Overview of the Current Financial Crisis

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1 Abstract

In this document, the author has collected information coming from various sources about the current financial crises, its origins, the role of efficient risk management, and the strategy that banks have implemented. He details also his personal views on the failure of the governance of banks over the last years, failure which contributes significantly to the current financial mess. This crisis has shown, to those who still doubted it, that banks are the main actors which support the real economy and, therefore, they should be managed carefully. Keeping this in mind and defining clear strategies, we think that banks could easily find again the way to reasonable sustainable profitability.

2 Global Environment

The autumn of 2008 marks the end of an era. After a generation of standing ever further back from the business of finance, governments have been forced to step in to rescue banking systems and the markets. Journalists, such as John Reed, suggest that the causes of this crisis have to be found within the banking industry: «It is relatively easy to list behaviour that contributed to the financial “mess”: greed, misaligned incentives, analytic failures, a tolerance for customer abuse and so forth. It is also easy to list the players: bankers, investors, rating agencies, accountants, regulators, boards, etc. I would also say the responsibility for all of this rests with “the industry”, not externalities such as deregulation (there was not any that was relevant) or easy money (a banking system surely should be able to function over normal cycles) or the government.» (Reed, 2008).

In its attempts to understand the crisis, The Economist (Economist, 2008_c) adds an important dimension to the ones mentioned above. CONFIDENCE is everything in finance. Today’s failure of confidence is based on three related issues: the solvency of banks, their ability to fund themselves in illiquid markets and the health of the real economy. Capital injections in banks by governments or private investors help to solve the solvency issue. But the main problem remains the credit markets. During the first two weeks of October, in the interbank market the prices banks pay to borrow money from each other were still near record highs. Moreover, the damage to the real economy is becoming apparent. In America consumer credit is now shrinking, and around 159,000 Americans lost their jobs in September, the most since 2003. Some industries are hurting badly: car sales are at their lowest level in 16 years as would-be buyers are unable to get credit. Across the globe forward-looking indicators, such as surveys of purchasing managers, are horrifyingly gloomy.
3 Industry Analysis

Porter’s Five Forces provides a convenient framework for exploring the economic factors that affect the profitability of an industry. The graph hereunder summarises these five forces in the context of the banking industry (Investopedia, 2008):

**Threat of New Entrants**
The average person cannot come along and start up a bank, but there are services, such as internet bill payment, on which entrepreneurs can capitalise. Banks are fearful of being squeezed out of the payments business, because it is a good source of fee-based revenue. Another trend that poses a threat is companies offering other financial services. What would it take for an insurance company to start offering mortgage and loan services? Not much.

**Bargaining Power of Suppliers**
In normal markets condition, the suppliers of capital might not pose a big threat. Nevertheless, today’s conditions are not normal. During tight liquidity periods, suppliers of capital will act cautiously.

**Bargaining Power of Customers**
The individual does not pose much of a threat to the banking industry, but one major factor affecting the power of buyers is relatively high switching costs. If a person has a
mortgage, car loan, credit card, deposit account and mutual funds with one particular bank, it can be extremely tough for that person to switch to another bank. In an attempt to lure in customers, banks try to lower the price of switching, but many people would still rather stick with their current bank. Nevertheless, in a period of lack of confidence, switching costs will not influence much customers’ behaviour: if customers do not trust their bank anymore, they will immediately switch to another. On the other hand, large corporate clients have banks wrapped around their little fingers. Financial institutions - by offering better exchange rates, more services, and exposure to foreign capital markets - work extremely hard to get high-margin corporate clients.

**Threat of Substitutes**
As you can probably imagine, there are plenty of substitutes in the banking industry. Banks offer a suite of services over and above taking deposits and lending money, but whether it is insurance, mutual funds or fixed income securities, chances are there is a non-banking financial services company that can offer similar services. On the lending side of the business, banks are seeing competition rise from unconventional companies. For example, Car Markers and Retailers all offer preferred financing to customers who buy big ticket items. If car companies are offering 0% financing, why would anyone want to get a car loan from the bank and pay interest?

**Rivalry Among Existing Competitors**
The banking industry is highly competitive. The financial services industry has been around for hundreds of years, and just about everyone who needs banking services already has them. Because of this, banks must attempt to lure clients away from competitor banks. They do this by offering lower financing, preferred rates and investment services. The banking sector is in a race to see who can offer both the best and fastest services, but this also causes banks to experience lower revenues. They then have an incentive to take on high-risk projects. In the long run, we are likely to see more consolidation in the banking industry. Larger banks would prefer to take over or merge with another bank rather than spend the money to market and advertise to people.

