AFTER THE CRISIS: SHIFTING THE PERSPECTIVE TOWARDS A REACTIVE REORGANIZATION IN THE BANKING SECTOR

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Abstract

Focused on the banking sector, the article analyses the change in approach that financial organizations needed to embrace in order to overcome the difficulties of the recently past financial crisis. In order to emphasize this difference, the article focuses both on the pre-crisis reorganization measures, and as well on the measures taken post-crisis. Furthermore, the article discusses and breaks down key elements such as the top transactions in the banking sector, the financing method, the restructuring measures, and the way the crisis affected and projected this shift in perspective.

Keywords: financial crisis, banking sector, reorganization, economy

Introduction

The decrease of the profitability of traditional banking activities created problems of financial stability, increasing the number of bank bankruptcies and increasing the tendency of banks to take greater risks, either getting engaged in granting riskier loans, or involving in "non-traditional" financial activities that promise higher returns but also entail greater risk-taking. Banks' non-traditional activities, as well as their involvement as derivatives dealers expose banks to risks and moral hazard problems.

Traditional activities of banks have been for a long time, the granting of long term loans and their financing them by attracting short-term deposits. In the last 30 years, economic forces have diminished the role of traditional banks within financial intermediation. As a source of funds for financial intermediaries, the deposits have decreased in importance. In addition, the profitability of traditional activities of banks, as well as of the loans granted has decreased. As a result, banks have turned to non-traditional activities as a way to maintain the original position of financial intermediaries.

The decline in profitability of traditional banking activities led banks managers to focus on higher risk-taking, out of the desire to maintain previous levels of performance. For example, banks granted loans to risky borrowers or were engaged in non-traditional activities that promise higher returns at higher risk. In search of new sources of revenue in financial derivatives, banks took risks that affected the solvency and stability of the financial system. The challenge raised by the decline of traditional activities of banks is twofold: the stability of the financial system must be maintained while restructuring the banking industry in order to achieve long-term financial stability (Franklin E., Mishkin F., 1995).

Before the financial crisis

Market factors (globalization process, the increase of competition between markets and institutions, the increased volatility in interest rates, exchange rates) have led to financial innovations that increased competition in the financial markets. Increased competition has led to the decrease of the banks' cost advantage in attracting funds and to the diminishing of their position in the credit market. The result was the decrease of the profitability of traditional banking activities, which required efforts by banks to diversify their operations to new, more profitable directions.

By 1980 deposits were a cheap source of funds for US banking institutions (commercial banks, savings and credit banks, savings and mutual banks, credit unions). Banks were subject to capping interest rates on deposits which imposed them to restrict the interest paid on demand deposits. Regulation Q has limited them to pay capped interest rates for term and savings deposits. For years, these regulations operated in favour of banks as an important part of their sources were demand deposits (in 1960 they held 60% of the total bank deposits). This led to a very low average cost of the funds attracted. However, this cost advantage has not continued. The increase in inflation starting with the late 60s led to higher interest rates and caused investors to be more sensitive to the difference between the returns of various assets.

The result was the so-called deleveraging process in which depositors withdrew their deposits from banks because they discounted low rates of interest, turning to assets with higher returns. Thus, the restrictive banking regulations have created opportunities for the development of non-banking financial investment. Non-bank competitors were not subject to capping interest rates on deposits, such as banks, and also had no costs associated to the establishment of unpaid minimum reserves and insurance premium payments for deposit insurance. (Corrigan E.G., 1990)

The establishment of MMMF (Money Market Mutual Funds) placed banks in a competitive disadvantage because their shareholders or depositors could obtain check writing services, obtaining at the same time higher rates of interest on their deposits. It was not surprising for a source of funds of banks to fall dramatically, namely demand deposits for which banks paid low rates of interest, have decreased as a percentage. These changes helped banks become more competitive in search of funds, which led to a substantial increase in the cost of funds, reducing the advantage they have enjoyed. The development of MMMFs market indirectly diminished the role of banks, supporting the expansion of competing finance companies. MMMFs asset growth has created a market for trading securities as these institutions must hold high quality liquid assets and on a short-term. Moreover, this market growth prompted financing companies which depended on the issue of trade securities for most part of their funds, develop lending activities as expensive as banks. These companies provided loans to many of the same companies that were traditionally financed by banks. In 1980, non-financial institutions granted loans representing 30% of total commercial and industrial credits granted by banks. Junk bonds market attracted some of the banks business. In the past only 500 companies were able to raise funds by selling bonds directly to the public through the banks whereas now even companies with low ratings can raise funds by issuing bonds.

