Reforming the Global Financial System: Implications for Long Term Investment Finance

BY

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INTRODUCTION

- The financial crisis that erupted in 2007-08 led by a collapse in US **subprime housing loans**.

- The crisis played out primarily in the **structured products** market in 'shadow banks', although commercial banks were also deeply affected as they originator, financer and distributer of these products in various capacities.

- The fallout of the crisis was the **collapse of giant financial institutions**, liquidation, acquisition, nationalization, capital infusion, interbank liquidity freeze, write offs, losses, job losses, tumbling share prices, and finally the deepest recession in economic activity since the Great depression of the 1930s.

- **Global policy response led by the G 20** through the Financial Stability Board (FSB) and Basel Committee for Banking Supervision (BCBS) to rein in the global financial system: 4 pronged response: **Regulatory reform, Supervision, Resolution, Assessment.**

- **National response**: 'Dodd-Frank' legislation in July 2010 in the US, Vickers Commission in the UK, Liikanen proposals in EU, etc.

Major financial institutions that collapsed in 2008:

- **Bear Sterns:** Major player in the securitization market – highly leveraged balance sheet (36:1) – sold to JP Morgan for $10 per share. (pre crisis level: $133).

- **Lehman Bros:** Highly leveraged – significant exposure to mortgage based lower rated derivative instruments – filed for Chapter 11 bankruptcy protection on September 15th, 2008 – no federal money pumped into Lehman bros (moral hazard) – potential buyers like Bank of America and Korea Development Bank backed off from buying Lehman – threw the world financial markets into tailspin.

- **Northern Rock:** 5th largest mortgage lender in the UK – excessive reliance on wholesale borrowings to fund its mortgages – active in securitizing its mortgage loans – kept originating mortgage loans at a pace faster than its ability to secure deposits to back them up – this business model collapsed when a disruption in the credit markets severely impaired the ability of the bank to secure buyers for its mortgage backed securities – bank was nationalized in February, 2008.

- **Wachovia Corp:** Stable deposit base – however trouble brewed in its giant loan portfolio – sticky portfolio came from its 2006 acquisition of a California based lender, Golden West Financial – its commercial real estate portfolio was also under stress – was taken over by Wells Fargo in October, 2008.

- **Merrill Lynch:** One of the largest broking firms in the US - Incurred huge losses on its portfolio of mortgage based CDOs – was absorbed by Bank of America in September, 2008.

- **AIG:** Largest insurer in the US – suffered huge losses on its CDS portfolio - Federal Reserve injected $85 billion into AIG in lieu of a 79.9% equity stake in the company.

- **Citigroup**, **JP Morgan Chase**, **Bank of America (ML)**, **Wells Fargo**, **AIG**, **Goldman Sachs and Morgan Stanley** were among the highest recipients of TARP funds.

- **Fannie Mae and Freddie Mac** : Practically nationalized with capital injection and guarantees by the US Government.

KEY AREAS OF REGULATORY REFORM

1. BASEL III Capital Adequacy Norms
2. Systemic Risk – SIFIs
3. Shadow Banking
4. Back to Glass-Steagall?: VOLCKER/VICKERS/LIIKANEN
5. OTC derivatives market
6. Compensation Practices
7. Consumer Protection

SUPERVISION – strengthening national regulatory oversight.

RESOLUTION – Living Wills and Bail in

ASSESSMENT: FSAPs through IMF and FSB

BASEL III

Revised capital adequacy norms with stricter capital norms and additional ratios to address issues of liquidity, pro-cyclicality and leverage.

CAPITAL RATIOS	BASEL II	BASEL III
CORE TIER I CAPITAL (Common equity requirement) to RWA	2%	4.5%
TIER 1 CAPITAL to RWA	4%	6%
TOTAL CAPITAL TO RWA	8%	8%
CAPITAL CONSERVATION BUFFER	-	2.5%
COUNTERCYCLICAL BUFFER	-	0-2.5%
LEVERAGE RATIO	-	3%

Key novel features of the revised Basel III norms:

- **Countercyclical capital buffer** :
  - Partly addresses the issue of pro-cyclicality.
  - Trigger point : Significant deviation in credit – GDP ratio
  - An element of pro-cyclicality retained through mark-to-market
    - Asset prices may fall out of proportion to default rates/yield to maturity.
    - However, mark to market losses may lead to firesales because of minimum capital requirements.
    - On the other hand, mark to market accounting would have saved the day during the Savings and Loans Crisis of the US in the 1980s when asset prices plummeted but there delay in loss recognition.
  - Emerging economies might be unfairly impacted by this ratio.
  - Concern that banks gaming 'risk-weights' to reduce capital requirement.

