Már Guðmundsson: The evolving structure of the post-crisis financial sector

Speech by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the 3rd Annual Palm Beach Strategic Forum, Palm Beach, USA, 8 April 2013.

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I am both pleased and honoured to address you here today and would like to thank the organisers for giving me the opportunity to do so.

This session is on global economic conditions and prospects. Other speakers have covered the macroeconomic and monetary policy aspects of the topic. I will use my allotted time to focus mostly on the financial sector, but I promise to say a few words about Iceland as well. There is, of course, an important link between the real economy and financial spheres. A broken financial sector is less likely to be able to finance the growth that we need.

In many advanced countries, we are in the early phases of a deleveraging process where, to a varying degree, households, companies, sovereigns and financial institutions are – by force or by choice – reducing debt levels that have become either unsustainable or obviously too risky in the new environment. Such generalised deleveraging can be a painful process, with a significant adverse effect on economic growth for a prolonged period, as former such episodes bear out. However, as I read the data, in many of our countries weak credit growth is due even more to limited credit demand than to supply. So if we were magically able to bring the financial sector back to full health and an optimal leverage ratio by tomorrow, we would not have solved the problem. Significant debt problems would still exist for several sovereigns and several parts of the non-financial private sector. In addition, we would still have the confidence crisis that has been so pronounced in Europe. So it is going to be a more protracted process. The EU has not resolved its crisis, although there has been progress in deleveraging and de-risking bank balance sheets.

In September 2008, when I was still at the BIS, I gave a speech in Boston bearing the title: *How might the current financial crisis shape financial sector regulation and structure?*[1] I realise now how foolhardy that endeavour was because those were indeed early days. But still, many of the potential changes that I mentioned have stood the test of time, such as the inevitable deleveraging; shifts in bank business models, especially on the funding side; the need for bigger capital and liquidity buffers; and how potentially difficult cross-border crisis management and bank resolution would turn out to be in the European context. But there were also very important elements missing from my list – elements that have turned out to be of major importance for the unfolding of the crisis and the reform agenda. Key among them are the interaction between sovereign debt and banking fragility and the problem of big banks in small countries – of which my country, Iceland, was a prime example and Cyprus is the latest. I will expand on this shortly.

The financial crisis and the policy responses to it, especially some of the drastic decisions taken in the heat of intense crisis management, have changed the structure of the financial sector and will do so more profoundly going forward. There are several reasons for this, such as the plain collapse and disappearance of financial institutions, the non-viability of certain business models and practices in the new environment, the need for the financial sector to shrink and deleverage after the real risks in this world had been revealed, the intended and unintended consequences of new prudential regulation, the coming effects of structural regulations that at least partly ring-fence insured deposits and payment systems from the "casino". Then there is the shrinking of cross-border banking through the retreat of banks

[1] See http://www.bis.org/speeches/sp081119.htm

behind their national borders and the weakening and, in some cases, collapse of international financial centres in smaller countries.

We can see where this is heading: towards a financial sector that is smaller, less leveraged, less complex, more fragmented, more regulated, and more national. Some of that is inevitable, and some retrenching from the excess levels of finance in relation to the real economy is probably beneficial at this stage, both at the national and the global level. The risk, however, is that the process could go too far. Yes, there are risks to financial globalisation, but there are also benefits. In order to reap those benefits, we need a safer framework for cross-border banking at the regional and global level and some ground rules for capital flows and capital controls.

Let me briefly turn my own country, Iceland, into a case study of some of the issues involved. During the financial crisis, three small European countries that had relatively big banking systems but no apparent fiscal problems prior to the crisis have suffered very serious financial and economic crises. These are Iceland, Ireland, and Cyprus. In all three countries, the balance sheets of the banks were around 8–9 times GDP.

All three are members of the EU single market – in Iceland's case, through the agreement on the European Economic Area. That includes free movement of capital and provision of financial services. The underlying principles are those of home licensing for operation anywhere in the area and of a level playing field for competition, where size and location are not supposed to matter. It therefore goes against the underlying principles of this framework to consider the size of banks relative to GDP as a metric for concern, as is now so rightly in fashion. We know now that there are deep flaws in this framework and that these flaws are important elements in the current euro area crisis, but they also played a significant role in the case of Iceland's banking crisis. A key issue here is the contradiction between these so-called European Passport rights, on the one hand, and national supervision, national deposit insurance, and national crisis management and resolution regimes, on the other. This is what recent European Union proposals of a banking union are supposed to address.

