Yves Mersch: International financial centers after the crisis

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at a Lunch-Conference of the BLC (Business Club Belgo-Luxembourgeois en Suisse), Zurich, 23 May 2011.

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Ladies and Gentlemen,

It is my pleasure to talk in front of this distinguished audience about the challenges of international financial centers after the crisis. I would therefore like to thank Business Club Belgo-Luxembourgeois en Suisse for inviting me to this conference breakfast.

The worldwide scenery of international financial centers is in transition. The respective locations face massive upheaval as global competition and the post-crisis reforms in regulation and supervision begin to bite. In order to overcome the challenges of a changing environment and to identify the potential opportunities, it is important to distinguish between the different drivers.

A large part of the challenges financial centers are facing, are due to regulatory changes, which result from the reform in the aftermath of the financial crisis. In addition there are global trends that have been going on already before the outbreak of the financial crisis and which continue to have an impact.

I will refer to these major sources of change in more detail in the course of my talk, provide some experience from Luxembourg, and will discuss the shortcomings and remaining challenges of the new regulatory framework.

International financial centers – hit hard by the global crisis

The high degree of integration and interconnectedness of financial markets contributed to the amplification and spread of the financial crisis around the world. The crisis had devastating effects on both the banking sector and the real economy, in particular in international financial centers with a high concentration of activities in banking, trading etc. They are the nodes of a global network.

By consequence, the global financial crisis hit Luxembourg's open economy and internationally-integrated financial center – although relatively less than the neighboring countries, such as Germany and France.

Luxembourg is the world's second largest investment fund center in terms of size (after the United States) and the largest in terms of interconnectedness, the most important private banking center in the euro zone and Europe's leading center for reinsurance companies. Moreover, Luxembourg is among the 25 most systemically important financial centers in the world.

At the height of the crisis, Luxembourg's sizeable investment fund industry endured substantial redemptions and its foreign-subsidiary dominated banking system experienced a sharp drop in the aggregate balance sheet as well as in the off-balance sheet positions. This led to a 20 percent contraction in the aggregate balance sheet of the foreign-subsidiary dominated banking system in Luxembourg. Banks have also seen a 30 percent drop in their off-balance sheet positions as assets under management dwindled. About 8 percent of the financial sector's work force lost their jobs, only a part of which could be re-employed by other institutes.

Still, Luxemburg was less scathed by the financial crisis than countries with a highly leveraged home banking sector that sometimes had expanded excessively abroad.

Moreover, the overall situation has since stabilized. No bank rescues were required since 2009 and investment fund assets have rebounded beyond pre-crisis peaks. In 2010, the number of investment funds that have been registered in Luxembourg increased by 5.9 percent to 3,463. The net asset value in turn rose by around 20 percent to 2.2 billion Euros.

Thanks also to the global recovery and developments in neighboring countries, growth resumed early in the second half of 2009 and labor markets showed initial signs of recovery. Last year, Luxemburg's Gross Domestic Product expanded by 3½ percent – compared to an average of 1.7 percent in the European Union.

The global financial crisis, nonetheless, will leave a lasting imprint on the Luxembourg economy.

Global trends increase competition

Even before the outbreak of the crisis in the summer of 2007 the worldwide scenery of international financial centers was in motion. At first glance, however, the picture looked rather static.

While the traditional financial centers in the industrialized world were prospering in an overall growing environment, and managed to defend their relative positions, emerging financial centers, particularly from Asia, were able to improve their competitiveness dramatically. It was therefore apparent that the top dogs would be facing increasing pressures to maintain their dominant positions.

As financial centers emerge and develop over long periods of time, they are not too easily shaken. Most of the described trends therefore will continue after the recovery from the crisis.

By consequence, traditional financial centers from the US and EU continue to represent the lions share of the global market. Although, in absolute terms, in many market segments overall levels of market activity have diminished, financial centers from the US and Europe provide around three-quarters of global financial services.

Let me be more precise:

– More than two thirds of global banking assets remain concentrated in financial centers in the US and Europe.

– The US and Europe capture more than three quarters of the global revenue pool in investment banking.

– Over two-thirds of all private and public debt securities and almost four-fifth of all interest-rates derivatives outstanding are registered in financial centers from the US and Europe.

– Foreign exchange trading still is highly concentrated in London and Chicago, with the UK and the US capturing together some 50 percent share in global trading. 70 percent of all foreign exchange derivatives transactions are undertaken in the US and the EU.