Banks have experienced a deterioration of benefits regarding the revenue they earned from their balance sheet assets. The development of commercial securities market (commercial papers) and of bond market (junk bonds) and asset securitization process development diminished their traditional advantage in terms of granting loans. The development of information technology that has facilitated for households, corporations, financial institutions, the possibility to assess securities quality, made it easier for companies the borrowing of funds directly from the public by issuing securities. Instead of turning to banks to finance themselves through short-term loans, many companies have borrowed by means of commercial papers. The total of these non-financial securities issued as a percentage of total commercials and production loans increased from 5% in 1970 to 20% in 1998. The possibility of securitizing assets caused non-banking financial institutions become competitors for banks. Advanced computer techniques and data processing and transmission technologies stimulated non-bank competitors to grant loans, transforming them into securities listed on this market and selling them to get more funds with which to pay more credits. Computer technology has eroded the competitive advantage of banks, reducing transaction costs and stimulating the banking financial institutions to assess the credit risk efficiently by using statistical methods. Thus, not only banks had an advantage in granting loans. There have been efforts made by the US to develop credit securitization activities.

In recent years, banks in other countries faced more competition due to the expansion of capital markets. Both, financial deregulation and fundamental economic forces increased the availability of information on the capital markets, making the financing of company’s activities by issuing securities easier and less costly, instead of resorting to banks. Even in countries where capital markets were less developed, banks have lost the share in the credit market because of corporate clients who had access to foreign markets and offshore markets such as Eurobonds. The same factors that led to the securitization process in the US have acted in other countries as well and decreased banks’ profitability out of traditional activities. Although the decline of traditional activities intervened faster in the US than in other countries, the same factors would lead to the diminishing of the traditional role of banks.

Banking alternatives in order to increase profitability

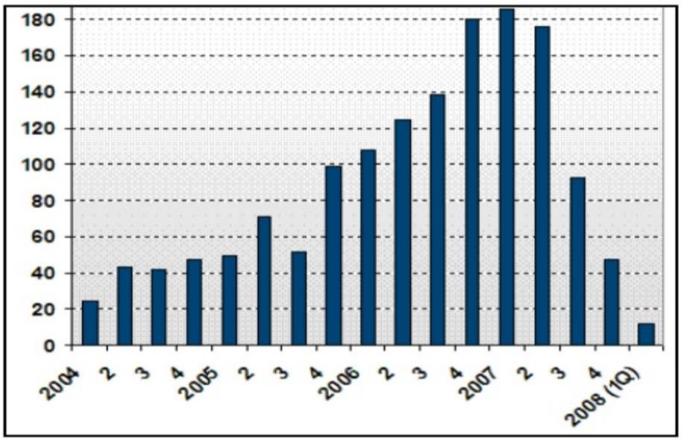
In any industry, a decline in profitability leads to the exit from that industry, often by a resounding bankruptcy or reduction in market share. This happened in the US banking industry during the 80s. Between 1960 and 1980, the number of bank failures in the US was below 10 per year, and during the 80’s they have grown to over 200 per year.

One of the alternative for banks to survive and maintain adequate levels of profitability was to maintain traditional lending activities by expanding to new lending, much riskier areas. For example, US banks have increased the risk assumed by placing a greater proportion of funds to mortgage loans, which was traditionally a risky type of loan. They also increased their loans granted for corporate takeover and for the purchase of majority stakes in heavily indebted companies. It was obvious that banks increased the loans granted to high-risk borrowers, so in the '80s, the specific provisions for credit risk of banks reported to assets have increased substantially. Universal banks created similar risks with their credit card operations. While the housing boom lasted, universal banks expanded credit card lending to nonprime borrowers and encouraged those borrowers to use home equity loans to pay off their credit card balances.

