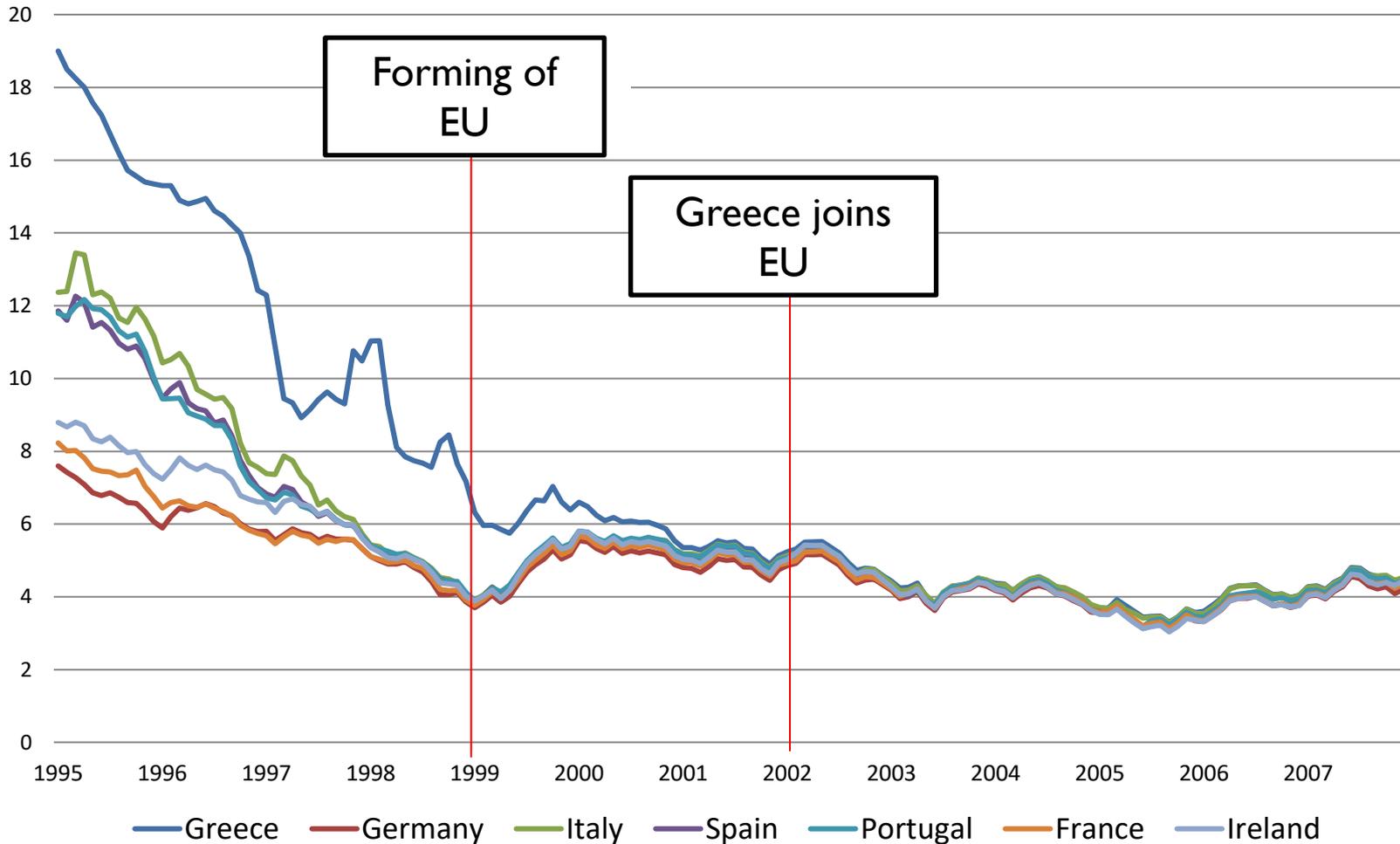
- Banks started to believe the pact and that **all** the EU countries could be considered **equally safe**.
- This led to banks scrambling to stock up on **higher yielding bonds** from **Greece, Ireland, Portugal** – as they had higher rates (i.e. required more compensation for investors to take on the added risk) than the safer countries such as Germany and France had!
- As Basel regulations required banks to hold *either cash or very safe instruments* (such as bonds) as required capital – these higher-yielding-than-normal safe assets were very luring to banks (similarities to MBS-frenzy?!)
 - The belief then of the Euro pact and the banks' frenzy to buy bonds of Greece, Ireland, Portugal, etc caused their bond rates **to fall quickly**, and borrowing rates for all the EU countries converged rapidly



European Crisis: the Root of the problem



Long term Government bond yields

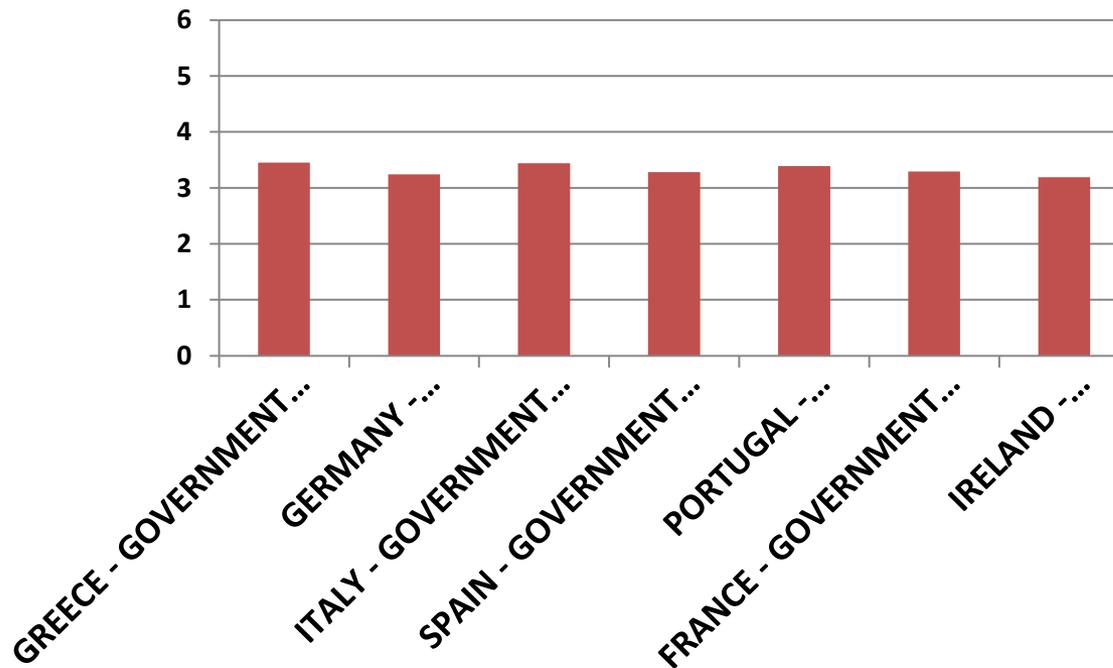




European Crisis



- Let us pause for a moment and consider this crazy graph from October 2005:
 - This is telling us that German Bonds differ by less than 30 basis points to Greek bonds, and are virtually equal to Irish bonds.





European Crisis



- What does this mean?
- The **bond yield** of a country signifies how markets price the **risk of lending** to a particular country.
- If a country is perceived as **highly risky** (as Greece in 1995), the **rates required** for investors to give such countries their funds are **high** (nearly 20% rate for Greece in 1995).
- But, as mentioned, during the 2000s investors seemed to consider all EU countries as equally risky – because they believed the pact.
- Somehow **regulators** were **blind** to the fact that if certain countries in the Euro zone were to lose fiscal credibility (by becoming too indebted), ***the value of these instruments will fall sharply.***



European Crisis



- What happened next seems clear to any rational person:
- Many of the European countries, particularly Greece, Portugal, Spain and Italy, embarked on a cheap spending spree – buoyed by the newfound **trust** by the market in their repayment abilities and banks queuing to give them money in exchange for their bonds
- **Eager to take advantage of the low rates for borrowing, they indulged in a spending spree – hoping in the process to get their economies growing fast.**
- **And it worked for a while...**



European Crisis



- All seemed to be going to plan – bond rates were reduced and EU economies were growing rapidly...
- But then... **Disaster struck.**
- The global economy suffered the GFC in 2008 following the contagious **mortgage debt crisis** in the US
- Europe felt this **directly** through a global **contraction** in economic growth and many of its banks could no longer lend to the already indebted countries to service their obligations (mostly repay older debts):

...And suddenly the spending spree could no longer be afforded by the peripheral countries...

