Media Roundtable

MACROPENSIERI CONTROCORRENTE

di Antonio Foglia

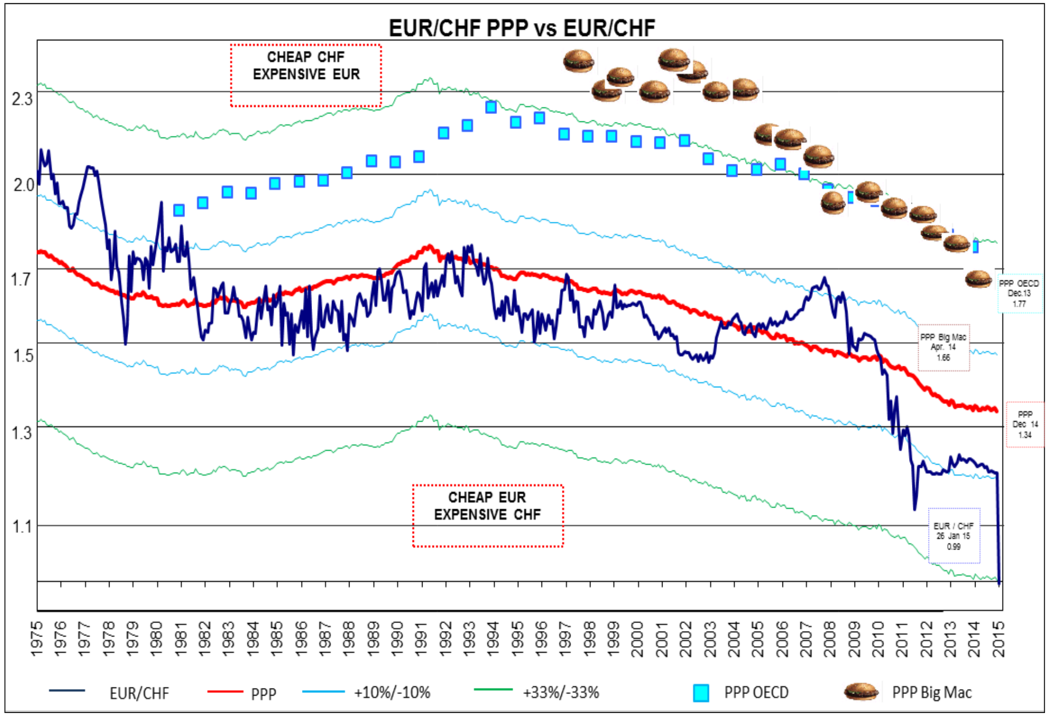
Lugano, 29 gennaio 2015

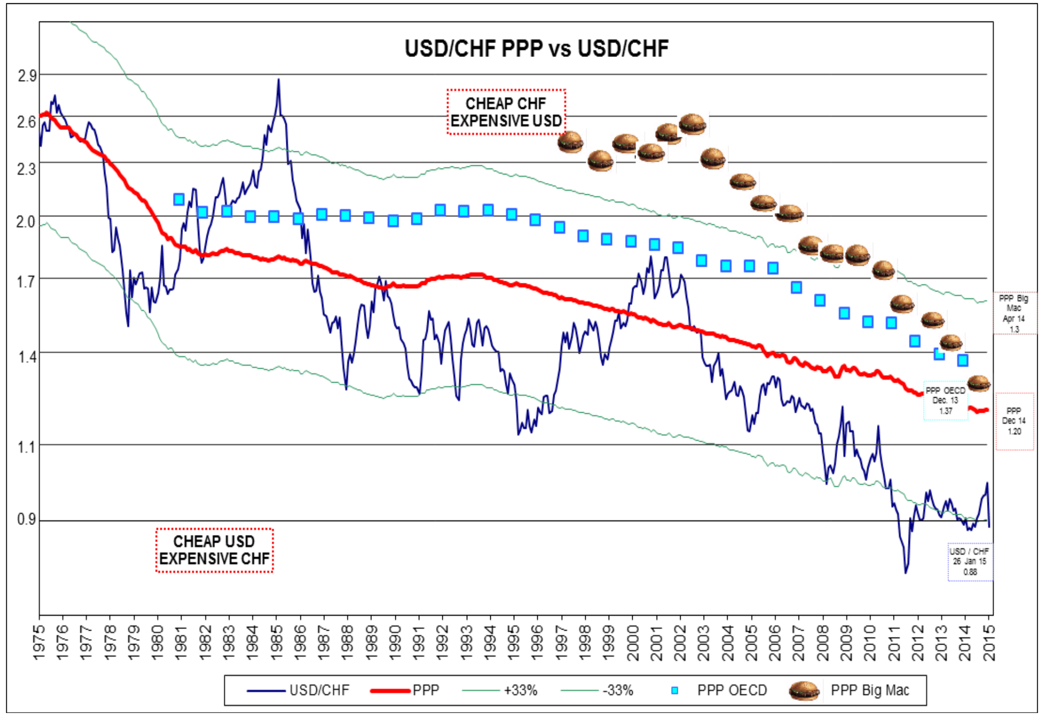
- The CHF issue
- Banks still dysfunctional: EU Stress Test
- Unresolved Eurozone

AN ONGOING MASSIVE COGNITIVE FAILURE

- The economy is a complex dynamic evolving system populated by fallible agents with imperfect knowledge.
- In such a system economic policy may not be nearly as effective as predicted by models and could backfire through unintended consequences.
- Financial regulation and large financial institutions have become themselves complex systems.
- The financial crisis was caused by massive unavoidable cognitive failure by regulators and bankers.
- We need to switch to new paradigms to understand what happened, why it will happen again, and hopefully be more resilient when it will.

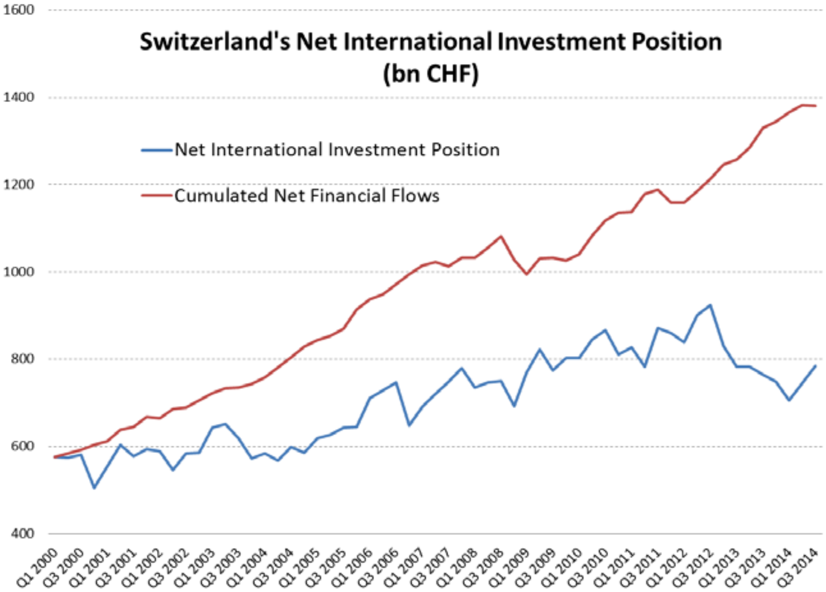
EXCESSIVE CHF LENDING?



