

**Financial services: challenges and prospects**

**Sector research on the impact of globalisation  
on the financial services**

**Draft final overview report**

Study for  
European Foundation for the Improvement of Living and Working Conditions  
EUROFOUND

Internal reference 09/0311/01

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Munich, 31 May 2010

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## Abbreviations

ABS	Asset-backed securities
AGM	Annual General Meetings
ATM	Automatic teller machine
BaFin	German Federal Financial Supervisory Authority
BFSR	Bank financial strength rating
bps	Basis points
BSA	Building Societies Association
CCP	Central Counter Parties
CDO	Collateralized debt obligation
CEA	European Insurance and Reinsurance Federation
CEE	Central and Eastern European countries
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CIS	Commonwealth of Independent States
CMBS	Commercial mortgage-backed securities
CRM	Customer Relationship Management
CRO	Chief Risk Officer
CTA	Commodity Trading Advisors
DNB	Dutch Central Bank
EACB	European Association of Cooperative Banks
EAD	Exposure at default
EBF	European Banking Federation
ESRB	European Systemic Risk Board
ESRC	European Strategic Risk Council
ETN	Exchange traded note
ETP	Exchange traded product
EURIBOR	Euro Interbank Offered Rate; euro based interest rate for interbank credits
FIC	Fixed Income & Currencies
FICC	Fixed Income, Currency and Commodities
FSA	Financial Services Authority in the UK

FSB	Financial Stability Boards
FSCS	Financial Services Compensation Scheme
FT	Financial Times
FTD	Financial Times Deutschland
FTE	Full-time equivalents
FYE	Fiscal Year End
H109	First half of 2009
HB	Handelsblatt
HR Treasury	Her Majesty Treasury
HVB	Hypo Vereinsbank
IASB	International Accounting Standards Board
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IIF	Institute of International Finance
IMF	International Monetary Fund
IPO	Initial public offer
LBO	Leveraged buyout
LGD	Loss given default
LIBOR	London Interbank Offered Rate; the interest rate for interbank credits
LOHAS	Lifestyle of health and sustainability
M&A	Mergers & Acquisitions
MIT	Mid-Term Incentives
NPL	Non performing loans
OCG	Office of Governmental Commerce
OTC	Over-the-counter trade
PD	Probability of default
PLC	Public Limited Company
PPL	potential problem loans
REIL	Risk elements in lending
RMBS	Residential mortgage-backed securities
RWN	Rating watch negative
SGB	Social Code
SIV	Structured investment vehicle
SME	Small and mid-sized enterprise
SoFFin	Financial Market Stabilization Fund in Germany
SZ	Süddeutsche Zeitung
TITF	Too important to fail
VaR	Value at risk

Counting convention      million = 10<sup>6</sup>; billion = 10<sup>9</sup>; trillion = 10<sup>12</sup>

## Executive summary

This study is about the adaptation of the European financial services sector after the culmination of the financial crisis in September 2008. It looks in detail at the business models which are applied in the different segments of the financial sector as response to the crisis. Eleven companies were investigated within five case studies and are described in a separate case study report. The economic trends in banking and insurance industries were scrutinised, and the present debate on the regulation of financial markets was reviewed. Based on this evidence, and the restructuring scenarios we wrote in 2009, three extended scenarios for the potential adaptation process of European financial industries are presented in this report.

The study was planned at a time when we expected the financial crisis to gradually phase out and the adaptation process to start its dynamics. The contrary appears to be the case. After infecting the real economy the financial crisis has been protracted to public budgets and is now swapping back to the financial system again. The economies are captured in a strong vicious circle which still has the power to lead into a severe depression. In this situation, financial companies have taken a wait-and-see-attitude, and concentrate on the strengths of their core business. Business associations express warnings about the negative effects of overhasty regulatory reforms and refer to the fragility of the current situation. Under such conditions, not much can be observed in the financial sector that points to a principal reversal of business strategies.

Financial companies nevertheless have adapted their business. A significant deleveraging process can be observed in private banking in particular. State-owned banks which are part of public rescue programmes have been restructured by the sale of peripheral and risky activities. Various private banks tried to expand their retail and commercial activities, however, returned to investment banking again when capital markets opened promising opportunities. Risk assessment tools have been improved and equity ratios have increased. Balance sheets have been repaired by substantial write-downs and profitability has returned to large parts of the business.

As the case studies reveal, this was at the expense of considerable job cuts which, in 2009, were in the range of 10 % among state-owned banks, around 5 % among private banks, and even the observed cooperative banks reduced employment by 1 %. Only the cases of an insurance company and an ethic bank experienced a rising number of jobs.

Remuneration systems for managers and investment brokers have been revised by the majority of companies with the idea to link income to the business performance of several years. In general the share of bonuses has been reduced in relation to fixed salaries and payments have been deferred by 3 to 4 years. A substantial part of bonuses is now rewarded as company shares. The effect of these changes on investment behaviour and risk appetite still has to be observed.

The business models of financial companies nevertheless show significant differences. They can be classified in three approaches:

- The group of “liberal” banks, investment funds and other intermediaries which draw high profits from trading books and proprietary trade. It undertakes the necessary adaptations of business operations under the new market conditions, but nevertheless tries to continue the previous profit-oriented strategy, urging for minor changes of the regulatory framework. Supported by the huge liquidity at low interest that has been made available since 2009, some expanded their activities also by mergers and acquisitions.
- The group of “state-owned” banks came under state control during the crisis, and now has to face severe restructuring. This includes both, the reaction to substantial losses in trading books and the reorientation of business strategies towards the core retail and commercial business. Public

supervision strongly affects the restructuring process but provides important advantages in form of state guarantees.

- The third group is classified “sustainable” as it follows long-term business strategies at lower leverage and less ambitious profit targets. This group was not strongly engaged in new financial markets and thus experienced minor losses from asset writedowns. Parts of the saving banks and cooperative banks belong to this group, as well as the newly emerging ethic banks. In some New Member States banks were legally restricted to engage in new financial markets. Finally, most of the insurance business can be classified as part of this group as this follows a conservative investment approach by tradition.

This classification coincides with the long-term skills scenarios for the European financial sector which were developed by Economix and DKRC in 2009 on behalf of the European Commission.<sup>1</sup> The study described the principal directions of restructuring in financial services by three scenarios, called “Laissez-Faire”, “State-Ownership” and “Sustainable Finance”. Now, the detailed analysis of company statements and statistical data undertaken by the series of case studies confirms this principal orientation of business strategies in financial industries.

The review of macro-conditions and of regulatory reforms which has been used as the basis of the new scenarios came to a set of conclusions:

- The series of shocks arising from the vulnerability of banks, households, companies and governments can hardly be expected to be over. Rising default risks on real estate markets, product markets and among banks in Europe and the US must be considered to provoke a strong feedback on banking assets and economic growth.
- The expectation of a rapid recovery was probably wrong. This is confirmed by recently published evidence from a long series of financial crises worldwide. The imbalances of global trade will continue. The exit scenarios developed by the European Commission all result in a transition phase with low or even negative growth.
- The uncertainty about regulatory reforms has been reduced by the recent approval of the “Wall Street Bill” by the US Senate, and the decision about hedge fund regulation and other issues in the European Union. The global debate about the worldwide framework which is envisaged by the G20 governments nevertheless can be expected to culminate until December 2010.

Based on these assessments, three alternative scenarios were developed:

- *The past is the future – a high risk status quo scenario*, which assumes that the forces to preserve the market position of big players and large groups are strong enough to avoid a principal reform of the financial system. The crisis is perceived as the accumulation of unfavorable circumstances rather than a systemic default. This opens “liberal” banks to continue their profit-oriented strategies while the “sustainable” segment will be able to defend its position without expanding substantially. Facing the rising strength of “liberal” banks, “state-owned” banks will be under stress and governments will try to reduce their engagements. The scenario is a high-risk scenario because actors assume that a further financial crisis can be kept under control with minor adjustments of regulation, and retail and commercial banking will provide a sufficient stability. As the simple occurrence of a big bank insolvency or a further state crisis may destabilize the system again, the scenario has to be classified “unsustainable”.
- *A new world order for financial markets – the end of the golden age*: this scenario expects the G20 governments to pass a fundamental reform of the world financial system in December 2010. This includes higher and risk-based equity ratios, the separation of investment banking

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<sup>1</sup> Economix/DKRC (2009): “Skills Scenarios for the Financial Services Sector in the European Union”, European Commission, DG Employment, Sector’s New Skills for New Jobs. Brussels.

from other retail and commercial banking, the submission of “living wills” at least by the big players, and efficient monitoring. The implementation of these rules will reduce the competitive advantages of “liberal” banks and bring the segments of “sustainable” and “state-owned” companies into a much better position. Higher equity ratios will be the key to this type of restructuring. In spite of a long and difficult transition period, the determinedness of the G20 governments will place a new orientation with long-lasting positive effects.

- *Divided economies – a worst case scenario*, assumes that the moment of truth has come and the financial crisis cannot be kept under control. Rising default rates and overburdened public budgets will force some governments in the Euro zone to cut liabilities by 20 to 30 percent and to resolve a series of banks. Austerity programmes of European countries will be an additional burden to the real economies and rising inflation in the US and the UK will create further imbalances. The volatility of exchange rates will reduce international trade. The weakness of the economies behind Euro, Dollar and Pound will strengthen the Asian countries. In addition to the disintegration of the world economy and the European Union in particular, the scenario results in a sharpened social divide. As the international regulation of financial markets is expected to fail, a strongly profit and growth oriented group of managers and professionals will continue to go for short-term speculation and arbitrage, supported by some countries offering liberal financial markets. This will be opposed by large parts of the societies who will start developing local network-based economies. The fundamental critique of globalised economies will lead to new approaches based on micro-organisms rather than macro-institutions.

All scenarios will further reduce employment in the financial sector. Of course this will be most severe in the “divided economies” scenario. However, the underlying force of cost savings will be strong in all variants as information and communication technologies will provide the potentials for continuous productivity rise. Social dialogue will best be developed under the assumptions of a new world order.

The scenarios were written with the ambition to describe the risks of current changes rather than the probability of certain events. For two times now, the liberal economies looked into the abyss of a total meltdown – financially and economically. Such scenarios are therefore needed in order to understand the threats of current evolutions, and to convince actors at all levels to fight for the recreation of a sustainable financial sector.

## 1. Introduction

Following the study on “Skills Scenarios for the European Financial Services Sector”, which we developed at the beginning of 2009 (Economix/DKRC 2009), this study intends to identify the major tracks of adaptation in the European financial sector in the aftermath of the financial crisis. The expectation of the study proposal was to look for the dominating business model which might have emerged after a reform of financial regulation and the clearing of market trends. The focus should be on business restructuring at the macro and the micro level in order to draw conclusions for employment, skills and the social dialogue.

The economic and political developments however wrote a slightly different agenda for this project. New regulations have not been passed until now, and many financial institutions – including their representative organisations – are in a wait-and-see position. Different restructuring and adaptation approaches are competing and it remains unclear which one will be the future of European financial services.

While the study is operating in an environment of greater uncertainty than expected, two principles of the study proposal are still valid:

- The alternative scenarios for the European financial sector – as they have been formulated in the skills scenario study – are now more visible than they were at the time when they were written. One part of the European financial sector is in state ownership and some will remain under this control for a longer period of time. A second group is implementing serious reforms in order to regain the trust of clients and markets and build up a sustainable business model. A third group continues to go for liberal capital markets with a strong profit orientation. The scenarios are therefore a good basis for analysing present restructuring trends.
- The idea to select different business models for the case studies is even more relevant now as the alternatives are not yet fixed. Thus it was important to find good representatives for the restructuring options.

The task of this study will therefore be to characterise alternative business models which might develop in future, particularly by looking at the conflict lines between these models. From the present viewpoint it appears to be very probable that different approaches will compete in the near future without a definite decision about a superior model. The coming years will be a period of testing, at the level of business as well as the level of public regulation. This will emphasise the relevance of scenarios.

We also had to adapt our methodology with regard to the great reluctance of financial companies to disclose their business strategies during the case studies. As the majority of companies refused participating in our study, we run the risk of being only accepted by companies in an excellent business positions but strategically less relevant approaches. In order to avoid such a bias, we decided to select the companies ourselves, and to gain the information from the annual reports, press releases and rating agencies. This also enabled us to do include more companies than originally planned for the five case studies. In addition to two individual cases, we investigated nine companies on the basis of this new methodology and asked them to amend our reports with additional information. The method has been successfully applied as the separate case study report reveals.

This overview report develops three scenarios for the phase of adaption in the European financial sector (Chapter 6). They are based on the reviews of restructuring trends, both at macro and sectoral level (Chapter 2) and the overview of the debate on regulatory reforms (Chapter 3). The evidence from the case studies is summarised in Chapter 4, including consumer reactions to the financial crisis.



Chapter 5 reviews the results of available scenarios for financial services and provides the reference to our skills scenarios from 2009. The conclusions from the analysis in Chapters 2 to 5 are drawn in the first part of Chapter 6 which provides a principal assessment of current trends.

In some parts, the report is forced to be rather “technical” as business developments in financial institutions and the aspects of financial regulation can hardly be discussed without referring to trade-specific terms. For a better understanding we included a glossary of technical terms in the case study report.

The writing of scenarios in such a phase of rapid changes, turbulent events on capital markets and unclear government decisions, has been a challenging task which forced us to update our information basis until the very last moment. The expert interviews which we conducted during the course of the study therefore were very important as they helped us to discern the principles of the ongoing processes rather than their appearance. We would like to express our thanks to all representatives of the social partners, company spokespersons, and researchers who used their valuable time to share their views with us and respond to our questions.

## **2. Course of the financial crisis**

### **2.1. Main macro trends**

The financial crisis started in 2007 with the mortgages crisis in the US and reached its peak with the insolvency of the US investment bank Lehman Brothers in September 2008. This pushed the world financial system to a near meltdown which could only be avoided by unprecedented rescue programmes from governments and central banks worldwide.

In the course of the crisis it became rapidly clear that European financial institutions suffered from losses similar to those of US institutions. These resulted from investments in subprime mortgages, buyout credits which could not be passed over to capital markets, insufficient hedging and finally from rising credit default risks in the real economy. In the weeks of financial panic, the exits from investments – formerly being rated as secure – appeared to be blocked. Banks had to depreciate assets by 1.2 trillion USD, and the IMF estimated a need for further reductions of 1.4 trillion USD. Since mid 2007 the market value of European and American banks decreased by 60 % until November 2009. This decline includes the recovery of stock prices since the end of 2008.

#### *Gradual recovery of the real economy*

Hitherto the financial crisis has triggered off a severe downturn of real economies with GDP shrinkages between 2.5 % and 7.5 % in large economic areas (Table 1). The decline, however, occurred in the western hemisphere and Russia while China and India continued to grow. This not only shifts the economic centre further to the East but also strengthens the role of Asian countries as financial centres.

The global recession has meanwhile come to an end with the help of substantial countercyclical expenditure programmes and expansionary monetary policies. The recovery, however, appears to be uneven and particularly Europe shows a scattered picture (European Commission 2010a):

- According to the spring forecast of the European Commission, EU growth will remain sluggish with a growth rate of not more than 1 % in 2010 and 1½ % in 2011. Greece and Latvia will remain in deep recession with a further GDP decline around 3 % in 2010. On the other side, Poland, Slovakia, Luxembourg, and the Scandinavian countries will grow with rates close to 2 %. The slow recovery is attributed to the expiration of support programmes, the unfavourable la-

bour market situation, and supply constraints from the financial sector – factors which all reduce domestic demand. Moreover, a rising number of governments in the Member States are forced to apply austerity programmes in order to reduce budgetary deficits. Exports – in particular to Asia – are thus the only positive driver of demand.

- The United States – in contrast – achieved impressive growth in the first quarter of 2010. Real GDP increased by 3.2 % in annualised terms and prospects for 2010 and 2011 are more favourable (Table 1). This is based on the expansion of inventories, resilient consumer spending, and the recovery of private investment in equipment and software (ECB 2010, p. 10). The dynamics of the domestic economy thus more than compensated the negative impact from declining government spending, the contraction of residential investment and the surplus of imports.
- The Japanese economy is still shrinking, however, at constantly lower rates during 2009. Having passed the difficult years 2008 and 2009 with strong GDP decline, low investment, deflation and declining wages, the 2010 forecast expects positive GDP growth mainly driven by exports. Japan intensifies its relations to China in order to take advantage from the dynamics in this region.
- The Chinese economy is expected to overtake Japan by volume with a GDP increase of 12 % in 2010. In the first quarter 2010, exports went up by 31 % compared to the previous year, and imports rose by 64 %. The new Five-Year-Plan starting in 2011 is assumed to strengthen domestic demand and local development. Huge foreign-exchange reserves, low public deficits and low risks for credit exposures improve the strength of the financial system. The future risk however is inflation which was 5.4 % in March 2010, driven by the rapid expansion of money supply and rapidly increasing real-estate prices.

**Table 1** GDP growth and unemployment

	GDP growth to previous year		Unemployment rate	
	2009	2010 <sup>a)</sup>	2009	2010 <sup>a)</sup>
European Union	-4.0	1.0	9.1	10.3
USA	-2.5	2.8	9.2	10.1
Japan	-5.6	2.1	5.5	6.1
China	8.5	9.0	-	-
India	5.4	6.4	-	-
Russia	-7.5	1.5	-	-

<sup>a)</sup> Estimated figures for 2010

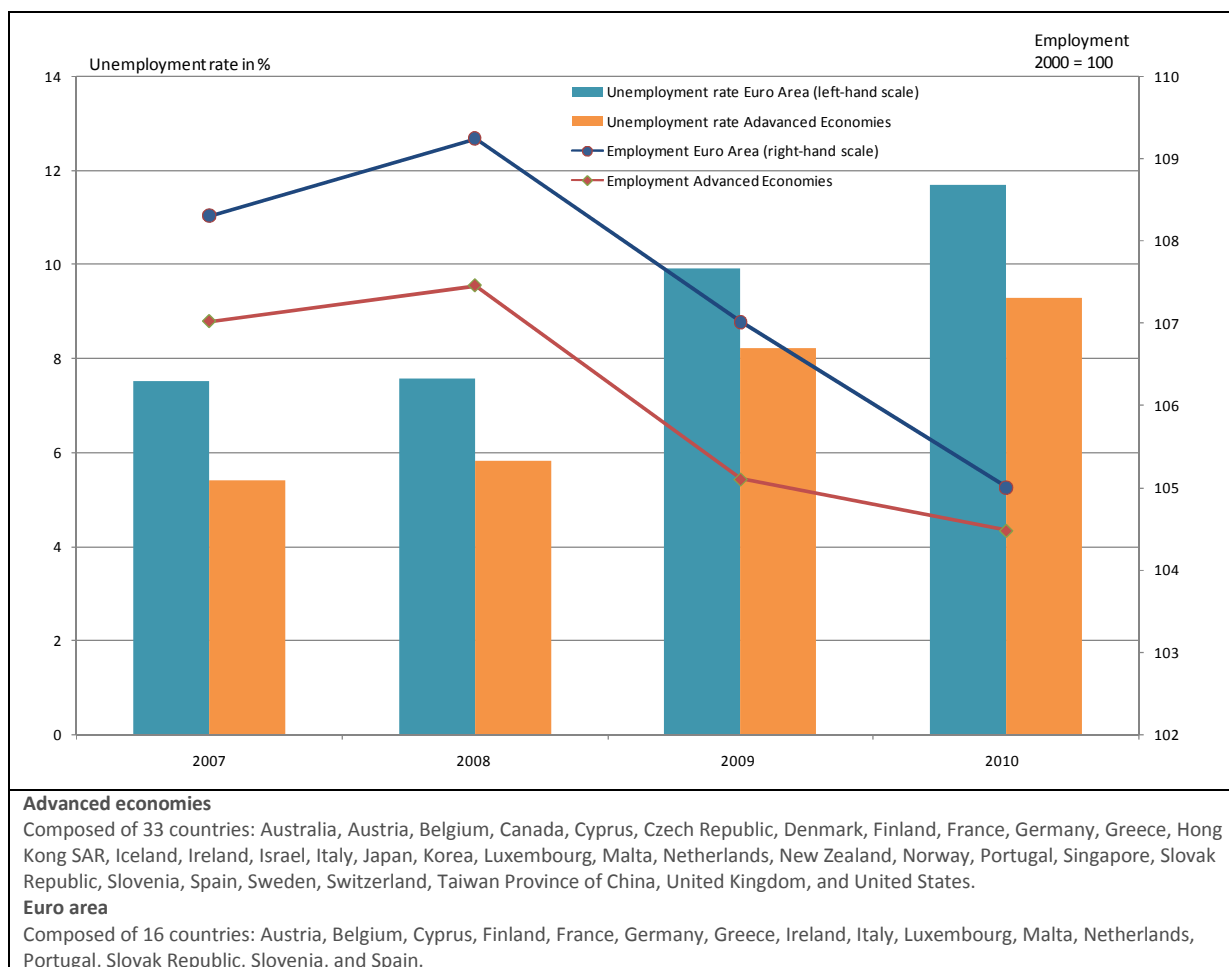
Source: European Commission

China is the centre of the world economy. This is apparently the most striking result of the financial crisis which rolled Europe back to low growth, burdened the US economy with instable cycles and prolonged the Japanese depression. The big economic areas in the western hemisphere have been significantly weakened as the financial crisis has absorbed substantial parts of growth potentials. They are all looking to China now to provide growth opportunities and to stabilise the world economy.

The world economic prospects remain ambiguous. It is still unclear whether crisis management will lead to a sustainable recovery or a renewed recession. The probability of the latter scenario increases if expansionary monetary and fiscal policies lose impetus and private demand fails to gain momentum in the face of limited credits (IMF 2009, 1).

### *Job cuts and labour hoarding*

The crisis has arrived on labour markets. In 2009 the Euro area lost 2 % of its 2008 jobs and – according to IMF projections – this is expected to continue in 2010 (Chart 1).

**Chart 1** Employment and unemployment

This is associated with the rise of unemployment rates which will increase in the Euro area to almost 12 % in 2010. In parallel, employment in advanced economies (including the USA, Australia, Japan and other, mainly Asian, countries) decreased in 2009 and job cuts will continue in 2010.

Employment figures suggest that labour hoarding has been significantly high during the crisis. The effects of the strong GDP decline in the European Union (-4.2 % in 2009) were absorbed mainly by working time reductions, partly supported by public short-time work arrangements and collective agreements. In addition, companies accepted the decline of labour productivity by 2.2 % and the resulting increase of real unit labour costs by 2.9 %. This indicates that companies were trying to sustain employment considering the importance of human capital and the difficul-

**Mr Weiss – about the impacts of the financial crisis on employment and training at the Erste Bank**

- The Human Resource strategy was not substantially changed after crisis but a new task arose for the Personnel Development department as some employees became scared by possible job losses and they brought the job at the bank into question. Thus managers were supported by the Personnel Development how to talk unsecured employees
- In general there is no difference in the qualification requirements between Middle and Eastern Europe. In Central and Eastern Europe (CEE) fewer products exist which request less training
- Due to the crisis training budgets were reduced. The reduction was higher in CEE than in Middle Europe: This resulted in less training regarding social competencies and communication while the general vocational education and training system remained unchanged. The cutbacks will remain during the next 4-5 years and the negative impacts are expected to remain over the next 30 years
- Financial consultants receive a high share of fixed income and a productivity bonus which is about 3-5 % of their salary. The bonus depends on the annual objectives and is not dependent on the number of sold products
- As no further expansion is planned no job increase is expected within the next years

ties to recruit new staffs in the expected upswing. This type of behaviour is not completely new but could not be observed with this intensity in previous downturns.

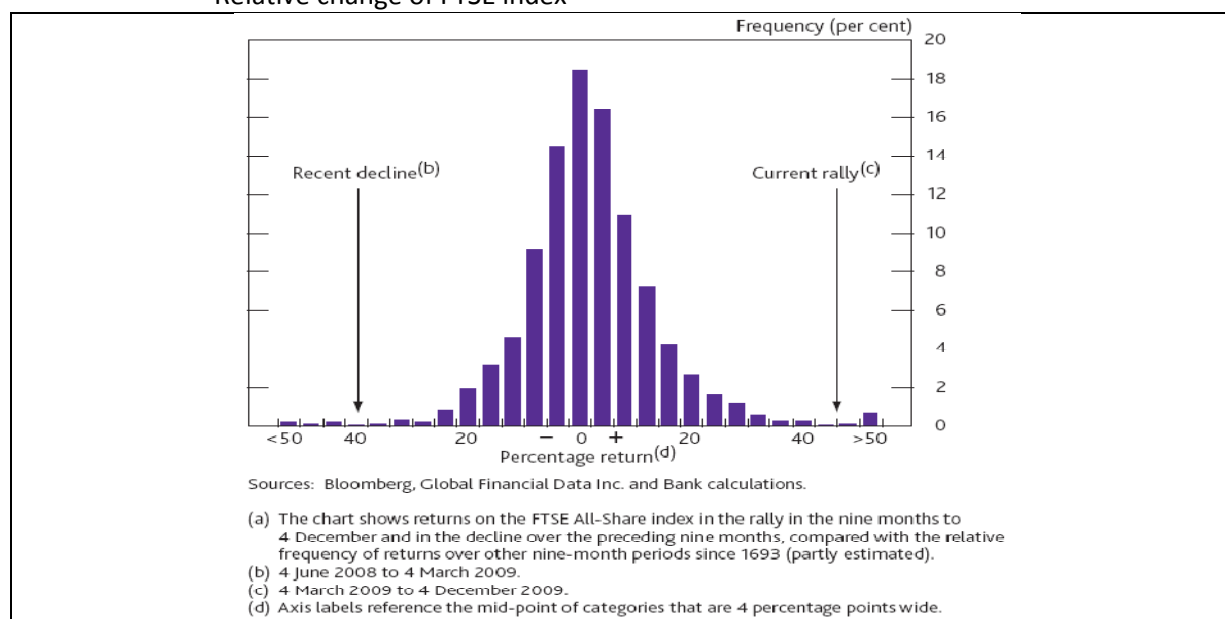
The implication is a largely job-less recovery that must be expected in the next years. The EU estimate for total employment is -0.9 % for 2010 and +0.3 % for 2011 (European Commission 2010a, p. 192). With the exception of Malta, all of the EU countries will continue to reduce employment in 2010 and only a gradual recovery is seen for 2011. The expansion of employment in 2011 will be below 1 % in most of the Member States. The crisis will thus have a long lasting effect on employment which keeps labour market performance below equilibrium.

### *Re-emergence of the credit crisis*

The attention of financial markets is presently concentrated on two major risks: the quasi insolvency of states like Greece and other countries with high budget deficits, and the rising credit defaults among companies and house owners. Both tendencies are suspected to create new eruptions in the financial system - largely unpredictable as regards the names of the next state, the next bank or the next company becoming insolvent, but raising the general awareness of risks, the attention to instabilities and the retention to engage in new credit relations. This must be expected not only to increase interest rates but to dry up certain risky markets as it was experienced on interbank markets during the first wave of the financial crisis in September 2008 and the Greek crisis in April 2010. This resulted in the partial standstill of the financial system which, in both cases, could only be resolved by broad government intervention.

The Bank of England demonstrated the exceptional situation with the historical analysis of the Financial Times Stock Exchange Index (FTSE). Chart 2 indicates the position of both the recent (2008) decline of stock prices and of the current (2009) upswing in the frequency distribution of stock exchange price changes since 1693. They are both well beyond the scope of regular changes. This means that not only the downturn of the UK stock exchange was exceptionally strong but the current upswing as well. The unsustainability of the present development is evident.

**Chart 2** Declines and rallies in UK equity prices since 1693  
Relative change of FTSE index<sup>(a)</sup>



Source: Bank of England (2009).

