

IN PROFILE

Mike Smith: The end of the 'Big Easy'

Marion Fahrer



The Chief Executive of ANZ examines how the global credit crunch ended the 'Golden Age' of access to easy money as consumers and investors extended their borrowings, financial institutions leveraged their balance sheets and misread potential market liquidity problems, and risks were transmitted rapidly through global financial markets. He foreshadows a return to more sustainable levels of investment returns, a renewed focus on balance sheet strength and an extended period of tight credit and deleveraging ahead.

Q What went wrong in the financial markets to have caused a global credit crisis of the magnitude that we are seeing currently? Was it mostly a case of risk management failures on the part of financial institutions or were there other factors not yet identified?

MS The current financial market turmoil is due to a complex range of issues, with the main one being the economic model adopted by most OECD countries in which consumer demand has been seen as the main driver of economic growth. In this environment the provision of liquidity and easy access to credit was critical. As a result, financial products became incredibly competitive and, in the past 10 years, money was probably the cheapest commodity in the world.

Another key contributing factor was the extent to which banks geared their balance sheets, to create a sort of multiplier effect on their capital. This is how the phenomenon of securitisation developed, effectively generating a 'machine of credit'. Rather than banks being constrained by their own capital, other markets were provided for people to invest in these vehicles. This created a snowball effect, with huge leveraging of banks' capital by other institutions, by insurance companies, by investors, and by hedge funds. The growth of the hedge funds was another extraordinary phenomenon which created even more liquidity. So we had more and more money in the world chasing fewer and fewer quality assets, inevitably reducing the quality of assets overall.

In terms of where the US banks went wrong, they dropped their credit

standards and mortgages became commoditised products. There was widespread lending to a class of borrowers that had not previously been able to borrow money because of their poor credit record.

Investment banks saw a huge opportunity for packaging these products and then on-lending or selling them to other parties with an enhanced yield. Because it was sub-prime, there were much more deeply subordinated pieces in any tranche, but they were still given triple-A ratings. The next issue was the involvement of the ratings agencies and the fact that investors got confused about what they were investing in. These debt structures were rated using the same criteria (in terms of A, double A, triple A) as corporates, so investors assumed that the risk was the same.

The Clinton administration also played a part; they wanted more people to be allowed to borrow money to improve their life and own a home, so Fanny Mae and Freddie Mac were encouraged to accept this low-doc and sub-prime mortgage risk. There was encouragement from everywhere. Although the rescue package is being described as Main Street bailing out Wall Street, that is not right. They're only in default on Wall Street because the people on Main Street can't repay their mortgages.

Fundamentally, the regulators didn't do their job and the investment banks and hedge funds, which were unregulated, have turned a potential problem into a massive problem. Also, capital markets have become globalised and banks have become dependent on these markets because they can't just raise the funds

through deposits. And when these markets are destabilised, this affects financial institutions and economies globally.

Q How much do you think the derivatives markets contributed to a lack of understanding of the actual level of risks and the spreading of risk within these markets? Has this been a major factor in all of this?

MS Absolutely. If institutions had only faced the direct risk associated with the underlying credit, I don't think this current credit crisis would have occurred. The issue was the degree of leveraging that had taken place and derivative instruments were the means by which this was achieved.

And, it is highly questionable as to whether the risk ratings that were assigned to these derivatives were appropriate. The concept of netting out all the risks assumed that the market for these products would remain fundamentally sound, i.e. be deep enough to have realistic prices. The derivatives market globally is now worth upwards of \$60 trillion but, in the current environment, financial institutions are desperately trying to reduce the size of their counterparty risks by ripping up the trades (where there are matching trades on either side of a deal).

To give you an example, if you had a \$2 billion portfolio of collateralised debt obligations (CDOs) and the underlying asset was structured to include quality credits like IBM and General Electric, your marked-to-market loss on that right now might be \$200 million, even though the underlying credit is still fine.

But, if you had a \$2 billion portfolio of direct loans to those companies, your expected loss under the Basel II regime would create a collective provision of \$2 million.

So, for the same amount of risk, right now, you have incredibly dysfunctional pricing. The market for derivatives is now completely out of whack. There is no market. And, the IFRS accounting rules are another problem for the banks, because they insist on marked-to-market valuations, but how do you mark to market when there is no market? This is a huge problem for the banks.

Q How long are the effects of the global credit crunch likely to continue? What do you think of the US\$700 billion rescue package by the US authorities?

MS Most of the fallout from the credit crisis will occur over the next two years, but it could take at least five years for all of the effects of this financial dislocation to be sorted out. This is because people are not going to want to realise the losses for some time, if they can avoid it. The impact on the US economy and the European Union will be quite dramatic.

The Asian economies will certainly be affected by all of this as well. Economic activity in China will slow, but it won't go into recession. This means that China will become absolutely critical as an engine of growth for the next few years, after which it will effectively become the most important economy globally. This was going to happen anyway, but what would have taken 15 years, has been speeded up and will now take more like five years. Or, if China

develops serious growth problems, then the whole world will go into a major downturn, but I think the former is more likely.

I think we've still got to work out the real dynamics of this latest bailout in the United States. What a lot of people still don't seem to understand is that the authorities have to save the US banking system. You can't run a healthy economy without a healthy banking system. One doesn't work without the other. The only country that has tried it is Argentina and look at what a mess that created.

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Q Do you anticipate other strong responses by regulators to the recent events in financial markets and, if so, in what areas? Are we likely to see parts of the market currently outside the regulatory regime (e.g. hedge funds, ratings agencies, sovereign wealth funds) being subject to regulation?