And that's when the can of worms got opened...



European Crisis



- As the **economy slowed** down and **businesses greatly contracted or even shut down** (following the drying up of credit markets and increased borrowing costs) across the EU region in 2008 – 2009: **Government revenue** through taxation **considerably contracted** in the EU member states (also considering the rise in unemployment)
- THUS it became clear to investors that the high **budget deficits** $\{(Government\ Spending) - (Government\ income\ through\ taxes)\}$ that these countries had been running has become **unsustainable** in light of the contraction and lower expectations of growth.



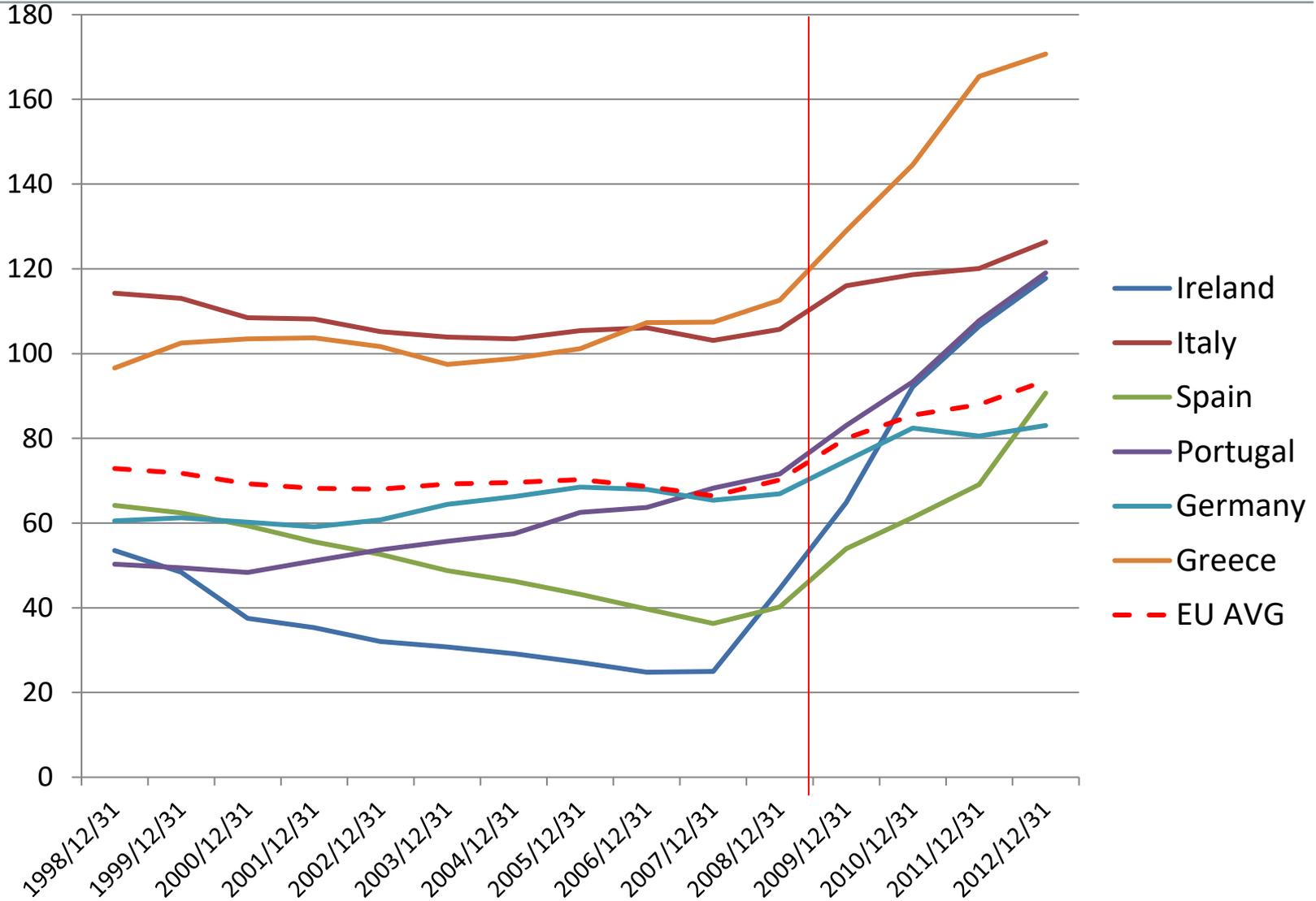
Sovereign Debt Perspective



- At the onset of the crisis, **Greece had a debt level nearly double the size of their entire economy.**
- The peripheral countries were virtually all exposed to extremely high debt levels and often had very large current account deficits (a dangerous **twin-deficit**)
- **Leading up to the crisis**, investors did not seem to care about the fundamentals of individual EU countries – seeing them rather as a unit. This changed after the GFC – exposing much of the overspending the banks and regulators were effectively blind to
- Then the music stopped for the over-spenders... and it all changed!