The industry analysis has shown that bankers have to make business in a complex environment. Therefore, the strategy that management of banks will implement in their firm will be crucial to guarantee their success. In the next section, we detail the strategy of the banking industry.
4 Banks Strategy and its Consequences

Before analysing the strategy of banks, it is key to remind what the meaning of banking is (Heffernan, 2004). The provision of deposit and loan products normally distinguishes banks from other types of financial firms. Deposit products pay out money on demand or after some notice. Deposits are liabilities for banks, which must be managed if the bank is to maximise profit. Likewise, they manage the assets created by lending. Thus, the core activity of banks is to act as intermediaries between depositors and borrowers. Obviously, over time, the panel of services offered by banks expand (Economist, 2008_a). This expansion has had a clear impact on banks strategy.

Strategy is defined (Hitt, Ireland, & Hoskisson, 2005) as an integrated and coordinated set of commitments and actions designed to exploit core competencies and gain a competitive advantage. A sustained competitive advantage is achieved only when competitors have failed in efforts to duplicate the benefits of a firm’s strategy or when they lack confidence to attempt imitation.

Over the past decade, by mimicking each other, most of the banks implemented the same type of strategy preventing them to create a sustainable competitive advantage. According to the author, this strategy could be summarised as follows:

- development of sophisticated products to on- and off-balance sheet vehicles; and
- growth for growth’s sake.

The mortgage market perhaps best illustrates how the development of sophisticated products can transform the scope and nature of a business and also what the limitations are of relying too heavily on markets for risk management (Buehler, Freeman, & Hulme, 2008_b). Traditionally, banks held their mortgages in a single portfolio. In the early 1980s, especially in the United States, they started to securitize these portfolios: they pooled their mortgages, divided the pools into tranches, and sold them to third-party investors – other banks, pension funds, or insurance companies. In this way the risks of mortgage default were taken off the books of the original banks, which went on to make further mortgage loans (and to collect the associated fees), which were also pooled. This growth in business led to unprecedented profitability in the banking sector. But by early 2007 it was clear that both the underwriting and the rating of mortgages had become far too lax, so when subprime default rates rose, a major financial crisis ensued. Its ramifications are still spreading. The higher default rates rapidly depressed the prices of mortgage securitizations, first of the lower-rated tranches and then of the higher-rated ones. Some global banks, though they were not direct U.S. mortgage lenders, held portfolios of highly rated mortgage-backed securities or CDOs of mortgage-backed securities. As the ratings of those securities dropped, the banks’ equity cushions
thinned; they had to write off billions in asset values, seek out huge infusions of capital, and sharply reduce lending. The resulting credit crunch has changed the policy landscape, creating pressure for interest-rate cuts and giving rise to special lending facilities for liquidity-starved financial institutions. But risk can still be sliced and diced into discrete elements. The lesson here is not that the banks were wrong to take advantage of the markets but that even the largest and most liquid derivatives markets depend on the quality of the underlying assets. Transferring risk does not mean eliminating risk.

As mentioned above, the second element of the banks strategy was growth for growth’s sake which means that, since the beginning of this century, bankers focused mainly on revenues and profits growths. Quarter after quarter, it was key for banks to present to all stakeholders that their profits has risen significantly with the objective of achieving a 2-digits growth on annual basis. As such this cannot be considered as a strategy, it would rather be considered as a lack of strategy. Researchers (Collis & Rukstad, 2008) confirm that very few executives can honestly answer the following simple questions in the affirmative: «Can you summarise your company’s strategy in 35 words or less? If so, would your colleagues put it the same way?». Moreover the companies that those executives work for are often the most successful in their industry. In particular, we think that this can be applicable to the banking industry.

Any strategy statement must begin with a definition of the ends that the strategy is designed to achieve (Collis & Rukstad, 2008). “If you don’t know where you are going, any road will get you there” is the appropriate maxim here. The definition of the objective should include not only an end point but also a time frame for reaching it. Since most firms compete in a more or less unbounded landscape, it is also crucial to define the scope of the business: the part of the landscape in which the firm will operate. What are the boundaries beyond which it will not venture? Alone, these two aspects of strategy are insufficient. You could go into business tomorrow with the goal of becoming the world’s largest bank within 10 years. But will anyone invest in your company if you have not explained how you are going to reach your objective? Your competitive advantage is the essence of your strategy: what your business will do differently from or better than others defines the all-important means by which you will achieve your stated objective.

