Global Financial Crisis, 10 Years On: Fatal Downward Spiral for European Banking

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Dear Mr. Chairman,
Dear Mr. Minister of Finance,
Ladies and Gentlemen,

The Bank of Cyprus is proud to be one of the principal sponsors, as in earlier years, of the annual Limassol Economic Forum, an event that brings together the economic and business leaders of Cyprus. On behalf of the Bank of Cyprus, I would like to extend a warm personal welcome to each one of you. Also, I would like to thank the organizers for inviting me to offer a keynote address.

As you know, last month marked the 10-year anniversary of the collapse of Lehman Brothers that precipitated the worst global financial crisis since the Great Depression. The systemic crisis has had pervasive economic, social, political and financial consequences, mainly on the United States and Europe, which are still being felt today.

In my presentation, I will obviously need to be very selective. I will focus on the question of whether the international financial system is now safer, and whether there is a risk of a new financial crisis. I would like also to address a question that has evaded the radar and the proper attention of many commentators and policy makers, namely the question of how the financial crisis has affected the competitive position of European banks relative to their American counterparts.

Several of my comments and conclusions apply in some measure also to Cyprus, as you will note.

So, let's start with the question whether the international financial system is safer today, 10 years after the crisis? The short answer is: definitely yes.

The response to the crisis by the fiscal, monetary and regulatory authorities, both at the national and the international level, has been unprecedented. In addition, and contrary to popular perception, the banks themselves have taken far-reaching corrective measures as well.

Banks are now more closely regulated, better capitalized and more liquid.

We would all agree that we have come a long way. But does this mean that the International financial system is crisis-proof today?

I am afraid the answer to this question is: no, the system is still not safe enough. The world is still faced with old and some new vulnerabilities. Of course, no one can say with certainty where and when the next crisis will hit and what it will exactly look like.

As a rule of thumb crises tend to erupt as a consequence of risks that have not been anticipated and/or fully identified, because risks have shifted to new areas or taken new forms.

How severe and wide-ranging a future financial crisis would be is difficult to predict in today's highly interconnected world. Its spread would depend on the magnitude of the initial shock, the policy response and the corrective measures that can be taken by all stakeholders.

And here unfortunately one has to say that the willingness and capability of individual countries to act effectively as well as of the international community to cooperate has weakened lately. And the scope for adequate new fiscal and monetary support has narrowed.

So, you may ask, what are the main vulnerabilities? There are several worth mentioning.

First, global debt has risen sharply in recent years. The total nonfinancial sector debt in jurisdictions with systemically important financial sectors has grown from $113 trillion dollars or about 215% of their combined GDP in 2008 to $167 trillion or close to 250% of their GDP by 2017, according to the latest IMF data. Some of the higher debt is less worrisome as it reflects the impact of the large fiscal stimulus of major advanced countries at relatively low interest rates, with a big chunk of this debt being held by the major central banks with QE programs. But the large pickup in the foreign currency-, mostly US dollar-denominated debt by frontier and emerging market countries and by the corporate sectors in several advanced and emerging market countries poses major risks under a less benign growth and interest rate environment and a potential appreciation of the US dollar, particularly for countries or corporates with large refinancing and borrowing needs. The recent experience of Turkey and Argentina are cases in point here.

But even highly indebted advanced countries face challenges as debt sustainability concerns increase and investor preferences change. Here Italy is a case in point.

The normalization of monetary policy by the Fed, which is already well under way, and by the ECB and the Bank of Japan in the future, could pose risks to global growth if it is not carefully calibrated. The increasing geopolitical and trade tensions as well as protectionist pressures add to the downside risks to global growth.

The second big vulnerability is the rise of so-called populism in recent years, as manifested in the election results in the US and major EU countries. It adds significantly to the downside growth risks, both because of policy actions or lack thereof it might induce at the national level, but also because of the risk it poses to effective international policy coordination and multilateralism.