The second way in which banks tried to maintain previous profits was to move towards new, out of the balance sheet activities, which are more profitable. This strategy has generated views related to the relevance of these transactions for banks and that these non-traditional transactions were riskier and led banks to take excessive risks. US were not the only country that has experienced an increase of the risk assumed by banks, as big losses and bankruptcies occurred in other countries too. Banks in Norway, Sweden and Finland responded to deregulation by means of the huge increase of loans for real estate, which was followed by an explosion, and then, by a fall in the real estate sector, causing the insolvency of several large credit institutions. Indeed, bank credit losses in these countries as a share of GDP, exceeded the aggregate losses of the credit and savings institutions in the US. The International Monetary Fund reported in 1993 that government and the taxpayers support to save the banking system in Scandinavian countries ranged from 2.8 to 4% of GDP, comparable to the costs of rescue actions in the US (3.2% of GDP). Japanese banks have suffered great losses due to riskier loans granted to the real estate sector in particular. The collapse in terms of property values in Japan has affected many banks, such as Sumitomo Trust and Banking Company, generating huge losses. Official estimates showed that 21 of the largest Japanese banks had more than $136 billions bad loans on which the interest payment was not made for more than 6 months. But private analysts believe that this amount was twice as high. Japanese Federation of banks, with government support, has established cooperation agreements to save the banking system. French and British banks were harmed due to the collapse of real estate prices and due to bankruptcies of large projects financed by banks in real estate. Olympia and York bankruptcy is a good example. As in the US, the provisions for French and British banks' credit increased in the 90s, although none of the banking systems seemed to be affected by any major bank collapse. Even in countries with strong banking systems, such as Germany and Switzerland, some banks had problems. Regional banks in Switzerland, went bankrupt, and in Germany BfG Bank suffered heavy losses (1.1 billion DM) in 1992 and needed a capital injection from the parent company, Credit Lyonnais.

The decline in profitability of traditional banking activities manifested worldwide and created the challenge for banks to expand to new activities and to take on additional risks. A major controversy has arisen in connection with the trend for banks to diversify their activities, turning to off-balance sheet operations, increasing their role on the derivatives market. (Gorton G., Rosen R, 1995). Thus, it took place a series of mergers. For example, Chase acquired several small investment banks and subsequently merged with J.P. Morgan, which was the commercial bank with the strongest ties to Wall Street (R. C. Smith, 2001). Three large European banks also established major positions in the U.S. securities markets by acquiring Wall Street firms. Credit Suisse acquired First Boston and Donaldson, Lufkin & Jenrette, while Deutsche Bank acquired Bankers Trust (not long after Bankers Trust had absorbed Alex. Brown), and UBS purchased PaineWebber (R. Bookstaber, 2007).

Major banks have become dealers on CDO derivatives markets. The motivation was to replace part of the traditional "bank" income loss, by the attractive returns arising from transactions with derivatives. Banks have increased their participation in these markets significantly in the past 10 years. In 1992 US banks had derivative contracts totalling over 8 trillion dollars as denominations, and in the first quarter of 2005 they reached 91.1 trillion dollars. Credit linked notes/collateralized debt obligations (CDOs) were combinations of a fixed income security with an embedded credit derivative. CDOs were designed to allow investors to capture returns on a single reference entity such as an underlying bond/loan or multiple reference entities a portfolio of bonds/loans. CDOs enabled the use of securitization techniques in order to create structured exposure to portfolios of multiple reference entities (portfolios of bonds/loans or other credit obligations). In order to achieve dominant positions in the capital markets large banks and also securities firms pursued similar strategies that ultimately led to their collapse. As a result, starting with 2001 Citigroup was considered the leading underwriter of stocks and bonds worldwide, and also one of the largest managers of CDOs next to Merrill Lynch until the subprime crisis started in 2007 (R. Smith, 2001). Coincidentally, the CDO market peaked as the financial crisis set in, with a total issuance of over $180 billion.