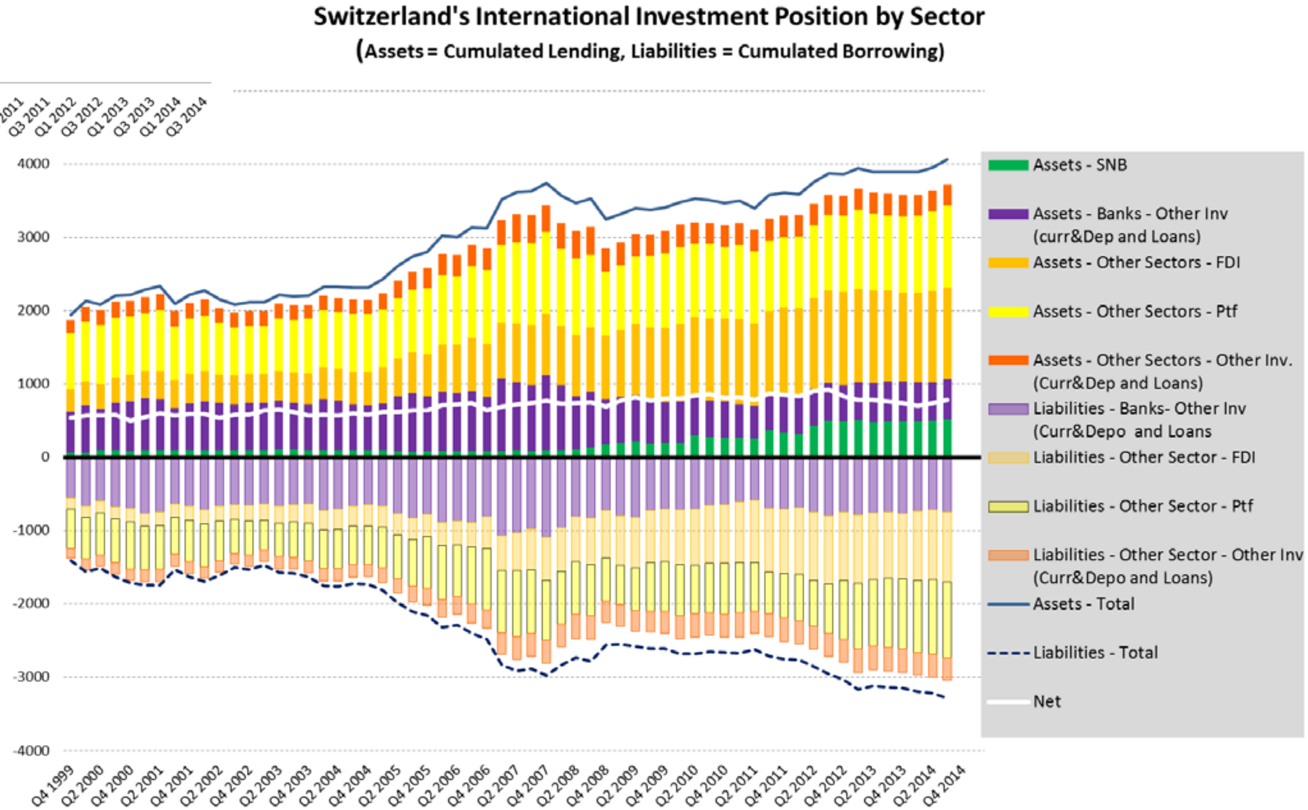


- Capital flight or short covering?
- Easy CHF monetary policy encourages CHF funding / lending
- A comparison with Sweden

CAPITAL FLIGHT OR SHORT COVERING?

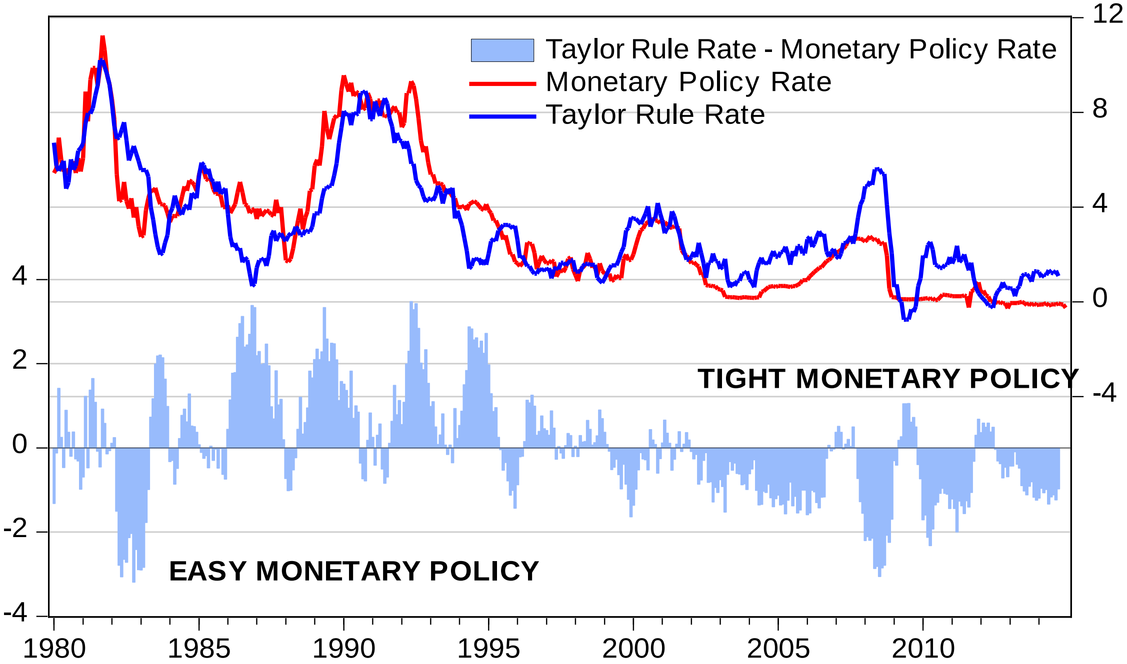


- The Swiss National Bank intervened in 2011 putting a 1.20 floor to the EUR/CHF exchange rate to limit the appreciation it thought was due to a flight to safety during the Euro crisis.
- When the Euro crisis abated, very few CHF were sold, leaving the BNS stuck with the world's largest reserves.
- This proved that the purchasers of CHF were most likely foreigners who had borrowed in CHF trying to cover their short position.

