Conference on

European Financial Systems: In and Out of the Crisis

Siena

The 2008 crisis and the future: Have the important lessons been learned?

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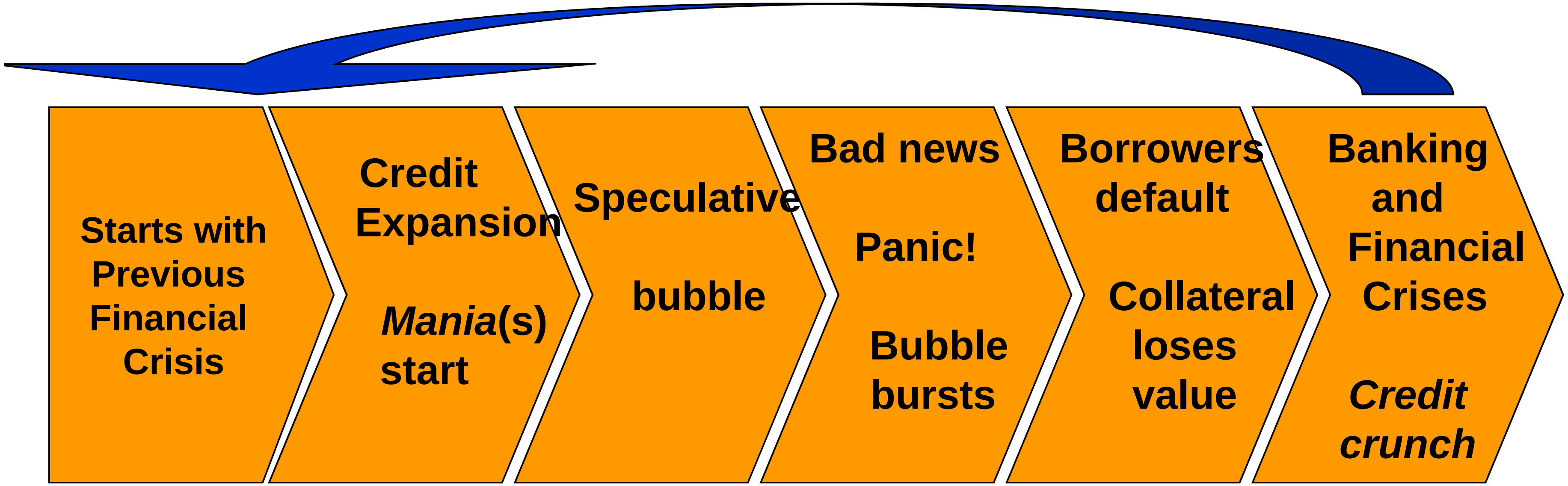
April, 1-2, 2011

The making of a financial crisis

manias, panics and crashes



- Central banks lower interest rates and inject liquidity to fight the crisis

- Excess money creates inflation in real and financial markets

- Mania leads to asset price bubble – high returns attract more investors
- Banks lend aggressively to speculators

- Bad news make investors nervous
- Panic selling brings asset prices down

- Heavy losses lead to default
- Lower asset prices lead to high banking losses since collateral is worthless

- Banks collapse
- Credit is severely restricted
- Real-side of the economy enters in recession: more banking losses

What happened this time? (the manias)

- Excess liquidity to fight:
  - LTCM, Russian debt and other late 1990's crisis
- Nasdaq / TMT technology bubble bursts in 2000
- More liquidity injected
- Several bubbles appear
  - Real Estate (ex: US, UK, Spain)
  - Credit Market
    - Aggressive and reckless lending
    - Deterioration of credit spreads
  - Structured Credit Products
  - Some sovereigns allowed excessive borrowing – in turn allowing for reckless spending (including taking long-term commitments)

"I can assure you there is nothing wrong with the bank not opening - my train was late!"

'Your card is fine. I'm just checking that your bank hasn't expired'

What happened this time? (panic)

- Where did the panic came from?
  - Subprime Mortgage Lending
- Why was it so serious?
  - Exposures to *subprime* were spread via securitisation
  - Mortgage Backed loans repackaged into highly leveraged Special Investment Vehicles
    - Which were financed by 6 month Commercial Paper
    - Panic lead to a complete stop in this and other interbank markets
  - The impressive growth of credit derivatives
  - Inadequate regulation and supervision
- Sovereign debt crisis
  - GIPSI's ….

"That's right, dear - take our money out and put it under the mattress."

"Is there any other business before we jump?"

Regulation and Supervision

- Regulation
  - Risk-based capital standards
  - In Basel II banks measure their own risks
    - Helped by Rating agencies
  - With IAS/IFRS banks mark-to-market their exposures
    - When market goes up exposures decline and capital goes up, but when the market goes down….
- Supervision
  - Reactive
  - Trusted Rating Agencies and Auditors

"It was either an earth tremor or another bank has collapsed."

"Who do you want to see first - a depositor, a borrower or a man from the FSA?"

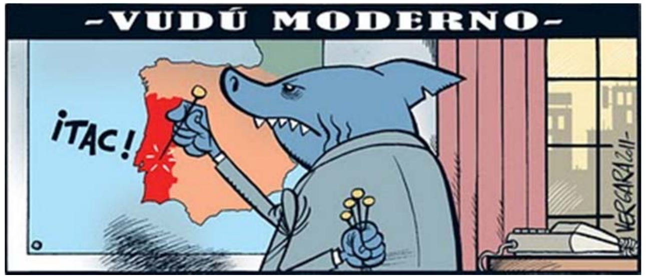
The Future

- What has changed in the Regulation / Supervision?
  - In 1932 a sequence of financial crisis was stopped by new and stringent regulation
  - The market was stable until the deregulation of the early 1990's
  - What about today's response?
    - Is "Basel 3" enough?
      - More capital on top of inadequate risk measurement inherited from Basel2 ?!!
    - When do we regulate credit derivatives?
- Incentive mechanisms in banks still encourage risk-taking
- Have the lessons been learned?

"It's in the newspaper your chairman received a £1,000,000 bonus. What did you get?"

What about Portugal?

- 2004-06 J.M. Barroso as Prime-Minister imposes budget stabilisation on top of Government agenda
- 2006 – Socrates becomes Prime-Minister
  - 2006 Luís Cunha as Finance Minister
    - the Bank of Portugal upwardly revises Barrosos' deficits
    - Budget stabilisation on top of the agenda
  - 2007 -11 Teixeira dos Santos as Finance Minister
    - Officially reached the "lowest" deficit ever in 2008
    - However strong "off-balance sheet" accounting going on
    - Main problems: Health Sector; PPP's; Social Security; Government-owned companies (transportation, roads)



