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The crisis of confidence on financial markets from a host country's perspective

What's going on?

The depth and the scale of the current crisis very well illustrate that the globalisation of financial markets has created an economic system far more dangerous than it seemed either to those who created it or those who opposed it. Global financial institutions have turned out not to be too large to fail, but also too large to save without ramifications for the rest of society, threatening a long-term breakdown in contemporary liberal market economics. In the period of prosperity, the impressive growth of trans-border capital groups became a good example of the internationalisation of the benefits stemming from internationalised economic activity, but in a period of crisis the threat of a nationalisation of losses means that globalisation is on the retreat and protectionism is growing.

Political changes, meanwhile, have not kept pace with the processes of economic globalisation. Political authorities have, and most likely will continue to have for a long time, a national character. The foundations of globalisation may turn out to be too weak when faced by angry citizenry and national democracy.

It is tragic that, as a result of the crisis, similar to a boating disaster, we do not yet know who will drown and who will survive, or what and for whom will be the consequences. The most frightening aspect, however, is that we do not fully understand what is happening. Diagnoses of the current state of affairs vary and the preventative funds being allocated by politicians are increasingly starting to look like a delayed victory of socialism.

All the elements of the crisis, which in terms of its range and costs to date have the hallmarks of a global catastrophe, have been a surprise. The most incomprehensible aspect seems to be the fact that this crisis has taken place in a period in which banks have been using management models

based on IT systems that a dozen or so years ago could only be dreamed of. What's more, banks that until recently had been perceived as models of good practise in the area of risk management are now undergoing serious financial problems and announcing losses running into the billions. It is worth recalling that some of these banks were initiators of Basel II's early warning regulations. The risk management models in Basel II are analogous to those that the world's largest banks, many of which are now coming out with huge losses, have applied in recent years. Basel II, however, avoids what appears to have been the most important element, namely systemic risk. In fact, it is based on analyses of the risk of insolvency of each bank on an individual basis. Meanwhile, it turns out that systemic risk is created not only by the large deposit banks, but also by other institutions. Securitisation processes have meant that the key sources of finance for banks' credit activities have become investment and pension funds and small investors, and not only depositors. The crisis of confidence on the financial markets has meant a hemorrhaging of sources of financing credit activity from the capital market, as well as the inter-bank market. Transactions on the inter-bank market have been replaced by repo type transactions. Market prices of money have been replaced by centrally planned prices. Central banks, instead of fulfilling their function as bank of last resort, have turned into banks of only resort. Systemic risk has also affected institutions not covered by the early warning regulations, including investment banks. It turns out that the regulatory environment is inadequate for the financial system's level of development.

The causes of this deep crisis of confidence require complex analysis. It is worthwhile, however, analysing the regulatory environment, focusing on the evident conflict of interests for those institutions that assess the credibility of market participants. I have in mind here in particular the ratings agencies and auditors, which provide information to market participants and are paid to do so by those they are assessing. In this situation the suspicion arises that it is possible to buy good ratings for papers issued or for a positive assessment of financial reports.

Accordingly, one of the solutions worth considering would be to obligate financial supervision authorities to approve ratings given by ratings agencies. Ratings could be made public only after receiving such approval. On the interbank market banks should exchange information on risk assessments prepared by banking supervision institutions in Europe. A more far-reaching

proposal would be to obligate financial supervision authorities to approve opinions given by auditors reviewing financial statements of banks. In the current situation it would be hard to say why home and host financial supervision authorities, which are financed by market participants should avoid responsibility for restoring confidence on financial markets, unless we think they are incompetent and biased.