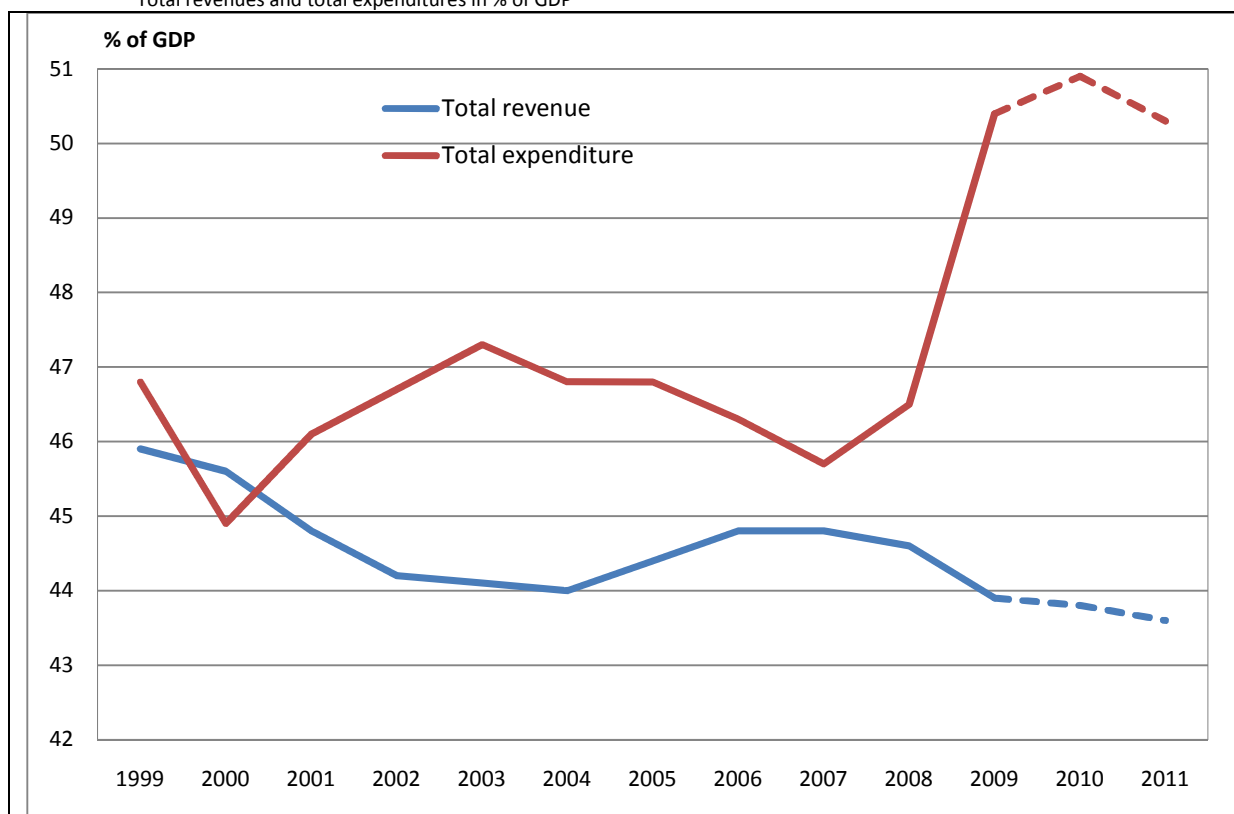
### Public budget crisis

In the meantime the financial crisis has become the crisis of public budgets. The calculations of the European Commission show that total expenditures of EU Member States, calculated as percentage share of GDP, exceeded the corresponding share of total revenues by six percentage points in 2009 (Chart 3). In 2010 a further increase to seven percentage points is expected and 2011 will bring only a minor release. The problem of public illiquidity has come closer with the second wave of the financial crisis.

Among the EU Member States, the UK, Ireland, Greece and France will have high deficits (Table 2). In addition, Portugal and Spain are also seriously burdened. Substantial budget cuts are planned in Ireland and Spain, and the EU Member States agreed on similar actions in Greece. Deficit values are well above the 3 % limit of the Maastricht Treaty and will force not only Greece but most of the EU Member States to reduce public deficits by expenditure cuts in particular. In order to understand the scope of budgetary accommodation, this means on EU average more than a bisection of current deficits.

According to calculations by the Bank for International Settlements, the problem is not restricted to the European Union. Not only the EU but Japan, the United States and even China and India will run into in part considerable deficits. As a result, "... total industrialised public sector debt is now expected to exceed 100 % of GDP in 2010 – something that has never happened before in peacetime" (OECD 2010).

**Chart 3 Public budgets in the European Union**  
Total revenues and total expenditures in % of GDP



Source: European Commission (2010)

The economist Nouriel Roubini wrote, the situation remains to be challenging as the countries are not only suffering from high public debt but from the loss of competitiveness in their real economies. Strong wage increases in recent years, the revaluation of the Euro, the real estate bubble in Spain

and Ireland, and limited productivity increase all contributed to the deterioration of the economic strength, particularly compared to China. High budget deficits are thus the result of weakening real economies rather than financial imbalances (Roubini 2010). This will strongly affect the future of these economies which will have to pass through a restructuring phase with low growth and high unemployment.

**Table 2** Fiscal imbalances

Fiscal situation and prospects <sup>1</sup>									
	Fiscal balance			Structural balance <sup>5</sup>			General government debt <sup>6</sup>		
	As a percentage of GDP								
	2007	2010	2011	2007	2010	2011	2007	2010	2011
Austria	-0.7	-5.5	-5.8	-1.4	-3.3	-3.6	62	78	82
Germany	0.2	-5.3	-4.6	-0.8	-4.0	-3.7	65	82	85
Greece	-4.0	-9.8	-10.0	-4.5	-6.9	-6.8	104	123	130
France	-2.7	-8.6	-8.0	-3.5	-6.8	-6.3	70	92	99
Ireland	0.2	-12.2	-11.6	-1.3	-9.0	-9.0	28	81	93
Italy	-1.5	-5.4	-5.1	-2.2	-2.6	-2.8	112	127	130
Japan	-2.5	-8.2	-9.4	-3.4	-7.4	-9.0	167	197	204
Netherlands	0.2	-5.9	-5.3	-0.6	-3.6	-3.1	52	77	82
Portugal	-2.7	-7.6	-7.8	-2.8	-6.1	-6.8	71	91	97
Spain	1.9	-8.5	-7.7	1.6	-5.2	-4.5	42	68	74
United Kingdom	-2.7	-13.3	-12.5	-3.4	-10.5	-9.9	47	83	94
United States	-2.8	-10.7	-9.4	-3.1	-9.2	-8.2	62	92	100
China	0.9	-2.0	-2.9				20	22	23
India	-4.4	-10.0	-8.7				81	86	86
Other Asia <sup>2</sup>	2.1	-1.2	-1.0				31	37	38
Central Europe <sup>3</sup>	3.7	-4.4	-3.9				23	28	29
Latin America <sup>4</sup>	-1.5	-2.4	-2.0				41	37	35

<sup>1</sup> Regional averages calculated as weighted averages based on 2005 GDP and PPP exchange rates. <sup>2</sup> Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. <sup>3</sup> The Czech Republic, Hungary and Poland. <sup>4</sup> Argentina, Brazil, Chile and Mexico. <sup>5</sup> Cyclically adjusted balance. <sup>6</sup> For Argentina, the Philippines and Thailand, central government debt.

Sources: IMF, *World Economic Outlook*; OECD, *Economic Outlook*.

### Inflationary risks

As these corrections in public deficits will hardly be accepted by voters, policy makers will search for an escape via inflation. Inflation, however, is a long-term rather than a short-term risk. Low growth and strong external competition will limit the possibilities to increase prices. The European Commission therefore estimates inflation rates between 1 and 2 % annually for 2010 and 2011 (2010, p. 3).

However, the anticipation of inflation is even more damaging than inflation itself. The current depreciation of the Euro can be understood as a reaction to the investors' expectation of higher inflation in the Euro zone. Many investors return into their home currencies, look for more stable currencies, like the Swiss Franc, or transmit their money into gold, real estate and other tangible goods.

The decline of the Euro exchange rate against the US Dollar is associated with the apprehension that the buy of Euro zone bonds by the European Central Bank may not be compensated by money supply cuts with short-term deposits. Obviously there is a fundamental conflict among EU Member States on whether monetary policy should ease fiscal deficits or strictly preserve monetary stability. It remains one of the principal questions for the medium-term future which side will gain a victory.



### *Default risks*

The second main risk comes from rising defaults on real estate markets and in the area of commercial credits. The Bank of England recently came to a very sceptical assessment: “Recent improved conditions need to be set against the backdrop of overextended balance sheets across a wide range of countries and sectors. The global boom in loan issuance has left a legacy of significant refinancing challenges for some companies, including those in the United Kingdom. Household default rates continue to rise sharply in the United States. There are also pockets of vulnerability in certain emerging economies within Central and Eastern Europe, where private sector credit has grown rapidly over the past few years, partly financed by foreign bank lending. These problems can have unanticipated spillovers, particularly if there is a lack of clarity about sovereigns’ support for quasi-government entities — as seen in Dubai and, earlier in the crisis, at US mortgage finance agencies Fannie Mae and Freddie Mac.” (Bank of England 2010, p. 7).

One of the European centres of this process is the UK commercial property market which experienced a rapid decline of prices during the crisis. Since 2007 property values have declined by 45 % which wiped out the gains of a whole decade. The share of vacant offices increased from 9 % to 12.6 % and default rates doubled to 7 %. Moreover, two thirds of the current property credits will have to be refunded during the next five years. Standard & Poor’s Corporation estimates writedowns at 9 % and 15 %, depending on the length of the financial crisis. This will have strong effects on other countries. Eleven German banks, especially the Landesbanken, are among the 23 most important credit providers for big construction projects in the UK (Handelsblatt 15.01.10).

Similarly in Spain, the peak of the property crisis is expected in 2010. Developer companies will have particular difficulties which will result in credit default rates between 20 % and 25 %. The overall default rate in real estate markets is expected to range around 5 %. Banks had to raise financial reserves by 6.5 billion Euros. Moreover, open credits were repaid by debtors as property transfers which now requires substantial writedowns. While larger banks are able to compensate these losses with their own resources, smaller banks are increasingly in trouble and in need of public support (JP Morgan 2010). The 45 savings banks which hold half of the Spanish banking market are strongly involved in the funding of real estate projects. The Spanish government was thus forced to establish a restructuring fund which can support banks up to € 99 bn (Financial Times 06.05.10).

Rising shares of non-performing loans have also been forecasted for Central and Eastern European countries, in particular for the Baltic States. According to IMF estimates, the share is expected to move up to 15 % or even 20 % in 2010 (IMF 2010, p. 19). Bulgaria, Romania and Croatia will experience default rates around 12 %. Poland, Hungary and the Czech Republic are estimated at 8 %.

Alarming signals are also coming from the USA. Prices for commercial buildings have declined by 30 % and the share of vacant buildings is approaching the level of the last crisis which occurred at the beginning of the 1990s. The current credit default rate is 7.4 % - five percentage points more than one year ago. One of the most prominent cases was the Stuyvesant Town in New York which was returned by the developer company to the credit banks. Tishman Speyer and Blackrock Fund acquired Stuyvesant Town with 11,200 apartments for \$ 5.4 bn in 2006. The decrease of the overall value to \$ 2 bn forced the proprietors out of the market. They returned the whole property back to the banks which gave \$ 4 bn as credits (Handelsblatt 15.02.2010).

Hence, the crisis is far from being over and the financial system is far from being stable. While the real economy recovered rapidly from the slack, the financial crisis shifted to public budgets and infected the most vulnerable countries and companies. Faced with an extreme rise of public deficits, governments will be forced to practice austerity with low growth during a probably long transition phase.

Most importantly, however, the crisis is on the way to change expectations considerably. A new sensitivity to risks, the perception of rising instability, the apprehension of inflation, and the awareness of global instabilities has visible effects on the behaviour of investors, companies and consumers. In this sense the financial crisis is going to affect the economies like a cloud of dust covering even the most remote places and decelerating activities comprehensively.

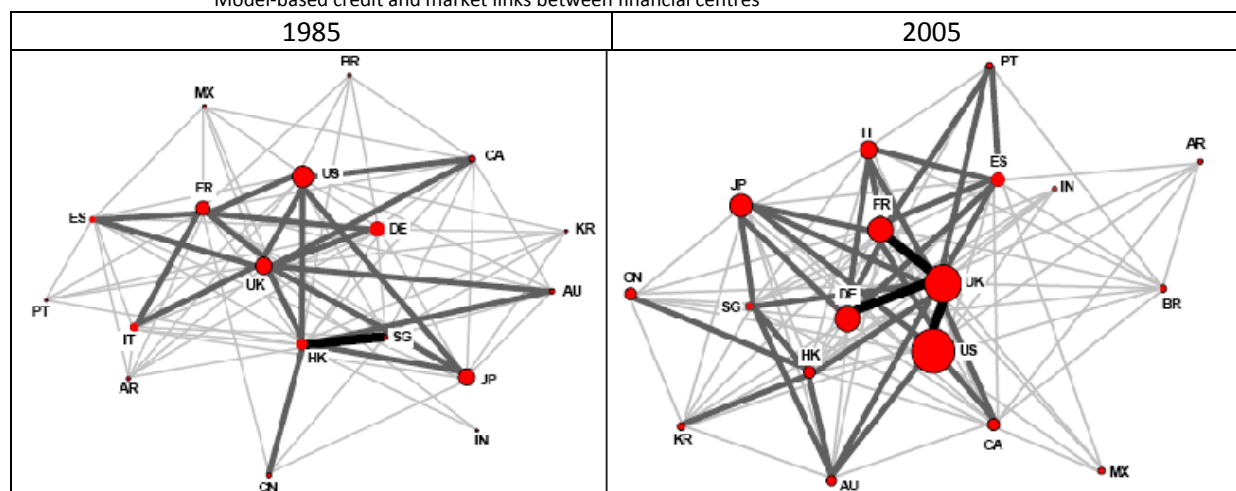
## 2.2. Banking

In 2009 and 2010 the health of the financial system has improved. With the global economy growing, risks to financial stability have subsided. The capital ratio of the Euro area banking system increased by 1 percentage point since autumn 2008 to 7.5 % in December 2009, the highest level ever recorded (European Commission 2010a, p. 35). Continued deleveraging in the banking sector helped reducing the predisposition to shocks and normalising markets. According the IMF estimates bank writedowns in the Euro area amounted to € 511 bn in April 2010 (2.9 % of total loans and securities; IMF 2010, p. 13). The amount is significantly lower than six months earlier but the compensation of around  $\frac{1}{3}$  is still ahead. With the rise of asset prices large parts of the banking sector returned to profitability.

Nevertheless, “the financial crisis is expected to change the economic and political environment of the banking industry stronger than any other event during the last decades” as Deutsche Bank Research writes (2009). Therefore, the sector sees only moderate prospects in the medium-term. It is expected to face comprehensive re-regulation, growing governmental influence, and increasing pressure from investors. Market growth will thus remain limited, and the further rise of equity ratios will constrain profitability.

Not all EU Member States have been affected by the financial crisis in the same way. This is due to the fact that the financial linkages have increasingly concentrated over the last decade (Chart 4). The US, the UK, Japan, France, and Germany became dominating financial centres, in addition to the fact that the total volume of credit and market links expanded considerably. It can be assumed that the picture for 2007 would demonstrate these findings even more explicitly.

**Chart 4** Links between national financial systems  
Model-based credit and market links between financial centres



Source: Sachverständigenrat 2009, Heldane 2009



Some national regulatory schemes did not follow the deregulation path, like Spain, Poland or Romania, and thus partly resisted the virus of financial instability. Generally, the banking systems of the New Member States remained concentrated on national markets. This also provided some protection against the infection. The indirect effects on the real economy however could not be prevented even in countries with a healthy financial system.

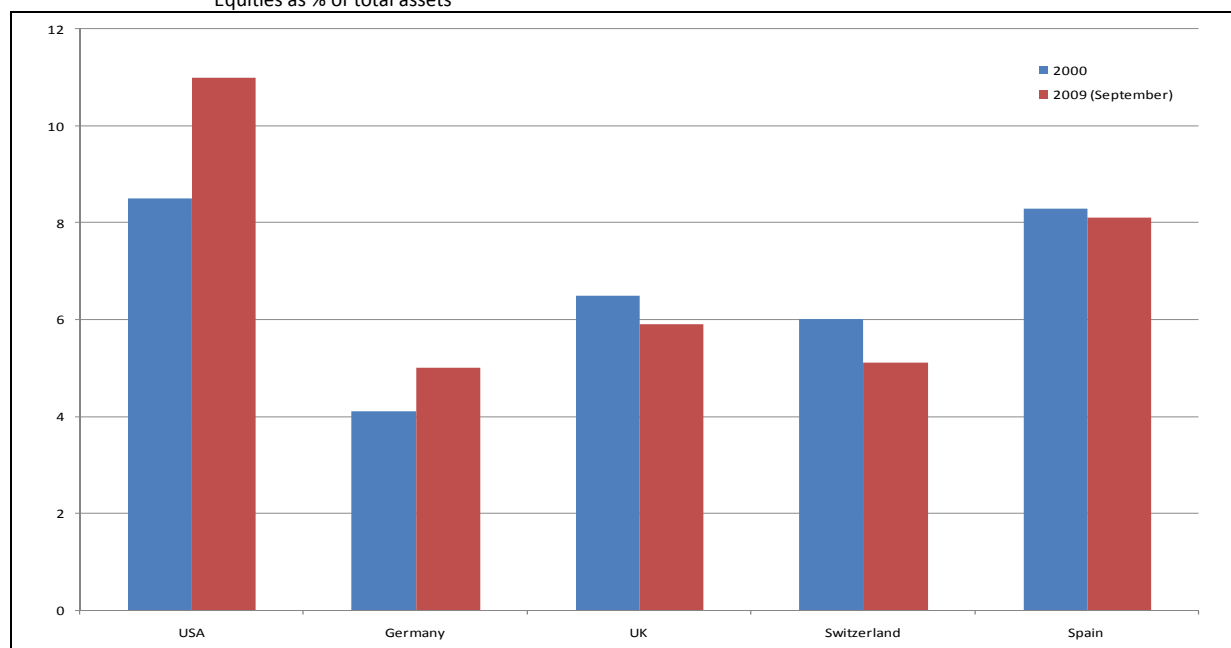
China kept its financial system under strict government control and did not participate in the extraordinary growth of western financial markets. The “underdeveloped” financial system – as it was criticised by OECD and IMF – appeared as an important advantage during the crisis. With a traditional banking sector concentrated on deposits and credits the system was not exposed to the risks of structured products or short-sales. With foreign exchange restrictions it was disconnected from the vulnerability of world financial markets. Of course, these risks were partly transferred to the central government. Nevertheless, the national financial system remained largely unaffected.

### 2.2.1. Equity ratios

Extended leverage ratios have been identified as a major source of instability in financial markets. Favoured by low interest rates and loose prudential rules the leverage ratio of US investment banks rose to levels between 25 and 35 in spring 2008. Non-banking institutions (Structured Investment Vehicles, SIVs) have been used to transfer risky assets out of official trading books. Meanwhile, banks made substantial efforts to lower the leverage ratio to a level of 15 (September 2009) and to raise equity ratios.

Official data do not fully reflect these changes as Chart 4 reveals. US and German banks were among those which achieved higher equity ratios by the end of 2009. In the UK and Switzerland however, equity ratios declined compared to 2000.

**Chart 5** Equity ratios  
Equities as % of total assets



Source: DB Research

In 2008 the performance of large and complex banks in the Euro area deteriorated significantly and resulted in a loss of 5.8 % on average. By the third quarter of 2009, the average profit margin recovered to 10.7 %, although this still remained low by recent historical standards (ECB 2009, p. 78).

While many banks have used the favourable market conditions in 2009 to restore their capital position, the recapitalisation of banks is hampered. According to the European Commission (2010, pp. 35), the positive earnings and profits development is unlikely to sustain as

- further losses from loan defaults have to be expected as lagged reflex from the real economy
- the strong revaluation of securities will not continue or even reverse
- the normalisation of short-term interest rates will reduce banks' earnings
- the injected public capital will have to be redeemed

Moreover, banks may face a “creditless recovery” or at least a substantial time lag of credit growth during the economic recovery. In particular the early stages of recoveries appear to be “creditless”. This may partly be compensated by the huge increase of government dept. On capital markets, however, banks will increasingly compete for funds with public institutions. This can be expected to raise interest rates.

Profitability of banks was very uneven, already before the crisis. The IMF comments: “In a number of countries, a significant part of the banking system lacks a viable business model, or suffers from chronic unprofitability. In the case of the European Union, the need for rationalisation of the sector can be seen in the striking variability of banking returns. The German system, for example, suffers from weak overall profitability, and large tail of unprofitable banks – primarily the nation’s Landesbanken.” (IMF 2010, p. 23). Weak banks are considered to compete aggressively for deposits, wholesale funding and scarce lending opportunities thus squeezing margins for the whole system.

The IMF findings, however, can also be interpreted as the contrast between profit-oriented and service-oriented banking systems. The traditionally low profitability of the German banking system is caused by the important role of public savings banks and cooperative banks which are less profit-oriented than private banks. In contrast, the high profits of private banks were related to high risks in derivatives markets and other investments. Profitability therefore is no reliable indicator for sustainability.

### 2.2.2. Derivatives markets

The latest figures on global derivatives markets reveal a slowdown of the gross value of over-the-counter derivatives (OTC) from \$ 32 trillion to \$ 22 trillion between December 2008 and June 2009, corresponding to € 21 trillion and € 15 trillion respectively. The major parts of OTCs are interest rate swaps, credit default swaps and currency swaps. The volume of the total market came close to the June 2008 level and was 2.2 times bigger than in 2006 (Chart 6). This means that the highly speculative part of international capital markets still has a significant volume.

The growth of derivatives markets impressively demonstrates the decoupling of financial markets

#### Mr. Warrender – about hedge funds

The demand for hedge funds decreased considerably during the last 12 month and it was difficult to raise money for hedge funds.

People who invest in hedge funds nowadays prefer investments with relatively high liquidity and as managers of hedge funds only can take out performance fees after the investors took out, there is higher pressure to match the interests of investors.

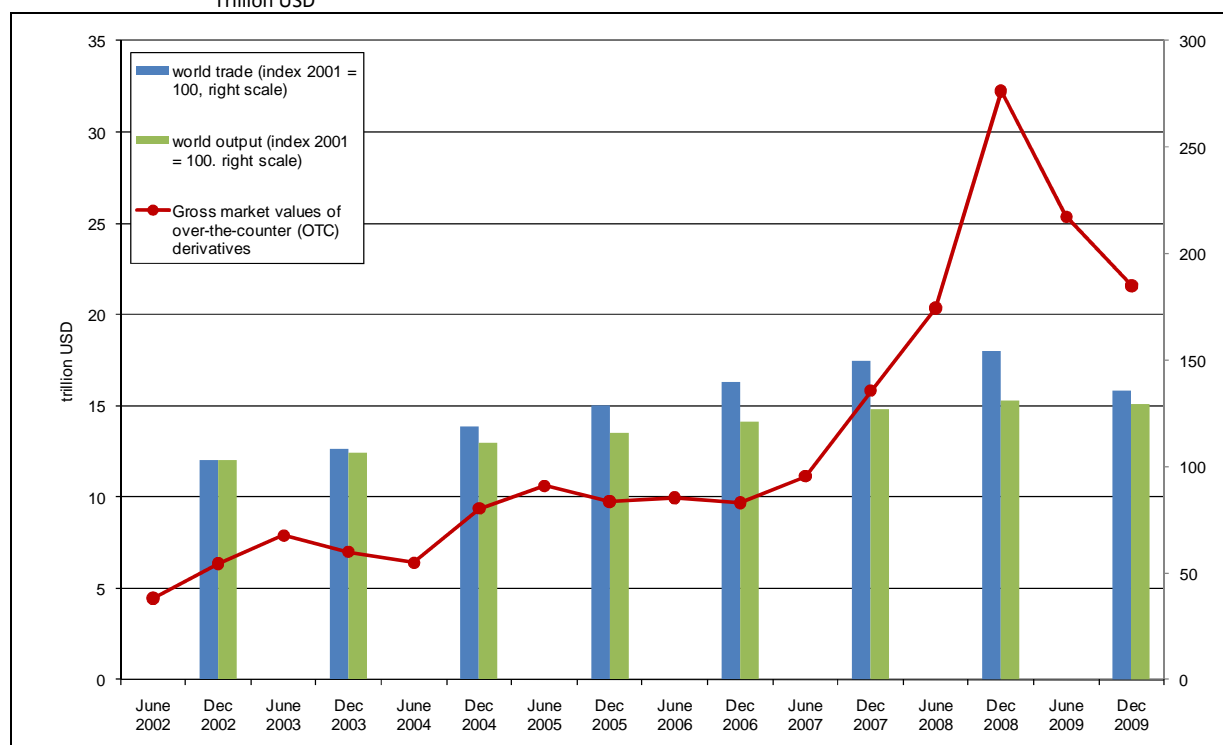
A transaction tax would affect hedge funds with a short-term nature (transactions in seconds) more than hedge funds with CTA.

Mr Warrender assesses the AIFM directive (an European directive to regulate close-end funds) as improvement and good suggestion as it will help regulators to receive the required information to understand and to focus on risk adequately.

According to Mr Warrender's view a job reduction of around 25 % is expected in the hedge fund sector.

from real economies. The enormous expansion of these markets is not related to anything like economic growth, world trade or credit exposures of the banking system. The maximum expansion of world trade between 2002 and 2008 was 54 % and world output increased by 31 %. Derivatives markets developed as an independent segment adding a great variety of new financial products to the market and containing a high level of risks.

**Chart 6** Gross market value of over-the-counter derivatives (OTC)  
Trillion USD



Source: BIS

### 2.2.3. Consolidation

Former banking crises were associated with a declining number of banks at least if there were no legal barriers to mergers and acquisitions. One of the examples cited in the literature is the crisis of the US savings banks in the late 1980s which reduced the number of banks considerably. Within five years 9,800 banks disappeared partly due to bankruptcy, but mainly because of mergers (DB Research 2009, 11). The same was observed after the banking crisis in Sweden in 1993 and after the Japanese financial crisis at the beginning of the 1990s.

Mergers are driven by three forces: the reduction of risks with the help of diversified financial structures, the economies of scale in the operation of financial services, and the increase of market power. These forces have resulted in rising market shares of the five biggest banks in Europe: in 19 of the 27 EU Member States these five banks have a market share of over 50 %.

The financial crisis has not stopped mergers and acquisitions in the financial industries, but it has presumably changed the criteria:

- governments forced banks in which they held a stake to restructure and separate from risky parts (for example: ING Groep, FORTIS and DEXIA).

- national mergers have become more important as uncertainties about economic trends, risks, and new regulation in other countries have increased. Moreover, national markets were upgraded in banking strategies together with the rising importance of commercial banking.
- Holdings have been disentangled and concentrated on “core” businesses in order to extend the capital basis. In particular, the banks’ insurance subsidiaries have been sold.

Future trends, however, are far from being clear. On one hand, the economies of scale and scope are still prevalent and thus size and growth are important. On the other hand, flexibility of services, risk limitation, and knowledge of local markets give advantages to decentralised banking systems with small units. Meanwhile the debate about the banks’ size has become a central issue: policy makers are willing to separate big banking groups, in order to avoid additional “too big to fail” cases.

#### 2.2.4. Public ownership

The depreciation of assets and the vanishing trust of private investors made governments the “investor as a last resort” in various cases (Table 2). Some of the European and US banks could only be saved with substantial public support. In addition to financial guarantees this was achieved by transitory capital transfers. In the course of the financial crisis, public investments tended to follow a long-term orientation with a stronger influence on management (e.g. Commerzbank). In some cases (e.g. Hypo Real Estate, Royal Bank of Scotland) a complete takeover into public ownership was necessary.

Meanwhile, most of the US banks repaid public investments whereas among European banks the majority did not - except the French banks that reimbursed the public packages until December 2009. This raises the probability that governments will be engaged in private banking for a longer term. In particular the “bad bank” option which was used by several vulnerable banks includes long-term public risk taking.