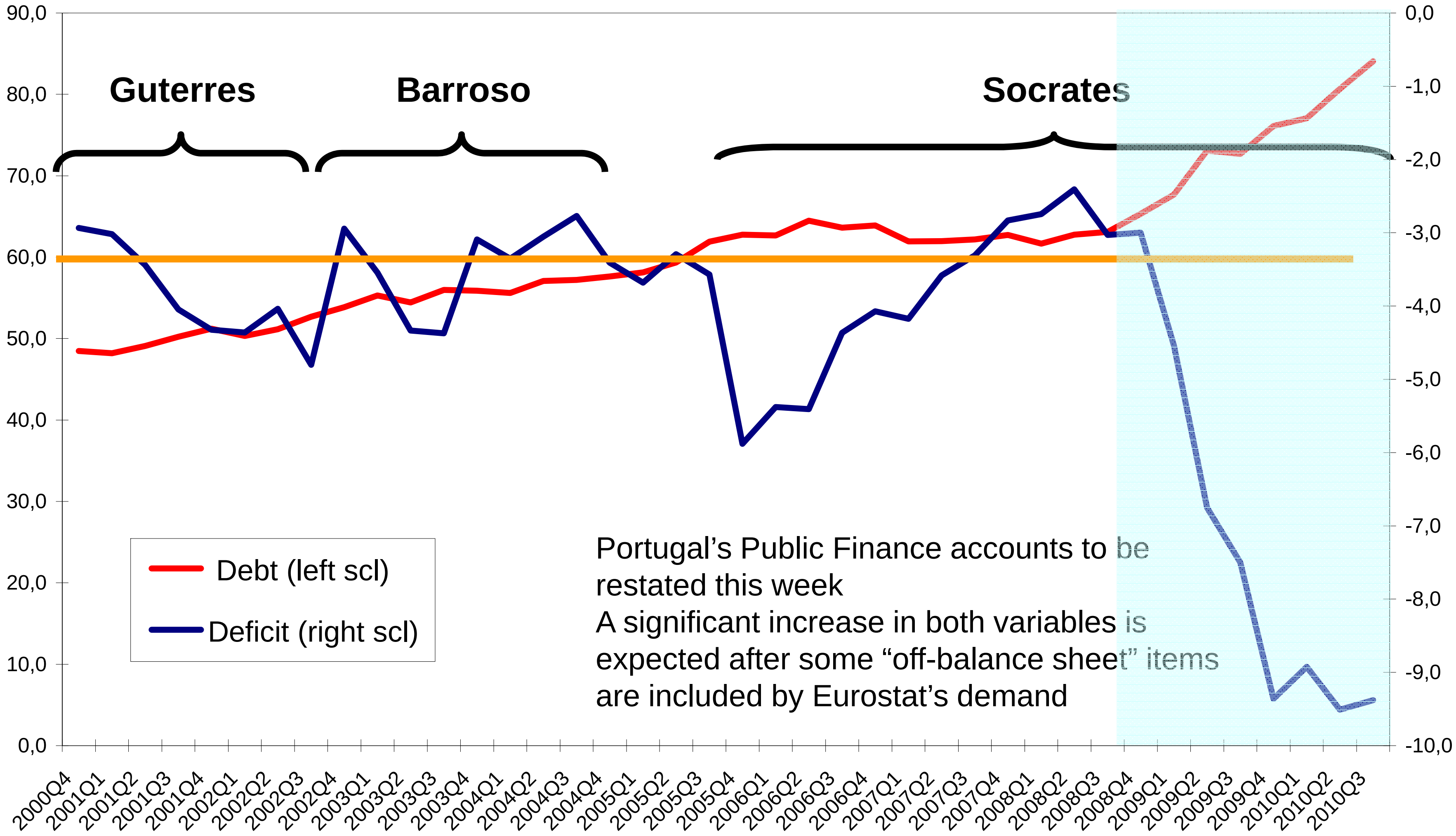
The sovereign-debt crisis

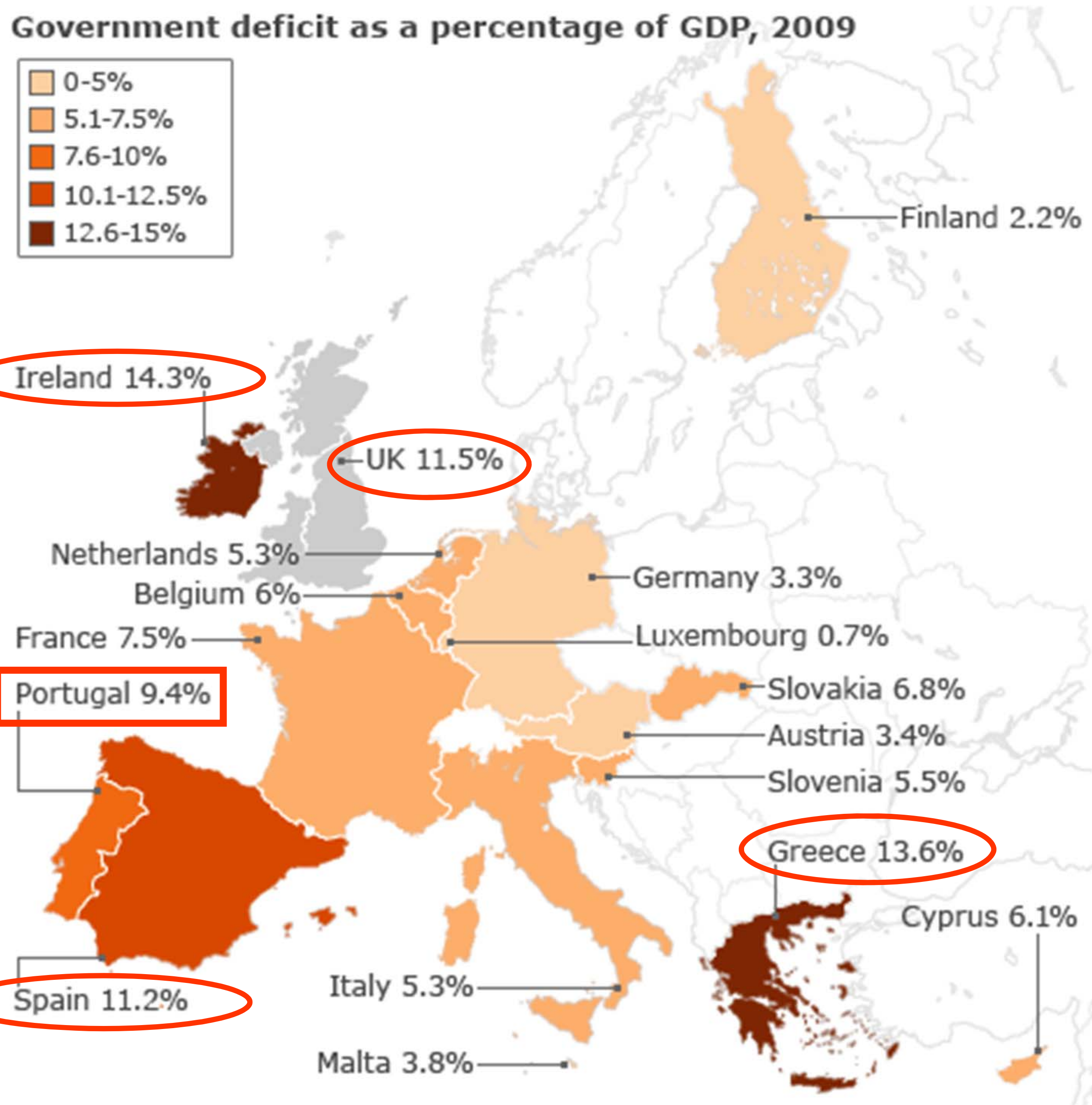

PHOTO: FRANCISCO LEONG/AFP/GETTY IMAGES

- Government budget affected by recession
  - Significant impact on Tax Revenue
  - Increased Government Subsidies
- Government Response
  - Increased Taxation (VAT from 19% to 23% in 4 years)
    - Increased income taxes
  - Reduced Social Spending (unenployment benefits, pensions, etc)
    - Pension System Reform
  - Public servants' pay frozen or lowered (up to 10%)
  - Creative accounting
  - Public sector "architecture" mostly untouched
  - Budget deficit deepens
  - In 2009 Budget stabilisation announced right before election
    - Taxes lowered; Civil servants received pay rise
  - By 2011 all Government financial credibility lost
  - Speculative attack?
  - Government collapses in March 2011

"I didn't get the government job. They said I lacked experience in *deficit spending*."