The lack of strategy of banks has had a clear implication. Banks, and more precisely their management, have forgotten that they exist to support the real economy. They enter in the spiral of “more profits, always more profits” decoupling them of reality in some sense. “The biggest we are, the best it is” was probably the main driver of executives of
banks over the last years. This combined with the credit crunch ended up with the financial crisis we are currently experiencing.

It is interesting to notice that in some countries, banks have not developed the same strategy. But it is also interesting to notice that this is mainly due to external factors. Italy pretends to have the soundest banks in Europe. Italy’s finance minister admitted that this is partly because Italian banks are less advanced and sophisticated than others in Europe. In Spain, none of the banks has needed rescuing. If Spanish banks have survived, it is thanks to the Bank of Spain’s tight regulation and to the prudence of Spanish bankers (Economist, 2008_d). Does this mean that good bank management can only be achieved with the presence of external referees? This statement is probably going too far. Nevertheless, there is probably something true in it.

5 Changing the Banking Business Model

As usual, errors of the past have to be used to improve future. Therefore, as all companies, banks need above all to think about how they will define and implement a clear strategy keeping in mind what their core activity is in the whole economy. As banks are competing in the financial service industry, when defining their strategy, executives have to keep in mind that they are four things a service business must get right (Frei, 2008).

The Offering

The challenge of service-business management begins with design. A service business cannot last long if the offering itself is fatally flawed. It must effectively meet the needs and desires of an attractive group of customers. For example, customers may compare your offering favourably with competitors one because of extended hours, closer proximity, greater scope, or lower prices. The management team must be absolutely clear about which attributes of service the business will compete on. Strategy is often defined as what a business chooses not to do. Similarly, service excellence can be defined as what a business chooses not to do well. If we agree with this, it implies that banks which are offering a large panel of financial services have somehow taken the wrong direction. Moreover, banks offering has to focus mainly on its core activity, i.e. the support of the real economy.

The Funding Mechanism

All managers, and even most customers, agree that there is no such thing as a free lunch. Excellence comes at a cost, and the cost must ultimately be covered. In a service business, developing a way to fund excellence can be complicated. Many times, pricing
is not transaction based but involves the bundling of various elements of value or entails some kind of subscription, such as a monthly fee. In a service business, therefore, management must give careful thought to how excellence will be paid for. There must be a funding mechanism in place to allow the company to outshine competitors in the attributes it has chosen. The classic approach to funding something of value is simply to have the customer pay for it, but often it is possible to make the form that payment takes less objectionable to customers. For instance, Commerce Bank, a Missouri-based company, is open late and on weekends (earning it high marks on extended hours) and it pays for that service by giving a half percentage point less in interest on deposits. Could it fund the extra labour hours by charging for evening and weekend visits? Perhaps, but a slightly lower interest rate is more palatable.

The Employee Management System
Companies often live or die on the quality of their workforces, but because service businesses are typically people intensive, a relative advantage in employee management has all the more impact there. Top management must give careful attention to recruiting and selection processes, training, job design, performance management, and other components that make up the employee management system. More to the point, the decisions made in these areas should reflect the service attributes the company aims to be known for.

The Customer Management System
In a service environment, employees are not the only people affecting the cost and quality of service delivered. The customers themselves can be involved in operational processes, sometimes to a very large extent. In the banking industry, the development of e-banking has contributed significantly to increase the involvement of customers in operational processes. The next step could be to move from e-banking to e-business. Nordea, a Helsinki-based bank, has already started experiencing this evolution (Jelassi & Enders, 2005).