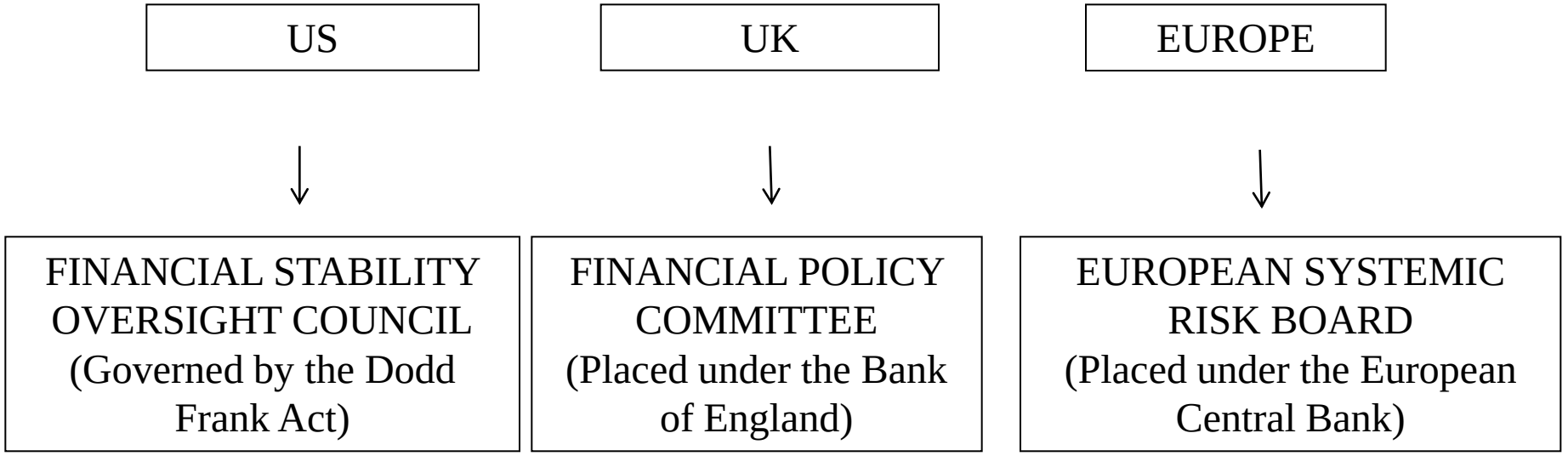
BASEL III ...contd.

- **Conservation buffer**
  - For use to recognize losses during business cycle downturns.
- **Leverage ratio** :
  - Non risk based measure to prevent build up of excessive leverage on balance sheet.
  - US has prescribed higher leverage norms for its banks compared to what the Basel committee has recommended.
  - Both on and off-balance sheet items (derivatives) to be considered for computing the denominator (total assets-non risk weighted).
  - Debate over moral hazard – shift to riskier, higher yielding portfolios
- **Liquidity based ratios**:
  - Liquidity coverage ratio:
  - Net stable funding ratio
- **Long phasing** in of reforms – up to 2013
- **Developing Countries in G 20 ahead** in implementation.

SYSTEMIC RISK

- Inadequate **capital and liquidity** in the financial system leading to a possible collapse of the system and some institutions.
- **Symptoms** of systemic risk: Domino effect, fire sales, contagion and failure in delivery of critical financial functions.
- US Financial Stability and Oversight Council (**FSOC**) : Advisory body to monitor and regulate institutions that pose systemic risk to the economy.
- FSOC is designated to perform the following tasks:
  - **Identify institutions** (banks & non banks) that pose systemic risk to the financial system – "Systemically Important Financial Institutions" (SIFIs).
  - Eligible institutions for **SIFI** – consolidated assets of $50 billion and above.
  - **Subject SIFI** to special regulation
    - Stringent capital and liquidity norms
    - Stress testing
    - Single counterparty credit limits
  - Reduce vulnerability in the **wholesale funding market**
- FSB also identifies **G-SIFIs** – needing those institutions to hold **extra capital** ranging from 1% to 2.5% of risk weighted assets. Most critical institutions (as per the list last released by FSB) were Citigroup, JP Morgan, Deutsche Bank and HSBC. These 4 will be subjected to highest slab of 2.5%.

