BBVA Economic Research Department

How the current financial turmoil is transforming the financial landscape in the EU

The International Banking Circle (IBC)

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Main messages

- Pending problems: The dimension of the problems in the European financial systems is comparable to that in the US. There is a strong heterogeneity across countries and institutions.
- Too little Europe: The response in Europe to the crisis has been driven by national considerations. This is due to a combination of factors which include a lack of harmonization of basic regulation and problems of burden sharing. In addition, short-term financial stability considerations have overshadowed long-term ones.
- The need for short term action: Several measures can be taken to overcome the current situation in the short term. First, state aid should entail strong conditionality, be short-lived and ought to guarantee that the more solid institutions become the main players in financial markets. Second, there is a compelling need for transparency, and the US stress test exercise is a good example. Finally, international liquidity markets should be re-established.
- Towards a new sustainable cycle: Accounting standards should facilitate the role of prudential rules, not interfere with them. Moreover, the new regulatory framework should not give rise to regulatory arbitrage. Finally, there is a lot of room for improvement in micro prudential supervision while too high expectations have been created about advances in macro –prudential supervision

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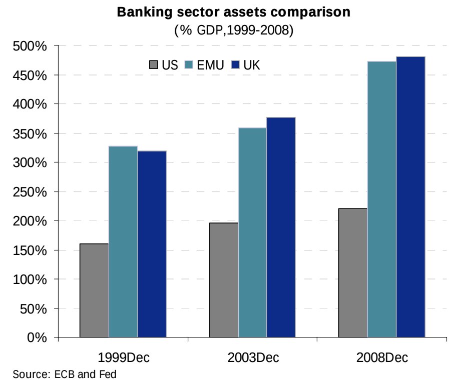
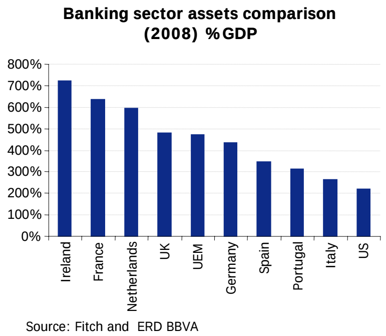
Developed economies on both sides of the Atlantic are facing similar problems in their financial systems



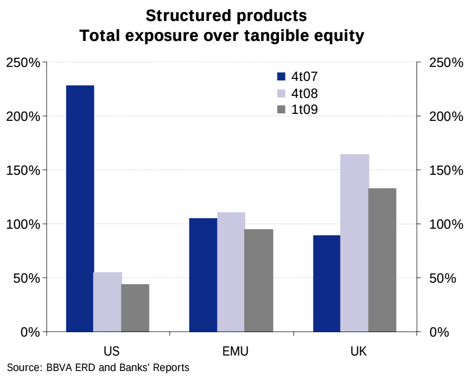


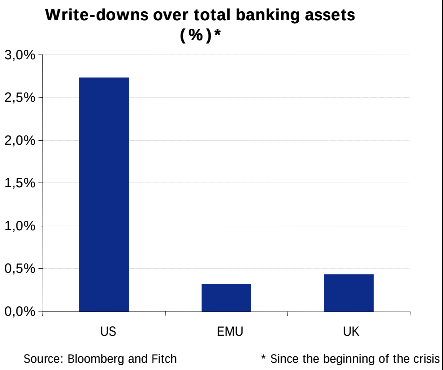
Europe has a problem in terms of asset inflation similar or higher than that of the US, with significant differences across countries

BBVA A troublesome starting point

The structure of banks' balance-sheets looks worrisome ...

... and progress in recognizing losses is very limited





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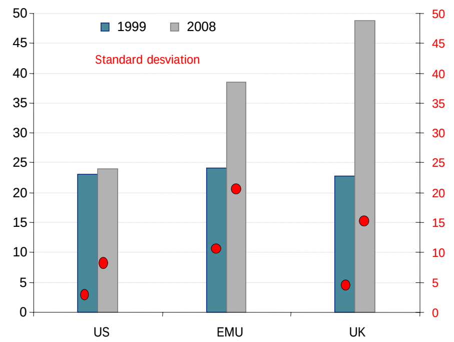
Heterogeneity among European banks is very significant and has increased over the last decade

Banks*: Assets over Tangible Equity



Source: Bloomberg
*20 biggest institutions by assets

BBVA A troublesome starting point

In our attempt to manage this crisis, in Europe we have forgotten some of the key aspects that we learnt in previous financial crises