Membership in the EU single market, along with the global conditions of cheap, abundant credit, made it possible for the Icelandic banks to expand phenomenally in the course of only five years, from less than two times GDP to more than 9 times GDP. Earlier in the decade, the banks had been privatised and became managed by relatively young, risk-loving former investment bankers. Much of the expansion was really off Iceland's border, with both financing and investment taking place abroad. In Iceland's case, there was a substantial additional risk compared to Ireland and Cyprus, as nearly 70% of the banks' balance sheets were denominated in foreign currency, with the traditional maturity mismatch that is the bread and butter of banking but without a credible lender of last resort to back it up. In other words, Icelandic banks had only limited access to ECB liquidity (although there was some access through subsidiaries in Luxembourg), which proved fatal during the global run on cross-border liabilities of banks that immediately followed the collapse of Lehman Brothers.

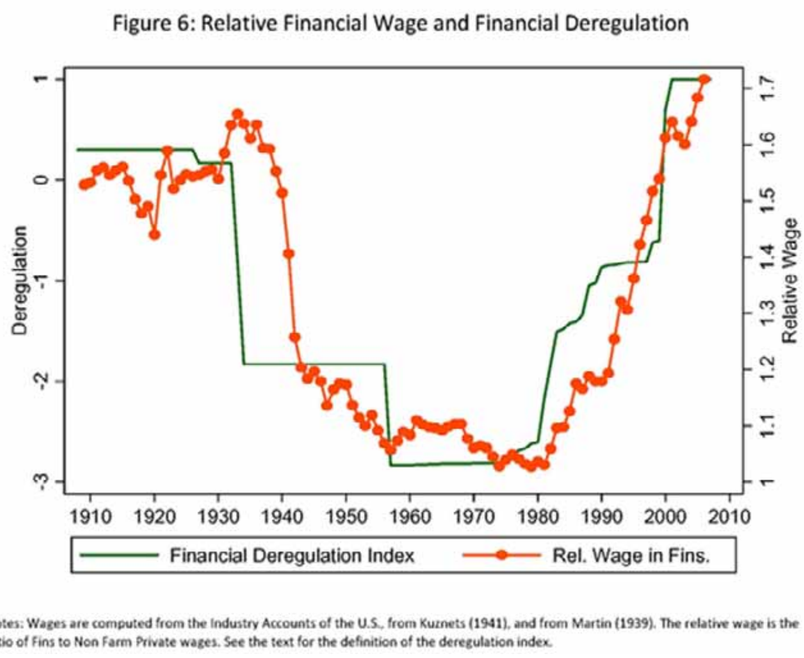
But there is always a silver lining. The lack of an adequate safety net and the absence of international or regional co-operation at the peak of the panic forced Iceland to adopt a radical solution in order to ring-fence the sovereign from the collapsing banks. These were private banks, and a bail-out by the Icelandic sovereign would have bankrupted the country.

The banks were split overnight into domestic and international banks without disruption in the public's access to banking services, and the international part went into resolution. The result was a drastic cut in the leverage ratio of the remaining banking system, from over 30 to around 5. Yes, Iceland had to introduce capital controls, which are still in place. But those controls did not take the form of limiting deposit withdrawals from banks, as was done in Cyprus, and current account transactions have been mostly unrestricted.

History and further research will tell whether this cold turkey response turns out to be better than more gradual approaches that sometimes turn into "death by a thousand cuts". When making that assessment, we have to take into account that Iceland's recession was the result of two stories: the macroeconomic boom-bust cycle in a small, open, and financially integrated economy, and the rise and collapse of three cross-border banks operating on the basis of EU legislation. The first is familiar, and Iceland was already on its way into a recession as a result of it when the banks collapsed. The second was unique at the time, as it occurred during the first international financial crisis since the birth of the EU single market.

Iceland lost around 12% of GDP from peak to trough during the recession. But the recovery began in the middle of 2010, and the Central Bank forecast from February is that Iceland's economy will grow by just over 2% this year. The recovery has already reduced the seasonally adjusted unemployment rate from over 9% at the peak to around 4½%. New banks, smaller and domestically oriented, have been rebuilt. But there are still significant legacy issues and challenges, including capital controls and inflation expectations well above target.

Source: Philippon (2008): The Evolution of the US Financial Industry from 1860–2007.



Source: Philippon and Reshef (2008): Wages and Human Capital in the US Financial Industry 1909–2006.

Before I close, let me expand my scope again and say a few words about possible broad long-term future trends regarding the relative size and importance of the financial sector. Look at these two graphs. One shows the share of the US financial sector in GDP going back to 1860. The other shows relative skill-corrected wages in the financial sector and an index of deregulation (where down is more regulation). We can see that there is a peak in all of these measures around the time of the 1929 crisis, followed by a secular decline. Regulation reaches a peak and relative wages bottom out in the 1960s and 70s. Then there is a long climb until just before the current crisis. If this was all we had to go on, it would be difficult to escape a certain prediction of what happens next! The big question is what it might mean for growth and prosperity. So it is important that we strike the right balance, as it is so aptly put in the programme for this event.

Thank you very much.