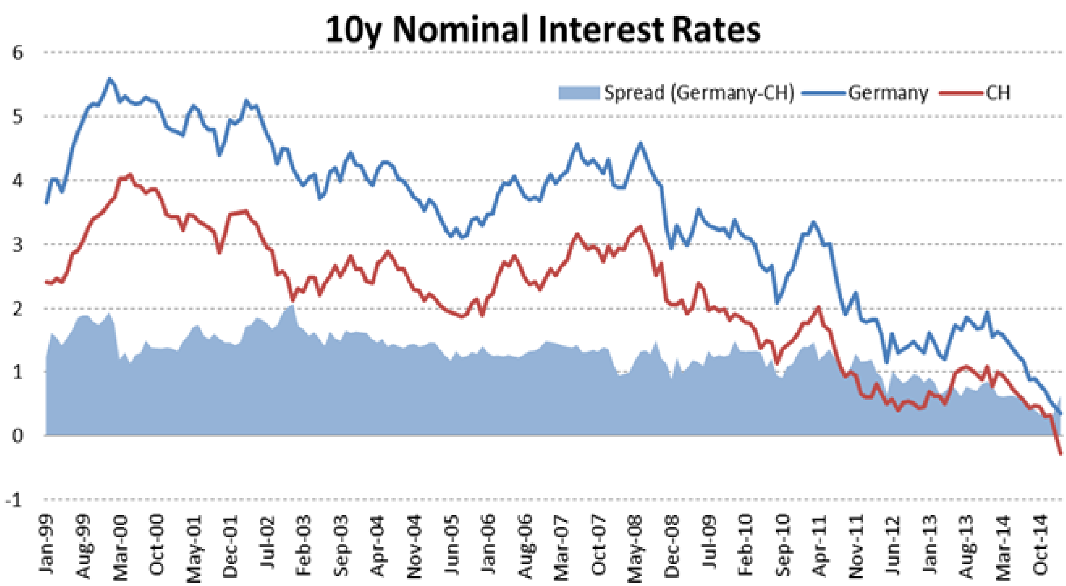


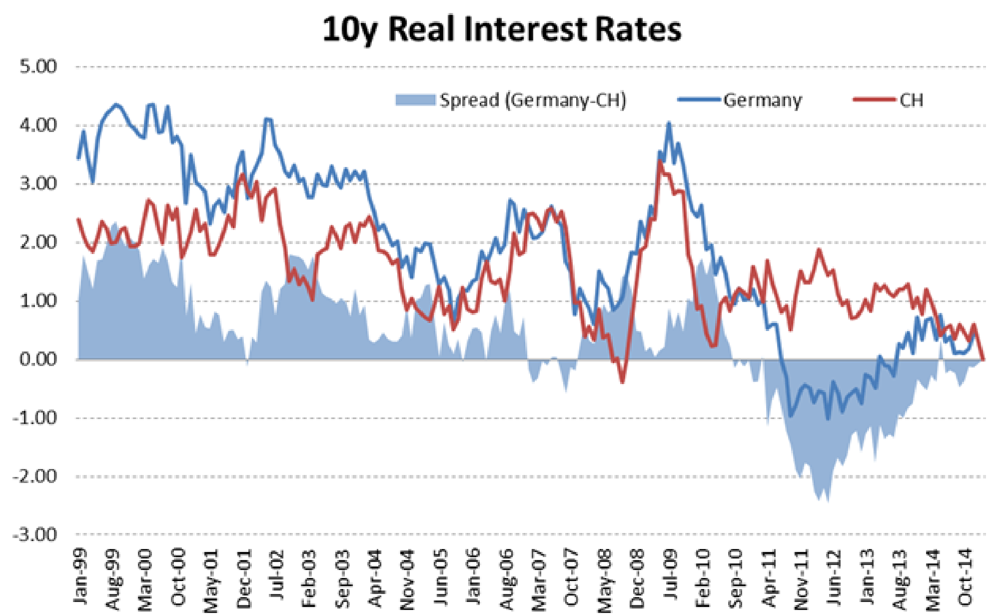
- The data available are grossly incomplete. The SNB's own statistics have a massive CHF 600bn discrepancy between cumulated flows and stocks quantities.
- The reserves accumulated by the SNB allowed the banks to decrease their foreign assets, possibly the loans in CHF that were being covered. Another stealthy bailout by the SNB of the major banks?

EASY CHF MONETARY POLICY ENCOURAGES CHF FUNDING/LENDING?



- Borrowing in CHF has been convenient for decades as the SNB has consistently had a loose monetary policy as the Taylor Rule graph on the left shows.
- Not only were Swiss nominal rates lower than those in the Eurozone, but real rates too, which for part of this period was also coupled with a weakening CHF, another distortion of the loose monetary policy.