Total Issuance of CDOs
Source: Barnett-Hart (2009, March 19)

After the financial crisis

The downfall of Lehman Brothers, which was considered the biggest American institution that declared bankruptcy in the history, opened a new chapter in the global financial crisis that started in the summer of 2007. Although the financial crisis appeared to be restrained on a small section of the real estate market, it had an enormous impact on the market value of banking shares in United States and Europe, which resulted in a loss of more than 3 trillion euros and in a decrease of 82% in their value. Moreover, the world had witnessed a sharp rise in lending costs and an increase in the risk aversion for lending to the private sector in both developed and emerging countries.

Starting with the summer of 2007, the monetary authorities began to implement different measures with the purpose of improving the financial liquidity. Thus, the conduct of banks at a global level was to keep at their disposal as many liquid assets, which exacerbated the distrust between business partners and the blocked the lending process. Interest rates and financial market volatility began to rise. Major US investment banks (Goldman Sachs and Morgan Stanley) have obtained permission from the authorities to revert to the status of commercial banks in order to stabilize their capital situation. The financial crisis had different negative effects on the banking sector worldwide thus requiring diverse strategic measures and restructuring methods.

In England, the authorities were forced to negotiate at the end of September 2008 the bailout of one of the specialized mortgage banks (HBOS) by one of its competitors in the local market. Moreover, the government was forced to nationalize Bradfor&Bingley, an important institution on the real estate market. In Belgium, Netherland and France, the governments intervened in order to save transnational Fortis bank from bankruptcy. Other emerging economies confronted with speculative attacks, with the sudden dissolution of the low-priced credit and with refinance difficulties of public debt. In these circumstances many of these states had to resort to adjustment programs and funding from the IMF in order to provide liquidity and capital injections to their institutions. The most frequent restructuring method for banks around the world was partial or total nationalisation causing large global banks to play a big role in inflating budget deficits and increasing public debts in major countries.

Between the outbreak of the financial crisis in June 2007 and April 2009, more than $1.32 trillion of losses were reported by financial institutions around the world, including commercial and investments banks and also insurance companies. In order to restore liquidity and stability to the global financial system, United States, Europe and England provided almost $9 trillion in the form of capital infusions, financial guarantees and asset purchase programs. As a result, in USA was created the Troubled Asset Relief Program ("TARP") by the Emergency Economic Stabilisation Act of 2008 ("EESA") that enabled the Treasury to either purchase or insure up to $700 billion in troubled assets owned by financial institutions, through various bank support programs such as Capital Purchase Program (CPP), Targeted Investment Program (TIP), Asset Guarantee Program (AGP) or Community Development Capital Initiative (CDCI). At the end of 2008, nine of the largest financial institutions in US were selected by their importance to the financial system to benefit from TARP funds and received $125 billion investment funds through the Capital Purchase Program (CPP). The purpose of CPP was to "stabilize and strengthen the U.S. financial system by increasing the capital base of an array of healthy, viable institutions, enabling them to lend to consumers and businesses."

Citigroup was one of the nine financial institutions selected to benefit from the TARP program that received $25 billion, which was the maximum amount invested by the Treasury in a financial institution under CPP. Citigroup used to be the largest banking organisation in the world by total assets until the financial crisis in 2008, quickly falling to the third position behind J.P. Morgan Chase & Co and Bank of America Corp (Relbanks, 2013). Moreover, Citigroup was also one of the largest global deposit banks, which held more than $794 billion in both domestic and foreign deposits and performed consumer banking in more than 100 countries worldwide. In this circumstances and given its major role that it played on the derivatives market ($500 million earnings from issuing CDOs in 2005), Citigroup recorded a significant drop in the stock price and incurred severe financial losses due to the subprime crisis, totalling more than $30 billion and also a loss of confidence among investors and shareholders. In order to reduce financial losses and to regain confidence from investors, Citigroup started to eliminate 5% of its global workforce (approximately 17.000 jobs) in 2007 and another 14% (approximately 52.000 jobs) in 2008 (Dash 2008).