Government Debt and Deficit (% GDP)



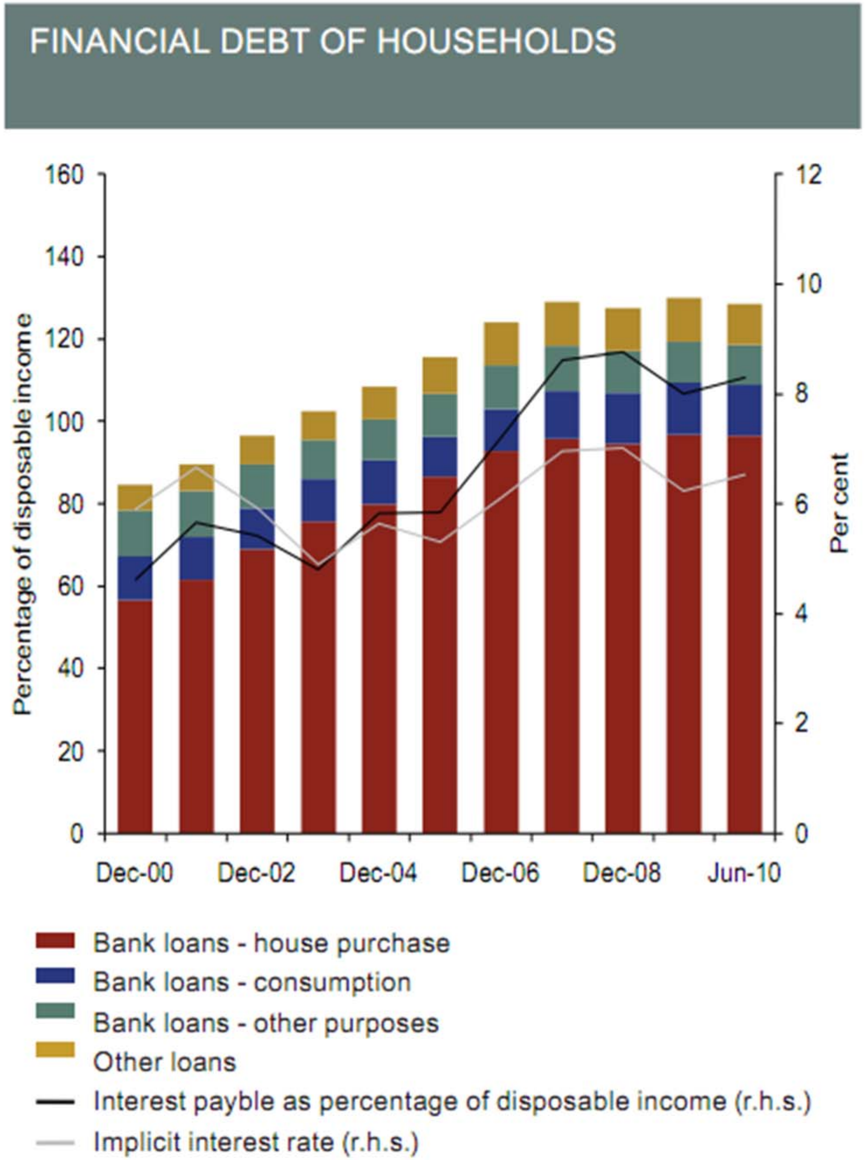

Government deficit as a percentage of GDP, 2009
0-5%
5.1-7.5%
7.6-10%
10.1-12.5%
12.6-15%
Finland 2.2%
Ireland 14.3%
UK 11.5%
Netherlands 5.3%
Germany 3.3%
Belgium 6%
France 7.5%
Luxembourg 0.7%
Portugal 9.4%
Slovakia 6.8%
Austria 3.4%
Slovenia 5.5%
Greece 13.6%
Cyprus 6.1%
Italy 5.3%
Spain 11.2%
Malta 3.8%

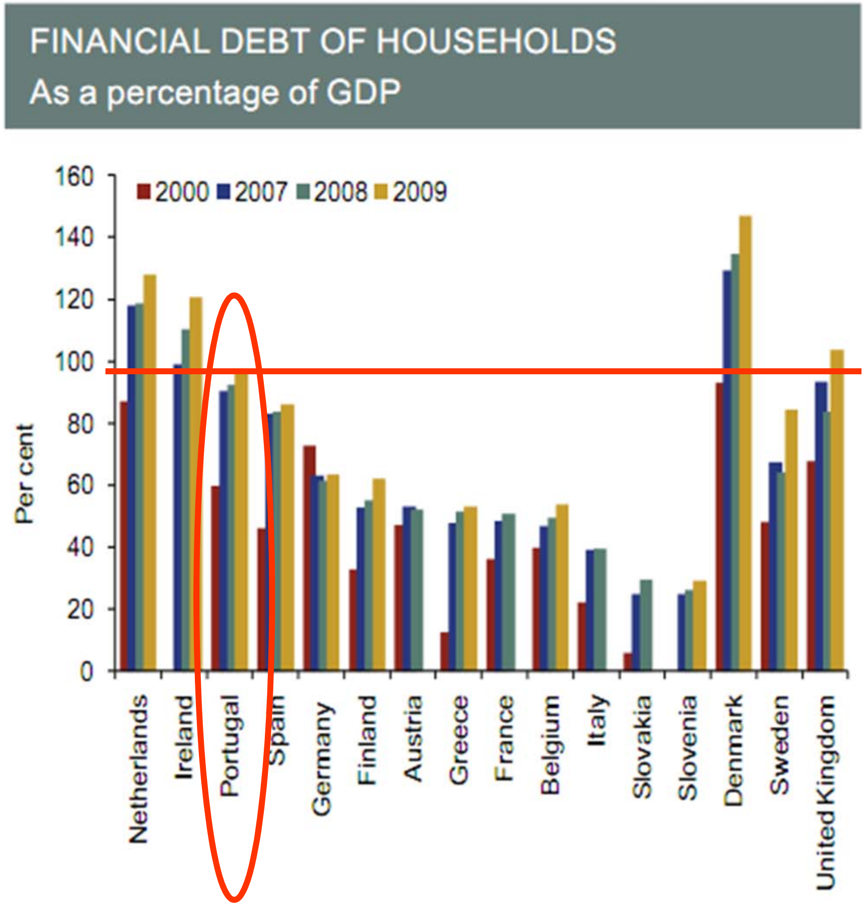
Sovereign 10-year bonds

Implications for the Financial Sector

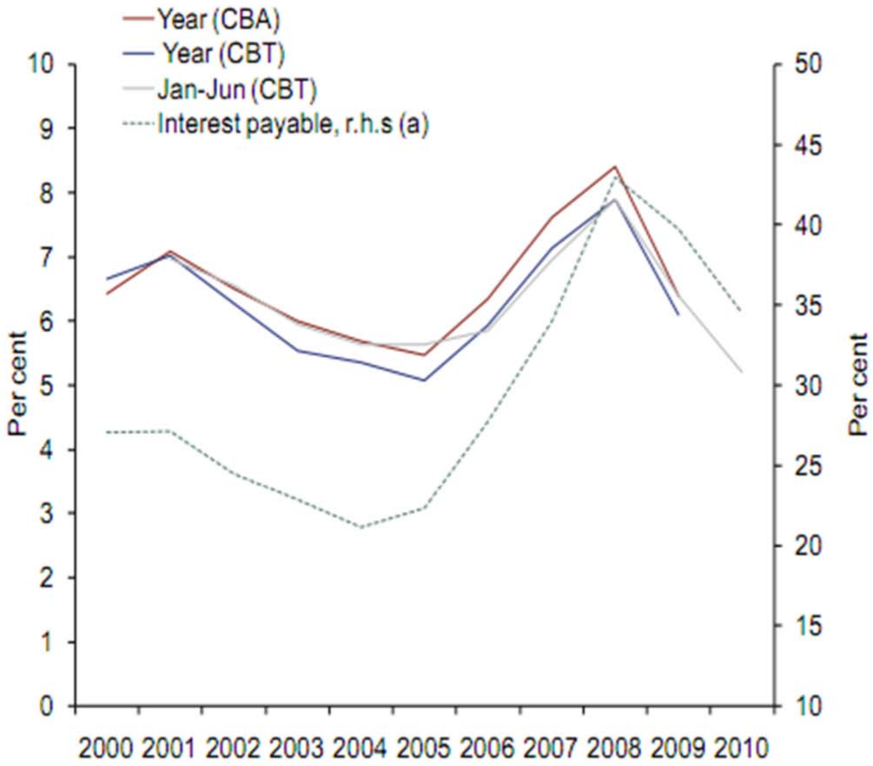
- Government debt's credit rating lowered in successive rounds
  - So was the bank's (even this week)
- Banks loose access to money markets
  - Face serious liquidity constraints
  - Despite being more solid than most EU counterparts
  - ECB progressively becomes single source of funds
    - Banks start the ECB/ Govt debt financing spiral
      - Borrow at 1% -> buy debt with >7% yield -> rediscount at ECB 1% -> buy more bonds @ >7% -> ………..
    - Some other forms of repos possible until recently
  - What will happen after June?

"Hey, we're government accountants. These numbers aren't supposed to add up."