Memorandum of Understanding on Cross Border Financial Stability by EU Ministers and CB Governors, released in June 2008

MoU CONTENTS	REACTIONS TO CRISIS
•*"The objective is not to prevent bank failures".*	"No single institution has been allowed to fail.
•*"In a crisis situation, primacy will always be given to private sector solutions"*	Almost all cases are solved through public intervention
•*"The use of public money to resolve a crisis could never be taken for granted"*	A substantial amount of money has been used so far.
•*"Policy actions in the context of crisis management will preserve a level playing field. […]" "Especially, any public intervention must comply with EU competition and state-aid rules."*	More than 50 national plans have been analyzed by the EU Commission or are under review: the level playing field is seriously endangered by a piecemeal approach in the response to the crisis. Other actions: defensive capitalization of banks across the board, blanket guarantees in some countries…

Why is the European reaction at odds with the MoU?

Why is the European reaction at odds with the MoU?

A piecemeal approach to the crisis among European countries has endangered the level playing field. Differences in state aid, domestic credit targets, defensive capitalization across the board and the adoption of blanket guarantees in some countries have been examples of this disordered approach.

1. Lack of harmonization of basic regulation hinders the adoption of an European approach
   - E.g. Consumer protection rules, deposit guarantee schemes, elements of commercial law, capital definitions, liquidity regulation, etc.
2. The fiscal cost of the crisis with 25 sovereign Treasuries: the problem of burden sharing
3. Short-term financial stability considerations are predominant at the expense of long-term considerations

Why is the European reaction at odds with the MoU?

4. Short-term financial stability considerations are predominant at the expense of long-term considerations

The fear triggered by the aftermath of Lehman Brothers bankruptcy has overshadowed considerations other that those related to the short term financial stability of the system in the design of policy measures.

Rushing for a solution due to a perception of systemic risk in the aftermath of LB' collapse…

Delays adjustments and allows survival of weak institutions

Increases uncertainty (negative role of expectations)

…COULD ENSURE FINANCIAL STABILITY IN THE SHORT-TERM …

…HOWEVER, IT JEOPARDIZES FINANCIAL STABILITY IN THE LONG-TERM.

In Europe in particular this approach is even more complex if we take into account a nationalist dimension

On the contrary, tackle industry restructuring with well-designed policies…

Anchors expectations with an "exit strategy"

Guarantees some basic principles of market efficiency and level playing field

Allows solid institutions to become the main players

…GUARANTEES STABILITY IN THE LONG-TERM AND ALSO ENSURES FINANCIAL STABILITY IN THE SHORT TERM

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Short run measures

Several measures can be taken to overcome the current situation in the short term.

1 **State aid plans should fulfill some requirements**

Implementing uncoordinated measures could seriously harm the level playing field in the long run. A European approach is needed.

Public interventions						
% GDP	Government capital	Debt Guarantee (approved)	Toxic assets Guarantee	Assets adquisitions (approved)	Assets adquisitions (effective)
Austria	1,4%	7,0%			
France	0,3%	2,9%			
Germany	0,7%	4,2%		1,7% *	
Ireland	0,5%	29,6%		6,3%	
Italy	0,4%	No public amount		0,2%	n.a
Netherlands	0,6%	5,6%			
Spain		5,3%		1,6%	0,5%
UK	0,2%	1,6%	3,8%	1,0%	0,3%
US	1,3%	1,8%	3,2%	19,7%	1,8%

* In discussion

Source: BBVA ERD and European Commission

What is required is an integral plan that covers both the assets and the liabilities of the affected institution and fulfils certain requisites:

- **be subject to a restructuring plan,**
- **impose restrictions on the management of the business,**
- **avoid competitive distortions,**
- **be subject to the achievement of milestones,**
- **be temporary and transitory.**

1 **State aid plans should fulfill some requirements**

Well-designed rescue packages should include an "exit strategy", as a clear horizon should be provided to market participants in times of uncertainty.

State aid ought to guarantee that the more solid institutions become the main players in financial markets, and not spend resources on institutions that are struggling for resurrection. The main target should be:

- to reduce the cost of credit and
- to provide solid bases for an efficient allocation of credit.

