

A Decade Post Lehman, Are Banks Safer?

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The filing for Chapter 11 bankruptcy by Lehman Brothers on September 15th 2008 marked a milestone in the history of modern banking and remains the largest bankruptcy filing in U.S history. The collapse of the Wall Street giant triggered a systemic shock across the globe and revealed how vulnerable the global banking industry was.

Ten years since the financial crisis, are global banks now safer? How well are they prepared for the next financial crisis in a rapidly changing external environment? How are they positioned to manage looming risks?

Stronger Balance Sheets but Lower Returns

Regulatory influence, in particular the implementation of Basel 3 globally, has been a major contributor to the enhanced stability and resiliency of banks.

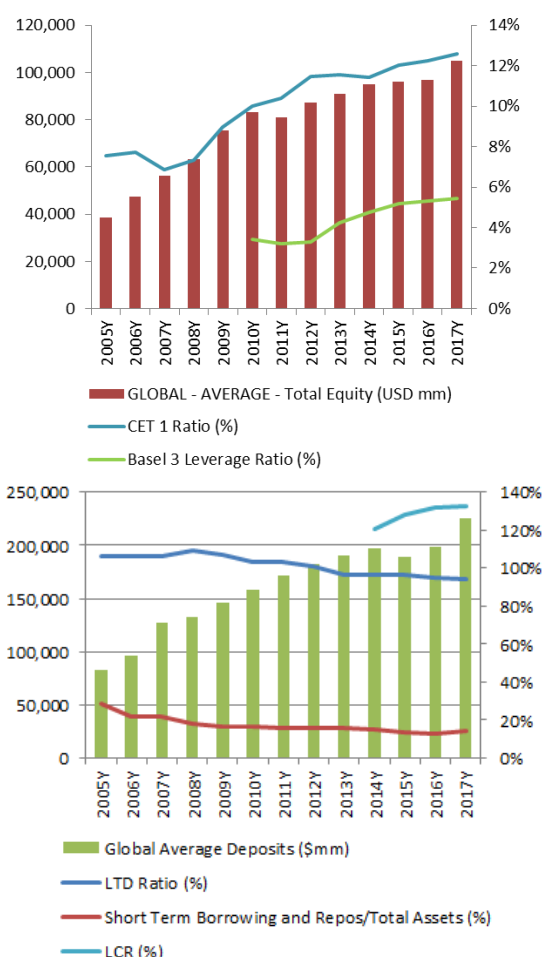
Banks have substantially increased the quantity and quality of their capital. Regulatory capital rose from around 7% in 2008, measured on a Tier 1 basis, to 13% in 2017, measured on a more conservative CET1 basis, providing banks more cushion to withstand any future market turmoil.

The 2008 financial crisis uncovered one of the sector's key weaknesses: an over-reliance on short term wholesale funding. In the run-up to the collapse of Lehman Brothers, investment banks built up their short term borrowings and repo liabilities to more than 30% of their total assets. The loss of investor confidence during the crisis resulted in the shutdown of short term wholesale funding markets.

Post crisis, driven by regulatory and market pressures, short term wholesale funding steadily declined to approximately 15% of total assets, whilst more stable customer deposit funding doubled.

Under the regulation of Liquidity Coverage Ratio (LCR)¹, banks are now required to hold a portfolio of high quality liquid assets to cover at least 100% of projected short term net cash outflows. A majority of global banks meet this requirement, reflecting satisfactory liquidity to mitigate the short term wholesale funding risk.

While balance sheets have improved, banks face challenges in delivering higher returns. Average return on equity (ROE) has fallen to below 10%. This is primarily due to higher capital requirements coupled with lower profits from low interest rates, low volatility, and higher regulatory and litigation costs. At the same time, there are evident signs of divergence in performance of global banks by regions. European banks recovered slowly and lost competitiveness with global peers, especially the stronger US banks. US investment banks benefited from the retrenchment of their European peers and gained wallet share across all segments of the more lucrative investment banking businesses.



¹ Liquidity Coverage Ratio is calculated as a ratio between high quality liquid assets (HQLA) over net cash outflows in 30-day period. The minimum LCR requirement of 100% applies from 1/1/2019 with the requirement having been phased-in since 2015.

