Eurofound

Financial services: Challenges and prospects

Overview report

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Project: Sector research on the impact of globalisation: Financial services

Foreword

The financial services sector, which includes the banking industry, insurance and financial intermediaries, has been profoundly affected by the recesssion. Having been at the centre of the financial and economic crisis, it has come under intense public scrutiny and has had to review many of its practices. Many companies have conducted internal reorganisations, modified their business models and sought to reduce costs – not least by shedding staff. Financial institutions, moreover, are also anticipating a decline in rates of profit, as well more stringent regulation of the sector and calls for the reform of bonus systems.

Against this background of industrial change, Eurofound commissioned a study, which used company case studies, a survey, expert interviews and an analysis of company statements and financial data, in order to investigate the response of the sector to these challenges, and to anticipate the future direction the sector will take.

This report collates the study's findings to review the economic trends in the banking and insurance industries and the debate on the regulation of financial markets. It looks in detail at the business models that are applied in the different segments of the financial sector as a response to the crisis. Finally, it outlines scenarios that project how the European financial services sector may adapt.

We trust that the report – as part of Eurofound's ongoing work in examining how sectors are responding to change – will assist policymakers in understanding developments in the financial services sector, a key player in Europe's economy.

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Executive summary

Introduction

The recent financial crisis has brought to light the serious challenges that the European financial services sector is facing. What are the prospects that a viable, more resilient financial industry will emerge from the crisis? This report reviews the economic trends in the banking and insurance industries and the debate on the regulation of financial markets. It looks in detail at the business models that are applied in the different segments of the financial sector as a response to the crisis. Finally, it develops scenarios for the potential adaptation process of the European financial services sector. The research was conducted by means of case studies of a range of companies in the sector, an online survey and interviews with experts from companies, social partners, research institutions and public authorities and a detailed analysis of company statements and financial data.

Policy context

It is unlikely that the series of shocks arising from the vulnerability of banks has come to an end. Rising default risks in real estate markets, product markets and among banks in Europe and the US will have a negative effect on banking assets and on economic growth. As a result, the exit scenarios developed by the European Commission all point to a transition phase with low or even negative growth. On the positive side, regulatory reforms have begun and the uncertainty about their scope and direction has been reduced by the US Senate's recent approval of the 'Wall Street Reform Bill', and the decision taken on regulating hedge funds, and on other issues, in the European Union. However, the global debate on a worldwide regulatory framework, as envisaged by the G20 governments, continues.

Key findings

As a response to the crisis, financial companies have adapted their business models, concentrating on the strengths of their core business. A significant deleveraging process (paying off of debt) can be observed in private banking in particular. A number of private banks have tried to expand their retail and commercial activities, but returned to investment banking when capital markets opened up promising opportunities. State-owned banks, which are part of the public rescue programmes, have been restructured by selling off peripheral and risky activities. Risk-assessment tools have been improved and equity ratios have increased. Balance sheets have been repaired by substantial writedowns and profitability has returned to large parts of the business.

However, this return to profitability was at the expense of considerable job cuts. In 2009, roughly 10% of jobs in the state-owned banks examined were cut (around 5% in the surveyed private banks). In the cooperative banks examined, employment was reduced by 1%. Only in one insurance company and a so-called 'ethical' bank did the number of jobs actually increase. Though the case studies do not give a complete picture of employment developments in the sector, they do show how restructuring in the sector impacted on the number of jobs.

A majority of companies have revised their remuneration systems for managers and investment brokers, linking income to business performance over a number of years. In general, the size of bonuses – in relation to fixed salaries – has been reduced and payments have been deferred by between three and four years. A substantial proportion of bonuses is now awarded in the form of company shares. The effect of these changes on investment behaviour and risk appetite is still to be observed.

Despite sharing some general trends, the business models of financial companies show significant differences. They can be classed according to three different approaches.

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One group of 'liberal' banks, investment funds and other intermediaries draws high profits from trading books and proprietary trade. While adapting their business operations to the new market conditions, they still try to continue their profit-oriented strategy, pressing for only minor changes in the regulatory framework.

A second group of 'state-owned banks', which came under state control during the crisis, now face severe restructuring. They have to adapt to substantial losses in trading books as well as the reorientation of business strategies towards the core retail and commercial business. Public supervision strongly affects the restructuring process but also provides important advantages in the form of state guarantees.

A third group is described as 'sustainable', since these institutions follow long-term business strategies with less leverage and less ambitious profit targets. This group was not greatly engaged in new financial markets and thus experienced only minor losses from asset writedowns. Parts of the saving banks and cooperative banks belong to this group, as well as the newly emerging 'ethical' banks and most of the insurance companies.

Scenarios for the future

Based on the above findings, three potential adaptation scenarios for the European financial sector were developed.

The past is the future

This scenario assumes that the big players are strong enough to ensure that no major reform of the financial system takes place. The crisis is generally interpreted as the accumulation of unfavourable circumstances rather than a systemic default. This allows 'liberal' banks to continue their profit-oriented strategies while the 'sustainable' segment will succeed in holding its position, albeit without expanding substantially. Faced with the growing strength of 'liberal' banks, 'state-owned' banks will be under stress and governments will try to reduce their involvement in such institutions. The scenario assumes that a further financial crisis can be avoided with only minor regulatory adjustments and that retail and commercial banking will provide sufficient stability.

A new world order for financial markets

This scenario sees the G20 governments agreeing a fundamental reform of the world financial system in December 2010. The reform includes higher and risk-based equity ratios, the separation of investment banking from retail and commercial banking, the submitting of resolution plans ('living wills') – at least by the big players – and efficient monitoring. Implementing these rules will reduce the competitive advantages of liberal banks and put the sustainable and state-owned companies into a much better position. Higher equity ratios will be the key to this type of adaptation, which will require a long and difficult transition period.

Divided economies

This scenario assumes that the financial crisis cannot be kept under control. Rising default rates and overburdened public budgets will force some governments in the euro area to cut liabilities by between 20% and 30% and to resolve – close or nationalise – a series of banks. Austerity programmes in European countries will be an additional burden on real economies and rising inflation in the US and the UK will create further imbalances. The scenario foresees the international regulation of financial markets failing, hence a strongly profit-oriented and growth-oriented group of managers and professionals will continue to engage in short-term speculation and arbitrage, supported by some countries offering liberal financial markets. This approach will be opposed by some sections of society, which will start developing local network-based economies. A fundamental critique of globalised economies will lead to new approaches based on 'micro-organisms' rather than macro-institutions.

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All scenarios see a further reduction of employment in the financial sector. This will be most severe in the third scenario. However, the pressure to achieve cost savings will be strong in all scenarios, while information and communication technologies will provide scope for continuous productivity increases. Social dialogue, in all the three scenarios, is best developed according to the assumptions of the second ('a new world order').

Introduction

Following the study on 'Skills scenarios for the financial services sector in the European Union' , which was developed by the authors at the beginning of 2009 (Economix/DKRC 2009), this study seeks to identify the major patterns of adaptation in the European financial sector in the aftermath of the financial crisis. The idea of the study proposal was to look for the dominant business model that might have emerged after a reform of financial regulation and the clearing of market trends, focusing on business restructuring at the macro and the micro level in order to draw conclusions regarding employment, skills and social dialogue.

Economic and political developments, however, required the developing of a slightly different agenda for this project. New regulations have so far not yet been passed, and many financial institutions – including their representative organisations – are in a wait-and-see position. Different restructuring and adaptation approaches are competing and it remains unclear which one will be the future of the European financial services.

While the study was conducted in an environment of greater uncertainty than expected, two principles of the study proposal are still valid.

- The alternative scenarios for the European financial sector – as they were formulated in the skills scenario study (Economix/DKRC 2009) – are now more visible than they were at the time when they were written. One part of the European financial sector is in state ownership; some institutions will remain under this control for a longer period of time. A second part of the sector is implementing serious reforms in order to regain the trust of clients and markets and build a sustainable business model. A third group continues to deal in liberal capital markets with a strong profit orientation. The scenarios are therefore a good basis for analysing present restructuring trends.
- The selection of different business models for the case studies is even more relevant now, since no one approach has yet been more strongly favoured than any other. Thus it was important to find suitably representative cases for the restructuring options.

The task of this study will therefore be to characterise alternative business models that might develop in the future, particularly by looking at the conflict lines between these models. From the present viewpoint, it appears very probable that different approaches will compete in the near future and there will be no clear decision about which is the superior model. The coming years will be a period of testing at the business level as well as at the level of public regulation.

The authors also had to adapt their methodology because of the reluctance of financial companies to disclose their business strategies during the course of conducting case studies. As the majority of companies refused to participate in the study, the risk was run that only companies in an excellent business position – but with strategically less relevant approaches – would agree to participate. In order to avoid such a bias, the authors decided to select a number of representative companies and acquire information from annual reports, press releases and rating agencies. This also permitted the inclusion of more companies in the five case studies than were originally planned for. In addition to two individual cases, nine companies were investigated on the basis of this new methodology and asked to amend the reports with additional information.

This overview report develops three scenarios for the adaption phase in the European financial sector (Chapter 6). The scenarios are based on the reviews of restructuring trends at both macro and sectoral level (Chapter 2) and the overview of the debate on regulatory reforms (Chapter 3). The evidence from the case studies is summarised in Chapter 4, which includes consumer reactions to the financial crisis. Chapter 5 reviews the results of available scenarios for financial services and makes reference to the earlier research into skills scenarios. The conclusions from the analysis in Chapters 2 to 5 are drawn in the first part of Chapter 6, which provides a first assessment of current trends.

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In some parts, it is necessary that the report be rather technical, since business developments in financial institutions and financial regulation cannot be discussed without referring to trade-specific terms.

Writing scenarios in a time of such rapid change, and of uncertainty regarding government decisions has been a challenging task, forcing the authors to continually update their information. The expert interviews conducted during the course of the study were therefore very important, since they helped the authors discern the mechanism behind ongoing developments, rather than simply their appearance. The authors would like to express their thanks to all representatives of the social partners, company spokespersons, and researchers who used their valuable time to share their views and respond to the authors' questions.

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The course of the financial crisis

Main macro trends

The financial crisis started in 2007 with the mortgages crisis in the US and reached its peak with the insolvency of the US investment bank Lehman Brothers in September 2008. This pushed the world financial system to a near meltdown, one that could only be avoided by unprecedented rescue programmes from governments and central banks worldwide.

In the course of the crisis, it rapidly became clear that European financial institutions had suffered from losses similar to those of US institutions. These resulted from investments in subprime mortgages, buyout credits that could not be passed over to capital markets, insufficient hedging and, finally, from rising credit default risks in the real economy. In the weeks of financial panic, the exit routes from investments formerly rated as secure appeared to be blocked. Banks had to depreciate assets by USD 1.2 trillion, and the International Monetary Fund (IMF) estimated the need for further reductions of USD 1.4 trillion. Between the middle of 2007 and November 2009, the market value of European and American banks decreased by 60%. This decline included the recovery of stock prices after the end of 2008.

Gradual recovery of the real economy

So far, the financial crisis has triggered a severe downturn of real economies with GDP shrinkages between 2.5% and 7.5% in large economic areas (Table 1). The decline, however, has occurred in the western hemisphere and Russia, while China and India continue to grow. This not only shifts the economic centre further to the east, but also strengthens the role of Asian countries as financial centres.

The global recession has meanwhile come to an end with the help of substantial counter-cyclical expenditure programmes and expansionary monetary policies. The recovery, however, appears to be uneven, particularly in Europe (European Commission 2010a). According to the spring 2010 forecast of the European Commission, growth in the Union will remain sluggish with a growth rate of not more than 1% in 2010 and 1.5% in 2011. Greece and Latvia will remain in deep recession with a further decline in gross domestic product (GDP) of around 3% in 2010. On the other hand, Luxembourg, Poland, Slovakia and the Scandinavian countries will grow with rates close to 2%. The slow recovery is attributed to the expiry of support programmes, the unfavourable labour market situation, and supply constraints from the financial sector, factors which all reduce domestic demand. A rising number of governments in the Member States have also been forced to apply austerity programmes in order to reduce budgetary deficits. Exports – particularly to Asia – are thus the only positive drivers of demand.

The United States – in contrast to Europe – achieved impressive growth in the first quarter of 2010. Real GDP increased by 3.2% in annualised terms and prospects for 2010 and 2011 are more favourable (Table 1). This is based on the expansion of inventories, resilient consumer spending, and the recovery of private investment in equipment and software (ECB, 2010, p. 10). The dynamics of the domestic economy have more than compensated for the negative impact of declining government spending, the contraction of residential investment and the surplus of imports.

The Japanese economy went through the difficult years of 2008 and 2009 with substantial decline in GDP, low levels of investment, deflation, and declining wages. The 2010 forecast, however, expects positive GDP growth mainly driven by exports. Japan is intensifying its relations with China in order to take advantage of the dynamics in this region.

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The Chinese economy is expected to overtake Japan by volume with a GDP increase of 9% in 2010. In the first quarter of 2010, exports went up by 31% compared with the previous year and imports rose by 64%. The new Five-Year Plan starting in 2011 is assumed to strengthen domestic demand and local development. Huge foreign exchange reserves, low public deficits and low risks for credit exposure improve the strength of the financial system. The future risk, however, is inflation, which stood at 5.4% in March 2010, and is driven by the rapid expansion of money supply and rapidly increasing real estate prices.

Table 1: *GDP growth and unemployment*

	GDP growth to previous year		Unemployment rate	
	2009	2010	2009	2010
European Union	-4.0	1.0	9.1	10.3
USA	-2.5	2.8	9.2	10.1
Japan	-5.6	2.1	5.5	6.1
China	8.5	9.0	-	-
India	5.4	6.4	-	-
Russia	-7.5	1.5	-	-

Note: Estimated figures for 2010 are estimates.
Source: *European Commission*

China is at the centre of the world economy. This is apparently the most striking result of the financial crisis, which put Europe into low growth, burdened the US economy with unstable cycles and prolonged the Japanese depression. The big economic blocs in the western hemisphere have been significantly weakened as the financial crisis has absorbed substantial areas of growth potential. They are now all looking to China to provide growth opportunities and to stabilise the world economy.

Global economic prospects remain ambiguous. It is still unclear whether crisis management will lead to a sustainable recovery or a renewed recession. The probability of the latter scenario increases if 'expansionary monetary and fiscal policies lose impetus and private demand fails to gain momentum in the face of limited credit' (IMF, 2009, p. 1).

Job cuts and labour hoarding

The crisis is now having an impact on labour markets. In 2009, the euro area had suffered an overall job loss of 2%, as against 2008. According to IMF projections, this is expected to continue in 2010 (Figure 1).

Figure 1: *Employment and unemployment*

Note: The Advanced economies are composed of 33 countries: Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malta, the Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom and United States.
The euro area is composed of 16 countries: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovak Republic, Slovenia and Spain.
Source: *IMF*

This is associated with the rise of unemployment rates, which will increase in the euro area to almost 12% in 2010. At the same time, employment in advanced economies (including the USA, Australia, Japan and other, mainly Asian, countries) decreased in 2009 and job cuts will continue in 2010.

Employment figures suggest that labour hoarding has been significantly high during the crisis. The effects of the strong GDP decline in the European Union (a decline of 4.2% in 2009) were mainly absorbed by working time reductions, partly supported by public short-time working arrangements and collective agreements. In addition, companies accepted the decline of labour productivity by 2.2% and the resulting increase of real unit labour costs by 2.9%. This indicates that companies were trying to sustain employment, taking into account the importance of human capital and the difficulties that might arise in recruiting new staff in the expected upswing. This type of behaviour is not completely new but had not been observed with this intensity in previous downturns.

The implication is a largely jobless recovery over the next few years. The EU estimate for total employment is a drop of 0.9% in 2010 and a rise of 0.3% in 2011 (European Commission, 2010a, p. 192). With the exception of Malta, all the

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EU Member States will continue to see falling employment in 2010, only a gradual recovery being foreseen for 2011. The expansion of employment in 2011 will be below 1% in most of the Member States. The crisis will thus have a long-lasting effect on employment, which will keep labour market performance below equilibrium.

Re-emergence of the credit crisis

Financial markets are presently concentrating on two major risks: the near-insolvency of states such as Greece and other countries with high budget deficits, and the rising credit defaults among companies and homeowners. Both trends are expected to create new eruptions in the financial system. While these are largely unpredictable as regards the names of the next state, the next bank or the next company to become insolvent, there is a generally high level of awareness of risk and of instability, and an unwillingness to take on new debt. This can be expected to not only increase interest rates, but to cause certain risky markets to dry up, as was experienced on interbank markets during the first wave of the financial crisis in September 2008 and the Greek crisis in April 2010. This resulted in the partial standstill of the financial system which, in both cases, could only be resolved by wide-ranging government intervention.

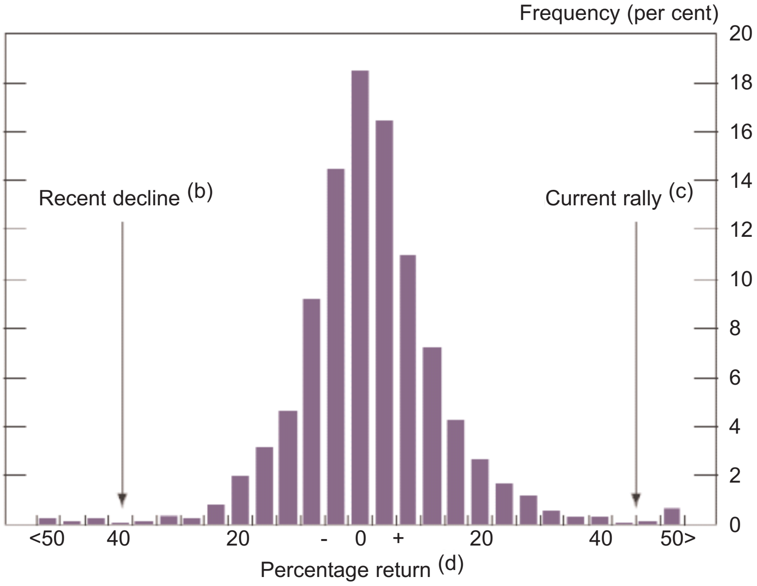
The Bank of England demonstrated the exceptional nature of the situation with its historical analysis of the Financial Times Stock Exchange Index (FTSE). Figure 2 indicates the position of both the recent (2008) decline of stock prices and of the current (2009) upswing in the frequency distribution of stock exchange price changes since 1693. They are both well beyond the scope of regular changes. This means that not only was the downturn of the UK stock exchange exceptionally strong – so is the current upswing. The unsustainability of the present development is evident.

Impact of the financial crisis on employment and training at Erste Bank, Austria

- The human resource strategy did not change substantially after the crisis, but a new task arose for the human resources department, since some employees were anxious about possible job losses. The human resources department supported managers in talking to employees who felt insecure.
- Training budgets were reduced due to the crisis. The reduction was higher in CEE countries than in Austria: This resulted in less training in social competencies and communication, while the general vocational education and training system remained unchanged. The cutbacks will remain in place over the next four to five years and the negative impacts are expected to remain for the next 30 years.
- For financial consultants, the fixed income proportion of their salary is high; they also receive a productivity bonus, which is between 3% and 5% of their salary. The bonus depends on the annual objectives and is not dependent on the number of products sold.
- Since no further expansion is planned, no job increases are expected within the next few years.

(Interview with Mr Michael Weiss, Head of Personnel Development and Recruiting, Erste Bank)

Figure 2: *Declines and rallies in UK equity prices since 1693; relative change of FTSE index*



Sources: Bloomberg, Global Financial Date Inc. and Bank calculations

(a) The chart shows returns on the FTSE All-Share index in the rally in the nine months to 4 December and in the decline over the preceding nine months, compared with the relative frequency of returns over other nine-month periods since 1693 (partly estimated).
(b) 4 June 2008 to 4 March 2009.
(c) 4 March 2009 to 4 December 2009.
(d) Axis labels reference the mid-point of categories that are 4 percentage points wide.

Source: *Bank of England (2009).*

Public budget crisis

In the meantime, the financial crisis has become a crisis of public budgets. The calculations of the European Commission show that total expenditures of EU Member States, calculated as a percentage of GDP, exceeded the corresponding share of total revenues by six percentage points in 2009 (Figure 3). In 2010, a further rise – to seven percentage points – is expected and 2011 will bring only a minor release. The problem of public illiquidity has become more serious with the second wave of the financial crisis.

Among the EU Member States, the UK, Ireland, Greece and France will have high deficits (Table 2). Portugal and Spain are also seriously burdened. Substantial budget cuts are planned in Ireland and Spain, and the Member States have agreed on similar actions in Greece. Deficit values are well above the 3% limit of the Maastricht Treaty and will force not only Greece but most Member States to reduce public deficits – in particular, by means of cuts in expenditure. In order to understand the scope of budgetary accommodation, this means that current deficits on average, must be halved.

According to calculations made by the Bank for International Settlements, the problem is not restricted to the European Union: Japan, the United States and even China and India will run into considerable deficits. As a result '...total industrialised public sector debt is now expected to exceed 100% of GDP in 2010 – something that has never happened before in peacetime' (OECD, 2009).

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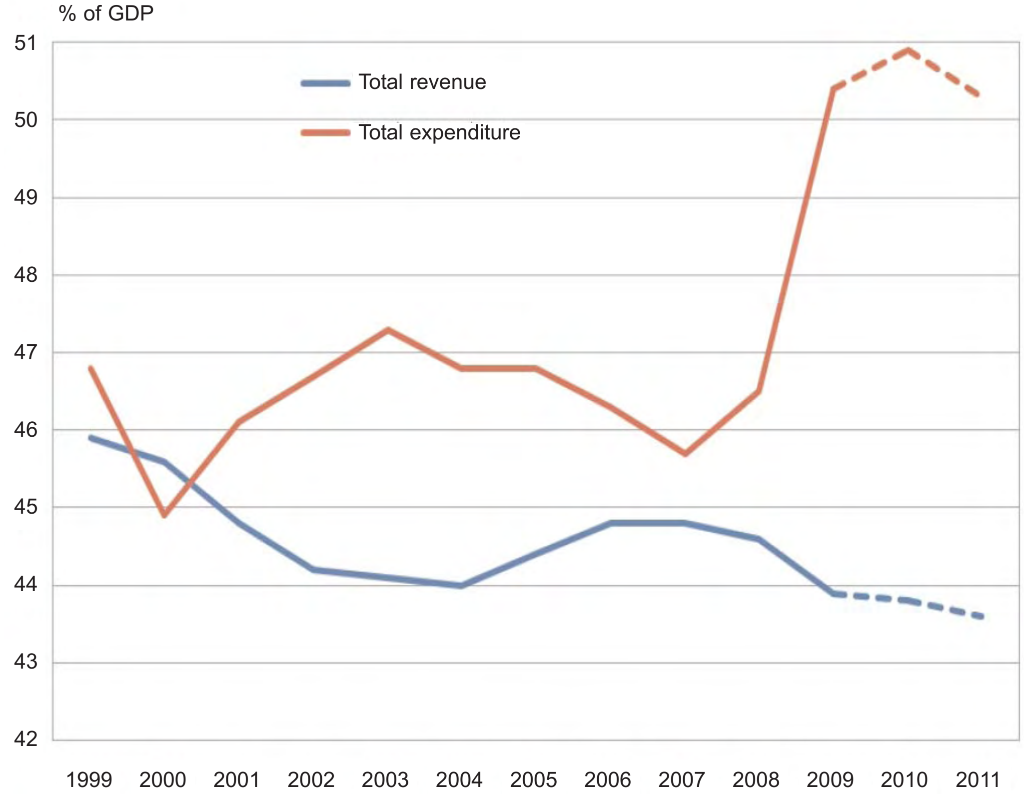
Figure 3: *Public budgets in the European Union; total revenues and total expenditures as percentage of GDP*



Source: *European Commission (2010a)*

The economist Nouriel Roubini wrote that the situation remains challenging as countries are not only suffering from high public debt but also from the loss of competitiveness in their real economies. Strong wage increases in recent years, the revaluation of the euro, the real estate bubble in Spain and Ireland, and limited productivity increases have all contributed to the deterioration in economic strength, particularly compared with China. High budget deficits are therefore the result of weakening real economies rather than financial imbalances (Handelsblatt, 2010a). This will strongly affect the future of these economies, which will have to pass through a restructuring phase with low growth and high unemployment.

Table 2: *Fiscal imbalances, as a percentage of GDP*

	Fiscal balance			Structural balance			General government debt [1]		
	2007	2010	2011	2007	2010	2011	2007	2010	2011
Austria	-0.7	-5.5	-5.8	-1.4	-3.3	-3.6	62	78	82
Germany	0.2	-5.3	-4.6	-0.8	-4.0	-3.7	65	82	85
Greece	-4.0	-9.8	-10.0	-4.5	-6.9	-6.8	104	123	130
France	-2.7	-8.6	-8.0	-3.5	-6.8	-6.3	70	92	99
Ireland	0.2	-8.6	-8.0	-3.5	-6.8	-6.3	28	81	93
Italy	-1.5	-5.4	-5.1	-2.2	-2.6	-2.8	112	127	130
Japan	-2.5	-8.2	-9.4	-3.4	-7.4	-9.0	167	197	204
Netherlands	0.2	-5.9	-5.3	-0.6	-3.6	-3.1	52	77	82
Portugal	-2.7	-7.6	-7.8	-2.8	-6.1	-6.8	71	91	97
Spain	1.9	-8.5	-7.7	1.6	-5.2	-4.5	42	68	74
United Kingdom	-2.7	-13.3	-12.5	-3.4	-10.5	-9.9	47	83	94
United States	-2.8	-10.7	-9.4	-3.1	-9.2	-8.2	62	92	100
China	0.9	-2.0	-2.9	-	-	-	20	22	23
India	-4.4	-10.0	-8.7	-	-	-	81	86	86
Other Asian countries [2]	2.1	-1.2	-1.0	-	-	-	31	37	38
Central and eastern Europe [3]	3.7	-4.4	-3.9	-	-	-	23	28	29
Latin America [4]	-1.5	-2.4	-2.0	-	-	-	41	37	35

Note: Regional averages are calculated as weighted averages based on 2005 and purchasing power parity (PPP) exchange rates; 'structural balance' refers to cyclically adjusted balance; [1] for Argentina, the Philippines and Thailand, the figures are for central government debt; [2] Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand; [3] Czech Republic, Hungary and Poland; [4] Argentina, Brazil, Chile and Mexico
Sources: *IMF, 2009; OECD, 2009*

Inflationary risks

As these corrections in public deficits will not be willingly accepted by voters, policymakers will search for an escape via inflation. Inflation, however, is a long-term rather than a short-term risk. Low growth and strong external competition will limit the possibilities of increasing prices. The European Commission therefore estimates inflation rates to be between 1% and 2% annually for 2010 and 2011 (2010a, p3).

However, the anticipation of inflation is even more damaging than inflation itself. The current depreciation of the euro can be understood as a reaction to investors' expectations of higher inflation in the euro area. Many investors are returning to their home currencies, looking for more stable currencies (such as the Swiss franc), or putting their money into gold, real estate and other tangible goods.

