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# Financial crisis: Lessons learned for banks and their controllers

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# Causes of the financial crisis.....

- Too much credit compared to economic output

<b>Total assets, in % of GDP</b>								
	2003	2004	2005	2006	2007	2008	2009	<i>Avg. speed p.a.</i>
<b>Eurozone</b>	<b>194,6%</b>	<b>202,5%</b>	<b>221,8%</b>	<b>233,1%</b>	<b>250,6%</b>	<b>262,4%</b>	<b>265,5%</b>	<b>5%</b>
<b>CEE</b>	<b>53,9%</b>	<b>54,6%</b>	<b>59,3%</b>	<b>65,2%</b>	<b>73,5%</b>	<b>81,6%</b>	<b>86,4%</b>	<b>8%</b>

# .....Causes of the financial crisis

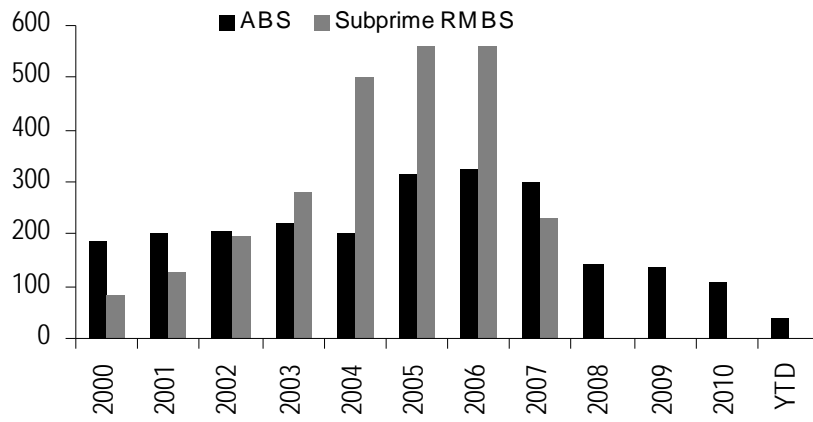
- Emerging market credit boom fuelled by G7 currency import

<b>Total assets, in % of GDP</b>								<b>Avg. Speed</b>
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>p.a.</b>
Poland	62,6%	62,5%	64,2%	68,6%	71,4%	85,7%	83,8%	<b>5%</b>
Hungary	76,5%	80,6%	90,0%	99,2%	107,7%	125,2%	130,7%	<b>9%</b>
Czech Republic	99,9%	93,9%	97,5%	97,1%	104,8%	112,6%	116,3%	<b>3%</b>
Slovakia	80,6%	85,4%	98,7%	88,4%	89,6%	93,5%	82,2%	<b>0%</b>
Slovenia	87,0%	90,7%	99,1%	108,6%	122,1%	127,9%	149,3%	<b>9%</b>
<b>CE</b>	<b>75,8%</b>	<b>75,8%</b>	<b>80,5%</b>	<b>83,4%</b>	<b>88,6%</b>	<b>100,4%</b>	<b>101,2%</b>	<b>5%</b>
Romania	31,3%	36,9%	45,1%	50,9%	62,5%	66,0%	74,3%	<b>16%</b>
Bulgaria	50,0%	64,2%	76,8%	85,5%	104,5%	104,2%	107,1%	<b>14%</b>
Croatia	90,3%	93,9%	98,7%	106,5%	109,8%	108,4%	113,8%	<b>4%</b>
Serbia	39,8%	44,4%	54,3%	64,9%	72,9%	70,4%	82,0%	<b>13%</b>
Bosnia and Herzegovina	53,0%	59,5%	69,3%	76,3%	89,7%	85,2%	86,5%	<b>8%</b>
Albania	53,2%	56,8%	60,9%	70,1%	75,6%	78,7%	75,1%	<b>6%</b>
Kosovo	25,9%	35,1%	32,2%	36,5%	41,3%	48,6%	54,4%	<b>13%</b>
<b>SEE</b>	<b>47,6%</b>	<b>53,9%</b>	<b>62,2%</b>	<b>69,6%</b>	<b>80,1%</b>	<b>81,0%</b>	<b>87,7%</b>	<b>11%</b>
Russia	42,3%	41,9%	45,1%	52,2%	61,1%	67,9%	75,4%	<b>10%</b>
Ukraine	39,5%	41,0%	50,5%	62,5%	83,2%	97,7%	96,2%	<b>16%</b>
Belarus	27,5%	29,1%	31,5%	36,5%	42,9%	48,9%	60,6%	<b>14%</b>
<b>CIS</b>	<b>41,5%</b>	<b>41,3%</b>	<b>45,1%</b>	<b>52,5%</b>	<b>62,3%</b>	<b>69,7%</b>	<b>76,6%</b>	<b>11%</b>

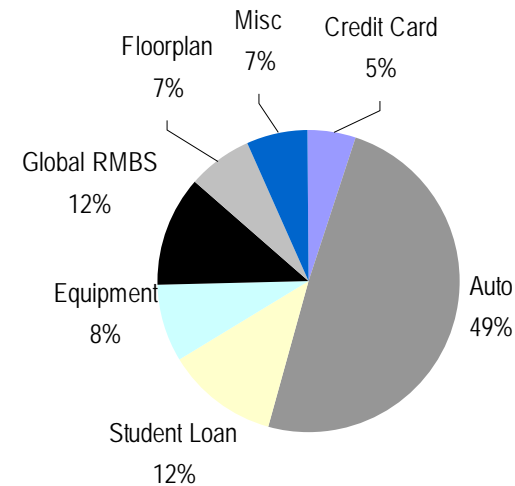
# .....Causes of the financial crisis

- Evasion of regulations: ABS- boom produced toxic assets mostly for other banks – no real disintermediation!