The third vulnerability is the distortions in the structure of property and financial asset prices caused by the long years of low interest rates, abundant liquidity and the search for yield by institutional investors and asset managers. There is a concern over possible asset price overvaluations or even bubbles, which expose capital markets to major shifts in the risk appetite of investors or potential overreactions to rising interest rates.

A fourth and related risk is that the continued rapid rise of passive investing and high speed algorithmic trading might unduly magnify the impact of potential shocks on asset prices and further distort the structure of asset prices.

My fifth area of concern is the fact that, while the regulatory response to the financial crisis has been broadly appropriate, it has created some distortions as it has been implemented at different speeds in the US and Europe and appears to have magnified rather than reduced some old vulnerabilities.

The five largest US banks, which had been considered as too-big-to-fail at the time of the crisis, are now even bigger, controlling 47% of US bank assets, compared with 44% in 2007. They have in many ways also eclipsed their European peers, such as in the share of deals, return on equity, stock price performance, market capitalization, and IT innovation spending.

At the same time the size of the shadow banking sector has increased rather than declined since the crisis, evading the regulatory radar. This sector is now $45 trillion in size, controlling 13% of the world's financial assets, up from $28 trillion in 2007.

The regulatory reforms of the past years have focused on correcting past mistakes and building better defences against future crises mainly through higher equity capital, more liquidity, new capital cushions, particularly for major systemic banks, and frequent severe stress testing by central banks.

The American regulatory response was very different from that chosen by Europe, and I think, Europe is paying and will continue to pay a high price for this. The American regulators were quicker and more demanding in pushing through a restructuring of the financial system with government assistance. As a consequence, the American banking system today is clearly healthier and more competitive than the European banking system.

The European regulators were relatively slow to respond to the crisis, and when they finally did respond in 2012-13, it coincided with the sovereign debt crisis in Europe when the European banks were already under pressure. This reduced further their ability to provide credit for the recovery of the economy.

To further promote growth, the Trump Administration is currently relaxing banking regulations which tilts the balance of the regulatory burden between the European and the US banking systems further in favour of the later.

Moreover, local regulators in Europe are planning to introduce additional regulations, such as revisions to the Capital Requirement Directive or MREL, the Minimum Requirements for own funds and Eligible Liabilities, which will be particularly demanding and damaging for small banks, including Cypriot banks.

Reform of the banking sector in the Eurozone is incomplete and Eurozone banks remain vulnerable. The arrangements for bank resolution are not yet fully settled and the European Deposit Insurance Scheme has not yet been agreed upon as some key countries are raising concerns.

The nexus of sovereign risk and banking risk is still an unresolved challenge in Europe. Eurozone banks are saddled with very large non-performing exposures of the order of €680 billion Euro and a number of banks are experiencing weak profitability, below the cost of equity.

Despite the progress made since the crisis, we therefore still have a long way to go. In my view, it is very important to achieve a judicious balance between micro-prudential regulations and strict financial stability on the one hand, and consideration of the role banks can and should play in promoting growth on the other. Excessive emphasis on maximizing financial stability through new provisions and capital increases could undermine unduly bank profitability and the banking system's capability to contribute to growth. Low or negative bank profitability is not conducive to new capital injections by existing or new bank shareholders. A balanced approach would allow banks to expand credit, promote growth and contribute to capital increases through internal organic profit generation.

The developments in the regulatory framework shed also some light on the last question I would like to briefly address, namely the competitive situation in the international banking system.

The findings are momentous. The US, the main scene of the crisis, site of the most spectacular bank failures and home of the major banks accused of causing the crisis, now dominates the global capital market business more than ever before. Their European competitors, meanwhile, have fallen almost hopelessly behind, especially in their investment banking activities. The actual and future potential costs of this development to Europe's economic dynamism and future strength are far from being recognized by European policy makers.