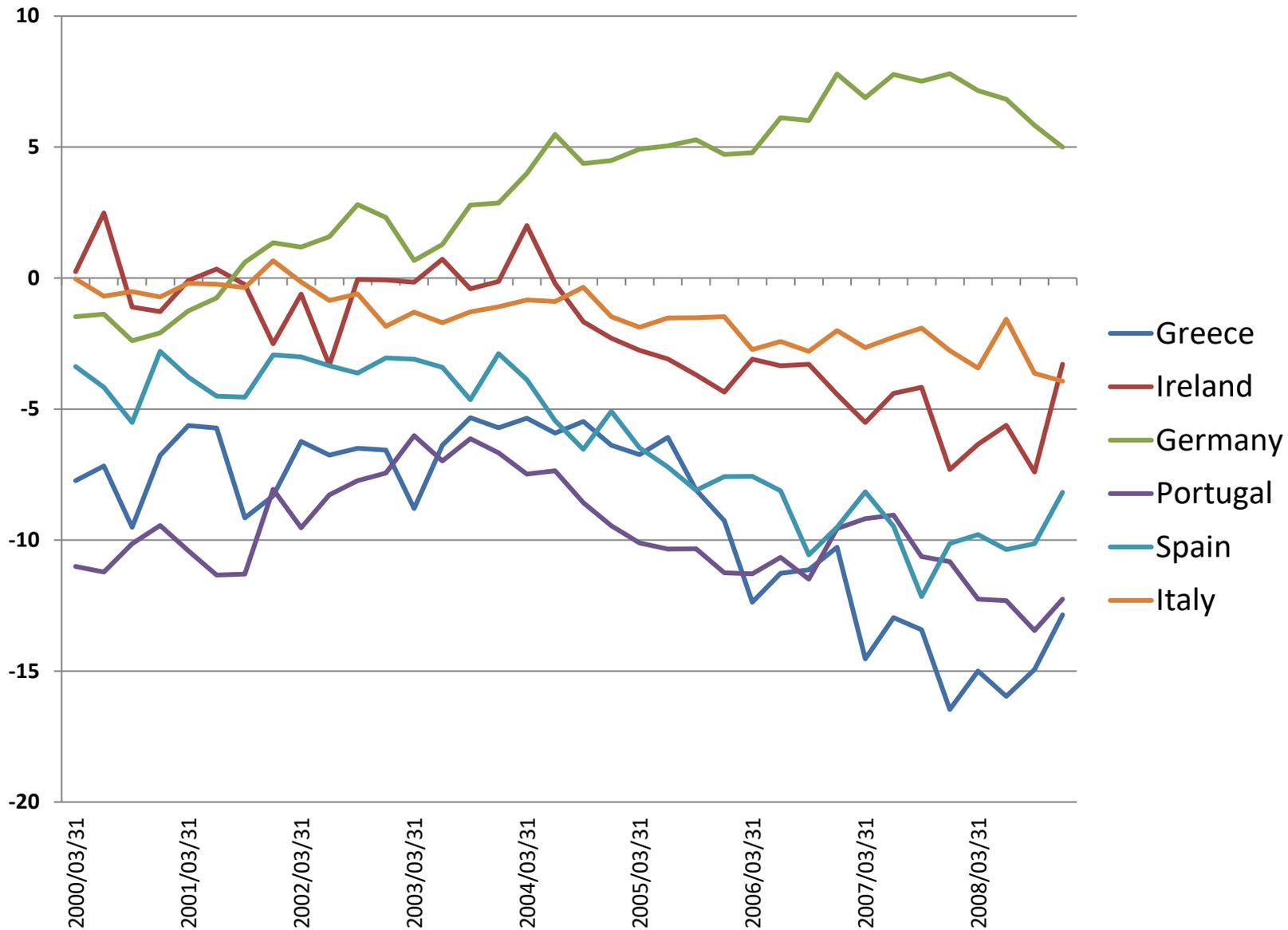


Gross Gvt Debt (% of GDP)





BoP: Current Account as % of GDP



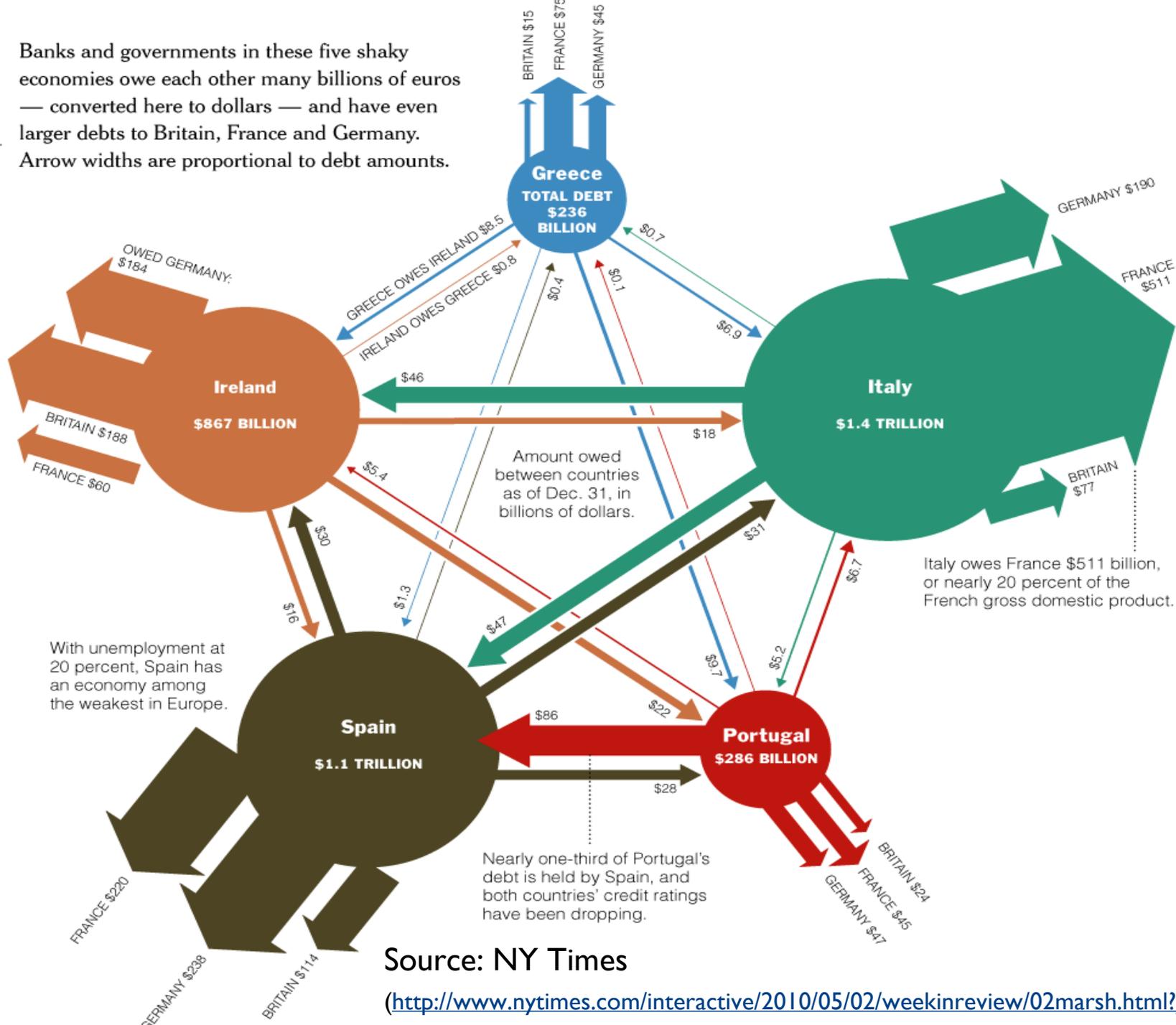


Youtube



- A good explanation, again from our Aussie friends, of these problems are from Clarke and Dawe:
- <http://www.youtube.com/watch?v=I5QwKEwo4Bc>

Banks and governments in these five shaky economies owe each other many billions of euros — converted here to dollars — and have even larger debts to Britain, France and Germany. Arrow widths are proportional to debt amounts.



Source: NY Times

(http://www.nytimes.com/interactive/2010/05/02/weekinreview/02marsh.html?_r=0)



Summary: How did this overspending of EU countries happen?



- From the perspective of the indebted countries:
 - They borrowed heavily hoping to leverage their economies to success - **on the belief that their economies would continue growing** at a faster pace than their debt repayments.
- From the perspective of the banks and investment institutions that funded this debt expansion:
 - They trusted the credibility of the Euro pact, believing that a bond from Greece is effectively as safe as a bond from Germany. This caused an arbitrage opportunity in terms of rate spreads between, e.g., Greece and Germany – driving their rates to near equality in a few years.
- From the perspective of the Northern (rich) EU nations (Germany, etc):
 - They believed in the sustainability of this story too – hoping that a stronger South (traditionally poorer EU nations) will ultimately boost their exports



European Crisis



- The result was that banks and investment institutions that funded the government spending spree started demanding **higher yields** for the peripheral countries' bonds as a result of the higher risk now faced by the countries in terms of their ability to repay its debt – thereby suddenly **raising** the **costs** of **borrowing** significantly.
- This turned into a major problem for two key players:

EU countries

The banks



The countries



- **The countries now faced a daunting conundrum:**
 - Faced with a slowing global economy and declining tax revenues post 2008—the indebted countries **needed to borrow** more in order **to service** its increasingly costly short term **debt obligations** (and hopefully “**ride out the storm**”)
 - Greatly increasing debt with the **hope of recovering** down the line...
 - BUT borrowing costs rose so dramatically, that borrowing to ease the short term pain became too expensive, and so they became more and more indebted as borrowing costs rose— leading to spiralling **solvency issues**.
 - This **raised the risk of sovereign default further— raising** the risk-premium (the **bond rate**) required by the investors – **causing a spiral** of higher yields, more indebtedness and more market distrust.



The countries



- Thus the rising risk premiums required by the investors caused a vicious cycle of indebtedness...
- ***But the problem was not only limited to the countries...***
- (Enter drum-roll)...
- The **banks** were now in serious trouble too!