The decline of the euro's exchange rate against the US dollar is associated with the apprehension that the purchase of euro-area bonds by the European Central Bank may not be compensated for by money supply cuts. Obviously, there is a fundamental conflict between EU Member States as to whether monetary policy should ease fiscal deficits or strictly preserve monetary stability. Which side will win this debate remains one of the principal questions for the medium-term future.

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Default risks

The second main risk comes from rising defaults in real estate markets and in the area of commercial credit. The Bank of England recently came to a very sceptical assessment:

> *'Recent improved conditions need to be set against the backdrop of overextended balance sheets across a wide range of countries and sectors. The global boom in loan issuance has left a legacy of significant refinancing challenges for some companies, including in the United Kingdom. Household default rates continue to rise sharply in the United States. There are also pockets of vulnerability in certain emerging economies within Central and Eastern Europe, where private sector credit has grown rapidly over the past few years, partly financed by foreign bank lending. These problems can have unanticipated spillovers, particularly if there is a lack of clarity about sovereigns' support for quasi-government entities — as seen in Dubai and, earlier in the crisis, at US mortgage finance agencies Fannie Mae and Freddie Mac'* (Bank of England 2009, p. 7).

One of the European centres of this process is the UK commercial property market, which experienced a rapid decline in prices during the crisis. Since 2007, property values have declined by 45% and have wiped out the gains of a whole decade. The proportion of vacant offices increased from 9% to 12.6% and default rates doubled to 7%. Moreover, two thirds of the current real estate loans will have to be paid back during the next five years. Standard & Poor's estimates writedowns at 9% and 15%, depending on the length of the financial crisis. This will have a substantial effect on other countries: for instance, 11 German banks, especially the Landesbanken, are among the 23 largest providers of credit for big construction projects in the UK (Handelsblatt, 2010b).

Similarly in Spain, the property crisis is expected to peak in 2010. Developer companies will have particular difficulties, which – it is expected – could result in credit default rates of between 20% and 25% (Financial Times, 2010c). The overall default rate in real estate markets is expected to be in the range of 5%. Banks had to raise financial reserves by €6.5 billion. Unsettled loans were repaid by debtors as property transfers, which now require substantial writedowns. While larger banks are able to compensate for these losses with their own resources, smaller banks are increasingly in trouble and in need of public support . The 45 savings banks that hold half of the Spanish banking market are deeply involved in the funding of real estate projects. The Spanish government was thus forced to establish a restructuring fund, which can offer banks support of up to €99 billion.

Rising proportions of non-performing loans have also been forecast for Central and eastern European countries, particularly the Baltic States. According to IMF estimates, the proportion is expected to move up to 15% or even 20% in 2010. Meanwhile, Bulgaria, Croatia and Romania are projected to experience default rates of around 12%, with rates of around 8% for the Czech Republic, Hungary and Poland (IMF, 2010a, p. 19).

Alarming signals are also coming from the US. Prices for commercial buildings have declined by 30% and the proportion of vacant buildings is approaching the level of the last crisis, which occurred at the beginning of the 1990s. The current loan default rate is 7.4% – five percentage points more than a year ago. One of the most prominent cases was Stuyvesant Town in New York, which was returned by the developer company to the creditor banks. Tishman Speyer and Blackrock Fund acquired Stuyvesant Town with 11,200 apartments for USD 5.4 billion in 2006. The fall in its overall value to USD 2 billion forced the owners out of the market. They returned the entire property to the banks, which gave USD 4 billion as credit (Handelsblatt, 2010b).

So the crisis is far from over and the financial system is far from stable. While the real economy recovered rapidly from the slump, the financial crisis shifted to public budgets and infected the most vulnerable countries and companies. Faced with an extreme rise in public deficits, governments will be forced to implement austerity measures with low growth rates, during what will probably be a long transition phase.

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Most importantly, however, the crisis is in the process of changing expectations considerably. A new sensitivity to risks, the perception of rising instability, the fear of inflation, and the awareness of global instabilities all have visible effects on the behaviour of investors, companies and consumers. In this sense, the financial crisis is going to affect all economies, and slow down activity everywhere.

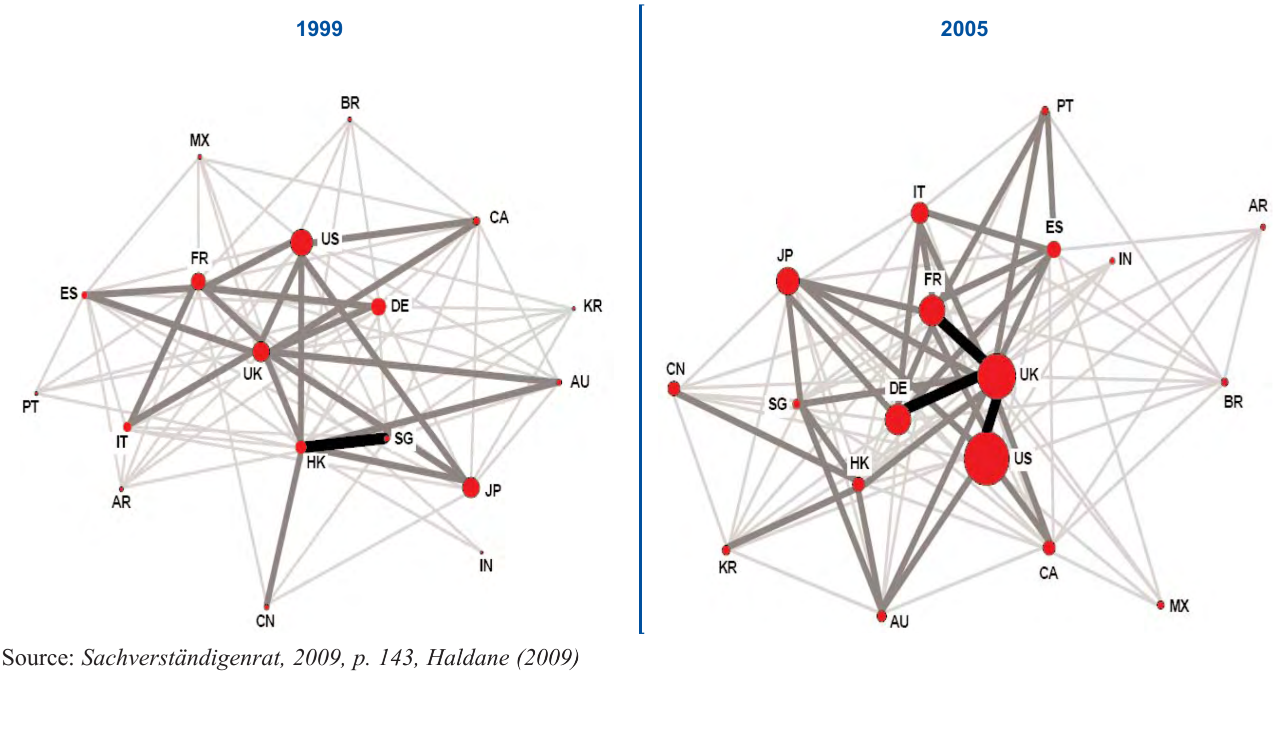
Banking

Throughout 2009 and 2010 the health of the financial system has improved. With the global economy growing, risks to financial stability have subsided. The capital ratio of the euro area's banking system rose by one percentage point from autumn 2008 to 7.5% in December 2009, the highest level ever recorded (European Commission, 2010a, p. 35). Continued deleveraging in the banking sector has helped to reduce the predisposition to shocks, so normalising markets. According to the IMF estimates, bank writedowns in the euro area amounted to €511 billion in April 2010 or 2.9% of total loans and securities (IMF, 2010b, p. 13). The amount is significantly lower than six months earlier but the compensation of around one third is still ahead. With the rise in asset prices, large parts of the banking sector have returned to profitability.

Nevertheless, 'the financial crisis is expected to change the economic and political environment of the banking industry stronger than any other event during the last decades' as Deutsche Bank Research writes (2009). Therefore, the sector sees only moderate prospects in the medium term. It is expected to face comprehensive re-regulation, growing governmental influence, and increasing pressure from investors. Market growth will thus remain limited, and the further rise of equity ratios will constrain profitability.

Not all EU Member States have been affected by the financial crisis in the same way. This is due to the fact that the financial linkages have become increasingly dense over the last decade (Figure 4). The US, the UK, Japan, France, and Germany became dominating financial centres, in addition to the fact that the total volume of credit and market links expanded considerably. It can be assumed that the picture for 2007 would demonstrate these findings even more explicitly.

Figure 4: *Links between national financial systems; model-based credit and market links between financial centres*



Source: *Sachverständigenrat, 2009, p. 143, Haldane (2009)*

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Some national regulatory schemes – for example, Spain, Poland and Romania – did not follow the path of deregulation, and thus partly resisted the virus of financial instability. Generally, the banking systems of the New Member States (NMS) remained concentrated on national markets. This also provided some protection against the infection. The indirect effects on the real economy, however, could not be prevented even in countries with a healthy financial system.

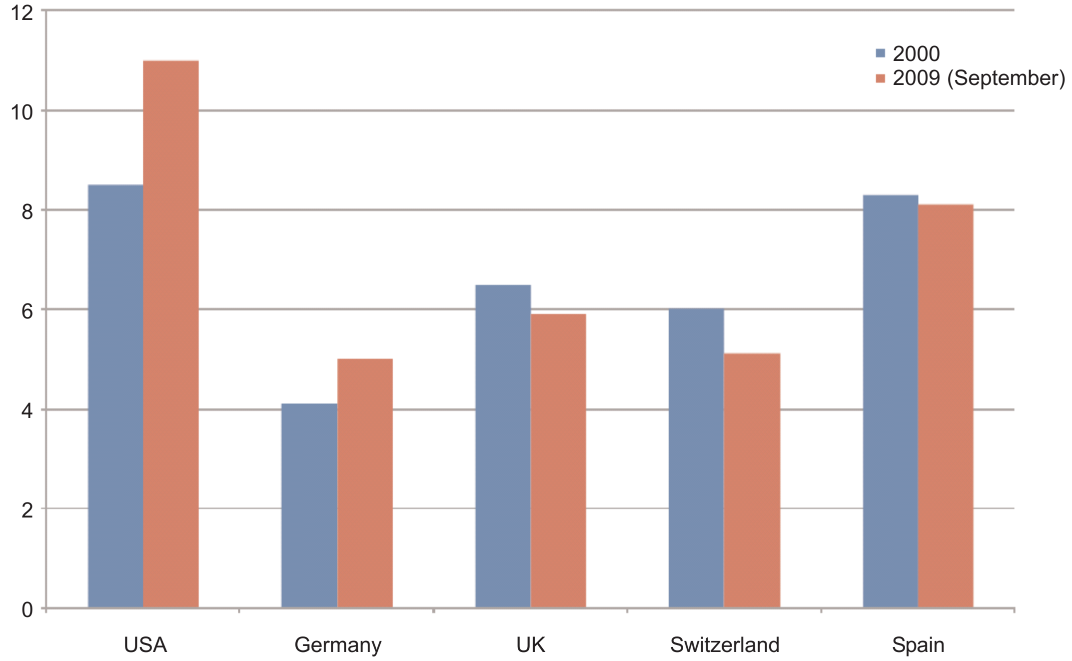
China and India kept their financial systems under strict government control and did not participate in the extraordinary growth of western financial markets. These 'underdeveloped' financial systems – as described by the OECD and the IMF – appear to have been an important advantage during the crisis. With a traditional banking sector concentrated on deposits and credits, the systems were not exposed to the risks of structured products or short sales. With foreign exchange restrictions, they were disconnected from the vulnerability of the world financial markets. Of course, these risks were partly transferred to the central government. Nevertheless, the national financial systems remained largely unaffected.

Equity ratios

Extended leverage ratios have been identified as being a major source of instability in financial markets. Favoured by low interest rates and loose prudential rules, the leverage ratio of US investment banks rose to levels between 25 and 35 in spring 2008. Non-banking institutions (structured investment vehicles, or SIVs) had been used to transfer risky assets out of official trading books. Meanwhile, banks made substantial efforts to lower the leverage ratio to a level of 15 (September 2009) and to raise equity ratios.

Official data do not fully reflect these changes, as Figure 4 reveals. US and German banks were among those that had achieved higher equity ratios by the end of 2009. In the UK and Switzerland, however, equity ratios declined compared with 2000 levels.

Figure 5: *Equity ratios – equities as percentage of total assets*



Source: *Deutsche Bank Research, 2009*

In 2008 the performance of large banks in the euro area deteriorated significantly, resulting in a loss of 5.8% on average. By the third quarter of 2009, the average profit margin had recovered to 10.7%, 'although this still remained low by recent historical standards' (ECB, 2009, p. 78).

While many banks used the favourable market conditions in 2009 to restore their capital position, the recapitalisation of banks is hampered. According to the European Commission (2010a, p. 35), positive earnings and profit developments are unlikely to be sustained for a number of reasons.

- Further losses from loan defaults are to be expected as a delayed reaction in the real economy.
- The strong revaluation of securities will not continue and may even reverse.
- The normalisation of short-term interest rates will reduce banks' earnings.
- Injected public capital will have to be redeemed.

Banks may also face a 'creditless recovery', or at least a substantial lag of credit growth during the economic recovery. The early stages of recovery appear to be particularly 'creditless'. This may partly be compensated for by the huge increase of government debt. On capital markets, however, banks will increasingly compete for funds with public institutions. This can be expected to raise interest rates.

The profitability of banks was already very uneven before the crisis. The IMF comments: 'In a number of countries, a significant part of the banking system lacks a viable business model, or suffers from chronic unprofitability. In the case of the European Union, the need for rationalisation of the sector can be seen in the striking variability of banking returns. The German system, for example, suffers from weak overall profitability, and a large tail of unprofitable banks – primarily the nation's Landesbanken (IMF, 2010b, p. 23). Weak banks are believed to compete aggressively for deposits, wholesale funding and scarce lending opportunities, thus squeezing margins for the whole system.

The IMF findings, however, can also be interpreted as the contrast between profit-oriented and service-oriented banking systems. The traditionally low profitability of the German banking system is due to the key role played by public savings banks and cooperative banks, which are less profit-oriented than private banks. In contrast, the high profits of private banks were related to high risks in derivatives markets and other investments. Profitability is therefore no reliable indicator for sustainability.

Derivatives markets

The latest figures on global derivatives markets reveal a slowdown in the gross value of over-the-counter (OTC) derivatives from USD 32 trillion (€21 trillion) to USD 22 trillion (€15 trillion) between December 2008 and June 2009. The major parts of OTC derivatives are interest rate swaps, credit default swaps and currency swaps. The volume of the total market came close to the June 2008 level and was 2.2 times bigger than in 2006 (Figure 6). This means that the highly speculative part of international capital markets still has a significant volume.

The growth of derivatives markets impressively demonstrates the decoupling of financial markets from real economies. The enormous expansion of these markets is not related to anything like economic growth, world trade or credit exposures of the banking system. The maximum expansion of world trade between 2002 and 2008 was 54%, with world output increasing by 31%. Derivatives markets developed as an independent segment adding a great variety of new financial products to the market (and carrying a high level of risk).

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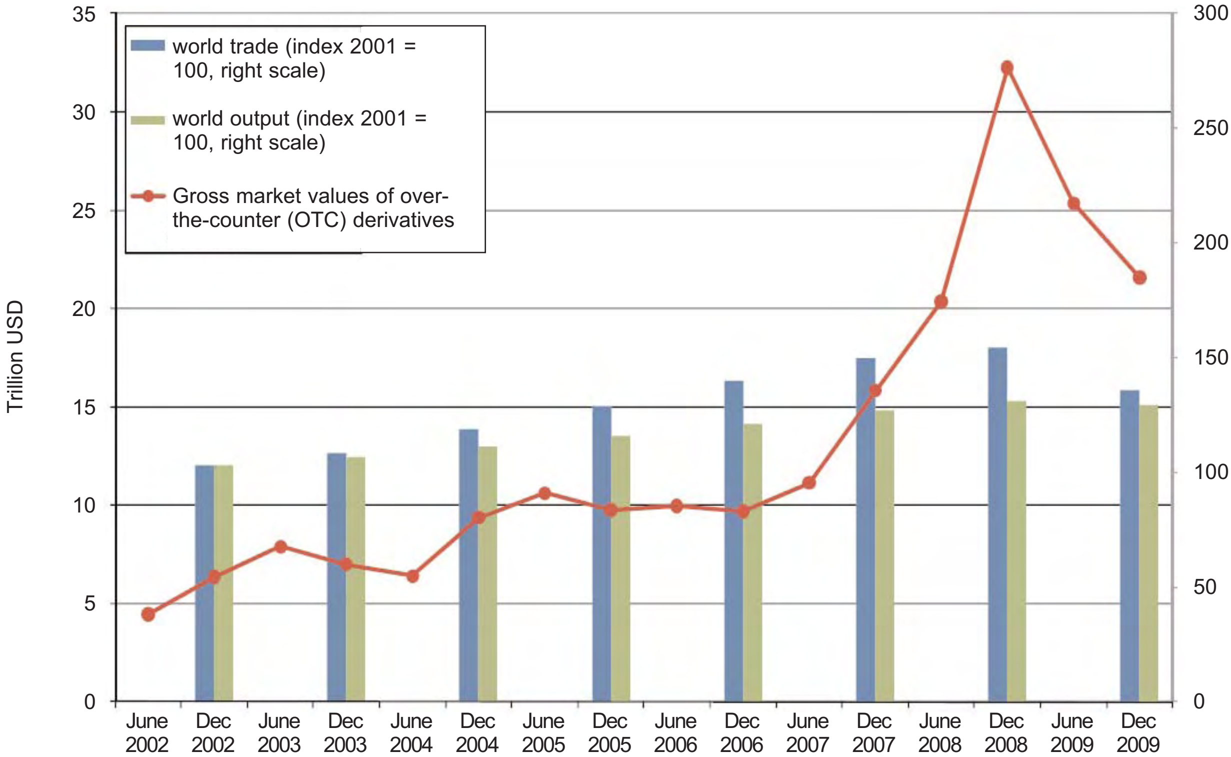
Figure 6: *Gross market value of over-the-counter derivatives, USD trillion*



Source: *Bank for International Settlements*

Hedge funds

Mr Neil Warrender, Head of Hedge Funds Consulting at LPR Consulting in the UK, outlined his view on the position of hedge funds. The demand for hedge funds has considerably decreased during the last 12 months, making it difficult to raise money for hedge funds. People who invest in hedge funds nowadays prefer investments with a relatively high liquidity and, since managers of hedge funds can only take out performance fees after the investors have taken their money out, there is greater pressure to match the interests of investors. A transaction tax would affect hedge funds with a short-term nature (where transactions take only seconds) more than hedge funds with a commodity trading advisor. Mr Warrender assesses the Alternative Investment Funds Management Directive (a European directive to regulate close-end funds) as an improvement, since it will help regulators to receive the required information to help them understand and focus on risk adequately. In Mr Warrender's view, a job reduction of around 25% is to be expected in the hedge fund sector.

Consolidation

Earlier banking crises were associated with a declining number of banks where no legal barriers existed to mergers and acquisitions. One of the examples cited in the literature is the crisis of the US savings and loans institutions in the late 1980s, which reduced the number of banks considerably. Within five years, 9,800 banks disappeared in part due to bankruptcy, but mainly because of mergers (Deutsche Bank Research, 2009, p. 11). Similar consequences were observed after the banking crisis in Sweden in 1993 and after the Japanese financial crisis at the beginning of the 1990s.

Mergers are driven by three forces: reduction of risk, with the help of diversified financial structures; economies of scale in the operation of financial services; and an increase of market power. These forces have resulted in rising market shares in the five biggest banks in Europe: in 19 of the 27 EU Member States, these five banks have a market share of over 50%.

The financial crisis has not stopped mergers and acquisitions in the financial industries, but it has changed the criteria by which they operate.

- Governments have forced banks in which they hold a stake to restructure and separate themselves from their more risky businesses (as seen, for example, in the case of ING Groep, FORTIS and DEXIA in Belgium and the Netherlands).
- National mergers have become more important as uncertainties about economic trends, risks, and new regulations in other countries have increased. National markets were upgraded in banking strategies together with commercial banking.
- Holdings have been disentangled and concentrated on ‘core’ businesses in order to extend the capital basis. In particular, the banks’ insurance subsidiaries have been sold.

Future trends, however, are far from clear. On one hand, the economies of scale and scope are still prevalent and thus size and growth are important. On the other hand, flexibility of services, risk limitation, and knowledge of local markets give advantages to decentralised banking systems with small units. Meanwhile, the debate about the size of banks has become a central issue: policymakers are willing to separate big banking groups in order to avoid additional ‘too big to fail’ cases.

Public ownership

The depreciation of assets and the vanishing trust of private investors made governments the ‘investor as a last resort’ in various cases (Table 3). Some of the European and US banks could only be saved with substantial public support. In addition to financial guarantees, this was achieved by transitory capital transfers. Over the course of the financial crisis, public investments tended to follow a long-term orientation with a stronger influence on management (as in the case of Commerzbank). In some cases (such as Hypo Real Estate and Royal Bank of Scotland) a complete takeover, bringing the bank into public ownership, was necessary.

Most of the US banks repaid public investments whereas among European banks the majority did not – except the French banks, which had reimbursed public packages by December 2009. This raises the probability that governments will be engaged in private banking for the longer term. In particular, the ‘bad bank’ option, which was used by several vulnerable banks, includes long-term public risk-taking.

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Table 3: *Public capital support for European and US banks*

Bank	European country	Euro (billion)	Repayment
Europe			
Royal Bank of Scotland	United Kingdom	50.1	
Lloyds	United Kingdom	25.2	
Commerzbank	Germany	18.2	
ING Group	Netherlands	10.0	Yes
BayernLB	Germany	10.0	
Dexia	Belgium	6.4	
KBC	Belgium	5.5	
BNP Paribas	France	5.1	Yes, 2011
Landesbank Baden-Württemberg	Germany	5.0	
UBS	Switzerland	3.9	Yes
USA		**USD (billion)**	
Citygroup	-	52.1	Partly
Bank of America	-	49.0	Yes
JPMorgan	-	25.0	Yes
Wells Fargo	-	25.0	Yes
Goldman Sachs	-	10.0	Yes
Morgan Stanley	-	10.0	Yes
PNC	-	7.6	
US Bancorp	-	6.6	Yes
SunTrust	-	4.9	
Capital One	-	3.6	Yes

Source: *Bloomberg, US Treasury, Deutsche Bank Research*

Restructuring of banking services

No clear trend of company restructuring in European banking services is visible. Much depends on new regulation, which is still being formulated. Some changes can, however, be discerned. Firstly, trading books will not regain their pre-crisis importance. This can be attributed to the significant reduction of proprietary trading, which was associated with a strong decline in jobs for traders. The behaviour of big investors and private clients moved towards better liquidity and higher security. Regulation is starting to restrict risky trading. Secondly, deglobalisation of markets may happen to some degree as national markets become more important. For many banks, national markets are by far the most important part of their business. Foreign activities do not always fit the prevailing business model and appear to be risky. National markets are the main source of funding. Long-term relations with investors and private clients appear to be important. Finally, national governments have supported many banks directly or indirectly. This is going to create a strong commitment to the country of residence and may lead to a retreat from international investment banking and trading.

Overall, diversification of activities is becoming more attractive because specialised banks were particularly affected by the financial crisis. The risk distribution of universal banks allowed for greater flexibility and better funding structures.

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INEUM France: impact on retail banking in France

- Only minor changes have taken place in French retail banking – cost savings and a shift of investment projects. No job cutting plans currently exist in French retail banking.
- The first impact of the new regulatory framework is that the control department must check financial proposals to clients. 'Traceability' is the new buzzword in the sector. 'Risks profiles' of customers are designed, and must be implemented by commercial services.
- The confidence problem has affected only assets, shares and private banking activities.
- All retail banks are now 'multi-channelled' using branches, phone banking, and internet banking. A new type of machine-based branch emerges – a 'money wall', composed of a range of automatic teller machines (ATMs) doing basic operations. Personal counselling capacities are available for customers in small offices.
- Great attention is paid to information for the customers: documents about the different financial products have to be checked by the Autorité des Marchés Financiers (AMF)
- Some banks (such as Société Générale) have taken the opportunity of the crisis to develop a new image, as a customer-oriented organisation.

(Information supplied by Axel Francerie and Wouter Hendriks,
Senior Consultants, Risk and Regulatory, at INEUM Consulting, France)

However, the prevailing trends of the last decade may override these tendencies. Firstly, asset trading – proprietary trading in particular – was the most profitable part of the banking business and still provides exceptional profit opportunities. The banking business is therefore partly returning to these activities with great financial success. Secondly, international banking business corresponds with international trade of goods and services, and with an openness of capital markets worldwide. A return to national banking is therefore unlikely. Only the pace of internationalisation may be expected to decelerate. Finally, the influence of economies of scale and scope are still very strong. Information and communication technologies provide an expanding potential for efficiency gains in the operational business, in communicating with clients and internet-based banking services. This may further promote the growth of the big players. (The recent deal between Deutsche Bank and SAP confirms this argument, Deutsche Bank ordering banking software based on SAP software, to replace their internally-produced system.) In addition, financing big international projects requires big financial institutions. These, however, have the ability to dominate markets. Being big, therefore, remains attractive.

Change of remuneration systems

The fundamental critique of bonus systems has caused some changes in banking management. The main argument that has been levelled is that the remuneration of traders, sales staff, and top management was linked to short-term economic performance rather than sustainability and long-term business targets. This created risk profiles that were not consistent with reliable and trusted banking practices. Bonus systems that provided payments immediately after selling the contract or straight after annual accounts did not consider the longer-term risks of the business. Moreover, the extraordinary size of payments to traders and top managers has been assessed by the public in many countries as not being fair.

Remuneration systems have been or will be changed in many banking institutions. This was initiated by the intervention of state owners in those banks that depended on public support during the crisis. However, even in banks that did not need public support, managements have started to introduce reforms. The Institute of International Finance (IIF) has set

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out the principles of remuneration: bonus payments should be related to profits over several years, and a proportion of some bonuses should be transferred to trustee accounts for a longer period of time. Banking management is also putting other new rules into practice.

An important characteristic of these reforms is that they apply to all levels of the company, from top managers to sales staff. How top managers are remunerated plays a pivotal role in a bank's performance, since they will organise the business to get the most from their incentive schemes. A reform that only changes bonus payments at lower levels will therefore not be fully effective. The use of bonus-malus components is also important to achieve a better profit-risk assessment in day-to-day business. Experience shows that the simple restriction of bonuses – or the taxation of bonuses – is less efficient, finding a legal loophole to evade these regulations usually being possible.

The most far-reaching approach aims to expand management and staff ownership. According to Professor Geoffrey Wood of London's Cass Business School, substantial equity investments, which can only be sold some years after separation from the company, would encourage a long-term responsibility for the business and reduce risk propensity.

According to UNI Finance, remuneration policies should not interfere with the freedom of association and the right to collective bargaining.

Insurance

Linkages to the crisis

The European insurance industry emphasises that although it has been greatly affected by the financial turmoil, this was not due to the financial crisis (CEA, 2008). This is partly true, since the exposure to credit risk embedded in structured products was limited and insurers were not significantly affected by the related losses. The exception, however, is in the bond and mortgage insurance that covered the loss of capital or interests of many securities. The insolvency of AIG in the US,[1] and of Fortis in Belgium revealed how risky this market segment of international insurance was and the extent to which this type of insurance contributed to the emergence of the financial crisis.