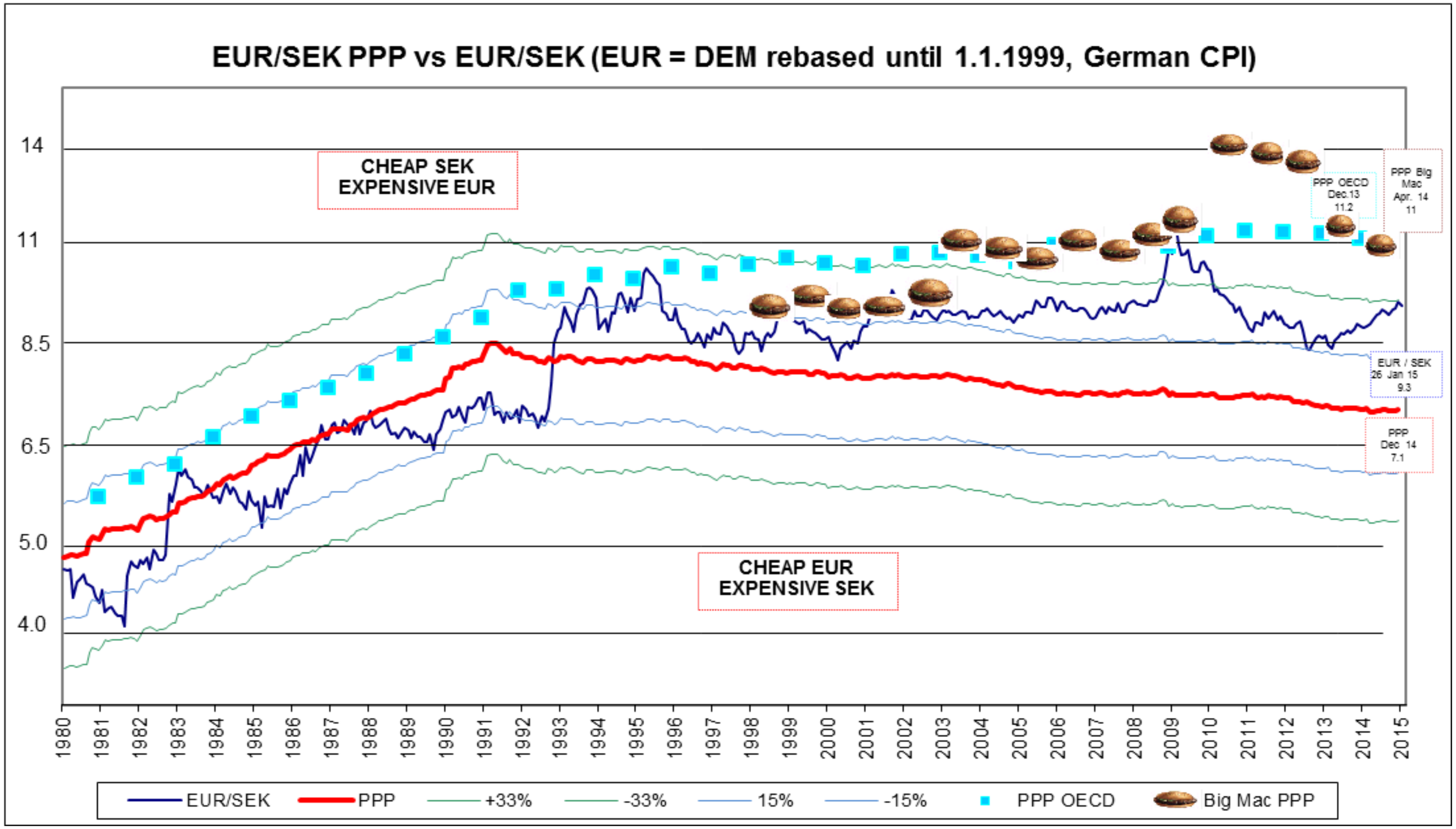


A COMPARISON WITH SWEDEN

	Average 2010-2014	
	Sweden	Switzerland
Nominal GDP (Eur bn)	405	500
Total Population (mn)	9.5	7.9
Real GDP Growth YoY	2.4%	2.0%
CPI Inflation	0.9%	0.0%
Unemployment Rate	8.0%	3.1%
Current Account as % GDP	6.2%	12.1%
Public Deficit as % GDP	-0.5%	0.6%
Public Debt as % GDP	40%	49%

- Switzerland and Sweden are similar small open economies with sound public finances. Why is the SEK weak while the CHF is overvalued?

- The current SNB policy of negative rates, while understandable given the circumstances, perpetuates the incentive for foreigners to borrow in CHF. The CHF should then weaken but the seeds for the next wave of eventual short covering are sawed.



BANKS STILL DYSFUNCTIONAL: EU STRESS TEST

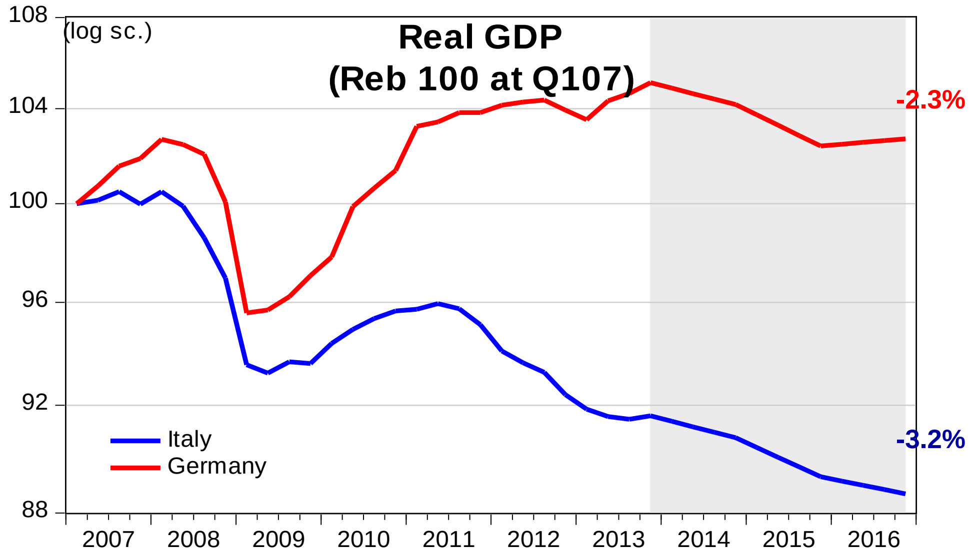
- The AQR/ST hypothesis were set to obtain about 10% failings to prove the exercise credible. But not many more in order not to undermine the sector's and regulator's overall credibility.

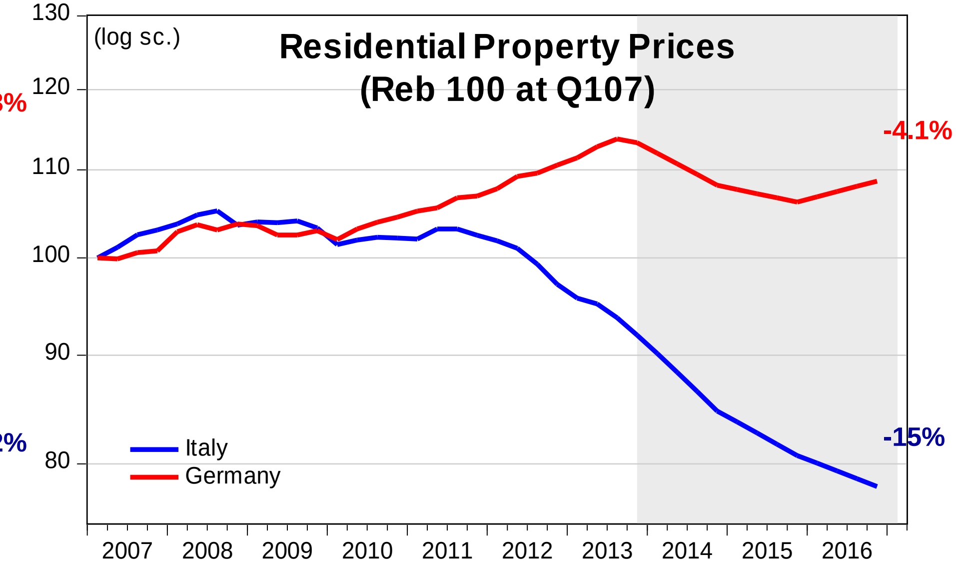
- Only a plausible adverse scenario was tested, not a black swan.

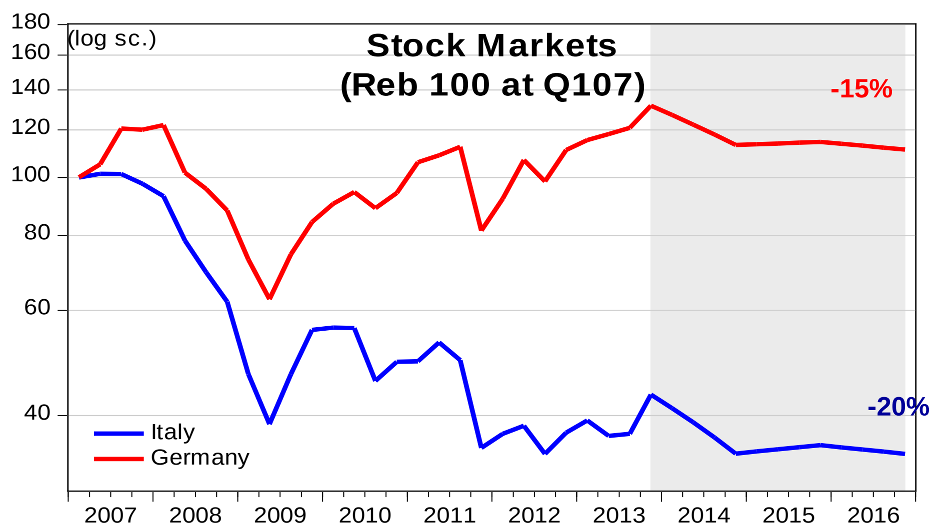
- Asymmetric hypothesis across the Eurozone are unnecessarily pro-cyclical.

