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# Strategies put to the test in the current global crisis – Which banking models are sustainable?

## Romanian Banking Forum – Discussion Paper

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# Agenda

A. Global crisis – what type, why and where to?

B. Impact on banking strategies/models

C. Future of Risk – strong reshaping of the function

D. Open discussion – what is likely to impact us in Romania

# A. Global crisis – what type, why and where to?

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# What crisis are we talking about? In fact, there have been four different crises

## Sub-prime crisis

- Falling house prices and rising interest rates in US lead to high number of people who could not keep paying their mortgages
- Packaging of risk/exposure to subprime sector in sophisticated products
- Intransparent tracing of subprime exposure among financial players

## Liquidity crisis

- Equity markets became very difficult/costly to access due to huge discounting
- Credit markets froze as banks became reluctant to take on more exposure, not knowing how many bad loans could be on the counterparty's books

## Financial crisis

- Major players not able to ensure short-term financing: Lehman Brothers, AIG, etc
- Stock markets plummeted
- Key failures in the framework of capital markets/regulations emerged
- Credibility/trust in the financial system at record lows

## Economic crisis

- Real consumer demand slow-down in certain sectors further worsened by perceived propensity away from consumption
- Reduced capacity and/or appetite for financing certain sectors
- Real and perceived financing difficulties for corporates lead to downward adjustment of growth prospects for key sectors

# Why? Looking behind the curtain, one could see several root causes

- Over-leveraging of households in a climate of cheap financing and short-termism – leading to current reduction of spending capacity
- Poor lending judgements in a bubble market
- Re-selling exposure in mixed products – thus combining exposure to sub-prime with exposure to other healthier sectors; the making of 'toxic products'
- Global distribution of toxic products in non-regulated manner
- Increased reliance on 'originate to distribute' strategies and over-leveraging – increasing overall risk of many financial players
- Poor and/or slow decision-making on the part of Governments/central banks – e.g. Lehman Brothers case, ECB conservatism

# Where to? We see three possible paths for the G7 world

Development scenarios after the world crisis – Which way will our global economy go?

| Scenario | Rapid Recovery | Extended Recession | Depression |
|---|---|---|---|
| Length & severity | • 6-12 months<br>• Slight economic dip | • 1-2 years<br>• Significant shrink in the global economy | • 3-5 years<br>• Dramatic and lengthy economic contraction |
| Affected areas | • Mainly financial industry with spillover in few sectors – e.g. automotive, real estate | • Majority of industries and regions of the world (except perhaps strong emerging markets like India or China) | • All industries and all regions of the world |
| Description | • Mainly one-dimensional crisis (financial crisis) | • Two-dimensional crisis (financial crisis and economic crisis) | • Three-dimensional crisis (financial crisis, real economic crisis and systemic crisis) |
| Possible measures | • Rescue packages to stabilize financial markets and encourage confidence | • Rescue packages doubled with economic programs | • Government and monetary policy interventions (little impact possible at this point) |
| Effects on economy | • Moderate effect on unemployment, inflation or consumer confidence | • Sharp rise in unemployment,<br>• Drop in inflation<br>• Increase in savings and government debt | • Soaring unemployment<br>• Deflating economy<br>• Decreasing confidence<br>• Protectionist tendencies and social tensions |
| Effects on business | • Erosion of value<br>• Light liquidity and refinancing problems<br>• Opportunities for cash-rich companies | • Collapse of sales and profits<br>• Need for restructuring<br>• Insolvency issues<br>• Opportunities for cash-rich companies | • Wave of insolvencies<br>• Chaotic business conditions<br>• Lack of investment<br>• Collapse of economy |

# B. Impact on banking strategies/business models

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# Excessive leverage in search of additional returns has been a major cause for financial sector failure

## Critical development path

**Phase 1:** Solid business

> Sufficient risk premiums are achievable
> Solid, stable balance sheet structures