The typical insurance business model, however, follows an investment policy that is in line with the financial commitments to policyholders. This means that investments are selected according to the required cash flow and assets are placed as long-term investments with a low risk profile. Most importantly, insurers do not use leverage to enhance their return on investment. Their liquidity depends primarily on premiums, which makes them less vulnerable. Liabilities depend on the emergence of risks in different insurance markets. These may fluctuate substantially. However, such a business model is certainly less exposed to fluctuations in financial markets.

Nevertheless, the asset portfolios of insurers have been strongly hit by the downturn on capital markets, the decline of interest rates and the contraction of economic activities. This has only partly been compensated for by the growth of saving and retirement products. As indicated in the section on banking, the sharp decline of stock prices could hardly be absorbed. Insurers were unable to escape from the general downward trend simply due to their size as investors and their long-term investment strategy. The total asset value of euro area insurers amounted to €4.4 trillion in 2008. Half of the

[1] AIG posted a loss of USD 61.7 billion (€74.1 billion) in the fourth quarter of 2008. The US government guaranteed the liabilities of AIG in order to protect the world economy from substantial losses.

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assets were kept as debt and fixed-income securities and 15% as shares. The rest was distributed over various forms of investments (ECB, 2009, p. 161). This resulted in the downgrading of credit ratings for the leading European insurance groups in 2009, the majority of companies being rated with a single A in October 2009, and only one being rated AA. In 2008, the rating had been significantly better with the majority in AA- and A+ (CEIOPS, 2009, p. 6).

The Polish life-insurance market

The Polish life-insurance market consists of investment-related businesses and protection-related businesses. The demand for life-insurance products has significantly risen in recent years. In 2006 and 2007, the increase was mainly driven by the investment-related part.

The financial crisis lead to a decrease of investment-related products as customers started to become wary regarding investment products, which are mainly sold by banks. Moreover, the Polish regulator sent a special note to all insurers asking them to reduce their investment-related business since they are connected to high credit risks. Thus, a significant slowdown was experienced in the market.

On the other hand, the protection-related part of life-insurance business did not experience a strong impact from the financial crisis, even though problems were expected due to companies going bankrupt. In Poland, the majority of protection-related business comprises group insurances. This means that large groups of workers are insured through the companies they work at.

(Interview with Mr Przemek Dabrowski, Head of Financial Division at PZU Polska, Poland)

Life insurance experienced a strong decline during 2009. As part of private capital investments, life insurance had to adjust to the economic downturn. Exits from life insurance contracts, however, did not increase substantially and thus did not burden the liquidity position of insurers. Non-life insurance remained less affected. In an environment of rising uncertainties, adequate risk management helped non-life insurance endure.

Monoline insurers – who provide financial guarantees for the interests and capital repayment of credits and bonds – came under significant stress with the deterioration of structured credit markets. Most of the seven European monoline insurers were thus downgraded by the rating agencies in 2009. The ratings of one of the agencies have even been withdrawn by the companies. A considerable potential for further deterioration in the firms' solvency levels was identified during 2009, particularly when underlying mortgage portfolios were taken into account. European regulators decided to monitor market developments closely '... and [institute] contingency planning in the event of further downgrades or even insolvency' (CEIOPS, 2009, p. 27).

Reactions to the crisis

As a major investor, the insurance sector is concerned that the financial system remain stable and secure. The sector therefore started to reorganise its activities and submitted proposals for the reform of financial industries.

Having been hit by the crisis, even though it is a risk-aware sector, the insurance industry has planned to move to a risk-based solvency regime. This move is foreseen by Solvency II, which should provide the mechanisms to detect threats at an early stage (see the later section on 'Coordination at G20 level'). According to the CEA, the European insurance and reinsurance federation, the sector urges the use of group-based assessments rather than single company risk assessments, and the strengthening of risk management in all financial institutions (CEA, 2009). It is critical of the fact that risk

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managers had difficulty making their voices heard, even in institutions with sophisticated risk management structures. Direct reporting lines of risk managers to the board are recommended. Moreover, incentive structures would have to be realigned between operational lines and top management.

The industry has a strong interest in applying less market-based valuation rules for assets. This appears to be a key issue, since it would affect balance sheets considerably. The mark-to-market valuation principle says that assets have to be valued at current market prices (or ‘fair value’). Insurers, however, do not report losses in the profit and loss account, unless the investment is considered to be impaired. This differs from the practices of banks, which generally record ‘at fair value through profit and loss’. The fair-value principle is identified as being pro-cyclical and its extension to the insurance industry is therefore criticised for emphasising this effect.

The sector also has a strong interest in maintaining insurance-linked securitisation. Insurance-linked securities are structured products that allow the ceding of insurance-related risks into capital markets. Since this type of securitisation differs from bank securitisation – the underlying risks being associated with non-financial events – it contributes to risk sharing and cost reduction.

Insurers also press for better information disclosure about complex products. Full transparency of underlying risks, including their embedded leverage, appears to be essential.

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Regulation of financial markets

The worldwide debate on new regulatory rules for the financial sector is producing a tremendous flood of arguments, suggestions and proposals: governments are working on improved regulations, financial institutions are intervening, and researchers are arguing. However, very little is being definitely decided and even less is being implemented.

The G20 governments have agreed to come to a conclusion on the reform of the financial system by December 2010. This can be expected to be a difficult path, since national priorities differ widely; however, politicians worldwide are under great pressure from both business communities and the public to establish efficient control mechanisms.

In the autumn of 2009, the US government submitted an extensive financial reform bill, the Wall Street Reform Bill, which intends to reduce systemic risks, improve consumer protection, allow better supervision, and restrict executive compensation – to mention only a few proposals included in the 1,400 page act.

The role of macro-prudential risk assessment

The crisis shows that the identification of risk was not optimal before the crisis. Some of the risks were underestimated and the relationship between the macro and micro level of supervision was missing. Thus there is a need to improve and strengthen macro-prudential supervision (the supervision of systematic risk in the financial system). In particular, on the macro level of prudential supervision, greater ability to detect risks to financial stability is required. When the risks are identified, the European Strategic Risk Council should have the power to recommend policy actions on the micro level.

A macro-prudential perspective is important particularly in three domains of public policy:

- monitoring and assessing risks – for example, the interconnections between financial institutions, sectors and markets, and the interplay between the financial sector and the real economy;
- a framework for prudential regulation, meaning the extension of coverage of regulation to all relevant components of the financial system that address systematic risk;
- a framework for prudential supervision in considering the potential use of prudential tools for addressing systematic risk.

(Interview with Mr Mauro Grande, Director General of the Directorate for General Financial Stability, European Central Bank)

The European Commission also developed legislative proposals, which aim to strengthen financial supervision. The regulations were submitted to the European Parliament in September and October 2009, the Parliament's Economic Committee debating the issue for the first time in May 2010. Moreover, a stricter regulation of hedge funds was adopted by the Council of Ministers and the Economic Committee. Additionally, Germany started to ban unsecured short sales of bank and state securities.

The debates on these proposals are ongoing. The amended US bill, which was submitted in March 2010, was still the subject of energetic lobbying by the US financial industry; however, the Wall Street Reform, passed by the US Senate in May 2010, will now have to be complemented by the proposal of the House of Representatives. The European Parliament received over 100 modification endorsements, and many institutions, such as the European Central Bank, the International Monetary Fund, the OECD and the social partners submitted their suggestions, as well as a great number of other organisations, political parties, and research institutes.

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This section reviews the major proposals by the G20 countries and European social partners, well as some important suggestions arising from research. These proposals address a variety of measures.

- **Set more rigorous banking prudential rules** as they are currently prepared by the Basel Committee, targeting the improved resilience of the financial system with higher equity ratios and risk-weighted validation of capital; in this context a broad discussion about bank resolution regimes took place, including the 'living will' approach, which calls for explicit and obliging resolution plans.
- **Impose taxes or levies** – a so-called 'Tobin Tax' – on capital market transactions, which aims to reduce short-term speculation.
- **Create guarantee funds**, which are served by financial intermediaries in order to prevent future instabilities in the financial system (envisaged by the European Union); the US version is a bank levy by which companies have to redeem, at least in part, the cost of the financial crisis to taxpayers.
- **Restructure the banking business** by separating investment and retail banking and limiting the size of companies in order to avoid 'too-big-to-fail' cases in the future.
- **Improve consumer protection** by extending the accountability of counselling services by financial intermediaries.
- **Reshape compensation schemes** by adding incentives for long-term value creation and supporting corporate social responsibility.
- **Build more efficient supervisory architectures** that resolve the weaknesses of current macro-prudential monitoring and micro-prudential supervision: this includes the regulation and control of derivatives markets and until-now unregulated financial activities such as hedge funds or over-the-counter transactions; in addition, a more rigorous regulation of rating agencies is envisaged.

At their April 2010 meeting in Washington DC, the G20 finance ministers and central bank governors reaffirmed their commitment to a financial reform that at its core must have '... stronger capital standards, complemented by clear incentives to mitigate excessive risk-taking practices'. By the end of 2010, internationally agreed rules will be developed to improve both the quantity and quality of bank capital and to discourage excessive leverage. The rules will be phased in by the end of 2012, and will address the improvement of financial and economic conditions (G20, 2010, p. 1).

The consensus on the principal aims underlines the needs for international cooperation, deemed essential on all sides. This however cannot hide the fact that governments have fundamental differences regarding the measures to be taken and their implementation. Conflict arises about who is responsible for the crisis and who is affected by its reform. The following section therefore presents the approaches to financial reform taken by different governments and institutions rather than analysing the appropriateness and expected efficacy of the measures listed above.

United States

'The failures that led to this crisis require bold action,' wrote Chris Dodd, Chairman of the Committee on Banking, Housing, and Urban Affairs in his summary of the US financial reform bill in May 2010. The bill aims to 'create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street, end 'too big to fail', [and] prevent another financial crisis'

(Dodd, 2010). The 'Wall Street Reform and Consumer Protection Act of 2009', as the bill is titled, implies a fundamental change in capital market regulation and supervision. It contains a long list of measures (US Congress, 2010).

- **Consumer protection** The independent Consumer Financial Protection Bureau will have the task of protecting consumers from unfair, deceptive and abusive financial products and ensuring that people receive clear information. The bureau will be authorised to examine and enforce regulations for banks and credit unions with assets of over USD 10 billion (€7.7 billion), mortgage-related business and non-bank financial companies.
- **Risk monitoring** The Financial Stability Oversight Council, which consists of federal financial regulators and independent members, will have to identify and respond to emerging risks in the financial system, and make recommendations to the Federal Reserve for rules for capital, leverage, liquidity, risk management and other requirements. The Council will be authorised to require systemic non-bank financial companies to be regulated by the Federal Reserve.
- **Restructuring financial companies** This is to be done by applying the 'Volcker rule', meaning that regulators will be able to implement regulations for banks prohibiting proprietary trading and relationships with and sponsorship of hedge funds and private equity funds. Non-banking institutions will be subject to similar restrictions.
- **Living wills** Large, complex companies will have to periodically submit plans for their rapid and orderly shutdowns. Companies that fail to submit such plans will be hit with higher capital requirements and restrictions on growth and activity. An orderly liquidation mechanism for systemically significant financial companies will be created. Shareholders and unsecured creditors will bear losses and management will be removed.
- **Transparency and accountability for derivatives** Over-the-counter derivatives will be regulated, derivatives will be traded on central clearing and exchange platforms, swap dealers and major swap participants will be subject to capital requirements, and market transparency will be improved. Hedge funds will be registered and monitored more closely. Securitised products will have to be backed by emitters with a minimum 5% credit risk.
- **Rating agencies** The Office of Credit Ratings at the Securities and Exchange Commission (SEC) will examine Nationally Recognised Statistical Ratings Organisations at least once a year and make key findings public. Rating agencies will be obliged to disclose their methodologies. Investors will have a right of action against rating agencies. Ratings analysts are required to pass qualifying exams and have continuing education.
- **Executive compensation and corporate governance** Shareholders are to be given a say on executive pay and the nomination of directors.

The extensive bill is a first benchmark for financial reforms. It focuses on supervising and restructuring financial industries rather than intervening in capital markets by means of regulation or taxes. The reform has been amended by the bank levy of USD 117 billion (€90 billion) by which the financial industry is expected to repay parts of the damages caused by the financial crisis. The parliamentary debate on the bill was at its peak in May 2010, as the Obama government needed the support of the US Senate (which is governed by a majority of Republicans, the opposition party to Obama's Democratic Party). Despite intensive lobbying against the bill by the US financial industry, strong support for the reform came from the public. The Financial Times wrote: '... there will be limited opportunities for changes, partly because of an anti Wall Street mood that makes it difficult for even sympathetic politicians to come out with measures that favour the banks' (Financial Times 2010a). And indeed, the US Senate approved the bill on 20 May 2010 with a majority of 59 to 39 votes.

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European Union

In Europe, the financial crisis has transformed into a sovereign debt crisis. Greece, for instance, needed a comprehensive support programme in order to avoid insolvency and debt conversion. Together with the IMF, a €110 billion credit line has been allocated up until 2012, which had been agreed on the basis of a comprehensive budgetary reform that should result in the reduction of public deficits from 13.6% of GDP to the 3% Maastricht limit by 2014. This includes cutting public salaries, stopping early retirement, increasing rates for value-added tax (VAT) and deregulating labour markets. Immediate protests against this austerity programme indicated that the population was little prepared to accept the major burden of the crisis.

Facing budgetary problems in other Member States and being attacked by international investors on the euro front, the finance ministers of the European Union decided on 9 May 2010 to launch the European financial stabilisation mechanism, with a total of €500 billion, extended by €250 billion from the IMF. Based on Article 122.2 of the Lisbon Treaty, the mechanism provides financial assistance in the form of loans and credits to Member States in difficulty. Spain and Portugal were recommended to further consolidate their public budgets. In addition, the European Central Bank was authorised to buy commercial and state securities.

Figure 7: *Euro exchange rates, May 2009–April 2010*

Note: (May 2009 = 100)
Source: *Bank of International Settlements*

Financial markets reacted with a further downturn of stock prices and the devaluation of the euro (Figure 7), and the German government responded with the partial ban of uncovered short-sales. Moreover, it was decided to go for a financial transaction tax. At the same time, the Economic and Financial Affairs Council (ECOFIN) decided to pass the Alternative Investment Funds Directive, which regulates hedge funds and other non-banking financial intermediaries.

The situation resembles a combat in which the regulatory power of sovereigns is pitted against the financial power of international investors (although both depend on functioning and efficient capital markets). Both have weapons that can weaken the opponent considerably: governments can enforce rigorous legal limitations to financial activities or even close certain markets, while investors can bring financial speculation to bear against countries, up to the point where credit markets dry up.

The Greek crisis revealed the shortcomings of European Monetary Union (EMU): EMU did not fully address the contradictions between a unitary monetary system and sovereign fiscal policies. Apart from the repeated weakening of the Maastricht fiscal principles by countries such as Germany and Italy – and the cheating on budgetary statistics by the Greek government – the weaknesses of some of the real economies became painfully apparent. The poor competitiveness of the Greek and Portuguese economies, the unhealthy expansion of the construction sector in Spain, the inflation of the financial sectors in the UK, Ireland and Lithuania were all unsustainable. As a consequence, serious restructuring is now required, due to the shrinkage of overall growth and need to repair public budgets.

The German government came up with a strategy paper, which addresses the next steps for combating the crisis (Handelsblatt, 2010c). It states that EMU is not prepared for the extreme case of a state insolvency and recommends stringent monitoring of public budgets, mandatory budgetary limits, effective penalties for non-compliant Member States, and orderly resolution systems for public entities.

Based on the suggestion of the High-Level Group on Financial Supervision in the EU (Laroisière, 2009), the EU Commission proposed that economic governance in the European Union be decisively reinforced in order to strengthen the Stability and Growth Pact and extend surveillance to macro-economic imbalances (European Commission, 2010b). The Commission suggested aligning national budget and policy planning and developing a permanent crisis resolution mechanism. It recommended that fiscal discipline be improved by:

- preventive budgetary surveillance and a peer review of broad budgetary guidelines;
- integration of budgetary discipline into national legislation;
- enforcement of the Stability and Growth Pact, giving more attention to the debt criterion;
- suspension of the Cohesion Fund in cases of severe violation of the pact;
- a more rigorous application of the existing suspension clause.

For some observers, this could be the entry point into a better coordination of fiscal and economic policies or even '... the birth of the United States of Europe' (Handelsblatt, 2010d) with an effective European integration mechanism. Others, however, see this as a further shock to the independence of Member States and the end of sovereign fiscal policies. A further debate on the constitution of the European Union has thus been triggered by the financial crisis.

In September 2009, the European Commission adopted legislative proposals to strengthen financial supervision in Europe (European Commission, 2009a). It suggests creating a European Systemic Risk Board (ESRB) to detect macro-prudential risks, and a European System of Financial Supervision (ESFS) to coordinate micro-prudential supervision.

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The ESFS is composed of three new European supervisory authorities for the banking, securities and insurance, and occupational pensions sectors. The new architecture of financial supervision is still in the process of legislation and debate continues about how it can be effectively linked to national supervision. Moreover, it is unclear which instruments can be applied to assess macro-prudential risks. Hence, there is still a long way to go until a European system of financial supervision will be in place.

Coordination at G20 level

At several summits since autumn 2008, the G20 group has focused on the need for a globally coordinated response to the financial crisis. While the G20 countries have agreed to develop international rules before the end of 2010, only the principles of financial reforms have been visible until now.

- **Banking prudential rules** aim to improve the quality and quantity of bank capital and to avoid excessive leverage. Additionally, the major G20 financial centres have committed themselves to adopting the Basel II rules on banking prudential requirements by 2011 in order to avoid regulatory arbitrage.
- **Compensation systems** A comprehensive agreement facilitated by the Financial Stability Board (FSB) with a focus on long-term value creation was agreed. Detailed implementation standards were developed regarding the pay structure, corporate governance arrangements and revised disclosure on remuneration policies. The monitoring of implementation by all financial organisations is crucial.
- **Derivatives markets** All standardised over-the-counter derivative contracts should be cleared through central counterparties by the end of 2012 at the latest. Trade transactions should be reported to trade repositories and non-centrally cleared contracts should be subject to additional capital requirements. Increased transparency of derivatives markets and different trading centres are also important.
- **Contingency and resolution plans** Systemically important financial institutions should develop these. Crisis management groups will be needed for crisis intervention and to improve the sharing of information in times of stress.

At the G20 summit 2009 in London, progress regarding the previous summit was evaluated and further measures were agreed to strengthen financial supervision and regulation, as well as global financial institutions. These comprise:

- establishing a new Financial Stability Board (FSB) with a strengthened mandate; the FSB should collaborate with the IMF to provide an early warning system for financial and macroeconomic risks;
- extending regulation and oversight of all systemically important financial institutions, instruments and markets – in particular, systemically important hedge funds;
- reshaping regulatory systems to improve the identification of macro-prudential risks;
- implementing new principles on pay and compensation and strengthening sustainable compensation schemes and the corporate social responsibility of all firms;
- setting in place regulations on excessive leverage and liquidity buffers to guarantee the quality, quantity, and international consistency of capital in the banking system;
- tightening regulation for credit rating agencies to prevent conflicts of interest;
- taking action against non-cooperative jurisdictions, including tax havens;

- Injecting an additional USD 1 trillion into the global economy in order to strengthen important emerging markets and developing countries, which have been the engine of recent growth;
- reforming international financial institutions, such as the IMF, to allow emerging and developing countries to have a greater influence.

While governments came up with different proposals at the Toronto summit in June 2010, the US government passed its financial reform act. This can be expected to greatly influence the results of further summits. The scope for national diversity appears to be limited, particularly regarding those elements of the reform which address systemic risks on one hand and the competitiveness of financial industries on the other. The likelihood of a Tobin tax seems to be low.

IMF proposal

The IMF proposed a regulatory reform in its *Global Financial Stability Report* from April 2010 (IMF, 2010b, p. xii). Features of the reform include:

- more and better capital, improvements in liquidity management and a restriction of build-up in leverage in order to make the financial system safer;
- handling the too-big-to-fail problem with a combination of ex-ante preventive measures and ex-post resolution mechanisms, particularly as some of the institutions have become bigger and more dominant since the crisis;
- capital charges on the basis of an institution's contribution to systemic risk, which are able to compensate the externalities that they impose on the system as a whole;
- additional tools for regulators to monitor systemic risks – in particular, systemic risk-based capital surcharges, levies on institutions, or even the power to limit the size of certain activities;
- clearing of OTC derivatives by central counterparties (CPPs).

According to the IMF, the future regulatory reform agenda is still a work in progress, but there is a pressing need to move forward soon: 'The window of opportunity for dealing with too-important-to-fail institutions may be closing and should not be squandered, all the more so because some of these institutions have become bigger and more dominant than before the crisis erupted' (IMF, 2010b, p. xv).

Basel II

The Basel committee has proposed a number of global reforms, which are part of the G20 process. These comprise:

- tighter rules for core tier-one capital and rising minimum ratios of tier-one capital to risk-weighted assets;
- increasing capital requirements for trading books;
- new leverage ratios, which would cap the size of a bank's overall assets relative to its tier-one capital;
- two liquidity rules: (1) sufficient easy-to-sell assets to survive 30 days of market chaos; (2) a 'net stable funding ratio', which requires each bank to keep a minimum level of long-term funding relative to its assets;
- counter-cyclical capital buffers, which would increase capital requirements at the height of a boom and limit a bank's abilities to pay dividends and bonuses if its capital ratios become too low.

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Basel II – the new Basel Framework for the International Convergence of Capital Measurement and Capital Standards – comprises international legislation on banking laws and regulations issued by the Basel Committee on Banking Supervision. It had to be implemented by all EU Member States by 1 January 2007 and was targeted at improving the stability and soundness of the financial system. Therefore, the framework focuses on stronger risk-orientation regarding the banks' capital requirements and on the consideration of recent innovations in financial markets as well as the institutions' risk management.

Basel II comprises three pillars. Pillar II and III are new components compared to the former Basel I accord.

- Pillar 1 defines the minimum capital requirements, including capital requirements for credit risk, operational risk and market risk. Several risk measurement methods exists (basic, standardised approaches or more risk-sensitive approaches based on internal methods of banks) in order to determine the capital requirements for these three risk areas.
- Pillar 2 includes the supervisory review process (SRP) and thus comprises qualitative requirements regarding the identification of the institutions' overall risk and the main influences on its risk situation. These qualitative elements should be evaluated from a supervisory perspective.
- Pillar 3 ensures market discipline and comprises enhanced disclosure requirements for the institutions.

Outlook for European financial regulations

In Professor Goodhard's view the Basel Committee, the Financial Stability Board, and the European Systemic Risk Board will introduce new regulations on capital and liquidity until autumn 2011. However, it will take between four and five years for the measures to come fully into effect. Legal changes in the solvency resolution will probably take nearly 10 years. Implementing restrictions on derivative markets is difficult, since it is hard to work out the purpose of any transaction and to distinguish between speculation and hedging. There might however be movement in the following areas:

- demand for better transparency: the reporting of all transactions with an OCG or through a centralised counter party; summaries and data analysis will support the regulator in understanding the concentration of risks;
- standardisation of large volume deals, interest swaps and credit default swaps.

(Interview with Professor Charles Goodhart, Professor of Banking and Finance at London School of Economics)

Basel II mainly addresses large, internationally active banks. Nevertheless, the basic framework can also be applied to institutions at varying levels of business activities and complexity. According to the Basel Committee, the expected effects of the rules are far reaching (BIS, 2009). The 'quality, consistency, and transparency of the capital base will be raised. This will ensure that large, internationally active banks are in a better position to absorb losses on both a going concern and a gone concern basis.' Under the current Basel Committee standard, banks can hold as little as 2% common equity to risk-based assets before key regulatory adjustments are applied. Also, the risk coverage of the capital framework will be strengthened and leverage ratios constrained. This will help to avoid the build-up of excessive leverage in the banking system and introduce additional safeguards. The counter-cyclical capital framework will contribute to a more stable banking system, which will help to dampen, rather than amplify, economic and financial shocks. A series of measures will promote the build-up of capital buffers in good times, which can be drawn upon in periods of stress. Short and long-term liquidity standards will be improved.

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In the new context of the financial crisis, the committee is now preparing what is called Basel III, a regulatory scheme that develops the first and second pillars.

Solvency II

Solvency II is a European reform of risk management in the insurance business. The reform implements a risk-based capital system, which replaces the existing solvency margin approach (Solvency I). 'The solvency margin is the amount of regulatory capital that an insurance undertaking is obliged to hold against unforeseen events.' (European Commission, 2009b). During Solvency I the need for a more fundamental review of overall financial positions of an insurance undertaking became visible, in particular 'taking into account current developments in insurance, risk management, finance techniques, international financial reporting and prudential standards, etc.' (European Commission, 2009b).

Solvency II adopts the three-pillar approach, as was established for the banking sector in Basel II.

- Pillar 1 covers quantitative requirements, while two capital requirements can be distinguished: the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR). The SCR is a risk-based requirement and the key solvency control level. It can be calculated according to the European Standard Formula or the firms' own internal models. The SCR covers all quantifiable risks that confront an insurer or reinsurer. The MCR represents different levels of supervisory intervention. When a firm infringes the MCR, authorisation can be withdrawn.
- Pillar 2 covers non-quantitative or qualitative requirements – for example, governance, risk management or supervisory activities. Capital levels are associated with compliance with these requirements.
- Pillar 3 maintains supervisory reporting and disclosure. In order to ensure market discipline and the stability of insurers and reinsurers, firms will need to disclose certain information publicly. Firms are required to report a greater amount of information to their supervisors.

At the time of writing, discussions are taking place regarding the application of Solvency II: private companies argue that the capital requirements are too high for a long-term business such as insurance, and the mutual companies are fighting against a system that will force them into a capitalistic business model. The fifth quantitative impact study carried out by the European Commission (QIS5) is expected in April 2011.

European social partners

Employer organisations and trade unions in the financial services industry submitted proposals for the reform of European financial markets. They all agreed on the need for more transparency and proper supervision, a stronger customer orientation of services, higher regulatory standards, the revision of payment schemes, and a sustainable banking system. However, different issues arise in their statements.

The European Banking Federation (EBF) is concerned about size prescriptions suggested by the US government and the regulation of leverage ratios. It maintains that banking should remain open and flexible, and governments should retreat from the business as soon as possible. In its paper *Principles for a successful future of banking in Europe*, the EBF describes the principles it has adopted (EBF, 2009).

- **Banking in an open market** The EBF insists on the need to continue with the open single European market: 'It is essential to avoid a return to the days of financial markets fragmented along national lines. The EU's single market is a great achievement and one which must be maintained.'