SYSTEMIC RISK MONITORING



INDIA: <u>Financial Stability and Development Council</u> under the Treasury

SHADOW BANKS

- Shadow banks are those **financial institutions** that provide financial intermediation beyond the (BASEL) regulated, deposit-based banking system.
- **Examples**: Hedge funds, money market funds, structured investment vehicles….
- **Operate like banks** – maturity mis-match, leverage, income from interest rate differentials, credit intermediation.
- **Not deposit based** and have no access to central bank windows of liquidity or guarantees.
- **Instruments** for borrowing liquidity – repos, asset backed commercial paper, collateralized debt obligations…
- Shadow banks are significant suppliers of liquidity to the formal banking system -- **inter-connectedness** between two parallel financial systems.
- **Significant credit intermediation** by shadow banks aided asset bubbles in the run up to the crisis.
- Shadow banks **can heighten pro-cyclicality** and credit freeze: recent Global Financial Crisis was triggered by a run on shadow banks

Shadow Bank Regulation

- **FSB still working** on measures to contain risks arising out of shadow banks.
- These measures are levied on the **banking side through high capital charges** on exposures to shadow entities and heightened disclosures. However, shadow banks themselves continue to remain **outside the perimeter of regulation**.
- FSB's **two-fold strategy**: (a) monitor non-banking financial system in systemically important financial **jurisdictions**, and (b) tighten regulatory standards on shadow banking activities such as **derivatives, repos and securitization**.
- The **constraints on the banking sector** through tightened credit standards would curtail loan books of banks, but could cause such sub prime customers to move towards shadow banks.
- **Volume of business** in shadow banking in the recent past is better than or almost close to the pre-crisis level.
- It appears shadow banks have emerged relatively unscathed from the crisis and so far still remain outside the perimeter of regulation, although more **complex structured products** such as CDOs, CMOs, and non-agency MBS are still dead.
- On the other hand, **banks have got entangled** in a web of regulatory diktats & plethora of burdens & restrictions about how to do banking?

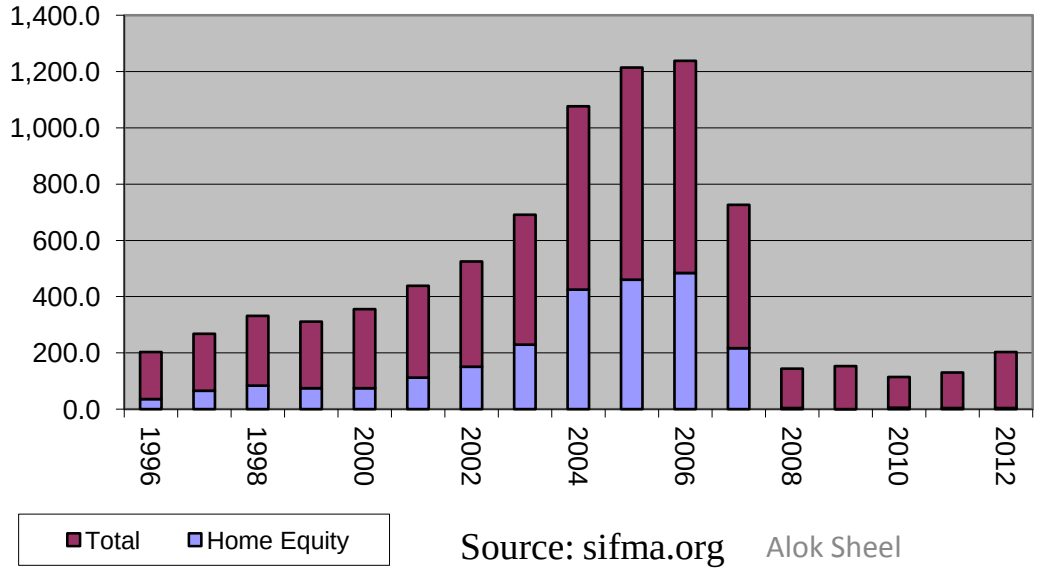
Global Shadow Banking Monitoring Report, Nov-2012 (FSB)