- For instance, results show German banks would likely not have survived the recent past that Italian banks have already endured, let alone the tougher Italian stress test.

PROCYCLICAL HYPOTHESIS







Stress tested a credible adverse scenario, not a black swan.

Procyclical stress test assumptions miss the point of the exercise entirely:

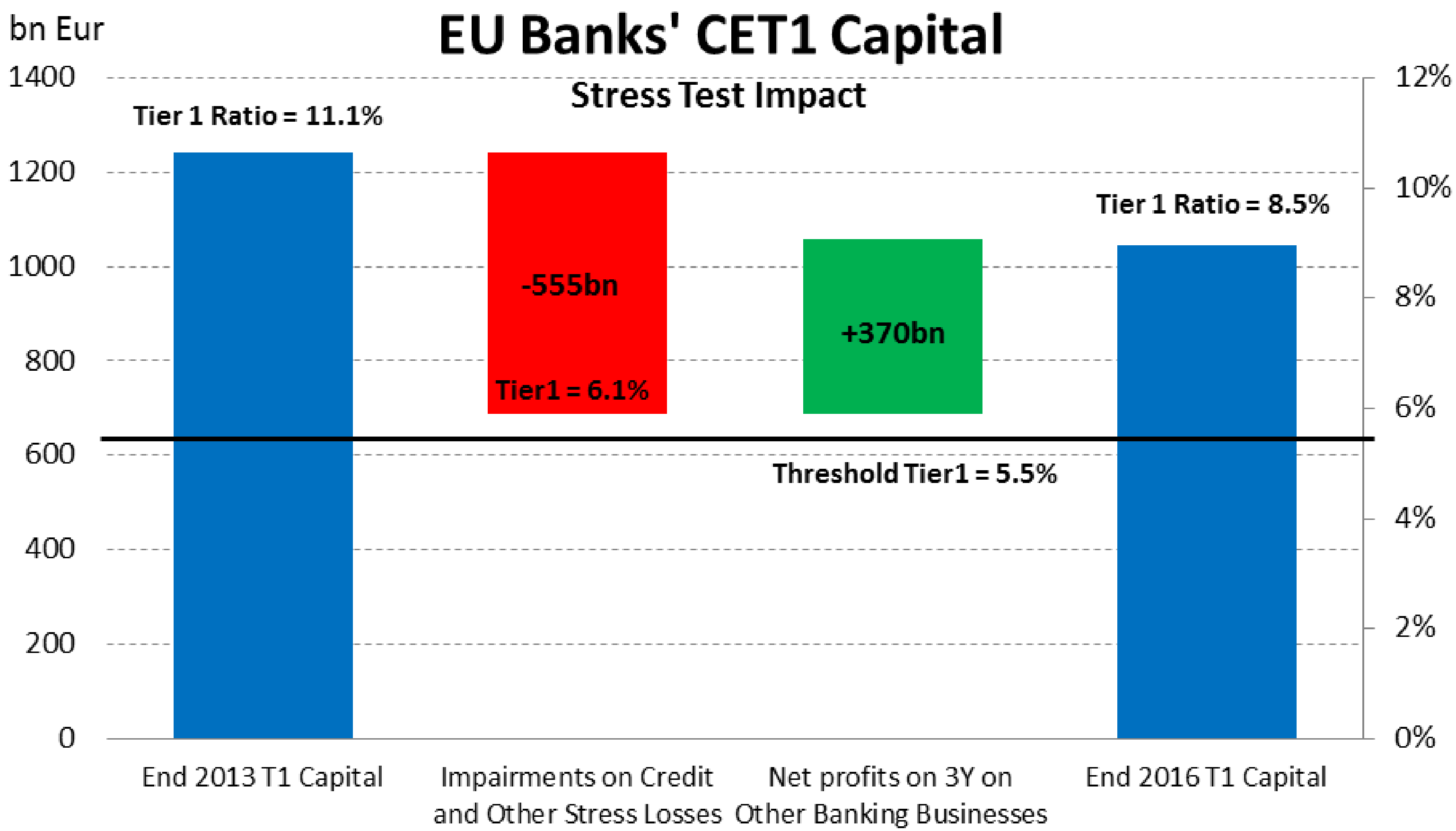
- a pat to the German banks that are fragile but standing tall thanks of their easy recent past but
- a slap to the more resilient Italian banks already on their knees due to post-crisis headwinds.

The results showed that all German banks would have failed in the environment that Italian banks endured and survived since 2008.

…STILL LED TO LARGER LOSSES THAN PERCEIVED…

- Stress Test looking over 3 years but the envisaged losses could be concentrated in a couple of quarters.
- After the stress test losses, banks would be too weak to finance in the markets having lost almost half their capital and remaining over 40x leveraged.
- Passing the stress test assures banks they will indeed receive ECB/Taxpayer support in case the downside scenario materialises.
- The Authorities are probably aware of this: expect higher prudential requirements (TLAC etc) for years to come.
- Not to curtail credit to the economy, Authorities should allow alternatives to banks to flourish, rather than spread questionable fears on misnamed "Shadow Banking".

LARGER LOSSES THAN PERCEIVED



After a hit that could happen in one or two quarters the banking system would be left with a Tier1 ratio of 6.1% only. This is a leverage of over 40x. Banks this weak would be almost insolvent and hence unable to refinance in the market and would have to rely on taxpayers' money again. Gains in the following 3 years on taxpayer funded operations would allow the banks to regain over half the losses.