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- **Properly supervised banking** ‘The European banking industry is witnessing a shift towards more intrusive and intensive supervision.’
- **Truly commercial banking** ’…public intervention needs to be withdrawn as soon as possible.’
- **Banking without size prescription** The EBF is concerned about the US President’s proposals to limit bank size.
- **Diverse banking models** The multi-faceted banking system consisting of private, public and cooperative banks should be preserved.
- **Customer-oriented banking** Notably in the field of credit intermediaries and information to consumers, banking should become more customer oriented.
- **Robust banking** ‘The banking business is highly sensitive to changes in capital requirements.’
- **Sustainable banking** ‘Banks must improve risk management, align remuneration and compensation schemes with long-term value creation, and gear incentive structures more strongly to customers’ wishes and the long-term corporate interest.’
- **Adaptable banking** Strategies have to be able to adapt products according to changes and demand.

The European Association of Cooperative Banks (EACB) stresses that ‘cooperative banks have demonstrated throughout the recent turmoil that they are a stable and resilient driving force for local European economies. They are, however, at risk of being widely impacted by the new EU and international regulatory framework’ (EACB, 2010a).

> *Careful consideration should particularly be given to the specific characteristics of the shares of cooperative banks, whether it will be in the context of reviewing the definition of capital, IFRS (accounting), prudential banking supervision or corporate governance measures. While the association fully endorses the principles of the Basel Committee, many questions regarding the specific role of cooperative banks are still open. Moreover, there are serious doubts that combined effects and correlations of the proposals can be properly assessed (EACB, 2010a).*

The World Savings Bank Institute and the European Savings Banks Group (WSBI-ESBG) also welcomes the Basel Committee’s proposal, but has ‘... serious concerns as regards the pace and volume of the envisaged regulatory changes: There is a high degree of uncertainty in the financial markets given the unpredictable outcome of the regulatory reforms’ and the unprecedented speed with which the new measures are devised and adopted. In addition, the ESBG highlights concerns regarding the ‘quality of the regulatory output’. It goes on to say that ‘There is a real risk of moving towards over-regulation […] The large amount of regulatory reform … puts a heavy burden on the retail banking sector, which was the most resilient during the crisis’ (WSBI-ESBG, 2010)

According to ESBG, retail banks may find it more difficult to mitigate the impact of certain parts of the reform proposal, given that their business model implies long-term commitments and a focus on financing the real economy which needs a certain amount of stability. ESBG also expresses the opinion that in many cases savings banks have proved their sustainability and soundness throughout the crisis. This often has been – at least partially – the merit of their organisation and stakeholder representation.

ESBG underlines that it does not agree with the comparison of savings banks to ‘quasi public banks’. The legal form of savings banks varies greatly – many are actually of a private legal nature - and they generally are not linked or controlled by public authorities. The ESBG also pointed out that the term ‘public banks’ (banks where the state is the main owner) should not be mixed up with the term of ‘banks supported by state aid measures’.

UNI Europa Finance (the global union for the banking and insurance industries) emphasises the need for strict control over all financial markets, the protection of pensions and life assurance, the restriction of tax exemptions and tax havens, and codetermination in company takeovers. In its paper *For a responsible and sustainable finance industry*, the union calls for principal restructuring. Its model for reform of the financial system contains four key elements (UNI Europa Finance, 2009).

- **A new business model that is customer-oriented and risk conscious** internal operating procedures and practices should be transparent; a structured dialogue with supervisors should be put into place; charters for the responsible sale of financial products should be developed.
- **Financial regulation** A comprehensive framework of financial regulation should cover all financial products and players; diversity of the finance industry should be maintained; commercial and retail operations should be separated.
- **Restructuring and bail-outs** State aid should be provided in normal market terms so that any losses are borne by shareholders and investors; it should be neutral regarding the competitive position of recipients and respect core labour standards; unions should be involved in both the restructuring and bail-out plans at sector and company level; lay-offs should be avoided and collective agreements respected.
- **Remuneration** Systems should be realistic, fair, sustainable, long-term and customer-oriented, and should not be based on increasing short-term revenues; variable pay schemes should be kept at reasonable levels, based on several years' results and should include claw-back provisions; the primacy of collective agreements must be respected.

In order to ensure that the business model, internal operation procedures and actual practice in finance companies promote rather than hinder regulatory objectives, excellent customer services, not least in terms of remuneration, incentive systems, skills development and working conditions are necessary. To this end, regulatory and supervisory approaches for the finance industry as well as internal risk assessment in finance companies also need to be adapted accordingly.

Research proposals

There is an expectation among research institutes that the creation of a new regulatory framework will be a difficult and long-lasting endeavour. New regulatory procedures will have to be designed and tested. New institutions will have to be established. Practical experience will have to be collected. Public supervisors will have to change their approach towards assessments of prospective risk rather than policing conformity with existing rules. In particular, a macro-prudential approach will have to be developed, one that includes all systemic components (financial institutions, markets, products), and addresses their macro-links. The reforms should be targeted at reducing the implicit guarantees provided by public budgets and limiting pro-cyclical incentives to market participants. Systemic risks are understood as external effects, which – in a manner analogous to environmental pollution – should be internalised (Sachverständigenrat, 2009).

Among the great number of reform proposals, three major directions can be identified:

- restructuring financial institutions in terms of size, specialisation or trade volumes;
- enforcing stronger market competition – the 'living will' concept;
- implementing stricter equity rules and price regulation – leverage ratios and a European financial stability fund.

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Restructuring financial institutions

The reforms outlined above are targeted at limiting the scope and/or size of financial institutions. With the recent decision to follow the 'Volcker' rule, the US government did both:

> *'Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers. If financial firms want to trade for profit, this firm should not be allowed to run these hedge funds and private equities funds while running a bank backed by the American people'* (statement by US President Barack Obama, 21 January 2010).

In addition, the President submitted a proposal to limit the consolidation of the financial sector. The proposal places broader limits on the excessive growth of the market share of liabilities at the largest financial firms to supplement existing caps on the market share of deposits.

Other proposals include reducing the cluster risks in the financial system by limiting interbank credits or other financial transactions. This approach is also applied by the European Commission.

Enforcing stronger market competition – the 'living will' concept

The idea of the 'living will' approach is to raise competitive pressure in the banking sector by establishing a structured and supervised procedure for market exit. The main instrument is the 'living will', in which a bank declares its contingency plan. Public supervision will not only approve this plan but will manage the procedures in such an event. This approach is preferred by the UK government and forms part of the US Wall Street Reform Bill.

The approach aims to reduce the implicit state guarantee by forcing banks to avoid insolvency and to confirm that public resources will not be made available. The risk of consequential bankruptcy will create greater incentives for risk aversion among managers, shareholders and clients.

The 'living will' approach

'Freedom of exit' is a new approach to dealing with systemic banks. Financial institutions have to explain what will happen in the case of insolvency. Thus, failing financial institutions will be subject to a structured insolvency procedure rather than state guarantees. Deposit insurance (or state guarantees) should be lowered and remain restricted to financial institutions with a strong sense of social responsibilities. Clients will become more aware of financial risks, become more selective, and demand higher interest rates, which are related to risk levels. Without state guarantees, banks will have to raise equity provisions in order to attract clients. This will limit profits and reduce the incentives to become bigger.

It will be important to separate regulators from consumer protection because consumer protection tends to safeguard deposits, while regulators tend to seek to sustain the functioning of the financial system.

(Interview with Professor Geoffrey Wood, Professor of Economics at Cass Business School, UK)

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Implementing stricter equity rules and price regulation

The approach of the Basel Committee aims to internalise the costs of risk. Higher equity ratios for higher risks, and controlled leverage ratios are the main instruments. This is the main approach of the Basel Committee, which targets a precise correspondence between risk taken and capital requirements.

Another approach is the European Financial Stability Fund as suggested for example by the German 'Sachverständigenrat' (2009). This proposal builds upon a sector-based rescue fund for vulnerable banks which is funded by the financial institutions. This means that the private financial sector will have to take care of future risks.

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Micro-level reaction to the crisis

The reactions of financial intermediaries to the financial crisis are multifaceted. As the following section will show, there are three principle types of adaptations.

The first group of institutions came under state control during the crisis and now faces severe restructuring. This includes both the reaction to substantial losses in trading books and the reorientation of business strategies towards the core business. The restructuring process is strongly determined by public supervision, which is still providing the necessary guarantees in order to stabilise financial systems.

The second group of banks draws high profits from trading books and its engagement in derivatives markets. It undertakes the necessary adaptation of business operations under the new market conditions, but nevertheless tries to continue its previous strategy, arguing for only minor changes in the regulatory framework. This group takes advantage of the huge liquidity that has been made available since 2009 by the low-interest policies of central banks.

The third group was less affected by the financial crisis because it was not engaged in new financial markets as much as the other two. It consists of savings and mutual banks, which in the past concentrated on retail banking. The disadvantage of being less profitable than other banks turned out to be an advantage, which this group is now actively using to expand market share. This group includes banks in Spain and the NMS, which were not allowed to engage in new financial markets due to legal restrictions. Most of the insurance business can be counted as part of this group, since it traditionally followed a conservative investment approach.

This classification of adaptations to the financial crisis coincides with the principle reactions developed under the earlier skills scenario project (Economix/DKRC 2009). The first group was described under the ‘State ownership’ scenario, in which the banking business is projected to become strongly state-controlled. The second group follows the ‘Laissez faire’ scenario, which assumes the continuation of previous business models with only minor state intervention. The third group behaves according to what the study calls the ‘Sustainable finance’ scenario, a business model that emphasises long-term profitability based on consumer trust and well-defined customer services. The following section is going to scrutinise the different adaptation models in the banking and insurance business based on the evidence collected from the case studies. The results of the expert interviews are also included. Most recent company information was collected from selected companies that are big players in financial markets. This reflects updated developments at the micro level in the financial centres of the European Union, including the NMS.

Common perceptions of market trends

Before analysing the restructuring characteristics of the different financial sector segments, a short view on common trends is provided. In a European perspective, there are four issues on which all financial intermediaries share similar views:

- a decline in rates of profit;
- the need for regulatory reform;
- reform of bonus systems;
- the advantages of universal banks.

Decline in rates of profit

There is a general expectation that profit rates in financial markets will decline. Higher equity ratios will be demanded by financial regulation, risk controllers will curb investments in risky but profitable markets, consumers will invest in less risky products, and companies will withdraw from parts of investment banking. A profit rate reduction of 20% to 25% is expected for asset management. This will bring financial services closer to the average profit rates of other industries, and will have consequences for work organisation and sector restructuring.

IBM – services in the financial sector

Risk management has always been important for banks, even before the crisis. The current trend is more about optimising risk management in order to use it as a basis for decision making. Existing instruments should be linked and used in a more efficient way. IBM is aware of the importance of risk management and offers a wide range of services in the area of business analytics and business intelligence. In this area, IBM purchased Cognos, ILOG and SPSS. These software products suit the current topics in the market, as the problem is not the lack of information, it is more about the analysis of information. The goal is that the analysed information contributes to decision-making.

Back-office activity is still a segment where banks can reduce their costs, as some banks still have old applications. Then the question has to be considered of whether it is efficient to maintain and advance the old system, or if it is better to switch to standard applications and products to optimise the back-office area. Optimising the back-office business entails a relatively low level of investment, but can free up employees who can be used for innovation and product development.

There will be new challenges for banks regarding financial regulations. Banks will need to adapt in a short period of time and two kinds of projects can be expected by IBM: consulting projects, to clarify how the requirements can be fulfilled, and adaptation projects (such as new applications) to ensure the required level of reporting.

(Interview with Mr Eckhard Bilitewski, Head of Financial Services – Industry Business Development, IBM Deutschland GmbH)

The need for regulatory reforms

Actors in financial markets are expecting substantial changes in the regulatory framework. They are very much aware that the bail-out by public budgets was an extraordinary action by governments, one that will have consequences. Policy actors are under pressure from both the public and the commercial world to achieve control of financial markets. A second financial crisis will have to be avoided. As former US Secretary of Labour, Robert Reich wrote: ‘Over the long term, the political stakes in reforming Wall Street are as high as the economic’ (Financial Times, 2010b). Under these conditions, the financial world is expecting reforms; however, only a limited consensus exists on what has to be done.

Reforming bonus systems

The financial sector is also aware that the public is unhappy about the level of bonus payments paid to investment bankers and management in a time of substantial losses. As the section on ‘Evidence from case studies’ will show, there is a range of initiatives underway in the sector; opinion differs regarding the usefulness and the structure of bonus payment reforms.

The advantages of universal banks

European banks applied the universal banking system in the past and are keen to safeguard this approach. The main arguments put forward to support it are that universal banking opens up better opportunities for risk distribution, implies improved transformation of capital flows, and gives access to more than one market. This allows risk transformation and avoids dependencies on single markets.

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The approach is particularly prominent in Germany, where big universal banks provide retail-banking services, commercial banking, capital-market banking, and asset management. For businesses, 'merchant banks' provide all financial services to companies, including foreign-trade finance, foreign-exchange transactions, and cash management.

However, this approach does not exploit the economies of scale that result from specialisation. It also does not clearly separate risks as was required by the Glass Steagall Act in the United States up until 1999 – and has now been suggested again by the 'Volcker' rule. With these benefits in mind, therefore, the Anglo-Saxon financial institutions implemented a much clearer separation of retail banking and investment banking and other parts of financial services.

'State-ownership' approach

Over the course of the crisis, a number of banks had to take advantage of state guarantees and public capital support. In Europe, for example, Royal Bank of Scotland (RBS), Lloyds, Dexia, Commerzbank and Bayern LB needed support, as did their US peers Citigroup, Bank of America and JP Morgan. These financial institutions suffered from the devaluation of financial investments during the crisis either because they were heavily engaged in this business or because they were among those that could not exit the markets early enough.

In contrast to the USA, only a few of the European banks under state control have been able to repay government funds at the time of writing. The consequence of this is that the restructuring process in these companies is now governed by public authorities, whose priority is to maintain their investment and safeguard customers' deposits. Companies therefore have had to change their business model to a 'back to basics' approach (as ING Group expressed it). All peripheral activities are for sale, not least in order to ensure that public investors be refunded. Thus, cost efficiency is important and employment losses are high. This means that these companies are presently losing market share and their competitive position is deteriorating. The end of the restructuring process and its outcome is not yet visible, since these institutions were all in a perilous situation.

Affected banks have revised their strategies, the majority switching to a less risky long-term orientation. Remuneration policies have been adapted with a focus on long-term success. In addition, many general board members have seen their salaries being reduced, for as long as the banks are relying on governmental support. Risk assessment has become more important and the tools have been improved. However, whether these changes are sufficient to create sustainable financial institutions will have to be monitored in the coming years.

After Dexia Bank Belgium needed capital injections and state guarantees due to serious financial challenges in 2008, a stringent plan to transform its business and to cut costs was implemented (Juravle et al, 2010). In particular, the bank improved its risk profile by disposing of loss-making business segments, refocusing on its principal clients (in particular public and wholesale clients) and core markets and announcing an intended reduction of the cost base by 15% (€600 million) by 2011. This is to be achieved by withholding management bonuses, withholding dividends to shareholders for 2008 and cutting 800 jobs. The job reduction is to be achieved by recruitment freezes, internal flexicurity measures (retraining or functional and geographical mobility) and early retirement measures.

For this case study, three representatives were selected: RBS, the bank in Europe with the highest level of governmental support; Commerzbank, the second largest credit institution in Germany; and Fortis, which was a large financial service provider for insurance, banking and investment management before it encountered severe problems in 2008. Most of Fortis had to be sold off, leaving only the company's insurance activities. Fortis was included in the 'state-ownership' approach case study to show how it was split up after the crisis and to include an insurance company in the analysis.

Response to the crisis

All three companies relied on governmental support to weather the crisis. The UK government became the majority shareholder at RBS, with a stake of 84%. Altogether, RBS received €50 billion in governmental support. This was necessary due to severe losses in 2008 (of GBP 7.1 billion or €8.2 billion) partly the result of RBS' takeover of the Dutch bank ABM Amro. RBS was forced to make a number of divestments as part of the settlement with the European Commission in respect of the state aid received. It is paying about GBP 2.5 billion (€3.1 billion as at July 2010) to the Government Asset Protection Scheme – an insurance scheme designed to help banks with bad loans – until 2011.

Table 4: 'State ownership' approach companies

Financial institution (source)	Economic performance 2009	Income structure 2009	Business model
Royal Bank of Scotland UK	Pre-tax operating result: €2.2 billion Tier 1 capital ratio: 14.4% Leverage ratio: 17x Employment total: 183,700 Employment change 2008–2009: -8%	Percentage of total income 2009: UK Retail (17.8%), UK Corporate (8.7%), Wealth (4.0%), Global Banking & Markets (39.6%), Global Transaction Services (9.0%), Ulster Bank (3.7%), US Retail & Commercial (9.8%), RBS Insurance (15.7%) and Non-Core Division & APS (-8.3%)	Target: to become one of the world's premier financial institutions, anchored in the UK but serving institutional customers in the UK and globally Operation: focus on retail and corporate banking in UK, US and Ireland (through its subsidiary Ulster Bank)
Commerzbank Germany	Pre-tax result: €-4.7 billion Tier 1 capital ratio: 12.6% Leverage ratio: 24x Employment total: 62,671 Employment change 2008–2009: -9.7%	Percentage of revenues 2009: Private Customers (59.9%) Mittelstandsbank (28.5%) Central & Eastern Europe (1.7%) Corporates & Markets (23.2%) Asset Based Finance (-2.57%) Portfolio Restructuring Unit (-19.6%) Others and Consolidation (8.9%)	Target: to reinforce its position as market leader in German private and corporate customer banking Operation: one of the leading banks for private and corporate customers in Germany
Fortis (remaining insurance part, today named Ageas) Belgium/Netherlands	Pre-tax profit: €1.6 billion Employment total: 10,613 Employment change 2008–2009: +2.3%	Percentage of net profit 2009: AG Insurance (73.9%) Fortis Insurance International (18.2%) General account (7.9%)	Target: international insurance company with strong partnerships in Europe and Asia Operation: leader in the Belgian market for individual life and employee benefits and leading non-life player through AG Insurance. Internationally, strong presence in the UK and other subsidiaries in France, Germany, Turkey, Ukraine and Hong Kong
BNP Paribas Fortis (also called Fortis Bank) Belgium	Pre-tax loss: €1.8 billion Tier 1 capital ratio: 12.3% Employment total: 35,000 Employment change 2008–2009: -5.4%	Percentage of total income 2009: Retail banking (40.8%) Asset Management (8.3%) Private Banking (5.2%) Merchant Banking (47.8%) Other Banking (- 1.6%)	Target: to become the reference bank in Belgium for all its clients Operation: make use of its core activities: Retail & Private Banking, Corporate & Public Banking, Corporate & Investment Banking and Investment Solutions

Note: The percentage of the net profit of Fortis excludes the net profits gained from the sale of a 25% plus one share of AG Insurance to Fortis Bank (€697 million) in May 2009.
Source: *Company information*

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Commerzbank experienced a severe pre-tax loss of €4.66 billion in 2009 and €5.45 billion in 2008 (on a pro forma basis assuming that Dresdner Bank was already part of Commerzbank Group in 2008). The company's results were heavily burdened by the takeover of Dresdner Bank, the third biggest bank in Germany. Due to the difficulties faced in 2008, Commerzbank's equity was strengthened by the German Financial Market Stabilisation Fund (SoFFin) in January 2009. Altogether, the governmental support came to €18 billion (of which €8.2 billion was silent participation). The German Federal Government with a 25% plus one share is now the major shareholder in the new Commerzbank.

Due to the financial crisis, Fortis ran into trouble in the second half of 2008. Fortis was affected by a continuously and rapidly decreasing share price. Fortis's interbank market access was affected by alarmist rumours and it had to struggle with substantial liquidity requirements. As a consequence, the Belgian government invested €4.7 billion, the Dutch government invested €4.9 billion and the Luxembourg government invested €2.5 billion in Fortis Bank in September 2008. In the following months Fortis was split up; 50% plus one share of Fortis Bank was sold to the Belgian state, which agreed to transfer 75% of Fortis Bank to BNP Paribas; the insurance business remained with the original Fortis organisation (today called Ageas) and the remaining parts were sold to the Dutch state.

The crisis enforced substantial writedowns on assets. At RBS, impairment losses increased to GBP 13.9 bn (€16.1 billion) in 2009 from GBP 7.4 billion (€8.6 billion) in 2008. Fortis Bank (or BNP Paribas Fortis) had impairment losses of €340 million in 2009. At Commerzbank, provisions for possible loan losses of €4,214 million in 2009 and €3,553 million in the previous year were made. RBS and Commerzbank reacted to the financial crisis with strong deleveraging. The volume of total assets decreased by 31% at RBS and 19% at Commerzbank (on a pro forma basis). At Fortis Bank (BNP Paribas Fortis), the volume of total assets was reduced by 26% while the insurance company Fortis experienced a slight increase of 0.4%. Risk-weighted leverage ratios at the banks have been reduced substantially and accordingly.

The two affected banks both introduced new strategies: at Commerzbank, 'Roadmap 2012' and at RBS, 'Roadmap to Recovery'. Both aim to reduce risks, increase profitability and focus on core businesses and private and corporate customer banking. In addition, both banks introduced a new non-core division – called the Portfolio Restructuring Unit at Commerzbank – where toxic assets are wound down and non-core assets can be run off.

Business models

The business models of the two banks are characterised mainly by their new strategies, which now emphasise the focus on long-term success with fewer risks. In previous years expansion was important, which was reflected in Commerzbank's takeover of Dresdner Bank and RBS' takeover of ABN Amro's investment banking division. Today, tight risk assessment, cost efficiency and a return to profitability within the next few years are the most important targets.

Both banks rely mainly on retail and commercial banking and plan to expand their profits in this segment. RBS has the strategic goal that retail and commercial banking in the UK, the US and Ireland should contribute two thirds of the profits, and the Global Banking & Markets (GBM) division (including investment banking) should contribute one third. In 2009, retail and commercial banking in the UK, the US and Ireland contributed to 40% of total income and GBM contributed the same proportion. The rest came from the Wealth, RBS Insurance and Global Transaction Services divisions, while the non-core division operated at a loss.

At Commerzbank, the Private Customers division is the core element and contributed 60% to revenues in 2009. The second largest division is the Mittelstandsbank division (28%), which serves small and medium-sized enterprises. Commerzbank's strategy document 'Roadmap 2012' outlines its plans to reinforce its position as market leader in German private and corporate customer banking. It is focusing on being a profitable core bank made up of the Private Customers, Mittelstandsbank, Corporates & Markets, and Central and Eastern Europe segments.

After the split up of Fortis, the remaining insurance business (Fortis) set up a new strategic plan, which focuses on strong partnerships in Europe and Asia and the streamlining of the company's existing portfolio against strict criteria. At Fortis in 2009, the AG Insurance division contributed the major part (73.9%) of net profits, while the other divisions provided 26.1%.

All three institutions were forced to sell several parts of their business as a consequence of governmental support. Since mid-2009, Commerzbank has sold Privatbank Reuschel & Co, two Swiss subsidiaries, Privatinvest Bank (Austria) its British Wealth Management segment Kleinwort Benson, Dresdner Van Moer Courtens, the Belgian branch of Commerzbank International S.A. Luxembourg, the Dutch Dresdner VPV (Asset management) and Dresdner Bank Monaco S.A.M.

RBS has sold more than 300 UK branches, a commodity trading business, its insurance division and its payments operation, Global Merchant Services.

Employment

The adjustment strategies of all three companies included a significant decline in the number of jobs. At Commerzbank, the number of employees decreased by 9.7% in 2009 compared with 2008, mainly due to the integration of the Dresdner Bank but also due to cost reductions. Around 60% of job reductions in 2009 were in the core segments Private Customers, Mittelstandsbank, Central & Eastern Europe and Corporates & Markets. In addition, a further reduction of 9,000 jobs within the next three years has been agreed. Nevertheless, there will be no enforced redundancies (betiebsbedingte Kündigungen) before the end of 2011.

At RBS the number of employees decreased by 8% in 2009. The number of employees has been reduced every year since 2007. Job cuts were made in several divisions; however, between 2008 and 2009 the cuts were predominantly in investment banking as part of a cost reduction programme. As a consequence of the integration of ABN Amro's investment bank into RBS's global markets division 7,000 jobs cuts were announced in April 2008 (Financial Times, 2008). In April 2009, the bank planned to cut 9,000 jobs worldwide in areas such as technology and call centres, group purchasing and managing group property. As a result 4,500 jobs in the UK have been affected (Financial Times, 2009). In addition, Bloomberg stated in May 2010 that there were plans to cut a further 2,600 jobs in RBS' insurance and consumer banking divisions (Bloomberg, 2010).

In the course of the financial crisis Fortis was split into Fortis (Ageas), BNP Paribas Fortis, with the remaining parts being sold to the Dutch state. Before the crisis, around 62,000 people were employed. Today, around 10,000 full-time employees work at Fortis (Ageas) and 35,000 at BNP Paribas Fortis (Fortis Bank). Between 4,000 and 5,000 jobs were lost due to the inclusion of Fortis Bank Nederland into ABN Amro Holding N.V. (Reuters Deutschland, 2009).

At RBS, job reductions contributed to its profitability. Due to the cost control initiatives across the group including major technology and back office restructuring, the core bank cost/income ratio – the ratio of operating expenses to total earnings, net of claims – improved from 66.2% in 2008 to 53.5% in 2009. In contrast, the cost/income ratio at Commerzbank (before the deduction of loan loss provisions) rose from 77.1% in 2008 to 82.2% in the reporting year.

Remuneration

The two banks adjusted their remuneration schemes by introducing long-term incentives. Bonus payments are deferred over a period of years and equity-based remuneration is a substantial part of total compensation for executives. At Fortis a similar system exists. There, the remuneration of executive committee members is made up of a fixed base salary, a variable annual incentive and a variable long-term incentive.

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At RBS, no discretionary cash bonuses were paid to any employee in 2008; nor were any deferred awards made to executive directors for their performance in 2008. The remuneration of Commerzbank's board of managing directors was severely reduced due to conditions imposed by SoFFin, limiting their earnings to a maximum of €500,000 per year.

At RBS's annual general meeting in 2010, the new long-term incentive plan was approved. As a result, executives can receive a payout equivalent to four times their salary after three years, subject to three conditions: half the award will be based on the achievement of certain profit targets in 2012; one quarter will be based on total shareholder return relative to peers; and the final quarter will depend on the share price of RBS reaching a certain level. All awards are subject to clawback.

At Commerzbank, a new bonus-penalty system was introduced in 2009, which targets an appropriate level of risk-taking, sustainability and transparency. One difference compared to the bank's peers is that three different remuneration models exist for managers, employees on non-collective pay scales, and investment bankers. At management level and for employees on a non-collective pay scale, salaries depend on individual performance as well as on the group's performance; at management level the proportion ranges between 60% to 40%. For investment bankers a part of their variable remuneration is delayed and takes account of both positive and negative performance at group, segment and divisional levels. 'One-third of the total variable remuneration is placed in a bonus bank and its payment depends on future performance' (Commerzbank, 2010, p. 138) This bonus bank aims to foster joint responsibility for results and to avoid inappropriate individual incentives in investment banking. Of the individual variable remuneration, 50% is converted into share awards to be paid after three years, with the other half being paid directly.

Risk management

According to their new strategies, the two banks have made considerable efforts to realign risk management and improve assessment methods. In addition, a new risk management structure is being developed.