Emerging financial markets, especially in Asia, have grown strongly in past years. But they, too, have been hit hard by the crisis. After they will have recovered from the setback of the crisis, experts expect that they will speed up again their catch-up process.

Concentration is ongoing as size still matters. Most experts predict that London, New York, Hong Kong, and Singapore are set to remain strongholds of global finance. Their major advantage is that they can build on existing market strength and favorable economic conditions.

In the long-run, emerging financial centers are likely to succeed in establishing the scale and scope in their market environment that will help them advance into the top group of global locations. The crisis may have accelerated this trend.

The foreseeable increasing global competition will put even more pressure on financial centers to defend or improve their respective positions. This holds in particular for those in Europe which is far from being a homogeneous jurisdiction.

Indeed, European financial market places are at risk to fall behind in the global race for markets shares. The main European financial centers in Paris, Zurich, Madrid, Milan, Frankfurt, Amsterdam, Luxembourg, and even London, have clearly lost ground compared to other advanced and emerging locations.[1]

Changing environment trough new rules

The financial crisis triggered a fundamental reassessment of the financial industry. Until four years ago, it was widely understood that financial markets were inherently self-correcting and therefore best left to their own devices. This prevailing paradigm has been sacrificed.

After more than two decades of deregulation in the majority of the industrialized countries, finance has entered a new era: various initiatives have been undertaken to reform and strengthen the global framework for financial stability and reduce the probability of such a devastating global crisis occurring again.

Major steps have been taken in the area of regulation, most notably in the “Basel III” capital accord. The Basel III rules stand on two pillars:

– First, they focus on strengthening micro-prudential regulations, aiming to bolster the resilience of individual banks during periods of stress. In particular, Basel III calls for more and better capital of financial institutions and also introduces leverage ratios and stresses the role of liquidity risk.

– Second, they also include macro-prudential regulations, aiming to mitigate systemic risks across the banking system.

Better and more capital buffers are supposed to make the banking sector more resilient in the case of another crisis. The increased capital requirement may come at high cost, though. If banks hold too little capital, they are left crisis-prone and in the potential need of bail-outs. Too much capital, however, could lead to huge swathes of the banking business becoming unprofitable. This might cause higher borrowing cost which could affect economic growth negatively. By consequence, riskier assets but more profitable activities might be driven into the shadow-banking sector.

But the regulation of the shadow banking system is still an unsolved issue. These entities are no banks in the legal sense, although they take – and generate – similar risks. If there is a strict silo-regulation of the formal banking sector, the actual risky business does not disappear, but moves on in the non-regulated sector.

An important issue is the problems of banks that have become too big or too interconnected to fail. The idea that a “Systemically Important Financial institution”, SIFI, will be saved in a crisis because of its systemic importance is not compatible with the core principles of a market economy. Those who fail in the market have to bear the ultimate consequence of leaving the market. But if the maxim is “too big to fail”, then the state and the taxpayers are vulnerable to blackmail.

[1] Compare Kern, Steffen: Global financial centres after the crisis, DB Research, August 2010.

The financial crisis has exacerbated the problem in so far as some of the surviving banks have become even bigger or more interconnected. Moreover, the government guarantees which were appropriate in the crisis now encourage banks to grow, to connect and to take even bigger risks.

To repair this clearly flawed incentive structure, the G20 endorsed the Financial Stability Board's (FSB) policy framework to address the moral hazard risks and externalities posed by SIFIs. The key policy objectives of the FSB SIFI framework are to

(i) increase their loss absorption capacity to reduce the likelihood of their failure,

(ii) to facilitate the orderly restructuring or unwinding of a failing SIFI to reduce the impact of its failure on the financial system ("living will");

(iii) to intensify supervisory oversight for SIFIs;

(iv) to strengthen core financial market infrastructures to reduce contagion risk from failure.[2]

Challenges imposed by liquidity rules

Though it is highly welcome that the new rules tackle liquidity risks, the new requirements for liquidity management could themselves become a source of instability. One reason is that the regulators' definition of liquidity is highly concentrated on government bonds. As the current environment shows, some market segments of government bonds can eventually dry up.

Another reason is the respective definitions of the Net Stable Funding Ratio (NSFR) and the Liquidity Coverage Ratio (LCR).

– The LCR is the main component of Basel III's liquidity regime. It is also known as the "Bear Stearns rule". It requires banks to maintain a stock of "high-quality liquid assets" that is sufficient to cover net cash outflows for a 30-day period under financial stress.