Era of De-Risking

Improved resilience of the sector is also underpinned by banks' commitment to de-risk their books. Since 2008, global banks (excluding Chinese banks) have reduced their exposures to riskier trading assets and remained relatively flat on lending assets. On-balance sheet derivative assets also declined, partially moving to central clearing.

Nonperforming loans (NPLs) in the US peaked in 2010 and have since returned to pre-crisis levels. The current credit environment in the US remains benign with very low level of impairment charges. However, with the US economy late in the cycle, a rapid downturn can quickly erode banks' credit profiles.

NPLs in European banks, after peaking in 2013, slowly declined but remained elevated relative to US peers, as the economic recovery lagged behind the US. Impairment level is particularly high at Italian, French and Spanish banks.

Rising Debt and Shadow Banking In China

Whilst global banks de-risked, Chinese banks rapidly expanded their loan books. Banking assets in China have risen to over 300% of China's GDP, nearly three times the emerging market average. Outside of the banking sector, shadow banking in China has exploded to an RMB65tn (\$10tn)² industry at end-2017, which is largely unregulated. Chinese banks, through the marketing of so called "wealth management products" (WWPs) to depositors and investors, extended credit to riskier borrowers who are not able to borrow through the traditional banking channel. The complicated scheme hides the true risks of the Chinese banking sector and increases vulnerability of the Chinese financial system.

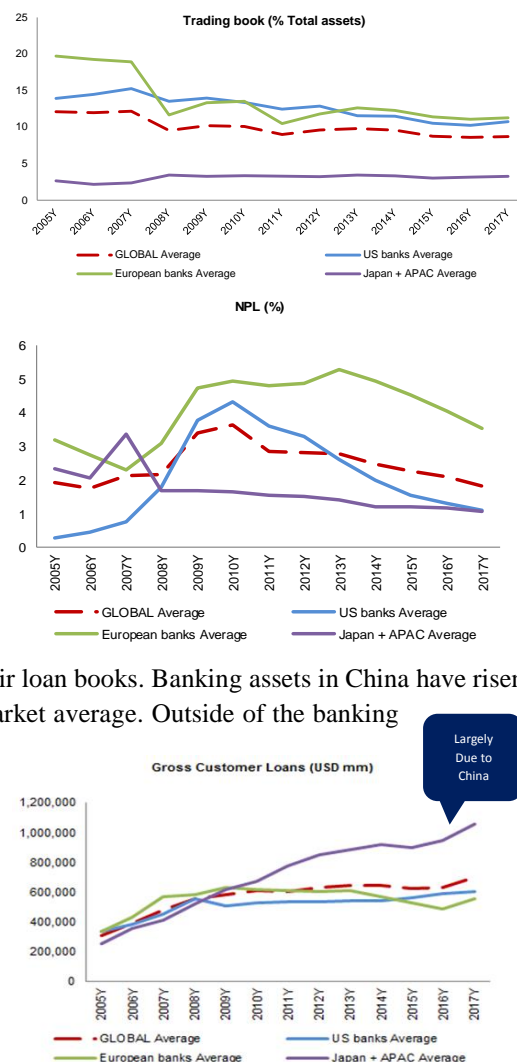
CCPs: Too Important To Fail?

One of the positive outcomes of the post-crisis financial regulations is the increased utilization of the Central Clearing Counterparties (CCPs), which has improved market transparency and efficiency and reduced counterparty risks. As of end-2017, 75% of global OTC interest rate derivatives and 55% of CDS were centrally cleared³.

Greater concentration of derivative transactions with the CCPs, however, has raised market and regulatory focus on risks faced by the CCPs. While CCPs have established risk management mechanisms, risk management processes and standards vary across CCPs. Unlike banks which have been pressured by regulators to put in place extensive resolution plans, orderly resolution of CCPs is much less developed than banks. Failure of a CCP would likely cause loss of market confidence.

Conclusions

Whilst increasing regulatory costs and unfavourable market conditions challenge banks' profitability, more stringent regulations have made global banks stronger to withstand future market shocks. Banks have become more cautious in taking on risks, resulting in the transfer of risks to shadow banks and the increasing concentration in CCPs, which warrant close monitoring.



² Moody's Investors Service

³ Bank for International Settlements