The modern conception of risk management in listed companies is usually treated as a part of the far wider system – the system for managing value for shareholders. Its basic function is achieving maximum risk-adjusted rates of return on own capital (RAMP, RAROC, RARORAC etc.). It allocates capital on the basis of this criterion. It is important to analyse the extent to which banks' own capital holdings diverge from the estimated economic capital necessary to cover undertaken or planned risk. The ideal situation is believed to be one in which estimated economic capital is identical to the regulatory capital required by external supervisory institutions. If own capital holdings far exceed economic capital then this difference is interpreted as representing idle share capital. In other words, the surplus of capital a bank holds estimated as necessary to cover potential losses becomes a “measure of inability” to make use of capital by the bank's management. Generally, one should assess banks' use of this conception positively. However, it is also worthwhile noting that risk management and estimating economic capital is, on the one hand, under pressure to maximize rates of return for shareholders, whose stakes in banks' capital is relatively small, and on the other hand this takes place under conditions of a “temptation overdose” resulting from ever greater predictability of central banks' behaviour during the crisis. There existed a situation that inclined participants towards ever lower levels of caution and undertaking activity at taxpayers' risk. This stimulated participants in the financial market to under-estimate risk. In the past decade, the concept of Value Based Management has been adopted by most banks in the world. Pressure to maximise rates of return for shareholders meant that banks' level of leveraged activity turned out to be excessive for institutions requiring public confidence. To calculate capital adequacy, the definition of own capital was widened to include capital that had previously been treated as own capital only in the event of bankruptcy. And the banks had become too large to collapse. In this situation only a part of own capital amortized the situation. In practise, this enlarged the level of banks' leverage and their financial risk. Moreover, the application of aggressive motivation systems for banks', brokers' and sales teams'

management further drove increases in risk taking. The universally accepted concept in recent years of Value Based Management in public trust institutions has not added to the stability of the banking system. The main issue is the inefficient system of supervision which has not and still is not capable of overseeing transborder capital groups.

Under pressure to maximise rates of return for shareholders, banks have been weakly motivated to consider the macroeconomic consequences of their actions. They behave similarly to companies polluting the atmosphere, and not paying for doing so. Regulations and taxation exist to avoid destruction of the environment. Lasse Pedersen and Nouriel Roubini have proposed regulations for system risk on the basis of an analogy with the market for pollution emissions¹. Each bank would be evaluated in terms of system risk, defined as the rate at which it could lead to a general crisis.

Regulatory institutions would evaluate the systemic risk of each bank individually and outline the necessary capital requirements for covering that risk. The banking system as a whole would have to hold sufficient capital as a ratio of its risk profile in the system. This would be allocated between specified banks analogously to how economic capital is allocated in banks between the various types of activity. Each bank would have to purchase system risk insurance. Ultimately, payments for this insurance would be passed on to the supervisor responsible for the stability of the market in which the bank operated. This interesting proposal represents a response not only to banks' rather high leverage, but also creates motivation among market participants to reduce system risk. The bank that restricts system risk would also lower the costs of insurance and the insurance fees would be set by the market. Bringing this idea to life in a recessionary climate would require financing of a part of the costs of insurance from public finances, but the solution would have a market character and could help bring back trust in the big banks. The solution would be complementary to the suggestion put forward by the high-level group chaired by Jacques de Larosiere. The key element in the suggestion is to establish three new EU authorities, independent bodies (for banks, securities and insurance). The new authorities would be in charge of 'legally binding mediation between national supervisors'. In addition the group suggest appointing the European Systemic Risk Council, which would replace the existing Banking

¹ Pedersen L. & Roubini N., *A proposal to prevent wholesale financial failure*, "Financial Times" 30 Jan 2009

Supervision Committee so as to monitor the stability of the macrosystem. The suggestions are not connected however with fiscal responsibility, which should remain on the national level. The issue of burden sharing in case of financial crisis on the European financial market is still without clear resolution. The Recommendation “In view... accordingly”² give new perspective but is still too general. From host country’s perspective this recommendation do not eliminate fears about nationalization of losses in economically weaker countries in the period of crises. The fears could be reduced by the proposal made by Lasse Pedersen and Nouriel Roubini. Consequently, with a view to effectively reforming the system of supervision of single financial market in EU it would be advisable that both proposals should be considered together.

