

ADAPT TO SURVIVE

Guido Ravoet of the European Banking Federation tells Steve Coomber how the financial community must learn from the painful lessons of the last few months and adapt quickly to a fast-changing banking environment.



It has been an extraordinary past few months for the banking and finance sector. Turmoil in the markets has developed into a full-blown crisis, accompanied by considerable investor panic. It is a crisis that has cost the global economy £1.8 trillion, according to a recent report by the Bank of England, threatened the financial stability of entire countries, and brought down some of the world's most prestigious financial institutions.

Yet, despite the pain endured so far, and the prospects of deep recession to come in many economies, the banking and finance sector must look to the future, says Guido Ravoet, Secretary General of the European Banking Federation (EBF). The lessons from the current crisis must be heeded to ensure a strong, effective global banking system in the long-term, he believes.

The road to crisis

The causes of the current problems are well established, says Ravoet. 'It really started in the US. Sub-prime loans were securitised by investment bankers, and then sold to banks and other institutional investors, including insurance companies, pension funds and local authorities, which invested in this kind of paper,' he says.

'The underlying loans became bad because sub-prime borrowers were unable to reimburse the underlying loans, and those assets became worthless, or at least had a significant drop in their value.

- Responses to the crisis are still not uniform across member states
- Nationalised banks could emerge with a competitive advantage over those that remained independent

At the same time, the credit markets froze. 'Interbank lending stopped because the banks mistrusted each other,' says Ravoet. 'There was a lack of transparency with regard to so-called structured finance products and banks were not sure whether their counterparties had a lot of these bad debts or toxic assets. So there was a lack of confidence in the market, banks just didn't trust to lend to each other because they were not certain about the creditworthiness of their counterparties.'

A significant trigger in the developing crisis was the collapse of Lehman Brothers, the global financial services firm. It came at a time when there was already a lack of confidence in the interbank markets, which then had an impact on the liquidity position of the banks. One reason that the fate of Lehman Brothers was so significant was that so many banks held paper issued by the investment bank, which added to the mistrust and lack of confidence in the sector. After Lehman Brothers filed for bankruptcy protection, the liquidity markets seized up, which had a dramatic knock-on effect for many other banks.

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And, when the holders tried to sell them, they discovered there was no longer a market for this type of asset.'

As Ravoet explains, the situation was compounded by new fair-value accounting rules, stipulating that institutions had to mark to market when they had these assets on their balance sheet. The result was a spate of substantial write-offs by banks. The investors began to panic and dump stock, prompting a dramatic drop in share prices.

The crisis led to unprecedented efforts to restore confidence in the banking sector, other financial institutions and the financial markets. The talk of remedies has moved beyond national and regional measures to suggestions that the global financial system needs restructuring as well as a shake-up of the International Monetary Fund (IMF).

However, although action has been coordinated to a degree, responses to

the crisis are still not uniform across EU member states. So while recapitalisation of relevant banks by governments is a widely adopted solution, as is a state guarantee on interbank lending, and most nations are using similar options, as Ravoet notes, the different options are used by each country to a different degree and in a different mix.

There is a worry about the use of differing approaches, says Ravoet. 'Because all the member states in Europe use a different approach, although they use the same tools, with different modalities, and different conditions for their banks, the European Banking Federation is concerned about the issue of a level playing field between the banks.'

Competition rules have been relaxed in the face of exceptional circumstances. But there is a risk that the new banks created as a result will emerge with a competitive advantage that would not normally have been permitted.

'It is a matter of concern and as a trade association we are for free competition and pluralism so that you have big banks and small banks competing with each other to offer their services. It provides more choice and better prices for the customer,' says Ravoet.

'But we leave it to the European Commission to see whether it can live with this in the future, when the crisis is over. What is certain is that now, in the middle of the crisis, if you have to choose between financial stability and optimal competition you choose the first because that is a higher public priority.'

The issue of the short selling ban on bank shares is another example of the different approaches adopted, says Ravoet.

'We now have a prohibition on short selling in all the member states. Yet while the principle is the same, the implementation is different,' he says. 'Some are just restricted to naked short selling, others to short selling with stock lending. So the scope is different. I think there is a lesson that we should learn from this crisis, that we need coordinated action EU-wide. That is important for the future.'

Changes ahead

Ravoet acknowledges that the financial crisis means that there are likely to be some significant changes made to the

banking sector in the future, at least in the short term.

'We expect stricter regulation. It's true, for example, that while banks were regulated these structured finance markets were not regulated at all. So you can expect some kind of regulation for these structured finance products, and also hedge funds. More transparency is certainly needed in these markets,' he says.

'We are, of course, continuing to work for the rapid implementation of the ECOFIN road map [agreed in October 2007] to strengthen the EU's capacity to prevent and manage future financial crises,

schemes, the review of the capital requirements directive and some rules on structured finance or securitisation. The latter includes a holding that the originator has to keep on his books, and also a stricter regime for large exposures, especially exposures between banks. Additionally there will be changes to the regulation of derivatives, especially credit derivatives.

'We do not know whether the Commission will come up with legislative initiatives, or request the industry to self regulate credit derivatives,' says Ravoet. 'Of course, we favour possible industry

counterparty risks of the borrower', he says. 'These things are essential for the good functioning of the modern financial sector and the economy at large. We need to keep the good things achieved by financial innovation but acknowledge that perhaps some of the markets have to be monitored more by the supervisors and regulators than in the past.'