**Table 2 Public capital support for European and US banks**

Bank	Country	Euro (bn)	Repayment
<b>Europe</b>			
Royal Bank of Scotland	UK	50.1	
Lloyds	UK	25.2	
Commerzbank	DE	18.2	
ING Group	NL	10.0	Yes
BayernLB	DE	10.0	
Dexia	BE	6.4	
KBC	BE	5.5	
BNP Paribas	FR	5.1	Yes
Landesbank Baden-Württemberg	DE	5.0	
UBS	CH	3.9	Yes
<b>USA</b>			
		USD (bn)	
Citygroup	USA	52.1	Partly
Bank of America	USA	49.0	Yes
JPMorgan	USA	25.0	Yes
Wells Fargo	USA	25.0	Yes
Goldman Sachs	USA	10.0	Yes
Morgan Stanley	USA	10.0	Yes
PNC	USA	7.6	
US Bancorp	USA	6.6	Yes
SunTrust	USA	4.9	
Capital One	USA	3.6	Yes

Source: Bloomberg, US-Treasury, DB Research

### 2.2.5. Restructuring of banking services

A clear trend of company restructuring in European banking services is far from being visible. Much depends on the new regulation which still is in the state of naissance. Some changes however can already be discerned:

- Trading books will not regain their pre-crisis importance. This can be attributed to the significant reduction of proprietary trading which was associated with a strong decline of jobs for traders. The behaviour of big investors and private clients changed towards better liquidity and higher security. Regulation is starting to restrict risky trading. To summarise, these activities do not promote the image of a secure financial institution.
- Deglobalisation of markets may happen to some degree as national markets become more important. For many banks, national markets are by far the most important part of their business. Foreign activities do not always fit the prevailing business model and appear to be risky. Moreover, national markets are the main source of funding. Long-term relations with investors and private clients appear to be important. Finally, national governments supported many banks directly or indirectly. This is going to create a strong commitment to the country of residence.
- Diversification of activities is becoming more attractive as specialised banks were particularly affected by the financial crisis. The risk distribution of universal banks allowed for a greater flexibility and better funding structures.

The strong trends of the last decade, however, may override these tendencies:

- Asset trading – proprietary trading in particular – was the most profitable part of the banking business and still provides exceptional profit opportunities. The banking business, therefore, is partly returning to these activities with great financial success.
- International banking business corresponds with international trade of goods and services, and with openness of capital markets worldwide. A return to national banking therefore is unlikely. Only the pace of internationalisation may be expected to decelerate.
- The economies of scale and scope are still very strong. Information and communication technologies provide

#### INEUM France: impact on retail banking in France

- Only minor changes in French retail banking: cost savings and a shift of investment projects. No job cutting plans in retail banking in France.
- First impact from new regulatory framework: controlling has to check financial proposals to clients. “Traceability” is the new word in the sector. “Risks profiles” of customers are designed and have to be implemented by the commercial services.
- The confidence problem has only affected assets, shares and private banking activities.
- All retail banks are now “multi-channel” using branches, phone banking, and internet banking. A new type of machine-based branches emerges: a “money wall” is composed of all sorts of ATMs doing basic operations. Personal counseling capacities are available for customers in small offices.
- Great attention is paid to information for the customers: documents about the different financial products have to be checked by the AMF (Autorité des Marchés Financiers)
- Some banks (e.g. Société Générale) took the opportunity of the crisis to develop a new image: the customer oriented organization.

an expanding potential for efficiency gains in the operational business, in communication with clients, and internet-based banking services. This may further promote the growth of the big players<sup>2</sup>. In addition, financing big international projects requires big financial institutions. These, however, have the ability to dominate markets. The attractiveness of magnitude therefore remains strong.

<sup>2</sup> The recent deal between Deutsche Bank and SAP confirms this argument. Deutsche Bank ordered a completely new type of banking software based on SAP software which will replace a 30 year old system of internally produced software.

### **2.2.6. Change of remuneration systems**

The fundamental critique of bonus systems has meanwhile caused some changes in banking management. The main argument was that remuneration of traders, sales staff and top management were linked to short-term economic performance rather than sustainability and long-term business targets. This has created risk profiles which were not consistent with reliable and trustful banking practices. Bonus systems which provided payments immediately after selling the contract or right after annual accounts did not consider the risks involved in the business. Moreover, the extraordinary size of payments to traders and top managers has been assessed as not being fair or adequate by the public in many countries.

In the meantime, remuneration systems have been or will be changed in many banking institutions. This was initiated by interventions of public owners in banks depending on public support during the crisis. But beyond this circle, management has started with reforms. The IIF has passed the principles of remuneration: bonus payments should be related to the profits from several years, and parts should be transferred to trustee accounts for a longer period. Banking management also puts new rules into practice.

An important characteristic of these reforms is that they comprise all levels of the company, from top managers to sales staff. Remuneration of top managers plays a pivotal role as they will organise the business according to their incentives. A reform which only changes bonuses at lower levels will not be fully effective. Moreover, the implementation of bonus-malus components is important to achieve a better profit-risk-assessment in daily business. The pure restriction of bonuses – or the taxation of bonuses – is less efficient as the experience shows. The possibilities to escape from these regulations are usually given.

The most far reaching approach intends to expand management and staff ownership. According to Wood, substantial equity investments which can only be sold some years after separation from the company would be able to raise the long-term responsibility for the business and reduce risk propensity.

## **2.3. Insurance**

### **2.3.1. Linkages to the crisis**

The European insurance industry emphasises that it was not the origin of the financial crisis but has been strongly affected by the financial turmoil (CEA 2008). This is partly true as the exposure to credit risk embedded in structured products were limited and insurers were not significantly affected by the related losses. The exception, however, is bond and mortgage insurance that covered the loss of capital or interests of many securities. The insolvency of AIG<sup>3</sup> in the US, and FORTIS in Belgium and Luxemburg revealed how risky this market segment of international insurance was and how strongly this type of insurance contributed to the emergence of the financial crisis.

The typical insurance business model, however, follows an investment policy which is in line with the financial commitments to policyholders. This means that investments are selected according to the required cash flow and assets are placed as long-term investments with a low risk profile. Most importantly, insurers do not use leverage to enhance their return on investment. Their liquidity de-

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<sup>3</sup> AIG posted a loss of \$ 61.7 bn in the fourth quarter of 2008. The US government guaranteed the liabilities of AIG in order to protect the world economy from substantial losses.

pend primarily on premiums which makes them less vulnerable. Liabilities depend on the emergence of risks in different insurance markets. These may fluctuate substantially. However, such a business model is certainly less exposed to fluctuations in financial markets.

Nevertheless, the asset portfolios of insurers have been strongly hit by the downturn on capital markets, the decline of interest rates and the contraction of economic activities. This has only in parts been compensated by the growth of saving and retirement products. As indicated in the section on banking, the sharp decline of stock prices could hardly be absorbed. Insurers were unable to escape from the general downward trend simply due to their size as investors and their long-term investment strategy<sup>4</sup>. This resulted in the downgrading of credit ratings for the leading European insurance groups in 2009: the majority of companies were rated with a single A in October 2009, and only one was rated AA. In 2008 the rating was still significantly better with the majority in AA- and A+ (CEIOPS 2009, p. 6).

**Mr. Dabrowski – about the Polish life-insurance market**

The Polish life-insurance market consists of investment-related businesses and protection-related businesses. The demand for life-insurance products rose significantly in recent years. In 2006 and 2007 the increase was mainly driven by the investment-related part.

The crisis caused a decrease of investment-related products as customers started to be afraid of investments and these investment-related products are mainly driven by banks. Moreover, Polish regulator sent a special note to all insurers to decrease investment-related businesses as they are connected to high credit risks. Thus, a significant slowdown was experienced in the market.

On the other hand the protection-related part of life-insurance business did not experience a strong impact by the financial crisis even though problems were expected due to bankruptcies of the companies. In Poland the majority of protection-related business comprises group insurances through the company the people work at.

Life insurance experienced a strong decline during 2009. As part of private capital investments, life insurance had to adjust to the economic downturn. Exits from life insurance contracts, however, did not increase substantially and thus did not burden the liquidity position of insurers. Non-life insurance remained less affected. In an environment of rising uncertainties, adequate risk management helped non-life insurance to sustain.

Monoline insurers – which provide financial guarantees for the interests and capital repayment of credits and bonds – came under significant stress with the deterioration in structured credit markets. Most of the seven European monoline insurers were thus downgraded by the rating agencies in 2009. The ratings of one of the agencies have even been withdrawn by the companies. A considerable potential for further deterioration in the firms' solvency levels was identified during 2009, particularly where underlying mortgage portfolios were considered. The European regulators decided to closely monitor market developments "... and contingency planning in the event of further downgrades or even insolvency" (CEIOPS 2009, p. 27).

### 2.3.2. Reactions to the crisis

As a major investor insurance is strongly interested in a stable and secure financial system. The sector therefore started to reorganise its activities and submitted proposals for the reform of financial industries.

Having been hit by the crisis even as a risk-aware sector, insurance industries plan to move to a risk-based solvency regime. This is intended by Solvency II which should provide the mechanisms to detect threats at an early stage (see section 3.3). According to the CEA (2009) the sector urges for group-based rather than single company risk assessments, and the strengthening of risk manage-

<sup>4</sup> The total asset value of Euro area insurers amounted to € 4.4 trillion in 2008. Half of the assets were kept as debt and fixed income securities and 15 % as shares. The rest was distributed over various forms of investments (ECB 2009, 161).



ment in all financial institutions. It criticises that risk managers had difficulty making their voices heard, even in institutions with sophisticated risk management structures. Direct reporting lines of risk managers to the board are recommended. Moreover, incentive structures would have to be realigned between operational lines and top management.

The industry has strong interests in applying less market-based valuation rules for assets. This appears to be a key issue as it would affect balance sheets considerably. The mark-to-market valuation principle says that assets have to be valued at current market prices (fair value). Insurers however do not report losses in the profit and loss account unless the investment is considered to be impaired. This differs from the practices of banks that generally record “at fair value through profit and loss”. The fair value principle is identified as being pro-cyclical and the extension to the insurance industry is therefore criticised for emphasising this effect.

The sector also has a strong interest in maintaining insurance-linked securitisation. These are structured products which allow ceding insurance-related risks into the capital markets. As this type of securitisation differs from bank securitisation – the underlying risks are associated with non-financial events – it contributes to risk sharing and cost reduction.

Insurers also urge for better information disclosure about complex products. Full transparency of underlying risks, including their embedded leverage, appears to be essential.

### 3. Regulation of financial markets

The worldwide debate on new regulatory rules for the financial sector is producing a tremendous flood of arguments, suggestions and proposals: Governments are working on improved regulations, financial institutions are intervening, researchers are arguing. However, very little is definitely decided and even less is implemented.

G20 governments agreed to come to a conclusion on the reforms of the financial system by December 2010. This can be expected to be a difficult path as national priorities are heterogeneous. The major common fact is that politicians worldwide are under severe pressure from both business communities and the public to establish efficient control mechanisms.

#### Mr. Grande – about the role of macro-prudential risk assessment

The crisis shows that the identification of risk was not optimal before the crisis. Some of the risks were underestimated and the relation between macro and micro level of supervision were missing. Thus there is need to improve/strengthen the macro-prudential supervision which is the supervision of systematic risk in the financial system.

On the macro level of prudential supervision an improvement in particular of the detection of risks to financial stability would be required. When the risks are identified the ESRC should have the power to recommend policy actions on the micro level.

A macro-prudential perspective is important particularly in three domains of public policy:

- Monitoring and assessment of risk, as for example the interconnection between financial institutions, sectors and markets and the interplay between the financial sector and the real economy
- Framework for prudential regulation, meaning the coverage of regulation to all relevant components of the financial system addressing systematic risk
- Framework for prudential supervision in considering the potential usage of prudential tools for addressing systematic risk

Already in autumn 2009 the US government submitted an extensive financial reform bill, the “Wall Street reform”, which intends to reduce systemic risks, improve consumer protection, allow better supervision, restrict executive compensation – to mention only a few proposals included in the 1,400 pages act.

The European Commission developed legislative proposals which target strengthening financial supervision. The regulations were submitted to the European Parliament in September and October 2009 whose Economic Committee had a first debate in May 2010. Moreover, a stricter regulation of



hedge funds was adopted by the Council of Ministers and the Economic Committee. In addition, Germany started to ban unsecured short sales of bank and state securities.

The debates about these proposals are cumulating in these days. The amended US bill which was submitted in March 2010 still was a matter of strong lobbying by the US financial industry but the bill was just recently passed by the US Senate. It will now have to be complemented by the proposal of the House of Representatives. The European Parliament received over 100 modification endorsements, and many important public institutions, like the European Central Bank, the International Monetary Fund, the OECD and the social partners submitted their suggestions. Not to speak of the great number of other organisations, political parties, and research institutes.

This section reviews the major proposals by the G20 countries, European Social Partners, and important suggestions from research. These proposals address a great variety of measures which can be summarised under the following headings:

- More rigorous *banking prudential rules* as they are currently prepared by the Basel Committee, targeting the improved resilience of the financial system by higher equity ratios and risk-weighted validation of capital. In this context a broad discussion about bank resolution regimes developed, including the living will approach which calls for explicit and obliging resolution plans.
- *Imposition of taxes or levies* on capital market transactions – known as the Tobin Tax – which aims at reducing short-term speculation.
- Creation of *guarantee funds* which are served by financial intermediaries in order to prevent future instabilities in the financial system. This is envisaged by the European Union. The US version is a bank levy by which companies have to redeem, at least in parts, the cost of the financial crisis to tax payers.
- *Restructure the banking business* by separating investment and retail banking and limiting the size of companies in order to avoid future too-big-to-fail cases.
- *Better consumer protection* by extending the accountability of counselling services by financial intermediaries.
- *Reshaping compensation schemes* by incentives for long-term value creation and support of corporate social responsibility.
- More efficient *supervisory architectures* which resolve the weaknesses of current macro-prudential monitoring and micro-prudential supervision. This includes the regulation and control of *derivatives markets*, in particular of hitherto unregulated financial activities like hedge funds or over-the-counter transactions. Moreover, a more rigorous regulation of *rating agencies* is envisaged.

In their April 2010 meeting in Washington the G20 finance ministers and central bank governors reaffirmed their commitment to a financial reform which at its core must have “... stronger capital standards, complemented by clear incentives to mitigate excessive risk-taking practices”. By end-2010 internationally agreed rules will be developed to improve both the quantity and quality of bank capital and to discourage excessive leverage. The rules will be phased in by end 2012 considering the improvement of financial and economic conditions (G-20 2010, p. 1).

The consensus about the principal aims underlines the needs for international cooperation which is deemed essential by all sides. This however cannot hide the fact that governments have fundamental differences about the measures to be taken and their implementation. Basic conflict lines arise along the questions who is responsible for the crisis and who is affected by the reform. The following section therefore presents the financial reform approaches of different governments and institutions rather than analysing the appropriateness and expected efficiency of the measures listed above.

### 3.1. US government

“The failures that led to this crisis require bold action” writes Chris Dodd, Chairman of the Committee on Banking, Housing, and Urban Affairs in his summary of the US financial reform bill which is presently negotiated in the US Senate. The aims of this bill are to “create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street, end too big to fail, prevent another financial crisis.” (Dodd 2010).

The “Wall Street Reform and Consumer Protection Act of 2009” as it is called implies a fundamental change of capital market regulation and supervision. It contains a long list of measures:

- *Consumer protection*: the independent Consumer Financial Protection Bureau will have the task to protect consumers from unfair, deceptive and abusive financial products and ensure people get clear information. The bureau will be authorised to examine and enforce regulations for banks and credit unions with assets of over \$ 10 bn (€ 7.7 bn), mortgage-related business and non-bank financial companies.
- *Risk monitoring*: the Financial Stability Oversight Council which consists of federal financial regulators and independent members will have to identify and respond to emerging risks in the financial system, make recommendations to the Federal Reserve for rules for capital, leverage, liquidity, risk management and other requirements. The Council will be authorised to require systemic non-bank financial companies to be regulated by the Federal Reserve.
- *Restructuring financial companies*: applying the “Volcker rule” regulators will be able to implement regulations for banks to prohibit proprietary trading and relationships with and sponsorship of hedge funds and private equity funds. Non-banking institutions will be subdued to similar restrictions.
- *Living wills*: large complex companies will have to periodically submit plans for their rapid and orderly shutdown. Companies that fail to submit such plans will be hit with higher capital requirements and restrictions on growth and activity. An orderly liquidation mechanism for systemically significant financial companies will be created. Shareholders and unsecured creditors will bear losses and management will be removed.
- *Transparency and accountability for derivatives*: over-the-counter derivatives will be regulated, derivatives will be traded on central clearing and exchange platforms, swap dealers and major swap participants will be subject to capital requirements, and market transparency will be improved. Hedge funds will be registered and monitored more closely. Securitised products will have to be backed by emitters with an at least 5 % credit risk.
- *Rating agencies*: the Office of Credit Ratings at the Securities and Exchange Commission (SEC) will examine Nationally Recognised Statistical Ratings Organisations at least once a year and make key findings public. Rating agencies will be obliged to disclose their methodologies. Investors will have a right of action against rating agencies. Ratings analysts are required to pass qualifying exams and have continuing education.
- *Executive compensation and corporate governance*: shareholders are given a say on executive pay and the nomination of directors.

The extensive bill is a first benchmark for financial reforms. It has a focus on supervising and restructuring financial industries rather than intervening in capital markets by regulation or taxes. The reform has been amended by the bank levy of \$ 117 bn (€ 90 bn) by which the financial industry is expected to repay parts of the damages caused by the financial crisis. The parliamentary debate about the bill was at its peak in May 2010, as the Obama government needed the support of the US Senate governed by a Republican majority. Despite intensive lobbying against the bill by the US financial industry, strong pressure was coming from the public supporting the reform. The Financial Times wrote: “... there will be limited opportunities for changes, partly because of an anti Wall Street mood that makes it difficult for even sympathetic politicians to come out with measures that

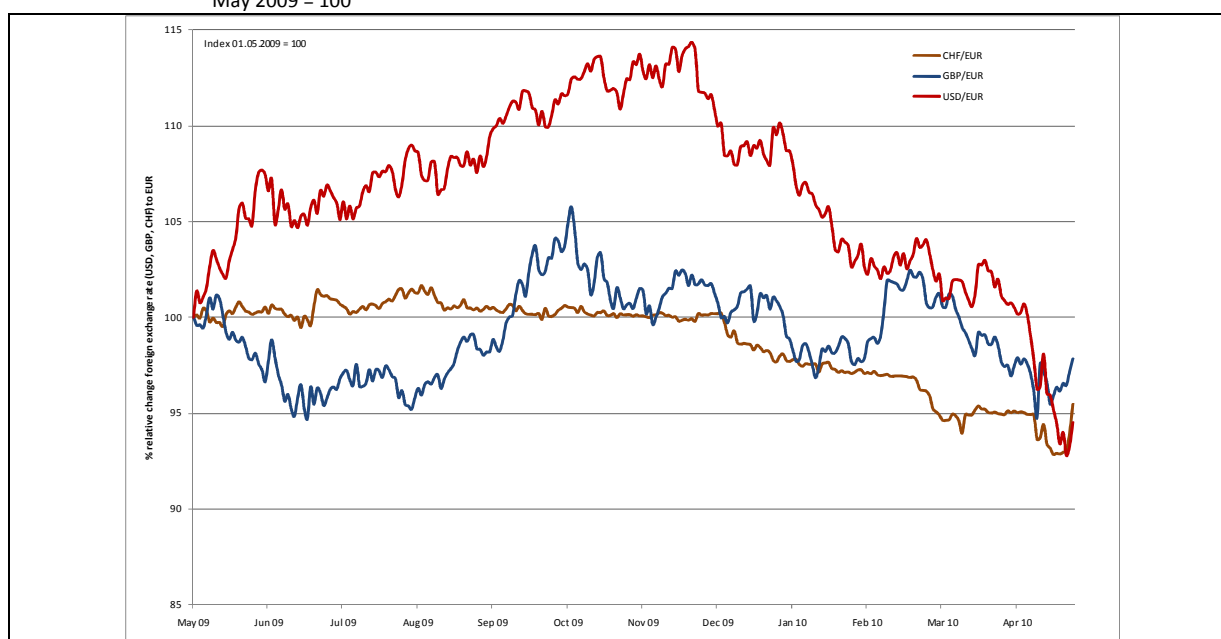
favour the banks.” (Financial Times 20.05.2010). And indeed, the US Senate approved the bill on 20 May 2010 with a majority of 59 to 39 votes.

### 3.2. European Union

In Europe in the meantime, the financial crisis has transformed into a country sovereign crisis. Greece needed a comprehensive support programme in order to avoid insolvency and debt conversion. Together with the IMF a € 110 bn credit line has been allocated up until 2012 which had been agreed on the basis of a comprehensive budgetary reform which should result in the reduction of public deficits from 13.6 % of GDP to 3 % Maastricht limit until 2014. This includes the cut of public salaries, the stop of early retirement, the increase of VAT rates and the deregulation of labour markets. Immediate protest against this austerity programme indicated that the population hardly accepts to take the major burden of the crisis.

Facing budgetary problems in other Member States and being attacked by international investors on the Euro front, the Finance Ministers of the European Union decided on 9 May 2010 to launch the European financial stabilisation mechanism with a total of € 500 bn amended by € 250 bn from the IMF. Based on article 122.2 of the Lisbon Treaty, the mechanism provides financial assistance in the form of loans and credits to Member States in difficulties. Spain and Portugal were recommended to further consolidate their public budgets. In addition the European Central Bank was authorised to buy commercial and state securities.

**Chart 7** Euro exchange rates  
May 2009 = 100



Source: BIS

Financial markets reacted with a further downturn of stock prices and the devaluation of the Euro (Chart 7), and the German government responded with the partial ban of uncovered short-sales. Moreover, it was decided to go for a financial transaction tax. In parallel, the Economic and Financial Affairs Council (ECOFIN) decided to pass the Alternative Investment Funds Directive which regulates hedge funds and other non-banking financial intermediaries.

All this looks like a serious combat in which the regulatory power of sovereigns is put against the financial power of international investors. Both have strong weapons which are able to weaken the opponent considerably. Governments can enforce rigorous legal limitations to financial activities or even close certain markets. Investors can concentrate financial speculation against countries up to the point where credit markets dry up. Even if both are depending on functioning and efficient capital markets, the battle is going to reach a peak during these days. Like in the United States, the debate is "... becoming worse and worse ... in a way that's becoming surreal" (Financial Times 02.05.2010).

The Greek crisis revealed the shortcomings of the European Monetary Union as it did not fully address the contradiction between a unitary monetary system and sovereign fiscal policies. Apart from the repeated weakening of the Maastricht fiscal principles by countries like Germany or Italy and the cheating of budgetary statistics by the Greek government, the weaknesses of some of the real economies became painfully apparent. The low competitiveness of the Greek and Portuguese economies, the unhealthy expansion of the construction sector in Spain, the inflation of the financial sectors in the UK, Ireland, or Lithuania, were all not sustainable. As a consequence, serious restructuring is now enforced by the shrinkage of overall growth and the repair of public budgets.

The German government came up with a strategy paper which addresses the next steps of combating the crisis (Handelsblatt 19.05.2010). It states that the European Monetary Union is not prepared for the extreme case of a state insolvency and recommends stringent monitoring of public, mandatory budgetary limits, efficient penalties for non-accommodating Member States, and ordered resolution systems for public entities.

The EU Commission proposed to reinforce decisively the economic governance in the European Union in order to strengthen the Stability and Growth Pact and extend surveillance to macro-economic imbalances (European Commission, 2010b). The Commission suggested aligning national budget and policy planning and developing a permanent crisis resolution mechanism. Fiscal discipline should be improved by

- Preventive budgetary surveillance and a peer review of broad budgetary guidelines
- Integration of budgetary discipline in national law
- Enforcement of the Stability and Growth Pact, giving more attention to the debt criterion
- Suspension of the Cohesion Fund in case of severe violation of the pact
- A more rigorous application of the existing suspension clause

For some observers this could be the entry point into the better coordination of fiscal and economic policies or even "... the birth of the United States of Europe" (Steingart 2010) with an effective European integration mechanism. Others, however, see this as a further shock to the independence of Member States and the end of sovereign fiscal policies. A further debate on the constitution of the European Union has thus been triggered by the financial crisis.

Already in September 2009, the European Commission adopted legislative proposals to strengthen financial supervision in Europe (European Commission 2009b). It suggests creating a European Systemic Risk Board (ESRB) to detect macro-prudential risks, and a European System of Financial Supervision (ESFS) for the coordination of micro-prudential supervision. The ESFS is composed of three new European Supervisory Authorities for the banking, securities and insurance and occupational pensions sectors. The new architecture of financial supervision still is in the process of legislation and the debate is how it can be effectively linked to national supervision. Moreover it is unclear which instruments can be applied to assess macro-prudential risks. Hence, a long way is still to go until the European financial supervision will be in place.

### 3.3. Coordination at G20 level

On several summits since autumn 2008, the G20 group focused on the need for a globally coordinated response to the financial crisis, and the summit in Toronto in June 2010 will continue to do so. While the G20 countries have agreed to develop international rules before the end of 2010, only the principles of financial reforms are visible until now:<sup>5</sup>

- *Banking prudential rules:* They aim to improve the quality and quantity of bank capital and to avoid excessive leverage. In addition, the major G20 financial centres committed themselves to adopt the Basel II rules on banking prudential requirements by 2011 in order to avoid regulatory arbitrage.
- *Compensation systems:* A comprehensive agreement facilitated by the Financial Stability Board (FSB) with a focus on long-term value creation was agreed. Detailed implementation standards were developed regarding the pay structure, corporate governance arrangements and revised disclosure on remuneration policies. The monitoring of implementation by all financial organisations is crucial now.
- *Derivatives markets:* All standardised over-the-counter derivative contracts should be cleared through central counterparties, by the end of 2012 at the latest. Trade transactions should be reported to trade repositories and non-centrally cleared contracts should be subject to additional capital requirements. Increased transparency of derivatives markets and different trading centres are also important.
- *Contingency and resolution plans* should be developed by systemically important financial institutions. Crisis management groups will be needed for crisis intervention and an improvement in sharing information in times of stress.

At the G20 summit 2009 in London, progress regarding the previous summit was evaluated and further measures to strengthen the financial supervision and regulation, as well as global financial institutions were agreed:

- Establishment of a new Financial Stability Board (FSB) with a strengthened mandate. The FSB should collaborate with the IMF in order to provide an early warning system for financial and macroeconomic risks.
- Extension of regulation and oversight of all systemically important financial institutions, instruments and markets, in particular systemically important hedge funds.
- Reshaping of the regulatory systems to improve the identification of macro-prudential risks.
- Implementation of new principles on pay and compensation and strengthening sustainable compensation schemes and the corporate social responsibility of all firms.
- In order to guarantee the quality, quantity, and international consistency of capital in the banking system, regulations on excessive leverage are and liquidity buffers are needed.
- Tighter regulation for credit rating agencies, in order to prevent conflicts of interest.
- To take action against non-cooperative jurisdictions, including tax havens.
- In order to strengthen important emerging markets and developing countries – which have been the engine of the recent world growth – additional resources were made available. Therefore additional \$ 1 trillion were injected into the global economy.
- Reform of international financial institutions such as the IMF to allow emerging and developing countries to have stronger influence.

While governments will come up with different proposals to the Toronto summit, the US government is going to pass its financial reform act soon. This can be expected to influence the results of the summit strongly. The scope for national diversity appears to be limited, regarding in particular those

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<sup>5</sup> This is based on the results of the Pittsburgh summit in September 2009.

elements of the reform which address systemic risks on one hand and the competitiveness of financial industries on the other hand. The likelihood of a Tobin tax e.g. seems to be low.

