

Association of Professional Economists
of BC

December 8, 2009

Route to Recovery & Reform (Banking capital adequacy & Global monetary bubbles)

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Summary

A. Everything you wanted to know...

Macroeconomic imbalances spread into the financial sector (BoP deficits draw Capital)
World capital drawn into a shadow banking system (no capital base or liquidity)
Downward spiral of default & deleverage of banking (with emergency govern't support)
Deflation & deleverage in credit impacts job losses & real economy (excess supply shows up)

B. ... But you were afraid to ask.

How do banks acquire more capital and liquidity amid rising loan losses & credit defaults?
How does job creation occur if credit creation is constrained? (or actually negative leverage)
Will the proposed fail-safe reforms eliminate systemic risk in banking? (added regulations)

C. Vicious vs Vigorous

Bank reforms & added capital are buttressing the walls of financial institutions that are under continuous siege from bubble-bursting credit-created crises.
Given continuous imbalances in balance of payments, (eg US – China trade), we will likely continually roll from excessive debt financed capacity & demand drop defaults.

Banking capital adequacy & Global monetary bubbles

1. Introduction

BIS - 'No one thought that the financial system could collapse.'

- we had a safety net:
- central banks that would lend
 - depositor insurance for consumers
 - regulators of individual f.i's

Crisis – modern financial system is very complex

- systemic risk difficult to assess
- risk measure't distorted by false models
- little regulation over tail risk (& default risk)

Actual – we observed massive financial sector stress

- outsized losses & outright failure : capital inadequate
- protracted periods of illiquidity assets/funding
- inherent asset class contagion: event risk not mitigated

“A major cause for concern is the limited progress in addressing the underlying problems in the financial sector (todate).” BIS, 79th Annual Report

2. Macroeconomics

Economies, exchange rates, and external capital flows.

Current account deficits:

- US balance of payments deficit requires capital
- foreign capital has to go somewhere into the US economy
- shadow banking system arose absorbing the capital inflow

Canadian contagion:

- Cda tied to US (70% of our exports and employment)
- ABCP had US sub prime assets & US collateralized debt tranches
- Cdn banks, capital loss on US operations or debt exposed to US

Currency exchange rates and interest rates:

- both rates used to promote consumption via debt
- capital flows outpace real economy (early warning on bubbles)
- rolling market bubbles (easier to print money than to delever)

Economy, is this a typical recession to recovery?

Classic theory (private sector response)

- drop interest rates
- stimulate demand
- credit growth → jobs rise

Current situation (private sector response)

- drop interest rates to zero
- demand keeps dropping
- credit declining → jobs fall

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Punchline:

We are at best in the early stage of establishing resilience in the financial system. We're in a feeble fiscally-led recovery to avoid a worse deflation.

“When real activity returns to normal, inflated central bank balance sheets will need to be slimmed down or policy interest rates raised in a timely way. Intermediation now conducted by central banks will have to be returned to the private sector while the financial system deleverages and shrinks.” BIS, 79th AR

3. Interplay: Banking & Economy

Financial institutions response to the crisis;

- feedback loop of credit losses to bank failures
- feedback loop of bank failures to credit crunch
- feedback loop of credit crunch to real economy

Bank capital cushion in the crisis:

- first round losses (eg ABCP) private capital infusion
- second round losses (eg prime borrowers) institutional deals
- final round (real GDP drops) required public guarantees

Regulators viewpoint of variables at play;

- credit growth required for real economy to operate
- structure & stability of financial system required
- regulators strike at capital (increase) and leverage (reduce)

Range of complexity

- single largest failure – WaMu - (purchased by JP Morgan Chase)
- complex failure – Fortis – (multi gov't equity infusions)
- one country problem & cross country complexity

Reversal of thinking on off balance sheet assets;

- systemic risk present on and off balance sheet
- capital base proved insufficient for off b/s book
- regulated banks gtee'd shadow bank liquidity

Recognition of what we knew as practitioners;

- financial engineering – too slick
- financial conglomerates – too correlated
- financial framework & real economy – too linked

Regulatory focus in this current crisis:

- porous regulatory perimeter (shadow banking)
- tail risk in banking (poor model & market pricing)
- off b/s collapse (poor asset quality & no capital in CDOs, ABCP)

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“We are in that messy mixture of having taken urgent action and lacking comprehensive reform. Remember, we face two enormous risks:

- the banking system is still fragile
- the fiscal support still needs an exit”

BIS, 79th Annual Report

4. Current Position

Where do we stand regarding financial sector stress and risks:

- necessary condition NOT met: force banks to take losses
- necessary actions NOT underway: current respite simply prolongs
- necessary deleveraging NOT in place: implies smaller fin'l sector

What can regulators hope to do about the current position:

- (1) policy makers have limited degree of control necessary to force banks to clean up their balance sheets (stability vs sustainability argument)
- (2) policy makers did intervene in a timely way (deposit insurance, capital infusions, asset purchases)
- (3) policy makers need to push for quicker adjustment re valuation & deleverage & accounting losses
- (4) policy makers face a prolonged period of reversing quantitative easing (selling securities to a deleveraging private sector as it stabilizes)

“Since markets can fail to self-correct , policy will now intervene to adjust for asset prices and credit booms.” BIS, 79th AR

What are the new ideas from the Basle based Bank for International Settlements?

- CCP, central counterparty settlement for OTC derivatives
- SCC, systemic capital charge based on statistical market share
- CCC, countercyclical capital charge built in good times

5. Current Practice at Vancity

- 50% capital cushion re provincial regulations
- AA level of economic capital re market data
- Tier 1 is 90% capital – retained earnings best

What are costs and benefits as proposed and practiced:

- safer local financial co-op
- less efficient co-op given low leverage
- sustainable co-op with fiduciary objective

What are we talking about for other Canadian banks and f.i.'s”

- possibly another 2% points of capital
- a priori capital on loans/investments
- quick compliance by 2011-12