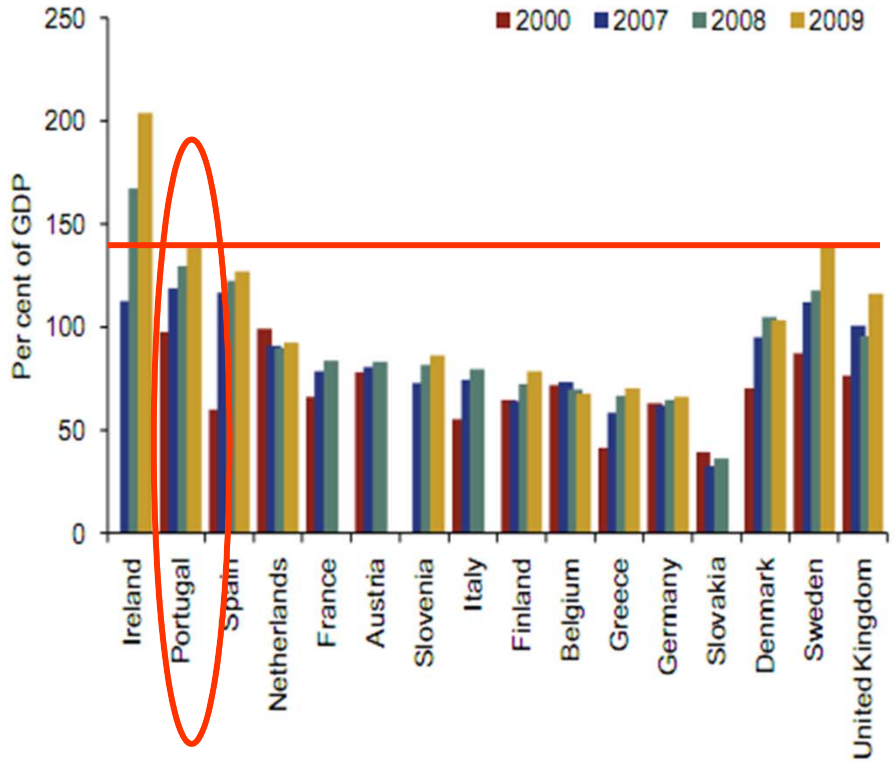

FINANCIAL DEBT OF HOUSEHOLDS
160
140
120
100
80
60
40
20
0
12
10
8
6
4
2
0
Percentage of disposable income
Per cent
Dec-00
Dec-02
Dec-04
Dec-06
Dec-08
Jun-10
Bank loans - house purchase
Bank loans - consumption
Bank loans - other purposes
Other loans
Interest payble as percentage of disposable income (r.h.s.)
Implicit interest rate (r.h.s.)

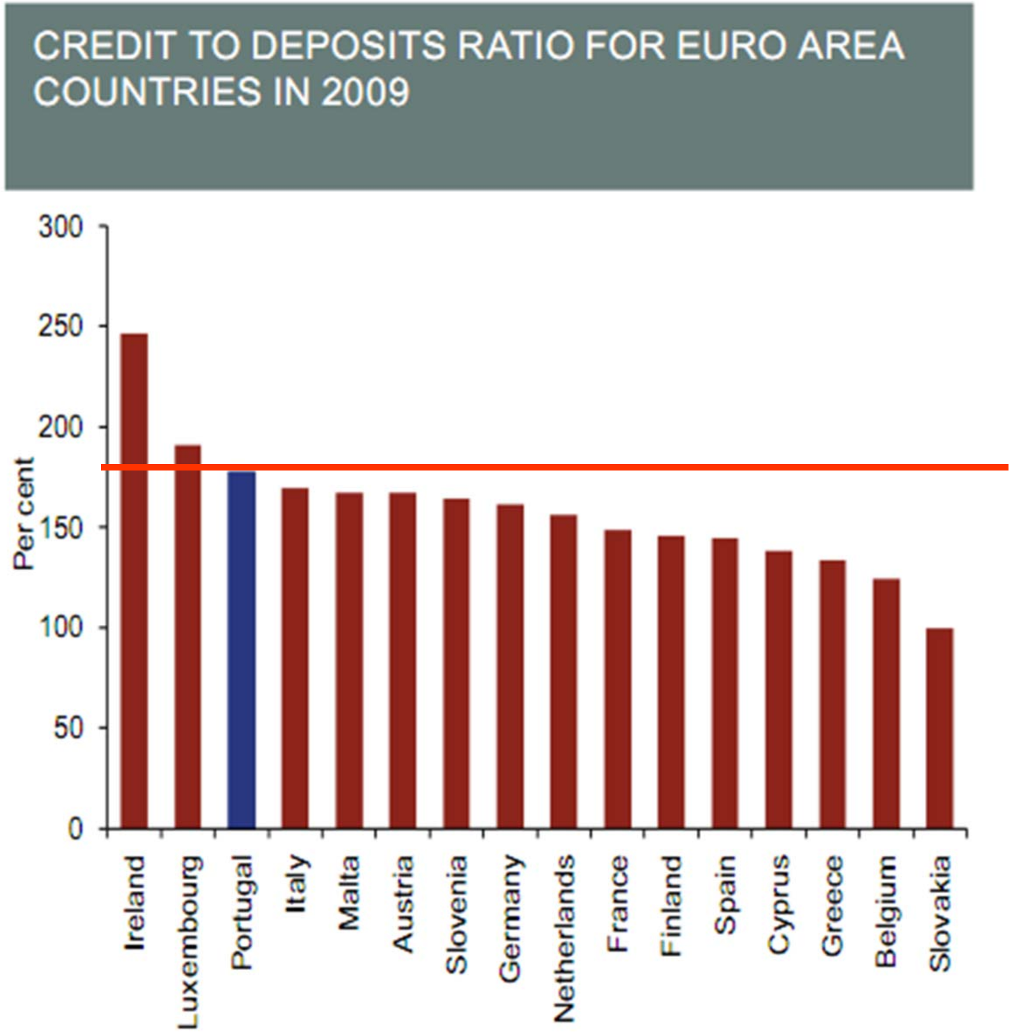

FINANCIAL DEBT OF HOUSEHOLDS
As a percentage of GDP
2000
2007
2008
2009
160
140
120
100
80
60
40
20
0
Per cent
Netherlands
Ireland
Portugal
Spain
Germany
Finland
Austria
Greece
France
Belgium
Italy
Slovakia
Slovenia
Denmark
Sweden
United Kingdom