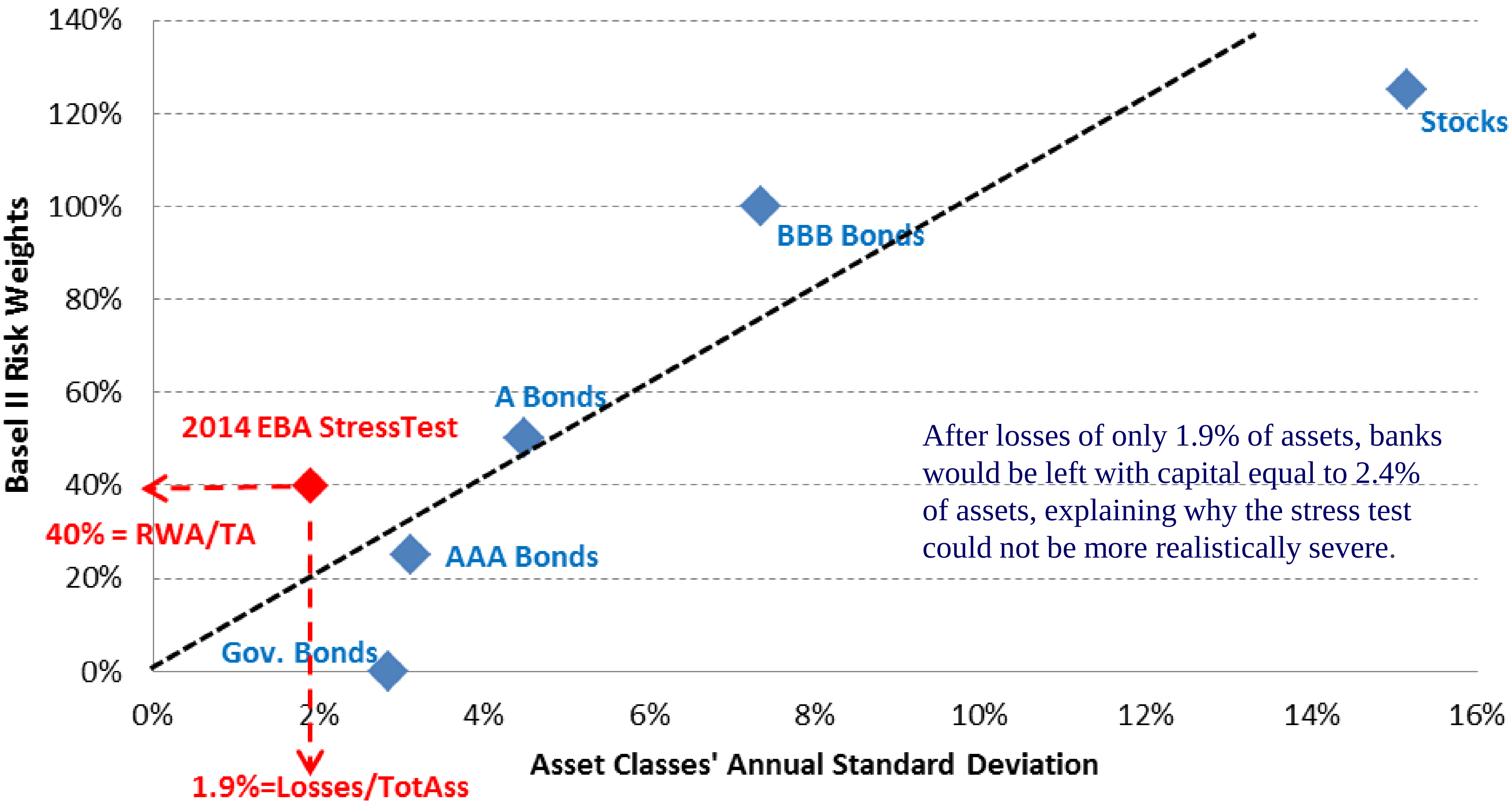
…LEAVING DESIRABLE RESILIENCE A DISTANT GOAL

- At worst, the EU banking system was simulated as losing 550bn, equivalent to less than 2% of its €28tn assets.
- When viewed alongside Basel risk weighting scales, the severity of these simulated losses seems small.
- The EU stress test simulated losses that are estimated to be only one half an annual standard deviation of the assets banks own.
- Banks are still far from a level of resilience that would allow them to withstand natural market volatility and keep on funding without recourse to taxpayers.
- The 2007 – 2008 crisis was a 3 standard deviation event. Banks would lose 2.5 – 3x their current capital should it ever happen again.
- The Fed Stress Test showed similar weakness in US banks when viewed this way.

BANKS'RESILIENCE REMAINS A DISTANT GOAL

The ECB Stress Test: Outcomes.

STRESS??? WHAT STRESS???



A SAMPLE BANK BALANCE SHEET 1/2

ECB Stress Test Sample - End 2013

Equity/RWA (Tier 1 Ratio)	11.1%
RWA/TA	40%
Leverage	22.5

	Nominal	*Basel II coeff.*	*Risk Weighted*
Stocks	337.50	@125%	421.9
AAA Bonds	1912.50	@25%	478.1
Tot Assets	2250		900.0
Tier 1 Capital	100		

A typical bank has a portfolio that has the same risk as one leveraged 3.4x in equities and 19.1x in AAA bonds. Other than in regulated banks, portfolios with so much risk do not exist because they would not survive long and hence the market would not fund them.

A SAMPLE BANK BALANCE SHEET 2/2

Simplifying assumptions:

- No risk weight for other risks (operational etc)
- BUT no benefit from diversification, which usually cuts by about 40% RWA in banks' models

Diversification benefits and dynamic risk control suffer from fallacy of composition that makes them systemic problems.

Some consider the goodwill associated with a banking licence as an important hidden asset. But this also assumes a bank is allowed to continue operations through taxpayers' funding when considered potentially insolvent by the market. It happened in the Financial Crisis but should not happen again.

THE OFFICIAL ANALYSIS OF THE CRISIS…

- "The bankruptcy of Lehman Brothers on 15 September 2008 turned what had previously been a crunch in the interbank market into an outright financial panic" → it was a liquidity rather than solvency crisis.

- "The crisis has revealed two deficiencies of the existing regulatory framework":
  1. "the focus on [ex-post] crisis management"
     → crisis prevention is doable and needed.
  2. "the focus on preventing distress at individual financial institutions […] failed to capture the build-up of financial-system-wide risk"
     → macro prudential supervisions is the solution.

- "Systemic risk arise from two sources":
  1. "TBTF, too interconnected to fail" → Regulate SIFI differently.
  2. "Procyclicality of financial institutions collective behaviour"
     → price stability mandate includes market prices.

[Quotes from a recent Central Banker speech]

…IS ENTIRELY WRONG

- Lehman was an insolvency, not liquidity crisis. 6 years after, the debt holders expect to recover ca 60% in the most favourable environment they could hope for. It is the revealed latent insolvency of the banking system that dried the interbank liquidity market up, not vice versa.

- Regulators failed in micro prudential supervision: half the big banks failed (BoE), none breached prudential rules ahead of failure. Having disastrously erred on a narrow mandate, why should they do better on a broader one?

- TBTF, too interconnected are real problems. Despite recognizing them, Authorities were unable to provide credible solution in 7 years. Market volatility arises from uncontrollable natural factors: the impact on long duration asset prices of small changes in expectations. Suppressing natural volatility pushes risk in the tails, not least by anesthetizing market participants to it.

BAILING-OUT GERMANY'S UNSUSTAINABLE VENDOR FINANCING

In a currency area, such as the Eurozone, a net exporting country must accept as payment the liabilities of net importing countries.

Over time, the persistent accumulation of credits on net importers living beyond their means makes those credits become ever more vulnerable.

The accumulation of official reserves, or of Target 2 balances, shifts the risks of vendor financing to the public sector.

