Risk Reward

riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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10 KEY PREDICTIONS FOR 2011

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HELICOPTERS DROPPING MONEY OR THE NEED FOR A NEW WORLD ORDER

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It has been a while since we have returned to this subject in the Global Risk Update. But as the global market lurches between disasters it is only right to think about what has happened, what is likely to happen in the future and what we need to prevent it.

We have long held the view that it was a failure of consistent regulation and accounting standards combined with a lack of global coordination that was at the heart of the crisis. The decision taken that effectively undermined the securitised asset market and led to the lack of confidence between financial institutions resulting in a liquidity crisis is where the blame perhaps really lies.

Was the world banking and finance community taking too much risk?

The idea that a company, bank or government borrows to invest and thereby creates wealth is well understood. This requires the banks to operate in a market of certainty where controlled risk taking is encouraged. Unfortunately the heart of the issue was and remains that government borrowing is distorting the capital markets. The problem is that actions by governments internationally (so-called quantitative easing) will eventually exacerbate a really problematic situation.

For every $10 that is taken off the balance sheet of a bank the government borrowing increases by between $50 and $100 depending on the credit quality of the borrowing party. With some of the most indebted countries in the world having some of the best credit ratings we end up with a ludicrous international business model. Basically the profligate submerging economies are receiving assets from the emerging economies. Worse than that rather than using this for investment that creates wealth, the funds are disappearing into the general taxation pot.

The Next Crisis

There will continue to be financial crisis until such time as the underlying cause – global economic imbalances, are actually dealt with, together with the reigning in of profligate countries. Another issue is actually the new regulation, referred to as Basel III, but actually being implemented through amending sections with Basel II. Of course Basel II had not been fully internationally implemented prior to the commencement of the crisis, so we have no real idea whether it would have made a difference or not. Our suspicion is that it would not have done so, but it is nowhere near as dangerous as the new proposed changes.

What the requirements will do for the internationally recognised banks is enforce an asset reduction on them. This will occur for a number of reasons, but estimates on the growth in risk weighted assets that will occur do vary considerably. We expect that increases will be between 30% and 70%. While it is difficult to estimate what this will mean for certain two responses can be anticipated.

1. Many banks will be seeking to raise significant amounts of new equity capital at the same time

2. Global GDP will probably decline by between 5% and 10%

In coming to this estimate we take into account of the information presented by the BIS itself. But matters are worse than that. Not only do the banks need to raise large amounts of capital but they will be doing so exactly when a large number of governments either have to raise new capital or refinance existing capital. In the absence of global coordination it will all end in tears with someone, somewhere defaulting – possibly an AAA rated government.

The Problem of Global Coordination

Capital is global. It moves between institutions, countries and continents and can go anywhere. In terms of international bodies we have the following:

- The Bank for International Settlements

  BANK FOR INTERNATIONAL SETTLEMENTS

  This is a committee of central bank supervisors who are designing international rules. They do not represent anyone other than central bankers. There are no representatives of banks, customers, society or politicians on the group. Accordingly they are limited in their outlook and approach.

- The Committee of European Banking Supervisors

  CEBS

  Another interesting group of supervisors who produce a range of interesting papers. They also have the same problems of the BIS.

- The United Nations

  A governmental body where everyone is – but not the banks, regulators, customers or society.

- The World Bank

  Another political body that fulfils certain international requirements but does not involve itself with economics.

- The International Accounting Standards Board

  International
  Accounting Standards
  Committee Foundation®

  An essentially unaccountable accounting standards setting body

So there is no body that has the strength or role of coordinating global liquidity or looking towards global systemic risk. Some national supervisors have attempted to win this ground, but they are unsuitable. So what do we need?

The Solution

We need a new world order for financial services and the global economy. Such leadership requires new structures and formats to meet legitimate challenges.

We propose the following:

1. A new International Capital Coordination Body be formed to develop the responses required by the global community
2. They should set up a global liquidity programme which is available to all licensed institutions in member countries
3. There should be 0.5% capital for each bank in a member country transferred to the ICCB to provide future liquidity
4. These funds should be available to global banks at a margin above their normal cost of funding – perhaps 75 basis points
5. Banks should receive a nominal interest charge on their deposits
6. All actions of the ICCB should be secret
7. The ICCB should also have responsibility for the coordination of capital issuance of its member countries
8. The ICCB should finally have responsibility for ensuring that international rules are:
   a. Coordinated
   b. Consistent
   c. Add value to the global community
   d. Improve systemic risk control

It is only by developing such a solution that we will be able to make real progress in these areas.

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