DEBT COST



FINANCIAL DEBT OF NON-FINANCIAL CORPORATIONS

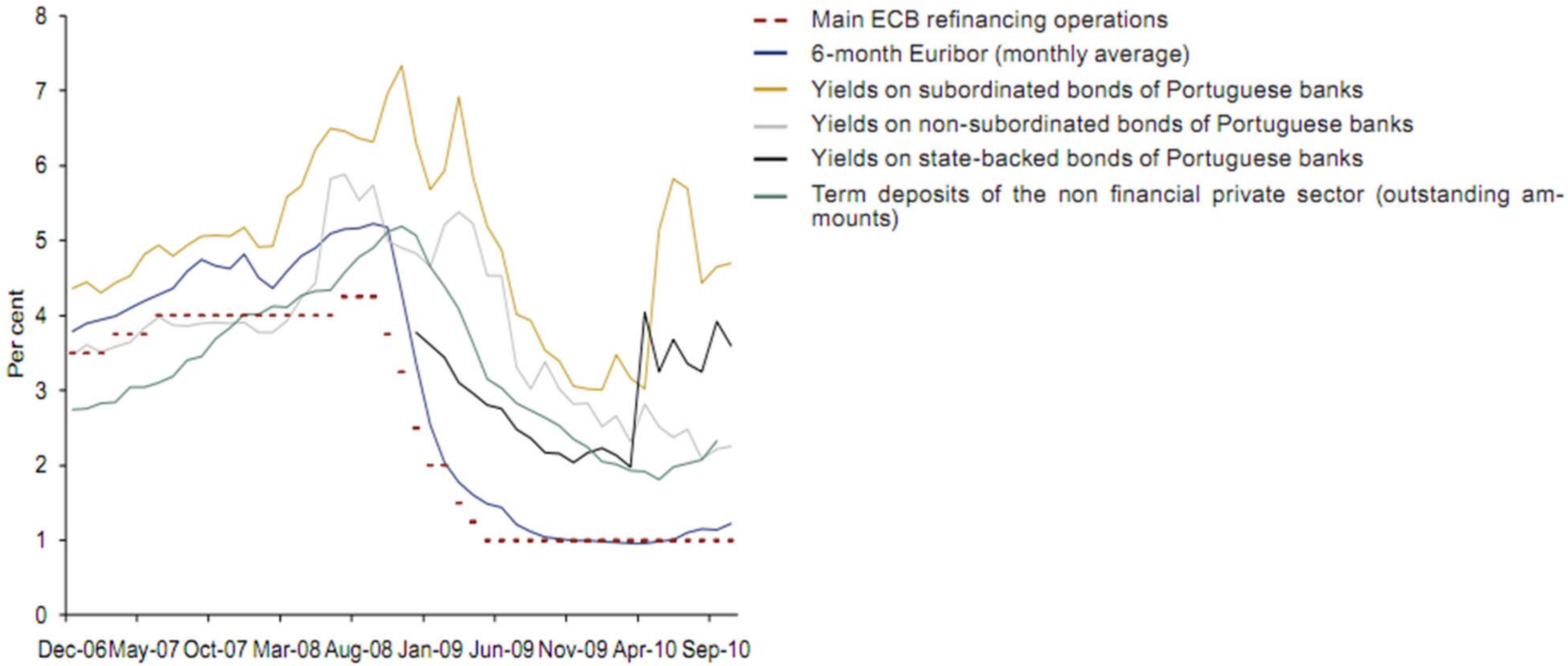




Source: ECB (*EU Banking Stability Report - September 2010*).

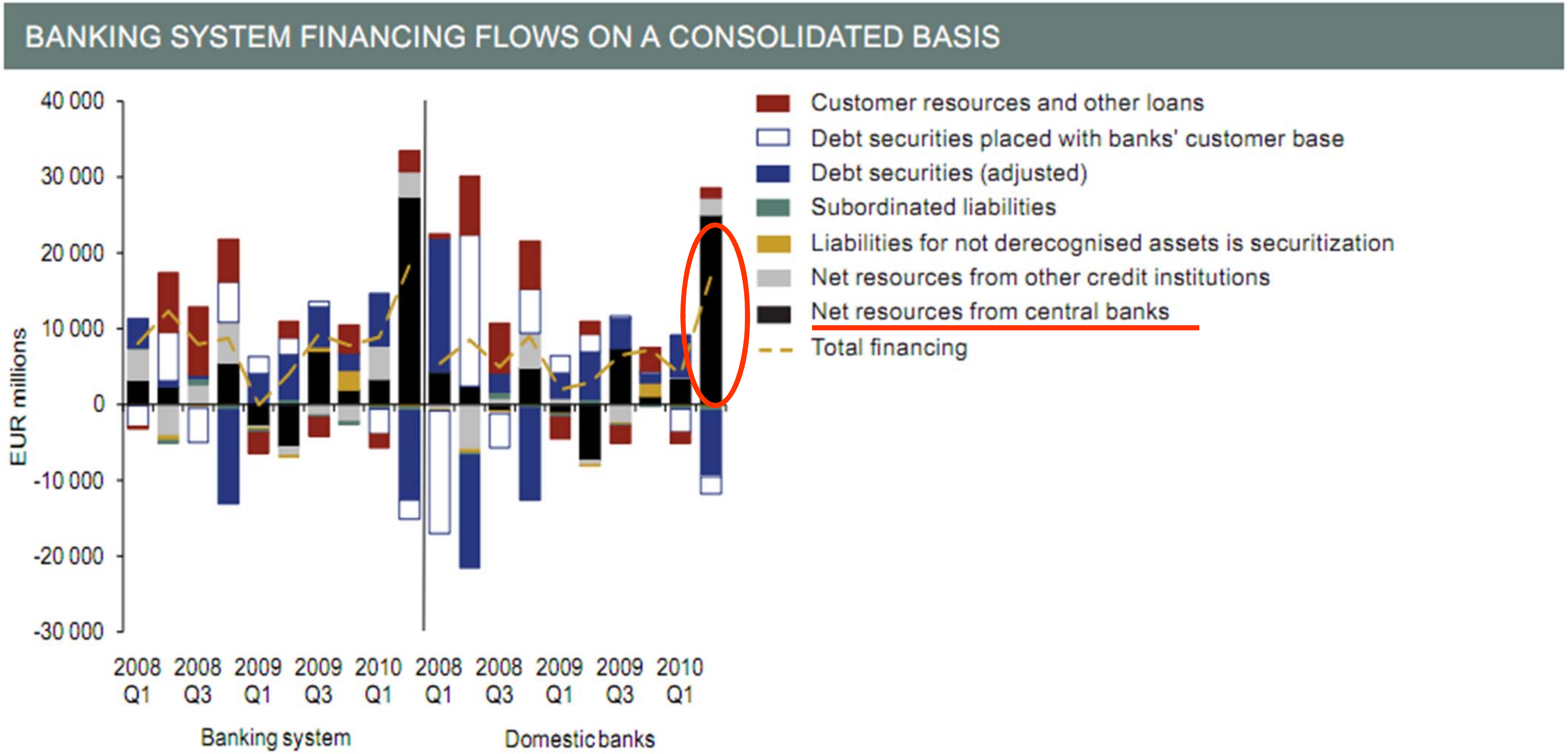
Note: The credit aggregate considered includes interbank loans and securitised and non-derecognised credits.

COST OF FINANCING FOR PORTUGUESE BANKS



Sources: Bloomberg and Banco de Portugal.

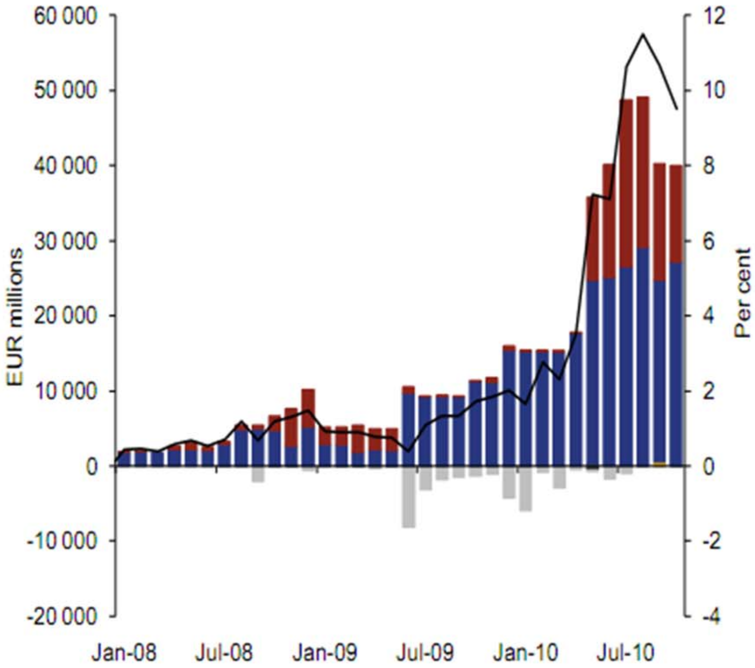
Note: The series with yields on bonds issued by Portuguese banks refer to a weighted average of bonds from *BCP*, *BES* and *CGD*. The lack of depth in the market has a strongly restrictive effect on bonds with comparable characteristics within each segment and the rates should therefore be considered merely indicative. Bonds issued with a state guarantee are subject to a commission to be paid to the government of 50 basis points, to which a risk premium for the credit default swap of the bank itself (or similar banks, if there are no CDSs for this issuer) is added if the maturity is longer than one year.