Size of shadow banking system (Euro nations and 20 other jurisdictions including US & UK)	
2002	$26 trillion
2007	$62 trillion
2008	$59 trillion
2011	$67 trillion

Shadow banking's share to total financial intermediation	
2007	27%
2009-11	25%

Size of shadow banking asssets in US, UK and Euro (2011)	
US	$23 trillion
Euro	$22 trillion
UK	$ 9 trillion

US's share of global shadow banking system (2011)	
2005	44%
2011	35%



Source: sifma.org

GLASS STEAGALL FIREWALL

- Enacted in the year **1933** in the US, the Glass Steagall Act created firewalls between commercial and investment banking.
- **Commercial banks** were **restricted** from:
  - Underwriting or dealing in **securities**,
  - Owning or investing in firms that undertook the business of dealing in underwriting of securities.
- **Investment banks** were restricted from accepting **deposits**.
- The Gramm-Leach-Bliley Act (1999) **repealed** the Glass Steagall Act and allowed bank holding companies to be simultaneous owners of commercial banks and investment banks.
- This repeal has taken a fair share of **blame for the financial crisis**, although it is unclear whether this would have prevented the collapse of financial institutions during the crisis: Bear Stearns, AIG, Merrill Lynch, Goldman Sachs and Lehman Bros were not commercial banks.
- Deposit taking commercial banks which had to be bailed out also got into trouble because of their **holdings** of the same illiquid securities and investment in these securities were **not restricted** by the Glass Steagall Act.

BACK TO GLASS STEAGALL?: VOLCKER, VICKERS AND LIIKANEN

- **Volcker Rule in the US :**
  - Authored by Paul Volcker (former Governor of the Federal Reserve) and Section 619 of the Dodd Frank Act, **prohibits a financial institution** from:
    - Engaging in trading (on the institution's own account) – **proprietary trades** – beyond 3% of its tier 1 capital.
    - **Investing in or sponsoring hedge** funds and/or private equity funds.

  - The **catch** in the proposed rule:

    - Proprietary trading is not allowed – but trading for the purpose of **hedging (risk management) is allowed.**
    - The line of **demarcation** between proprietary trades and hedging is so thin than one can always overlap the other
    - Is the regulator capable enough to **identify** this difference
    - Or, are FIs too good at **bending** around this rule
    - The case of JP Morgan – **London Whale** – large CDS losses on 'hedging'.

❑ Vicker's report in the UK: (September, 2011)

- "The Independent Commission on Banking" set up by the UK government recommended **"ring-fencing" of the consumer banking unit** from other riskier trading activities of the bank. The consumer banking unit will remain independent, have its own capital, profitability & management, **but would remain under the larger banking group**.

- Issues:

  - **Contagion risk** has obviously not been factored in.
  - **Poor quality** of mortgage origination – a retail activity – can still create bigger problems for the ring fenced unit.
  - Cutting off wholesale banking arm from retail could jeopardize availability and **cost of funds** for the retail arm. Working capital needs for SME's could be impacted.
  - If the ring fenced unit is to undertake plain vanilla lending, **how would it undertake hedging** (risk management tool) for its customer's currency risk?
  - **Higher capital norms** (10%) are being prescribed for the ring fenced entity. This is way above the Basel III norms. Would this not act as a double hammer for the retail unit, one being reduced access to wholesale funding? Will loans to SME's not suffer – they form a major backbone of UK's economy.

- **Liikanen Report (European Union)** of October 2012:

  - Mandated by the European Commission, the Report authored by Erkki Liikanen, governor of the Bank of Finland, seeks to reform the structure of banking in Europe. A key recommendation is **"Separation" between proprietary and other significant trading activities**:

    - If a bank's assets held for trading constitutes more than 15% to 25% of total assets, then such a bank would be required to **transfer all its investment activities** to a separate legal entity.
    - This new legal entity would continue to operate **under the main banking group**.
    - Not permitted to tap into the **deposit base** of its retail banking arm.
    - **Hedging to remain within the retail banking arm** – to enable risk management for its retail and corporate customers.