At RBS, a new Board Risk Committee has been created. RBS aims to achieve a stable AA category risk profile, by means of de-risking and shrinking the group's balance sheet and limiting the over-reliance on wholesale markets for funding. In particular, risk management has been improved by a new credit approval process, a new risk limits framework that will reduce exposures to high risk countries and an improved reporting programme to increase transparency.

Risk appetite is defined in both quantitative and qualitative terms:

- 'quantitative', which encompasses stress testing, risk concentration, VaR, liquidity and credit-related metrics;
- 'qualitative', which means ensuring that the group applies the correct principles, policies and procedures.

Commerzbank also uses stress tests as early warning indicators. In stress scenarios, all potential losses of each risk type occur simultaneously. In addition, Commerzbank monitors its risk-taking capability by comparing the capital requirement arising from the risk profile against risk cover; a regulatory and economic capital model for analysing the group's capital requirement is used.

At Fortis, risk management is supported by the Audit & Risk Committee, which ensures the adequacy of Fortis' capital. For the company, it is essential to avoid credit risk concentration (any exposure to counterparties with the potential to produce a significant amount of capital loss due to bankruptcy or failure to pay); diversifying portfolios can help avoid this.

Table 5 shows risk-weighted assets and Tier 1 ratios for the selected banks.

Table 5: *'State ownership' approach – risk management (€ billion)*

Year: 2009	Commerzbank	Royal Bank of Scotland
Total assets	844	1,783
Risk-weighted assets	280	513
Core Tier 1 capital	29.5	56.4
Tier 1 capital	-	73.9
Core Tier 1 capital/risk-weighted assets (%)	10.5	11
Tier 1 capital/risk-weighted assets (%)	-	14.4

Source: *Company information, Economix*

Ratings

The positive long-term ratings for RBS (A-1, A, AA-) and Commerzbank (Aa3, A, A+) from the three large rating agencies have improved, thanks to the financial support of governments and the high probability that there would be further support if needed. However, there are also uncertainties about short- and medium-term earnings' prospects due to difficult economic circumstances.

Standard & Poor's sees RBS's diversified global business and its realistic new strategy as strengths, as it does its government support and the use of the Asset Protection Scheme. However, it also judges that RBS experienced reputational damage due to its disastrous takeover of the ABN Amro Bank. (Standard & Poor's 2009a). In December 2009, Fitch Ratings also saw 'substantial challenges faced by the management in achieving its strategic and financial goals the group's heavy reliance on wholesale funding.' (Fitch Ratings, 2009, p.1) Fitch also saw improvements in the group's capital as well as some progress in restructuring the balance sheet. 'Total third-party assets in the non-core division declined by 32% during the nine months to end-September 2009 as assets were run off and written down. However, non-core assets remain substantial and winding down these assets will be a complicated task, taking several years' (Fitch Ratings, 2009, p.1).

Moody's (2009a) changed its rating of Commerzbank's financial strength from 'stable' to 'negative' due to the adverse impact of capital measures on Commerzbank's future profitability. The coupon payments for governmental support received will burden the bank's profitability as well as integration costs of Dresdner Bank and rising risk charges. According to Standard & Poor's, Commerzbank is also confronted with 'challenges in terms of funding capacity and capital requirements for its large wholesale commercial businesses.' (Standard & Poor's, 2009b). The increased Tier 1 ratio is important for Commerzbank's asset quality. However, 'further rising credit charges on the customer bank will, [according to Moody's], not be the only factor exerting pressure on Commerzbank's performance during 2010. An improvement in lending margins will not fully offset the decline in revenues [...] that will result from downsizing total assets.' (Moody's 2009b)

Standard & Poor's sees the following development for Commerzbank's risk management:

> *'Commerzbank has dedicated significant resources to establishing a comprehensive risk-measurement system for its VaR model and economic capital concept. At the same time, however, risk management has become more reliant on statistical risk modelling, which may have contributed to mispricing risk exposures or underestimating concentration risks. The acquisition of a large, weak and capital markets-oriented bank like Dresdner Bank in the middle of severe financial market turmoil also raises some doubts, [according to Standard & Poor's], about Commerzbank's risk appetite, considering the questionable risk-reward trade-off of the transaction.'* (Standard & Poor's, 2009b).

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Outlook

According the rating agencies, the operating environment will continue to be difficult in 2010. The stable outlook given for RBS by Standard & Poor's (2009a) reflects both the expectation that the UK government will remain supportive, and that the stand-alone credit profile has the potential to improve over the medium term. Some progress has been seen in restructuring the balance sheet. However, winding down non-core assets will be a complicated task, taking several years.

Standard & Poor's outlook on the short to medium-term challenges for Commerzbank was negative due to 'the impact of the recession on its loan book, which could still result in more severe losses than currently factored into our ratings' (Standard & Poor's 2009b, p.4). Moreover, the necessary restructuring process for lowering its non-strategic and wholesale-oriented activities and its capital leverage will also remain challenging.

Commerzbank and RBS both believe that losses peaked in 2009 and expect a slight improvement in 2010. They also have ambitious targets regarding their profitability.

RBS plans to generate a sustainable 15% return on equity powered by market-leading businesses in large customer-driven markets. The bank aims to have all main core businesses in leadership positions by 2013. It is also targeting a sustainable growth rate of 5%–10% by 2013. This means that cost control is important as it plans to deliver more than GBP 2.5 billion (€2.9 billion) efficiency savings by 2011. It intends its cost/income ratio, net of claims, to be lower than 50% which would place RBS among the most efficient of its global peers. As mentioned above, retail and commercial banking in the UK, the US and Ireland should contribute two thirds of profits, and Global Banking & Markets should contribute one third.

Commerzbank intends to be operating at a profit again by no later than 2011. From 2012 onwards, it plans to generate an operating profit of more than €4 billion per year, and an after-tax return on equity of approximately 12%. Therefore, risk-weighted assets will be reduced to less than €290 billion by 2012. According to Commerzbank (2010) there are particular targets for single business divisions. The 'rapid integration of Dresdner Bank and rigorous cost management' will further expand the Private Customer division's 'strong market position'. The Mittelstandsbank aims to 'further enhance its position as the leading export financer in the German economy'. Over the medium and long term, economies in Eastern Europe will, according to Commerzbank, experience stronger growth than those in western Europe and in the US. Within the bank's Central and Eastern Europe (CEE) segment, Commerzbank will particularly focus on 'its strong position in Poland'. Corporates & Markets (C&M) will increase client-oriented services for the bank's core target groups. Other business areas will be reduced or discontinued.

Fortis expects 2010 to be a challenging year (Fortis, 2010). According to an article in Handelsblatt (Handelsblatt, 2010e) Fortis holds bonds from Italy, Greece, Portugal and Spain to the value of around €18.1 billion. It emphasises that potential decisions which will be made within the next year will be aligned with long-term goals of the company. In Continental Europe it will particularly focus on Fortis' core competencies, for example strengthening existing partnerships. In addition risk management will be improved, in terms of continuously assessing the portfolio in order to strengthen or divest sub-activites. Fortis also want to place investments in areas of growth.

'Liberal' approach

A broad group of financial institutions follow a 'liberal' approach, based on the free movement of capital and unrestricted innovation in capital markets. Investment banking is an important part of the business while retail banking is its basis. Many of the big players in European banking markets see themselves as universal banks, which offer all types of financial services; these include Deutsche Bank, Barclays, Unicredit, BNP Paribas, Société Générale, etc. Nevertheless, this group includes a great variety of investment banks, funds and intermediaries which service the big consumer-oriented banks with specialised financial products. Moreover, the big institutions have created their own investment banking subsidiaries. Their common view is that the pre-crisis business model has strong advantages since capital markets proved to be efficient and provided important market opportunities and profits.

Of course, many companies in this segment will be adapting their business models in response to the financial crisis. Many raised equity ratios during 2009, improved risk assessment tools, reduced costs by cutting jobs, and revised their bonus systems. These adaptations – however – do not address the core business, which includes a strong investment segment in addition to retail and commercial banking.

The strategy was reaffirmed by the rapid recovery of profits in 2009. Profit rates are not yet back to their pre-crisis levels but are comparable to average long-run achievements. The recovery is mainly attributed to trading activities and the upgrading of assets in the course of the recent upswing. The fair-value principle and the 'cheap money' policy of central banks have both contributed to profits. This confirms that the previous business model is economically reasonable. No fundamental change is seen to be required.

For this case study, three representative companies were selected: Barclays, Deutsche Bank and Unicredit. Details of the firms' performance and operations are outlined in Table 6.

Table 6: *'Liberal' companies*

Financial institution	Economic performance 2009	Income structure 2009	Business model
Barclays UK	Pre-tax profit: €11.6 billion Tier 1 capital ratio: 13% Leverage ratio: 20 Employment total: 144,200 Employment change 2008–2009: -5.6%	Investment banking and asset management (48%) Retail and commercial banking (52%)	Target: to be a universal bank leading the global financial services industry Operation: pioneering financial markets with the best people and a strong customer orientation
Deutsche Bank Germany	Pre-tax profit: €5.0 billion Tier 1 capital ratio: 12.6% Leverage ratio: 23 Employment total: 77,100 Employment change 2008–2009: -4.2%	Corporate and investment banking (70%) Asset and wealth management (10%) Private and business clients (20%)	Target: to be the leading global investment bank Operation: strengthening profitability of corporate and investment banking; focussing on asset and wealth management; expanding operations in Asia
Unicredit Italy	Pre-tax profit: €3.3 billion Tier 1 capital ratio: 7.6% Leverage ratio: 24 Employment total: 165,100 Employment change 2008–2009: -5.4%	Retail banking (41%) Commercial and investment banking (36%) Central and Eastern Europe (23%)	Target: to be a universal bank with strong customer orientation Operation: customer centricity by proximity and simplicity; cost efficiencies by concentrating activities

Source: *Company information, press media*

Response to the crisis

None of the three banks relied on public financial support during the crisis. Josef Ackermann, the Deutsche Bank CEO, said that it would be a shame for Deutsche Bank to apply for the tax payers' support (Spiegel online, 2010). Similarly, Barclays took no part in the British government's injection of GBP 7 billion (€7.9 billion) in order to recapitalise banks in 2008. Instead, the bank raised new capital and cut dividends. Unicredit also raised new capital in 2009–2010.

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The crisis enforced substantial writedowns on assets. In 2008, Deutsche Bank had to compensate for a €10 billion loss from the trading book and the bank's own investments. Similarly, Barclays had a writedown of GBP 8 billion (€9.4 billion) in 2008. At the same time, provisions for credit losses increased over the course of the crisis. Unicredit had to correct values of both assets and credits by €3.7 billion in 2008 and €8.3 billion in 2009. All three banks reacted to the financial crisis with strong deleveraging. The volume of total assets has decreased by 10% for Unicredit and by around 30% for both Barclays and Deutsche Bank. Risk-weighted leverage ratios have been substantially and accordingly reduced.

The 2009 upswing on stock exchanges all over the world brought banks back to profitability. Barclays in particular achieved almost a 100% increase in pre-tax profits on its already remarkable 2008 profits. This resulted in a 24% profit rate for shareholders in 2009. Deutsche Bank achieved a profit rate of 15% after a similar loss in 2008. Unicredit came up with a profit rate of only 5.5%, due to the significant rise of writedowns in 2009.

Business models

These banks see themselves as universal banks but nevertheless have different targets. Barclays and Unicredit have a stronger retail banking orientation, while Deutsche Bank describes itself as a universal investment bank. They all have the ambition to be a leading company in financial services. Barclays and Deutsche Bank define this target in a global context, while Unicredit sees itself as a strong leader in its core markets of Italy, Germany, Austria and the countries of central and eastern Europe (CEE). All three banks have a strong corporate and investment banking pillar, which was their major source of revenues in 2009. This is particularly so for Deutsche Bank, which earned 70% of its 2009 revenues in this segment. For Barclays, the proportion was 48% and for Unicredit 36%.

Customer relations became a core element of the business strategies over the course of the crisis. Unicredit developed the 'One For Clients' approach, which started restructuring customer services with the aim of increasing proximity and simplicity. Deutsche Bank launched 'Phase Four' of its management plans targeting leadership in its home markets of private banking and asset management.

Nevertheless, shareholder value is the top goal of the banks' strategies. As Barclays said in its 2009 annual Report (Barclays, 2010, p. 15), 'Our primary objective is generating returns for shareholders. But we recognise that we can, and should, in ways consistent with that objective, contribute to the well-being of society by conducting our business responsibly and by performing well, on behalf of our customers, our core functions of payments and money transmission, safe storage of deposits, maturity transformation and lending, and the provision of advice and execution in underwriting and trading.' Deutsche Bank also wants to '...turn strong relative performance through the crisis into profitable growth for our shareholders in the post-crisis environment' (Deutsche Bank 2010). This indicates that improving market services and customer relations, formulating investment strategies, and boosting jobs are sub targets to the improvement of shareholder value. They are instrumental rather than generic targets. During the crisis the banks continued their expansionary strategies. Barclays acquired Lehman Brothers' North American Investment Bank in 2008. Deutsche Bank bought parts of Deutsche Postbank AG (which has an important retail banking basis), the Sal. Oppenheim Group (which has strong asset management facilities), and ABN Amro's commercial banking branch. It also expanded its Chinese exposures. Unicredit continued with the integration of Italian subsidiaries and restructuring its activities abroad. All the companies used their recovered financial strength for growth by expansion.

Employment

The adjustment strategies of all three companies included a significant reduction in the number of jobs. In 2009, Barclays cut 5.6% of its jobs, Unicredit reduced employment by 5.4% and Deutsche Bank by 4.2%. These job cuts are unprecedented in the recent history of the companies. They were particularly severe in retail banking and asset management. Head offices were, however, not affected in the same way and some – as in the case of Barclays – even expanded.

The reduction of employment contributed to profitability substantially. Cost–income ratios declined between four and six percentage points to 58% for Barclays and 56% Unicredit. Deutsche Bank almost halved the ratio to 72%. This was due to losses in 2008, which shifted costs well above income.

Remuneration

All three banks adjusted their remuneration schemes by introducing long-term incentives. Bonus payments are now being deferred over a period of years and equity-based remuneration is a substantial part of total compensation for executives. At Deutsche Bank, employees who create risk positions receive 14% of their remuneration as part of a fixed salary, 36% as a cash bonus and 50% as deferred awards over a period of three and three-quarter years. Similar formulae are applied by Unicredit and Barclays.

Regarding top management remuneration, the CEOs of Barclays and Deutsche Bank did not receive any performance bonuses in 2008. At Barclays, there were no salary increases and no annual performance bonuses given to employees in 2008, and long-term awards were 64% lower than in 2007. In general, sensitivity to public criticism regarding bonus practices has greatly increased. Banks have started to publish remuneration reports on a voluntary basis and are following suggestions to introduce long-term incentives. In the meantime, however, competition in labour markets for investment bankers has started to rise again and this is the first stress test for the new schemes (with still unknown results).

Risk management

All banks made considerable efforts to realign risk management and improve assessment methods. The chief risk officer is usually a member of the management board and a series of risk committees execute the risk assessment in various operational segments. Performance targets are used to monitor diverse activities.

Economic capital is used as a principal approach to calculate the capital needed to absorb severe and unexpected losses arising from exposures. It is calculated for credit risks, market risks including traded default risks, operational risks and general business risks. In the course of the crisis, however, economic capital has been continuously recalibrated to reflect the extreme market moves of 2008. This means that the concept strongly relies on past experience, which is misleading in times of radical change. Economic capital amounted to €21 billion at Deutsche Bank, €24 billion at Barclays and €44 billion at Unicredit in 2009.

Stress tests have been used to evaluate the impact of changes in general economic conditions on credit risks, and the effect of extreme market developments on asset values. Moreover, operational and liquidity risks have been assessed with assumptions beyond the key model parameters. Table 7 gives information about risk-weighted assets and Tier 1 ratios for the three selected banks.

Table 7: ‘Liberal’ approach to risk management, 2009 (€ billion)

	Deutsche Bank	Barclays	Unicredit
Total assets	1,501	1,603	929
Risk-weighted assets	273	448	452
Core Tier 1 capital	23.8	44.8	38.3
Tier 1 capital	34.4	58.3	42.9
Core Tier 1 capital/risk-weighted assets (%)	8.7	10	8.5
Tier 1 capital/risk-weighted assets (%)	12.6	13	9.5

Source: *Company information, Economix*

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Ratings

During the first post-crisis year, the ratings for the three banks were slightly downgraded. This is remarkably positive as these banks operate in the centre of capital markets and have a strong international orientation. Banks did not capture their aggregate exposures to the underwriting of different asset classes sufficiently and thus were unable to exit markets as quickly as was needed. The banks were therefore left with large, 'lumpy', higher-risk credit market exposures on their books as capital markets closed. They experienced large writedowns but were able to compensate for these losses with sufficient resources, cost savings and a rapid recovery. In effect, they all successfully survived the crises and saw no reason to change their business strategies.

One of the reasons for the minor downgrading is that all three banks profited from being 'systemically relevant' banks. They did not receive public support directly; however, the indirect stabilisation of the financial system by the provision of liquidity and guarantees helped them substantially in recovering from the crisis and in compensating for the high volume of writedowns. The supportive stance of national governments and the prospect of a gradual recovery of the European economies thus positively affected the 2009 ratings. (The corollary of this is that a weakening ability of governments to expand public debt and to promote economic growth might again reduce the ratings for these banks.)

A second reason for the stabilised ratings is the deleveraging of exposures. Revenue diversification, sound liquidity and diversified funding, ongoing risk reduction and improving capitalisation are all substantial positive factors in the assessments. Nevertheless, this includes some concerns about volatile and uncertain operating environments. The growing weight of investment banking and the challenges of managing rapid growth of investment banking activities weigh negatively on the ratings. This is reinforced by the expectation that impairment charges are likely to grow. Further writedowns are expected, particularly in the remaining leveraged finance transactions and monoline-wrapped securities. The continuing preponderance of capital market activities and the ensuing challenges for risk management have prompted Moody's to downgrade Deutsche Bank's long-term rating by two grades from Aa1 to Aa3. Similarly, for Unicredit the on-balance sheet risks from its main investment banking arm, HVB, is assessed as being a weak point. Moreover, exposure to emerging markets in Europe – a point that is evaluated as being a major strength by the Unicredit management board – is listed by the rating agencies as being a potential risk.

A third reason for the better rating is the cost efficiencies that were used by all banks to compensate potential losses. The reduction in the number of jobs and the adjustment of compensation and bonuses was assessed positively. The banks are expected to successfully implement further cost savings.

Outlook

According to the rating agencies, the operating environment will continue to be difficult in 2010. Balance sheets are still vulnerable to the currently difficult economic and operating environment and capital ratios are expected to remain above historical levels. This will limit expansionary plans and burden profitability. An upgrade in the ratings would depend on:

- a reduced reliance on capital market activities;
- clear evidence that risk management and business line activities are working together efficiently;
- improved structural liquidity through a combination of a higher proportion of liquid assets and a reduced reliance on short-term wholesale funding.

The banks expect not only to remain profitable but also to increase profitability in the medium and long-term. Adjustments of operational business have proved to be effective and the opportunity to expand operations in growth markets is opening up.

Deutsche Bank plans to increase '(...) profitability in Corporate and Investment Banking (CIB) with renewed risk and balance sheet discipline' (Deutsche Bank 2010, p. 132), expand retail banking and asset management, approach Asian markets and revitalise performance. In total this should provide a €10 billion profit in 2011 compared with €5 billion in 2009

Unicredit's strategy relies on further growth in the CEE countries and in the the former Soviet Commenwealth of Independent States (CIS), and on the progressive stabilisation of the global economic recovery. With limited growth for foreign and government debt, the bank feels well positioned in these markets. Nevertheless, profits will continue to be under pressure in the short-run due to deteriorating credit quality and lower net interest incomes. In the long-run however, the bank's profitability is expected to improve significantly. The bank feels well positioned to exploit growth opportunities and cost efficiencies (Unicredit Group, 2010).

Barclays plans to deleverage its activities further and bring down – over time – the loan-to-deposit ratio. The bank puts returns before growth and feels that prudence should determine the approach to balance sheet size. It will '… continue to act as responsible corporate citizens' and 'ensure its wider responsibilities to society' (Barclays 2010, p. 18). This, however, appears to contradict its strong commitment to provide returns to its shareholders as long as there is no switch to long-term sustainability. The overall strategy therefore remains unclear.

'Sustainable' approach

Banks which follow a 'sustainable finance' approach are characterised mainly by a conservative and risk-sensitive business approach. Their key segment is retail banking and a focus on good customer relations is a high priority. Some, such as Santander and Rabobank, are also active in the area of asset management, investment or insurance. This group of banks was not seriously affected by the crisis. Other banks in this classification follow a social-ecological business approach. The German GLS Bank, Umweltbank or the Dutch Triodos bank all saw in an increase in the number of customers, following the financial crisis.

There are different reasons why institutions with a 'sustainable finance' approach have not been as badly affected by the crisis as their competitors.

- They are not allowed by law to engage in risky markets. Spanish and Polish banks, for example, had to follow legal restrictions that curbed profits during the expansion of financial markets. In the course of the crisis, these restrictions appeared as a fundamental advantage, ensuring that the banks avoided substantial losses. Another example is building societies in the UK, which are not allowed by law to trade derivatives.
- They are strongly decentralised – like the German savings banks or the mutual banks (Sparkassen, Volksbanken) – and were thus limited, by virtue of size, in the extent to which they could participate in proprietary trading. As in the German case, however, their central organisations – the Landesbanken in particular and to a lesser degree the DZ Bank – were heavily engaged in trading risky products and now have to cope with substantial losses from these engagements. Similarly, the Spanish savings banks are presently coming under massive pressure from their real estate investments. The entire systems of savings and cooperative banks can therefore only be classified as sustainable in so far as a substantial reform of their lead organisation has been implemented.

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- They took a deliberate decision to concentrate on basic financial services rather than approaching new markets. The Svenska Handelsbanken is a good example of such a business model. The decision not to engage in the Baltic States and to apply a conservative approach avoided the burdens taken on by Swedish competitors Swedbank, SEB and Nordea. These institutions are now strongly affected by their investments in Estonia, Lithuania and Latvia.
- They applied a risk-aware investment strategy as the basis of their business. This includes most of the insurance companies that adapted their investment operations to continuous financial flows rather than short-term investment opportunities.

The business model of mutual (or cooperative) banks can be classed as taking the 'sustainable finance' approach, due to their strong customer focus and long-term commitment. Since they are owned by their members, they do not have shareholders and are not driven by a focus on short-term profits and increasing dividends. Without pressure to show high quarterly profits, business can be done with a long-term perspective and with a focus on the interests of members and customers. European cooperative banks have been hit relatively less severely by the direct effects of the crisis than private and investment banks. Their losses and writedowns appear to be relatively moderate and mainly concentrated in international activities: more than 95% of writedowns registered worldwide were due to commercial banks and some public banks (EACB, 2010c). Membership of cooperative banks is also increasing. The number of members of cooperative banks as a percentage of the total population in six European countries (Austria, Finland, France, Germany, Italy and the Netherlands) increased from 14% to almost 17% between 1996 and 2008.

There is also partial information available for 2009, which indicates further advances regarding the number of clients. According to the German central organisation of the cooperative banking group, BVR, the number of members of cooperative banks in Germany increased by 1% in 2009 to 1.6 million. This corresponded with the growth rates of previous years. Rabobank Nederland, the umbrella organisation of local branches of Rabobank in the Netherlands, reported a 3.2% increase to 1.7 million members in 2009, which was a slight acceleration of the growth rate. In Italy, however, the Associazione Nazionale fra le Banche Popolari recorded a decline of around 1% in 2009.

For this case study, three representatives were selected:

- Rabobank;
- Santander;
- GLS Bank.

Rabobank is a large cooperative bank in the Netherlands, with a long history of excellent customer relations and tight risk management. Santander is a large Spanish international financial group, with high cost efficiency. GLS Bank is a small, dynamic German bank which can be classified as an ethical bank and operates in the specific market segment of ecological and social projects with a strong focus on sustainable investments. More details are outlined in Table 8.

Table 8: *Companies with a 'sustainable' approach*

Financial institution	Economic performance 2009	Income structure 2009	Business model
Rabobank Netherlands	Net profit: €2.3 billion Tier 1 capital ratio: 13.8% Employment total: 59,311 Employment change 2008–2009: -2%	Net profit by segments: Domestic retail banking (53%), Wholesale banking and international retail banking (28%), Asset management and investment (1%) Leasing (5%) Real estate (3%) Others (10%)	Target: to become the Dutch market leader in all financial services and an international food and agriculture bank, to retain a high credit rating and high standards in respect of a corporate social responsibility (CSR) policy Operation: strong customer focus, increased efficiency due to cost reduction programme
Santander Group Spain	Net profit: €8.9 billon Tier 1 capital ratio: 10.1% Employment total: 169,460 Employment change 2008–2009: -0.9%	Net profit by segments: Retail banking (70%) Global wholesale banking (26%) Asset management and insurance (4%)	Target: to be a large international financial group, which provides high returns to shareholders and meets all the financial needs of its customers. Operation: customer-focused business model with geographical diversification, high efficiency and strong risk-awareness
GLS Bank Germany	Net profit: €0.202 million Employment total: 254 Employment change 2008–2009: +20%	Business volume by segments: Customer loans (51%) Bank deposits (29%) Fixed-interest securities (17%) Investments (1%) Others (2%)	Target: to deliver transparent socio-ecological banking services to an increasing number of customers Operation: strong customer-orientation, focus on sustainable projects, expanding to Austria

Source: *Company information, press media*

Response to the crisis

None of these three banks relied on public financial support during the crisis because they did not experience any severe losses. All showed strong overall performance. Nevertheless, they are being affected by the generally worsened economic circumstances. The two larger companys, Rabobank and Santander, experienced an increase in impairment losses in 2009. In response to the crisis, both increased their Tier 1 ratios.

Santander states in its 2009 Annual Report: 'The last two years of economic and financial crisis have made it clear that a bank's profitability must be measured on a long-term basis. This means having [a] recurrent and sustainable business which shows responsibility to shareholders, employees, customers and society at large' (Santander, 2010). The bank showed a good business result (net ordinary attributable profit was 0.7% higher at €8,943 million) compared with its peers, despite the challenges encountered in 2009. Thus it feels affirmed in its strategy.

Rabobank decided to scale down its non-client-related operations undertaken at global financial markets as a result of the financial turmoil. Since the bank needs an adequate Tier 1 ratio and stable profit growth in order to maintain its high credit rating, it has set the following long-term financial targets: a Tier 1 ratio of at least 12.5%, a minimum return on equity of 8%, and 10% net profit growth.

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GLS Bank has been affected by the crisis in a positive way and it is now confronted with the challenge of managing a continuously increasing number of customers. This is due to the increasing popularity of ethical banking in recent years. The crisis has encouraged this trend: an increasing number of savers are questioning the growth and profit orientation of traditional banks and are looking for alternatives. Between 2008 and 2009, GLS Bank's business volume increased by 33% and its customer base by 18%. One of GLS Bank's responses to the crisis has been to hire more employees. This trend is expected to continue. The results of GLS Bank show a much better performance than German cooperative banks on average: the business volume of all cooperative banks in Germany increased by only 3.3% between 2008 and 2009 and the number of members increased by 1% (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, 2010).