Source: Citigroup.com

On September 15, 2008 Bank of America announces the intention to buy Merrill Lynch, a deal valued at $50 billion, the same day that Lehman Brothers filed for bankruptcy, even though BofA was considered a potential buyer of Lehman. Like many other financial institutions, Merrill was severely affected by the financial crisis due to the bad bets on repackaged debt securities and was facing a drop of 65% in share value throughout the year and also severe liquidity problems (net losses of more that 17 billion in 2008 only). In October, 2008 Citigroup received the first amount of $25 billion under CPP whereas Bank of America received $15 billion and Merrill Lynch $10 billion from selling preferred stock to the US Government through TARP (Dash, 2009). In a matter of weeks, Citigroup and Bank of America were in need of additional support from the Government. In order to avoid bankruptcy, on December 31, 2008 the Government provided Citigroup with an additional $20 billion through TARP under a new program entitled TIP (Targeted Investment Program), and also guaranteed the value of $306 billion of Citigroup's assets. An additional $20 billion were also provided by the Treasury to Bank of America on January 16, 2009 through TARP. The deal was similar to the Citibank one, as the Treasury guaranteed the value of $118 billion in loans in exchange for preferred shares. At that time Citigroup was considered a systemic risk and his failure would have serious implications on the broader economy and would led to huge financial losses (R. Newman, 2009).

Conclusions

Financial innovation and deregulation that took place worldwide have created alternatives for both depositors and borrowers. Deregulation opened the way to a wide range of financial tools to the public, creating a deleveraging process worldwide. In this context, financial institutions searched for new ways to mention their profits high by expanding to new lending, much riskier areas (real estate loans, mergers) or by entering the derivatives market. The participation of banks on the derivative market was significant, starting with $8 trillion contracts in 1992 to $91.1 trillion in 2005. Due to lower lending standards, the subprime mortgages begin to increase significantly, especially during 2004 and 2006 until the housing prices fell and interest rates begin to rise, marking the beginning of the subprime crisis (Crouhy, Jarrow, & Turnbull, 2008). Starting with 2007 hundreds of mortgage companies, insurance companies and global investment banks collapsed. The negative effects of the financial crisis worldwide were alarming and consisted mainly in major assets loss, reduced liquidity and financing problems. As a result, starting with June 2007 and until April 2009, more than $1.32 trillion of losses were reported by financial institutions around the world, including commercial and investments banks and also insurance companies

In order to overcome these effects and to avoid a global economic disaster, significant national and international actions were required. Therefore, the monetary authorities began to implement different measures with the purpose of improving the financial liquidity. In this context interest rates and financial market volatility began to rise.
In US was created The Troubled Asset Relief Program (TARP) by the Emergency Economic Stabilisation Act that enabled the Treasury to either purchase or insure up to $700 billion in troubled assets owned by financial institutions. At the end of 2008, nine of the largest financial institutions in US were selected by their importance to the financial system to benefit from TARP funds and received $125 billion investment funds through the Capital Purchase Program (CPP). Out of these nine financial institutions, the Treasury provided Citigroup $45 billion, which was the largest package received among banks. These actions not only prevented Citigroup from failing but also turned out to be profitable for the Government, which ultimately gained more that $12 billion.
Given the major role Citigroup played on the derivatives market and the fact that was interconnected with financial institutions throughout the world, the collapse of Citigroup was considered a systemic risk and would have had devastating effect on the global financial system and would destabilise the economy.

Short Biography

Alexandra Micu is a PhD candidate in the second year, in Economy and International Business at the Academy of Economic Studies in Bucharest, where she also has a Master’s degree in International Financial Risk Management. Having a practical 2 years experience in the banking sector in Romania, Alexandra wants to develop better insights regarding the global financial system dynamics, being interested especially in banking reorganization.

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