USA: New issues of ABS & Subprime RMBS in USD bn



USA: Only ABS new issue 2011 by sector



Annual ABS supply - new issues (\$bn)

Year	Subpr.		Total
	ABS	RMBS	
2000	188	84	272
2001	203	127	330
2002	206	196	402
2003	222	279	501
2004	201	501	702
2005	314	560	874
2006	327	559	886
2007	299	232	531
2008	142	0	142
2009	140	0	140
2010	106	-	106
2011 YTD	41	-	41
<b>Cumulative</b>	<b>2.389</b>	<b>2.538</b>	<b>4.927</b>

Ca. 18% of total US bank assets

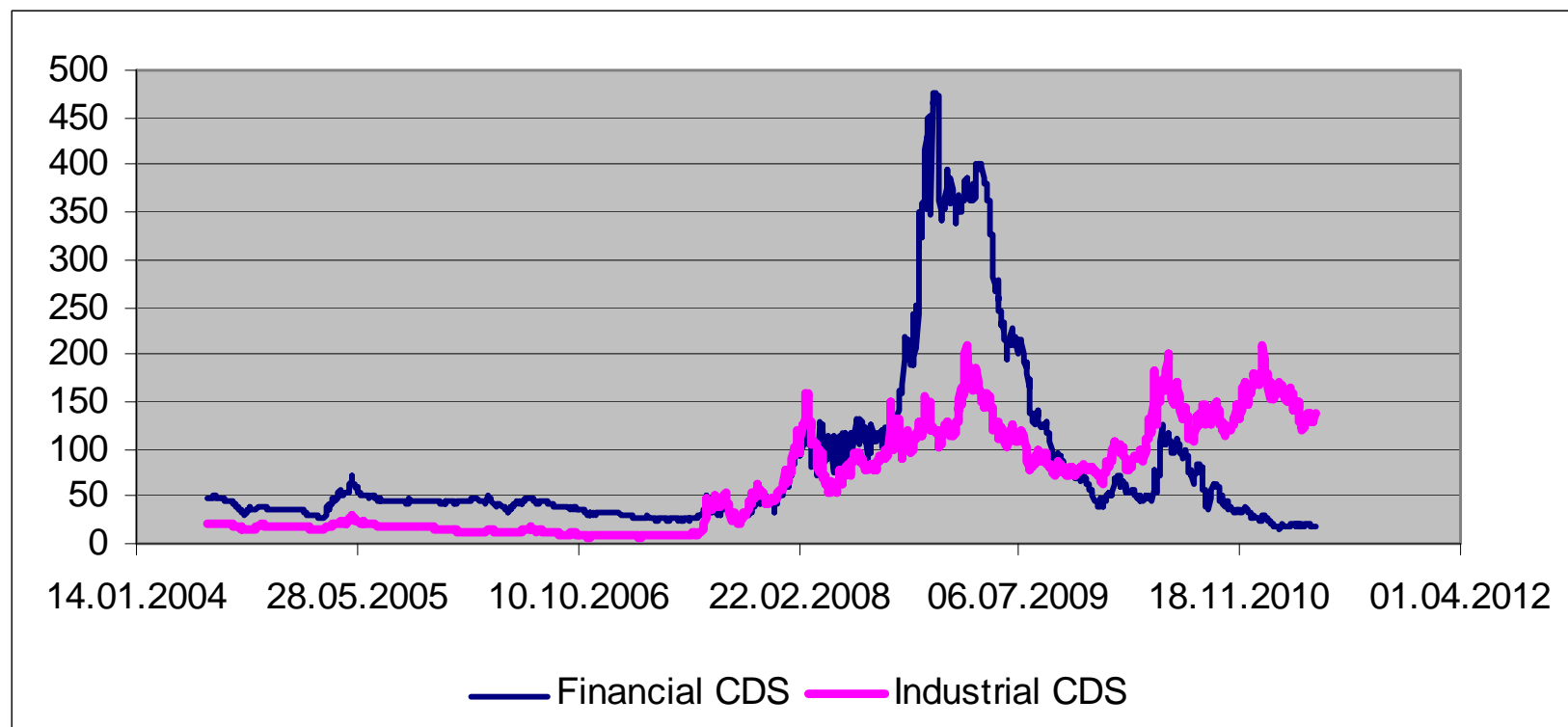
# .....Causes of the financial crisis

- Too big banks compared to their countries

## Top 5 banks compared to GDP

<b>Germany (2008)</b>	Assets in EURbn	<b>Austria (2007)</b>	Assets in EURbn
Deutsche Bank	2.202	Bank Austria	209
Commerzbank	625	Erste Bank	201
Hypovereinsbank	458	RZB	137
LB Baden Württemberg	448	Volksbank	79
DZ Bank	427	BAWAG-PSK	45
<b>Total</b>	<b>4.160</b>	<b>Total</b>	<b>671</b>
GDP at current prices	2.481		272
Total assets (big 5) in % of GDP	<b>168%</b>		<b>247%</b>