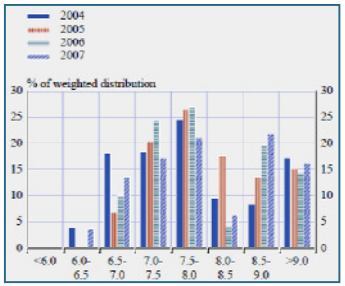
**But:**

> Constant pressure on margins through fragmented market, over-capacities

**Phase 2:** Additional returns via risk leverage

> First banks discover the possibility of additional returns beyond the original business, through risk leverage

Frequency distribution of Tier 1 capital ratios for selected bank groups in Europe

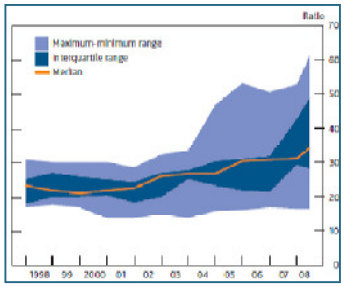



Source: ECB, Financial Stability Review June 2008

**Phase 3:** Pressure for risk leverage

> Traditional players are forced to use risk leverage, as the original business is no longer profitable

Leverage ratio of UK banks




Source: Bank of England, Financial Stability Report No. 24

**Market failure in crisis situations cannot be avoided**

**Regulating body will limit or prohibit risk-leverage**

**Question: If the risk leverage can no longer be used, are the remaining business models still profitable?**

# Are there any stable and profitable business models?

## Basic types of risk business models

| Risk management business models | Profit drivers | Examples | Future? |
|---|---|---|---|
| Take and keep risks | > Margin from client relationship<br>> Risk premium | > Buy-and-Hold for credit business | Will become basis for stable, sustainable business models |
| Transform risks | > Price differences due to information gap<br>> Commissions | > Originate-to-Distribute models in securitization | Past focus on information arbitrage will not be able to withstand the crisis |
| Speculative risk positions | > Price differences generated by market distorsions or market changes | > Credit Treasury, Proprietary Trading | Speculative positions will be rejected |
| No risks taken | > Service fees | > Private Banking | Will continue, but will not be able to support the entire industry through its volumes |

# Reorientation to stable, client-oriented businesses is key in sailing the uncertain financial waters of the present day

## Basic balance sheet structure

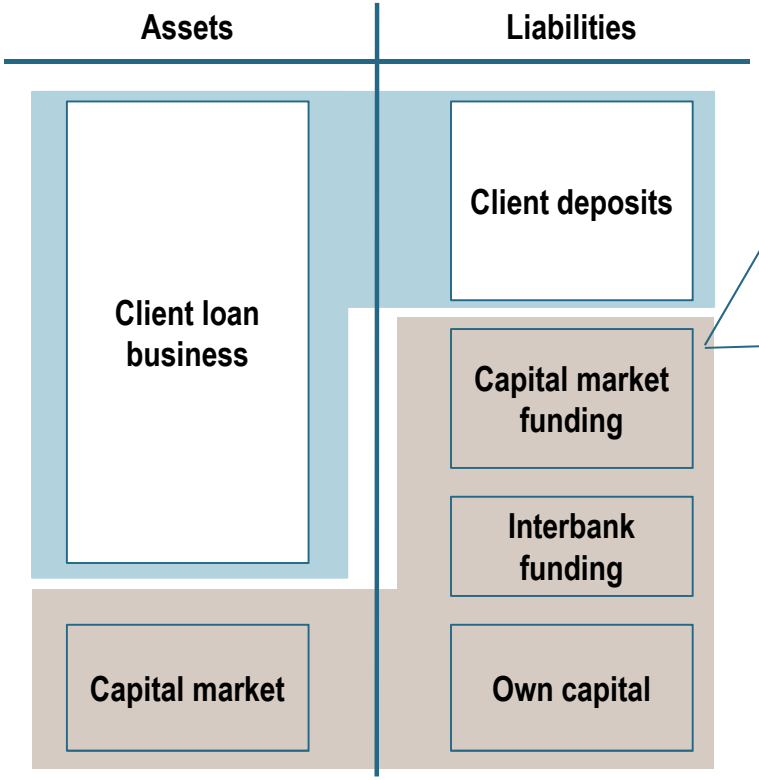
Approach:
- Client-oriented business models generate added value through the relationship

Question:
- Can the models become profitable?