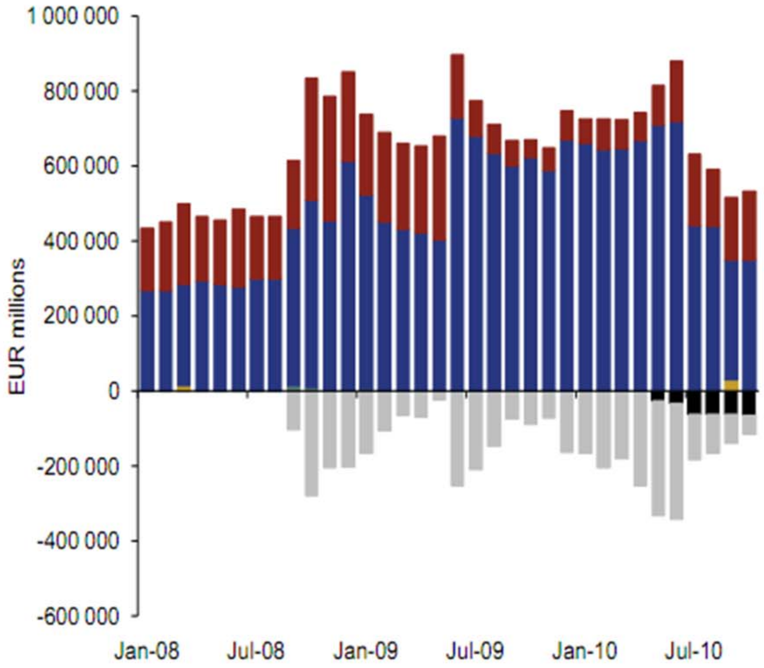
Source: Banco de Portugal.

Notes: The estimates for securities issued by banks but placed with their costumer base are excluded from the item "Debt securities". There is a series break in mid 2007 which corresponds to an enlargement in the number of institutions analysed.

OUTSTANDING AMMOUNTS OF MONETARY POLICY CREDIT AND DEPOSIT OPERATIONS OF PORTUGUESE BANKS



OUTSTANDING AMMOUNTS OF MONETARY POLICY CREDIT AND DEPOSIT OPERATIONS OF PORTUGUESE BANKS

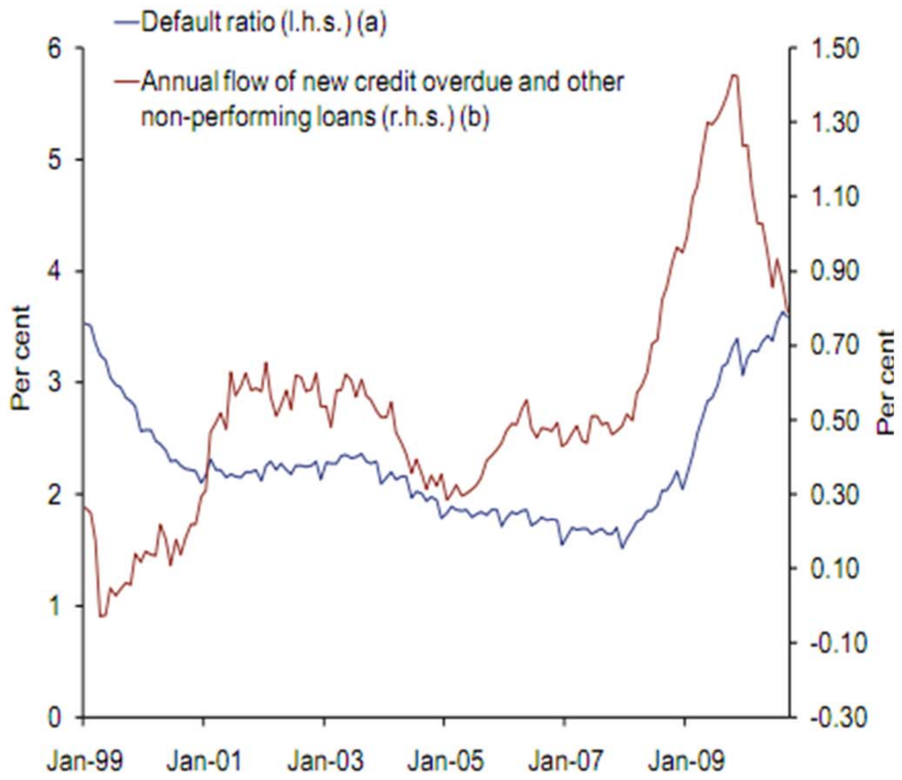


- Main refinancing operations
- Longer-term refinancing operations
- Marginal lending facility
- Other liquidity provision operations[a]
- Deposit facility
- Other liquidity absorption operations[b]
- Share of the Portuguese banking system in total Eurosystem financing

Source: Banco de Portugal.

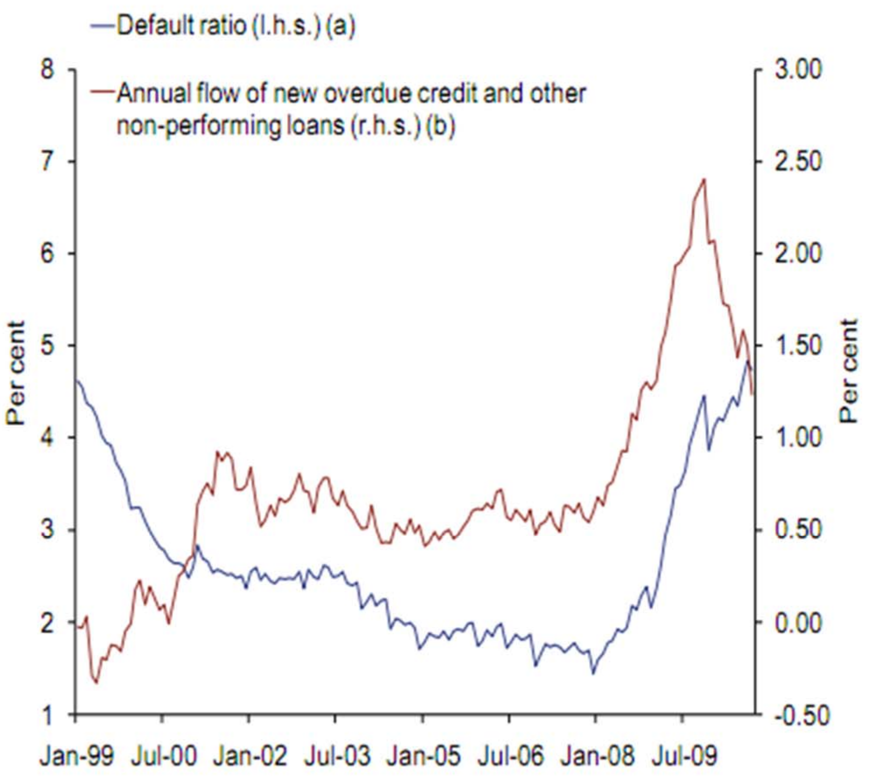
Notes: (a) Includes "Fine-tuning operations" and "Structural operations". (b) Includes Fixed-term deposits" and "Reverse transactions".

DEFAULTS IN BANK LOANS TO THE RESIDENT NON-FINANCIAL PRIVATE SECTOR



Source: Banco de Portugal.

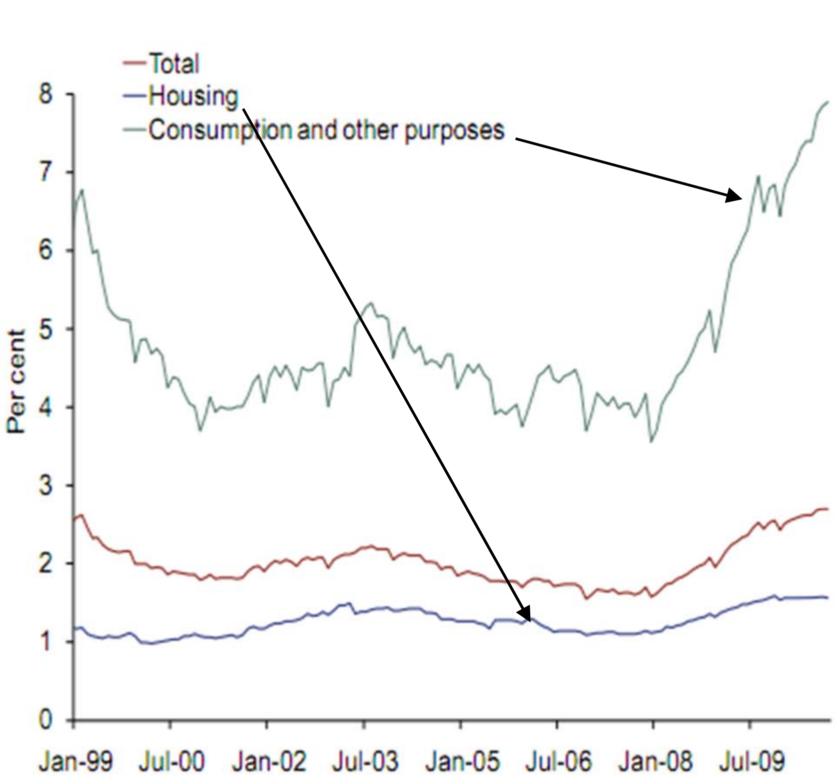
DEFAULTS ON LOANS TO NON-FINANCIAL CORPORATIONS



Source: Banco de Portugal.