Type of public aim programmes approved by the European Commission

	Government capital	Government guarantee	Deposit Guarantees	Liquidity/Open market operations	Asset acquisitions	Bad bank	Bad bank proposals
Austria	x	x					
Belgium/France/Luxembourg		x					
Belgium/France/Netherlands		x			x		
France	x	x	x	x			
Germany	x	x	x			x	
Ireland	x						x
Italy	x	x	x				
Netherlands	x	x	x	x	x		
Spain		x	x	x	x		
United Kingdom	x	x	x	x			

Source: BBVA ERD and European Commission

1 **State aid plans should fulfill some requirements**

A good example of a piece-meal approach is the case of interbank market: a genuine euro-area market prior to the crisis where different European countries have implemented divergent measures.

Ireland: since September 2008, the first blanket Government guarantee of interbank market. The total liability was valued at about $600-billion, more than twice the GDP of Ireland, and will last for two years.

Austria: state-guaranteed clearing house for non-collateralized interbank loans

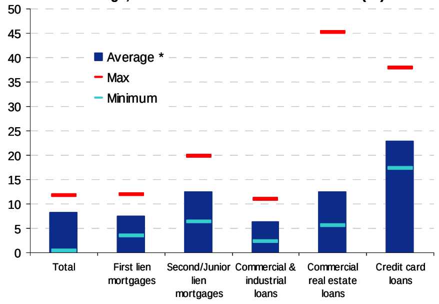
Italy: clearing house sponsored by the Bank of Italy for collateralized loans

Greece: banks are allowed to borrow "good" against "bad" collateral to be discounted at the ECB

2 There is a compelling need for transparency

US: the stress test exercise is a good example of transparency. A substantial heterogeneity among institutions has been shown.

US stress test: loss rate by asset category: Average, min and max for selected institutions (%)



*Average of 14 institutions. Institutions with dealings substantially different from the rest and those with erratic ratios have been eliminated.

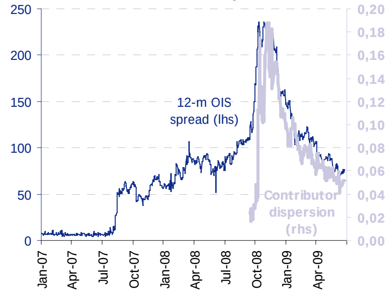
	US Stress Test	Euro Stress Test
Objective	Assessing capital needs	Assessing losses, not capital
Scope	Individual, for largest banks	Aggregate
Criteria	Unified	Diverse, depending on national regulators
Transparency	High: results disclosed individually	No disclosure
Impact	High: capital raising required	None, no effective results

Exercise of limited use

3 Liquidity markets should be re-established

Despite a gradual normalization of interbank markets in the last few months, European funding markets remain seriously distorted. These problems could become permanent if coordinated measures are not taken shortly

12-month OIS spread (bps) vs 12-month contributor dispersion



Source: Bloomberg and Euribor

A solution based on the existing framework and design is unlikely to be feasible

In order to fix this market failure, the involvement of European official institutions is required.

For instance in the interbank market, it would be desirable to have a new bucket of solid private institutions to be used as a reference. This would mean setting-up the market again.

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Long run measures

Long term financial stability must be taken into account in policy reaction to the crisis

1 **Accounting Standards should facilitate the role of prudential rules, not interfere with them.**

International accounting standards (IAS) have not facilitated the creation of robust financial institutions; the crisis has proved that IAS

- **Generate procyclicality by penalizing the creation of capital/provisions buffers and prudent hedging actions**
- **Excessive reliance on mark-to-market gives rise to excessive volatility**
- **Overall, foster the short-term as opposed to a medium-term orientation in decision making**

2 **Regulatory arbitrage should be avoided**

The new regulatory framework should aim at being universal: uniform regulations and supervision procedures across geographies and financial institutions.

By looking at previous as well as current financial crises, there is no clear pattern to show that the size and nature of financial institutions are the features which give rise to instability. Larger and complex financial institutions are not more risk prone.

The main factor generating crises is the inherent proclivity in financial markets to operate procyclically.

As a result, it is necessary to create: 1) countercyclical regulation, 2) strict supervision and 3) adequate incentives for market discipline to be effective in dealing with procyclicality.

Regulatory arbitrage proves to be detrimental for the financial systems over time

3 **There is a lot of room for improvement in micro prudential supervision in many countries, while too high expectations have been created about advances in macro –prudential supervision**

Improving macro-prudential supervision will be a <u>difficult task</u>, as the state of the art does not provide for a solid framework to perform this function :

- **INDICATORS: What does "financial stability" mean? What are the thresholds?**
- **HORIZON: Longer than that for monetary policy, but how much longer?**
- **TOOLS: Different to those used for monetary policy, but which ones?**

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