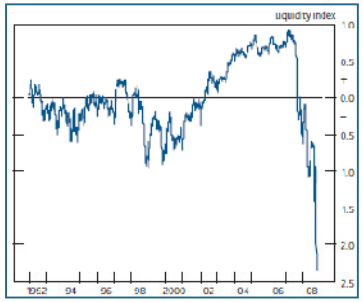
Premise:
- Functional funding markets

Relationship between three-month LIBOR to three-month OIS[1)]


Source:Bank of England, Financial Stability Report No. 24




Financial market liquidity




Source:Bank of England, Financial Stability Report No. 24

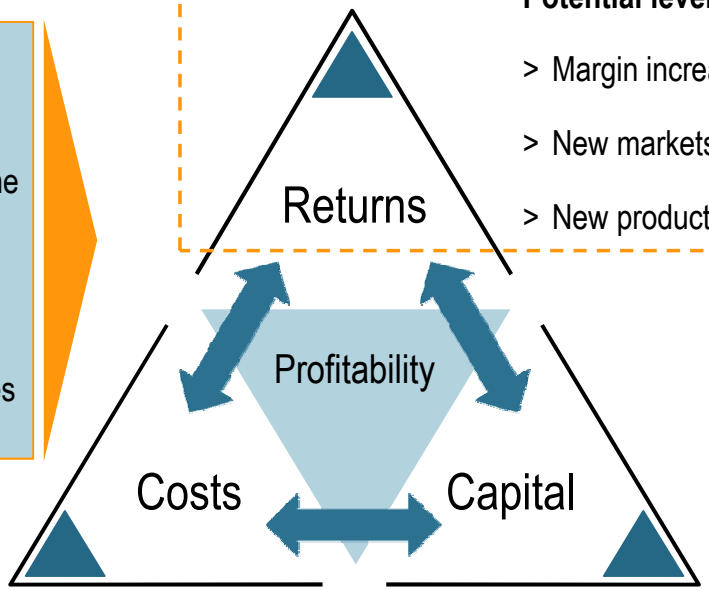
Funding and treasury function must support client-oriented business model

1) OIS: Overnight Indexed Swap

# How can profitability be improved? Banks have three levers at their disposal; Romanian banks largely use one

Profitability levers

**Overview on Romania:**
> Returns are still the key lever employed by local banks – margin conservation is one of the main current concerns
> Cost ratios are only now beginning to be tackled – the crunch is forcing providers to carefully consider sale capacities




**Potential levers:**

> Margin increase

> New markets/customer segments

> New products

**Efficiency improvement through:**

> Reduction of over-capacities → Already potential in Romania

> Process innovation → High potential in Romania

**Efficient use of capital:**

> Increasing core capital ratios put pressure on profitability

> Cycle management enforces the use of a capital buffer → Pressure on profitability