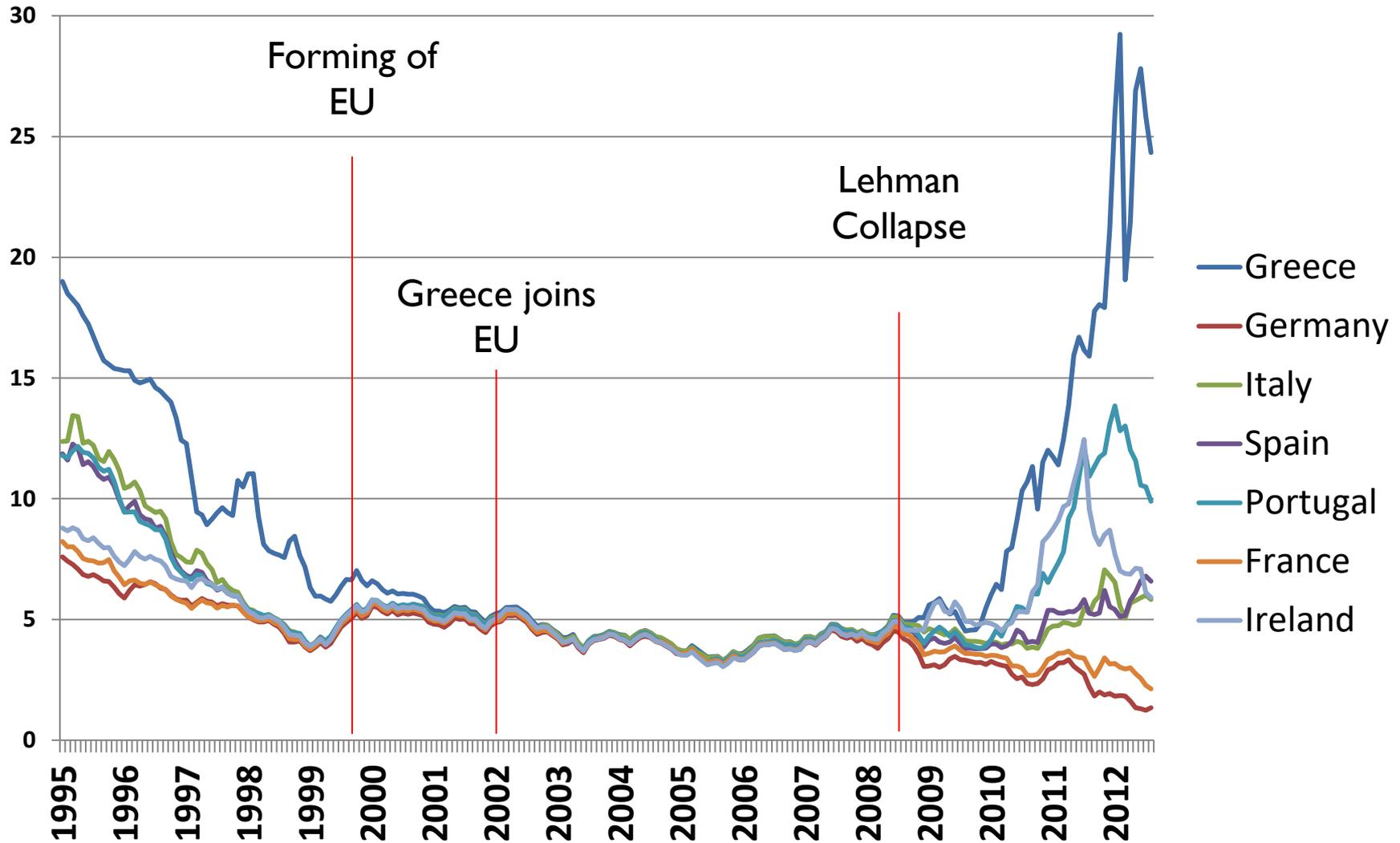
How a bond works



- To understand why Greece's solvency issue immediately became a bank in France's solvency issue, consider the following characteristic of a bond:
- **If the market yield rises, the price of an existing bond drops**
- Why? Because as bonds that are already issued have a fixed interest rate agreed upon up front— if market rates rise, the **value** of the old bond (having a lower rate on it) **decreases immediately**
 - the lower price of the bond then compensates investors for the lower interest payment offered on the bond previously issued – so that potential for arbitrage is removed



Things really started to unravel in 2010...





The Banks



- Now as the yields gradually increased and later sky-rocketed following the US crisis (which served to expose the massive levels of unsustainable sovereign debt in Europe)...
- **The value of issued bonds on the books of the European banks dropped significantly (Market $i \uparrow$ – Bond $P \downarrow$)**
- And as noted earlier – the **banks** were the ones holding most of these bond assets following their scramble to get them – holding it as capital on their balance sheets, while running high leverage ratios to invest in other products (similar to the US banks).
 - The difference – their capital base was now eroding...



The Banks



- This implied that the banks had to **write down** many of the assets on its balance sheets (mark-to-market became an issue...)
- The problem was, these banks were mostly also **highly leveraged** (**extremely high debt to equity ratios**)
 - To understand this, consider that the leverage ratio (or an indication of indebtedness) is given by:

Debt (high levels of debt)

Equity (large amount backed by gvt Bonds)



The banks and country problems combine!



- Now as many banks experienced solvency problems and some declared bankruptcy –banks began to write down debts to other banks. Thus a **banking crisis** erupted as credit markets froze, and banks were unable to roll over their debts (gridlocked)
- This led, in turn, **back to the countries** – who now struggled to find buyers of their debt instruments (relying strongly on banks in the past to lap up sovereign debt): further raising **their borrowing costs** and underlining **their solvency problems**.



Wise words from Soros



- This dramatic chain of events was summarized very well by George Soros (well known and much respected investor):
- *“It took some time for the financial markets to discover that government **bonds**, which had been considered riskless, are subject to speculative attack and may actually default; but when they did (realize this), risk premiums rose dramatically. This rendered commercial banks, whose balance sheets were loaded with those bonds, potentially insolvent. And that constituted the two main components of the problem confronting us today: a **sovereign debt crisis** and a **banking crisis** which are **closely interlinked**”*



What happened next?!



- Faced with this two-pronged problem, the EU had to act.
- And **act fast**.
- The **problem?**
- **All 17 EU members at the time had to agree on the terms of the solution (as required by the common EU law).**
 - This has, over the last three years, led to **Summit after Summit**, loads of **rhetoric, bailouts, more bailouts, promises of bailouts** and attempts to provide seemingly sufficient **assurances** of future stability in an effort to drive down sovereign borrowing costs...
- **Is there a solution to the Banking woes?**



Governments couldn't save the banks...



- To stave off the impending EU banking crisis – **banks need bail-outs** to get their balance-sheets in order.
- **But who** can recapitalise the Eurozone banks sufficiently? In the present bearish conditions in the equity markets, only governments can garner the needed financial resources necessary for this recapitalisation...
- **But** in order to do so, governments will have to **issue more debt**. The result of this is predictable: the **creditworthiness** of governments will **deteriorate**. Inevitably, this will **intensify** the **sovereign debt crisis**, feeding back into the balance sheets of the banks that hold the bonds of those who are supposed to save them.
- **Hence. No option of government bail-outs. Who's left?**