### 3.4. IMF proposal

The IMF proposed a regulatory reform in the Global Financial Stability Report from April 2010 (IMF 2010, p. xii). This includes

- more and better capital, improvements in liquidity management and restriction of build-up in leverage in order to make the financial system safer
- handling the too-big-to-fail problem with a combination of ex ante preventive measures and ex post resolution mechanisms, in particular as some of the institutions have become bigger and more dominant than before the crisis
- capital charges on the basis of an institution's contribution to systemic risk which are able to compensate the externalities which they impose on the system as a whole, that is the impact their failure would have on others
- additional tools for regulators to monitor systemic risks, in particular systemic risk-based capital surcharges, levies on institutions, or even the power to limit the size of certain activities
- clearing of OTCs by central counter parties (CCPs)

According to the IMF, the future regulatory reform agenda is still a work in progress, but there is a great need to move forward soon. "The window of opportunity for dealing with too-important-to-fail institutions may be closing and should not be squandered, all the more so because some of these institutions have become bigger and more dominant than before the crisis erupted." (IMF 2010, p. xiv).

### 3.5. Basel II

The Basel committee has proposed global reforms which are part of the G20 process:

- Tighter rules for core tier-one capital and rising minimum ratios of tier-one capital to risk-weighted assets
- Increasing capital requirements for trading books
- New leverage ratios that would cap the size of a bank's overall assets relative to its tier-one capital
- Two liquidity rules: (1) sufficient easy-to-sell assets to survive 30 days of market chaos; (2) a "net stable funding ratio" that requires each bank to keep a minimum level of long-term funding relative to its assets
- Countercyclical capital buffers that would increase capital requirements at the height of a boom and limit a bank's abilities to pay dividends and bonuses if its capital ratios become too low

#### Prof. Goodhard – about European financial regulations in the next 18 month

According to Prof. Goodhard's view the Basel Committee, the FSB and the ESRB will introduce new regulations on capital and liquidity in the next 18 months. The transitional phase will take 4-5 years, before the measures come fully into effect. Legal changes in the Solvency resolution will probably take nearly 10 years.

Restrictions of derivative markets are difficult as it is hard to work out the purpose of any transaction and to distinguish between speculations and hedging. There might be movements in the following areas:

- Demand for better transparency: Report of all transactions with an OCG or through a centralized counter party. Summaries and analysis of data will support the regulator to understand the concentration of risks.
- Standardisation of large volume deals, interest swaps and credit default swap.

Basel II – the new Basel Framework for the International Convergence of Capital Measurement and Capital Standards – comprises international legislation on banking laws and regulations issued by the Basel Committee on Banking Supervision. It had to be implemented by EU Member States by 1 January 2007 and was targeted at improving the stability and soundness of the financial system. There-



fore, the framework focuses on stronger risk-orientation regarding the banks' capital requirements and on the consideration of recent innovations in financial markets as well as the institutions' risk management.

Basel II comprises three pillars. Pillar II and III are new components compared to the former Basel I accord:

- Pillar 1 defines the minimum capital requirements, including capital requirements for credit risk, operational risk and market risk. Several risk measurement methods exist (basic, standardised approaches or more risk-sensitive approaches based on internal methods of banks) in order to determine the capital requirements for these three risk areas.
- Pillar 2 includes the supervisory review process (SRP) and thus comprises qualitative requirements regarding the identification of the institutions' overall risk and the main influences on its risk situation. These qualitative elements should be evaluated from a supervisory perspective.
- Pillar 3 ensures the market discipline and comprises enhanced disclosure requirements for the institutions.

Basel II mainly addresses large, internationally active banks. Nevertheless, the basic framework can also be applied to institutions of varying levels of business activities and complexity. According to the Basel Committee, the expected effects of rules are far reaching (BIS 2009). The quality, consistency, and transparency of the capital base will be raised. This will ensure that large, internationally active banks are in a better position to absorb losses on both a going concern and a gone concern basis. Under the current Basel Committee standard, banks can hold as little as 2 % common equity to risk-based assets before key regulatory adjustments are applied. Also the risk coverage of the capital framework will be strengthened and leverage ratios constrained. This will help to avoid the build-up of excessive leverage in the banking system and introduce additional safeguards. The countercyclical capital framework will contribute to a more stable banking system, which will help dampening, instead of amplifying, economic and financial shocks. A series of measures will promote the build up of capital buffers in good times that can be drawn upon in periods of stress. Short and long-term liquidity standards will be improved.

In the new context of the financial crisis, the Committee is now preparing what is called Basel III, a regulatory scheme that develops the first and second pillar.

### 3.6. Solvency II

Solvency II is a European insurance reform of risk management in the insurance business. The insurance reform implements a risk-based capital system which replaces the existing solvency margin approach.<sup>6</sup> During Solvency I – the former risk-supervision reform of insurance undertaking – the need for a more fundamental review of overall financial positions of an insurance undertaking became visible. Therefore, current developments in insurance, risk management, international financial reporting etc, are now taken into account.

Solvency II adopts the three pillar approach as it is established for the banking sector in Basel II.

- Pillar 1 covers the quantitative requirements, while two capital requirements can be distinguished - the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The SCR is a risk-based requirement and the key solvency control level. It can be calculated according to the European Standard Formula or the firms' own internal models. The SCR covers all

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<sup>6</sup> The solvency margin is the amount of regulatory capital an insurance undertaking is obliged to hold against unforeseen events.

quantifiable risks an insurer or reinsurer is confronted with. The MCR represents different levels of supervisory intervention. When a firm infringes the MCR, authorization can be withdrawn.

- Pillar 2 covers non- quantitative or qualitative requirements, for example governance, risk management or supervisory activities. Capital levels are associated with the compliance with these requirements.
- Pillar 3 maintains supervisory reporting and disclosure. In order to ensure market discipline and the stability of insurers and reinsurers (disclosure), firms will need to disclose certain information publicly. Moreover, firms are required to report a greater amount of information to their supervisors (supervisory reporting).

At the moment a lot of discussions take place about the application of Solvency II: some companies argue that the capital requirements are too high for a long term business like insurance (see ABI in Great Britain), and the mutual companies are fighting against a system that will force them into a capitalistic business model. An impact study carried out by the European Commission (QIS5) is expected for April 2011.

### 3.7. European social partners

Social partners submitted proposals for the reform of European financial markets. They agree in the demand for more transparency and proper supervision, stronger customer orientation of services, higher regulatory standards, the revision of payment schemes, and the achievement of a sustainable banking system. However, different concerns are arising in the programmes.

The European Banking Federation (EBF) is highly concerned about size prescriptions as suggested by the US government and the regulation of leverage ratios. Banking should remain open, flexible, and governments should retreat from the business as soon as possible. In the paper “Principles for a successful future of banking in Europe” the EBF describes the principles adopted by the Federation as the following (extract from EBF 2009):

- *Banking in an open market*: EBF insists on the necessity to go on with the open single European market. “It is essential to avoid a return to the days of financial markets fragmented along national lines. The EU’s single market is a great achievement and must be maintained”.
- *Properly supervised banking*: the European banking industry is witnessing a shift towards more intrusive and intensive supervision.
- *Truly commercial banking*: public intervention needs to be withdrawn as soon as possible.
- *Banking without size prescription*: EBF is rather afraid by the American President’s propositions to limit the bank’s size.
- *Diverse banking models*: the multi-faceted banking system consisting of private, public and cooperative banks should be preserved
- *Customer-oriented banking*: notably in the field of credit intermediaries and information to consumers.
- *Robust banking*: the banking business is highly sensitive to changes in capital requirements.
- *Sustainable banking*: banks must improve risk management, align remuneration and compensation schemes with long-term value creation and gear incentive structures more strongly to customers’ wishes and long-term corporate interest.
- *Adaptable banking*: Strategies have to be able to adapt the products to changes and demand.

The European Association of Co-operative Banks (EACB) underlines that “cooperative banks have demonstrated throughout the recent turmoil that they are a stable and resilient driving force for local European economies. They are, however, at risk of being widely impacted by the new EU and international regulatory framework.” (EACB 2010a). Careful consideration should particularly be



given to the specific characteristics of the shares of cooperative banks, whether it will be in the context of reviewing the definition of capital, IFRS (accounting), prudential banking supervision or corporate governance measures. While the association fully endorses the principles of the Basel committee, many questions regarding the specific role of cooperative banks are still open. Moreover, there are serious doubts that combined effects and correlations of the proposals can be properly assessed (EACB 2010b).

The European Savings Banks Group (ESBG) also welcomes the Basel Committee's proposal, but has "... serious concerns as regards the pace and volume of the envisaged regulatory changes" (ESBG 2010): There is a high degree of uncertainty in the financial markets given the unpredictable outcome of the regulatory reforms, and the unprecedented speed by which the new measures are devised and adopted. However, there are strong concerns about the quality of the regulatory output. There is a real risk of moving towards over-regulation. The large amount of regulatory reforms puts a heavy burden on the retail banking sector, which was the most resilient during the crisis. Retail banks will find it more difficult to mitigate the impact, as they have much lower flexibility in adapting their business model.

UNI Finance emphasises strict control over all financial markets, the protection of pensions and life assurance, the restriction of tax exemptions and tax havens, and the co-determination in company takeovers. In the paper "For a responsible and sustainable finance industry" UNI Finance calls for principal restructuring. The key elements of reforming the financial system are (extract from UNI Finance 2009):

- *A new business model which is customer-oriented and risk conscious*: internal operating procedures and practices should be transparent; a structured dialogue with supervisors should put in place; charters for the responsible sale of financial products should be developed.
- *Financial regulation*: a comprehensive framework of financial regulation should cover all financial products and players; diversity of the finance industry should be maintained; commercial and retail operations should be separated.
- *Restructuring and bail-outs*: state aid should be provided in normal market terms so that any losses are borne by shareholders and investors; it should be neutral regarding the competitive position of recipients and respect core labour standards; unions should be involved in restructuring and bail-out plans at sector and company level; lay-offs should be avoided and collective agreements respected.
- *Remuneration*: systems should be realistic, fair, sustainable, long-term and customer-oriented, and not be based on increasing short-term revenues; variable pay schemes should be kept at reasonable levels, based on several years and include claw-back provisions; the primacy of collective agreements must be respected.

### 3.8. Research proposals

There is the expectation among research institutes that the creation of a new regulatory framework will be a difficult and long-lasting endeavour. New regulatory procedures will have to be designed and tested. New institutions will have to be established. Experience will have to be collected in practice. Public supervisors will have to change their approach towards prospective assessments of risks rather than controlling conformity with existing rules. In particular, a macro-prudential approach will have to be developed which includes all systemic components (financial institutions, markets, products), and addresses their macro-links. The reforms should be targeted at reducing the implicit guarantees provided by public budgets and limiting pro-cyclical incentives to market participants. Systemic risks are understood as external effects which – parallel to environmental pollution – should be internalised (Sachverständigenrat 2009).

Among the great number of reform proposals, three major directions can be identified:

- Restructuring financial institutions regarding size, specialisation or trade volumes
- Stronger market competition: the living will concept
- Equity rules and price regulation: leverage ratio and a European financial stability fund

### *Restructuring financial institutions*

These reforms are targeted at limiting the scope and/or the size of financial institutions. By the recent decision to follow the Volcker rule the US government did both: “Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. If financial firms want to trade for profit, this firm should not be allowed to run these hedge funds and private equities funds while running a bank backed by the American people.” (Barak Obama, 21 January 2010). In addition, the President submitted a proposal to limit the consolidation of the financial sector. The proposal places broader limits on the excessive growth of the market share of liabilities at the largest financial firms, to supplement existing caps on the market share of deposits.

Other proposals intend to reduce the cluster risks in the financial system by limiting interbank credits or other financial transactions. This approach is also applied by the European Commission.

### *Stronger competition: the living will approach*

The idea of this approach is to raise competitive pressure in the banking sector by establishing a structured and supervised procedure for market exit. The main instrument is the “living will” in which a bank declares its contingency plan. Public supervision will not only approve this plan but manage the procedures in this case. This approach is preferred by the UK government and part of the US Wall Street bill.

The approach is targeted at reducing the implicit state guarantee by forcing banks to prevent the case of insolvency and clarifying that public resource will not be available. This risk of bankruptcy will create greater incentives for risk aversion to managers, shareholders, and clients.

#### **Prof. Wood – about living will approach:**

The “freedom” of exit is the key change to a new financial business, which means that failing financial institutions will be subject to a structured insolvency procedure rather than state guarantees.

Deposit insurance (or state guarantees) should be lowered again and remain restricted to the poor. Clients will become more aware of financial risks, become more selective, and demand higher interest rates due to the rise of risks.

Without state guarantees, banks will have to raise equity provisions in order to attract clients. This will limit profits and reduce the incentives to become bigger.

It will be important to separate regulators from consumer protection because consumer protection tends to safeguard deposits while regulators tend to sustain the functioning of the financial system.

### *Equity rules and price regulation: leverage ratios and a European financial stability fund*

This approach intends to internalise the costs of risks. Higher equity ratios for higher risks, and controlled leverage ratios are the main instruments. This is the main approach of the Basel Committee which targets a precise correspondence between risks and capital requirements.

Another approach is the European financial stability fund which is suggested to build up a sector-based rescue fund for vulnerable banks which is financed by financial institutions. Thus the private financial sector will have to take care of future risks.

## 4. Adaptation to the crisis at the micro level

The reactions of financial intermediaries to the financial crisis are multifaceted. As the following section will show, there are three principle types of adaptations:

- The first group came under state-control during the crisis and now has to face severe restructuring. This includes both the reaction to substantial losses in trading books and the reorientation of business strategies towards the core business. The restructuring process is strongly determined by public supervision which is still providing the necessary guarantees in order to stabilise financial systems.
- The second group of banks draws high profits from trading books and the engagement in derivatives markets. It undertakes the necessary adaptations of business operations under the new market conditions, but nevertheless tries to continue the previous strategy, urging for minor changes of the regulatory framework. They take advantage of the huge liquidity that has been made available since 2009 by the low interest policies of central banks.
- The third group was less affected by the financial crisis because it was not engaged in new financial markets as much as the other groups. It consists of savings and mutual banks which already concentrated on retail banking in the past. The former disadvantage of being less profitable turned out to be an advantage which is now actively used to expand market shares. Moreover, this group includes banks in Spain and the New Member States which were not allowed to engage in new financial markets due to legal restrictions. Finally, most of the insurance business can be counted as part of this group as it by tradition followed a conservative investment approach.

This classification of adaptations to the financial crisis coincides with the principle reactions developed under the skills scenario project (Economix/DKRC 2009). The first group was described as the “State-Ownership” scenario, in which the banking business is strongly state-controlled. The second group follows the “Laissez-Faire” scenario assuming the continuation of previous business models with minor state intervention. The third group behaves according to what was called the “Sustainable Finance” scenario, a business model which emphasises long-term profitability based on consumer trust and well defined customer services. The major difference to the financial services scenario report, however, is that in reality these scenarios appear in common rather than being mutually excluding alternatives for future development.

The following section is going to scrutinise the different adaptation models in the banking and insurance business based on the evidence described in the case study report. In addition, the results of the expert interviews are included. Most recent company information was collected for the selected companies which in part are big players in financial markets. This reflects updated developments at the micro level in the financial centres of the European Union including the New Member States.

### 4.1. Common perceptions of market trends

Before analysing the restructuring characteristics of the different financial sector segments, a short view on common trends is provided. From the European perspective there are four issues where we see strong similarities in the perception among all financial intermediaries.

#### *Decline of profit rates*

There is a general expectation that profits rates in financial markets will decline. Higher equity ratios will be demanded by financial regulation, risk controllers will curb investments in risky but profitable markets, consumers will invest in less risky products, and companies will withdraw from parts of investment banking. A profit rate reduction of 20 % to 25 % is expected for asset management. This

will bring financial services closer to the average profit rates of other industries, and will have consequences for work organization and sector restructuring.

### *The need for regulatory reforms*

Actors on financial markets are expecting more or less substantial changes in the regulatory framework. They are very much aware that the bail-out by public budgets was an extraordinary action by governments which will not remain without consequences. Policy actors are under serious pressure from both the public and the commercial world to achieve control of financial markets. A second financial crisis will have to be avoided. As Robert Reich wrote: “Over the long term, the political stakes in reforming Wall Street are as high as the economic” (FT 13.01.10). Under these conditions the financial world is expecting reforms however there is only a limited consensus on what has to be done.

### *Reform of bonus systems*

The business is also aware that citizens are upset about bonus payments to investment bankers and management in periods of substantial losses. As section 4.5 will show there are various initiatives in the sector which are on the way. Nevertheless, there are different opinions about the usefulness and the structure of bonus payment reforms.

### *The advantage of universal banks*

European banks applied the universal banking system in the past and are keen to safeguard this approach. The main arguments are that universal banking opens better opportunities for risk distribution, implies improved transformation of capital flows, and gives access to more than one market. This allows risk transformation and avoids dependencies on single markets.

The approach is particularly prominent in Germany where big universal banks provide retail banking services, commercial banking, capital market banking and asset management. For businesses, “merchant banks” exist which provide all financial services to companies, including foreign trade finance, foreign exchange transactions, and cash management.

However, this approach does not exploit the economies of scale which result from specialisation. It also does not clearly separate risks as it was required by the Glass Steagall Act in the United States up until 1999 – and is now suggested again by the “Volcker” rule. The Anglo-Saxon financial institutions therefore followed a much stronger separation of retail banking and investment banking and other parts of financial services.

## **4.2. “State-ownership” approach**

A series of banks had to refer to state guarantees and public capital support. In Europe for example Royal Bank of Scotland (RBS), Lloyds, Dexia, Commerzbank and Bayern LB needed support such as

#### **Mr Bilitewski – about IBM services needed in the financial sector**

- Risk Management has always been important for banks, already before the crisis. The current trend is more about optimisation of risk management in order to use it as a basis for decision-making. Existing instruments should be linked and used in a more efficient way. IBM is aware of the importance of risk management and offers a wide range of services in the area of Business Analytics and Business Intelligence. In this area IBM purchased Cognos, ILOG and SPSS. These software products suit the current topics in the market, as the problem is not the lack of information – it is more about the analysis of information. The goal is that the analysed information contributes to decision making
- Back-office activity is still a segment where banks can reduce their costs, as some banks still have old applications. Then the questions have to be considered if it is efficient to maintain/advance the old system or if it is better to switch to standard application and products to optimise the back office area. The optimisation of the back-office business is related to comparably high investments but can unburden employees who can be used for innovation and product development.
- There will be new challenges for banks regarding financial regulations. Banks will need to adapt in a short period of time and two kinds of projects can be expected by IBM: Consulting project to clarify how the requirements can be fulfilled and adaptation projects (e.g. new applications) to guarantee required reporting and obligations to report

their US peers Citygroup, Bank of America and JP Morgan. These financial institutions suffered from the devaluation of financial investments during the crisis as they were strongly engaged in this business or because they were among those that could not exit the markets early enough.

In contrast to the USA, only a few of the European banks under state control were able to repay government funds by today. The consequence of this is that the restructuring process in these companies is now governed by public authorities. Their main interest is to maintain their investment and to safeguard deposits of customers. Companies therefore have to change their business model to a “back to the basics” approach (as ING Group expressed it). All peripheral activities are for sale, also with the aim to refund the public investors. Thus, cost efficiency is important and employment losses are high.

This means that these companies are presently losing market shares and their competitive position is deteriorating. The end of the restructuring process and its outcome is not yet visible as they all were in a dramatic situation.

Strategies of affected banks were revised and the majority switched to a less risky long-term orientation. Remuneration policies were adapted with a focus on long-term success. In addition general board members often receive a reduced salary as long as the banks rely on governmental support. Risk assessment gained importance and the tools have been improved. However, whether these changes are sufficient to create sustainable financial institutions will have to be monitored in the following years.

For example after Dexia Bank Belgium needed capital injections and state guarantees due to serious financial challenges in 2008, a stringent plan to transform its business and to cut costs was implemented (EUROFOUND 2010). In particular the bank improved its risk profile by disposing loss-making business segments, refocused on its principal clients (in particular public and wholesale clients) and core markets and announced to reduce the cost base by 15 % (€ 600 m) by 2011. The third target was achieved by paying no bonuses to the management and no dividend to shareholders for 2008 as well as 800 jobs cuts, achieved through recruitment freezes, internal flexicurity measures (retaining or function and geographical mobility) and early retirement measures.

For this case study, three representatives were selected: RBS, the bank in Europe with the highest governmental support, Commerzbank, the second largest credit institution in Germany, and Fortis which was a large financial service provider for insurance, banking and investment management before it encountered severe problems in 2008. Thus, most of the company had to be sold in parts, with only insurance activities remaining. Fortis has been included in the “state-ownership” approach case study, in order to show its split up after the crisis and to include an insurance company in the analysis. The stylised facts for these companies are given in Table 3.

### *Response to the crisis*

All three companies relied on governmental support:

- The UK government became the majority shareholder at RBS and has a stake of 84 %. Altogether, RBS received € 50 bn governmental support. This was necessary due to a strong loss in 2008 (£ 7.1 bn or € 8.2 bn) which was partly caused by the burdening takeover of the Dutch ABN Amro bank. It was forced to make a number of divestments as part of the settlement with the European Commission in respect of the state aid received. Moreover the bank pays about £ 2.5 bn to the Government Asset Protection Scheme until 2011 – an insurance scheme designed to help banks with bad loans.

**Table 3** “State ownership” approach companies

Financial institution (source)	Economic performance 2009	Income structure 2009	Business model
Royal Bank of Scotland UK	Pre-tax operating result: € -2.2 bn Tier 1 capital ratio: 14.4 % Leverage ratio: 17x Employment total: 183,700 Employment 2009/08: - 8 %	% of total income 2009: UK Retail (17.8 %), UK Corporate (8.7 %), Wealth (4.0 %), Global Banking & Markets (39.6 %), Global Transaction Services (9.0 %), Ulster Bank (3.7 %), US Retail & Commercial (9.8 %), RBS Insurance (15.7 %) and Non-Core Division & APS (-8.3 %)	Target: become one of the world's premier financial institutions, anchored in the UK but serving institutional customers in the UK and globally Operation: focus on retail and corporate banking in UK, US and Ireland (Ulster Bank)
Commerzbank DE	Pre-tax result: € - 4.7 bn Tier 1 capital ratio: 12.6 % Leverage ratio: 24x Employment total: 62,671 Employment 2009/08: -9.7 %	% of revenues 2009: Private Customers (59.9 %) Mittelstandsbank (28.5 %) Central & Eastern Europe (1.7 %) Corporates & Markets (23.2%) Asset Based Finance (-2.57%) Portfolio Restructuring Unit (-19.6 %) Others and Consolidation (8.9 %)	Target: reinforce position as market leader in German private and corporate customer banking Operation: one of leading bank for private and corporate customers in Germany
Fortis (remaining insurance part; today named Ageas) BE/NL	Pre-tax profit: € 1.6 bn Employment total: 10,613 Employment 2009/08: + 2.3 %	% of net profit 2009: AG Insurance (73.9 %) Fortis Insurance International (18.2 %) General account (7.9 %)	Target: international insurance company with strong partnerships in Europe and Asia Operation: leader in the Belgian market for individual life and employee benefits and leading non-life player through AG Insurance. Internationally, strong presence in the UK and other subsidiaries in France, Germany, Turkey, Ukraine and Hong Kong
BNP Paribas Fortis ( also called Fortis Bank) BE	Pre-tax loss: € 1.8 bn Tier 1 capital ratio: 12.3 % Employment total: 35,000 Employment 2009/08: - 5.4 %	% of total income 2009: Retail banking (40.8 %) Asset Management (8.3 %) Private Banking (5.2 %) Merchant Banking (47.8 %) Other Banking (- 1.6 %)	Target: become the reference bank in Belgium for all its clients Operation: make use of its core activities: Retail & Private Banking, Corporate & Public Banking, Corporate & Investment Banking and Investment Solutions.
Note: The % of the net profit of Fortis excludes the net profits gained from the sale of 25 % plus one shares of AG Insurance to Fortis Bank (€ 697 m) in May 2009.			

Source: Company information

- Commerzbank experienced a severe pre-tax loss of € 4.66 bn in 2009 and € 5.45 in 2008 (on a pro-forma basis assuming that Dresdner Bank was already part of Commerzbank Group in 2008). The company's results were heavily burdened by the takeover of Dresdner Bank, the third biggest bank in Germany. Due to the difficulties faced in 2008 its equity was strengthened by the German Financial Market Stabilization Fund (SoFFin) in January 2009. Altogether the governmental help was € 18 bn (whereof € 8.2 bn is a silent participation). The German Federal Government with 25 % plus one share is now the major shareholder in the new Commerzbank.
- Due to the financial crisis Fortis ran into troubles in the second half of 2008. Fortis was impacted by a continuously and rapidly decreasing share price. Moreover, Fortis's interbank market access was affected by alarmist rumours and it had to struggle with substantial liquidity requirements. As a consequence the Belgian government invested € 4.7 bn, the Dutch government € 4.9 bn and the Luxembourg government € 2.5 bn in the Fortis Bank in September 2008. In the following months Fortis was split: 50 % plus one share of Fortis Bank were sold to the Belgian State which agreed to transfer 75 % of Fortis Bank to BNP Paribas; the insurance business remained in Fortis (today called Ageas) and the remaining parts were sold to the Dutch state.



The crises enforced substantial writedowns on assets. At RBS impairment losses increased to £ 13.9 bn (€ 16.1 bn) in 2009 from £ 7.4 bn (€ 8.6 bn) in 2008. Fortis bank (now owned by BNP Paribas) had impairment losses of € 340 m in 2009. At Commerzbank provisions for possible loan losses of € 4,214 m in 2009 and € 3,553 m in the previous year were made. RBS and Commerzbank reacted to the financial crisis with strong deleveraging. On a pro-forma basis the volume of total assets decreased by 31 % at RBS and by 19 % at Commerzbank. At Fortis Bank (BNP Paribas Fortis) the volume of total assets was reduced by 26 % while the insurance company Fortis experienced a slight increase of 0.4 %. Accordingly risk-weighted leverage ratios at the banks have been reduced substantially.

The two affected banks both set up new strategies: at Commerzbank the “Roadmap 2012” and at RBS the “Roadmap to Recovery” which stands for reducing risks, increasing profitability and a focus on their core businesses private and corporate customer banking. In addition both banks introduced a new non-core division (at Commerzbank it’s called Portfolio Restructuring Unit) where toxic assets are winded down and non-core assets can be run-off.

### *Business models*

The business models of the two banks are mainly characterised by their new strategies which now emphasise the focus on long-term success with fewer risks. In previous years expansion was important, what was reflected in the takeovers of Dresdner Bank by Commerzbank and ABN Amro’s investment banking division by RBS. Today, tight risk assessment, cost efficiency and return to profitability again within the next years are the most important targets.

Both banks mainly rely on retail and commercial banking and plan to expand their profit in this segment. RBS has the strategic goal that retail and commercial banking in the UK, US and Ireland should contribute two-thirds to profit and the Global Banking & Markets (GBM) division (including investment banking) should contribute one-third. In 2009 retail and commercial banking in UK, US and Ireland contributed 40 % of total income and GBM contributed the same proportion. The rest came from the divisions Wealth, RBS Insurance and Global transaction Services, while the non-core division created a loss.

At Commerzbank the division Private Customers is the core element, which contributed 60 % to revenues in 2009. The second largest division is the division Mittelstandsbank (28 %) which serves small and mid-sized enterprises. Due to Commerzbank’s new strategy “Roadmap 2012”, it plans to reinforce its position as market leader in German private and corporate customer banking. Its focus is on being a profitable core bank featuring the segments Private Customers, Mittelstandsbank, Corporates & Markets, and Central and Eastern Europe.

After the split up of Fortis the remaining insurance business (Fortis) set up a new strategic plan which focuses on strong partnerships in Europe and Asia and the streamlining of the company’s existing portfolio against strict criteria. At Fortis the AG Insurance division contributed the major part (73.9 %) to net profits, while the other divisions provided 26.1 % in 2009.