# C. Future of Risk – Dramatic reshape of the function

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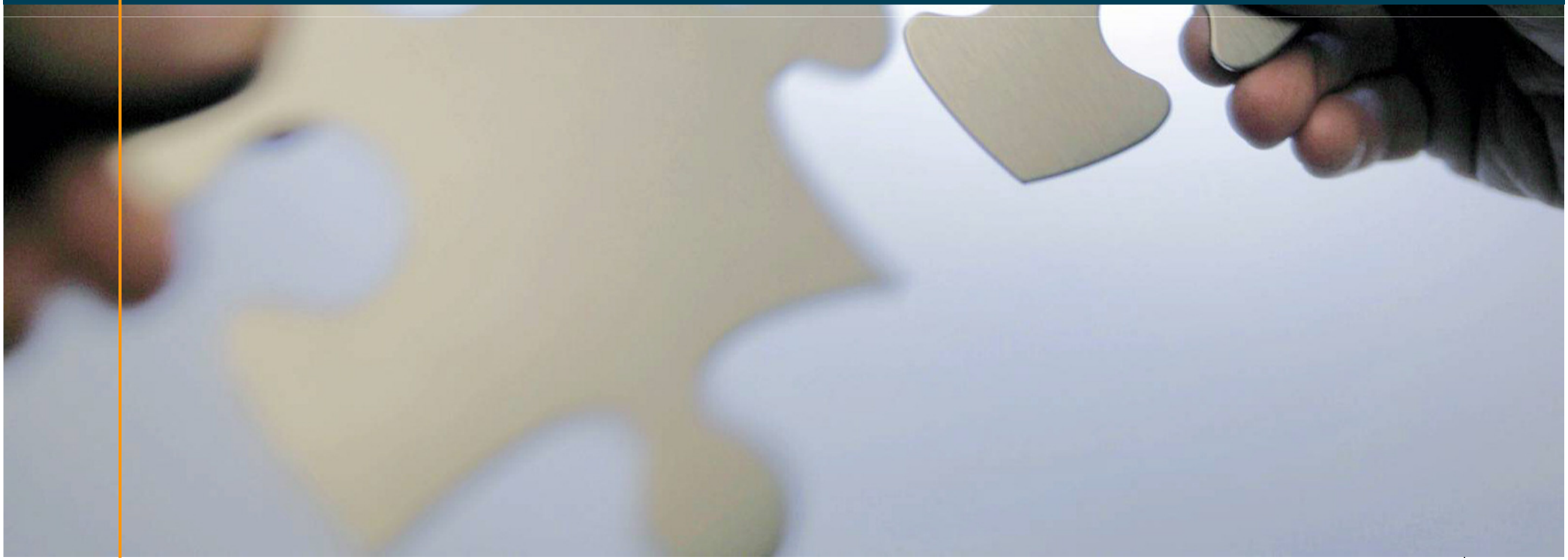


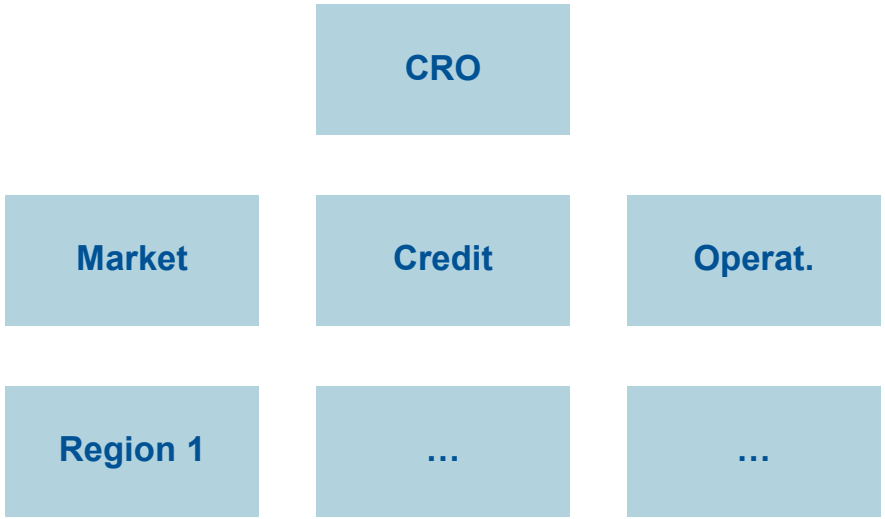
# The future of Risk – what trends can be seen?

1 Break up of silos

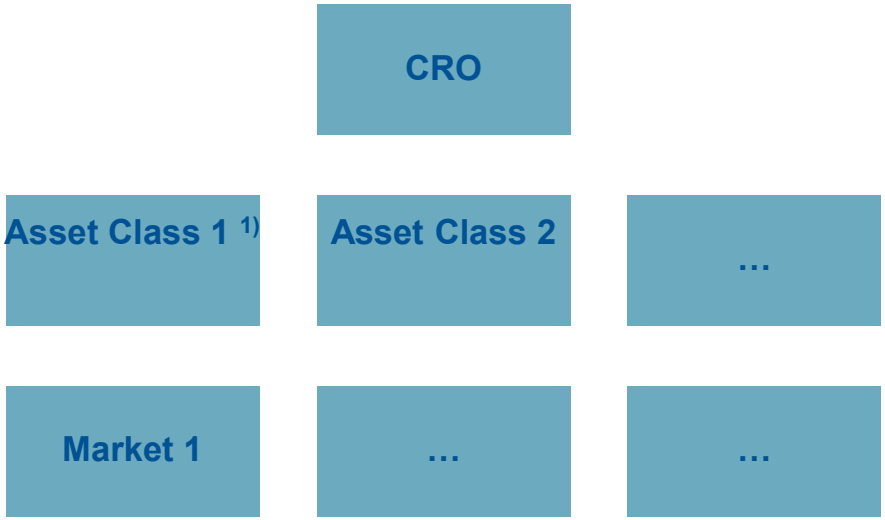
# The future of Risk – what trends can be seen?