DEFAULT RATIOS ON BANK LOANS

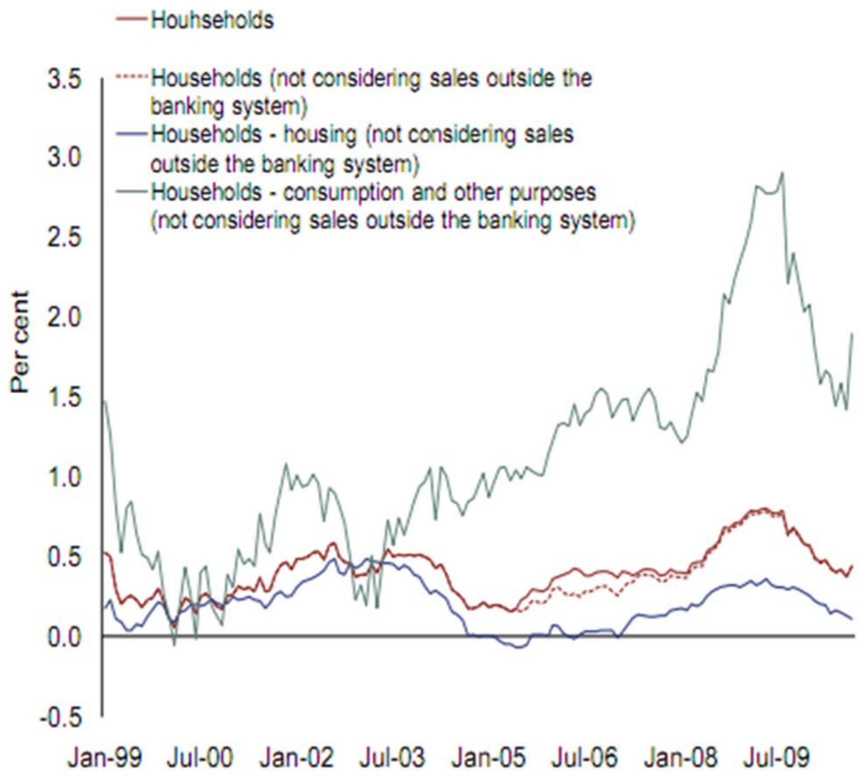
Households



Source: Banco de Portugal.

ANNUAL FLOW OF OVERDUE CREDIT AND OTHER NON-PERFORMING LOANS

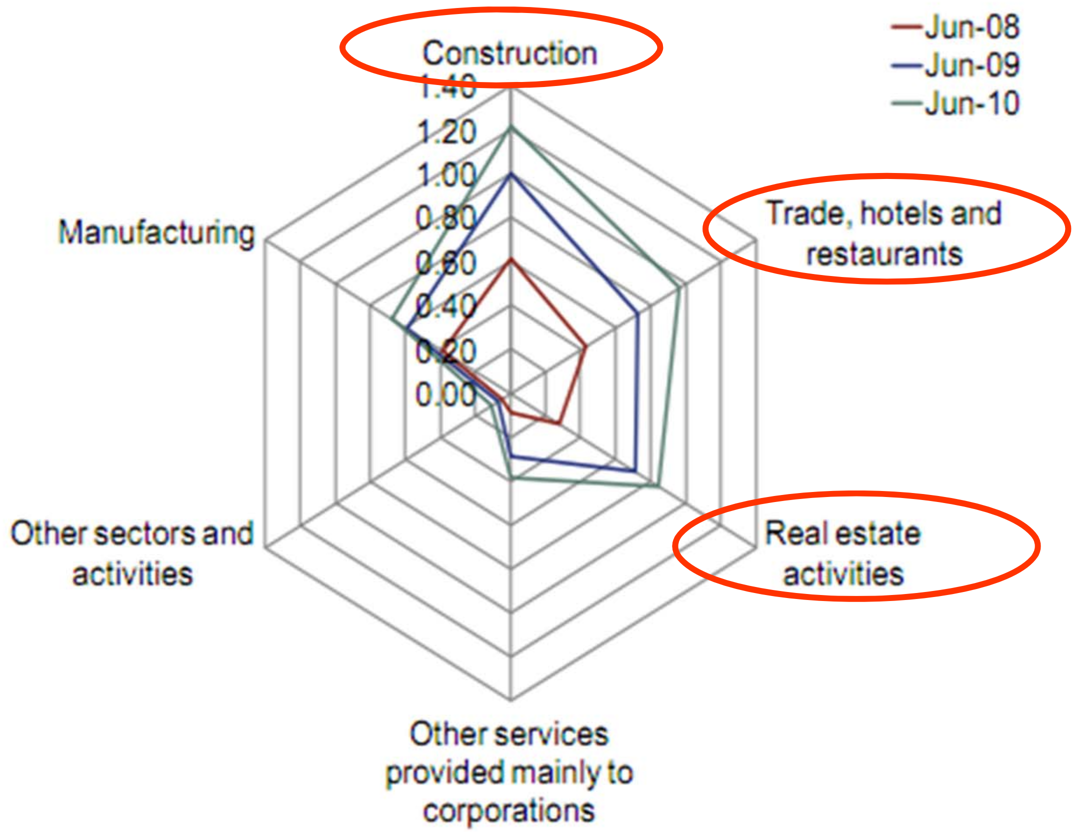
Households



Source: Banco de Portugal.

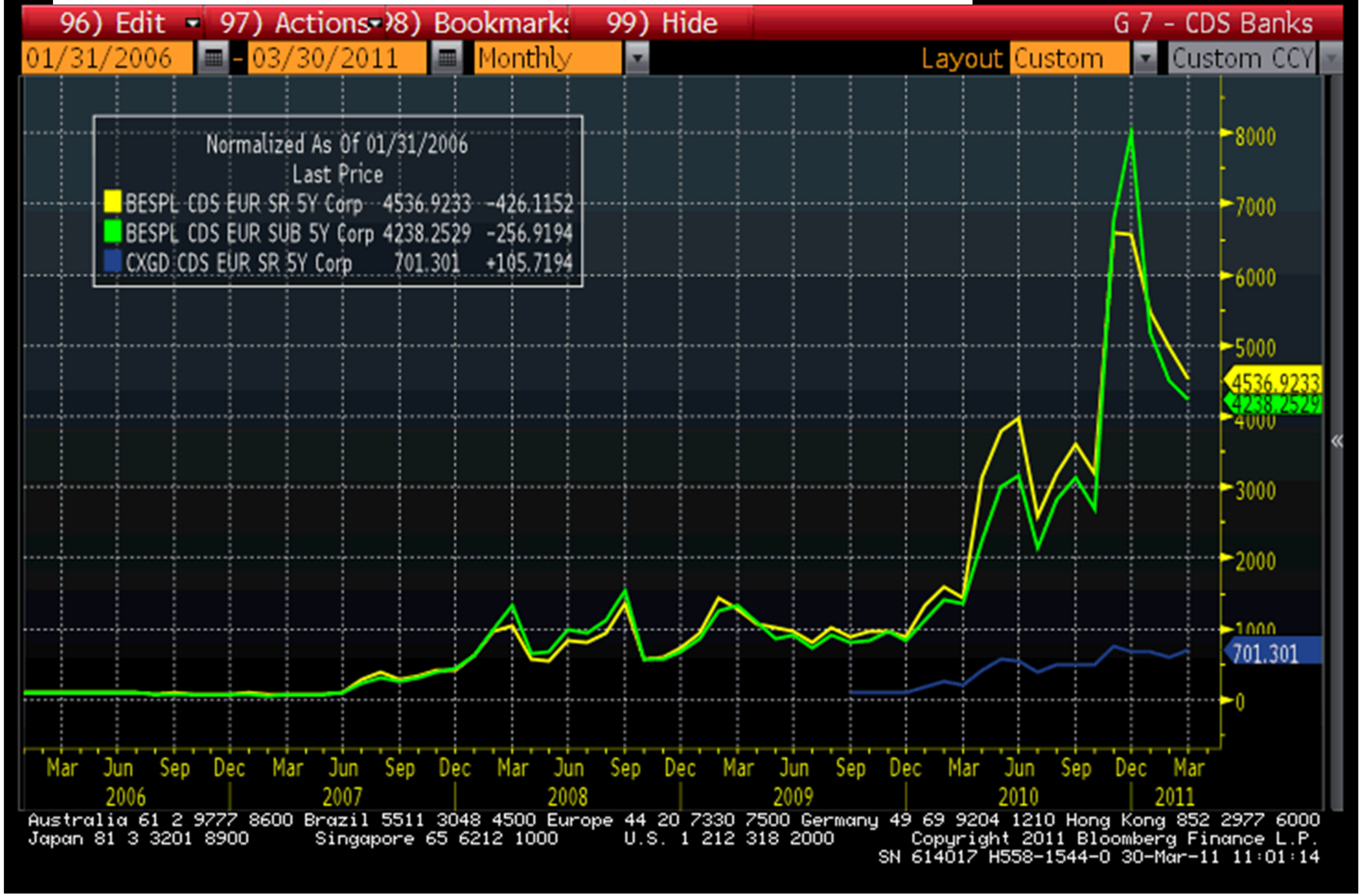
DEFAULT RATIO OF NON-FINANCIAL CORPORATIONS