  - The catch in this recommendation lies in the **huge balance sheets of European banks** like ING, Deutsche, Nordea. Even after hiving off risky activities under separate units, any losses incurred by these units would be so huge (amounting to more than 50% of the respective Euro nation's GDP) that they would lead to colossal losses and systemic risk. No rescue fund will suffice to absorb these losses.

OTC DERIVATIVE MARKET REFORMS

- A large, unregulated OTC derivative market makes the financial system vulnerable to **systemic risk**.

- **Key elements** of the reform measures proposed:
  - **Standardize** trades
  - Clear trades through **central counterparties** (CCPs)
  - **Report** all OTC trades to a repository.
  - **Authorities in charge** : CFTC (Commodity futures trading commission) and SEC in the US.

- Around EUR 150 trillion worth of derivatives are likely to remain outside the central clearing system – estimates by BIS and FSB.
- Banks might need to compress or water down derivative exposure drastically to shrink asset base and meet regulatory norms on leverage – RBS study – August, 2013
- US Swap industry might also be cut to size
- Fear that big central counterparties could become new sources of systemic risk.

EXECUTIVE COMPENSATION – TITLE IX OF THE DODD FRANK ACT

- "Say on pay" and "Golden parachutes" – Approval by **shareholders, but "non-binding**".
- **Compensation committee** – Comprise of independent directors.
- "Executive compensation vs financial performance " .
- Hedging of company securities by director, employees.
- Pay gap between chief executive & the rest

Disclosure

- 'Clawback" : recovery of incentive-based compensation when results are re-stated due to non compliance with federal laws.
- Eliminate incentive based pay arrangements for financial institutions where:
  - Assets are more than $1 billion
  - Such pay is deemed as excessive
  - Such pay could lead to material financial loss
  - Personnel covered are executive officers, employees, directors or principal shareholders.
- Implementation marred by factors like:
  - Threat of judicial intervention in favor of lobbyists.
  - Difficulty in implementing laws – e.g. data for median pay (to disclose pay gap) is difficult to determine.
  - Laws are complex & agencies like SEC who are responsible for implementation are understaffed.
  - However, for provisions like shareholder resolution for executive compensation and golden parachute, final rules have been adopted.

CONSUMER PROTECTION

- A **major pillar** of the Dodd-Frank Act
- Consumer Financial Protection Bureau(CFPB) – Consumer Financial Protection Act, 2010.
- Autonomous government funded agency.
- Objective : To enable access to all consumers in America of financial intermediation in a manner or at rates that are just, equitable and free from deceptive intent and practices.
- CFPB possesses rulemaking, supervisory and enforcement powers over financial products, services and institutions that sell these products.
- Supervises depository institutions, credit unions with assets over $10 billion.
- Supervises non bank entities – irrespective of size.
- Key area of work:
  - Mortgage servicing rules: assess ability to repay mortgage (qualified mortgage)
  - Financial literacy & education
  - Inflexible student loan repayment plans & credit cards
  - Protect vulnerable financial consumer from deceptive marketing schemes – facilitated around $425 million worth of refunds to 6 million customers.

RESOLUTION

- **Orderly Liquidation Authority** – OLA – under Dodd Frank Act provides roadmap for handling resolution of complex and insolvent financial institutions.
- **Federal Deposit Insurance Corporation** (FDIC) has been assigned the task of discharging the mandate of OLA. It acts as a receiver.
- An institution which is **on the brink of default and insolvency** and which poses grave risk to the system is eligible for resolution under OLA.
- Under OLA:
  - Shareholders and creditors are made responsible for the losses **('bail-ins')**
  - **Taxpayer money is not to be used** to liquidate a failing institution: if sale of assets/clawbacks inadequate, balance through tax on financial companies.
- **Living Wills** :
  - Large bank holding companies ($50 billion or more of assets) are required to submit a road map or step-by-step guide for systematic resolution should the institution need a systematic resolution, without disrupting the financial system.
  - Several institutions **have submitted** this blue print. However, its efficacy is a test of time.
- **FSB** has also stepped in to lay a roadmap of recovery & resolution for G-SIFIs.
- **European Union** has proposed formation of a **"resolution fund"** with a budget of EUR 55 billion. Source of funds – bank levies. Germany is opposed to the plan. The so-called doom loop (vicious circle between weak euro banks & weak sovereigns) may continue.
- EU already has in place a **European Stabilization Mechanism** (ESM) since Sept, 2012. The Cyprus EUR 10 billion bailout was jointly funded by IMF & ESM.