If we agree that the current financial crisis is mainly a crisis of confidence in public trust institutions, a fundamental question appears to be whether that trust can be bought? Is it possible to rebuild trust in global banks by financing the purchase of their toxic assets? The answer appears to be yes, but at what cost and over what period? It is of course always possible, with the assistance of billions of dollars, to recapitalise another bank, even if it has been poorly managed, and to rebuild trust among market participants in that bank’s solvency for a defined, relatively short, period, until it turns out that the recapitalisation is insufficient and the bank is once again insolvent. It is, however, too large to fall.

There is no doubt that rebuilding trust in the financial markets and the value of the banks during a crisis situation requires the support of external capital. This is, however, usually a necessary condition of realising a recovery programme. Recapitalising a bank is possible either by its shareholders (current and future) or by taxpayers. Situations do occur, however, where shortly after dividend payouts to shareholders are made, the bank requests public assistance. This usually results from a sharp fall in the value of the bank’s assets unpredicted at the moment it was decided to make the dividend payments. A public bail out using public moneys, however, that does not have the same causation and occurs shortly after dividends are paid out to owners, and often connected with the payout of high bonuses and salaries for management, can only deepen the crisis of trust.

² The High-Level Group on Financial Supervision in the EU. Report., Brussels, 25 February 2009.

These phenomena are becoming increasingly controversial and complicated when looked at from the perspective of a host country, where the banks - daughter units dependent on multinational holdings – demand public support. If we imagine a situation in which a bank – a daughter company - pays out a dividend, the majority of which goes to the mother company from another country, and shortly afterwards itself requires recapitalisation, the decision to seek a public bail out may turn out to be impossible for political reasons. If, in addition, we imagine a situation in which a dividend is paid to the mother company, which as a result of the crisis has been nationalised, that would mean in effect a transfer of public funds from the budget of the host country to that of the budget of the mother company's country.

Parent banks and their subsidiaries

How is it that the crisis of confidence has spread via the interbank markets to countries where the good financial standing of participants on the interbank market is unquestionable and the financial sector did not purchase any “toxic” assets? In Poland, about 65% of banking sector assets are controlled by multi-national banks. Until recently the financial credibility of these renowned names enabled their daughter units (domestic banks) access to relatively cheap sources of capital borrowed on domestic and foreign markets, as well as financing their own activities on the basis of loans from their mother companies. This situation changed diametrically in the fourth quarter of 2008. The availability of funds decreased sharply after the collapse of Lehman Brothers. This has caused severe difficulties on the domestic financial market in the host countries despite the universal belief that being owned by strategic investors in host countries meant that banks would be able to underpin the security of the financial sector.

In Poland, the value of granted loans exceeds the value of deposits by about 20%. In conditions of limited access to external sources of financing, the banks are offering interest rates of 7-9% on the depository market, against an official cost of money on the interbank market of 4-5%. The problem is that the price on the imperfect interbank market is not representative. The extreme cost of obtaining money by banks has for several months exceeded the price of previously borrowed corporate credits and mortgages, for which the WIBOR (LIBOR for polish currency) is the reference price. In such conditions one cannot be surprised that banks are not inclined to sign

new credit agreements. Rebuilding confidence in the interbank market has a fundamental significance for rationalising credit risk management.

The loss of confidence by strategic investors in domestic banks is of key significance here. It is why, despite the good standing of domestic banks, an additional risk arises, connected with the behaviour of the mother companies in the crisis situation. Amongst other things, this is why the Polish financial supervisor demands that domestic banks provide daily updated information on current financial flows to mother banks, and vice versa.

It is hard to expect daughter companies to garner much confidence on the local interbank market in a situation where the mother company has little confidence on the global market.

The problem lies in a lack of transparency in managing liquidity and the internal capital of multinational financial groups. Rebuilding faith and trust on the financial market demands transparent relations between mother and daughter companies, in particular in the crisis period. In fact, the activities undertaken by strategic investors in helping daughter companies often go unnoticed by the market, and without doubt this has had an influence in raising the trustworthiness of the financial systems in host countries, although the potential threats may be huge.