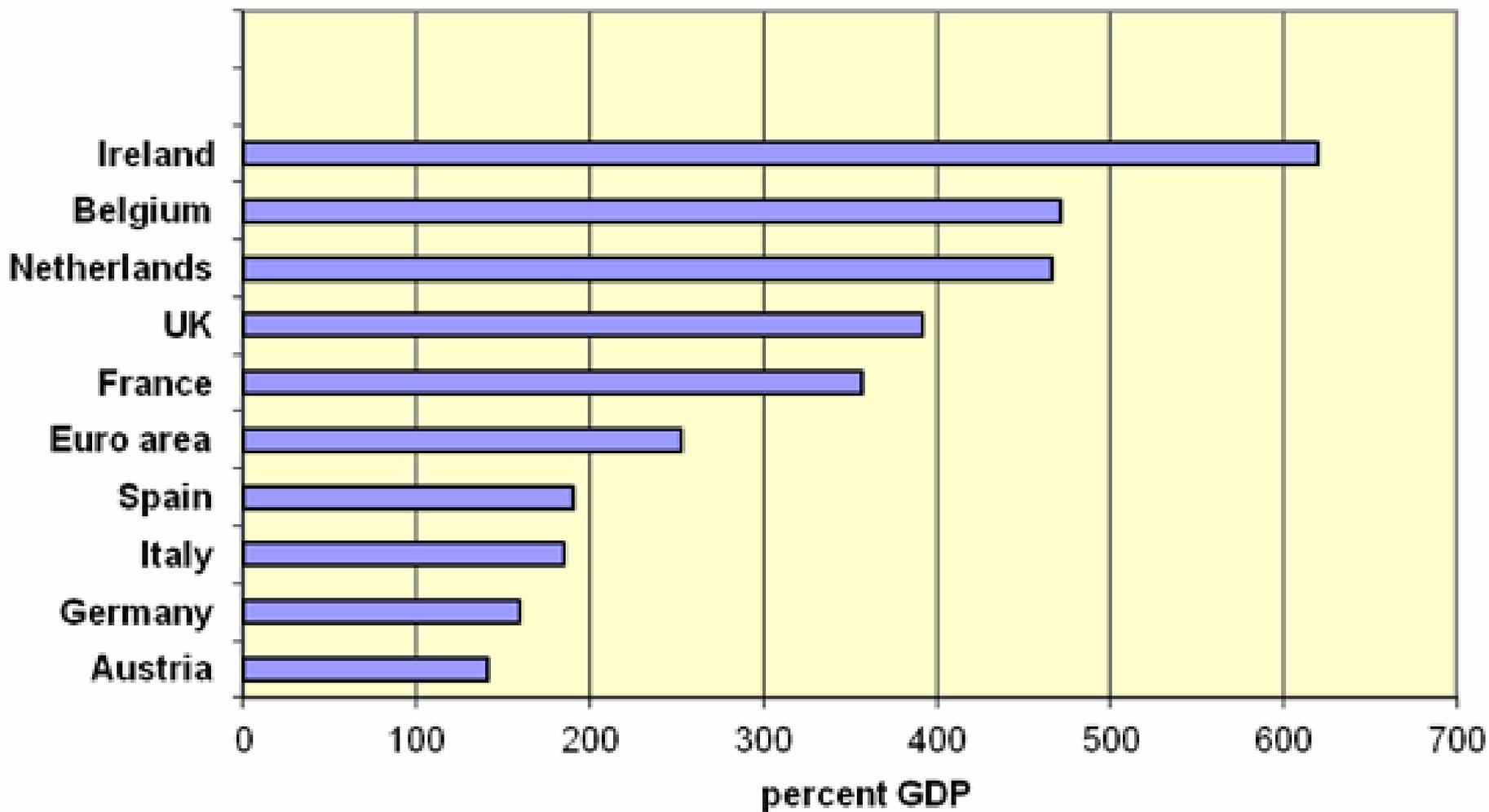
ECB couldn't save the banks



- Should the ECB have stepped in as lender of last resort to the troubled EU banks??(Similar to the funds provided for by the US Fed?)
 - This would have turned out far **more expensive** than buying up government debt instruments in order to drive down bond rates – and driving up the equity side of the banks
 - **The reason being that the debts of the banking sector in the EU are many times larger than the exceedingly high country debt levels !!** (Bank debts are 250% of EU GDP, compared to sovereign debt's 80%)



- The extent of banks' indebtedness per country in 2008 (De Grauwe, 2011)





Solution? – Government Bond rates need to come down...



But who should buy the debt instruments if not the banks themselves (which is obviously not going to work)?!

I. Should the IMF help?

Ideally not, as they typically impose strict conditions, and this might cause a political backlash in the face of fears of EU members losing their autonomy.



Solution



2. **Should the EU community collude in order to help the struggling economies by providing funds that would stave off an impending Greek (and possibly Portuguese, Irish, etc) debt default?**
 - This is (understandably) **strongly opposed** by the stronger economies that would bear the greatest cost of such a package – with many implying that this would punish their governments for their prudent spending in the past



Solution



- 3 Should the indebted countries, like Greece, simply default, leave the Euro Zone and adopt their previous currencies (like the Drachma?)**
- Such a scenario holds the strong possibility of **contagious effects** emanating from it. More countries may in time follow suit, **dampening investor confidence in the Euro area pact** and raising borrowing costs further for **all** EU countries.
 - What's more is that such fears could greatly undermine the value of the Euro.



Solution



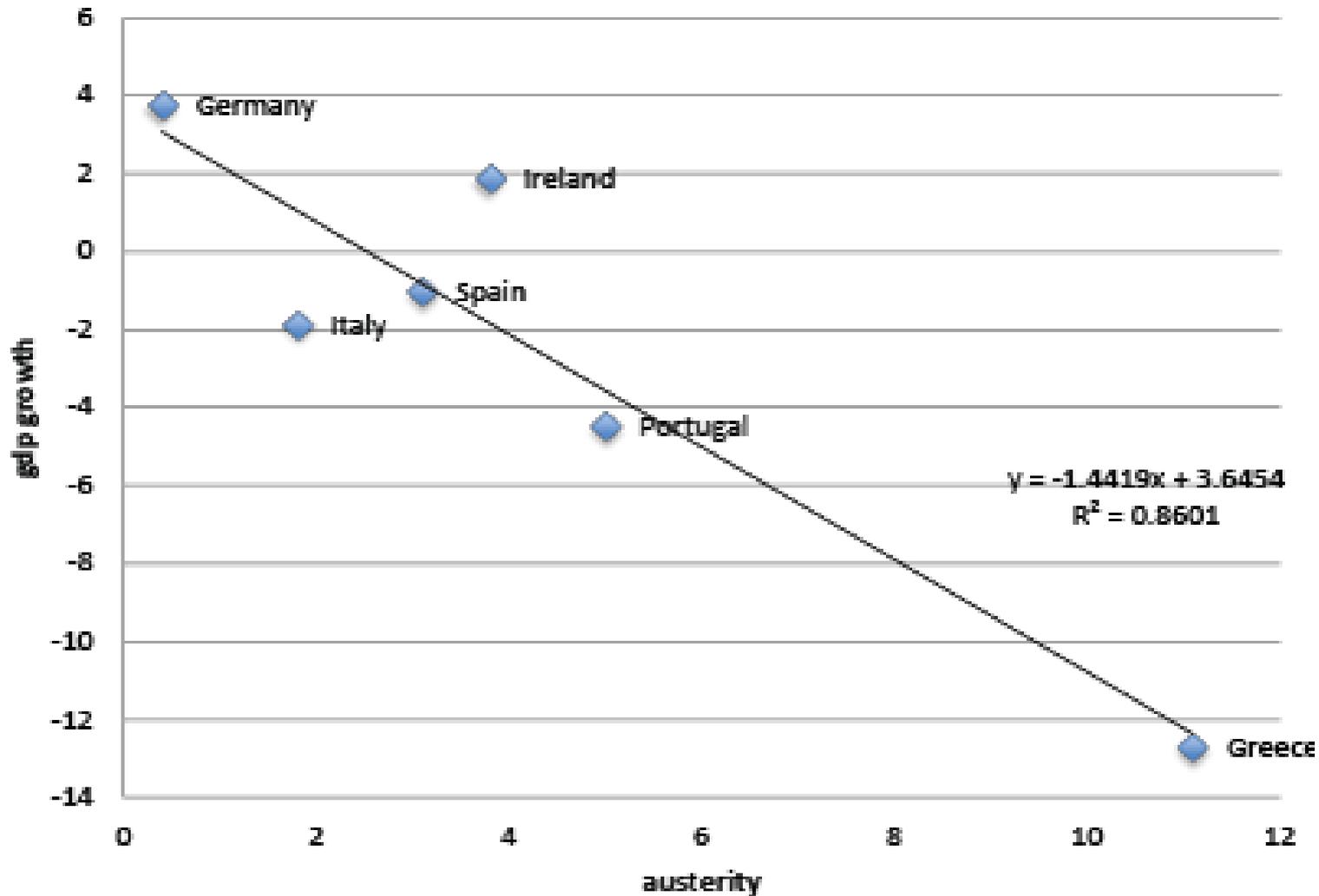
4 Should the struggling economies merely get their own houses in order through strict **austerity** measures?

