

Patient must be brought out of induced coma

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New financial structure /

The global financial structure has been put into an induced “coma” by government assistance packages. When these expire, the sector will have to stand on its own two feet and face new demands on capital adequacy and authorities looking more closely over the industry’s shoulder.

The global economy is backing away from the abyss step by careful step. Economic growth is slowly picking up around the world, and – with a helping hand from government assistance packages – the financial markets are functioning once more.

The options for obtaining liquidity are again sensible, bond loans are growing and equity prices are on the up. However, this is largely due to the actions of the world’s governments, who have intervened with various rescue packages for the financial sector.

But what will happen when these packages expire and the financial system has to again stand on its own two feet. Is the financial sector ready to move forward in its current form and structure? And what demands will governments, politicians and international society make in terms of new rules and regulations that might reduce the risk of the latest financial crisis returning?

Cannot continue

“There is no doubt that we will see dramatic changes to the global financial structure in the coming years. It is a process that we in the banks are already addressing, but rising demands from politicians and consumers will reinforce the process,” says Executive Vice President Jens Peter Neergaard, Global Risk at Danske Bank.

He is thinking here mainly of the situation that arose in 2007, when serious problems began to surface in the financial system. Falling house prices and massive loan losses put the system under pressure, and as a result the banks ultimately lost confidence in each other. This led to liquidity shortages, which eventually led to fewer loans being granted – and a global economy that was reduced to a crawl.

From being a relatively peaceful and uncomplicated place to be, the global financial sector developed into a witch’s cauldron where no-one was trusted, and where economic meltdown was a very real threat.

Patient placed in a respirator

The financial crisis has bottomed out, but it is not over yet. Jens Peter Neergaard compares the situation now with a hospital where an ill patient, who the doctors are not entirely sure how to treat, is placed in an induced coma.

“The banks were placed in a respirator, metaphorically speaking, in September 2008. This had two effects: First, it gave us the chance to reconstruct ourselves from the inside; second, it gave the doctors – the central banks and supervisory authorities – time to come up with new courses of treatment. The sector was suffering from an unknown and virulent disease that required fast and effective action – therefore it made sense to place the banks in a respirator. However, while the sector is lying in a respirator, it is not lying still. The financial sector long ago started to strengthen its capital base and reduce its vulnerability to liquidity shortages in the markets – the banks are reconstructing. The treatment has been experimental – record low interest rates and quantitative easing – but there is no doubt we are approaching the point where the respirator can slowly and carefully be turned off,” says Jens Peter Neergaard.

Placing the patient in a respirator does not, however – to continue with Jens Peter Neergaard’s metaphor – cure the patient, it simply buys time, and further treatment is needed before the patient can be declared cured:

“Naturally, one does not simply turn off the respirator from one day to the next – the financial sector will gradually learn to stand on its own feet in the coming years in a world that has definitely not become any easier from the banks’ point of view. The trend of the past 25 years towards ever more stable macroeconomic growth accompanied by low interest rates and inflation has been replaced by pronounced economic oscillations and uncertainty. The demands on the banks’ immune system have therefore increased considerably.”

“This means that some banks will not be able to live up to the future demands placed on the banking business. There is therefore reason to expect that the future will bring an increasing number of mergers within the sector on a global scale. Bank closures will also become more common, but the healing process is already under way – so when the respirator is turned off, the sector will be much stronger than when we were forced to resort to this life-saving equipment,” says Jens Peter Neergaard.

More regulation

Looking ahead, Jens Peter Neergaard envisages a landscape characterised by much greater regulation and control of financial firms: Stricter requirements on banks’ capital adequacy, quality of capital, liquidity management; better risk assessment, better assessment of customer credit risk; new accounting requirements on, for example, the valuation of write-downs on losses, dynamic provisions; rules on depositor guarantees, gearing, solvency; regulation of salaries and bonuses and more supervision by the authorities.

“Regulation will change the situation dramatically. The politicians are demanding it – and we welcome it. Voters will increasingly demand that something is done to prevent a repeat of the financial crisis – be that under the auspices of the EU, G20, IMF or many others, including the USA’s president Barack Obama, the German chancellor Angela Merkel or France’s president Sarkozy. There is a clear political ambition to create more or less uniform global rules in this area, but unfortunately I think this is a little unrealistic,” says Jens Peter Neergaard, who continues:

“Sadly, regional and even more inappropriate national initiatives will be passed that could distort competition between banks. I have no doubt about the need for tighter regulation of the sector. This is as such the chance to reduce the risk of a relapse – but it demands careful regulation. Otherwise, new loopholes will simply be opened in the financial system – with the risk of complications arising”.

“No-one can be interested in that. Meanwhile, the risk of over-regulation is very high. Something often forgotten in the debate is that a badly functioning financial system impacts the welfare of everyone. All groups in society are interested in sound and sensible regulation that reduces the risk of future financial illness. However, one should not forget the side-effects of overmedicating,” he adds.

New times

The many new requirements being placed on the financial markets in an attempt to avoid a new financial crisis will also ultimately mean more expensive loans for customers. The new regulations are increasing the banks’ funding costs, and therefore Jens Peter Neergaard also foresees a new trend emerging whereby large corporate customers, in particular, will increasingly wish to be independent of the banks.

“This means the banks will be increasingly advising customers out in other parts of the capital markets – buying and selling equities and currencies, issuing corporate bonds, and the like. The banks already perform these services, but there will be a greater focus here in the future,” says Jens Peter Neergaard, who also has a metaphor for the strategic thinking of the financial and other sectors at the moment:

“One could compare it to a boat that has to be sailed out of a fjord and onto the open sea. At the moment we are navigating from point to point, i.e. focusing on the short term, because we are still in the fjord. But soon we will have to pass out of the fjord and sail on the open water. But this means we will have to navigate from a more long-term perspective if we are to arrive at the right destination, and thus there will be a need for a more long-term strategy – which will be a very interesting task,” says Jens Peter Neergaard.

By Flemming J. Mikkelsen; Danske Bank

Characteristics of the future financial structure

- More consolidation
- Pensions funds buying banks
- More regulation
- Increased capital demands
- Better quality of capital
- Higher provisions for the down times
- Better liquidity management and solvency
- Increased demands for depositor guarantees
- Tighter rules for major loan arrangements
- Increased accounting requirements
- Regulation of salaries and bonuses
- Greater transparency in processes
- Stricter control by the authorities

...though fewer/less

- banks
- gearing