All three institutions were forced to sell several parts of their business as a consequence of governmental support. Since mid-2009 Commerzbank sold Privatbank Reuschel & Co, two Swiss subsidiaries, Privatinvest Bank (Austria) and its British Wealth Management segment Kleinwort Benson, Dresdner Van Moer Courtens and the branch Belgian of Commerzbank International S.A. Luxembourg, the Dutch Dresdner VPV (Asset management) and Dresdner Bank Monaco S.A.M.

RBS sold more than 300 UK branches, a commodity trading business, its insurance division and Global Merchant Services – its payments operation.

### Employment

The adjustment strategies of all three companies included a significant decline in the number of jobs. At Commerzbank the number of employees decreased by 9.7 % in 2009 compared to 2008 mainly due to the integration of the Dresdner Bank and due to cost reductions. Around 60 % of job reduction in 2009 was related to the core segments of Private Customers, Mittelstandsbank, Central & Eastern Europe and Corporates & Markets. In addition to that a further reduction of 9,000 jobs within the next three years has been agreed. Nevertheless, there won't be any enforced redundancies (*betriebsbedingte Kündigungen*) before the end of 2011.

At RBS the number of employees decreased by 8 % in 2009. Since 2007 the number of employees was reduced every year. Job cuts appeared in several divisions, however between 2008 and 2009 in particular in investment banking due to a cost reduction programme. As a consequence of the integration of ABN Amro's investment bank into RBS's global markets division 7,000 jobs cuts were announced in April 2008 (FT, 27.05.2008). In April 2009 the bank planned to cut 9,000 jobs worldwide in areas such as technology and call centres, group purchasing and managing group property. Thereof 4,500 jobs in the UK have been affected (FT, 08.04.2010). In addition to that Bloomberg stated in May 2010, that further 2,600 jobs in RBS's insurance and consumer banking divisions were planned to be cut.

In the course of the financial crisis Fortis was split into Fortis (Ageas), BNP Paribas Fortis and the remaining parts sold to the Dutch state. Before the crisis around 62,000 people were employed. Nowadays, around 10,000 FTE work at Fortis (Ageas), 35,000 FTEs at BNP Paribas Fortis (Fortis Bank). Around 4,000 - 5,000 jobs were lost due to the inclusion of Fortis Bank Nederland into ABN Amro Holding N.V. (Reuter Deutschland, 21.05.2010).

At RBS the reduction of employment contributed to its profitability. Due to the cost control initiatives across the group, including major technology and back office restructuring the core bank cost/income ratio, net of claims, improved from 66.2 % in 2008 to 53.5 % in 2009. In contrast, the cost/income ratio at Commerzbank – i.e. the ratio of operating expenses to total earnings before deduction of loan loss provisions – rose from 77.1 % in 2008 to 82.2 % in the reporting year.

### Remuneration

The two banks adjusted their remuneration schemes by introducing long-term incentives. Bonus payments are deferred over a period of years and equity based remuneration is a substantial part of total compensation for executives. At Fortis a similar system exists. There, the remuneration of executive committee members comprises a fixed base salary, a variable annual incentive and a variable long-term incentive.

At RBS no discretionary cash bonuses were paid to any employee in 2008 as well as no deferred awards in relation to 2008 performance have been made for executive directors. The remuneration of Commerzbank's board of managing directors was strongly reduced due to requirements of Soffin, which says that they are not allowed to earn more than € 500,000 per year.

At RBS's annual general meeting 2010 the new long term incentive plan has been approved. Due to the adopted plan executives can receive a payout equivalent to four times salary after three years, subject to three conditions being fulfilled. Half of the award will be paid based on the achievement of certain economic profit targets in 2012. One quarter will be based on total shareholder return relative to peers, while the final quarter will depend on RBS's share price reaching a certain level. All awards are subject to clawback.



At Commerzbank a new bonus-penalty system, which targets an appropriate level of risk-taking, sustainability and transparency has been introduced in 2009. An exception in comparison to other peers is that three models are tailored for different groups of employees. At management level and for employees with a non-collective pay scale the salary relate to individual to the group's performance (at management level the proportion is 60 % to 40 %). In addition a new remuneration policy applies to investment bankers: a part of their variable remuneration is delayed and takes account of both positive and negative performance at group, segment and divisional level. One-third of the total variable remuneration is placed in a bonus bank and depends on future performance. This bonus bank is intended to foster joint responsibility for results and to avoid inappropriate individual incentives in investment banking. Half of the individual variable remuneration is converted into share awards to be paid after three years, the other half is paid directly.

### *Risk management*

According to their new strategies the two banks have made considerable efforts to realign risk management and improve assessment methods. In addition to that a new organisational structure is applied for risk management.

At RBS a new board risk committee was created. RBS targets a stable AA category risk profile achieved by de-risking and shrinkage of the group's balance sheet and the limitation of the over-reliance in wholesale markets for funding. In particular risk management has been improved by a new credit approval process, a new risk limits framework in order to reduce exposures to high risk countries and an improved reporting programme to increase transparency.

Risk appetite is defined in both quantitative and qualitative terms as follows:

- Quantitative: encompassing stress testing, risk concentration, VaR, liquidity and credit related metrics; and
- Qualitative: ensuring that the Group applies the correct principles, policies and procedures.

Commerzbank also uses stress tests as early warning indicators. In stress scenarios all potential losses of each risk type occur simultaneously. In addition, Commerzbank monitors its risk-taking capability by comparing the capital requirement arising from the risk profile against risk cover. Therefore, a regulatory and economic capital model for analysing the group's capital requirement is used.

At Fortis risk management is supported by the Audit & Risk Committee which ensures the adequacy of Fortis' capital. For the company the avoidance of credit risk concentration (any exposure to counterparties with the potential to produces a significant amount of capital loss due to bankruptcy or failure to pay) is fundamental and is counteracted by diversified portfolios.

**Table 4** Summary "state-ownership" approach - Risk management

In € bn	Commerzbank	Royal Bank of Scotland
Total assets	844	1783
Risk weighted assets	280	513
Core Tier 1 capital	29.5	56.4
Tier 1 capital	/	73.9
CT1/ RWA (%)	10.5	11
T1/ RWA (%)	/	14.4
CT1 = Core Tier 1 capital; T1 = Tier 1 capital; RWA = Risk weighted assets		

Source: Company information, Economix

### *Ratings*

The positive long-term ratings for RBS (A-1, A, AA-) and Commerzbank (Aa3, A, A+) of the three large rating agencies are improved due to the financial support of governments and the high probability that there would be further support if needed. However, there are also uncertainties about short- and medium-term earnings prospects due to difficult economic circumstances.

Standard & Poor's sees RBS's diversified global business and its realistic new strategy as a strength, as well as the governmental support and the use of the Asset Protection Scheme. However, it also sees that RBS experienced a reputational damage due to its misjudged transaction of ABN Amro Bank. In December 2009 Fitch also saw substantial challenges for the management to achieve its strategic and financial goals and pointed to the group's heavy reliance on wholesale funding. Fitch also saw improvements in the group's capital in addition to some progress in restructuring the balance sheet. Total third party assets in the non-core division declined by 32 % during the nine months to end-September 2009 because assets have been run off and written down. However, non-core assets remain substantial and winding down these assets will be a complicated task, taking several years.

Commerzbank's financial strength rating of Moody's was changed from stable to negative due to the adverse impact of capital measures on Commerzbank's future profitability. The coupon payments for the governmental support will burden the profitability in addition to integration costs of Dresdner Bank and rising risk charges.

In addition, Commerzbank is confronted with challenges in terms of funding capacity and capital requirements for its large wholesale commercial businesses. The increased Tier 1 ratio is important for Commerzbank's asset quality. However, further rising credit charges on the customer bank will according to Moody's not be the only factor exerting pressure on the group's performance in 2010. An improvement in lending margins will not fully offset the decline in revenues that will result from the downsizing of total assets.

Regarding risk management Commerzbank has dedicated significant resources to establishing a comprehensive risk-measurement system for its value at risk model and economic capital concept. At the same time, however, risk management has become more reliant on statistical risk modeling, which may have contributed to mispricing of risk exposures or underestimation of concentration risks. The acquisition of a large, weak and capital markets-oriented bank like Dresdner Bank, in the middle of severe financial market turmoil, also raises some doubts, according to Standard & Poor's, about Commerzbank's risk appetite, considering the questionable risk-reward trade-off of the transaction.

### *Outlook*

According the rating agencies, the operating environment will continue to be difficult in 2010. The stable outlook of RBS on one hand reflects the expectation that the UK government will remain supportive and on the other hand that the stand-alone credit profile has the potential to improve over the medium term. Some progress is seen in restructuring the balance sheet. However, winding down non-core assets will be a complicated task, taking several years.

The outlook of Standard & Poor's for Commerzbank was negative of the short- to medium-term challenges due to the impact of the recession on its loan book, which could still result in more severe losses than currently factored into ratings. Moreover, the restructuring process needed to reduce its nonstrategic and wholesale-oriented activities and its capital leverage will also remain challenging.

Commerzbank and RBS believe that 2009 have been the peak regarding losses and expect a slight improvement in the following year. They also have ambitious targets regarding their profitability:

- RBS's plans to generate a sustainable 15 % return on equity, powered by market-leading businesses in large customer-driven markets. The bank targets to have all main core businesses in leadership positions by 2013. Moreover it targets sustainable 5 - 10 % organic growth by 2013. Thereby cost control is important as it plans to deliver more than £ 2.5 bn (€ 2.9 bn) efficiency savings by 2011. The cost income ratio with net of claims targets to be lower than 50 %, which would place RBS among the most efficient of its global peers. As already mentioned above, two-thirds of profits should be contributed by retail and commercial banking in the UK, US and Ireland and the division Global Banking & Markets should contribute one-third.
- Commerzbank intends to be operating at a profit again by no later than 2011. From 2012 onward, Commerzbank intends to generate an operating profit result of more than € 4 bn per year, and an after-tax return on equity of approximately 12 %. Therefore risk-weighted assets will be reduced to less than € 290 bn by 2012. There are particular targets for single business divisions: the Private Customer division's strong market position will be further expanded through the rapid integration of Dresdner Bank and rigorous cost management. The Mittelstandsbank aims to further enhance its position as the leading export financier in the German economy. Economies in Eastern Europe will post stronger growth over the medium and long term than those in Western Europe and in the US. Within its Central and Eastern Europe (CEE) segment, Commerzbank will particularly concentrate on its strong position in Poland. Corporates & Markets (C&M) will place client-oriented services for the bank's core target groups at the centre of its activities. Other business areas will be reduced or discontinued.
- Fortis targets to maintain business momentum and to meet the expectations of customers while at the same time to manage legacy issues. Any of decisions which will be taken will be in the long-term future of the company. In Continental Europe a three stage approach will be pursued to actively manage Fortis Continental Europe's portfolio. Thereby the focus on core competencies, including the strengthening of partnerships, expanding multichannel distribution, and innovating the product offering is crucial. Moreover, the current portfolio will continuously be assessed and sub-scale activities will be strengthened or divested. Selective investments in areas of growth are also targeted.  
Though to the turmoil caused by the high debt of European countries Fortis is burdened. In the end of 2009 the company hold bonds of Italy, Greece, Portugal and Spain of around € 18.1 bn. Thus risks regarding the bond remain also in 2010.

#### 4.3. "Liberal" approach

A broad group of financial institutions follow a "liberal" approach which is based on the free movement of capital and unrestricted innovation in capital markets. Investment banking is an important part of the business while retail banking is its basis. Many of the big players on European banking markets see themselves as universal banks which offer all types of financial services, like Deutsche Bank, Barclays, Unicredit, BNP Paribas, Société Générale, etc. Nevertheless, this group includes a great variety of investment banks, funds and intermediaries which are servicing the big consumer oriented banks with specialised financial products. Moreover, the big institutions created their own investment banking subsidiaries. Their common view is that the pre-crisis business model has strong advantages, capital markets proved to be efficient and provided important market opportunities and profits.

Of course, many companies in this segment are going to adapt their business models in response to the financial crisis. They started to raise equity ratios during 2009, improved risk assessment tools, reduced costs by cutting jobs, and revised their bonus systems. These adaptations however do not

address the core business which includes a strong investment segment in addition to retail and commercial banking.

The strategy was reaffirmed by the rapid recovery of profits in 2009. Profit rates are not yet back to the pre-crisis levels but are comparable to average long-run achievements. The recovery is mainly attributed to trading activities and the upgrading of assets in the course of the recent upswing. The fair value principle and the “cheap money” policy of central banks contributed to profits. This confirms that the previous business model is economically reasonable. No fundamental change is required.

For this case study, three representatives were selected: Barclays, Deutsche Bank and Unicredit. The stylised facts for these companies are given in Table 5.

**Table 5** “Liberal” approach companies

Financial institution (source)	Economic performance 2009	Income structure 2009	Business model
Barclays UK	Pre-tax profit: € 11.6 bn Tier 1 capital ratio: 13 % Leverage ratio: 20 Employment total: 144,200 Employment 2009/08: -5.6 %	Investment banking and asset management (48 %) Retail and commercial banking (52 %)	Target: universal bank leading the global financial services industry Operation: pioneering financial markets with best people and strong customer orientation
Deutsche Bank Germany	Pre-tax profit: € 5.0 bn Tier 1 capital ratio: 12.6 % Leverage ratio: 23 Employment total: 77,100 Employment 2009/08: -4.2 %	Corporate and investment banking (70 %) Asset and wealth management (10 %) Private and business clients (20 %)	Target: Leading global investment bank Operation: strengthening profitability of corporate and investment banking; focussing on asset and wealth management; expanding operations in Asia;
Unicredit Italy	Pre-tax profit: € 3.3 bn Tier 1 capital ratio: 7.6 % Leverage ratio: 24 Employment total: 165,100 Employment 2009/08: -5.4 %	Retail banking (41 %) Commercial and investment banking (36 %) Central and Eastern Europe (23 %)	Target: universal bank with strong customer orientation; Operation: customer centricity by proximity and simplicity; cost efficiencies by concentration of activities;

Source: Company information, press media

### *Response to the crisis*

None of the three banks relied on public financial support during the crisis. Josef Ackermann, the Deutsche Bank CEO, is cited with the comment that “it would be a shame for Deutsche Bank to apply for the tax payers’ support” (Der Spiegel, 15.10.2008). Similarly, Barclays defeated the plan of the British government to inject £ 7 bn in order to recapitalise banks in 2008. Instead the bank raised new capital and cut dividends. Unicredit also raised new capital in 2009/10.

The crises enforced substantial writedowns on assets. In 2008 the Deutsche Bank had to compensate a € 10 bn loss from the trading book and the bank’s own investments. Similarly, Barclays had a write-down of £ 8 bn (€ 9.4 bn) in 2008. In parallel, provisions for credit losses increased in the course of the crisis. Unicredit had to correct values of both assets and credits by € 3.7 bn in 2008 and € 8.3 bn in 2009. All three banks reacted to the financial crisis with strong deleveraging. The volume of total assets decreased between 10 % for Unicredit and around 30 % for Barclays and Deutsche Bank. Accordingly risk-weighted leverage ratios have been reduced substantially.

The 2009 upswing on stock exchanges all over the world brought banks back to profitability. Barclays in particular achieved almost a 100 % increase of pre-tax profits in comparison to the already remarkable profit in 2008. This resulted in a 24 % profit rate for shareholders in 2009. Deutsche Bank achieved a profit rate of 15 % after a similar loss in 2008. Unicredit came up with 5.5 % which was due to the significant rise of writedowns in 2009.

### *Business models*

The banks see themselves as universal banks but nevertheless have different targets. Barclays and Unicredit have a stronger retail banking orientation while Deutsche Bank describes itself as a universal investment bank. They all have the ambition to be a leading company in financial services. Barclays and Deutsche Bank define this target in the global context. Unicredit sees itself as a strong leader in its core markets Italy, Germany, Austria and the CEE countries. All three banks have a strong corporate and investment banking pillar which was the major source of revenues in 2009. This is particularly strong for Deutsche Bank which earned 70 % of its 2009 revenues in this segment. For Barclays the share was 48 % and for Unicredit 36 %.

Customer relations became a core element of the business strategies in the course of the crisis. Unicredit developed the “One for Clients” approach which started restructuring customer services with the target of increasing proximity and simplicity. Deutsche Bank launched “Phase Four” of its management plans which e.g. targets leadership in home markets of private banking and asset management.

Shareholder value nevertheless is the top goal of the banks’ strategies. As it is written in Barclay’s 2009 Annual Report (p. 15), “Our primary objective is generating returns for shareholders. But we recognise that we can, and should, in ways consistent with that objective, contribute to the well-being of society by conducting our business responsibly and by performing well, on behalf of our customers, our core functions of payments and money transmission, safe storage of deposits, maturity transformation and lending, and the provision of advice and execution in underwriting and trading.” Deutsche Bank also wants to “... turn strong relative performance through the crisis into profitable growth for our shareholders in the post-crisis environment.” (Letter of the Chairman of the Management Board, in Deutsche Bank, Annual Report 2009, p. 4). This indicates that market services, customer relations, investment strategies, and jobs are instrumental rather than generic targets.

Already during the crisis the banks started to continue their expansionary strategies. Barclays acquired Lehman Brothers’ North American Investment Bank in 2008. Deutsche Bank bought parts of Deutsche Postbank AG with an important retail banking basis, Sal. Oppenheim Group with strong asset management facilities, and ABN Amro’s commercial banking branch. Moreover it expanded its Chinese exposures. Unicredit, finally, continued the integration of Italian subsidiaries and restructuring of activities abroad. The companies use their recovered financial strength for growth by expansion.

### *Employment*

The adjustment strategies of all three companies included a significant decline in the number of jobs. In 2009, Barclays cut 5.6 % of its jobs, Unicredit reduced employment by 5.4 % and Deutsche Bank by 4.2 %. These job cuts are unprecedented in the recent history of the companies. They were particularly severe in retail banking and asset management. Head offices however were not affected in the same way or – as in Barclays – even expanded.

The reduction of employment contributed to profitability in a substantial way. Cost/income ratios declined between 4 and 6 percentage points to the level of 58 and 56 % for Barclays and Unicredit.

Deutsche Bank almost halved the ratio to 72 %. This was due to the losses in 2008 which shifted costs well above incomes.

### *Remuneration*

All three banks adjusted their remuneration schemes by introducing long-term incentives. Bonus payments are deferred over a period of years and equity based remuneration is a substantial part of total compensation for executives. At Deutsche Bank e.g. employees who create risk positions receive 14 % of their remuneration as fixed salary, 36 % as cash bonus and 50 % as deferred awards over a period of 3 ¾ years. Similar relations are applied by Unicredit and Barclays.

Regarding top management remuneration, the CEOs of Barclays and Deutsche Bank did not receive performance bonuses in 2008. At Barclays no salary increase and no annual performance bonus was provided to employees in 2008, and long-term awards were 64 % lower than in 2007. In general the sensitivity to public criticism of bonus practices has strongly increased. Banks started to publish remuneration reports on a voluntary basis and followed the suggestion to introduce long-term incentives. In the meantime competition on labour markets for investment bankers however started to rise again which means a first stress test for the new schemes with still unknown result.

### *Risk management*

All banks made considerable efforts to realign risk management and improve assessment methods. The chief risk officer is usually a member of the management board and a series of risk committees is executing the risk assessment in various operational segments. Performance targets are used to monitor the diverse activities.

Economic capital is used as a principal approach to calculate the capital needed to absorb severe and unexpected losses arising from exposures. It is calculated for credit risks, market risks including traded default risks, operational risks and general business risks. In the course of the crisis, however, economic capital has been continuously recalibrated to reflect the extreme market moves in 2008. This means that the concept strongly relies on past experience which is misleading in times of radical change. Economic capital amounted to € 21 bn at Deutsche Bank, € 24 bn at Barclays and € 44 bn at Unicredit.

Stress tests have been used to evaluate the impact of changes in general economic conditions on credit risks, and the effect of extreme market developments on asset values. Moreover, operational and liquidity risks have been assessed with assumptions beyond the key model parameters.

Table 6 gives information about risk weighted assets and Tier 1 ratios for the three selected banks.

**Table 6** “Liberal” approach – Risk management

In € bn	Deutsche Bank	Barclays	Unicredit
Total assets	1501	1603	929
Risk weighted assets	273	448	452
Core Tier 1 capital	23.8	44.8	38.3
Tier 1 capital	34.4	58.3	42.9
CT1/ RWA (%)	8.7	10	8.5
T1/ RWA (%)	12.6	13	9.5
CT1 = Core Tier 1 capital; T1 = Tier 1 capital; RWA = Risk weighted assets			

Source: Company information, Economix



### *Ratings*

During the first post-crisis year the ratings for the three banks have been downgraded slightly. This is remarkably positive as these banks operate in the centre of capital markets and have a strong international orientation. Banks did not capture sufficiently well their aggregate exposures to the underwriting of different asset classes and thus were unable to exit markets as quickly as needed. The banks were thus left with large, lumpy, higher-risk credit market exposures on their books as capital markets closed. They experienced large writedowns but were able to compensate these losses by sufficient resources, cost savings and a rapid recovery. In effect, they all successfully survived the crises and thus had no reason to change their business strategies.

One of the reasons for the minor downgrading is that all three banks profited from being “systemic relevant” banks. They did not receive public support directly, however, the indirect stabilisation of the financial system by the provision of liquidity and guarantees helped significantly to recover from the crisis and to compensate the high volume of writedowns. The supportive stance of national governments and the prospect of a gradual recovery of the European economies thus had positively affected the 2009 ratings. In reverse this means that a weakening ability of governments to expand public debt and to promote economic growth might again reduce the ratings for these banks. As a second reason, the deleveraging of exposures has also contributed to the stable ratings. According to Fitch, revenue diversification, sound liquidity and diversified funding, ongoing risk reduction and improving capitalisation are substantial positive factors in the assessments.

Nevertheless, this includes some concerns about volatile and uncertain operating environments. The growing weight of investment banking and the challenges of managing rapid growth of investment banking activities weigh negatively on the ratings. This is reinforced by the expectation that impairment charges are likely to grow. Further writedowns, particularly in the remaining leveraged finance transactions and monoline-wrapped securities are expected. The continuing preponderance of capital market activities and the ensuing challenges for risk management prompted Moodys to downgrade Deutsche Bank’s long-term rating by two grades from Aa1 to Aa3. Similarly for Unicredit, the on-balance sheet risks from its main investment banking arm, HVB, is assessed to be a weak point. Moreover, the exposure to emerging markets in Europe – a point that is evaluated a major strength by the Unicredit management board – is listed among the potential risks by the rating agencies.

A third reason were cost efficiencies which were used by all banks to compensate potential losses. The reduction of the number of jobs and the adjustment of compensation and bonuses was assessed positively. The banks are expected to successfully implement further cost savings.

### *Outlook*

According to the rating agencies, the operating environment will continue to be difficult in 2010. Balance sheets are still vulnerable to the current difficult economic and operating environment and capital ratios are expected to remain above historical levels. This will limit expansionary plans and burden profitability. An upgrade of ratings would depend on

- a reduced reliance on capital markets activities
- clear evidence that risk management and business line activities are working together efficiently
- improved structural liquidity through a combination of a higher proportion of liquid assets and a reduced reliance on short-term wholesale funding

The banks not only expect to remain profitable but to increase profitability in the medium and long-term. Adjustments of operational business proved to be efficient and opening the opportunity to expand operations in growth markets:

- Deutsche Bank plans to increase profitability in investment banking (“... while satisfying discipline in risk and balance sheets”), expanding retail banking and asset management, approaching



Asian markets and revitalising performance. In total this should provide a € 10 bn profit in 2011, compared to € 5 bn in 2009.

- Unicredit's strategy relies on further growth in CEE and CIS countries and on the progressive stabilisation of the economic recovery worldwide. With limited growth for foreign and government debt, the bank feels well positioned in these markets. Nevertheless, profits will continue to be under pressure in the short-run due to deteriorating credit quality and lower net interest incomes. In the long-run however the bank's profitability is expected to improve significantly. The bank feels well positioned to exploit growth opportunities and cost efficiencies.
- Barclays plans to further deleverage its activities and to bring down – over time – the loan to deposit ratio. The bank puts returns before growth and prudence should determine the approach to balance sheet size. It will "... continue to act as responsible corporate citizens" and "ensure its wider responsibilities to society". This, however, appears to be in contradiction with its strong commitment to provide returns to its shareholders, as long as there is no switch to long-term sustainability. The overall strategy therefore remains unclear.

#### 4.4. "Sustainable" approach

Banks which follow a "sustainable finance" approach are mainly characterised by a conservative and very risk-sensitive business approach. Their key segment is retail banking and a focus on good customer relations is a high priority. Some of them such as Santander and Rabobank are also active in the area of asset management, investment or insurance. The group of these banks were not seriously affected by the crisis. Other banks in this scenario type following a social-ecological business approach such as the German GLS Bank, Umweltbank or the Dutch Triodos bank even benefited from the financial crisis regarding an increasing number of customers.

The individual saving and cooperative banks are part of the "sustainable finance" approach, as they are characterised by a strong customer orientation. Their lead organisations however, e.g. the German Landesbanken and the DZ Bank, have been severely affected by the financial crisis. Similarly the Spanish saving banks are presently coming under massive pressure from their real estate investments. The entire system of saving and cooperative banks therefore can only be classified as sustainable, as far as a substantial reform of their internal organisation has been implemented.

There are different reasons why institutions with a "sustainable finance" approach have not been affected so badly by the crisis compared to other competitors, as these banks:

- Are not allowed by law to engage in risky markets. Spanish and Polish banks for example, had to follow legal restrictions which curbed profits during the expansion of financial markets. In the course of the crisis these restrictions appeared as a fundamental advantage which avoided substantial losses. Another example are building societies in the UK which are not allowed by law to trade derivatives.
- Are strongly decentralised – like the German savings banks or the mutual banks (Sparkassen, Volksbanken) – and were thus limited by size to participate in proprietary trading. As in the German case, however, their central organisations – the Landesbanken in particular and to a lesser degree the DZ Bank – were strongly engaged in trading risky products and now have to cope with substantial losses from these engagements. Similarly the Spanish saving banks are presently coming under massive pressure from their real estate investments. The entire systems of saving and cooperative banks therefore can only be classified as sustainable, as far as a substantial reform of their lead organisation has been implemented.
- Took a deliberate decision to concentrate on basic financial services rather than approaching new markets. The Svenska Handelsbanken is a good example of such a business model. The decision not to engage in the Baltic States and to apply a conservative approach avoided the bur-

dens which had to be experienced by the Swedish competitors Swedbank, SEB and Nordea. These institutes are now strongly affected by their investments in Estonia, Lithuania and Latvia.

- Applied a risk-aware investment strategy as the basis of their business. These are most of the insurance companies which adapted their investment operations to continuous financial flows rather than short-term investment opportunities.

The business model of mutual (or cooperative) banks can be classed into the “sustainable finance” approach. As they are owned by their members they do not have shareholders and are not driven by a focus on short-term profits and increasing dividends. Without pressure to show high quarterly profits, the business can be done with a long-term perspective and with a focus on the interests of members and customers. European cooperative banks have been hit relatively less severe by the direct effects of the crisis than private and investment banks. Their losses and writedowns appear to be relatively moderate and mainly concentrated in the international activities – more than 95 % of writedowns registered worldwide were due to commercial banks and some public banks (EACB 2010). Moreover, cooperative banks see increasing membership. The number of members of cooperative banks as percentage of total population in 6 European countries (Austria, Finland, France, Germany, Italy and the Netherlands) has increased from 14 to almost 17 percent between 1996 and 2008.

There is also partial information available for 2009 which indicates further advances regarding the number of clients. According to the German central organisation of the cooperative banking group, BVR, the number of members of cooperative banks in Germany increased by 1 % in 2009 to 1.6 million. This corresponded with the growth rates of previous years. Rabobank Nederland, the umbrella organisation of local Rabobanks in the Netherlands, reported a 3.2 % increase 1.7 million members in 2009, which was a slight acceleration of the growth rate. In Italy, however, the Associazione Nazionale fra le Banche Popolari stated a decline of around 1 % in 2009.