ASSESSMENT OF FINANCIAL STABILITY & REGULATORY REFORMS IN MAJOR JURISDICTIONS

IMF, in collaboration with the World Bank
(***Financial Sector Assessment Program***)
Key instrument of the Fund's surveillance objective

FSB
Peer review,
Seeking periodic reporting,
Regional consultative groups.

Progress of Reforms

- **Slow progress** on reforms:
  - Long phase-in period for BASEL III.
  - European and UK legislations not in place
  - 3 years since the passage of the Dodd Frank Act, it still remains work-in-progress

Rules finalized	40.20%
Missed deadline (rules proposed)	27.13%
Missed deadline (rules not proposed)	16.08%
Future deadline (rules proposed)	1%
Future deadline (rules not proposed)	15.57%

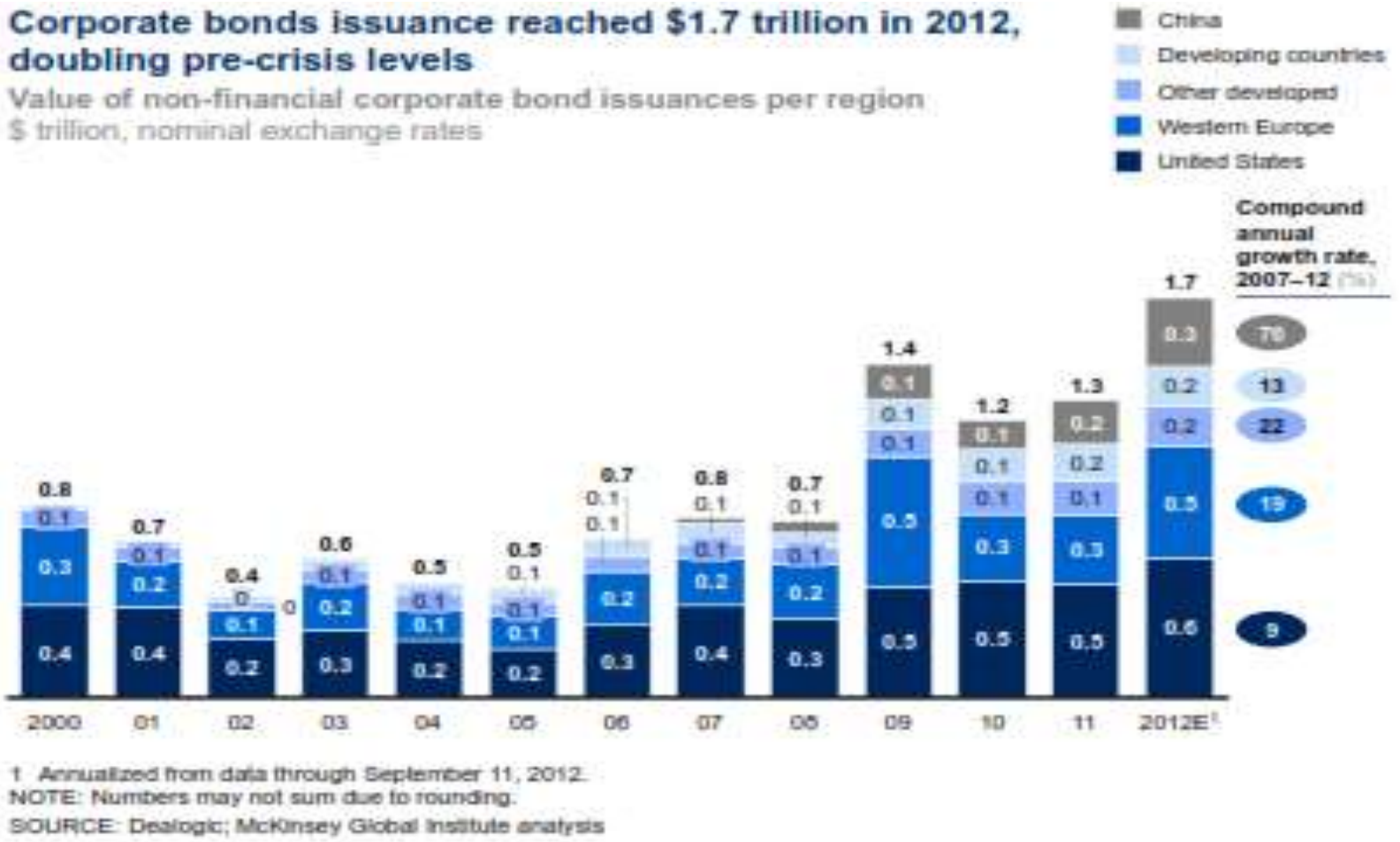
- **Data as of 3rd Sept, 2013**
- **Source: davispolk.com**
- **Data implies % of total rules that need to be finalized, i.e. 398**