- The problem with austerity is simple:
- Austerity aims to **reduce** the **fiscal debt burden**: [*Debt/GDP*]
- **BUT Strict Austerity = Fiscal consolidation without growth enhancing policies: which would lead to a reduced GDP, and thus a reduced tax base.**
- **Which would in fact raise the *Debt/GDP* ratio – defying the purpose!!!!**



Austerity and GDP growth 2011-2012

From: De Grauwe & Ji (<http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications>)





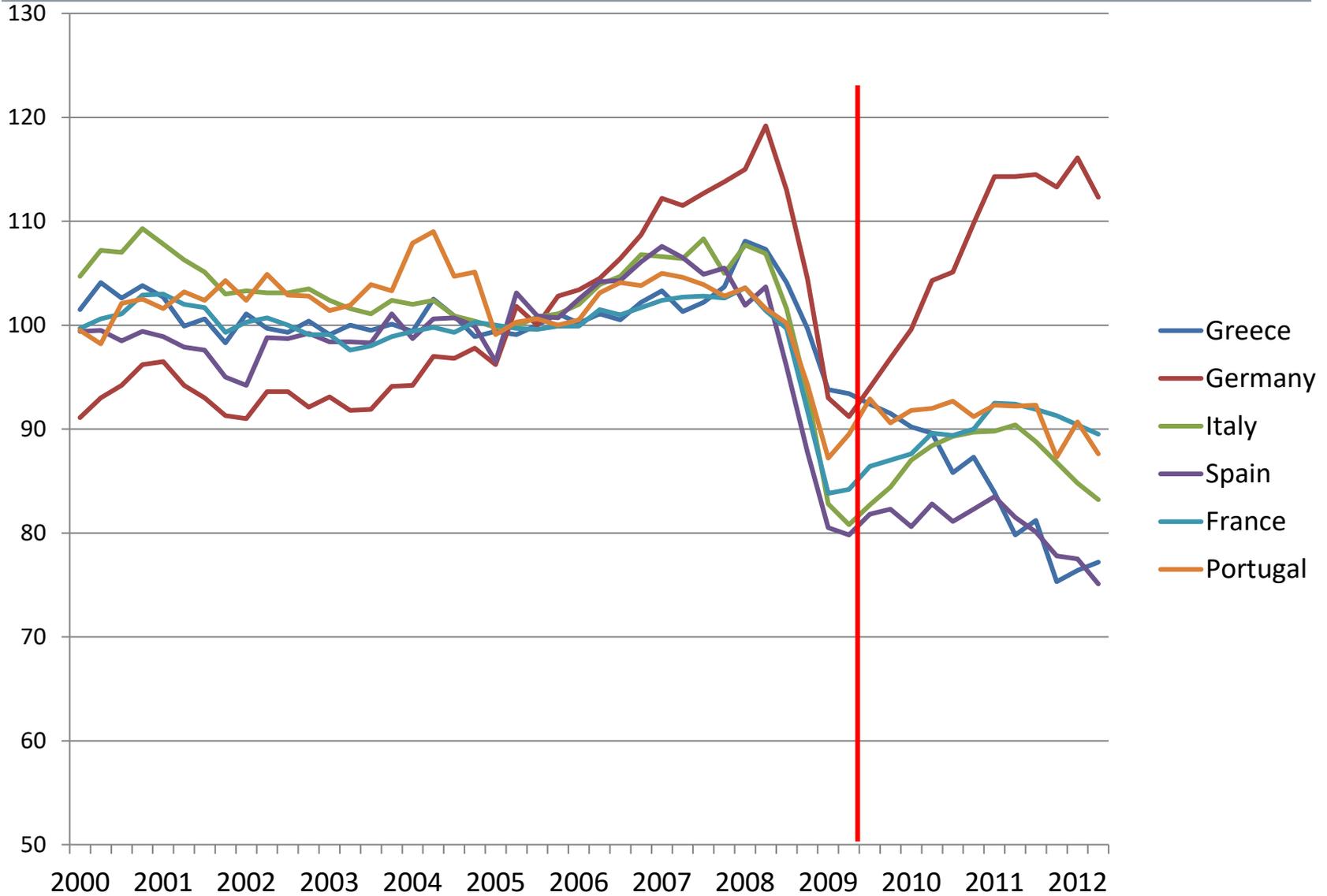
Result



- ***Unsurprisingly***, the first summit on how to fix the dual sovereign debt and banking crisis was a **massive failure**.
- This set the tone for a **prolonged** period of **indecisiveness** and **differing political interests**.
- This resulted in a repeat of the crisis in 2008, with production and job creation slow to recover throughout the Euro zone (with some countries entering a prolonged contraction)

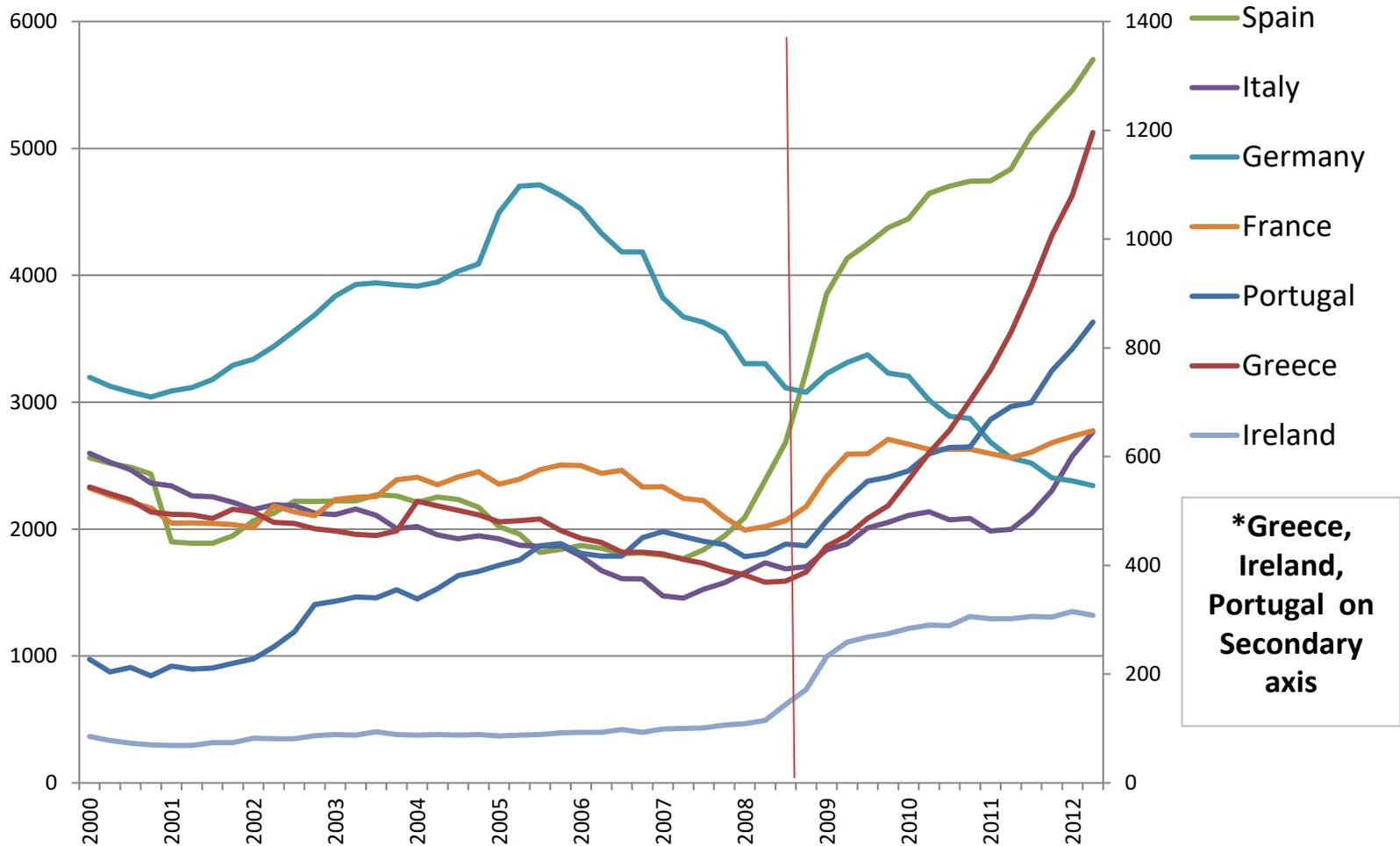


Total Manufacturing Production (2005 index)





Unemployment Levels (S.A. all persons > 15 years) (1000s)





The moment



- And then, it was “**resolved**”: **September 2012**
- Somehow, markets calmed and it seemed like the worst was over (and that no country would go bankrupt / will have to exit the Euro)
- **Bond rates fell significantly**, and banks balance-sheets were no longer under such strain (although they remained heavily indebted to this day)
- How did this happen?!