**Table 7** “Sustainable” approach companies

Financial institution (source)	Economic performance 2009	Income structure 2009	Business model
Rabobank NL	Net profit: € 2.3 bn Tier 1 capital ratio: 13.8 % Employment total: 59,311 Employment 2009/08: -2 %	Net profit by segments: Domestic retail banking (53 %), Wholesale banking and international retail banking (28 %), Asset management and investment (1 %) Leasing (5 %) Real estate (3 %) Others (10 %)	Target: become the Dutch market leader in all-finance services and an international food and agri bank, the retention of a high credit rating and high standards in respect of a corporate social responsibility (CSR) policy Operation: strong customer-focus, increased efficiency due to cost reduction programme
Santander Group ES	Net profit: € 8.9 bn Tier 1 capital ratio: 10.1 % Employment total: 169,460 Employment 2009/08: -0.9 %	Net profit by segments: Retail banking (70 %) Global wholesale banking (26 %) Asset management and insurance (4%)	Target: large international financial group, which provides high returns to shareholders and meets all the financial needs of its customers. Operation: customer-focused business model with geographical diversification, high efficiency and strong risk-awareness
GLS Bank DE	Net profit: € 0.202 m Employment total: 254 Employment 2009/08: +20 %	Business volume by segments: Customer loans (51 %) Bank deposits (29 %) Fixed-interest securities (17 %) Investments (1 %) Others (2 %)	Target: deliver transparent socio-ecological banking services to the increasing number of customers Operation: strong customer-orientation; focus on sustainable projects; expanding to Austria

Source: Company information, press media

For this case study, three representatives were selected: Rabobank, a large cooperative bank from the Netherlands with a long history of excellent customer relations and tight risk management, Santander, a large international financial group with high cost efficiency and GLS Bank, a small and dynamic bank from Germany which can be classified as ethic bank which operates in the specific market segment of ecological and social projects, and has a strong focus on sustainable investments. The stylised facts for these companies are given in Table 7.

### *Response to the crisis*

None of the three banks relied on public financial support during the crisis as they did not experience severe losses. All of them showed a strong overall performance. Nevertheless, they are also affected by the generally worsened economic circumstances. The two large representatives in this scenario group, Rabobank and Santander, experienced an increase in impairment losses in 2009. As response to the crisis both banks increased their Tier 1 ratios.

Santander states in its Annual Report 2009: “The last two years of economic and financial crisis have made it clear that a bank’s profitability must be measured on a long-term basis. This means having recurrent and sustainable business which shows responsibility to shareholders, employees, customers and society at large.” The bank showed a good business result (net ordinary attributable profit was 0.7 % higher at € 8,943 m) despite the occurring challenges in 2009 and compared to peers. Thus it feels confirmed in its strategy.

Moreover, Rabobank decided to scale down its non-client-related operations undertaken at global financial markets as a result of the financial turmoil. In addition since the bank needs an adequate Tier 1 ratio and stable profit growth in order to maintain its high credit rating, it has set the following long-term financial targets: a Tier 1 ratio of at least 12.5 %; a minimum return on equity of 8 % and 10 % net profit growth.

GLS Bank has been affected by the crisis in a positive way and it is confronted with the challenge to manage the continuously increasing number of customers. This is due to the increasing favour of ethic banking that became visible in recent years. The trend has been strongly supported by the crisis, as an increasing number of savers question the unbroken growth- and profit-orientation of traditional banks and look for alternatives. Between 2008 and 2009 GLS Bank’s number of customers increased by 18 % and its business volume by 33 %. One important response of GLS Bank to the crisis has been the need to hire more employees. This trend is expected to continue. The results of GLS Bank point out a much better performance than German cooperative banks on average: The business volume of all cooperative banks in Germany increased by 3.3 % between 2008 and 2009 and the number of members by 1 % (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, 2010).

### *Business models*

All three banks have a large retail banking division which is the major source of revenues. At Santander the retail division contributed 70 % to net profit and at Rabobank 53 % respectively. At GLS bank the retail and commercial banking segment is dominant. Customer relations have been a core element in the business strategy of all three banks, already before the crisis.

Santander and Rabobank see themselves as international financial service providers. One key element of Santander’s business model is efficiency. Santander states that it “has one of the most cutting edge technology and operations platforms in international banking, which allows it to turn cost savings into greater value for the customer. It is one of the most efficient banks in the world, with a cost-to-income ratio of 41.7 % (37.6 % excluding depreciations and amortisations).” In addition to

that Rabobank also implemented a cost reduction programme to increase the efficiency of the bank (the efficiency ratio which is equivalent to a cost/income ratio was 61.5 % in 2009).

Transparency is a very important characteristic of GLS Bank and can be interpreted as its source of success. Customers appreciate that they can decide in which area their money should be invested and they receive detailed information about all initiatives supported. For example, GLS Bank commercial papers are chosen and continuously monitored by strict criteria determined by a financial investment committee (*Anlageausschuss*). Due to a number of criteria companies involved in the following areas are excluded from the GLS portfolio – nuclear power, controversial economic or ecological practices, animal experiments or production of tobacco and drinks with high alcohol content.

The banks differ regarding their ownership structure and their geographical diversity. Rabobank and GLS bank are mutual banks and owned by their members who have the right to actively take part in decision making. Each member has one vote at the annual general meeting, independently from the number of cooperative shares. This enables the bank to pursue long-term goals rather than short-term profits – what is a typical characteristic for the “sustainable finance” approach. As Santander has shareholders it is part of their strategy to provide satisfying dividends to them. Santander announced to pay out a 2 % higher dividend in 2009 compared to the previous year. Santander can be categorised in the “sustainable finance” approach due to its risk-averse business model and its low cost income relation.

While GLS is a small bank with seven branches in Germany and the plan to open its first branch in Austria this year, the other banks have branches spread all over the world. Santander is proud to be the international bank with the most branches in the world, serving 92 million customers. Its principal geographical areas are Continental Europe, UK and Latin America. Rabobank has a dominant position in the Dutch market (is the market leader in the Dutch agriculture market as well as for retail savings and residential mortgages), and it additionally operates in 30 other countries.

### *Employment*

At Santander and Rabobank the number of employees decreased by 0.9 % and 2 % respectively. Reasons for job cuts at Rabobank have been decreased activity levels and the implementation of cost cuts. In domestic retail banking the full-time equivalent (FTE) employment level dropped by 1 % and at the division wholesale banking and international retail banking by 5 %. In order to reduce costs and increase efficiency the “Rabobank 2010 Vision” programme which targets at updating and improving customer services at substantially lower cost, in combination with a process redesign. Therefore the staff of local Rabobanks took part in support programmes.

At Santander Group the total number of employees decreased by 0.9 % (- 1,501 jobs) in 2009. The newly acquired bank Sovereign added 8,847 employees in 2009. In Latin America the number of employees declined by 10,000 mainly due to the disposal of America Banco de Venezuela. In the UK 1,430 jobs were cut in 2009. According to the newspaper The Telegraph, the bank stressed that the job losses were not in reaction to the financial crisis but part of the planned £ 180 m (€ 208 m) of annual cost savings after the acquisition of the UK bank Alliance & Leicester (The Telegraph, 12.12.2008).

Due to strong growth of the business, the GLS bank continuously increased the number of employees within the last years. It currently employs about 250 persons and plans to hire 60 additional employees in 2010. For the bank recruitment is easy as many excellent job candidates apply for vacant jobs. In particular some job candidates previously worked for large private banks. They seem to prefer the reasonable ethic concept of GLS bank over the financial incentives of large private banks.

### *Remuneration*

None of the three banks had to implement a new remuneration model as an answer to the financial crisis.

According to Rabobank Annual Report 2009 “the remuneration structure within the organisation has never been such that it might encourage irresponsible risks being taken”. At Rabobank the remuneration of the executive board distinguishes salaries, variable compensation and pension provisions. No variable compensation is awarded in form of option and/or share packages. A short-term and long-term (three years) variable compensation of the executive board of 15 % of fixed income exists. A variable compensation component exceeding 30 % of fixed income is paid only to a small number of individuals at highly specialised positions within Rabobank International.

At Santander the variable part of directors’ remuneration varies between 56 and 65 %. The variable component is paid out in cash and shares, while the shares are deferred for three years. The number of shares paid out is linked to the bank’s total shareholder return. In addition to that an obligatory investment plan exists, which obliges executive directors to invest 10 % of their gross variable remuneration of the previous three years in shares. Thus, incentives are given to target the company’s long-term success.

GLS Bank’s remuneration system distinguishes eight different functional groups, while number 8 are the management board members who earn around € 160,000 per year. The lower functional groups 1 to 4 are paid better than in private banks, and wages at higher functional groups are often lower. Bonus payments do not exist at GLS Bank.

### *Risk management*

The methodology of risk management was not adapted due to the crisis in all three banks. Santander pursues a risk policy which focused on maintaining a low-medium predictive profile in all risks and Rabobank has a long tradition of a very conservative approach to risk and credit management.

For GLS Bank the most important risk is the counterparty (or loan default) risk. Therefore a rating method is used which classifies all customer loans into internally defined risk classes. The grouping of loans into respective risk classes is adjusted in the case of changes to the creditworthiness of the borrower. The credit default rate of 0.3 % in 2009 was very low. In order to control for risks associated with changes in interest rates, GLS Bank uses an interest rate swap with WGZ Bank to the amount of € 80 m in 2009. However, the diversification of the credit portfolio is limited due to the bank’s ethical selection process of projects. In case of worsening economic conditions for example in the environmental sector or public finance, this could affect the bank in a negative way. This is also reflected in Fitch’s A rating that stands for safe investment, unless unforeseen events should occur in the economy at large or in that particular field of business.

At Santander and Rabobank economic capital is used as a principal approach to calculate the capital needed to absorb severe and unexpected losses arising from exposures. It is calculated for credit risks, market risks including traded default risks, operational risks and general business risks. At Rabobank it dropped by 2 % in 2009 to € 22 bn. The reduction was primarily caused by a decrease in interest rate risk in the banking book. At Santander economic capital was € 44 bn in 2009 (and € 40 bn in 2008).

At Santander and Rabobank analysis of scenarios and stress testing have been used in order to complement the analysis of market and credit risk and to evaluate the impact of changes in general economic conditions on credit risks, and the effect of extreme market developments on asset values.

Table 8 shows risk weighted assets and Tier 1 ratios for the selected banks.

**Table 8** “Sustainable” approach – Risk management

In € bn	Rabobank	Santander
Total assets	608	1110
Risk weighted assets	233.4	561.7
Core capital	/	48.4
Tier 1 capital	32.3	56.7
CC/ RWA (%)	/	8.6
T1/ RWA (%)	13.8	10.1
CC = Core capital; T1 = Tier 1 capital; RWA = Risk weighted assets		

Source: Company information, Economix

### Ratings

GLS Bank has a A+ rating of Fitch (safe investment, unless unforeseen events should occur in the economy at large or in that particular field of business) and an A rating of the rating agency Ethibel for being the first ethical bank in Germany. Moreover, GLS Bank was awarded by the British magazine *The new economy* as “Sustainable Bank of the Year in Germany” in April 2009.

The A rating of Ethibel is the highest grade from a range between A and E. Ethibel is a rating agency located in Brussels which - in addition to financial performance – evaluates the sustainability of financial institutions. GLS Bank’s strategy of ethical banking is seen as enrichment for the financial services sector. Ethibel appreciates GLS Bank’s high degree of transparency, its focus on ecological, social and innovative projects as well as its microfinance fund. GLS Bank’s employment shows a high degree of stability. High commitment to vocational education and training of the bank, close communication within working teams and the application of trust-based working hours are reflected in the A rating. Salaries are categorised as social and well-balanced. The operating efficiency of the bank is also evaluated to be very good. Provisions for risks are comprehensive and well-documented. GLS Bank is a member of BVR, the German central organisation of the cooperative banking group, thus deposits of customers are protected to the full extent.

The credit rating of the large rating agencies for Rabobank Nederland, is AAA (credit risk almost zero) for a long time and Santander has had a AA (safe investment, low risk of failure) rating in recent years. These positive and stable ratings reflect the stable business profiles with strong retail divisions, comparably resilient performance during the crisis and strong risk management capabilities. However, Moody downgraded the long-term rating of Santander from Aa1 to Aa2 due to concerns about the broad deterioration of the Spanish economy, to which Santander remains heavily exposed, as well as its recently increased exposure to the UK and the US, which both also face severe economic disruptions.

Santander’s and Rabobank Nederland’s both have strong risk management capabilities. In particular, the cautious approach regarding risk appetite and management philosophy of Rabobank Nederland is appreciated by rating agencies. Moreover, as a mutual, it is not driven by short-term performance indicators. The liquidity management is seen as strength due to the bank’s large retail deposit base. However, even the bank has a conservative selection of exposures it has high group exposures towards other financial institutions. Moody’s also appreciates that Rabobank Nederland has decided to scale down its non-client-related operations undertaken at global financial markets as a result of the financial turmoil.



Regarding Santander, the rating agencies appreciate the culture of independent and tight risk management. The bank strictly separates risk and commercial areas, and has a committee decision-making process. Its risk function has a high status within the bank. Santander has passed on its risk culture and organisation to its subsidiaries and developed integrated risk standards and a credit organisation, while rotating experienced managers within its subsidiaries.

Both large banks had good rating results regarding the asset quality, even the agencies saw deteriorating asset quality for Santander. For Rabobank Nederland it was evaluated as strong due to its conservative underwriting criteria with a stable and low level of impaired loans. Rabobank Nederland's asset quality is strengthened by the high proportion of domestic loans to individuals. Reported losses on this portfolio were 2 bps in the first half of 2009, below the historic average of 3 bps. For Santander further asset quality pressures are expected as non-performing loans will increase. However, the bank's consolidated assets in Spain will likely be less affected than the overall system due to the diversification by region and by sector of its book. In addition, risk premiums stand to increase substantially in the consumer finance business and across all Latin America, particularly in Mexico and Brazil.

### *Outlook*

According to the rating agencies, the operating environment will continue to be difficult in 2010. The outlook for Rabobank is negative due to expected subdued macroeconomic conditions in the Netherlands which could affect the bank's profitability, asset quality and capital adequacy. Impairment losses are expected to remain high in 2010. Considering Santander, the rating agencies observed increasing credit deterioration in most economies in which Santander is present. Any additional acquisition could carry negative implications for the ratings.

The banks expect 2010 to be a challenging year and that effects of the financial crisis will remain visible in the real economy. For Santander the priorities remain the same: management of spreads and control of costs, risk control and management of loan-loss recoveries. Santander expects that pre-crisis growth rates will not be reached. Non-performing loans will increase and the bank will suffer the double impact of both low demands for loans and pressures on spreads associated with repricing. Nevertheless there will also be chances to gain market shares through organic growth and acquisition opportunities in some markets.

Rabobank will prioritise tight cost management and high-quality customer contacts. It has therefore set the following core objectives:

- become the Dutch all-finance market leader (or retain this position, as appropriate)
- build on its position as the world's leading international food and agri bank
- achieve greater commercial synergy with subsidiaries

Moreover, it expects that the level of bad debt costs will remain high. Rabobank intends to maintain its provision on the savings and the mortgage markets and strengthen its position in the corporate and private banking market. In the second biggest business segment Wholesale Banking and International Retail Banking the activity with structured financial products will be reduced while renewable energy & infrastructure finance will develop further.

GLS Bank expects that the trend of sustainable and responsible use of money will continue and will influence the development of the business positively. Until now, the client sectors develop positively in spite of the financial and economic crisis. GLS wants to continue its engagement in all areas with a particular focus on independent schools and kindergartens, trade of organic food and renewable energies. Growth is expected to continue, even rising interest rates and growing competition in financial services will lead to a continued trend of declining interest margins in the medium term. For



the next years a growth of at least 25 - 35 % per year is expected – in particular regarding the deposit and credit business. Turbulent times on capital markets will increase risk costs in the future and will increase risk management's importance in the company. In addition the bank also plans to expand to Austria by the end of the year. An important task will be the integration of new employees in the continuously growing company.

#### **4.5. Evidence from individual case studies**

In addition to the type-oriented case studies presented in the previous sections, two individual case studies were undertaken, in order to address the importance of a long-term view on the evolution of financial services.

The UK building societies are taken as an example of a banking segment, based on mutual principles, which continued to apply a traditional and security oriented approach in the mortgages market. It survived the crisis without severe damages – in contrast to those companies which “demutualised”. This provides further evidence about the advantages that arise from long-term perspectives and high risk awareness.

The second case is Generali Insurance, in particular the French subsidiary of Generali, which indicates the importance of work organisation and industrial relations for a firm's resilience in the crisis. Based on reorganisation concepts developed before the crisis, the company continued to introduce lean organisation and participatory work relations in order to improve efficiency and promote innovation. This characterises both, the role of human resource management for the immune system of a company and its importance for long-term growth.

##### **4.5.1. UK building societies**

###### *The banking segment of UK building societies*

The UK building societies are an excellent example of traditional mutual banking that went out of fashion during the liberalisation of banking markets but has been reinforced by the crisis. Going back to the 18<sup>th</sup> century, the concept of secure mutual funding by house owners survived until today. During the liberal period of 1980s and 1990s the number of building societies decreased substantially as deregulation allowed “demutualisation”. Most of these societies were acquired by big private banks, like the Bank of Scotland, Barclays, Lloyds, or Santander. Some of the demutualised building societies followed a risk and profit oriented approach and were strongly hit by the crisis, parts of which were nationalised (e.g. Northern Rock) or resolved (e.g. Dunfermline Building Society).

The remaining building societies were much less affected by the crisis because they kept to their traditional business model. This is characterised by a high securitisation of assets by residential property, a low share of wholesale funding, and by the ban of taking positions in derivatives markets, currencies or commodities. During the crisis, building societies reduced their overall exposures and deleveraged their balance sheets (Table 9). In 2009 credit repayments exceeded gross lending. The focus was on security and cost efficiencies rather than growth. Employment in the UK building societies declined by 2.5 % in 2009.

In the current situation, the UK building societies face a series of challenges. Competition is rising as private and nationalised banks want to escape from wholesale funding as far as possible by raising funds on retail deposits markets. In addition, the historically low interest rates and lower credit demand are narrowing interest rate margins. Finally, they have to bear – without being responsible –

the costs of the crisis by rising capital and liquidity requirements, competition from nationalised banks, and contributions to the Financial Services Compensation Scheme.

**Table 9 UK building societies – performance data**

	2009	2008	% change 2008-09
Number	52	55	-5.5
Total assets (£ bn)	335	360	-6.9
Mortgage assets (£ bn)	225	250	-10.0
Saving balances (£ bn)	220	235	-6.4
Employees	47,374	48,578	-2.5

Source: BSA

The principal orientation of building societies is towards members not shareholders, and members are interested in good services rather than profits. This requires offering cheaper mortgages and better rates of interests on savings than competitors. Members have a say in business practices and basic business decisions.

The business model works as customer satisfaction survey revealed: Over two thirds (68 %) of building society customers feel that societies treat their customers fairly, while just over half of bank customers (55 %) think the same about their providers. Moreover, building societies are more trusted and more customers think that the societies provide value for money.

#### *Leek United*

Regarding Leek United, the single case observed within this case study, the findings confirm the results of the group analysis. The business strategy of Leek United has been stable in recent years and is committed to traditional values. Credit exposures are predominantly financed by savings accounts, and the decline of deposits prompted the bank to decrease total assets. Wholesale funding is kept at minimum levels. Derivatives are mainly used as interest swaps.

With shrinking overall activity, Leek United targeted to improve cost efficiency and productivity. This resulted in a 5 % job cut in 2009 and a 16 % decline compared to 2007. Salaries are at “industry standards” with annual executive pay between € 130,000 and € 200,000.

Even if Leek United performed comparably successful during the crisis, the advantage of being a conservative and reliable business partner with a long-term reputation is not directly used to increase the market shares in times after the crisis. According to Prof. Wood, Cass Business School, building societies were essentially protected from every source of shock that arose during the crisis due to their narrow business model. Hence, every step outside their business model would make them less secure.

The BSA expects fewer building societies in five years time, but still successful companies which provide a valid alternative to the banks driven by shareholder value. There will be low margins but a safe business model which is better trusted than those of banks. The focus on customers, low risks and high service levels will remain very important. Building societies will not go out of business, but will grow less rapidly than they did in the boom years. The takeover of market shares from private banks may only be possible in the long-run. With very low interest rates and competition from nationalised banks this is no option for the short-run.

## 4.5.2. Generali

### Generali Group

Generali is the third insurance group in Europe after Axa and Allianz. The group is represented in 65 countries in the world. It is the leader in Italy and it has significant positions in Germany, Austria, France, Spain, Switzerland and Israel. Recently the group started to develop activities in all the New Member States and expanded to China. Generali owns 176 companies and employs 85,000 persons.

#### *Mr Lane – about the future opportunities for insurance companies*

In the next five years there will be a couple of factors that favour insurance companies:

- People will realise the value of guarantees
- In some countries the amount of people approaching retirement age is huge. These people need assistance in managing their properties
- In emerging markets there are opportunities for car insurances and savings for retirements

The group is particularly present in life insurance but manages a wide range of products such as car and home insurance, specific insurance for professionals and companies, property insurance, leisure covers and policies for production, commercial and professional activities. In the life insurance the groups offers life accident insurance and new products for health complementary insurance, retirement plans and other saving products. In addition, a wide range of financial and real estate services and assets management is supplied.

**Table 10**                      **Generali turnover**  
€ billion

	2007	2008	2009
Turnover	66.2	68.8	70.5
Life	45.4	46.8	48.9
Non-life	20.8	21.9	21.6

Source: Generali Group Report 2009, September

The group managed to pass the financial crisis with continuously rising turnover. Premiums increased by 6.2 % in 2009 and reached over € 70 bn, thanks to the group's geographic spread and diversified distribution channels (Table 10). The net earned premiums increased too. The most visible effect of the crisis was the downturn in the non-life segment where premiums written declined due to the recession and severe competition. The 2009 solvability ratio increased to 187 % compared to 177 % in the previous year. It is one of the best in Europe.

According to Claude Tendil, CEO of Generali France, no insurer – except AIG and some “bancassurance” companies – was directly affected by the crisis, and no French insurer asked for public support. The crisis affected the insurance business via the economic situation of its clients. In contrast to other parts of the financial system, insurance business “... is to provide guarantees to the people not to externalise risks”. In this context the management change to a “professional, polyvalent and high skill model” appears to be essential, even for the internet distribution channel (Les Echos 18 May 2009).

### Generali France

Following this appraisal, Generali France introduced a new model for work organisation named ORT (Organisation du Travail Responsabilisant, or Empowered Work Organisation). This new organisation has been the response to fundamental changes in the insurance business rather than an answer to the crisis. The first experiments started in 2007 aiming at the clients' requirements, the quality of operations, team work, the conditions for higher employee activity and productivity, and developing cooperation between the different departments. Compared to a traditional work organisation with a strictly formal hierarchy and prescribed tasks, it seemed necessary to give much more initiative to each employee and to each team. This would mean shorter processing periods and overcoming the pattern of industrialised work, lean hierarchies, and more autonomy for the workers.

Employee engagement and responsibility have been rewarded in terms of involvement in the approach and in terms of skills and competence enhancement rather than higher wages. Monetary awards were expected to be provided by the higher efficiency of work organisation. In the whole group a profit sharing system is applied.

The employees' representatives were fully involved in the approach; with seminars and negotiations about the wages policies and the training policies. A three year agreement was signed with unions for the period 2008-2010 which regulates the general wage increase and the structure of wage groups. Saving funds are offered and free shares are regularly distributed to the employees.

The reorganisation of working processes has considerably contributed to the resilience of the company against financial and economic risks. Moreover, it is the basis of innovation. This clearly reveals the fundamental role of work organisation and industrial relations not only for the firm's competitiveness but for its long-term growth.

## 4.6. Employment

### 4.6.1. Number of jobs

The previous analysis revealed that almost all of the selected financial institutions had job losses in 2009. In particular those who were under state control reported job cuts between 8 % and 20 %. In the "liberal" group the number of jobs declined between 4 % and 5 %, and even the "Sustainable Finance" group – with the exception of Generali insurance – did not show employment growth.

Of course, this is anecdotal evidence rather than a statistical fact. Aggregated figures for the most recent changes in employment within financial services however are rare for the most recent period. Thus no comprehensive representation is currently possible.

Another indication is the job statistics for the city of London which has been established by the Centre for Economic and Business Research (Table 11). This shows an overall decline of 13.8 % for jobs in the city between 2007 and 2009. The strongest drawbacks happened in "corporate finance", "derivatives and forex", and "investment banking", while "fund management" experienced a minor increase.

**Table 11**      **London City jobs**  
Thousands

	2007	2009	% change
Investment banking	62,4	44,2	-29,2
Equities and bonds	84,8	74	-12,7
Derivatives and forex	16,5	11,4	-30,9
Corporate finance	15,1	8,7	-42,4
Fund management	48,5	49	1,0
Insurance	45,5	43,7	-4,0
Professional services	81,3	74,3	-8,6
Total	354,1	305,3	-13,8

Source: Centre for Economic and Business Research

The first evidence on the adaptation of employment levels in financial services nevertheless shows a high degree of consistency with the expectations of the "Skills Scenarios". It was assumed that all three scenarios will be associated with job cuts, and the "State Ownership" scenario will show the strongest decline, while jobs in the "Sustainable Finance" scenario will be least affected

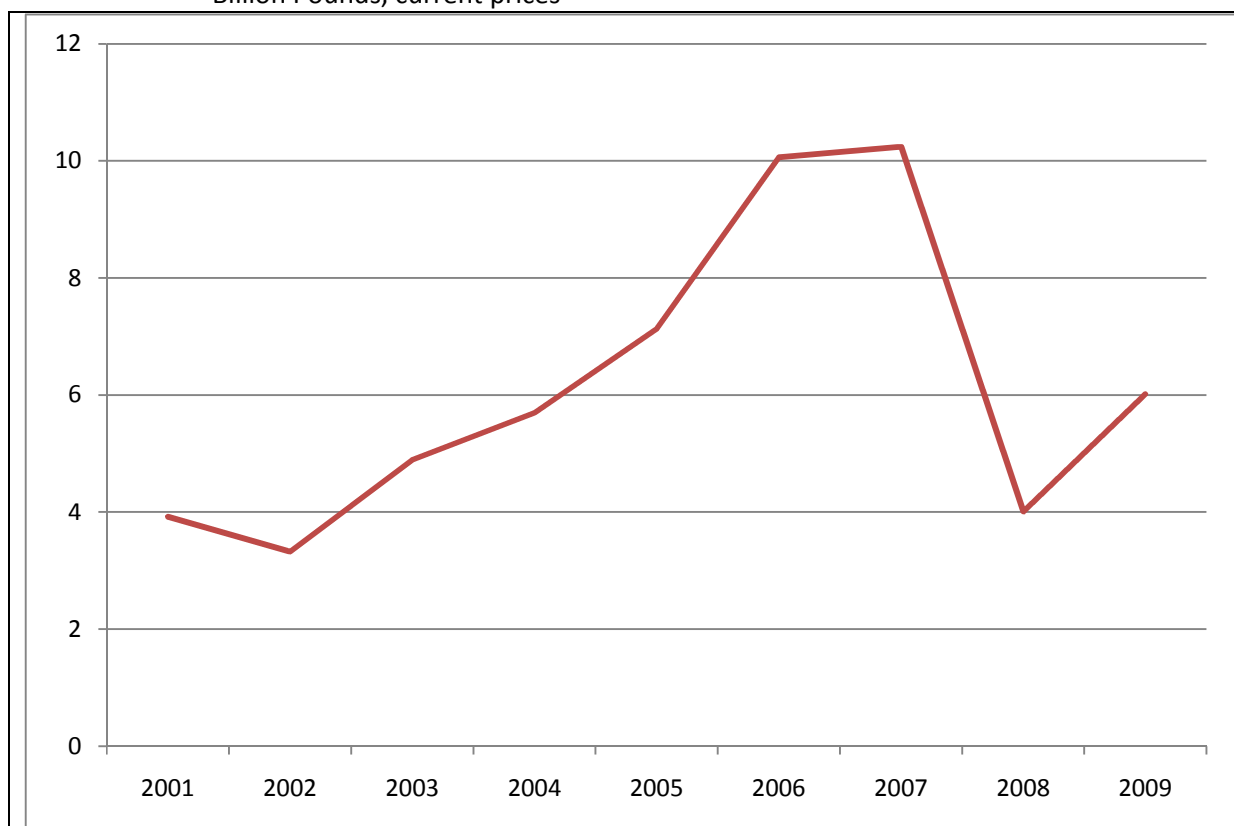
(Economix/DKRC 2009). This appears to be the probable result as far as the financial crisis has developed up to now.