- Corporate customers have better credit standings than banks



From the inside view of bank controlling almost everything was fine:

- Always **higher growth than planned** – equity was the bottleneck
  - Hybrid tier 1 instruments
  - Controlling measure: Higher internal equity costs
- Often **higher ROE achieved than planned** – equity costs were earned
- Almost **unlimited wholesale funding available**
  - ➔ controlling/treasury introduced liquidity costs in FTP – low levels
  - ➔ asset driven steering of the bank, less priority for deposits
- Securitization of **own assets highly welcomed**
- Leaning against the beginning appetite to book almost all kinds of securities.

## ■ Know your customer, know your business

- Bankers are dealers in trust. To build up trust **you have to know the customer needs** → relationship banking
- When you are using – or being forced by competition to use – more or less **fancy capital market instruments**, only take those you understand and **act as a broker not as an ultimate investor** of these instruments.
- Ultimate investors of capital market instruments should be:
  - private investors
  - institutional investors
  - investment funds.....

## ■ Be sure what kind of bank you will be

- **a lender of loans held to maturity** → draw profits from your position as a financial intermediary and your inside knowledge of your customers? or
- **a trader of loans** → draw profits from the right timing of buying/selling?

## ■ Try to avoid the worst combination of the above 2 options:

- Being a holder of instruments of CM- instruments of counterparties you don't know because you bought at prices too high.

# How controlling can contribute?

■ Set economic capital limits and consequently penalize violations even on the expense of missed profits

- Tie the performance of a profit centre to the **achieved RORAC** on economic capital but.....
- if the consumed EC falls **below the EC limit**, RORAC is calculated **dividing net profit by the limit**, or
- if the consumed EC **exceeds the EC limit**, RORAC is calculated **reducing the achieved net profit** by the amount earned with the excess capital.

**Example:**

Economic Capital Limit	450		
Limit Level Applied	95%		
Limit Excess	105%		
	Scenario 1	Scenario 2	Scenario 3
Economic Capital according to utilization	315,00	450,00	585,00
Economic Capital Limit Utilization	70%	100%	130%
Profit After Tax	40,95	58,50	76,05
RORAC based on actual utilised capital	13%	13%	13%
RORAC depending on Limit Utilization	9,10%	13,00%	10,00%

- Strictly monitor the balance between customer assets and customer liabilities
  - Try to achieve a **loan deposit ratio** of about 100%.
  - Make money out of the fact that **the customer is trusting you!**
  - Reduce your dependency on wholesale funding (own issues)
  - **Don't buy ABS** where you don't know the counterparties and you are dependent on other banks' monitoring.
  - Try to **sell your own securitized assets to your customers** and partner investment funds.
  
- Do not grant loans to customers in a currency the customer do not earn
  - Such products increase the customer's risk
  - Excess FCY loans into countries with non G7 currencies lead to an unhealthy capital inflow

# How controlling can contribute?

## Take risk adjusted results as the main performance indicator in order to prevent procyclical incentives

- RORAC after standard risk costs (SRC) and ROE after actual risk costs (ARC)– both are relevant for performance measurement. For bonus purposes: The difference between SRC and ARC of the current year additionally counts with a 20% (or 50%) weighting into the positive or negative direction of the RORAC

### **Standard risk costs (SRC) and actual risk costs (ARC) used for performance and bonus assessment**

*Possible variant, assumed data for illustration only*

Year	SRC	ARC	SRC minus ARC	PbT after ARC	PbT after SRC	PbT Perfor mance*
2007	75	0	75	570	495	533
2008	86	17	69	530	461	496
2009	110	197	-87	169	256	213
2010	153	238	-85	173	258	216
2011	109	79	30	300	270	285
	533	531	2			

\*) PBT after SRC + 50% of SRC minus ARC

# How controlling can contribute?

## ■ Modest target setting

- Set realistic targets, keep the **macroeconomic conditions** in mind
- Don't demand too high RORACs/ROEs otherwise you drive business into hazard
- Targeting a **reduction of assets** is not a "shame"

## ■ Convince management that a bank can sufficient profitable when stagnating and even shrinking.

- Be prepared to **reduce capacities**
- Strictly monitor the cost development
- Provide information and instruments to **reallocate scarce resources** mainly personnel and IT
- Provide understandable and **decision oriented reports about costs, efficiency, productivity and capacity utilization.**
- **Avoid additional IT systems.** The positive business case in the beginning turns negative when interface and maintenance costs are exploding