Hero of the Euro



- How did this happen? What / who brought down the bond rates?!

- In 2012... In stepped:

Super Mario!

aka:

- Mario Draghi, ECB chairman





Calm (before the storm?)



- In Sept 2012, markets reached some form of calm following the runaway bond yields and looming debt crisis in the EU region...
- **In fact, viewing the 10 year bond rates today tells a far different story from a year ago today:**
- Greece: 10.3% (27.82% a year ago)
- Germany: 1.94% (1.3%)
- Spain: 4.48% (6.12%)
- Italy: 4.35% (6.10%)
- Portugal: 6.73% (10.56%)



Calm (before the storm?)



- A year before Mr Draghi took the reins, the ECB (under Jean-Claude Trichet) **spent over €200bn (£156bn) through its Securities Market Programme (SMP)**, buying up Eurozone debt in an effort to subdue the market panic which threatened to sink Spain and Italy (and already almost ruined Ireland, Greece and Portugal's fiscal position).
- **So what did Draghi do to calm the markets?!**



Calm (before the storm?)



- How did he do it?

Simple. He said: “we will do whatever it takes to save the Euro”

- On Sept. 6, the ECB Governing Council put money where Draghi’s mouth was, committing to buy unlimited quantities of sovereign debt in an effort to buy back the trust of the market (and drive down bond rates)
- Ironically, it worked without the **ECB ever needing to buy a single bond** as a result. The mere commitment from the ECB’s side did the trick.



- *“The decision by the ECB in 2012 to commit itself to unlimited support of the government bond markets was a **game changer** in the Eurozone. It had **dramatic effects**. By taking away the intense existential fears that the collapse of the Eurozone was imminent the ECB’s lender of last resort **commitment pacified government bond markets and led to a strong decline in the spreads of the Eurozone countries”***
- With this strong decline came the recovery (or mere respite?) of banks whose balance-sheets contained loads of these debt instruments and having solvency issues as a result.



This reminded me of a scene from Team America.



- The ECB's promise seemed equally crazy as the one in the movie, yet it managed to calm the markets very effectively.
- Few questioned how they will go beyond their mandate as the ECB. Few questioned how the Germans will allow it.
- Few questioned how this will work... and so it ultimately did work.

- *Draghi promised: “**The Euro will never die**”*

<http://www.youtube.com/watch?v=8yaTCXcvTGY>



How did it work?!



- Basically (without being technical about it), the promise worked for the same reason you keep your money at the bank: you know it will be there tomorrow.
- If people started doubting the bank's ability to safeguard its money – they will rush to collect their's first... causing a *run on the bank*.
- Similarly, investors doubted that countries in the EU will pay their money back in full. This caused a “run” through investors selling bonds and pushing up the rates...



How did it work?!



- By telling the markets that the ECB will buy back any and all of the government debt securities and do whatever necessary to stabilize bond rates, it meant that banks holding government debt were safeguarded in terms of getting their money back and that rates would recover. This eliminated the need for:
 - a) selling to avoid possible default b) selling to avoid risk of further rate hikes (that would imply losses in value of bond holdings)

But was the subsequent calm warranted?

- While the decrease in the bond rates was certainly welcome, nothing changed in terms of the EU's poor fundamentals of over-indebtedness, high unemployment and low GDP growth...



Is this the end of the crisis?



- The German Bundesbank recently sought to **challenge the commitments** made by the ECB as unconstitutional from Germany's perspective to back this.
- While they may decide not to go through with it, it shows the cracks in the hastily arrived at promises of Mr Draghi.
- And if those promises begin to lose its legitimacy, we may be in for another slide – with it becoming yet harder to make credible promises to investors in the future!!!!
- <http://www.ceps.eu/book/eurozone-bank-recapitalisations-pouring-water-leaky-bucket>



There are some clear arguments against the ECB's program



- As outlined by De Grauwe, the following risks apply when considering the ECB's current promise to buy gvt bonds (see: <http://www.voxeu.org/article/european-central-bank-lender-last-resort>)
- Inflationary fears if the ECB does step in to buy bonds.
- By intervening in the government bond markets, the ECB is committing future taxpayers wealth (does it constitute an equitable transfer of wealth?) to fund the unbridled expenditures of corrupt nations in the past



TIMELINE



- **Here follows a (abbreviated) time line of events that transpired following the US Subprime Mortgage crisis.**
- This is given to place into context where we currently are w.r.t. to the on-going turmoil in Europe



TIMELINE



- **2008:**
- **September:** Lehman Collapses – Global Downturn starts
- **October:** EU members set up EU200bn stimulus plan to help prop up banks affected by the Subprime mortgage crisis



TIMELINE



- **2009:**
- **October: Greece:** Papandreou's PASOK government comes to power— bringing to light the full extent of the previous regime's overspending and corrupt management of public funds (upward revision of 2009's declared budget deficit from 3.7% to 13.6%).
- **This rattles markets.**
- Papandreou takes 20% salary cut to lead by example to get Greece's budget back in line with EU standards.
- Greece pleads for fiscal help – **Germany says Nein.**



TIMELINE



- **2010**
- **February:** First EU summit – no decision on Greece.
- **March:** Greece effectively insolvent. Leaders meet again.
 - Mass strikes in Greece following strong **austerity** measures employed by the gvt.
 - No fiscal help yet.
- **May:** EU leaders finally agree on the systemic banking risk (especially to French banks) brought on by Greece. Merkel concedes:
 - Bailout is given to Greece (**EU 110bn given, Greek debt: EU330bn**).



TIMELINE



- **2010:**
 - Markets are rallying by now at speculation of imminent Greek default, and other countries following suit.
- **June: EFSF** is created – pool of EU750bn to support countries that might experience fiscal problems.
 - Talks of a Eurobond – but Merkel says Nein, for obvious reasons.



TIMELINE



- **2010:**
- **October:** Germany strongly insist on private creditors to Greece taking haircuts.
 - Markets shudder: Germany getting cold feet?
- **November:** **Ireland's** similar dismal fiscal situation comes to light. Another bailout is given (EU85bn).
 - Markets wonder who's next?!



TIMELINE



- **2011: Fresh start?**
- **January:** several new supervisory bodies are created:
EBA, ESMA & EIOPA
 - *Markets wonder: how will adding complexity to the supervisory structures help the EU council and ECB's ability to reach decisions and act accordingly if more fiscal problems arise?!!*
- **11 March:** Pact for the Euro is made again. Markets happy, for now.
 - ESM is created in response (replacing EFSF): **worth EU500bn**



TIMELINE



- **2011:**
- **May:** Portugal requires bailout (EU78bn).
- **Mid 2011:** Further concerns are raised about the solvency of **Spain** and **Italy**.
 - Both countries experience **rising borrowing costs** amid declining EU market sentiment. Both economies employ **unpopular austerity measures**.
 - Mass EU unemployment and strike action against tough austerity measures.
 - Markets **not** impressed at EU situation.