## 2 Shift in Organizational Principles

### Risk Type Centered Organization




### Asset Class Centered Organization

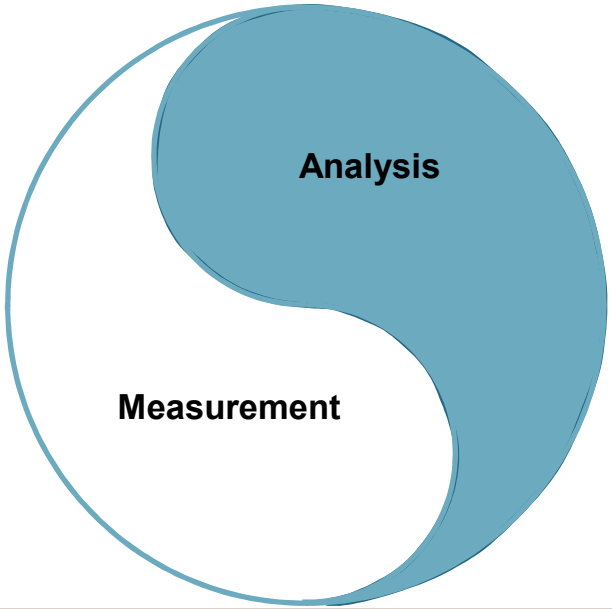



1) Leveraged Finance, etc.

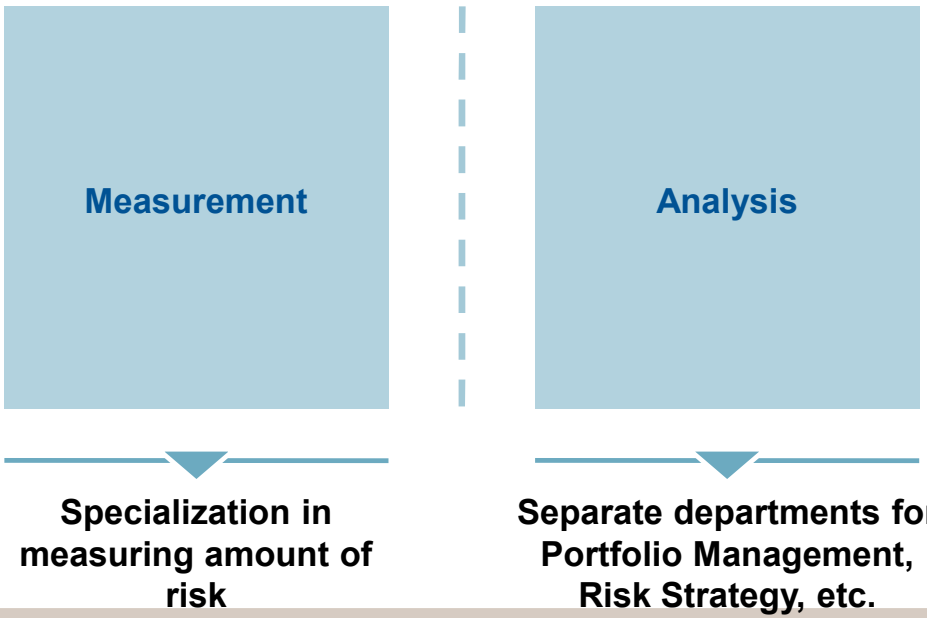
# The future of Risk – what trends can be seen?