Another change that Ravoet supports is to expect flexibility in exceptional cases like this with regards to accounting rules on valuation of illiquid assets. This allows banks to reclassify assets from their trading books and not have to use the mark-to-market approach.

'The IASB [International Accounting Standards Board] agreed that, in this specific exceptional situation, when markets are simply not working any more, banks should be allowed to take these assets out of the trading book where they have to be marked to market. They can then be put into the banking book, where you have the historical cost, the amortised cost, and you can keep them until maturity.'

Not that Ravoet is for abandoning fair-value, believing that a mixed measurement approach is the best solution, with a balance between historical amortised costs and fair value.

Some might argue that, because the failure of financial modelling seems to have caused the current crisis, there is no reason to suppose that the banks or anyone else should trust mark-to-market valuations. And that reclassifying assets per the IASB's amended rules is just putting off the bad news for another day, rather than addressing the issues at hand.

Ravoet, however, believes that transparency through financial reporting, with the mark-to-market model use being fully explained, will address these concerns.

Another issue that has been linked to the crisis is executive compensation and the bonus system. Compensation that rewards excessive risk taking, in the absence of tough oversight, has been blamed for fuelling huge markets in exotic financial instruments, such as collateral debt obligations.

The EBF's position is, as might be expected, that compensation is a matter for the shareholders of banks, and not governments. Although Ravoet does

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and the overall implementation of these initiatives is on track.'

As Ravoet points out, this includes legislation for rating agencies, more harmonisation on deposit guarantee

initiatives and self regulation as much as possible, but we expect that there will be some level of stricter governance.'

It could be argued that self-regulation is not the answer, given that it appears to have failed to prevent the current problems. Indeed, many believe that banks would do well to go back to a more traditional business model, taking deposits and making loans, rather than borrowing money to finance their trading of exotic financial instruments.

That is not a view that Ravoet shares, however. 'Perhaps financing through financial markets became too important, compared to the funding by the deposits. But I think that we should keep both, because it is to the advantage of business that banks can leverage through financial markets and are not just bound to do their deposit taking. However, you need a good proportion of both the traditional model of banking through deposit taking, as well as funding through the financial markets, in order to serve companies well.'

Measured response

Ravoet says that he is anxious that, while stricter regulation is inevitable, the authorities and the legislators do not overreact and kill financial innovation.

'There are lots of good things about so-called securitisation products like collateral debt obligations, and credit defaults swaps, that are a kind of insurance against

European banks review the credit crisis

In a press conference following the EBF Board meeting held on 7 November, Michel Pébureau, president of the European Banking Federation (EBF) and chairman of BNP Paribas, told journalists that the extraordinary measures taken by national governments in support of their national banking systems are beginning to prove their efficiency. He said that efforts must continue from both the public and private sectors to ensure the proper financing of the economy.

Pébureau praised the role played by governments in coordinating at EU level and the cooperation and swift reactions from European authorities, central banks and supervisors in putting in place the various measures.

He acknowledged that the financial services industry carries its share of responsibility in the crisis. Furthermore, he explained that government-led rescue plans impose severe conditions to the beneficiaries. 'These plans are no "gift" to banks, declared Pébureau. They are solely aimed at containing damage to the broader underlying economy.' EBF has set up a high-level working group to monitor and assess the long term effects of these different measures on further market integration in the EU and on international competitiveness.

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acknowledge that there is pressure from society at large, and politicians, to introduce some kind of regulation in this area, this would need to be self-regulation, and not legislated initiatives.

Attention should be focused on sustainable growth and long-term profits when putting together incentive packages and not just short-term gains, he says.

Important lessons

Ravoet believes it would be a travesty if the banking sector emerged from the crisis without learning some important lessons for the future. Fortunately, he says, banks have already taken on board a number of lessons from this chastening experience.

‘We have to put the pieces together and try to learn lessons from this. As the first priority I would introduce more global monitoring and coordination of the financial institutions, certainly on a European level. We need to go further with the supervision of cross-border banking institutions through the college of supervisors, with more coordination between the supervisors across Europe and globally and, if a consensus is not achievable, the home supervisor should have the last say.’

‘Secondly, there is a need for more monitoring and a better framework for liquidity management. Thirdly, there should be more Europe-wide and global monitoring of structured financial markets, based on transparency,’ Ravoet says.

While financial markets should be able to grow, there must still be a link to the real economy and economic growth. In the last ten years financial markets grew three times as much as the real economic

growth, Ravoet points out, which generated this artificial situation.

Macro-economic monitoring of financial markets is required and is key to effective global financial stability, he adds. There needs to be a reassessment of the role of international financial institutions, such as the Financial Stability Forum and the IMF.

‘Crises are challenges,’ says Ravoet. ‘The size of this crisis is unprecedented and it is hard to accept that such a huge amount of capitalisation has gone but we must try to learn lessons and make the best from this for the future.’ FBA



Guido Ravoet

Guido Ravoet is the secretary general of the European Banking Federation, the united voice of banks established in Europe. The Federation is a forum where best practices are exchanged, legislative proposals and initiatives are debated and common positions adopted.

EBF represents, defends and promotes the interests of its members, promotes the development of the industry, provides value-adding information and efficient and professional services to its member associations and assists new members in accession procedures.