It is important to improve the statistical basis of employment by the end of this project. This will be achieved by the exploitation of public statistics and further company based statistics from annual reports for the big players and sector analysis for SMEs.

#### 4.6.2. Bonus payments

The previous analysis also revealed that the reform of bonus payments has begun. A series of banking companies have introduced schemes with improved long-term incentives and restricted top management salaries. After strong criticism from the public, the British banks HSBC, Barclays, Royal Bank of Scotland and Lloyds renounced plans to increase bonus payments for top managers by up to 40 %. The American Citygroup introduced a 100,000 USD limit for cash bonuses which is supplemented with shares which cannot be sold for some years. The Deutsche Bank introduced a similar regulation: a bonus above 100,000 Euros will be paid in  $\frac{1}{4}$  cash and the rest in stocks over a period of four years. Top salaries in state controlled banks are limited, as for example in the German Commerzbank, where annual salaries are restricted to 500,000 Euros as long as state investments are not served. The example of London City shows, bonus payouts decreased significantly in 2008 and started to rise again in 2009 (Chart 8).

**Chart 8** London City bonus payout  
Billion Pounds, current prices



Source: Centre for Economic and Business Research

Bonus payments have become a matter of public irritation in many countries of the world, particularly in the USA. The idea of the G20 resolution in Pittsburgh was to prevent salary rules from provid-

ing incentives for high risk investments. In this context, top management salaries are pivotal as these incentives can be expected to be transferred into the internal structures of companies. However, it is a sensitive matter particularly for companies with a high share of returns from investment banking and asset management. They avoid job cuts as much as possible as the average investment banker is reported to take around 40 % of his turnover to the new job. This creates a strong dependency of companies from its traders.

In the USA the big banks therefore started to pay high bonuses again. JP Morgan is reported to pay investment bankers an average bonus of \$ 379,000 for 2009. The State of New York Bonus Report 2009 refers to a 17 % increase of bonus payments in 2009. On average \$ 124,000 were paid out. 36 % of revenues from trading were discharged. In previous years this amounted to 50 % (HB 24.02.10).

Following a study by Linklaters, governments used different approaches to regulate high bonus payments (Linklaters 2010):

The British government introduced a 50 % bonus tax for bonuses above £ 25,000, and the US government restricted tax deductions a limit of \$ 1 m. France followed the British example. Tax measures are expected to have limited effects as employers are going to take the tax burden. Deutsche Bank is reported to have made a € 225 m provision of bonus tax payments expected in the UK (HB 13.01.10).

Germany introduced a regulation which obliges companies to orient at least half of the bonus payment according to long-term and sustainable value creation. Guaranteed bonuses are prohibited. The British regulation, however, is taking another direction: in addition to performance orientation, bonuses should enable the companies to recruit competent managers. This clearly reveals the sensitivity of companies regarding their position on high-skill labour markets.

Many countries refrained from explicit bonus regulations and referred to the “comply or explain” principle. This obliges companies to follow public suggestions or to explain publicly why they did not.

Repayment of bonuses is restricted to exceptional events (Germany), or to balance sheet fraud (USA). Most of the countries however did not introduce such malus systems.

#### **4.7. Consumer reactions to the financial crisis**

During the financial crisis many consumers lost confidence in and were unsatisfied with their financial institute and financial advisors. The rebuilding of consumer trust and the improvement of financial services is thus one of the most important elements to overcome the financial crisis. As only limited evidence is presently available on this issue, the following section mainly focuses the German evidence.

##### *Gallup study about customer confidence*

The research institute Gallup has conducted surveys in Germany, the UK and US about banking clients' satisfaction with the services of their branch. The surveys were adapted to the conditions of each country.

##### *Germany*

In Germany around 3,800 bank customers were chosen randomly and interviewed by telephone between September and October 2009 (Gallup Germany, press release 23.02.10). Altogether, substantial deficits in customer satisfaction were revealed. Only 14 % of the customers felt entirely

bound to their financial institute. The cooperative banking associations achieved the highest values (16 %) whereas the saving banks and private banks underperformed with 13 % and 11 % respectively.

According to Gallup, the main causes for the weak performance can be found in the dissatisfaction with the services provided by the bank. The study revealed that:

- only 39 % of the interviewees were satisfied with the services (UK: 46 %, US: 69 %)
- only 21 % think that the staff works absolutely accurately
- only 26 % believe that their financial institute keeps the promises given
- and only 31 % think that the bank's employees enjoy their work

Briefly said, there is a clear lack of confidence. Especially readiness for duty, kindness, and politeness and to feel welcome and appreciated by the bank's staff could improve the confidence and satisfaction of their customers.

The branch of the customer's bank is still – after cash points – the most important part for customer contact. 66 % of interviewees have visited their branch at least once during the last six months. Modern channels are not used by the majority of customers, for example online banking is only used by 36 %.

#### *UK*

In the UK 1,311 adults who have a relationship with a retail bank were interviewed between October and November 2009.<sup>7</sup> According to the results, 29.4 % of UK retail banking customers indicated that they are “highly satisfied” with their bank and 46.4 % are “highly satisfied” with the branch they use. Even though almost half of the interviewees are highly satisfied with their branch, only 24.1 % of interviewees say that their bank's employees “always do things right the first time”. 48 % indicated that they had a problem (of some sort) with their retail bank within the past six month. Moreover, only 25.8 % strongly agree that their bank “always delivers on its promises”.

All in all 54.8 % of interviewees visit their branch bank at least once a month, even 17.4 % visit it at least once a week. Only 4.6 % of interviewees have ever used online banking which indicates the high demand for assistance at the branches. Thus, the service at the banks is very important in the UK but only 24.9 % of interviewees indicated that their bank “has employees who seem to enjoy working there”.

#### *Stiftung Warentest*

At the end of 2009 the German consumer protection foundation Stiftung Warentest published the results of the investment counselling test for German financial intermediaries. 147 counselling interviews were conducted in seven large banks, nine savings banks and five cooperative banks between the end of July 2009 and beginning of September 2009 (Stiftung Warentest 2009).

Overall the testers came to a disastrous result: giving scores between 1 (best) and 6 (worst), three banks received a 3, 16 were evaluated with a 4, and two banks got a 5.

In the counselling interview the testers asked for a safe investment of € 30,000 for five years with an expected return of 4 %. At that time such an investment did not exist and the advisors should have pointed to a higher risk or a lower return. The advisors, however, suggested certificates, private pension funds and equity funds with comparatively high risks. As Stiftung Warentest writes, the bonus was obviously more important than customer satisfaction. Moreover, more than half of the

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<sup>7</sup> The information was collected from Caroline Leonard who is a Proposal Writer at Gallup UK



banks failed to ask their customers about income and property. A further five banks did not enquire about the financial knowledge of the customers.

### *Mandatory minutes of consultation*

Since the beginning of 2010, minutes of consultation are prescribed for bank counselling interviews in Germany. TNS-Infratest has examined the satisfaction of customers with the minutes on behalf of the DZ bank (DZ Bank 2010). 1,131 investment-affine persons were interviewed at the beginning of February 2010.

The results can be summarised as follows:

- 67 % of the interviewees that had already conducted a counselling interview evaluated the minutes as meaningful.
- For most of the investors the minutes act as an insurance and an instrument which improves transparency. 56 % expect that the quality of counselling will rise because of the minutes.
- Around two thirds make their investment decisions with essential support from their advisors, 19 % involve them to a minor degree and 16 % state that they make their investment decisions alone.

Banks are presently working on new and improved information systems for private clients. The HSBC bank is going to introduce a traffic light system for investments in order to illustrate the different risk categories of financial products. The available information will exceed the range of legal information requirements.

## **5. Recently published scenarios**

### **5.1. Skills scenarios for European financial services – the Economix/DKRC view**

Long-term scenarios for skill needs of the European financial sector were developed by Economix Research & Consulting on behalf of the European Commission (Economix/DKRC 2009). The study is part of a comprehensive analysis of future skill needs in the European Union launched by the Directorate General for Employment, Social Affairs and Equal Opportunities. The scenarios identify different development paths up until 2020 and draw conclusions for human resource policies in the EU Member States. They take the strategic responses to the challenges of the financial crisis as their starting point. Three alternatives have been developed:

- Scenario 1 – called “**sustainable finance**” – assumes that the sector will develop a completely new business model, based on long-term investment strategies, consumer trust and high-quality consulting services. This exerts a cultural shock to the business, as it means the reversal of profit targets, standardisation, and controlling instruments in favour of sustainability.
- Scenario 2 – called “**laissez-faire**” – draws less radical conclusions from the crisis, assuming the continuation of short-term profit orientation from the past. Public control will remain weak, also due to impediments at the international level. Standardisation of financial products will be fostered. Mergers & acquisitions will be revived. The instability of financial markets will not be removed.
- Scenario 3 – called “**state ownership**” – assumes that neither government nor the big players in the financial business will be able to keep control of the current crisis. Financial and economic turmoil will accumulate into a wave of destructive power. This will result in a significant reduction of economic activities for a long period, and force financial services into an administrative role.

All scenarios are expected to cause strong employment losses in the financial sector of the European Union – at least in the near future. Later recovery depends on the strategic choices made. In the “sustainable finance” scenario the number of jobs will increase due to the extension of consulting and business services. In the “laissez-faire” scenario the investment branch in particular will cause ups and downs in employment. In a publicly regulated financial sector employment will remain at a low level for a long time.

The point these scenarios all have in common is that each one expects a continuous upgrading of skills – however with different types of specialisation:

- scenario 1 assumes a new type of banker who acts with a long-term rather than short-term perspective, regards consumer trust as the basis and thus aims towards sustainable business relations. This requires a new orientation of human resource development in principle.
- in scenario 2, the trends of the past will continue using short-term profit targets, flexibility and market orientation as guidelines of human resource policies. Back office functions will largely be transferred to highly standardised service providers.
- in scenario 3, human resource policies will be security and cost oriented. They will require sound administrative practices rather than market orientation.

As the emergence of the financial crisis is strongly rooted in competence profiles, the study recommends employment-related policies to address the need for adequate training and increased R&D investments in the financial sector. Among the comprehensive list of suggestions, two priorities emerge in this context:

- Training policies should be reoriented towards the principles of capital markets, decent client consultation, controlling and risk assessment. Governments should take initiatives to implement such new types of training in the financial sector.
- As the tools of risk assessment failed to indicate long-term risks, R&D programmes should be launched to improve these instruments. Controlling principles should be reappraised in order to develop strategic controlling.

Human capital appears to be the key to restructuring, and public institutions can raise the pressure on the financial sector to develop a sustainable business model. Education and training is one approach to proceed along this route.

## 5.2. The future of financial services – the CBI and PWC vision

For 20 years CBI and PricewaterhouseCoopers have conducted the Financial Services Survey in the UK which offers a quarterly insight into recent trends and future prospects in financial services. Participants are from banks, building societies, investment managers, securities traders and the insurance industry. They are asked if they have become more or less optimistic about the situation in their sector. Moreover, the survey gives information about trends regarding the value and volume of business, charges, costs, profits, employment and training.

Due to this experience, CBI and PWC looked to the next 20 years in financial services in the aftermath of the financial crisis. The sector analysis in the UK is based on the opinions of experts at CBI and PWC and interviews with 20 leading figures in and around the industry.

The study revealed the following main findings for the UK:

- Impacts of the crisis were evaluated differently. Banks, unsurprisingly, were hit the strongest. British insurers had emerged relatively unharmed, even the demand for some riskier insurance products had declined.

- The global banking sector will continue to be dominated by a few large institutions – mostly universal banks which have the strongest capital base. There will be more consolidation of banks internationally. Moreover, Chinese banks are expected to become a global banking power and appear in the top 10.
- Global investment banks suffered from casualties during the financial crisis. In the future new competition will emerge from hedge funds and boutique advisers.
- UK banking will be dominated by the big five banks (Barclays, HSBC, Lloyds Group, RBS, Santander) but also new competitors will arise with the consolidation of smaller organisations. State-supported banks will be restructured. Building societies could play a strengthened role in retail banking due to continuing mergers.
- London will remain an important centre for asset management. No serious restructuring among UK leaders is expected. However, recent acquisitions tend to be from foreign entrants from North America and Continental Europe. Moreover, the EU Alternative Investment Fund Managers Directive is a threat for London as a European centre for hedge funds and private equity.
- Insurance will be further consolidated, even though capital requirements in the aftermath of the financial crisis could hamper the sector.
- Financial products will become more transparent as people have lost trust in complicated financial products. Innovation will have to fight to prove its worth.
- There will be pressure on banks and other sectors to stop focusing on profit maximisation in a short-term prospect and to considerably more pursue a sustainable business strategy over medium and long-term periods.
- Government intervention and stricter regulations are expected to continue. Moreover, international coordination of measures in order to avoid a recurrence of the financial crisis will be pursued.
- Risk management will become more important. Regulators will develop capital adequacy rules further by defining risk-adjusted requirements for some particular activities. Thus, some investment activities will lose attractiveness.
- Due to competitive advantages in financial services London's role as a financial centre has not been damaged by the crisis so far. However, excessive or inappropriate regulations will weaken the UK's competitive advantages (English language, time-zone, legal system, and professional services and systems).
- Tax rises which are not temporary and appear to be politically motivated could drive firms and individuals out of London and could hamper overseas financial services organisations to expand to the UK.

### 5.3. The future of the global financial system – the World Economic Forum's opinion

In 2009 the World Economic Forum developed four scenarios on the future of the post-crisis financial sector. The report scrutinised the governance and structure of the global financial system in the near- and in the long-term perspective. The former is based on analysis of recent changes in the financial system and the long-term outlook is based on scenarios up to 2020.

#### *Short-term outlook (up to 2012)*

The financial sector is forced to adapt to a new environment of tighter credit and slower economic growth, stronger government intervention and a threat to the previous pace of globalisation. Four trends have been identified:

- **Interventionist regulatory reform:** Due to the commitment of global policy-makers to a new regulatory framework the expansion of regulated entities, increased global regulatory coordination and constraints in the growth prospects of incumbent financial institutions can be expected.

- **Back to basics in banking:** All types of banks have started to repair their balance sheets with higher liquidity and capital ratios, in combination with reduced short-term wholesale funding. Re-regulated banks are observed to refocus on core competencies. However, bank strategies are less likely to overlap as banks will focus on their individual competitive advantages.
- **Restructuring in alternatives:** Several actors have suffered in the current financial crisis, from both deleveraging and market turmoil. Hedge fund experienced substantial losses. Meanwhile, many investors pay more attention to low-cost indexation strategies and “new beta” asset classes. This could foster “unconstrained” providers of capital – such as family offices and sovereign funds.
- **A tale of two insurers:** The fortunes of the insurance industry are broadly split up in two ways: property & casualty versus life insurers and North America versus Europe. Many organisations will be able to capitalise due to the emergence of new acquisition opportunities, continued demand for retirement products and an increased use of traditional insurance products to hedge risk. Thus, they will be able to strengthen their underlying businesses.

### *Long-term scenarios (up to 2020)*

The future of the financial system will be influenced by a wide range of external forces and uncertainties. Four potential long-term scenarios were developed during 2008 by 250 financial executives, regulators, policy-makers and senior academics in eight different workshops. The scenarios differ regarding a wide range of drivers such as the evolution of energy and commodity prices, global economic growth, fiscal policies, trade regimes, climate change, exchange rate policies, extremism, demographics and global wealth distribution. In principle, however, they are segmented by the type of multilateral cooperation or non-cooperation in world markets.

The four scenarios are:

- Scenario 1 called **“Financial regionalism”** describes a financial world separated into three regional blocks—the US led Democratic Trade Alliance, the expanded EU area and the Eastern International Economic Community led by China. This new structure forces global organisations to construct tripartite strategies to operate globally. Moreover, old and new champions seeking to operate on a regional basis, while Asian financial institutions are dominating the global landscape in terms of size. Due to a deepened crisis in the US and Europe throughout 2010, emerging markets turn away from a series of global talks, reject western models and ideals, and form their own block of domestically focused economies. The US is in an isolated position. Most of the trade which flows among the blocks decline sharply - with the exception of tourism and energy materials. Energy security becomes a key issue.
- Scenario 2 is called **“Re-engineered western centrism”**: After a short period dominated by politicians and regulators, the financial world is once again a major engine of profitability and growth which is managed by insiders. The advanced economies drive a new phase of growth due to restructuring in the developed world and marginalised exchanges with emerging markets. The West maintains an economic and moral leading position by playing a primary role in corporate restructuring; driving productivity increases and maintaining free trade globally. In comparison to the West, emerging economies were severely affected by the global recession.

The biggest achievement in this scenario is the reform of existing international financial institutions - dubbed “Bretton Woods II”- and the creation of a supranational regulatory authority. Unfortunately, Bretton Woods II has shortcomings regarding the needs of emerging economies and the new regulatory regime fails to consider structural flaws in risk management, leading to renewed fears of an even bigger crisis.

- In scenario 3 called **“Fragmented protectionism”** the financial world is extremely localised and highly volatile. Those with the ability to execute trades across borders face major arbitrage opportunities. Unfortunately, capital controls in most jurisdictions make this very difficult and the political risk is high. This is a world mainly characterised by division, conflict, currency controls and race-to-the bottom dynamics that cause deepened long-term effects of the financial crisis. Due to the global recession, a range of other events, such as inter-state conflict, domestic unrest and natural disasters contribute to make things worse. Countries are eager to look after their own economic interests, blaming each other and turning to populist, protectionist policies. As a consequence resource conflicts and security threats emerge as well as terrorism. This keeps nationalism and protectionism alive despite the high economic costs.
- Scenario 4 called **“Rebalanced multilateralism”** describes a world of initial barriers regarding the coordination and disagreement on effective risk management approaches which are overcome in the context of rapid shifts in geo-economic power. The global community learns from its mistakes through cooperation: While the US goes through successive crises and the emerging economies battle their own problems, the world eventually realises that meaningful collaboration is the only way forward. Major shifts in international institutions and a new recognition of the meaning of global governance play a dominant role and imply that the financial system is better suited to the challenges of a complex, interdependent world in 2020, if not at all perfect. Emerging markets play a major role in setting the pace for economic growth, cooperation in financial policy and new approaches to systemic financial risk. The financial system is globally integrated. However, due to the rapid growth of emerging markets, in many cases it is dominated by BRIC-focused players.

### *Technology and innovation*

In 2007 the World Economic Forum developed three scenarios to explore how technology and innovation will reshape the financial services industry by 2020. The objective was to investigate the access to, and delivery of financial services. The scenarios were also developed to face uncertainty with greater knowledge and understanding and to help identify future risks and opportunities within the financial service sector. The scenarios were developed at workshops in Davos, San Francisco, London, Boston, Tokyo and New York by leaders in business, society, academia and government from Asia, Europe and North America. They were led by questions of how the globalisation of financial services will evolve and what type of innovation will arise.

The three scenarios are:

- Scenario 1 – called **‘Global Ivy League’** – constitutes a state in which innovations are mainly driven by a small number of large global financial service providers. The current systems, distribution and sales channels and business models will be incrementally improved and the service providers developed as global processing factories with customised front-ends. The governments will support globalisation but will protect customers and regulate the sector only in a conservative approach. The trust in digital media will decline and thus consumers will favour traditional service providers.
- Scenario 2 – called **‘Next Frontier’** – illustrates a world in which financial services act on global markets but the innovations are mainly driven by new entrants and specialised players. The governments pursue deregulation and technology enables a number of new business models to arise. The financial service sector will operate as modular ecosystem of highly specialised providers. New players include telecommunication companies, peer-to-peer financial service providers, processing providers, retailers and internet companies.
- Scenario 3 – called **‘Innovation Island’** – differs to the other scenarios as local and regional financial service markets diverge fundamentally. This is caused by geopolitical tensions and instability which slow down globalisation. Government policies towards the financial service sector differentiate among countries. Three trends emerge:

- **‘Leapfrogging’**: Government regulations and investment in infrastructure in large emerging economies (e.g. China and India) promote the local financial service industry and expand access to the poor which will lead to new business models that ‘leapfrog’ over developed markets and to a large variety of specialised players (e.g. mobile banking and peer-to-peer e-platforms).
- **‘Business as usual’**: Innovation neither accelerates nor decelerates and thus leads only to small changes in business models. This applies to developed countries such as the US or European countries.
- **‘Back to the past’**: Governments in the remaining countries and regions (mainly developing countries) raise control over the financial service sector but do not promote local innovation. Thus, there will only be little progress and even regression in the efficiency and quality of financial services.

World economic growth will differ depending on the degree of globalisation. Protectionist environments are assumed to curb growth while open markets will lead to growth rates of 4 %. Financial services have been expected to grow continuously until 2010 based on the increase of wealth. The largest expansion was expected in health insurance, retail banking and asset management while retail banking was predicted to have slow growth. The 2020 share of financial services of GDP was estimated to range between 8 % and 11 %. The “Global Ivy League” scenario is dominated by an industrialised operating model. In the other two scenarios, a greater variety of operating models with many specialised players is visible – due to the vertical disintegration of the value chain.

## 6. Scenarios for the phase of adaptation

This chapter will develop three scenarios for the adaptation process in European financial services, based on the conclusions that can be drawn from the analysis in the previous chapters. Two major drivers have been identified and are now used as starting point for the scenario description:

- The risks of a recurrence of the financial crisis due to the instabilities of financial markets, the uncertainty of growth in the real economies, the imponderability of public households, and their feedback on financial markets. In the first two scenarios, the financial crisis can be kept under control. In the third however, this control will get lost.
- The determinedness of the G20 countries and the rest of the world to establish an efficient regulatory framework for financial markets. The introduction of such a framework will not only stabilise the financial and economic systems but have strong impact on restructuring in the financial business. Scenario 1 and 3 expect the failure of the negotiations, while scenario 2 expects a success.

The three scenarios resulting from these combinations of prime drivers are called

- The past is the future – a high-risk status quo scenario
- A new world order for financial markets – the end of the golden age
- Divided economies – a worst case scenario

Of course, there are a series of other drivers, like the behaviour of Asian countries in the ongoing G20 negotiations, or public reactions to policy decisions and business practices. These are included in the scenarios in order to paint the full picture of economic and social development. The impact on employment, income relations and social dialogue is discussed in each of the scenarios.



## 6.1. Summary of current trends

### *Disconnected financial markets*

In contrast to many expectations in the immediate aftermath of the crisis, the financial sector has not reached calm waters yet. The financial crisis first transmitted into an economic crisis which now has become a sovereign crisis. The weaknesses of financial intermediaries merged with the failure of already vulnerable companies, the poor position of redundant workers, and finally with economically weak economies. While the contagion is spreading and affecting the actors with the weakest immune systems, the questions of cause and effect is becoming more and more blurred. However, the origin of the crisis is still very clear.

During the last decade a financial system has been developed which is largely disconnected from the real economy. New and profit yielding segments for derivative financial investment – based on speculation and arbitrage – emerged as a consequence of the liberalisation of financial markets, of the globalisation of capital flows, and real time access to trading platforms worldwide. Favoured by a low interest monetary policy, the investors used strong leverage to finance short-term financial derivatives rather than long-term real growth projects. The financial system separated from the rest of the world without being independent. At the end of the game, the system was not sustainable as the enormous sum of bets was based on wrong expectations. Being unable to cover the risks with own resources, financial intermediaries heavily depended on public help, and parts of them continue to do so.

The process is part of a widely applied reform approach where liberal economic policies go hand in hand with the widening disparity of income and wealth. The upper segment of the population experienced unprecedented income growth as top earnings among managers or investment brokers expanded to the hundredfold rather than the tenfold of average workers. This has been a central driver for the expansion of the new financial markets which has provided plenty of opportunities to achieve such extraordinary profits, all the more as the new products were hardly understood by the rest of the world, even the rest of the financial world. A new class of bankers has taken the responsibility, strongly oriented towards short-term profits, and addressed to shareholders rather than the society. The blindness of the clients and the high profits even attracted dubious characters that are now suspect or even convicted to criminal action, as the examples Goldman-Sachs and Madoff reveal.

While a few of the top financial managers realised the risks of the ongoing transformation, they did not have the power to keep the system on a sustainable track and did not implement the restrictions we are talking about today. In this sense, the financial crisis appears as the failure of a whole generation of managers who were unable to resist the temptations of short-term profits and to perceive the fundamental economic and societal role given to the financial system.

Only the severe crisis has been able to reduce the incentives and sharpen the awareness of the unavoidable link between profit and risk. An important part of the financial business, nevertheless, is currently engaged in the restitution of the former markets. Some leaders in the financial business still understand the crisis as the disastrous combination of unfavourable conditions and refer to the efficiency gains from highly flexible capital markets. This is strongly supported by the experience of moral hazard which allowed engaging in high risks without taking the full financial responsibility. Public support programmes, having been indispensable to protect the population and the real business, are now inviting risk-oriented financial actors to restart their business.



### *Weak economic growth*

The continuum of negative shocks can hardly be expected to be over. The crisis is now the crisis of public budgets which will soon be transmitted to the real economy again by the way of budgetary austerity programmes. Rising default rates will feed back to the balance sheets of banks and create new vulnerability which can only be cured by public contingency programmes again. The vicious circle has been entered.

Hence, the expectation of a rapid recovery was wrong. As research evidence from previous financial crises suggests, financial stress must be expected to reduce growth for a longer period (Reinhart, Rogoff 2009b, p. 224): first, asset markets collapses are deep and prolonged, second, the aftermath of banking crisis is associated with profound declines in output and employment, and third, government debt tends to explode, mainly due to the inevitable collapse of tax revenues.

This is exactly what happens in Europe and the US. The restructuring of economies, the modernisation of public infrastructure, the expansion of education and training systems, the continuation of social programmes, all this belongs to the dreams of the past. The crisis is rather going to absorb good parts of economic growth in order to finance abandoned construction sites and further write-downs on the virtual property of the previous decade. It is not going to burden only those who were engaged in speculation. In contrast it applies its inhuman principles by weakening the weak and strengthening the strong. Some observers understand this as the start of an inevitable regeneration. However, at which price?

One high price is the enormous increase of public expenditures. Citizens will have to pay for the wrong investment decisions and the luxury life of top earners in the past. Public services will be constrained and growth potentials will remain unused. Overall economic growth will be weak and tax revenues will follow. Tax rates can be expected to increase. This will be a decade of public poverty with high tax burdens – a lost decade in the sense that parts of the income that will be produced has already been spent in the previous decade.

The strong economic growth of the real economy, which we presently see in the US in particular, is urgently needed to pass this period of settlement as rapidly as possible. However, stimulus packages are phasing out and the probabilities of an update are low. The financial crisis still is far from having ended and additional burdens are visible e.g. in form of the recent turmoil triggered by the Spanish saving banks (HB 26.05.2010).