## 3 Organization

### Today

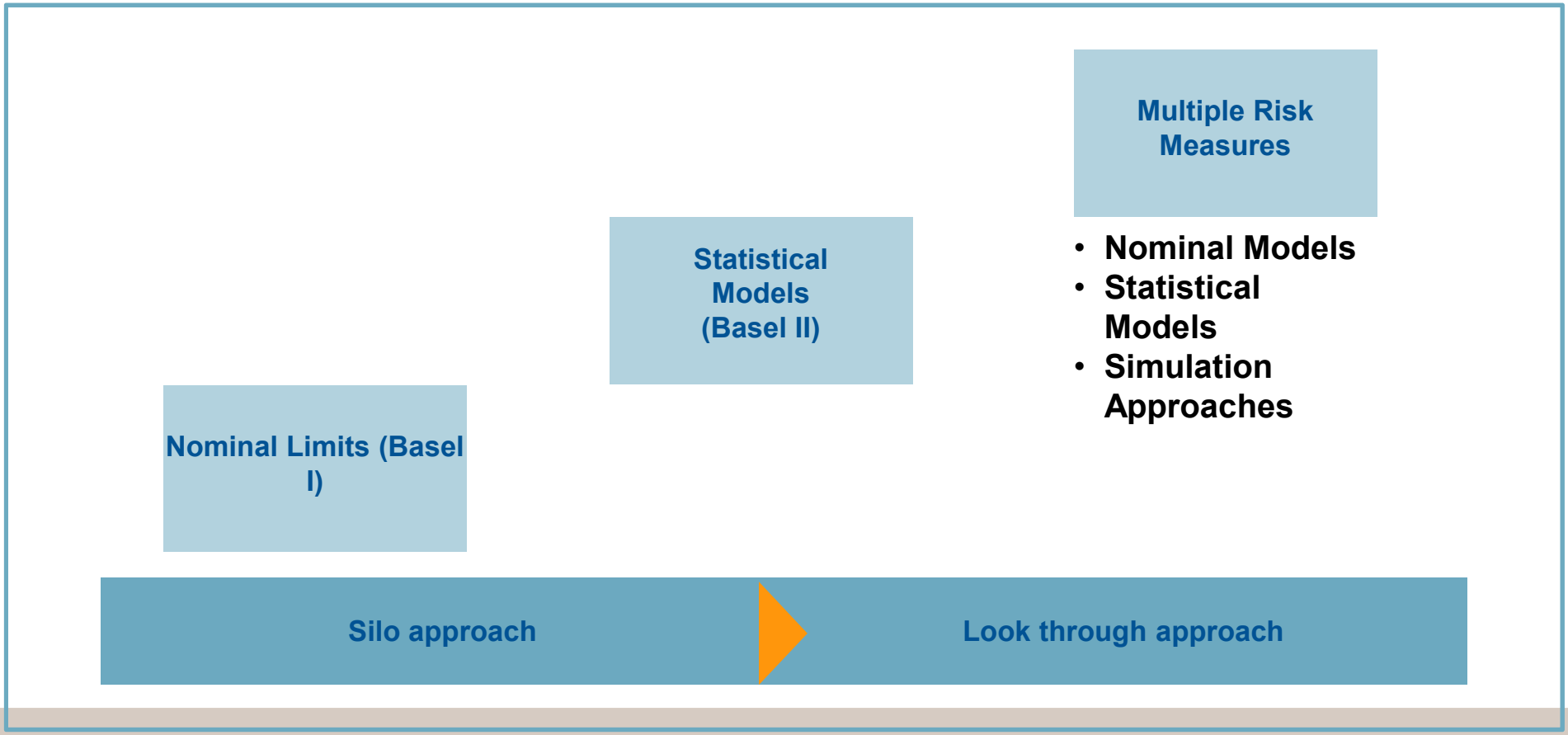



### New



# The future of Risk – what trends can be seen?

## 4 Methodologies – No exclusive reliance on statistics



# The future of Risk – what trends can be seen?

**Risk is not only a limiting function, but**

- **Forward looking (not volatility; Trends!) using scenario analyses**
- **Portfolio Management**
- **Independence / Effectiveness**
- **Break up of silos**
- **Look through approach**
- **Product design under risk perspectives**

**Enforce changes through organizational transformation**

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# D. Impact in Romania – open discussion

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