Sectoral contribution



Source: Banco de Portugal.

Credit Default Swaps – Major Banks



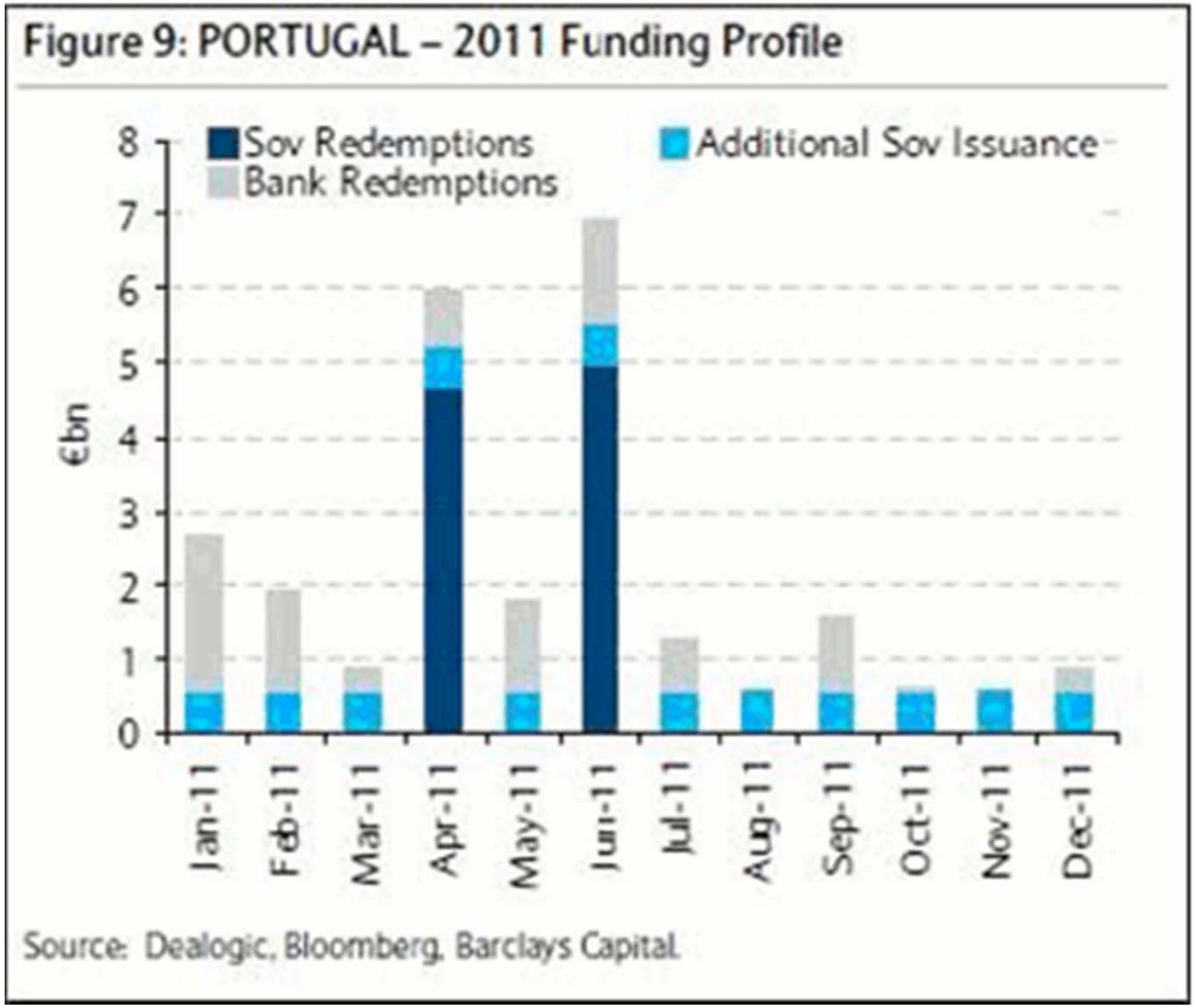


Figure 9: PORTUGAL – 2011 Funding Profile
Sov Redemptions
Bank Redemptions
Additional Sov Issuance
€bn
8
7
6
5
4
3
2
1
0
Jan-11
Feb-11
Mar-11
Apr-11
May-11
Jun-11
Jul-11
Aug-11
Sep-11
Oct-11
Nov-11
Dec-11
Source: Dealogic, Bloomberg, Barclays Capital

"She sings of the pain of a €9 billion bond redemption by June"

Prospects for families

- Reduced salaries and pensions
  - Especially in the public sector
- Increased Taxes
- Increased inflation
  - Stimulated by Global bubbles
- Increased unemployment
- Increased interest payments
  - Higher mortgage instalments
- Higher mortgage and consumer loan defaults

Prospects for Companies

- Tougher tax impositions
- Reduced credit availability
  - Liquidity problems
  - Higher interest rates and even higher spreads
  - Bankruptcies
- Falling demand on domestic market
- Cheaper labour due to unemployment
- Property crisis?

Wednesday Mar 30 2011
All times are London time

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Portugal and Brazil: role reversal

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The EU finds Portugal troubling: no government, high resistance to austerity and chronic economic underperformance (gross domestic product has stagnated for a decade). Negotiations are tough.

Here is an out-of-the-box way to deal with the situation: annexation by Portuguese-speaking Brazil (a decade of 4 per cent annual GDP growth, much higher recently). Portugal would be a big province, but far from dominant: 5 per cent of the population and 10 per cent of GDP.

Sure, the old colonist would resent the loss of status. But the former colony has something to offer, even beyond narrower credit spreads and proportionally much lower government and current account deficits. Brazil is one of the Brics, the emerging centre of world power. That sounds like a better home than the tired old EU.

E-mail the Lex team in confidence

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What now?

- Portugal is going through a tough stabilisation programme:
  - Reduced Economic Sovereignty
  - Increased Tax Revenue
  - Reduced Government Spending
  - Bank de-leveraging leading to liquidity crisis for corporate sector
  - Forcing economy into depression
    - Making difficult to generate tax revenue
  - The whole process taking the economy in a **downward spiral**
- Government needs re-engineering
  - Departments; PPP's; Govt Companies
- Some form of **debt restructuring** needed to bring economy back into growth and increased tax revenue