MS Regulators often provide knee-jerk responses to situations — closing the stable door when the horse has already bolted. I expect we'll get all sorts of

regulation. But frankly, where they should be looking is at the investment banking businesses and the hedge funds, and other unregulated financial institutions where they have gone after this holy grail of increased earnings per share, quarter on quarter. This focus on short-term goals is where they've come unstuck.

The return on capital coming out of the banking system has been unrealistically high and it was not sustainable. In Australia, for example, we've had 15 years of continual growth, positive returns and a benign credit environment. You can't sustain that. So what we're seeing now is not recession; this is a just a normal part of the cycle in which good companies succeed, but bad companies fail.

Investors can't expect banks to keep providing such high levels of returns. Those days are over, I'm afraid. The regulators are going to insist on more caps on the banks, and that's going to reduce returns even more.

The dependence on ratings agencies has also got to change. I think there needs to be some oversight of rating agencies, to make them more accountable when they get things wrong. Basel II is all based on ratings so these agencies are an essential part of the system, but their track record is really a disgrace.

Q Can you give some insights into how the global market turbulence has affected banking in Australia? What other challenges and opportunities are Australian banks facing in this environment?

MS The biggest problem facing the Australian banking system is its reliance on global wholesale funding markets.

These are not normal times. There is clearly a lack of understanding in the political arena about how banks work and their importance to the system. I have to say, however, that the government has worked hard at getting on top of these issues and I think the Prime Minister and the Treasurer have a good understanding of the importance of the banking system. The issue is serious and it is in the national interest that there is a bipartisan position on this.

Lending growth is obviously going to be restricted in the future because of difficulty in accessing capital and this is going to be a major issue for all

banks over the next five years. We are fortunate in Australia in that we haven't needed to access capital to repair our balance sheets.

But we have to go to the same sources for capital as all the other banks in the world and they have tapped the market this year for about \$350 billion just to repair the holes.

In this environment, banks have the dilemma that although we are facing enormous pressures in terms of our funding costs, we want to maintain our loyalty to customers. In recent years, however, banks have moved into the investment banking business and have been doing business in non-traditional banking areas, with non-core customers. Investment banks are transactions based, buying and selling financial services, generally without any loyalty to customers.

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that occurs, the deleveraging effect globally is going to be enormous and access to credit is going to be much more difficult.

This is going to cause a slowdown in all of the economies around the world. I think that China is now likely to become a more dominant economic power sooner than expected and this is fantastic news for Australia. We couldn't be better placed to benefit from this regional growth.

Q With the level of consolidation underway in the financial sector, and the scale of banking businesses growing internationally, do you think that the four pillars policy may result in foreign takeovers of Australian banks?

MS There aren't any 'four pillars' for any other businesses, like retailing or mining, so I am not sure why banks

Although the banks have generally understood what the risks have been, they haven't realised that there could be a market dislocation on the scale that we are seeing currently. No-one could envisage a situation in which the market could seize up globally. The unravelling of all of this leverage is now creating a large problem. As that occurs, the deleveraging effect globally is going to be enormous and access to credit is going to be much more difficult.

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face this constraint. What we'll see now is huge consolidation in Europe and the United States, so that mega-banks will be created. And, although the Australian banking system will probably come through this pretty

well, we'll look like minnows in the pond. We'll become irrelevant.

It's blindingly obvious to me that in this situation the domestic banks will be far more likely to be subject to foreign takeovers. Hopefully, this might convince the government that this kind of regulation is not in Australia's best interests at all. What will happen is that we'll be like New Zealand — somebody will come in and buy our banking system.

Q **What do you think of the moves by the last remaining investment banks in the US to convert from securities firms to bank holding companies? What are the global financial market implications of this? Does it have any implications for banks' regional growth aspirations?**

MS There's likely to be a change in the model back to more traditional banking models, and I have no problem with that — it is very healthy.

I suspect that the balance sheet is going to become quite important again and capital is definitely going to become critical. So yes, there will be an opportunity or two for banks. Of course, the consolidation process will have to continue, and that will provide opportunities.

We should still be able to pursue growth opportunities in Asia in line with our overall strategy, but we will have to wait for some of the value to come off in these markets. This is already starting to occur, but Asia (ex Australia) has been the least affected by this. Australia has been

affected by what is going on in the United States and Europe, rather irrationally, but we should see some opportunities coming out of Asia in the next couple of years.

Q **Financial innovation/ engineering seems to have been dealt a major blow by the sub-prime mortgage problem and the resulting credit crunch. Do you think this will continue or will these problems be resolved by greater transparency and better regulation in some areas?**

MS I think financial innovation in the corporate and institutional areas probably got a bit out of control but there will still be plenty of scope for innovation and creativity in terms of currency and balance sheet management in the future and that is important. Where innovation is likely to be more constrained is in terms of the banks' ability to use the same money twice or three times.

In the personal sector we'll continue to see some really good innovation in areas such as banking on the i-Phone. Technology will continue to promote ease of access to information and banks need to remember that they are in the service business. In the past, banks were often so product-focused and product-managed, that they didn't think of the customer as a customer of the bank; they were seen as a customer of a product line. So if you wanted to change your address and you had 11 products, you'd have to make 11 phone calls. That's not the sort of thing customers want.

Our focus is on making banking simpler and easier. There is a real

feeling in this country that banks are bad, and this is the same in the United Kingdom whereas, in Hong Kong, banks are respected because they can help you make money. This goes back to the banks here not designing themselves for their customers. We really need to make banking much more straightforward.

Let's hope that in the move to regulate and improve transparency, the regulators don't make things more complex. When regulations are imposed on business, they invariably add cost and very little value. Look at what happened with Sarbanes-Oxley. Has it prevented any problems in financial markets? All it has done is shift New York from being the premier financial centre to the second, because everybody's gone to London to avoid having to conform with this regulation. This wasn't because they objected to the process; purely the level of bureaucracy and the cost. ■

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