Business models

All three banks have a large retail banking division, which is the major source of revenues. At Santander, the retail division contributed to 70% of net profits and at Rabobank, 53%. At GLS Bank the retail and commercial banking segment is dominant. Customer relations have always been a core element in the business strategy of all three banks, even before the crisis.

Santander and Rabobank see themselves as international financial service providers. One key element of Santander's business model is efficiency. Santander states that it 'has one of the most cutting edge technology and operations platforms in international banking, which allows it to turn cost savings into greater value for the customer. It is one of the most efficient banks in the world, with a cost/income ratio of 41.7% (37.6% excluding depreciations and amortisations)' (from the Santander website) Rabobank also implemented a cost reduction programme to increase the efficiency of the bank (the efficiency ratio, which is equivalent to a cost/income ratio was 61.5% in 2009).

Transparency is a very important characteristic of GLS Bank and the bank sees this as its source of success. Customers appreciate that they can decide which area their money should be invested in and they receive detailed information about all initiatives supported. For example, GLS Bank's commercial papers are chosen and continuously monitored with strict criteria determined by a financial investment committee. Companies involved in the following areas are excluded from the GLS Bank portfolio: nuclear power, controversial financial or ecological practices, animal experimentation and production of tobacco and drinks with a high alcohol content.

The banks differ regarding their ownership structure and their geographical diversity. Rabobank and GLS Bank are mutual banks and are owned by their members, who have the right to actively take part in the decision-making process. Each member has one vote at the annual general meeting, independent of the number of cooperative shares they have. This enables the bank to pursue long-term goals rather than short-term profits – a typical characteristic of the 'sustainable finance' approach. Since Santander has shareholders, the bank aims to provide them with satisfactory dividends. Santander announced 2% higher dividend in 2009 than in 2008. Santander can be categorised in the 'sustainable finance' approach because of its risk-averse business model and its low cost–income ratio.

GLS Bank is a small bank with seven branches in Germany; it plans to open its first branch in Austria in 2010; the other banks, in contrast, have branches all over the world. Santander is an international bank, with 92 million customers. Its principal geographical areas are continental Europe, the UK and Latin America. Rabobank has a dominant position in the Dutch market, being the market leader in the Dutch agricultural market as well as in retail savings and residential mortgages; it operates in 30 countries in addition to the Netherlands.

Employment

At Santander and Rabobank, the number of employees has decreased by 0.9% and 2% respectively. At Rabobank, job cuts were due to decreased activity levels and the implementation of cost cutting. In domestic retail banking, the level of full-time equivalent employment level has dropped by 1% and in the wholesale banking and international retail banking division it has dropped by 5%. In order to reduce costs and increase efficiency, the 'Rabobank 2010 Vision' programme was introduced. This is targeted at updating and improving customer services at substantially lower costs in combination with a process redesign. Staff of local branches of Rabobank therefore took part in support programmes.

At Santander Group, the total number of employees decreased by 0.9% (1,501 jobs) in 2009. The newly acquired bank Sovereign added 8,847 employees in 2009. In Latin America, the number of employees declined by 10,000, mainly due to the disposal of America Banco de Venezuela. In the UK, 1,430 jobs were cut in 2009. According to UK newspaper the Telegraph, the bank stressed that the job losses were not a reaction to the financial crisis but instead part of a planned GBP 180 million (€208 million) annual cost savings after the acquisition of the UK bank Alliance & Leicester.

Due to the strong growth of its business, GLS Bank has continuously increased the number of employees in recent years. It currently employs about 250 persons and plans to hire 60 additional employees in 2010. It would appear that some applicants prefer the ethos of GLS Bank over that of other banks.

Remuneration

None of the three banks has had to implement a new remuneration model in response to the financial crisis.

According to Rabobank's annual report for 2009 'the remuneration structure within the organisation has never been such that it might encourage the irresponsible risks being taken' (Rabobank, 2010). At Rabobank, the remuneration of the executive board distinguishes between salaries, variable compensation and pension provisions. No variable compensation is awarded in the form of an option and/or as share packages. A short-term and long-term (long term being three years) variable compensation of 15% of fixed income exists for the executive board. A variable compensation component exceeding 30% of fixed income is paid only to a small number of individuals in highly specialised positions within Rabobank International.

At Santander, the variable part of executive directors' remuneration varies between 56% and 65%. The variable component is paid out in cash and shares while the shares are deferred for three years. The number of shares paid out is linked to the bank's total shareholder return. An obligatory investment plan also exists, which obliges executive directors to invest 10% of their gross variable remuneration of the previous three years in shares. Thus incentives are given to directors to strive for the company's long-term success.

GLS Bank's remuneration system distinguishes between eight different functional groups, whereby Group 8 refers to the management board members, who earn around €160,000 per year. The lower functional groups (1 to 4) are paid better than in private banks, and wages for the higher functional groups are often lower. Bonus payments do not exist at GLS Bank.

Risk management

The crisis did not result in risk management methodology being adapted in any of the three banks. Santander pursues a risk policy that focuses on maintaining a low to medium predictive profile for all risks. Rabobank has a long tradition of having a very conservative approach to risk and credit management.

For GLS Bank the most important risk is the counterparty (or loan default) risk. Therefore, a rating method is used that classifies all customer loans into internally defined risk classes. The grouping of loans into the respective risk class is adjusted in the case of changes to the credit-worthiness of the borrower. The 2009 credit default rate of 0.3% was very low. In order to control risks associated with changes in interest rates, GLS Bank used an interest-rate swap with WGZ Bank to the amount of €80 million in 2009. However, the diversification of the credit portfolio is limited due to the bank's criteria for ethical selection of projects. In the case of worsening economic conditions – for example, in the

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environmental sector or public finance – this could affect the bank in a negative way. This is also reflected in Fitch's current A rating (meaning a safe investment, unless unforeseen events should occur in the economy at large or in that particular field of business).

At Santander and Rabobank, economic capital is used as a principal approach to calculate the capital needed to absorb severe and unexpected losses arising from exposures. It is calculated for credit risks, market risks including traded default risks, operational risks and general business risks. At Rabobank, economic capital dropped by 2% in 2009 to €22 billion. The reduction was primarily caused by a decrease in interest-rate risk in the banking book. At Santander, economic capital was €44 billion in 2009 (and €40 billion in 2008).

Santander and Rabobank use the analysis of scenarios and stress testing in order to complement the analysis of market and credit risks. They also use scenarios and stress testing to evaluate the impact of changes in general economic conditions on credit risks and the effect of extreme market developments on asset values.

Table 9 shows risk-weighted assets and Tier 1 ratios for the selected banks.

Table 9: *'Sustainable' approach to risk management*

Year: 2009 (in €billion)	**Rabobank**	**Santander**	**GLS Bank**
Total assets	608	1,110	1.35
Risk-weighted assets	233.4	561.7	0.704
Core Tier 1 capital	/	48.4	0.066
Tier 1 capital	32.3	56.7	0.076
Core Tier 1 capital/risk-weighted assets (%)	/	8.6	9.4
Tier 1 capital/risk-weighted assets (%)	13.8	10.1	10.7

Source: *Company information, Economix*

Ratings

GLS Bank has an A+ rating from Fitch (meaning a safe investment, unless unforeseen events should occur in the economy at large or in that particular field of business) and an A rating from the rating agency Ethibel in 2005, for being the first ethical bank in Germany. Moreover, GLS Bank was awarded 'Sustainable Bank of the Year in Germany' in April 2009 by the British magazine *The New Economy*.

The A rating from Ethibel is the highest rating possible (ratings ranges between A and E). Ethibel is a rating agency located in Brussels that evaluates the sustainability of financial institutions in addition to their financial performance. GLS Bank's strategy of ethical banking is seen as enriching for the financial services sector. Ethibel appreciates what it sees as GLS Bank's high degree of transparency, its focus on ecological, social and innovative projects and its microfinance fund. According to Ethibel, GLS Bank's employment profile shows a high degree of stability. A high level of commitment to vocational education and training within the bank, close communication within working teams and the application of trust-based working hours are all reasons given by the agency for its A rating. Salaries are categorised as social and well-balanced. The operating efficiency of the bank is also evaluated as 'very good', while provisions for risks are seen as comprehensive and well-documented. GLS Bank is a member of BVR, the German central organisation of cooperative banks, hence customers' deposits enjoy 100% protection.

For a long time, the credit rating of the large rating agencies for Rabobank Nederland is AAA (meaning that credit risk almost zero). Santander has had an AA rating in recent years (meaning a safe investment, with a low risk of failure).

These positive and stable ratings reflect the banks' stable business profiles with strong retail divisions, comparably resilient performance during the crisis and strong risk management capabilities. However, Moody's downgraded the long-term rating of Santander from Aa1 to Aa2, due to concerns regarding the broad deterioration of the Spanish economy (to which Santander remains heavily exposed) as well as the bank's recently increased exposure in the UK and the US (both countries also facing severe economic disruptions).

Santander and Rabobank Nederland both have strong risk management capabilities. In particular, the cautious approach regarding risk appetite and management philosophy of Rabobank Nederland is appreciated by rating agencies. Moreover, since Rabobank is a mutual bank, it is not driven by short-term performance indicators. The liquidity management is seen as a strength due to the bank's large retail deposit base. However, the bank does have a conservative selection of exposures and the group has significant exposure to other financial institutions. Moody's appreciates that Rabobank Nederland has decided to scale down its non-client-related operations undertaken in global financial markets as a result of the financial turmoil.

Regarding Santander, the rating agencies appreciate its culture of independent and tight risk management. The bank strictly separates risk and commercial areas and has a committee decision-making process. Its risk function has a high status within the bank. Santander has passed on its risk culture and organisation to its subsidiaries and developed integrated risk standards and a credit organisation while rotating experienced managers within its subsidiaries.

Both of these large banks had good ratings regarding asset quality, even though the agencies saw a deteriorating asset quality for Santander. Rabobank Nederland was evaluated as being strong due to its conservative underwriting criteria, with a stable and low level of impaired loans. Rabobank Nederland's asset quality is strengthened by the high proportion of domestic loans to individuals. Reported losses on this portfolio were two basis points in the first half of 2009, below the historic average of three basis points. For Santander, further asset quality pressures are expected as non-performing loans will increase. However, the bank's consolidated assets in Spain are likely to be less affected than the overall system due to the diversification of its book by region and by sector. Risk premiums stand to increase substantially in the consumer finance business and across all of Latin America, particularly Mexico and Brazil.

Outlook

According to the rating agencies, the operating environment will continue to be difficult in 2010. The outlook for Rabobank is negative due to expected subdued macroeconomic conditions in the Netherlands which could affect the bank's profitability, asset quality and capital adequacy. Impairment losses are expected to remain high in 2010. Turning to Santander, the rating agencies observed increasing credit deterioration in most economies in which Santander is present. Any additional acquisition could carry negative implications for the ratings.

The banks expect 2010 to be a challenging year and anticipate that the effects of the financial crisis will remain visible in the real economy. For Santander the priorities remain the same: management of spreads and control of costs, risk control and management of loan-loss recoveries. Santander expects that pre-crisis growth rates will not be reached. Non-performing loans will increase and the bank will suffer the double impact of both low demands for loans and pressures on spreads associated with repricing. Nevertheless, there will also be opportunities to gain market share by means of organic growth and acquisition opportunities in some markets.

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Rabobank will prioritise tight cost management and high-quality customer contacts. It has therefore set the following core objectives:

- to become the Dutch finance market leader (or retain this position, as appropriate);
- to build on its position as the world's leading international food and agricultural bank;
- to achieve greater commercial synergy with subsidiaries.

Moreover, it expects that the level of bad debt costs will remain high. Rabobank intends to maintain its provision on the savings and the mortgage markets and strengthen its position in the corporate and private banking market. In its second biggest business segment, Wholesale Banking and International Retail Banking, activity with structured financial products will be reduced while Rabobank's specialised finance team called Renewable Energy & Infrastructure Finance is foreseen to develop further.

GLS Bank expects that the trend of sustainable and responsible use of money will continue and will influence the development of ITS business positively. Until now, the client sectors have developed positively in spite of the financial and economic crisis. GLS Bank wants to continue its engagement in all areas with a particular focus on independent schools and kindergartens, the trading of organic food and renewable energy. Growth is expected to continue: even rising interest rates and growing competition in financial services will lead to a continued trend of declining interest margins in the medium term. For the next few years a growth rate of at least 25% to 35% per year is expected – particularly in the deposit and credit business. Turbulent times on capital markets will increase risk costs in the future and will increase the importance of risk management. The bank also plans to expand to Austria by the end of the year. Another important task will be the integration of new employees in the continuously growing company.

Evidence from individual case studies

In addition to the type-oriented case studies presented in the previous sections, two individual case studies were undertaken in order to address the importance of a long-term view on the evolution of financial services.

The UK building societies are taken as an example of a banking segment, based on mutual principles, that has continued to apply a traditional and security-oriented approach in the mortgages market. This segment survived the crisis without severe damage, in contrast to those companies that 'demutualised'. This provides further evidence of the advantages that arise from long-term perspectives and high risk awareness.

The second case is Generali Insurance, in particular the French subsidiary of Generali; the case study points to the importance of work organisation and industrial relations for a firm's resilience in the crisis. Based on reorganisation concepts developed before the crisis, the company continued to introduce lean organisation and participatory work relationships in order to improve efficiency and promote innovation. This characterises both the role of human resource management in the 'immune system' of a company and its importance for long-term growth.

UK building societies

The banking segment of UK building societies

UK building societies are an excellent example of traditional mutual banking that went out of fashion during the liberalisation of banking markets. The strengths of mutual banking have, however, been illustrated by the crisis. The concept of secure mutual funding by house owners dates back to the 18th century and has survived to the present day. During the liberalisation period of the 1980s and 1990s, the number of building societies decreased substantially as deregulation allowed 'demutualisation'. Most of these societies were acquired by big private banks, such as the Bank of Scotland, Barclays, Lloyds, or Santander. Some of the demutualised building societies followed a risk- and profit-oriented approach and were, as a result, strongly hit by the crisis. Some, such as Northern Rock, were nationalised and some, such as the Dunfermline Building Society, after its collapse due to over-exposure to commercial loans, were resolved under the Special Resolution Regime.

The remaining building societies that kept to the traditional business model were much less affected by the crisis. This model is characterised by a high level of securitisation of assets by residential property, a low share of wholesale funding, and by a ban on taking positions in derivatives markets, currencies or commodities. During the crisis, building societies reduced their overall exposures and deleveraged their balance sheets (Table 10). In 2009, credit repayments exceeded gross lending. The focus was on security and cost efficiencies rather than growth. Employment in UK building societies declined by 2.5% in 2009.

In the current situation, the UK building societies face a series of challenges. Competition is rising as private and nationalised banks want to escape as far as possible from wholesale funding by raising funds on retail deposit markets. The historically low interest rates and lower credit demands are also narrowing interest rate margins. Building societies have to bear the costs of the crisis, without being responsible for it, by raising capital and liquidity requirements, facing competition from nationalised banks, and making contributions to the Financial Services Compensation Scheme.

Table 10: *UK building societies, performance data 2008–2009*

	2008	2009	Percentage change 2008–2009
Number	55	52	-5.5
Total assets (GBP billion)	360	335	-6.9
Mortgage assets (GBP billion)	250	225	-10.0
Saving balances (GBP billion)	235	220	-6.4
Employees	48,578	47,374	-2.5

Source: *Building Societies Association*

The principal orientation of building societies is towards members, not shareholders, and members are interested in good services rather than profits. This requires that the societies offer cheaper mortgages and better interest rates on savings than do their competitors. Members have a say in business practices and basic business decisions.

This business model works, according to a customer satisfaction survey, which revealed that over two thirds (68%) of building society customers feel that societies treat their customers fairly, while just over half of bank customers (55%) think the same about their providers. Moreover, building societies are more trusted and more customers think that the societies provide value for money (Building Society Association, 2009).

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Leek United

With the single case examined in this case study, the findings confirm the results of the group analysis. The business strategy of Leek United has been stable in recent years, the building society being committed to traditional values. Credit exposures are predominantly financed by savings accounts, and the decline of deposits has prompted the bank to decrease total assets. Wholesale funding is kept at minimum levels. Derivatives are used mainly as interest swaps.

With shrinking overall activity, Leek United aimed to improve cost efficiency and productivity. This resulted in a 5% job cut in 2009 and a 16% decline compared with 2007. Salaries are at ‘industry standards’ with annual executive salaries between €130,000 and €200,000.

Even though Leek United was relatively successful during the crisis, the advantage of being a conservative and reliable business partner with a long-term reputation has not been used to increase market share in the post-crisis period. According to Professor Geoffrey Wood of City University London, building societies were essentially protected from every source of shock that arose during the crisis due to their narrow business model. Hence, every step outside their business model would make them less secure.

The Building Societies Association expects there to be fewer building societies in five years’ time; however, those that remain will be successful companies that provide a valid alternative to the banks’ shareholder-value driven model. While they will have low margins, their safe business model will be more generally trusted than that of banks. The focus on customers, low risk and high levels of service will remain important. Building societies will not go out of business, but will grow less rapidly than they did in the boom years. The winning of market share from private banks may only be possible over the long term. With very low interest rates and competition from nationalised banks, short-term growth in market share is not envisaged.

Future opportunities for insurance companies

In the next five years three key factors will favour the development of insurance companies.

- People will appreciate the value of insurance guarantees.
- In some countries, large numbers of people are approaching retirement age. These people need assistance in managing their properties.
- In emerging markets there are opportunities for car insurance and retirement savings.

(Interview with Nick Lane, Head of Group Strategic Planning, AXA Group, France)

Generali

Generali Group

Generali is the third-largest insurance group in Europe after Axa and Allianz. The group is represented in 65 countries throughout the world. It is the leader in Italy and it has significant positions in Germany, Austria, France, Spain, Switzerland and Israel. Recently, the group has launced activities in all the NMS and has expanded to China. Generali owns 176 companies and employs 85,000 staff.

The group is particularly active in life insurance but manages a wide range of products such as car and home insurance, specific insurance for professionals and companies, property insurance, leisure cover and policies for production, commercial and professional activities. In life insurance, the group offers life accident insurance and new products for insuring complementary health treatments, retirement plans and other savings products. A wide range of financial and real estate services and assets management is also supplied.

Table 11: *Generali turnover (€ billion)*

	2007	2008	2009
Turnover	**66.2**	**68.8**	**70.5**
Life	45.4	46.8	48.9
Non-life	20.8	21.9	21.6

Source: *Generali Group Report 2009, September*

The group managed to pass through the financial crisis with a continuously rising turnover. Premiums increased by 6.2% in 2009 and reached over €70 billion, thanks to the group's geographic spread and diversified distribution channels (Table 10). Net earned premiums increased too. The most visible effect of the crisis was the downturn in the non-life segment, in which premiums written declined due to the recession and severe competition. The 2009 solvability ratio increased to 187% compared with 177% the previous year – resulting in one of the best ratios in Europe.

According to Claude Tendil, CEO of Generali France, no insurer – except AIG and some 'bancassurance' companies – was directly affected by the crisis, and no French insurers asked for public support. The crisis affected the insurance business only indirectly, through the financial situation of its clients. In contrast to other parts of the financial system, the role of the insurance business '...is to provide guarantees to the people not to externalise risks'. In this context the management change to a 'professional, polyvalent and high skill model' appears to be essential, even for the internet distribution channel (Les Echos 18 May 2009).

Generali France

Following this appraisal, Generali France introduced a new model for work organisation – Empowered Work Organisation (OTR). This new organisation is a response to fundamental changes in the insurance business rather than an answer to the crisis. The first experiments started in 2007 and targeted the clients' requirements, the quality of operations, team work, the conditions for greater employee activity and productivity, and developing cooperation between the different departments. Compared with a traditional work organisation, with a strictly formal hierarchy and prescribed tasks, it seemed necessary to give much more initiative to each employee and to each team, which – in turn – would mean shorter processing periods. It is expected that this model of work organisation will overcome the patterns of industrialised work, introduce lean hierarchies, and enhance autonomy for workers.

Employee engagement and responsibility have been rewarded in terms of involvement in the approach and in terms of skills and competency enhancement, rather than higher wages. Monetary awards were expected to be gained thanks to a more efficient work organisation. A profit-sharing system is applied throughout the whole group.

The employees' representatives were fully involved in the approach, with seminars and negotiations about the wage and training policies. A three-year agreement was signed with the unions for the period 2008–2010, which regulates the general wage increases and the structure of wage groups. Savings funds are offered and free shares are regularly distributed to the employees.

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The reorganisation of work processes has contributed considerably to the resilience of the company against financial and economic risks. Moreover, it is the basis of innovation. This clearly reveals the fundamental role of work organisation and industrial relations, not only for the firm's competitiveness but for its long-term growth.

Employment

Number of jobs

The previous analysis revealed that almost all the selected financial institutions suffered from job losses in 2009. Those that were under state control, in particular, reported job cuts of between 8% and 20%. In the 'liberal' group, the number of jobs declined between 4% and 5%, and even the 'sustainable finance' group – with the exception of Generali insurance – did not show employment growth.

Of course, this evidence is limited to the companies in question and cannot be generalised to the sector as a whole. Aggregated figures for the most recent changes in employment within financial services are difficult to find for the most recent period and no comprehensive evaluation is currently possible.

One indicator, however, is the job statistics for the City of London (the UK's financial 'hub') established by the Centre for Economic and Business Research (Table 12). This shows an overall decline of 13.8% in jobs in the City between 2007 and 2009. The most severe job cuts took place in 'corporate finance', 'derivatives and forex', and 'investment banking', while 'fund management' experienced a minor increase.

Table 12: *Employment in City of London, 2007–2009 (thousands)*

	2007	2009	Percentage change
Investment banking	62.4	44.2	-29.2
Equities and bonds	84.8	74.0	-12.7
Derivatives and forex	16.5	11.4	-30.9
Corporate finance	15.1	8.7	-42.4
Fund management	48.5	49.0	1.0
Insurance	45.5	43.7	-4.0
Professional services	81.3	74.3	-8.6
Total	354.1	305.3	-13.8

Source: *Centre for Economic and Business Research*

The first evidence about the adaptation of employment levels in financial services shows a high degree of consistency with the expectations of the skills scenarios. It was assumed that all three scenarios would be associated with job cuts, the state-ownership scenario showing the greatest decline, and the sustainable-finance scenario the least (Economix/DKRC 2009). This appears to be the probable result, at least judging by the progress of the financial crisis to date.

It is important to improve the statistical basis of employment trends. This can be achieved by using public statistics and further company statistics (from annual reports) from big financial players and from sector analyses of SMEs.

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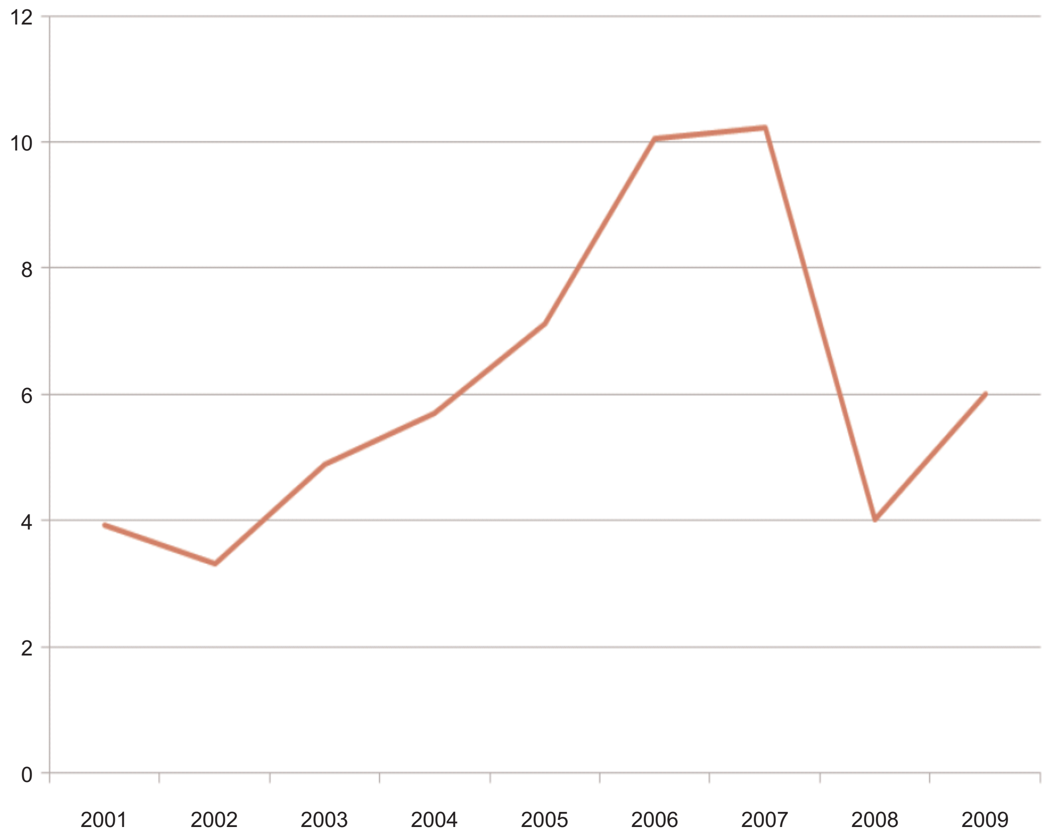
Bonus payments

The previous analysis also reveals that the reform of bonus payments has begun. A number of banking companies have introduced schemes with improved long-term incentives and restricted salaries for top management. After strong criticism from the public, the British banks HSBC, Barclays, Royal Bank of Scotland and Lloyds renounced plans to increase bonus payments for top managers by up to 40%. The American firm Citigroup introduced a USD 100,000 limit for cash bonuses supplemented by shares, which cannot be sold for some years. Deutsche Bank introduced a similar regulation: any bonus above €100,000 will be paid one quarter in cash and the rest in stocks over a period of four years. Top salaries in state-controlled banks are limited. In the German Commerzbank, for instance, annual salaries are restricted to €500,000, until such time as public investments have been repaid. The example of the City of London shows that bonus payouts decreased significantly in 2008 and started to rise again in 2009 (Figure 8).

Figure 8: *City of London bonus payouts, GBP billion, current prices*



Source: *Centre for Economic and Business Research*

Bonus payments have attracted controversy in many countries, particularly in the US. The aim of the G20 resolution in Pittsburgh was to stop salaries and bonuses providing incentives for high-risk investments. In this context, top management salaries are pivotal, since these incentives can be expected to be transferred into the internal structures of companies. However, this is a sensitive matter, particularly for companies with a high share of returns from investment banking and asset management. These companies try to avoid cutting jobs as much as possible since the average investment banker is reported to take around 40% of their turnover to any new job. This makes a company very dependent on its traders.

As a result, big banks in the USA have started to pay high bonuses again. JP Morgan is reported to have paid investment bankers an average bonus of USD 379,000 (€263,000 as at July 2010) for 2009. Publications by the State of New York

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about Wall Street bonunses revealed a 17% increase in bonus payments in 2009. The average bonus was USD 124,000 (€96,615). Thirty six percent of revenues from trading were discharged; in previous years this amounted to 50% (Handelsblatt 2010d).