While the largest US bank, JP Morgan, has currently a market capitalization of $360 billion dollars, the capitalization of Deutsche Bank, which until a few years ago ranked in the top three investment banks in the world, is now only around €20 billion euros. This reflects the sharp decline in the relative profitability of European banks. According to data reported by the *Financial Times*, the top five European banks made $60 billion dollars in net profits in 2007, which was 20% higher than the earnings of their top five US rivals. In the meantime the picture has changed dramatically. The net earnings of the top five European banks have declined by two thirds since 2007 to only $17.5 billion in 2017, 25% below the profits of JPMorgan alone.

How can the relative demise of European banks be explained? There are a number of key reasons.

First and foremost is the fact that the European sovereign debt crisis followed the global financial crisis on its heels. Not only did the debt crisis take up for years a large part of the attention of European bank managers, delaying the necessary adjustment measures at their banks after the financial crisis, it also prevented a rapid economic recovery in Europe and thus further curtailed bank business. In addition, the European Central Bank's policy of zero interest rates in response to the double crisis to prevent a severe recession has put more pressure on bank profits.

The US banks, on the other hand, were able to adjust immediately and fully to the new conditions after the financial crisis. The US government also supported them in a pragmatic and non-ideological way. For example, it used the financial crisis to consolidate the US domestic banking market and created even larger financial institutions than before, regardless of the too-big-to-fail problem that had become apparent during the crisis. In addition, in October 2008 it recapitalized the nine largest banks, even those that did not need any additional capital at all, through the injection of $125 billion dollars of preferred capital overnight without diluting bank ownership in order to strengthen their financing power and stimulate the US economy.

In contrast, the European governments gave much less support to their financial industry and resisted the needed consolidation. In particular, they failed to clean up their mostly overcrowded national banking markets and drive forward a Europe-wide single financial market that could compete with the American one. Instead of establishing competitive units and structures, weak institutions were kept alive with taxpayers' money. Governments also imposed a harsh cap on remunerations for top bank managers causing a brain drain in a sector that is particularly dependent on human capital, further constraining the industry's development.

In addition, public opinion and in turn political opinion in Europe do not hold investment banking and bankers in high regard. Most Europeans consider investment banking as not needed or even dangerous. The financial crisis has reinforced this attitude even further.

Relative to their US peers, European banks are also disadvantaged by deep-rooted institutional differences. Compared to European banks, US banks cover a much smaller share of the funding needs of the US economy, rely more on investment banking fees than on interest income, and show less assets on their balance sheets. As a consequence, European banks have a much higher capital requirement and their profitability is more sensitive to changes in economic activity and interest rates.

Finally, there have been some serious management errors by some European banking institutions in recent years.

All this taken together, has resulted in insufficient profitability by European banks relative to their US competitors.

In order not to fall by the wayside in the ongoing unprecedented process of technological change, enormous investments in material and human capital are required, which only profitable banks can fund. Those who are not in a position to do so would quickly fall hopelessly behind the competition. The same applies to the investments needed to increase the European global presence in an increasingly multipolar world.

The European banks often can no longer afford the costs associated with expanding their global presence. They are even forced to dismantle their existing network, just at a time when it is becoming more important than ever. This is a fatal downward spiral.

In view of the new "America First" course set by the US Administration, the growing challenge posed by China and the weakening of Europe's global position brought about by Brexit, European leaders are rightly concerned about the future position of Europe as a major source of power and influence on the world stage.

Regrettably, however, there is no evidence of a strong commitment by European policy makers to the global competitiveness of a key industry such as the financial industry, for example by resolutely promoting a common banking market that would make cross-border mergers more attractive.

There is still time for a reversal. But not for long.

In conclusion, I have covered several interrelated issues and the remaining challenges facing the global financial system, with special emphasis on the dangerously weakening European investment banking capability on a global scale.

The financial world is a safer place 10 years after the financial crisis, but not fully safe, particularly in Europe. Many people agree that there is a risk of a new crisis, though we cannot tell when, where and how it would happen.

Therefore we have to guard against complacency and excessive emphasis on tending to yesterday's vulnerabilities. Instead, we should be more forward looking and redouble our efforts to address the challenges and emerging vulnerabilities of tomorrow.

Thank you very much.