THE COMMERCIAL BANKER'S PERSPECTIVE: THE RESPONSE TO NEW CHALLENGES IN FINANCIAL MARKETS

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Outline

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New Challenges-Global Markets

- US residential real estate induced "crisis of confidence" in structured finance markets
- Systemic impact on international inter-bank liquidity of the "crisis of confidence"
- Major global financial institutions resorting to central banks for liquidity, and international institutional investors for capital
- Off balance sheet assets suddenly come on balance sheet further impacting liquidity

New Challenges-Global Markets

- Basel II regulatory capital requirements applied at a time of deteriorating asset portfolio credit ratings
- Increasing size, complexity, correlation, and contagion in international financial markets
- Uncertainty surrounding the extent of the potential impact of sub prime and the credit crunch, in terms of size and time period
- Regulatory, and government, coordination and resources relative to scale of potential financial market impact domestically and internationally

New Challenges-Global Markets

- Alignment of Executive incentive compensation schemes with sustainable performance, reflecting the blended Risk Appetite of all stakeholders
- Valuation of complex financial instruments
- Securitization, underwriting standards, and distance from borrower vulnerabilities
- Investment Bank, Mortgage Lender and Rating Agency practices
- Slowdown of capital flows to emerging markets
- Commodity and food price inflation

New Challenges-Regional Markets

- Fast financial sector growth, in both quantitative and qualitative terms
- Stock market volatility, and margin lending
- New product development in Islamic banking and real estate lending
- Infrastructure and project financing pipeline build up amidst construction cost escalation
- Specialized human resource scarcity

New Challenges-Regional Markets

- Over $2 trillion project funding requirements, regionally, contemporaneous with international credit squeeze, and other emerging bottlenecks above
- Regional demographics create simultaneous twin challenges on the unemployment and inflation fronts
- Limited productivity improvements due to skill deficits in the labor market
- US Dollar depreciation impact on many regional currencies

Basel II and Emerging Challenges

- On the global front it may be argued that implementation of Basel II did not lead to averting the Sub Prime crisis, and the ensuing credit crunch
- Before arriving at such a conclusion a number of factors need to be considered
- For one, Basel II was not fully implemented in some markets, most notably the US market
- The brunt of the crisis originated at institutions such as Mortgage Lenders and Investment banks

Basel II and Emerging Challenges

- The concern with securitized structures was reflected, to some degree, in Basel II given the more risk sensitive treatment of such structures compared to the treatment under the original Accord
- An important dimension that was introduced in Basel II is that of Operational Risk and Control Assessments
- It may be argued that major contributing factors such as lax lending practices, underwriting fraud, model risk, liberal compensation practices, and external events, such as the over due correction in the US housing market, were all operational risk issues

Basel II and Emerging Challenges

- Along with increased risk sensitivity Basel II espoused coordination amongst regulators, especially with respect to internationally active banks
- Had this not occurred, to some degree, addressing the liquidity crisis ensuing from Sub Prime may have been more difficult
- This however, does not preclude that there are areas that can be refined, especially related to addressing liquidity, stress testing, correlations, due diligence and operational risk assessments

Commercial Bank Response

- Internationally active banks, and regulators, across the globe have instituted “lessons learned” and remedial processes
- One of the most important of these has been addressing liquidity management amidst systemic crises
- There has been a significant slow down in structured finance activity, and heightened sensitivity viz off balance sheet instruments and derivative products
- Obviously the credibility of external ratings of structured finance instruments has been impacted

Commercial Bank Response

- In our region, while the impact has been less pronounced, a re-assessment is taking place of the degree of exposure towards international capital markets
- Business models are likely to be fine tuned towards a higher focus on domestic and regional markets
- Obviously there has been a correction in credit margins in line with the global trend
- It is not clear whether a review of Operational Risk review and governance practices is underway
- While real estate lending is the object of focus, it is not clear whether new prudential practices will be instituted

Regulatory Response

- On the liquidity front, the response and coordination amongst major central banks and regulators is commendable
- I understand that refinements to Basel II may already be underway on the Liquidity front, treatment of Off balance sheet instruments, and other areas
- Other areas that I believe seriously need to be looked at include governance at FI's, and residential real estate lending

Regulatory Response

- In our region, real estate financing is likely to grow significantly, therefore it would be prudent that it gets off the ground on the right foot, from a regulatory perspective
- Cross border activity of regional, and international banks into domestic systems is increasing
- This entails increased coordination amongst regional regulators, and with international regulators, to mitigate the risk of cross border fall out of market crises
- Event risk due to regional geo politics also affords putting in place contingency plans, to address liquidity squeezes that may result from regional tensions from time to time
- It would obviously make immanent sense to incorporate some of the amendments to Basel II that may be instituted due to the recent debacle

Conclusions

- The size and complexity of structured finance markets is a challenge that needs to be addressed by banks and regulators alike
- Liquidity assessments, stress tests, and contingency measures need to be hard coded into formal amendments of regulatory code and bank practice
- Coordination amongst regulators, regionally, needs to be enhanced given issues such as cross border activity, contagion, and event risks

Conclusions

- Other issues that need attention include Governance practices (especially at systemically critical banks), Executive Compensation alignment, Operational Risk Assessments of underwriting practices, et. al.
- Rating Agency assessments require more critical review, and thorough independence of due diligence at investing banks
- Fiduciary practices at Investment Banks and Major FI’s warrant more scrutiny