As indicated in a study by Linklaters, governments use different approaches to regulate high bonus payments (Handelsblatt, 2010b). The British government has introduced a 50% bonus tax for bonuses above GBP 25,000, (€30,369) and the US government has restricted employers' tax deductions to a limit of USD 1 million (€780,000) per employee per year. France followed the British example. Tax measures are expected to have limited effects since employers will have to shoulder the tax burden. Deutsche Bank is reported to have made a €225 million provision for bonus tax payments expected in the UK (Handelsblatt 2010b).

Germany has introduced a regulation that obliges companies to award at least half their bonus payments for long-term and sustainable value creation. Guaranteed bonuses are prohibited. The British regulators, however, are taking a different direction. In addition to performance orientation, they say, bonuses should enable companies to recruit competent managers. This clearly reveals the sensitivity of the UK regulators to the position of companies concerned about alienating high-skill labour markets.

Many countries have refrained from formulating explicit bonus regulations and reverted to the 'comply or explain' principle. This obliges companies to follow public suggestions or to explain publicly why they have not done so.

Paying bonuses back is restricted, apart from in the case of exceptional events (Germany) or of balance sheet fraud (USA). Most countries have not introduced such penalty systems.

Consumer reactions to the financial crisis

During the financial crisis, many consumers lost confidence in their financial institutions and financial advisors and were not satisfied with their performance. Rebuilding consumer trust and improving financial services is thus one of the most important elements of overcoming the financial crisis. Since only limited evidence is presently available on this issue, the following section focuses mainly on Germany.

Gallup study of customer confidence

The research institute Gallup has conducted surveys in Germany, the UK and US about banking clients' satisfaction with the services of their branch. The surveys were adapted to the conditions of each country.

Germany

In Germany, around 3,800 bank customers were interviewed between September and October 2009 (Gallup Germany, 2010). Altogether, substantial gaps in customer satisfaction were revealed. Only 14% of customers felt entirely happy with their financial institution. The cooperative banking associations achieved the highest scores for satisfaction, 16% of customers feeling entirely happy, while the savings banks and private banks scored 13% and 11% respectively.

According to Gallup, the main causes for weak performance come down to dissatisfaction with the services provided by their bank. The study revealed that:

- only 39% of the interviewees were satisfied with the services they received (in the UK, 46% and in the US, 69%);
- only 21% think that staff are entirely accurate in the work they do;

- only 26% believe that their financial institution keeps the promises it gives;
- only 31% think that their bank's employees enjoy their work.

In short, there is a clear lack of confidence. Customers' confidence and satisfaction could be improved by increased staff efforts to be of help, kind and polite, and to make customers feel welcome and appreciated.

A customer's branch is, after ATMs, the most important point of interaction with their bank. The survey found that 66% of interviewees had visited their branch at least once during the previous six months. In contrast, online banking is used by only 36% of customers.

UK

In the UK, 1,311 adults (who are retail banking customers) were interviewed between October and November 2009.[2] According to the results, 29.4% of UK retail banking customers indicated that they are 'highly satisfied' with their bank and 46.4% are 'highly satisfied' with the branch they use. Even though almost half the interviewees are highly satisfied with their branch, only 24.1% of interviewees say that their bank's employees 'always do things right the first time'. As many as 48% indicated that they had had a problem of some sort with their retail bank within the past six months. Only 25.8% strongly agreed that their bank 'always delivers on its promises'.

Overall, 54.8% of interviewees visit their branch bank at least once a month and 17.4% visit it at least once a week. Only 4.6% of interviewees have used online banking, which indicates the high level of demand for counter service. This means that service in bank branches is very important in the UK, yet only 24.9% of interviewees indicated that their bank 'has employees who seem to enjoy working there'.

Stiftung Warentest

At the end of 2009, the German consumer protection foundation Stiftung Warentest published the results of an investment counselling test for German financial intermediaries. Between the end of July 2009 and the beginning of September 2009, 147 counselling interviews were conducted in seven large banks, nine savings banks and five cooperative banks (Stiftung Warentest, 2009).

The overall results were poor: on a scale from 1 (best) to 6 (worst), three banks received a score of 3, 16 received a score of 4, and two banks were scored 5.

In the counselling interview, the testers asked for a safe investment of €30,000 for five years with an expected return of 4%. At that time, such an investment did not exist and the advisors should have pointed out that the choice was to take either a higher risk or settle for a lower return. The advisors, however, suggested certificates, private pension funds and equity funds, all of which carried relatively high risks. As Stiftung Warentest commented, the bonus was obviously more important to the advisors than customer satisfaction. More than half the banks also failed to ask their customers about income and property. A further five banks did not enquire about the customers' financial knowledge.

[2] The information was collected from Caroline Leonard who is a Proposal Writer at Gallup UK.

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Mandatory minutes of consultation

Since the beginning of 2010, minutes of the consultation must be taken during all bank counselling interviews in Germany. TNS-Infratest has examined the satisfaction of customers with these records on behalf of DZ bank (DZ Bank, 2010). In all, 1,131 persons who had recently invested, or who planned to invest in the future, were interviewed at the beginning of February 2010.

The results can be summarised as follows.

- 67% of the interviewees who had already attended a counselling interview evaluated the minutes as meaningful.
- For most of the investors, the minutes act as insurance and as an instrument to improve transparency, while 56% expect that the quality of counselling will rise because of these records.
- Around two thirds make their investment decisions with essential support from their advisors, 19% involve their advisors to a limited degree and 16% state that they make their investment decisions alone.

Banks are presently working on new and improved information systems for private clients. HSBC is introducing a ‘traffic light’ system to help investors understand the different risk categories of financial products. The available information will exceed the range of legal information required. Incentives for salespersons or advisors need to be changed to guarantee that they give good advice in the interest of the customers.

Recently published scenarios

Skills scenarios for European financial services – the Economix/DKRC view

Long-term scenarios for the skill needs of the European financial sector were developed by Economix Research & Consulting on behalf of the European Commission (Economix/DKRC 2009). The study is part of a comprehensive analysis of future skill needs in the European Union launched by the Directorate General for Employment, Social Affairs and Equal Opportunities. The scenarios identify different development paths up until 2020 and draw conclusions for human resource policies in the EU Member States. They take the strategic responses to the challenges of the financial crisis as their starting point. Three alternatives have been developed.

- Scenario 1 – '**sustainable finance**' assumes that the sector will develop a completely new business model, based on long-term investment strategies, consumer trust and high-quality consulting services. This exerts a cultural shock to the business, as it means the reversal of profit targets, standardisation, and controlling instruments in favour of sustainability.
- Scenario 2 – '**laissez-faire**' draws less radical conclusions from the crisis, assuming the continuation of a short-term profit orientation. Public control will remain weak due also to impediments at the international level. Standardisation of financial products will be fostered. Mergers and acquisitions will be revived. The instability of financial markets will persist.
- Scenario 3 – '**state ownership**' assumes that neither government nor the big players in the financial sector will be able to keep control of the current crisis. Financial and economic turmoil will combine to destructive effect. This will result in a significant reduction of economic activity for a long period and force financial services into an administrative role.

All scenarios are expected to cause widespread unemployment in the financial sector of the European Union, at least in the near future. Later recovery depends on the strategic choices made. In the 'sustainable finance' scenario, the number of jobs will increase due to the extension of consulting and business services. In the 'laissez-faire' scenario the investment branch in particular will cause ups and downs in employment. In a publicly regulated financial sector employment will remain at a low level for a long time. What these scenarios all have in common is that each one anticipates a continuous upgrading of skills with, however, different types of specialisation.

- Scenario 1 assumes a new type of banker who acts with a long-term rather than short-term perspective, regards consumer trust as essential and thus aims for sustainable business relations. This requires a new orientation of human-resource development principles.
- In scenario 2, the trends of the past will continue – using short-term profit targets, flexibility and market orientation to guide human resource policies. Back-office functions will largely be transferred to highly standardised service providers.
- In scenario 3, human-resource policies will be security and cost oriented. They will require sound administrative practices rather than market orientation.

Since the emergence of the financial crisis is strongly rooted in competency profiles, the study recommends employment-related policies to address the need for adequate training and increased research and development (R&D) investments in the financial sector. Among the comprehensive list of suggestions, two priorities emerge.

- Training policies should be reoriented towards the principles of capital markets, adequate consulation with clients, better understanding of financial products, control, and risk assessment. Governments should take initiatives to implement such new types of training in the financial sector.

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- Since risk-assessment tools failed to indicate long-term risks, R&D programmes should be launched to improve these instruments. Controlling principles should be reappraised in order to develop strategic control.

Human capital appears to be the key to restructuring, while public institutions can increase the pressure on the financial sector to develop a sustainable business model. Education and training is one way of proceeding along this route.

The future of financial services – the CBI and PWC vision

For 20 years, the Confederation of British Industry (CBI) and PricewaterhouseCoopers (PwC UK) have conducted the Financial Services Survey in the UK. The survey offers a quarterly insight into recent trends in and future prospects for financial services. Representatives of banks, building societies, investment managers, securities traders and the insurance industry participate in the survey. They are asked if they have become more or less optimistic about the situation in their sector. The survey also looks into trends regarding the value and volume of business, charges, costs, profits, employment and training.

With this experience, CBI and PwC UK looked to the next 20 years in financial services in the aftermath of the financial crisis. The sector analysis they conducted for the UK was based on the opinions of experts at the CBI and PwC UK and interviews with 20 leading figures in and around the industry.

The study revealed the following main findings for the UK.

- Different organisations evaluate the impact of the crisis differently. Banks, unsurprisingly, were hit hardest. British insurers have emerged relatively unharmed; the demand for some riskier insurance products has declined.
- The global banking sector will continue to be dominated by a few large institutions, mostly universal banks, which have the strongest capital base. There will be more consolidation of banks internationally and China is expected to become a global banking power, with its banks appearing in the top 10.
- Global investment banks suffered casualties during the financial crisis. In the future, new competition will emerge from hedge funds and boutique advisers.
- UK banking will be dominated by the big five banks (Barclays, HSBC, Lloyds Group, RBS, Santander); in addition, new competitors will arise with the consolidation of smaller organisations. State-supported banks will be restructured. Building societies could play a strengthened role in retail banking due to continuing mergers.
- London will remain an important centre for asset management. No serious restructuring among UK leaders is expected. However, recent acquisitions tend to be from foreign entrants, from North America and continental Europe. The EU Alternative Investment Fund Managers Directive represents a threat for London as a European centre for hedge funds and private equity.
- Insurance will be further consolidated, even though capital requirements in the aftermath of the financial crisis could hamper the sector.
- Financial products will have to become more transparent because people have lost trust in complicated financial products. Innovation will have to fight to prove its worth.
- There will be considerable pressure on banks and other sectors to stop focusing on profit maximisation in the short-term and to pursue a more sustainable business strategy over medium- and long-term periods.
- Government intervention and stricter regulations are expected to persist and international coordination of measures aimed at avoiding a recurrence of the financial crisis will be pursued.

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- Risk management will become more important. Regulators will develop capital adequacy rules further by defining risk-adjusted requirements for particular activities. As a result, some investment activities will become less attractive.
- Due to a competitive advantage in financial services, London's role as a financial centre has not been damaged by the crisis so far. However, excessive or inappropriate regulation will weaken the UK's competitive advantages, which include the use of the English language and its time zone, legal system, and professional services and systems.
- Tax increases that are not temporary and appear to be politically motivated could drive firms and individuals out of London and could hamper overseas financial services organisations wishing to expand into the UK.

The future of the global financial system – the World Economic Forum's opinion

In 2009, the World Economic Forum developed four scenarios on the future of the post-crisis financial sector. The Forum's report scrutinised the governance and structure of the global financial system in the short and long term. The short-term outlook is based on an analysis of recent changes in the financial system and the long-term outlook is based on scenarios up to 2020 (World Economic Forum, 2009).

Short-term outlook (up to 2012)

The financial sector is being forced to adapt to 'a new environment of tighter credit and slower economic growth, increased government intervention and a threat to the previous pace of globalisation' (World Economic Forum, 2009). Four trends have been identified.

- **Interventionist regulatory reform** Due to the commitment of global policymakers to a new regulatory framework, the expansion of regulated entities, increased global regulatory coordination and constraints in the growth prospects of incumbent financial institutions can be expected.
- **Back to basics in banking** All types of banks have started to repair their balance sheets with higher liquidity and capital ratios, in combination with reduced short-term wholesale funding. Re-regulated banks are refocusing on core competencies. However, bank strategies are less likely to overlap as banks will focus on their individual competitive advantages.
- **Restructuring in alternatives** Several actors have suffered in the current financial crisis, both as a result of deleveraging and market turmoil. Hedge funds have experienced substantial losses. Meanwhile, many investors are paying more attention to low-cost indexation strategies and 'new beta' asset classes. This could foster 'unconstrained' providers of capital such as family offices and sovereign funds.
- **A tale of two insurers** The fortunes of the insurance industry are broadly split two ways: property and casualty versus life insurers, and North America versus Europe. Many organisations will be able to capitalise due to the emergence of new acquisition opportunities, continued demand for retirement products and an increased use of traditional insurance products to hedge risk. As a result they will be able to strengthen their underlying businesses.

Long-term scenarios (up to 2020)

The future of the financial system will be influenced by a wide range of external forces and uncertainties. Four long-term scenarios were developed during 2008 by 250 financial executives, regulators, policy-makers and senior academics in eight different workshops. The scenarios differ regarding a wide range of drivers such as the evolution of energy and commodity prices, global economic growth, fiscal policies, trade regimes, climate change, exchange rate policies, extremism, demographics and global wealth distribution. In principle, however, they are segmented by the type of multilateral cooperation or non-cooperation in world markets.

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The four scenarios can be summarised as follows.

Scenario 1 – '**Financial regionalism**' describes a financial world separated into three regional blocs—the US-led Democratic Trade Alliance, the expanded EU area and the Eastern International Economic Community led by China. This new structure forces global organisations to construct tripartite strategies to operate globally. Moreover, old and new champions will seek to operate on a regional basis, while Asian financial institutions will dominate the global landscape in terms of size. Due to a deepened crisis in the US and Europe throughout 2010, emerging markets will turn away from a series of global talks, reject western models and ideals, and form their own bloc of domestically focused economies. The US will be in an isolated position. Most of the trade that flows among the blocs will decline sharply – with the exception of tourism and energy materials. Energy security will become a key issue.

Scenario 2 – '**Re-engineered western centrism**' describes the way in which, after a short period dominated by politicians and regulators, the financial world is once again a major engine of profitability and growth managed by insiders. The advanced economies will drive a new phase of growth due to restructuring in the developed world and marginalised exchanges with emerging markets. The West will maintain an economic and moral leading position by playing a primary role in corporate restructuring, driving productivity increases and maintaining free trade globally. In comparison with the West, emerging economies will have been severely affected by the global recession. The biggest achievement in this scenario is the reform of existing international financial institutions – known as 'Bretton Woods II' – and the creation of a supranational regulatory authority. Unfortunately, Bretton Woods II has shortcomings for the needs of emerging economies, and the new regulatory regime fails to consider structural flaws in risk management, leading to renewed fears of an even bigger crisis.

Scenario 3 – '**Fragmented protectionism**' describes a financial world that is extremely localised and highly volatile. Those with the ability to execute trades across borders will face major arbitrage opportunities. Unfortunately, capital controls in most jurisdictions will make this very difficult and the political risk will be high. This is a world characterised mainly by division, conflict, currency controls and race-to-the bottom dynamics leading to long-term impacts from the financial crisis. Due to the global recession, a range of other events, such as inter-state conflict, domestic unrest and natural disasters will have contributed to make things worse. Countries will be eager to look after their own economic interests, blaming each other and turning to populist, protectionist policies. As a consequence, resource conflicts and security threats will emerge as well as terrorism. This will keep nationalism and protectionism alive despite their high economic cost.

Scenario 4 – '**Rebalanced multilateralism**' describes a world of initial barriers to coordination, and disagreement on effective risk management approaches. These are overcome in the context of rapid shifts in geo-economic power. The global community will learn from its mistakes through cooperation: while the US will go through successive crises and the emerging economies will battle their own problems, the world will eventually realise that meaningful collaboration is the only way forward. Major shifts in international institutions and a new recognition of the meaning of global governance will play a dominant role and will imply that the financial system is better suited to the challenges of a complex, interdependent world in 2020, even if it is not perfect. Emerging markets will play a major role in setting the pace for economic growth, cooperation in financial policy and new approaches to systemic financial risk. The financial system will be globally integrated. However, due to the rapid growth of emerging markets, in many cases it will be dominated by players from Brazil, Russia, India and China (BRIC).

Technology and innovation

In 2007, the World Economic Forum developed three scenarios to explore how technology and innovation will reshape the financial services industry by 2020. The objective was to investigate access to, and delivery of financial services. The scenarios were also developed to face uncertainty with greater knowledge and understanding and to help identify future risks and opportunities within the financial service sector. The scenarios were developed at workshops in Davos, San Francisco, London, Boston, Tokyo and New York by leaders in business, society, academia and government from Asia, Europe and North America. They were led by questions of how the globalisation of financial services will evolve and what type of innovation will arise (World Economic Forum, 2007).

Scenario 1 – the ‘**Global Ivy League**’ constitutes a state in which innovations are mainly driven by a small number of large global financial service providers. The current systems, distribution and sales channels, and business models will be incrementally improved and the service providers developed as global processing factories with customised front ends. Governments will support globalisation but will protect customers and regulate the sector only in a conservative manner. Trust in digital media will decline and thus consumers will favour traditional service providers.

Scenario 2 – the ‘**Next Frontier**’ describes a world in which financial services act on global markets but innovations are driven mainly by new entrants and specialised players. Governments pursue deregulation and technology enables a number of new business models to arise. The financial service sector will operate as a modular ecosystem of highly specialised providers. New players will include telecommunication companies, peer-to-peer financial service providers, processing providers, retailers and internet companies.

Scenario 3 – ‘**Innovation Island**’ differs from the other scenarios in that local and regional financial services markets diverge fundamentally. This is caused by geopolitical tensions and instabilities, which will slow down globalisation. Government policies towards the financial service sector will differentiate among countries.

Three trends will emerge from these scenarios.

- ‘**Leapfrogging**’ Government regulations and investment in infrastructure in large emerging economies such as China and India will promote the local financial services industry. This will expand access to the poor, which will lead to new business models that ‘leapfrog’ over developed markets and lead to a large variety of specialised players. Such models include mobile banking and peer-to-peer ‘e-platforms’.
- ‘**Business as usual**’ Innovation will neither accelerate nor decelerate and will therefore lead to only small changes in business models. This will apply to developed countries such as the US or European countries.
- ‘**Back to the past**’ Governments in the remaining countries and regions, mainly developing countries, will increase the level of control over the financial services sector but will not promote local innovation. There will therefore only be little progress and even a regression in the efficiency and quality of financial services.

World economic growth will differ depending on the degree of globalisation. Protectionist environments are assumed to curb growth while open markets will lead to growth rates of 4%. Financial services were expected to grow continuously until 2010 based on the increase of wealth. The largest expansion was expected in health insurance, retail banking and asset management while retail banking was predicted to have slow growth. By 2020, the proportion of GDP contributed by financial services was expected to range between 8% and 11%. The ‘Global Ivy League’ scenario is dominated by an industrialised operating model. In the other two scenarios, a greater variety of operating models with many specialised players is visible, due to the vertical disintegration of the value chain.

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Scenarios for the adaptation phase

This section will develop three scenarios for the adaptation process in European financial services, based on the conclusions that can be drawn from the analysis in the previous chapters.

The three scenarios, which will be detailed in full on subsequent pages, are:

- ‘The past is the future – a high risk scenario’;
- ‘A new world order for financial markets – the end of the golden age’;
- ‘Divided economies – a worst case scenario’.

Two major drivers for creating these scenarios have been identified and are going to be used as a starting point for the scenario description. These drivers are:

- the risk of a recurrence of the financial crisis due to the instabilities of financial markets, the uncertainty of growth in real economies, the uncertainty about future public budgets, and the way in which this feeds back into financial markets (in the first two scenarios, the financial crisis can be kept under control; in the third, it cannot);
- the determination of the G20 countries and the international community to establish an efficient regulatory framework for financial markets: introducing such a framework will not only stabilise the financial and economic systems but will also have a strong impact on restructuring in the financial business (scenarios 1 and 3 expect these negotiations to fail, while scenario 2 expects them to succeed).

Of course, there are a number of other drivers, such as the behaviour of Asian countries in the ongoing G20 negotiations, or public reactions to policy decisions and business practices. These are included in the scenarios in order to paint a full picture of economic and social development. The impact on employment, income relations and social dialogue is discussed in each of the scenarios.

Summary of current trends

Disconnected financial markets

In contrast to many expectations in the immediate aftermath of the crisis, the financial sector has not reached calm waters yet. The financial crisis first transformed itself into an economic crisis and has now become a sovereign crisis. The weaknesses of financial intermediaries have merged with the failure of already vulnerable companies, the poor position of redundant workers, and finally with weak economies. While the contagion is spreading and affecting the actors with the weakest ‘immune systems’, the questions of cause and effect are becoming more and more blurred. However, the origin of the crisis is still very clear.

During the last decade a financial system has been developed that is largely disconnected from the real economy. New and profit-yielding segments for derivative financial investment, based on speculation and arbitrage, emerged as a consequence of the liberalisation of financial markets, the globalisation of capital flows, and real-time access to trading platforms worldwide. Favoured by a low interest monetary policy, investors used strong leverage to finance short-term financial derivatives rather than long-term real growth projects. The financial system separated itself from the rest of the world without being independent of it. In the end, the system was not sustainable since the enormous sum of bets was based on inaccurate assumptions. Being unable to cover the risks with their own resources, financial intermediaries depended heavily on public help, and some continue to do so.

The process is part of a widely applied reform approach, in which liberal economic policies go hand-in-hand with a widening disparity of income and wealth. The upper segment of the population experienced unprecedented income growth as top earnings among managers or investment brokers expanded a hundredfold compared wtih those of average workers. This has been a central driver in the expansion of new financial markets, providing plenty of opportunities to achieve extraordinary profits, especially since as the new products were barely understood, even in financial circles. A new class of bankers strongly oriented towards short-term profits has taken charge, focusing on shareholders rather than society.

While a few of the top financial managers realised the risks in the changes that were underway, they did not have the power to keep the system on track in a sustainable way and did not implement the restrictions being discussed in today's climate. In this sense, the financial crisis appears to be the failure of a whole generation of managers who were unable to resist the temptations of short-term profits and did not feel obliged to consider the fundamental economic and societal role that the financial system plays.

Only the severity of crisis has been able to reduce incentives and sharpen awareness of the unavoidable link between profit and risk. A substantial proportion of the financial sector, nevertheless, is currently engaged in the restitution of former markets. Some leaders in the sector still view the crisis as nothing more than a disastrous combination of unfavourable conditions, and continue to refer to the efficiency gains from highly flexible capital markets. This attitude is supported by recent experience of the moral hazard that has played, allowing financial market actors to engage in high-risk activity without having to bear the full financial responsibility for their actions. Public support programmes, having been indispensable in protecting the population and the real economy, are now inviting risk-oriented financial actors to resume their previous business approach.

Weak economic growth

The economic shocks cannot be expected to have finished. The crisis is now a crisis of public budgets, which will soon be transmitted to the real economy again by way of austerity programmes. Rising default rates will feed back to the balance sheets of banks and create a new vulnerability, which once again, will only be cured by public contingency programmes. The vicious circle has started to revolve again.

As a result the expectation of a rapid recovery has proved wrong. As research evidence from previous financial crises suggests, financial stress must be expected to reduce growth for a longer period (Reinhart and Rogoff, 2009b, p. 224): firstly, asset-market collapses are deep and prolonged; secondly, the aftermath of the banking crisis is associated with profound declines in output and employment; and thirdly, government debt tends to explode, mainly due to the inevitable collapse of tax revenues.

This is exactly what is happening in Europe and the US. The restructuring of economies, the modernisation of public infrastructure, the expansion of education and training systems, and the continuation of social programmes all belongs in the past. It is more likely that the crisis will result in a substantial proportion of future economic growth being used to finance abandoned construction sites and further writedowns on the virtual property of the previous decade. It is not only those who were engaged in speculation who will have to carry the burden; rather, the impact of the crisis will further weaken the weak and strengthen the strong. Some observers regard this as a necessary starting point for regeneration. However, it comes at a price.

One high price is the enormous increase in public expenditure. The public will have to pay for mistaken investment decisions and the lifestyle previously enjoyed by top earners. Public services will be constrained and growth potentials will remain unrealised. Overall economic growth will be weak and tax revenues will be similarly sluggish. Tax rates can

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be expected to increase. This will be a decade of public poverty with high tax burdens – a lost decade in the sense that some of the income that will be produced in this coming decade was already spent in the previous decade.

The strong economic growth of the real economy, which can be seen now in the US in particular, is urgently needed in order that countries can pass through this period of consolidation as rapidly as possible. However, stimulus packages are being phased out and the probability of their being extended is low. The financial crisis is still far from over and additional burdens are visible, for example in the form of the recent turmoil triggered by the Spanish savings banks (Handelsblatt 2010f).

Another consequence of low growth in Europe is that the world economy will be rearranged around Asian markets. These are the new growth centres, attracting many investors and redirecting financial and commodity flows. China's financial institutions have increased their strength considerably. The Industrial and Commercial Bank of China is the fifth largest company worldwide, with 385,000 employees and total assets of RMB 9,760 billion (€1,148 billion). It is followed by the China Construction Bank, the Bank of China, and China Life Insurance which – together with energy providers – all rank among the ten biggest companies in China (Handelsblatt 2010g). The Chinese banking system is therefore well prepared to take a stronger role in the world financial system.

Global trade imbalances will also persist, at least in the medium term, and will continue to result in accumulated debt in countries with negative current account balances and a build-up of foreign exchange assets in countries with positive account balances. This is unsustainable and points to the need for fundamental structural reforms.

Two scenarios have been developed by the European Commission as regards the unwinding of global imbalances (European Commission, 2010a).

- A benign scenario, under which the correction of the US current account deficit is offset by an equivalent increase in aggregate demand in Asia, led by China, and helped by the removal of the de facto exchange rate pegs to the US dollar. While overall effects for the EU are expected to remain minor, growth – notably in the euro area – would remain sluggish in line with weak potential growth.
- A harmful scenario, in which Asia maintains its exchange rate pegs to the dollar and fails to offset a permanent reduction in aggregate demand in the US. In this scenario, growth in both the euro area and the world economy as a whole suffers. To avoid this outcome, the EU Commission recommends removing rigidities in services, labour and capital markets, reducing skills mismatches and boosting innovation and productivity.

This is the unfavourable choice between stagnation and recession. Substantial imbalances exist between European countries in the euro area, which can only be removed by a permanent restructuring of real economies. This, however, means a long transition period with low growth and high unemployment.