Another important element that banks should take into account when they define their strategy is risk. Banks must be able to specify the risks they run and have some sense of how they might play out, whether for or against them. Identifying risks sounds easy, but in fact getting agreement around the ones the company faces can be quite difficult. Functional and business unit heads may understate or dismiss some of their risks in order to hang on to their share of the budget. The legal and financial functions may have different views of risk and no easily shared language or tools for discussing them (Buehler, Freeman, & Hulme, 2008_a).
Overseeing a risk-management effort requires constant vigilance and commitment from bank’s managers, beginning with the board. The best risk managers have a culture of continual questioning and openness, in which information is simultaneously challenged and filtered to reduce the chance of surprises. Even banks with an appreciation of risk and some sophistication about managing it usually do not go far enough. Commonly they adopt a decentralized approach: risks are owned by business units, and headquarters provides oversight and some aggregation of risks through portfolio choices. Experience tends to show that the most effective model is a centralized one, with a powerful chief risk officer who reports to the CEO but also presents regularly at the board level. Companies with this structure tend to manage volatile risks that require vigilance and discipline.

6 Regulation of Banking Activities and its Impact

Since always, an important objective of governments is to provide a stable economic environment for private individuals and businesses. To increase confidence in the financial system and protect people and businesses, there has been a trend worldwide toward the development of progressively more complicated rules on the capital that financial institutions are required to keep. This is because the ability of a financial institution to absorb unexpected losses is critically dependent on the amount of equity and other forms of capital held.

Bank regulators are in many ways taking the lead in developing a methodology for setting capital requirements for financial institutions. The regulation of banks is based on international standards called the Basel II accords.

Basel II is based on three pillars. In Pillar 1, the minimum capital requirement for credit risk in the banking book is calculated in a way that reflects the credit ratings of counterparties. The capital requirement for market risk is based on a Value-at-Risk methodology and there is a capital charge for operational risk.

Pillar 2, which relates to the supervisory review process, allows regulators in different countries some discretion in how rules are applied (so that they can take into account local conditions) but seeks to achieve overall consistency in the application of the rules. It places more emphasis on intervention when problems arise. Supervisors are required to do far more than just ensure that the minimum capital required under Basel II is held. Part of their role is to encourage banks to develop and use better risk management techniques and to evaluate these techniques. They should evaluate risks that are not
covered by Pillar 1 and enter into an active dialogue with banks when deficiencies are identified.

Pillar 3, the market discipline, will require banks to disclose more information about the way they allocate capital and the risks they take. The idea here is that banks will be subjected to added pressure to make sound risk management decisions if shareholders and potential shareholders have more information about those decisions.

As shown in this section, the banking industry is largely regulated. So the question is not “Do we need to regulate banks?” but it is rather “Is the current regulation efficient?” Some authors have already pointed out that they are some imperfections in the Basel rules as they provide too much freedom to banks in the way they determine the capital they need (Suarez, Dhaene, Henrard, & Vanduffel, 2005). In this sense, it is clear that regulators should refine the Basel II accords ending up with new rules which should increase the minimum capital that banks need to hold to protect their business from the risk they face.

Banks nationalisation could also be an alternative to increase regulation of banks. But will this really improve the protection of our financial and economical systems? Recently, to prevent a total failure of the banking system, governments have decided to nationalise partially or totally some banks. The bigger risk inherent in greater state control is the slow strangulation of the economy by government officials. As Alan Greenspan said: «It is crucial that any reforms to the structure of markets and regulation do not inhibit our most reliable and effective safeguard against cumulative economic failure: market flexibility and open competition». Politicians need to remember his words if they take the banks into state ownership. It must be a strictly temporary measure (Telegraph, 2008).

7 Conclusion

As usual, dramatic crisis are needed to question ourselves. Due to this unprecedented financial crisis, all economic actors need to sit down together to revisit the meaning of banking. Executives and shareholders of banks need to analyse what was wrong with their business model in order to deliver better services and manage more carefully their institutions in the future. Regulators and rating agencies have to ask themselves why they failed in their monitoring mission. Governments should investigate if fair value accounting is still appropriate (Economist, 2008_b) and should perhaps rethink the role of central banks. Non-banking institutions, such as hedge funds for instance, operating
in financial markets have played a role in this crisis. Is this still acceptable? These are part of the questions which need new answers to design the new banking industry.

As the causes of this crisis have to be found within the banking industry itself, we think that the solution should primarily come from the industry. As we explained in this document, we think that the improvement of the governance of banks will probably solve a significant number of the problems: refinement of risk management, adapt service offering to customers target, improve operational effectiveness, etc. Integrating all these components in the global strategy of banks should help them to achieve the ultimate goal, i.e. the creation of a sustainable competitive advantage. Therefore, due to the significant fall in stock prices of banks, this crisis can be seen as an interesting opportunity for investors who are ready to change and redesign the banking industry.

8 Bibliography