– The NSFR seeks to counter maturity mismatches in the balance sheet of financial institutions. It calculates the proportion of long-term assets, which need to be funded by longer term stable funding.

While the LCR stresses the liquidity situation up to 30 days, the NSFR focuses on the situation beyond one year. Assets which are liquid for more than 30 days and less than one year are not taken into account, not even on a weighted basis. However, the Basel Committee on Banking Supervision (BCBS) has recognized this shortcoming and is investigating the issue.

In addition, there is the risk that the reformed banking regulation has damaging impact on the European model. The treatment of covered bonds, mutual funds, deposits etc. in the liquidity ratios affect the business model oft many continental European banks. One can also question whether the main victims of the new rules will not be the European universal banking model which was certainly not at the origin of the crisis but constituted an anchor of stability.

Finally, the lack of a resolution framework for cross-border financial institutions remains on the agenda. In spite of the insight, that the reform of regulation and supervision cannot be successful at the national level alone, it is still unclear how the costs would be distributed if a cross-border institution would get into difficulty and should need to be saved.

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[2] Financial Stability Board, Macroprudential policy tools and frameworks: Update to G20 Finance Ministers and Central Bank Governors, February 2011.

Shortcomings in macro prudential supervision …

As the importance of systemic financial stability has become apparent, questions on macroprudential policies have become highly topical. Unfortunately good answers are outnumbered by open questions.

There are few purely macroprudential policy tools, and in many cases policy makers need to rely on micro prudential instruments. The financial sector is constantly changing, and the level of risk does not remain the same. Systemic risk is difficult to measure and define. The credit to GDP ratio for example is not a particularly good indicator of risks. Financial cycles often last longer than business cycles. The probability of different shocks may be difficult to estimate. Their impact, however, is even more difficult to assess e.g. because of non-linearity. The application of the classical Tinbergen rule ("one tool – one objective") is not possible.

In short: the understanding of how to use which instrument in which situation remains at a very early stage.

Three layers of shortages can be identified:

1. The analytical framework is short of data;
2. The instrumental framework is short of experience
3. The institutional framework is short of resources

We therefore need to recognize the limits of our understanding; these difficult questions must be approached with a certain degree of humility.

… in spite of progress in the institutional set-up

Although the toolkits are still in their infancy, institutional progress has been made in macro prudential supervision. In the EU, the European Systemic Risk Board (ESRB) was established in January 2011. Its mission is to contribute to prevent or mitigate systemic risk to the financial stability in the Union. The ESRB comprises the ECB, the national central banks of the EU, the three new European authorities on banking, insurance and securities, the European Commission, and the Economic and Financial Committee (representing national treasuries). Its role will be to conduct macroprudential surveillance across the EU, to issue risk warnings and recommendations, so as to contribute to the prevention and mitigation of systemic risks. Recommendations can be issued to any national or supranational authority.[3]

Macro prudential policy is viewed as having a wide range of tools from monetary, fiscal and competition policies. But these instruments are under the responsibility of others. In the light of the above-mentioned shortcomings, however, there is the risk that macro prudential becomes policy making with other peoples instruments. The potential fight for competencies among different institutional bodies might undermine the effectiveness of the macro prudential approach.

Concluding remarks: Challenges remain, opportunities emerge

The financial crisis has traumatized the global financial system. The huge losses of many major financial institutions and negative feedback loops from the real economy in the aftermath of the financial crisis have triggered changing market structures. In addition, global competition between financial centers has intensified.

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[3] IMF: Macroprudential Policy: An Organizing Framework, March 2011.

In response to the crisis, the world has moved into a new stage of international regulation and supervision of financial markets. The new rules – many of which have not been implemented yet – start to bite already, due to the tightening of capital requirements and a more homogeneous regulatory framework which pose challenges in particular to smaller financial centers.

But this changing environment implies also opportunities to improve their relative positions. In order to do so the provision of convincing conditions is of the essence. Local factors gain weight, e.g. a well-educated workforce in an open and flexible labour market and excellent infrastructure. The respective governments should comply with robust public finance in line with a stability-oriented monetary policy.

Smart regulation – at national, regional and global level – and a stable legal and institutional framework are a prerequisite for success. Global standards are needed to ensure a level playing field. At the same time, it is crucial that international financial centers of systemic importance have a voice in the international standard setting, so these can benefit from their wealth of experience and competence in supervision based on the proximity and high interaction with the supervised entities.