Regulation of financial markets

Since the culmination of the financial crisis in September 2008, governments have reorganised the institutional structure of financial supervision. At the international level, the Financial Stability Board has been established to coordinate financial supervision and advise the G20 governments. At the European level, two institutions will be created in 2011: the European Systemic Risk Board and the European System of Financial Supervisors.

A few measures have been implemented.[3]

- The European regulation of hedge funds was passed in May 2010.
- Substantial parts of OTC papers will be exchanged over trading platforms, and Germany has partly banned uncovered short-sales.
- Consumers have to be informed about key features of investment products.

Many regulatory measures have been suggested.

- The level of core Tier 1 capital ratios is still open as is the implementation of liquidity buffers. Both will become more concrete when the results of the impact studies, presently being undertaken by the Basel Committee, are available.
- International accounting standards have been submitted in the first phase. Two more phases are expected.
- Solvency II will have to be implemented by the EU Member States by the end of 2012.
- Rating agencies will have to be registered in the EU and will be supervised by national authorities.
- Updated standards for corporate governance, particularly concerning management, risk assessment and transparency will be discussed in 2010.
- Supervisory colleges will coordinate cross-border supervision of systemic banks.

This is a long list of proposals rather than actions. Nevertheless, the principal direction of financial regulation is likely to be decided during 2010 at the G20 summits, particularly at the December summit in Seoul. The summits will have to decide on the principles of financial reforms in order to create a new basis for functioning and deleveraged international financial markets. The key principles include:

- the application of the ‘Volcker Rule’, which separates retail and investment banking;
- the imposition of size limits on systemic banks;
- the regulation and supervision of derivatives markets;
- the enforcement of living wills;
- the imposition of a bank levy;
- the introduction of a trading tax.

[3] For more details see ‘Regulation of financial markets’ on page 17

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This list contains enough controversial issues to ensure a long and intense debate. In particular, those countries that passed through the crisis without serious impairments are currently objecting to additional burdens. Moreover, banking and insurance associations advise against higher capital ratios, reduced leverage, financial levies etc. As the European Banking Federation stated in 2010. There is, however, a limit to the amount of extra regulation that the banking sector can sustain, particularly if it is to preserve its capacity to finance the economy. There is also a limit to the competitive distortions in the global market place that the European sector can withstand as a result of ill-implemented regulatory changes' (European Banking Federation, 2010b). In its opinion, there is also great uncertainty about the impact of new rules.

However, the US experience shows that the pressure from an angry public is strong and politicians may not get a mandate for a second bailout of financial institutions. The Wall Street Reform Bill can therefore be expected to have a strong impact on G20 negotiations, and European governments will feel the pressure to take action considering the imbalances of their economies.

Hence it can be assumed that the regulatory framework will change. There will be an increase in capital ratios and/or a bank levy, a restructuring of those institutions previously deemed 'too big to fail', stricter control over derivatives markets, and more rigorous accountancy rules. While it is clear that changes will be introduced, it is too soon to say how effective they will be and to what extent they will affect the behaviour of financial intermediaries.

Currently, those who were responsible for overseeing the system – in an attempt to address some of the damage done – are enforcing restrictive rules without undertaking a complete overhaul of the regulatory framework. As a consequence, financial intermediaries have started to increase capital ratios, improve risk assessment, and revise bonus systems. The necessary deleveraging of the financial sector started with full awareness of the recent crisis and in anticipation of a new regulatory framework. Financial regulation will therefore need to enforce the deleveraging process and safeguard any achievements.

New business models?

The review of the case study evidence suggests that the management teams of financial companies reacted to the crisis essentially by going back to the model of their core business. All of the companies in the cases analysed followed this approach. Universal banks are trying to be universal banks, savings banks remain saving banks, and investment banks continue to be investment banks. A general deleveraging of the banking business can be observed, but with only minor restructuring. All the companies want to develop their traditional strengths and are cautious about approaching new market segments. The 'bancassurance' approach is out of date. Venturing into new financial markets has been largely stopped. Mergers have focused on acquiring companies with closely related activities, particularly in retail banking.

This comes as a surprise because a crisis provides plenty of opportunities to attract new customers, squeeze weak competitors out of their markets, and buy companies out at low prices. However, new risks are being avoided because resources are scarce. Deleveraging therefore not only decelerated growth but slowed down the restructuring of the business in all areas of the financial sector.

This is also the reason why no clear 'leader' emerged from any of the scenarios developed in 2009 (Economix/DKRC 2009). Different trends continue in parallel: large private banks, small savings banks and mutual banks, and the new group of state-controlled banks, which still require public help. Given this structure, the financial sector currently has a wait-and-see attitude, looking forward to a new regulatory regime, backing up market positions, and still fighting against the imponderability of the crisis. Business models will therefore be adapted only gradually in the near future.

The next section will outline the scenarios in detail.

The past is the future – a high-risk status quo scenario

In this first scenario an attempt was made to think about the consequences of the present trends summarised in the previous section. There are strong forces at work: the situation is fragile, with neither the economic upswing nor the sustainability of the financial system guaranteed. Hence, this is called a 'high-risk' scenario.

Revival of 'liberal' capital markets

Banks and financial intermediaries following a 'liberal' approach can be expected to use every opportunity to expand their business volume. Having mastered the crisis successfully and having returned to profitability, they may be the first in raising additional funds on capital markets in order to finance their expansionary plans. The demonstration of stability and market power may convince investors – and eventually regulators – that this business model is not only promising but also sustainable, at least if the general economic conditions are balanced.

A growing proportion of investors will go into the markets seeking a return on their investment, rather than security. They will continue to look for short-term profits and expect financial intermediaries to provide such opportunities. New products will therefore be developed with more sophisticated risk assessment features but also with high leverage. Hence, financial intermediaries will gradually releverage their activities as much as is compatible with the new, more restrictive regulations. Investment banking will be revived and will become a growth market again.

Financial markets will successfully delay the introduction of more rigorous regulation, making reference to the fragile economic recovery and arguing that such reforms should be evaluated in detail before being implemented. Substantial regulatory reforms can therefore not be envisaged before 2020 – if at all – because the period of light regulation will open the opportunity to restructure the business according to the preferences of these financial actors. Of course, the business will not return to the pre-crisis system with non-transparent products, high leverage and a substantial volume of non-banking transactions. The business will have to provide proof of greater safety, transparency and trust. Marketing departments will attest to these new features of financial products, and product development will also adjust to these trends. The principal business orientation towards shareholder values, however, will remain unchanged.

Companies will also seek to exploit economies of scale. These will remain substantial due to the permanent improvement of information technology. Complex risk-assessment tools will have to be established. Administrative operations will be further automated and services for private clients fully transferred to the internet or automatic service machinery. Back-office processes will be concentrated on big service providers. Asset-management tools will be sophisticated. All this requires huge amounts of financial resources, which can only be marshalled by big companies. They have opportunities to win this competition in the field of cost efficiencies.

Exit from state-ownership

Governments will keep to their plans of exiting from the control that they currently hold on banks that have been rescued by public funds. The recovery of the banking sector will improve the situation in state-controlled banks, and restructuring plans will contribute to that. Faced with the strong motivation of private banks to expand their retail banking business, opportunities for mergers will arise. Those parts with sufficient profitability will be sold to the 'liberal' banks, which will have meanwhile achieved a dominant position. The unprofitable parts will be closed or shifted into 'bad banks'.

The overall profitability of state-owned banks will remain weak as their access to the high yield investment banking segment is restricted. They are still burdened with substantial writedowns on securities. As low-profit banks are generally inclined to take higher risks and pay higher interest rates for deposits in order to improve their current financial position, the future risk of writedowns remains high. This has recently been revealed by the disproportionate exposure of state-

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owned banks to Greek securities. With these facts in mind, governments will be highly motivated to exit from state ownership.

The high probability of takeovers is due to the widening gap of profit rates between independent private and state-owned banks. This will not only improve the relative financial position of independent private banks, and thus provide the resources for takeovers, but will also expand the distance between the two groups regarding market position and technology. State-owned banks will have difficulty in investing in new technologies on a broad scale. The independent private banks will therefore be in a position to offer superior technological standards and high cost savings. However, the market position of state-owned banks in retail banking will remain attractive as customers will stay with their banks due to the explicit state guarantee.

The core problems of this segment are those banks that have only a limited chance of returning to profitability in the medium term. These are the bad banks of the future. While risks have already been taken by public budgets, for example with the German Landesbanken, there will be only limited scope for further support, given current budgetary restrictions. The need for orderly resolution – a winding up of the banks in a structured procedure – will grow.

A stable market segment for local banks

The strong retail orientation of savings banks and cooperative banks has limited the profitability of this sector and will continue to do so. Both segments will continue to focus on customer services rather than profits, and hence will be able to preserve their market shares. However, they will not have the resources to expand their activities into new market segments such as asset management for wealthy clients or international trade. No substantial movement can be expected, as the case studies confirm. This will be strongly linked to the fact that any change of business model is inevitably punished by the customers. The example of Leek United revealed that any modification of the traditional business model is going to irritate clients. The company is therefore continuing with the successful business approach of the past and – as a consequence – growth appears to be demand driven rather than supply driven. Such difficulties exist for large parts of the local savings and cooperative banks sector.

Ethical banks: demand-driven growth of ethical banks

This does not exclude the further rapid growth of 'niche' banks as the German GLS bank has demonstrated. An increasing number of customers consider environmental and social principles to be important for the banking business and so prefer these types of ethical banks. A further expansion of these banks can therefore be expected.

The current shift towards these banks will be strongly linked to demand, and a rising number of ethical banks will enter this market. Other banks will probably join this trend and offer similar ethically oriented financial products. However, the overall orientation of the bank will be important to clients rather than the features of a single product. The opportunities for simply copying and integrating the 'ethical' approach into other business models will remain limited.

Insurance

In a similar way to private banks, the insurance business will be able to avoid radical changes in the regulatory framework in this status-quo scenario. This means that the validation of assets will not be fully changed to the fair-value principle, reporting requirements will be kept at acceptable levels and capital requirements will be only moderately increased. This will provide the opportunity to continue present business approaches and preserve different company structures.

Life insurance will remain exposed to the crisis. This is the segment of the insurance sector with substantial financial reserves, invested primarily in stocks, state bonds, and to a minor degree in derivatives. Stress tests showed that this is the most sensitive part of the insurance business after monoline insurers. New risks will arise for life insurance with the instability of sovereign debt. The downgrading of different state bonds will force life insurance to increase capital ratios and redirect assets towards better securities.

Moreover, the life-insurance business is under pressure from low interest rates, which reduce the net interest margin between interests on assets and guaranteed life insurance yields. For parts of life insurance contracts that have such guarantees, these already low margins turned into negative figures, because of changes in monetary policies. The situation will remain difficult during the low-interest phase.

Impact on employment and working conditions

Sluggish economic growth and the focus on cost efficiency in all segments of the financial sector will further reduce employment prospects in the sector. While the crisis can be assumed to have resulted in a significant reduction of employment in investment banking, among state-owned banks, and to a lesser degree in most of the other segments of financial services, the need to apply more productive technologies and more efficient work organisation concepts will continue to result in reduced employment. This will affect traditional front- and back-office services more than investment banking, which will see an upswing again.

Social dialogue will remain difficult under these conditions. New forms of work organisation will not only increase the workload but will also become more restrictive as more rigorous rules are imposed by risk assessment and internal controlling. Efficiency standards will continue to rise.

Remuneration schemes will not return to previous models as the principle of deferred payments of bonuses will be assessed as being efficient. Investment bankers, however, are in a good position to negotiate for higher bonuses as they again contribute to profits disproportionately. Management remuneration can also be expected to rise.

A high-risk scenario

While this scenario assumes prevailing trends in the financial services sector to be stable, it nevertheless appears to be a high-risk scenario. It excludes the emergence of a third or fourth shock wave. It assumes that private banks are able to compensate for rising credit default risks and keep control over investment-banking activities. It expects that governments will not kill the economic upswing and will be able to achieve a gradual exit from both state-ownership of vulnerable banks and high levels of public debt. The scenario adopts a primarily optimistic stance.

Moreover, the scenario portrayed cannot be described as sustainable as it does not address the factors that caused the crisis. On the contrary, it assumes that minor corrections of the regulatory framework will be sufficient to avoid further imbalances. This may be the case in the short or medium term. The latent risks of new imbalances, however, persist and markets will determine at what point in time they will become apparent.

Finally, the scenario assumes that all banks will concentrate on retail banking markets in order to improve the sustainability of their business models. This cannot work as a strategy, as these markets are occupied by various providers and cannot be expected to grow rapidly. Strong competition on retail markets will therefore further reduce the attractiveness of this segment. Profit-oriented banks will be inclined to return to the highly speculative parts of investment banking.

As long as the current adaptation process follows this scenario – actively promoted by parts of the banking industry and passively supported by the deferral of regulatory reforms – all actors run high risks. The insolvency of a large bank, or a further state crisis, could destabilise the system again. Hence it is time to think about alternative scenarios.

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A new world order for financial markets – the end of the golden age

Passing through a phase of controversial debates during 2010, the G20 governments will nevertheless compromise on the basics of a new financial order, which will strongly affect the world financial system. An agreement will be reached because there are clear signs of a second mortgages crisis in the US and Europe, which will destabilise a series of banks and once more have a significant impact on public budgets. Both the general public and the business community will be pressing for greater controls over financial markets in order to return to greater stability in both product and labour markets. The prevailing financial system is perceived as a source of ongoing instability. The new financial markets in particular are seen as instruments of wealth redistribution rather than of value creation. Financial regulation will thus be prompted to curb these markets to levels that are needed by the real economy. The anger among voters will persist, and politicians will be expected to bring an end to excessive speculation in order to avoid future economic crises. Facing the fact that a reemergence of the financial crisis will affect all economies, due to the tight linkages between them, countries that do not feel themselves to be responsible for the difficulties will agree to share the burdens of the new financial system.

Outline of the new financial order

At the December 2010 summit in Seoul, the G20 governments agree on a series of fundamental principles of the new world order for financial markets.

- Equity ratios will be increased gradually but substantially, in order to improve the resilience of all financial intermediaries. The ratios will vary according to the risk of assets and the systemic relevance of the companies.
- Firewalls will be established by the strict separation of retail and investment banking. The size of companies can be restricted if there are substantial systemic risks.
- Financial intermediaries with systemic relevance will have to periodically submit ‘living wills’ for a rapid and orderly shutdown. Financial supervision will be enforced to impose such plans.
- Non-banking and non-insurance financial intermediaries will be subject to financial monitoring and regulation. Derivatives will be traded fully on central clearing platforms.
- Rating agencies will have to register and disclose assessment methods, and investors will have the right of action against the agencies. Rating analysts will be required to pass qualifying exams and participate in ongoing training.
- The role of supervisory boards over information and decision rights will be strengthened.

The reform – which uses the US Wall Street Reform Bill as a template – will be supported by the rapid creation of the already decided financial supervisory boards in the US and Europe. Other countries will establish equivalent bodies. Particular attention will be given to macro-prudential risk assessment, based on a permanent exchange of statistical information and assessment results. For political reasons, a bank levy will be imposed on big banks. This however, will be assessed as insufficient both for refunding the cost of the financial crisis and for protecting against future crises. For similar reasons, a transaction tax will not be introduced.

The basic short-term instrument of the new financial order is the equity ratio, which allows supervisors to directly impact leverage ratios and profit rates of financial intermediaries. The main long-term instruments are the direct and size-related restructuring measures and the enforcement of living wills. The latter will considerably improve risk assessment and long-term financial reserves.

Restructuring trends

The application of the 'Volcker Rule' will strongly limit the universal banking system in Europe. Large banks will have to sell their proprietary trade subsidiaries and end their engagements in the new financial markets. They will be transformed into service oriented retail and commercial banks on one hand, and property-oriented investment banks on the other. This will be more than an organisational change. It will cut the cross-funding between retail or commercial banking and investment banking. As investment banks will have to raise funds on capital markets, this can be expected to submit investment banks to stronger market control and possibly higher interest rates.

Higher equity ratios will reduce profitability or – as far as markets allow – increase credit costs. As equity ratios will be risk-based, the effect will not be neutral regarding the different segments. Investment banking will again be affected – high-risk investment banking in particular. This is the intended effect of a system that wants investors to become aware of their risks, reduce internal and external risk sharing, and establish the required security funds with their own resources. The living wills can be expected to change decisions in the same direction.

Together with the various measures for improving supervision, the rules can be expected to go far beyond the early identification of future crises. They will achieve a long-lasting reduction of leverage, at least if governments decide to raise equity ratios. They will also achieve the shrinkage of investment banking and derivatives markets. They will reduce profits from banking and insurance activities in general, and, depending on market developments, raise prices for credits and lower returns on investment. They will terminate the golden age of financial services.

The banks with a 'liberal' business model will be particularly affected as they belong to the systemically relevant big players, provide a universal range of banking services and are strongly involved in proprietary trade. They will have to develop two business models instead of one: one for retail and commercial banking and the other for the new, independent investment banking company. As they will not be allowed to have direct financial links between the two parts, they will communicate with each other only via capital markets. This will isolate the risks of investment banking and thus raise capital costs according to the perceptions of markets rather than the banks' own considerations. Moreover, all activities will be oriented towards lower leverage and lower profits. This will increase competition on retail and commercial markets and accelerate productivity-oriented reorganisation.

With higher capital requirements, the state-owned banks will have difficulty achieving profit targets. Moreover, they will have problems in raising new capital and thus financial stress will increase. Nevertheless, they will be ahead of 'liberal' banks as regards the restructuring of their business. This provides advantages due to the size and competitive position in retail banking markets. Being submitted to the same equity rules as other banks, their retail banking business will bring back market strength. Under the condition that governments are willing to absorb the 'brown fields' of toxic assets, state-owned banks will have the opportunity to play a strong role in retail and commercial banking and become independent again. Government shareholders will promote this development as it will open the opportunity to sell shares with profits.

The segment of 'sustainable' financial intermediaries will be strongly favoured by the reforms, particularly as customers have a clear preference for security-oriented products and trusted financial relations. The business representatives will realise the advantages of the reform as it confirms the 'sustainable' business model as the benchmark for the whole industry. Higher equity ratios can be expected to reduce profit margins of the 'liberal' banks and thus reduce their competitive edge in comparison to 'sustainable' companies. Business associations in the 'sustainable' sector will therefore change their strategy and will actively support the implementation of the financial reforms.

The insurance industry will also profit from both customer orientation and financial reforms. The disadvantage of higher solvency ratios will be more than compensated for by rising demand, particularly for life insurance.

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Impact on employment and working conditions

The risk-based equity ratios will be a heavy burden for investment banking, hedge funds and the new financial markets in general. Employment can be expected to decline further in this segment. Investment bankers will not only face the decline of job opportunities but also a fundamental reorientation of their business. High-speed speculation will be substituted for by long-term asset management and the sustainable maximisation of return on investment. Only some of the present generation of investment brokers will be able to accommodate this cultural shock, particularly as the process will be associated with strongly declining income. A new generation of brokers will take the lead.

Financial services in general will face hard times as the reforms will curb profits rates markedly. Because the possibilities for price increases will be limited due to sluggish economic growth, the focus will continue to be on cost efficiency. All segments of financial services will therefore work hard to exploit the cost-saving potentials of information technologies and work reorganisation. The intensity of labour will further increase and work responsibilities will be extended. The overall number of jobs will continue to decline due to the shrinking profitability of the whole industry.

The need to keep customers satisfied will force financial services providers to invest in the quality of their services and the competencies of front-office staff in particular. The cost–income ratio in counselling services will rise due to the extended length and the improved quality of customer advisory processes. Employment will expand in these services and the wages of front office staff will rise in line with their increasing skills level. Expenditures for continuing vocational training will increase.

Employment in back offices will decrease further. The cost–income ratio for technical and administrative services will decrease due to the permanent substitution of labour by information and communication technologies (ICT). The skills composition of staff in the back offices will be upgraded as simple tasks continue to disappear.

A long transition phase

It will take time for a new financial world order to be implemented. Negotiations on the regulatory framework will take years, as will the sector's adaptation to the new circumstances. The negative impacts will be concentrated on financial industries in general while the positive effects of a more stable financial system will favour the real economy. And, as in many reforms, the short- and medium-term effects will be negative and positive impacts will only arise in the long term, meaning that detractors of the new order will feel justified in criticising it for some time into the future.

The determination of the G20 governments, however, will put in place a new orientation with long-lasting effects. The new order will act as a counterbalance to the turbulent events on capital markets and so reduce uncertainties among investors. Even if it is not entirely effective in the short run, it will affect the behaviour of private customers, companies and financial intermediaries positively and reorient their decisions towards the desired sustainability, and so result in calmer decision-making in capital markets.

Nevertheless, economies will pass through a long transitional phase with reduced growth, negative impacts from budget consolidation, and high unemployment. The cost of the financial crisis will have to be paid for by a long period of suboptimal growth. There is not much choice in any of the scenarios. In this scenario, however, the long-term prospects are sufficiently positive to merit the risks inherent in a fundamental financial reform.

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Divided economies – a worst case scenario

In this scenario, the financial crisis will continue to rage in Europe and the United States. The mortgages crisis in Spain will act as a stress test for the new European financial stability mechanism and will trigger a further downward spiral of the economic downturn. Public budgets will be overburdened with rescue programmes for both financial and non-financial companies. The turbulence will inhibit any international consensus on financial regulation. Every government will try to regain control over the capital markets. These however will be in uproar, enforcing a rapid rise in interest rates and bringing credit transactions close to a standstill. The situation will be worsened by events in the US, where a second wave of credit defaults will lead to the closure of a series of banks and bring the big players under stress again.

Spain, Portugal and Greece will be forced to resolve – close or nationalise – parts of the banking sector and restructure public debt with a cut of between 20% and 30% of their public debts. The US and the UK will see rising inflation and the periodic devaluation of their currencies. The euro area will refrain from monetary easing and stick to budget consolidation instead. Foreign exchange markets will become highly volatile as will stock exchange prices. Uncertainties will increase and at some point in time things will slide out of control.

Together with the confusion on capital markets, the austerity programmes of the euro area will lead to a deep recession. Stability funds will be overstressed. None of the countries will be able to comply with the Maastricht Treaty criteria. The big countries will develop their own strategies and rules to come out of the mess. Negotiations on a new financial order will fail. The euro area will show signs of disintegration.

The weaknesses of the economies behind the euro, the dollar and sterling will strengthen the power of the Asian countries, China in particular. Chinese banks and insurers will start to acquire European and US companies, and manufacturing companies will buy Western technology in large volumes. Investors and producers in Europe and the US will concentrate on the Asian markets in order to participate in the still positive growth of these economies. This will give China a strong say in the rules of international finance and a central role in the recovery of the world economy.

Impact on restructuring

The financial sector will be hit hard by these developments. Due to the integration of the system, all segments will be affected, even those that have been so far undamaged. The number of insolvencies among banks will increase as structured liquidation procedures are developed. Investors will strongly favour real estate and commodities.

During the first phase of the depression, private banks and insurance will be seriously affected by high default rates and the devaluation of financial assets. State-owned banks will largely be resolved. Due to the failure of financial market regulation, however, new opportunities will arise in liberal countries. They will attract substantial parts of investment banking at the expense of the more restrictive countries. This will help the new financial markets to revive by re-establishing internationally linked capital markets. Derivatives will be created at high speed. The investment banking business will try to recreate itself without making the mistakes of the past. This means huge investments in risk assessment tools and the quality of automated trading.

In the ‘sustainable’ part of the financial sector, savings banks in particular will come under stress as quasi-public banks. Investors will avoid investments in institutions with strong links to public authorities. Moreover, savings banks will hold large numbers of risky mortgages. In contrast, the cooperative sector will see new opportunities by profiling itself as the leader of the ‘ethical economy’. Mutual credit banks with a strong environmental and social orientation will be strongly preferred by customers who have lost trust in public authorities. These banks will also provide a wide range of micro-credits which will be needed to restart the economy.

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Sharpened social divide

Under such conditions, European countries will experience a deeper social divide, putting at risk the solidarity of European societies. On one side, a profit- and growth-oriented group of managers and professionals will be able to resurrect the previous strategies based on the opportunities of a widely unregulated financial sector. They will profit from the weakness of public authorities and search for high-profit investments worldwide, reinforce the relocation of production facilities to foreign countries, participate in the growth of Asia and South America, and select their place of residence according to tax rates.

On the other side, the local economy and the average working class person will strengthen their local economic and social relations. The major development strategy will rely on strong networks and regional linkages. Commodity flows will be redirected, tax revenues will be kept in the region, and social support programmes will be concentrated on local populations. Financial institutions will cut international relations and focus on regional developments. Some regions will even start issuing their own currencies.

The regionalisation of the economy will be promoted by those who are convinced that the globalisation of economies has been a fundamental error, believing that important aspects of social life have been violated by the global economy, environmental concerns have been neglected, and the financial system has emerged as a source of instability rather than growth. Faced with the incapability of public institutions to manage the crises, these parties will feel that they are responsible for constructing a new approach, one based on 'micro-organisms' instead of macro-institutions.

Employment effects, income and working conditions

Such a scenario will result in Depression-era levels of unemployment and a sharp decline in income. A large proportion of the population will be living at subsistence levels, public services will be run at minimum standards, production facilities will lie idle, and infrastructure will deteriorate. The income disparity will mean unprecedented wealth gaps between rich and poor.

In contrast to the times of the Great Depression however, the capacity for self-organisation will be strong. Given high skill levels in large parts of the population, countries will be able to achieve economic recovery with a broad human capital base. This will allow economic relations with local economies to be recast in a variety of approaches. Diversity, not harmony, will be the source of growth.

The financial sector will be strongly segmented under such conditions. The internationally oriented 'liberal' segment will be opposed to the locally oriented 'sustainable' segment. Financial relations between the two parts will be kept at a minimum and working conditions will differ fundamentally: high-performance profit maximisation at high salaries in the 'global' section of the economy, as opposed to client-oriented welfare maximisation at low incomes in the 'sustainable' section. The social divide cannot be expressed more clearly.

Social dialogue will come to an end in the 'liberal' segment of the financial sector. Neither managers nor workers will see the need for such a dialogue as all will feel like entrepreneurs and will have the bargaining power to protect their interests. In the 'sustainable' segment, however, social dialogue will flourish, since ensuring the representation of different interest groups will be a key principle of a network-based society.

A worst-case scenario

Of course this scenario describes the near-collapse of the liberal economies in the western hemisphere. The realistic content of this projection can certainly be questioned. However, this scenario was written not with the intention of describing the likely outcome of the crisis but rather to illustrate the risks currently being faced. The liberal economies have now looked twice into the abyss of a total meltdown, financially and economically. Such worst-case scenarios are therefore needed in order to understand the threats posed by current evolutions and to convince actors at all levels to fight for the reestablishment of a sustainable financial sector.

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Annex

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The recent financial crisis has brought to light the serious challenges that the European financial services sector is facing. What are the prospects of a viable, more resilient financial industry emerging from the crisis? This report reviews the economic trends in the banking and insurance industries and the debate on the regulation of financial markets. It looks in detail at the business models that are applied as a response to the crisis.

Finally, it develops scenarios for the potential adaptation process of the European financial services sector. The research was conducted by means of case studies of a range of companies in the sector, an online survey and interviews with experts from companies, social partners, research institutions and public authorities.

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