Another consequence of low growth in Europe is that the world economy will be rearranged around Asian markets. These are the new growth centres attracting many investors and redirecting financial and commodity flows. China's financial institutions have increased their strength considerably. The Industrial and Commercial Bank of China is meanwhile the fifth largest company worldwide with 385,000 employees and total assets of RMB 9,760 bn (€ 1,148 bn). It is followed by the China Construction Bank, the Bank of China, China Life Insurance which – together with energy providers – all rank among the ten biggest companies in China (HB 14.05.2010). The Chinese banking system therefore is well prepared to take a stronger role in the world financial system.

In addition, global trade imbalances will persist at least in the medium term and continue to accumulate debt in countries with negative current account balances, and foreign exchange assets in countries with positive account balances. We all know that this is unsustainable and points to the need for fundamental structural reforms.

Two scenarios have been developed by the European Commission as regards the unwinding of global imbalances (European Commission 2010, p. 48):

- A *benign scenario* under which the correction of the US current-account deficit is offset by an equivalent increase in aggregate demand in Asia, led by China, and helped by the removal of the de facto exchange rate pegs to the US dollar. While overall effects for the EU are expected to remain minor, growth notably in the Euro area would remain sluggish in line with weak potential growth.
- A *harmful scenario* would imply that Asia maintains its exchange rate pegs to the dollar and fails to offset a permanent reduction in aggregate demand in the US. Under this scenario, not only growth in the Euro area, but also in the world economy as a whole would suffer. As an escape from this unfavourable situation, the EU Commission recommends the removal of rigidities in services, labour and capital markets, the reduction of skills mismatches and the boost of innovation and productivity.

This is the unfavourable choice between stagnation and recession. Moreover, substantial imbalances exist between European countries in the euro zone which can only be removed by permanent restructuring of the real economies. This however means long transition periods with low growth and high unemployment.

### *Regulation of financial markets in preparation*

Since the culmination of the financial crisis in September 2008 governments have reorganised the institutional structure of financial supervision. At the international level, the Financial Stability Board has been established which coordinates financial supervision and advises the G20 governments. At European level two institutions will be created in 2011, the European Systemic Risk Board and the European System of Financial Supervisors.

The number of implemented measures still remains small

- The European regulation of hedge funds has been passed in May 2010
- Great parts of OTC papers will be exchanged over trading platforms, and German has partly banned uncovered short-sales
- Consumers have to be informed about key features of investment products

... in comparison to the great number of suggestions:

- The level of core Tier 1 capital ratios is still open as is the implementation of liquidity buffers. Both will become more concrete when the results of the impact studies presently undertaken by the Basel Committee will be available.
- International accounting standards have been submitted in a first phase. Two more phases are to be expected.
- Solvency II will have to be implemented by the EU Member States by the end of 2012.
- Rating agencies will have to be registered in the EU and will be supervised by national authorities.
- Updated standards for corporate governance concerning in particular management, risk assessment, and transparency will be discussed in 2010.
- Supervisory colleges will coordinate cross-border supervision of systemic banks.

This is a long list of proposals rather than actions. Nevertheless, the principal direction of financial regulation is likely to be decided during 2010 at the G20 summits, the December summit in Seoul in particular. The summits will have to decide on the principles of financial reforms in order to create a new basis for functioning and deleveraged international financial markets, in particular the

- application of the „Volcker Rule“ which separates retail and investment banking
- imposition of size limits to systemic banks
- regulation and supervision of derivatives markets
- enforcement of living wills

- imposition of a bank levy
- introduction of a trading tax

This list contains a sufficient number of controversial issues to expect a long and intensive debate. In particular those countries which passed through the crisis without serious impairments are currently against additional burdens. Moreover, banking and insurance associations advise against higher capital ratios, reduced leverage, financial levies etc. As the EBF stated in 2009, “banking should remain open, flexible and governments should retreat from the business as soon as possible.” In their opinion, there is a risk of over-regulation and a great uncertainty about the impact of new rules.

However, the US experience shows that the pressure from an annoyed public is strong and politicians will hardly get the mandate for a second bailout of financial institutions. The “Wall Street Bill” can therefore be expected to have a strong impact on G20 negotiations, and European governments will feel the pressure to take action considering the imbalances of their economies.

Hence one can hardly expect that the regulatory framework will remain the same. There will be an increase in capital ratios and/or a bank levy, the restructuring of the “too-big-to-fail”, a stricter control over derivatives markets, and more rigorous accountancy rules. Something is going to happen. The question however is how effective it will be and how strongly it will affect the behaviour of financial intermediaries.

Already now, the responsible supervisors feel the blame of having failed, and thus enforce restrictive rules even without a complete revision of the regulatory framework. As a consequence, financial intermediaries started to increase capital ratios, improve risk assessment, and revise bonus systems. The indispensable deleveraging of the financial sector started in awareness of the crisis and in anticipation of the new regulatory frames. Financial regulation will therefore have the role to re-enforce the deleveraging process and safeguard the achievements.

### *New business models?*

The review of the case study evidence suggests that the management of financial companies mainly reacted in a way which can be labelled as “back to the core business”. All of the cases analysed by this study followed this approach. Universal banks try to be universal banks, savings banks remain saving banks, and investment banks keep being investment banks. A general deleveraging of the banking business can be observed but only minor restructuring. All companies want to develop their traditional strengths and are cautious to approach new market segments. The “bankassurance” approach is out of date. Adventures into the new financial markets are largely stopped. Mergers occurred by acquiring companies with closely related activities in retail banking in particular.

This is a surprise as the crisis provides plenty of opportunities to attract new customers, squeeze weak competitors out of their markets, and simply buy companies at low prices. However, new risks have to be avoided as resources are scarce. Deleveraging thus not only decelerated growth but slowed down restructuring of the business in all areas of the financial sector.

This is also the reason why we were unable to identify a clear preference for one of the scenarios which we developed last year (Economix/DKRC 2009). We observe the continuation of the “parallel worlds” with large private banks, small saving banks and mutual banks, and the new group of state-controlled banks which still require public help. Given this structure, the financial sector is in a wait-and-see attitude, looking forward to a new regulatory regime, backing up market positions, and still fighting against the imponderability of the crisis. We will thus see only gradual adaptations of business models in the near future.

## 6.2. The past is the future – a high-risk status quo scenario

In this first scenario we try to think about the consequences of the present trends which are summarised in the previous section. There are strong forces working in this direction as we can see from daily news. However, the situation is fragile as both, the economic upswing and the sustainability of the financial system are far from being guaranteed. This is the reason why it is called a high-risk scenario.

### *Revival of “liberal” capital markets*

The banks and financial intermediaries following a “liberal” approach can be expected to use every opportunity to expand their business volume. Having mastered the crisis successfully and being back to profitability, they may be the first in raising additional funds on capital markets in order to finance their expansionary plans. The demonstration of stability and market power may convince investors – and eventually regulators – that this business model is not only promising but sustainable, at least if the general economic conditions are balanced.

A growing fraction of investors will go into the markets with a major interest in return on investment rather than security. They will continue to look for short-term profits and expect financial intermediaries to provide such opportunities. New products will therefore be developed with more sophisticated risk assessments features but high leverage. Hence, financial intermediaries will gradually re-leverage their activities as far as this is compatible with the new and more restrictive regulations. Investment banking will revive and become a growth market again.

Financial markets will successfully delay the introduction of a more rigorous regulation with reference to the fragile economic recovery and the argument that such reforms have to be evaluated in detail before implementation. Substantial regulatory reforms can therefore not be envisaged before 2020 – if at all, because the period of low regulation will open the opportunity to restructure the business according to the preferences of this league. Of course, the business will not return to the pre-crisis system with intransparent products, high leverage and a substantial volume of non-banking transactions. The business will have to provide the proof of higher safety, transparency and trust. Not only the marketing departments will be professional in demonstrating these features, but product development will adjust to these trends. The principal business orientation towards shareholder values, however, will remain unchanged.

Companies will also be professional in exploiting the economies of scale. These will remain substantial due to the permanent improvement of information technologies. Complex risk assessment tools will have to be established. Administrative operations will be further automated, services for private clients fully transferred to the internet or automatic service machinery. Back office processes will be concentrated on big service providers. Asset management tools will be sophisticated. All this requires huge amounts of financial resources which can only be funded by big companies. They have good chances to win this competition on the field of cost efficiencies.

### *Exit from state-ownership*

Governments will keep to their plans to exit from state-control over banks that have been rescued by public funds. The recovery of the banking sector will improve the situation in state-controlled banks, and restructuring plans will contribute to that. Faced with the strong motivation of private banks to expand their retail banking business, opportunities for mergers will arise. Those parts with sufficient profitability will be sold to the “liberal” banks which will have achieved a dominating position in the meantime. The unprofitable parts will be closed or shifted into “bad banks”.

The overall profitability of “state-owned” banks will remain weak as their access to the high yield investment banking segment is restricted. In addition they are still burdened with substantial write-downs on securities. As low profit banks in general are inclined to take higher risks and pay higher interest rates for deposits in order to improve their current financial position, the future risk of write downs remains high. This has recently been revealed e.g. by the disproportionate exposure of “state-owned” banks to Greek securities. With these facts in mind, governments will be highly interested to exit from state-ownership.

The high probability of takeovers is due to the widening gap of profit rates between independent private and “state-owned” banks. This will not only improve the relative financial position of independent private banks, and thus provide the resources for takeovers, but expand the distance between the two groups regarding market position and technology. “State-owned” banks will have difficulties to invest in new technologies on a broad scale. The independent private banks will therefore be in the position to offer superior technological standards and high cost savings. However, the market position of “state-owned” banks in retail banking will remain attractive as customers stay with their banks due to the explicit state guarantee.

The core problems of this segment are those banks which have a limited chance to return to profitability in the medium term. These are the bad banks of the future. While risks have already been taken by public budgets, for the German Landesbanken e.g., there will only be limited scope for further support if budgetary restrictions are considered. The need for orderly resolution will increase.

#### *A stable segment for local banks*

The strong retail orientation of savings banks and cooperative banks has limited the profitability of this sector and will continue to do so. Both segments will continue to focus on customer services rather than profits, and hence will be able to preserve their market shares. However, they will not have the resources to expand their activities into new market segments like asset management for wealthy clients or international trade. No substantial move can be expected as the evidence from the case studies confirms.

This will be strongly linked to the fact, that the change of business models is inevitably punished by the customers. The example of Leek United revealed that any modification of the traditional business model is going to irritate clients. The company therefore continues with the successful business approach of the past and – as a consequence – growth appears to be demand driven rather than supply driven. Such difficulties exist for large parts of the local savings and cooperative banks.

#### *Demand driven growth of ethic banks*

This does not exclude the further rapid growth of “niche” banks, like the German GLS bank demonstrated. An increasing share of customers considers environmental and social principles to be important also for banking business and thus prefer this type of ethic banks. A further expansion of these banks can thus be expected.

The current shift towards these banks will be strongly linked to demand, and a rising number of ethic banks will enter this market. Other banks will probably join this trend and offer similar ethnically oriented financial products. However, the principal orientation of the bank will be important to clients rather than the features of a single product. The chance of simply copying and integrating the ethic approach into other business models will remain limited.

#### *Insurance*

Similar to private banks, the insurance business will be able to avoid radical changes of the regulatory framework in this status-quo scenario. This means that the validation of assets will not be fully

changed to the fair value principle, reporting requirements will be kept at acceptable levels and capital requirements will only be moderately increased. This will open the opportunity to continue present business approaches and preserve the different company structures.

Life insurance will remain exposed to the crisis. This is the insurance segment with high financial reserves, invested in state bonds primarily, stocks and to a minor degree in derivatives. Stress tests showed that this is the sensitive part of the insurance business in addition to monoline insurers. New risks will arise for life insurance with the instability of sovereign debt. The downgrading of different state bonds will force life insurance to increase capital ratios and redirect assets towards better securities.

Moreover, life-insurance business is under pressure by low interest rates which reduce the net interest margin between interests on assets and guaranteed life insurance yields. This margin turned out to be negative for parts of life insurance contracts with such guarantees due to the changes in monetary policies. The situation will remain difficult during the low-interest phase.

#### *Impact on employment and working conditions*

Sluggish economic growth and the focus on cost efficiency in all segments of the financial sector will further reduce employment prospects. While the crisis can be assumed to have resulted in a significant reduction of employment in investment banking, among state-owned banks, and to a lesser degree in most of the other segments of financial services, the need for the application of more productive technologies and more efficient work organisation concepts will continue to reduce employment. This will affect traditional front and back office services more than investment banking, which will see an upswing again.

The social dialogue will remain difficult under these conditions. New forms of work organisation will not only increase the workload but become more restrictive as more rigorous rules are imposed by risk assessment and internal controlling. Efficiency standards will continue to rise.

Remuneration schemes will not return to previous models as the principle of deferred payments of bonuses will be assessed to be efficient. The investment bankers however are in good position to negotiate for higher bonuses, as they again contribute to profits disproportionately. Management remuneration can also be expected to rise.

#### *A high-risk scenario*

While this scenario takes prevailing trends in the financial services sector as being stable, it nevertheless appears to be a high-risk scenario. It excludes the emergence of a third or fourth shock wave. It assumes that private banks are able to compensate rising credit default risks and keep control over investment banking activities. It expects that governments will not kill the economic upswing and will be able to achieve a gradual exit from both, state-ownership of vulnerable banks and high public debt. There is a lot of optimism in this scenery.

Moreover the scenario can hardly be expected to be sustainable, as it does not remove the factors which caused the crisis. In contrast, it assumes that minor corrections of the regulatory framework will be sufficient to avoid further imbalances. This may be the case within the short or medium-term. The latent risks of new imbalances however persist and markets will decide at which point in time they will become apparent.

Finally, it assumes that all banks will concentrate on retail banking markets in order to improve the sustainability of their business models. This however can hardly work as these markets are occupied by various providers and cannot be expected to grow rapidly. Strong competition on retail markets



will therefore further reduce the attractiveness of this segment. Profit oriented banks will be inclined to return to the highly speculative parts of investment banking.

While the current adaptation process follows this scenario – actively promoted by parts of the banking industry and passively supported by the deferral of regulatory reforms – all actors run high risks. The simple occurrence of big bank insolvency or a further state crisis may destabilise the system again. Hence, it's time to think about alternative scenarios.

### **6.3. A new world order for financial markets – the end of the golden age**

Passing through a phase of controversial debates during 2010 the G20 governments will nevertheless compromise on the basics of a new financial order which will strongly affect the world financial system. The agreement will be achieved because there are clear signs of a second mortgages crisis in the US and Europe which will be going to destabilise a series of banks and will have significant feedback on public budgets again. Both, the population and the commercial world will be strongly urging for severe controls over financial markets in order to return to greater stability on product and labour markets. The prevailing financial system is perceived as a source of continuous instability. The new financial markets in particular are seen as instruments of wealth redistribution rather than value creation. Financial regulation will thus be prompted to curb these markets to levels that are needed by the real economy. The irritation among voters will continue to be serious, and politicians will be expected to dry up hyper-speculation in order to avoid future economic crises. Facing the fact that economies are strongly linked and a re-emergence of the financial crisis will affect all economies, also countries which do not feel to be responsible for the difficulties will agree to share the burdens of the new financial system.

#### *Outline of the new financial order*

On their December 2010 summit in Seoul, the G20 governments will agree on a series of fundamental principles of the new world order for financial markets:

- Equity ratios will be increased gradually but substantially, in order to improve the resilience of all financial intermediaries. The ratios will vary according to the risk of assets and the systemic relevance of the companies.
- Firewalls will be established by the strict separation of retail and investment banking. The size of companies can be restricted if systemic risks are becoming substantial.
- Financial intermediaries with systemic relevance will have to periodically submit “living wills” for a rapid and orderly shutdown. Financial supervision will be enforced to impose such plans.
- Non-banking and non-insurance financial intermediaries will be subject to financial monitoring and regulation. Derivatives will fully be traded on central clearing platforms.
- Rating agencies will have to register, disclose assessment methods, and investors will have the right of action against the agencies. Rating analysts will be required to pass qualifying exams and have continuing education.
- The role of supervisory boards will be strengthened regarding information and decision rights.

The reform – which uses the US “Wall Street Bill” as a template – will be supported by the rapid creation of the already decided financial supervisory boards in the US and Europe. Other countries will establish equivalent bodies. Particular attention will be given to macro-prudential risk assessment, based on a permanent exchange of statistical information and assessment results. For political reasons, a bank levy will be imposed on big banks. This however will be assessed as being insufficient for both, refunding the cost of the financial crisis and the protection against future crises. For similar reasons, a transaction tax will not be introduced.



The basic short-term instrument of the new financial order is the equity ratio which allows supervisors to directly impact leverage ratios and profit rates of financial intermediaries. The main long-term instruments are the direct and size-related restructuring measures and the enforcement of living wills. The latter will considerably improve risk assessment and long-term financial reserves.

### *Restructuring trends*

The application of the “Volcker Rule” will strongly limit the universal banking system in Europe. The large banks will have to sell their proprietary trade subsidiaries and close their engagement in the new financial markets. They will be transformed into service oriented retail and commercial banks on one hand and property oriented investment banks on the other. This will be more than an organisational change. It will cut the cross-funding between retail or commercial banking and investment banking. As investment banks will have to raise funds on capital markets, this can be expected to submit investment banks to stronger market control and possibly higher interest rates.

Higher equity ratios will reduce profitability or – as far as markets allow – increase credit costs. As equity ratios will be risk-based, the effect will not be neutral regarding the different segments. Investment banking will again be affected – high-risk investment banking in particular. This is the intended effect of a system which wants investors to become aware of their risks, reduce internal and external risk sharing, and establish the required security funds by own resources. The living wills can be expected to change decisions in the same direction.

Together with the various measures for the improvement of supervision, the rules can be expected to go far beyond the early identification of future crises. They will achieve a long-lasting reduction of leverage, at least if governments are decided to raise equity ratios. They will also achieve the shrinkage of investment banking and derivatives markets. They will reduce profits from banking and insurance activities in general, and depending on market developments raise prices for credits and lower returns on investment. They will terminate the golden age of financial services.

The banks with a “liberal” business model will be particularly affected as they belong to the big players with systemic relevance, provide a universal range of banking services and are strongly involved in proprietary trade. They will have to develop two rather than one business model, one for retail and commercial banking, and the other for the new and independent investment banking company. As they will not be allowed to have direct financial links between the two parts, they will communicate with each other only via capital markets. This will isolate the risks of investment banking and thus raise capital costs according to the perceptions of markets rather than the banks’ own considerations. Moreover, all activities will be oriented towards lower leverage and lower profits. This will increase competition on retail and commercial markets and accelerate productivity-oriented reorganisation.

With higher capital requirements the “state-owned” banks will get into difficulties achieving profit targets. Moreover, they will have problems in raising new capital and thus financial stress will increase. Nevertheless, they will be in advance to “liberal” banks as regards the restructuring of their business. This provides advantages due to the size and competitive position in retail banking markets. Being submitted to the same equity rules like other banks, their retail banking business will bring back market strength. Under the condition that governments are willing to absorb the brown-fields of toxic assets, “state-owned” banks will have the opportunity to play a strong role in retail and commercial banking and become independent again. Government shareholders will promote this development as it will open the opportunity to sell shares with profits.

The segment of “sustainable” financial intermediaries will be strongly favoured by the reforms, in particular as customers have a clear preference for security-oriented products and trustful financial

relations. The business representatives realise the advantages of the reform as it confirms the “sustainable” business model as the benchmark for the whole industry. Higher equity ratios can be expected to reduce profit margins of the “liberal” banks and thus reduce their competitive edge in comparison to “sustainable” companies. Business associations in the “sustainable” sector therefore will change their strategy and will actively support the implementation of the financial reforms.

The insurance industry will also profit from both, customer orientation and financial reforms. The disadvantage of higher solvency ratios will be more than compensated by rising demand, for life insurance in particular.

### *Impact on employment and working conditions*

The risk-based equity ratios will be a heavy burden for investment banking, hedge funds and the new financial markets in general. Employment can be expected to decline further in this segment. Investment bankers will not only face the decline of job opportunities but a fundamental reorientation of their business. High-speed speculation will be substituted by long-term asset management and the sustainable maximisation of return on investment. Only parts of the present investment brokers will be able to accommodate to this “cultural” shock, in particular as the process will be associated with strongly declining incomes. A new generation of brokers will take the lead.

Financial services in general will face hard times as the reforms will curb profits rates effectively. As the possibilities for price increases are limited due to sluggish economic growth, the focus will continue to be on cost efficiency. All segments of financial services will therefore work hard to exploit the cost saving potentials of information technologies and work reorganisation. The intensity of labour will further increase and work responsibilities will be extended. The overall number of jobs will continue to decline, due to the shrinking profitability of the whole industry.

The strong role of customer satisfaction will force financial service providers to invest into the quality of services and the competences of front officers in particular. The cost/income relation in counselling services will rise due to the extended length and the improved quality of customer advisory. Employment will be expanded in these services and wages of front officers will rise according to the increasing skill levels of the officers. Expenditures for continuing vocational training will increase.

Employment in back offices will further decrease. Cost/income relations for technical and administrative services will decrease due to the permanent substitution of labour by ICT. The skills composition of staffs in back offices will be upgraded as simple tasks will continuously disappear.

### *A long transition phase*

It can hardly be expected that the new financial world order will be implemented in short time. The negotiations on the regulatory framework will take years, not to speak of the adaptation of the business to the new orders. As in many reforms, the short and medium term effects will be negative, and positive impacts will only arise in the long term. In addition, the negative effects will be concentrated on financial industries in general while the positive effects of a more stable financial system will favour the real economy. The win-win constellation will only appear in the long-run. This will keep castigators strong.

The determinedness of the G20 governments, however, will place a new orientation with long-lasting effects. As a counter-balance to the turbulent events on capital markets it will be able to reduce the uncertainties among investors by providing a promising solution. Even if this will not be fully efficient in the short-run, it will positively affect the behaviour of private customers, companies and financial intermediaries and reorient their decisions towards the desired sustainability. This will calm down many of the hysterical reactions on capital markets.

The economies will nevertheless pass through a long phase of transition with reduced growth, negative impacts from budget consolidation, and high unemployment. The cost of the financial crisis will have to be compensated during a long period of suboptimal growth. There is hardly any choice in none of the scenarios. Only in this scenario, however, the long-term prospects are sufficiently positive to go for the risks of a fundamental financial reform.

#### **6.4. Divided economies – a worst case scenario**

In this scenario, the financial crisis will continue to rage in Europe and the United States. The mortgages crisis in Spain will not only be a stress test for the new European financial stability mechanism but trigger a further spiral of the vicious circle of the economic downturn. Public budgets will be overburdened with rescue programmes for both financial and non-financial companies. The turbulences will inhibit any international consensus on financial regulation. Every government will try to regain control over the capital markets. These however will be in uproar, enforcing a rapid rise of interest rates and bringing credit transactions close to a standstill. The situation is impaired by the US where a second wave of credit defaults will lead to the closure of a series of banks and bring the big players under stress again. The moment of truth has come.

Spain, Portugal and Greece will be forced to resolve parts of the banking sector and restructure public debt with a cut by 20 to 30 % of their obligations. The US and the UK will see rising inflation and the periodic devaluation of their currencies. The Euro zone will refrain from monetary appeasement and stick to budget consolidation instead. Foreign exchange markets will become highly volatile as will stock exchange prices. Uncertainties will increase and at some point in time things will move out of control.

Together with the confusion on capital markets, the austerity programmes of the Euro zone will lead into a deep recession. Stability funds will be overstressed. None of the countries will be able to comply with the Maastricht Treaty criteria. The big countries will develop their own strategies and rules to come out of the mess. Negotiations on a new financial order will fail. The Euro zone will show signs of disintegration.

The weaknesses of the economies behind Euro, Dollar and Pound will strengthen the power of the Asian countries, China in particular. Chinese banks and insurers will start to acquire European and US companies, and manufacturing companies will buy western technology in large volumes. Investors and producers in Europe and the US will concentrate on the Asian markets in order to participate in the still positive growth of these economies. This will give China a strong say in the rules of international finance and a central role in the recovery of the world economy.

##### *Impact on restructuring*

The financial sector will be hit strongly by these developments. Due to the integration of the system, all segments will be affected, even those which have been prevented from damage until now. The numbers of insolvencies among banks will increase as structured resolution procedures will have been developed. Investors will strongly prefer real estate and commodities.

During the first phase of the depression, private banks and insurance will be seriously affected by high default rates and the devaluation of financial assets. State-owned banks will largely be resolved. Due to the failure of financial market regulation, however, new opportunities will arise in liberal countries. They will attract substantial parts of investment banking at the expense of the more restrictive countries. This will help the new financial markets to revive by re-establishing internationally

linked capital markets. Derivatives will be created at high speed. The investment banking business will try to recreate without making the mistakes of the past. This means huge investments into risk assessment tools and the quality of automated trading.

In the “sustainable” part of the financial sector, notably savings banks will come under stress as quasi-public banks. Investors will avoid investments into institutions with strong links to public authorities. Moreover, savings banks will hold high amounts of risky mortgages. In contrast, the cooperative sector will see new opportunities by profiling as the leader of the “ethic economy”. Mutual credit banks with a strong environmental and social orientation will be strongly preferred by customers who have lost trust in public authorities. Moreover, these banks will provide a wide range of micro-credits which will be needed for the restart of the economy.

### *Sharpened social divide*

Under such conditions, the European countries will have to experience a strong social divide. On one hand, a profit and growth oriented group of managers and professionals will be able to resurrect the previous strategies, based on the opportunities of a widely unregulated financial sector. They will profit from the weakness of public authorities and search for high-profit investments worldwide, reinforce relocation of production facilities to foreign countries, participate in the growth of Asia and South America, and select their place of residence according to tax rates. The solidarity of European societies will be at risk.

On the other hand, the local economy and the average working class will start to intensify economic and social relations. The major development strategy will rely on strong networks and regional linkages. Commodity flows will be redirected, tax revenues will be kept in the region, and social support programmes will be concentrated on the own population. Financial institutions will cut international relations and focus on regional development. Some regions will even start issuing their own currencies.

The regionalisation of the economy will be developed by citizens who are convinced that the globalisation of economies has been a fundamental error: important aspects of social life have been violated by the global economy, environmental concerns have been neglected, and the financial system has emerged as a source of instability rather than growth. Faced with the incapability of public institutions to manage the crises, they will feel the responsibility for a new approach. This should be based on micro-organisms instead of macro-institutions.

### *Employment effects, income and working conditions*

It appears to be evident that such a scenario will result in depression levels of unemployment and a sharp decline of incomes. A high share of the population will be living at subsistence levels, public services will be run at minimum standards, production facilities will lie idle, and the infrastructure will deteriorate. The income dispersion will see unprecedented gaps.

In contrast to the times of the Great Depression however, the ability of self-organisation will be strong. Based on the high skill levels of large parts of the population, countries will be able to achieve the economic recovery with a broad human capital basis. This will allow recreating economic relations with local economies in a variety of approaches. Not harmony but diversity will be the source of growth.

The financial sector will be strongly segmented under such conditions. The internationally oriented “liberal” segment will be opposed to the locally oriented “sustainable” segment. Financial relations between the two parts will be kept at the minimum and working conditions will differ fundamentally. High-performance profit maximisation at high salaries in the “global” section of the economy will be

opposed to client-oriented welfare maximisation at low incomes in the “sustainable” section. The social divide cannot be expressed more clearly.

The social dialogue will come to an end in the “liberal” segment of the financial sector. Both, managers and workers won’t see the need for such a dialogue as they will all feel to be entrepreneurs and have the bargaining power to protect their interests. In the “sustainable” segment however the social dialogue will flourish as the representation of different interest groups belongs to the principles of a network-based society.

#### *A worst case scenario*

Of course this scenario describes the near apocalypse of the liberal economies in the western hemisphere. The realistic content of this projection can certainly be questioned. However, we wrote this scenario not with the idea to describe the likely outcome of the crisis but the risk at which we are operating at present. For two times now, the liberal economies looked into the abyss of a total meltdown – financially and economically. Such scenarios are therefore needed in order to understand the threats of the current evolutions, and to convince actors at all levels to fight for the reestablishment of a sustainable financial sector.

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