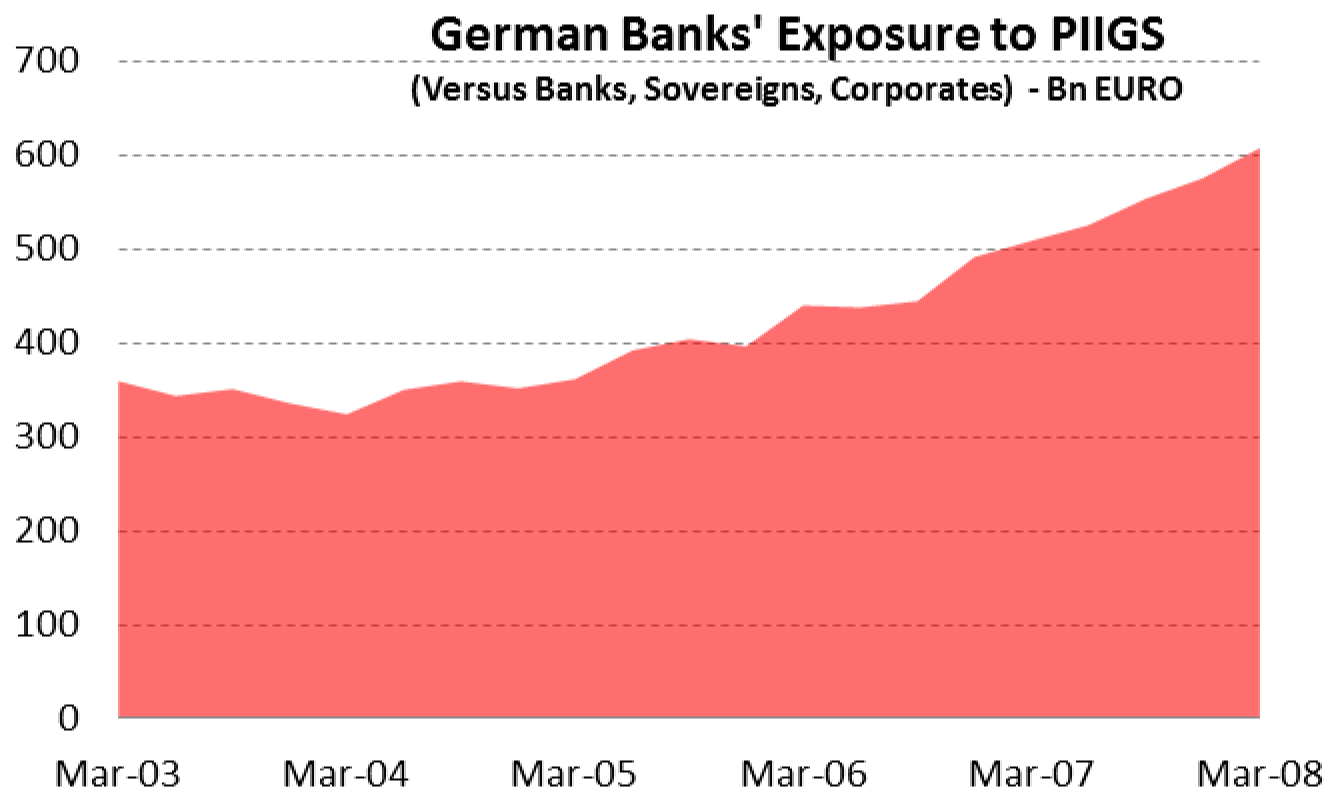
By hiding the risk, this transfer inhibits the private sector's self restraint and, in effect, subsidizes exports.

ACCUMULATION OF CREDITS

Between 2003 and 2008 the German banking system accumulated around € 300 bn of additional credits on the Periphery.

Roughly half of this growth was due to persistent current a/c surpluses (vendor financing), and half to the search for the higher yield available in the Periphery.

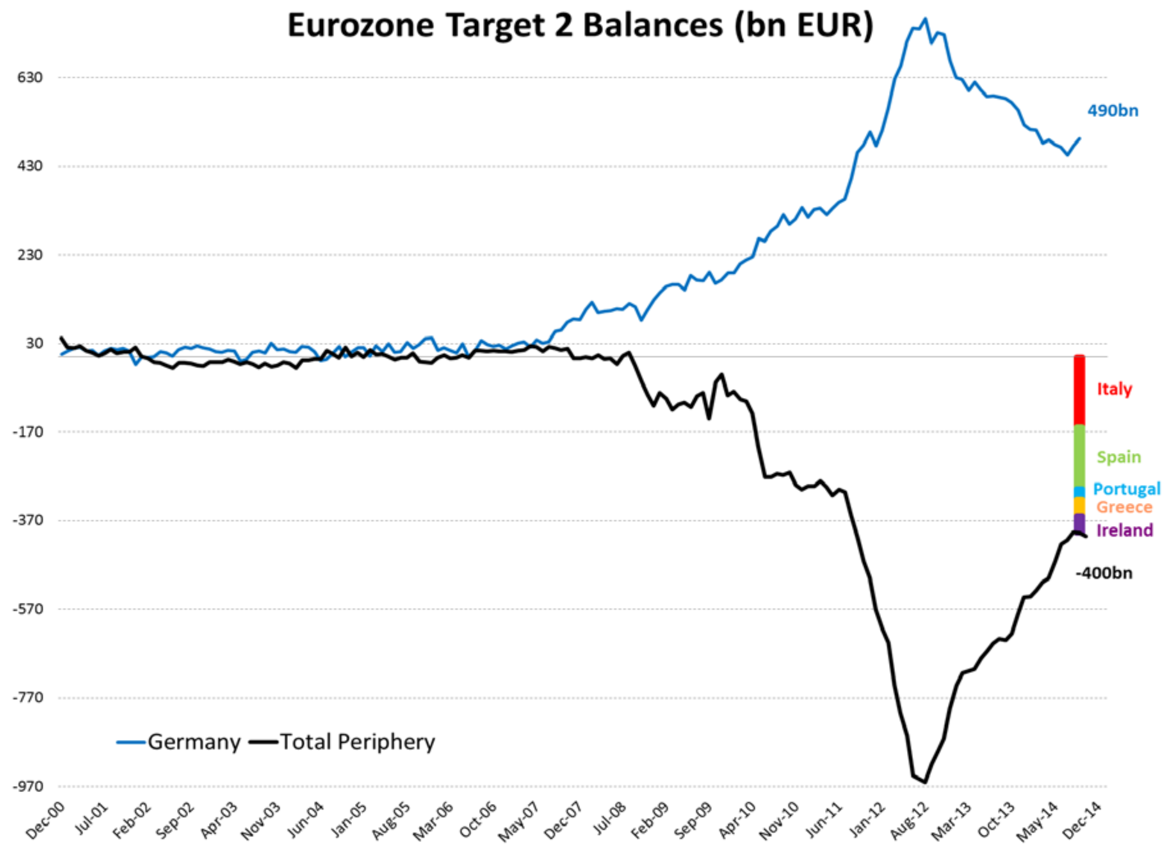
By 2008, the German banking system had accumulated € 600 bn of credits on the Periphery, equal to over 1.5x its capital.



RISKS ARE EXPOSED

With the onset of the financial crisis, the private sector became less willing to finance the Periphery.

Repatriation of bank credits on the Periphery was made possible by the intervention of the public sector as evidenced by the sudden increase of Target 2 balances.