TIMELINE



- **2011:**
- **December:** ECB provides EU489bn liquidity injection (in the form of cheap credit) to help prop up banks, after Greek debt haircut of 50% rock many bank balance-sheets.
 - UK veto's the even stronger pact made at the insistence of Germany, which imposes even more stringent austerity measures on all members. Rift forming in the EU?



TIMELINE



- **2012:**
- **January:** Credit rating **downgrades** for many top EU members
- **March:** Figures show unemployment in EU has reached its highest levels yet (averaging 11%, with Spanish Unemployment at over 23%).
 - Labour unrests spread throughout Europe.
- **May:** Spanish bank, Bankia, requires govt bailout of EU 19bn



TIMELINE



- **2012:**
- **June:** Concerns over Spain's solvency forces it to accept rescue package of EU 100bn of cheap credit lines to prop up its banks. Spanish pride hit hard.
- **15 June:** Gordon Brown announces his fears of France and Italy also requiring bailout funds.
- He also claimed that all EU countries, even Germany, are at risk and might require external funding to ensure its banks stay solvent.
- Brown calls for the “inescapable logic” of a fiscal union. Germany and France are not as favourable to the idea.
 - **Markets NOT happy at these remarks. Bond yields keep rising and banks & countries suffer**



TIMELINE



- **2012:**
- **August:** ECB announces it *might* conduct Outright Monetary Transactions to stave off further turmoil. This does little to calm markets.
- **6 September:** ECB makes bold announcement of *details* of the **Outright Monetary Transactions (OMTs)**.
 - This time markets respond favourably to the proposals which include an **unlimited bond-buying programme** in secondary sovereign bond markets – calling on EU members to back a full ESM programme in order to fund the OMTs.
- Draghi announces that the **ECB will do “whatever is necessary”** to ensure the continued stability and functioning of the EU system. **No quantitative limits are set on the transactions.**



TIMELINE



- **2012:**
- **September:** ECB promises **full transparency** in its buying of gvt bonds through OMTs, providing markets with information on the market values of their bond holdings, and the breakdown of country of origin and time to maturity of all instruments bought.
 - This has been an **unprecedented move** by the ECB, and most believe a strong step in the direction of European fiscal unity.
- Borrowing costs in EU receded strongly thereafter, with fresh hopes of a recovery emerging...



What's in it for Germany?



- So why would the EU powerhouse, Germany, be so eager to keep the EU together (even if under **their** terms)? It wants to provide some credence to beliefs that the EU pact will remain:
- **First:** a break-up of the Euro will **leave** the **Bundesbank** alone with over a trillion Euros of **unenforceable claims** – debts they would then likely never recover.
- **Secondly:** The end of the Euro currency would imply **German exports** to the rest of Europe (and probably the world) will become **increasingly expensive** – severely hurting their economy. In fact, trade with the rest of Europe (facilitated by the EURO), is largely responsible for Germany's great success of late



OECD quote – Banking Union the answer?



- “In the eurozone, more needs to be done to tackle the negative links between public finances, bank solvency and risks of a euro exit”
- “In the long run, this (requires) a **fully-fledged banking union** with fiscal backstops. In the near term, recapitalization of banks should be undertaken where necessary.”



In a modern, interconnected financial market...



The **US**
housing
market
collapse

**US and
Europe**
experience
economic
decline

Greece
runs into
solvency
problems
following
unexpected
economic
downturn

Greek,
Portuguese,
Irish, Italian,
Spanish, etc.
borrowing costs
rise
tremendously,
causing the
value of these
bonds to
plummet...

EU banks
holding
these bond
instruments
run into
solvency
problems

This causes
potential
problems
for other
banks in EU:
leading to a
drying up of
liquidity

Investor
sentiment
around
EU drops,
borrowing
costs
around
region
rise to
historic
highs.

Many
EU
nations
experience
solvency
issues
as a
result
of what
started
in US
housing
market.



REGULATORY SHORTCOMINGS FROM THE US AND EU CRISIS EXPOSED



Regulatory shortcomings identified



- The following broad lessons can be learnt from these two inexorably linked examples of fund mismanagement:
- US example:
 - More needs to be done in terms of broadening the scope of regulation – to include off-balance sheet activities, especially of those institutions that are deemed systemically important;
 - Central banks and fiscal authorities need to specify clearly **up front** what it will do when confronted with credit liquidity issues. It needs to state unambiguously how it will respond – and make sure that institutions have no incentive to become so large that it requires bail-out funding; thus it needs to ensure that implicit guarantees do not encourage risk taking behaviour;



Regulatory shortcomings identified



- US example (contd):
- What constitutes legitimate capital held by banks and other key financial institutions -
and specify sufficiently large capital adequacy ratios (CARs) that need to be unambiguously defined and better monitored;
- Leverage ratios need to be capped **effectively** and information of such activities made easily accessible to the public
- Regulatory authorities need to ensure ratings agencies are well equipped and capable of giving sound and unbiased reflections of the risk faced by financial and banking institutions.
- In particular, regulatory authorities need to ensure that they are flexible enough to adapt to the ever changing financial & economic environment. Unfortunately we have seen in the past that the effectiveness and intensity of regulations are counter-cyclical



Regulatory shortcomings identified



- EU example:
 - From the EU lessons, many of the same problems emerge;
 - Similar to the crisis that emerged from the US, regulatory authorities did not fully comprehend the embedded risks in the instruments that banks held as supposedly legitimate capital (US – MBS; EU – highly indebted governments' debt instruments)
 - This allowed banks to gear (leverage) far above what would have been possible had regulations (and thereby definitions) of legitimate capital been adequately considered given new (macroeconomic / market tendency) information.
 - The EU crisis also illustrated that even assets regarded as traditionally “risk-free” can become very risky if leverage ratios become sufficiently large, to the degree where small price adjustments can trigger a debt spiral



Regulatory shortcomings identified



- This example of the EU banking crisis highlights a crucial failure on the part of regulators: in their weak and static definitions of **bank capital**.
 - To prescribed safe levels of capital in the capital adequacy ratio (CAR) of banks - the definition of adequate capital is vital.
 - Not only that, but it requires a constant critical discussion to ensure that what we define as safe capital is indeed that: safe.
- **Regulators should have considered the changes in the economic landscape critically...** which should have guided regulators in the Euro area to re-evaluate the behaviour of banks in the build-up to the Euro crisis... and whether the great exposure of EU banks to sovereign debt instruments were truly safe (considering that the value of these instruments hinged on the credibility of the Euro, and thus effectively on the ability of the smaller countries to keep their house in order and stay in the common currency...)



Regulatory shortcomings identified



- Both the EU and the US banking crises show the ease with which large modern financial institutions can circumvent regulation.
- Such a circumvention of regulation creates the following two problems:
 - **First**, it gives regulatory credence to the actions of financial institutions that adhere to the rules *de jure*, but not *de facto* (thereby removing the incentive for investors to uncover the true risks associated with certain investment strategies).
 - **Secondly**, it creates a profitable incentive for larger financial institutions to use resources in order to make their products adhere to regulatory standards – e.g. creating off-balance sheet SPVs that hide risk and thereby freeing up capital to be used as more scope for collateral



Discussion



- Perhaps a **more adequate approach** to regulating complex systems, like a financial institution, would be to focus on making information as widely available as possible.
 - As opposed to trying to regulate the entire system
- This could entail **less homogenization** in the **regulatory frameworks** used across sectors and jurisdictions, as well as introducing more heterogeneity in the assessment of the credit worthiness of institutions.

Having 1000s of eyes, instead of only a few (like in the US), evaluating credit risk → institutions will be forced to make their products & behaviour simpler and easier to understand.



Discussion



- Another serious consideration that needs more serious discussion if we are to make financial systems safer and more equitable in terms of the cost of crises:
 - Making investors and financial institutions personally liable for losses.
 - Thus, if large shareholders / management can be held liable for their actions – this would significantly alter the way that investments are conducted. At the moment they face infinite upside gains, with limited downside gains (limit by the value of the investment only – not liable for losses).
 - *This could, however, greatly constrain investments if not employed properly...*