An important element in transparency in relations between mother and daughter companies is dividend policy.

Taking high dividends from domestic banks, that is companies belonging to multi-national banks, during a period of crisis on financial markets has a pro-cyclical character from the point of view of the host country and anti-cyclical from that of the mother company's country. In this situation, the expectations of host nation supervisors that in a period of turbulence on financial markets mother companies will not exert pressure on daughter units to pay dividends is justified, given that this creates additional risk for the stability of the national financial market in the host country. On the other hand, majority shareholders, as smaller shareholders, have the right to receive dividends and the banking supervisor has no right to forbid such payments if the bank fulfills the early warning requirements. Moreover, it would be questioned by the supervisor of

ownership rights, and this without much doubt would not increase the investment attractiveness of the host country. A dividend is a right for owners to take part in the division of profits from selling the firm's shares and represents a very important reason to invest one's own capital in the first place. Since the start of the market economy in the 17th century, dividends have represented a permanent feature of the tradition and culture of cash returns to owners of joint stock companies and that is why any questioning of this right would be a strategic mistake. It is worth bearing in mind, however, that in finance theory an opinion universally expressed is that "dividends to the greatest extent depend on cash flow, which reflects the ability of companies to pay dividends, more than on net profits, which are the result of delineated accounting practises and which do not necessarily reflect the reality of payment possibilities". Countless empirical research also shows that the correlation of dividend payouts is far greater for cash flow than for profits. This argument may have a significance if we look at the Polish banking sector in 2008, when high profits were accompanied by liquidity turbulence on the interbank market.

The host countries' supervisors have the possibility of imposing more restrictive early warning regulations in the area of liquidity management and capital adequacy requirements for the banking sector. Introducing more restrictive early warning regulations on financial markets in a period of crisis would, however, represent pro-cyclical activity. It was necessary to do this during the period of prosperity. The fundamental functions of banking supervision are in fact undertaking preventative actions, and not crisis management. In the current situation the host countries' supervisor should recommend, for a period of the next several years, a significant hike in banks' capital adequacy ratios and set the deadlines for raising the levels they need to achieve. This would probably induce strategic investors to change their dividends policies.

Not very restrictive national supervisory activity on the EU's unified financial market would lead, during a period of prosperity, to a fall in the attractiveness of the banking sector in countries with the most restrictive regulations. It would appear, however, that reactions may be different during a period of a crisis of confidence, when the role of trust and security are more important than rates of return.

The crisis of confidence in the financial market from the host country's perspective has a somewhat different quality than that of the mother country, with different problems raising supervisors' and regulators' anxiety. The national character of the financial safety net has turned out to be inadequate in resolving the challenges facing the global financial market and problems unresolved during the period of prosperity have only deepened the current crisis of confidence.

Societal antipathy towards foreign banks is growing in Poland as a result of the radical limitations imposed on banks' credit activities, increases in credit restrictiveness, the raising of margins and no renewing of signed agreements. Opinions are appearing in the media that liquidity is being drained out of the Polish banking sector to mother companies' countries, despite the FSA assuring that nothing indicates that mother countries' banks have been looking to use the financial support of their Polish daughter units. Generally, the crisis atmosphere is not conducive to the integration process or to building new financial safety net architecture. In the home countries pressure has been growing on banks to withdraw from their international interests and concentrate on financing their domestic enterprises. Many of them in fact have been saved by taxpayers' money. In the host countries suspicion is growing about strategic investors, who have lost their reputations and are also raising the risk of spreading the crisis.

To date, however, the behaviour of mother companies in relation to their daughter units in host countries does not give cause for negative assessment. Fears stem rather from the worsening financial state of mother companies and their loss of credibility. The absence of systemic solutions that would allow for integrated crisis management on the European and global financial markets is only deepening such difficulties. Building new financial safety net architecture in conditions of a crisis of trust is very difficult, and all the more so because during the good times we did not manage to develop answers to the question of who should pay for a trans-national banking crisis.