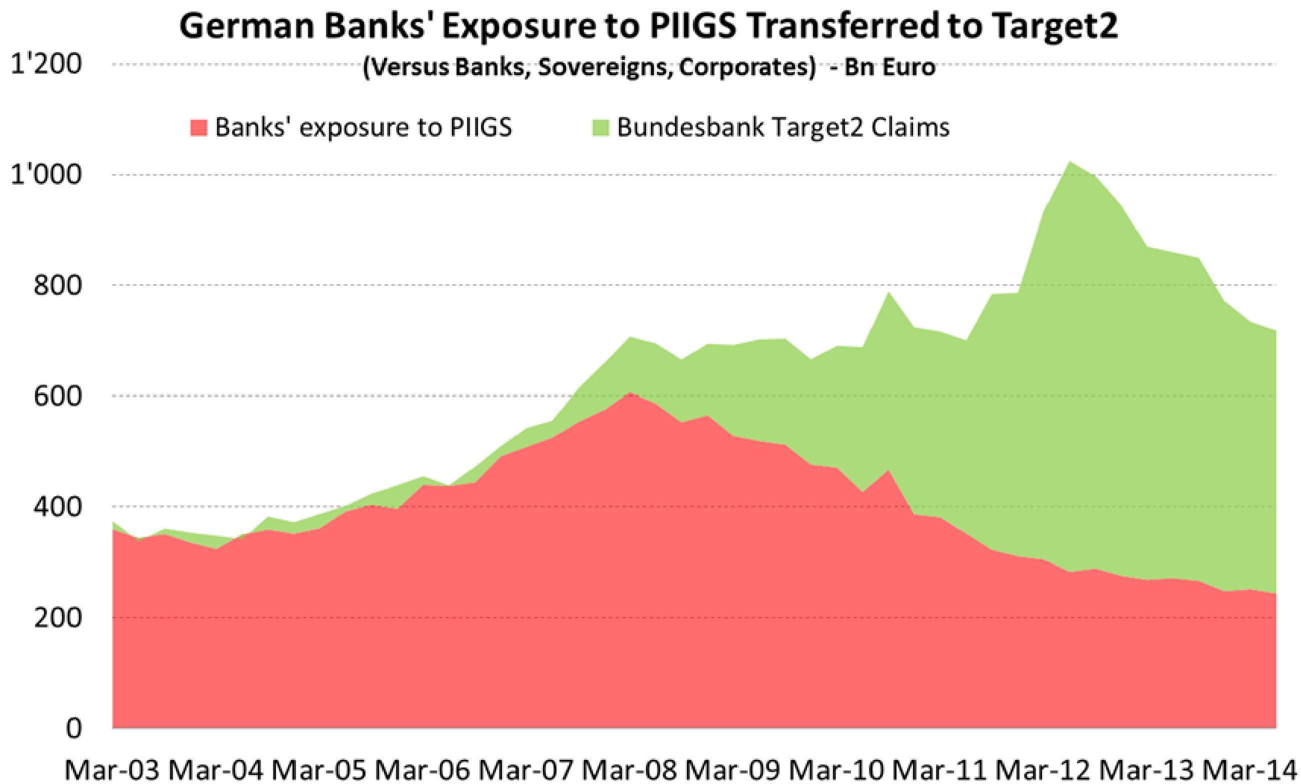


The ECB’s LTRO funds accelerated the process by providing Periphery banks with cheaper funds and encouraging repayment of more expensive and drying international interbank flows.

€ 520 BN BAIL OUT OF GERMAN BANKS

Since the beginning of the crisis, the German banking system has been able to reduce exposure to the Periphery by about € 520 (equal to 1.4x its capital) despite continuing (but reduced) current a/c surpluses.

The Bundesbank filled the gap and saw its Target 2 balances grow by the required amount.



GERMANY MUTUALIZED ITS SOURING CREDITS

Target 2 allowed German banks to dispose of credits on the Periphery perceived as an increasing risk in favour of safer deposits at the Bundesbank.

The Bundesbank's Target 2 balance, though, is not a credit only toward the Periphery because it is guaranteed by all ECB shareholders.

Germany has in fact mutualized the souring credits it had accumulated on the Periphery (due in good part to its persistent current a/c surpluses) by replacing those with the much safer Target 2 balances.

Had the German private sector remained exposed to the Periphery, and its banking sector at risk of insolvency, German politicians would have been more lenient on Debtors, the natural solidarity between creditor and debtors would have emerged, and the risks of vendor financing would have been evident.

OTHER EUROZONE ISSUES

- Debt / GDP larger than 70% in ‘foreign currency’ are historically unsustainable. Eurobonds are a must.
- PPI[G]S had better fiscal discipline since joining the Euro than Germany or France. Including unfunded government pension liabilities, German public finances are fare worse than Italy’s.
- German economic model delivered low private sector growth and negative real wages for 15 years despite massive foreign and public support. Structural reforms are needed in Germany too as its Constitution is proving unworkable even in a loose federation of states.
- The fragmentation of banking is happening on both lending and deposit taking. A major component of the freedom of capital movement has been lost, and it probably weights on confidence.
- Keynesian Fiscal spending can’t plug the demand hole: with 2-4% of GDP (a minimum for impact) one can roughly rebuild the whole highway system of a country. Mobilizing such resources on a useful time frame seems impossible in modern economies.

ECB’S QUANTITATIVE EASING

- Unless confidence returns, BCE money creation will end up in the liquidity trap. Hayek: “The more the state ‘plans’, the more difficoult planning becomes for individuals”.
- Lower rates, higher bond prices: cui prodest?
- Italy one credit notch to go: a bazooka to Renzi’s head.
- Extremely timid mutualization doesn’t pose or solve the key Eurozone problem. Worse it reminds everyone the ECB considers that sovereign defaults may happen.
- Private Sector Involvement heavier in any restructuring after QE.
- Gambling on a wrong strategy and raising the stakes all the time.
- Lower oil price, lower Euro means ECB could buy more time. Will it be wasted again?

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After earning a degree in Political Economy from Bocconi University in Milan, he worked in Tokyo, New York and London to complete his training. He has been professionally involved in Private Banking and with Hedge Funds since the mid-1980's. In addition to co-managing several leading multimanager Hedge Funds, including Leveraged Capital Holdings N.V., the world's oldest offshore multimanager fund, and Global Managers Selection Funds, the largest Italian Fund of Hedge Funds, Antonio Foglia is or was also a director of several Hedge Funds, including George Soros' Quantum Endowment Fund.

Antonio Foglia is a member of the Swiss Society for Financial Market Research and of the Italian Financial Analysts' Association. He served three terms on the Foundation Board of the Swiss Finance Institute, is a member of the Scientific Committee of Italy's Confindustria and a Trustee of the Central European University.

Articles by Antonio Foglia appear on Italy's leading newspapers Corriere della Sera and il Sole 24 Ore.

The author is grateful for research assistance provided by Chiara Casale. The views expressed in this presentation are those of the author only and not of the institutions with which he is affiliated.

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