- **What is causing this policy delay**
  - Possibly strong vested interests and lobbying by banks and real estate players?
  - Concerns that new rules & restrictions could restrict housing recovery & hinder credit take off and hence the recovery in economic growth?
- **Some of the core objectives of regulatory reforms being defeated:**
  - Big banks have grown even bigger.
  - The 'safer' regulated component of the financial system has shrunk while the riskier part – shadow banking – has emerged practically unscathed.
  - The "originate and distribute" model was widely held responsible for the financial crisis. Dodd Frank proposed 5% "risk retention" ('skin in the game') by mortgage originators. However, all mortgages that meet the basic underwriting standards (high quality mortgage / Qualified residential mortgage – QRM) are exempt from this norm.

Reform, Credit & Investment

- New and enhanced capital requirements constraining credit growth, and therefore SMEs dependent on bank credit.
- SMEs have historically led the recovery in employment following recessions.
- Large Corporates have direct access to capital markets – non-financial Corporate bond markets never contracted during the global financial crisis.
- Systemically important financial activity again migrating to shadow banking?

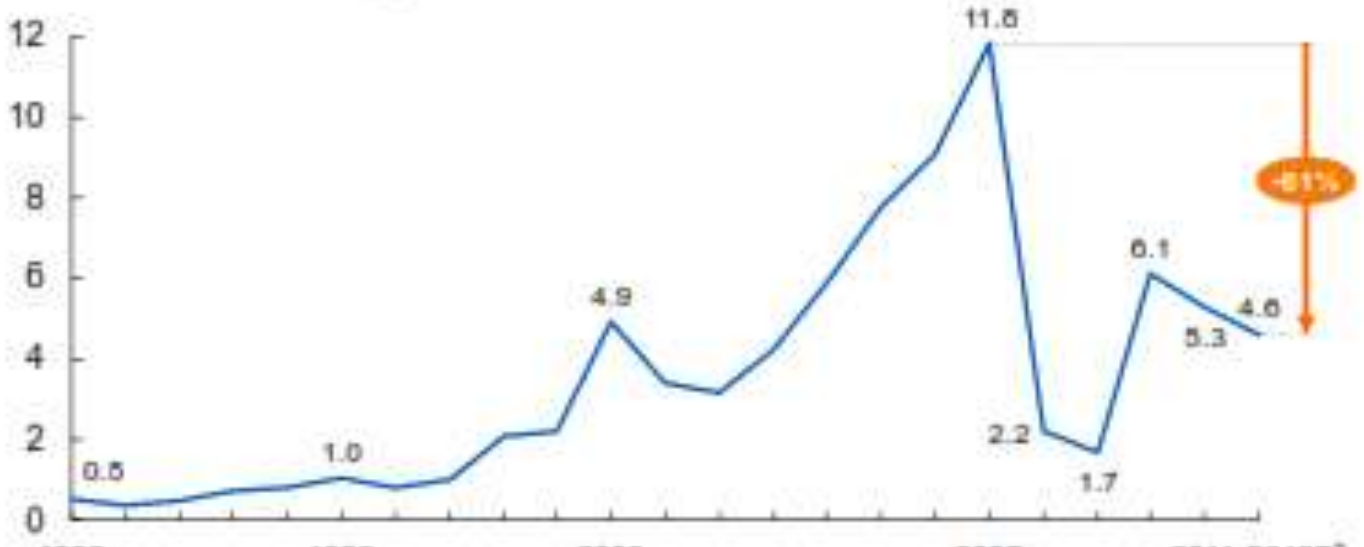
Corporate Bond Issuance



Post crisis cross border capital flows have fallen sharply

Cross-border capital flows fell sharply in 2008 and today remain more than 60 percent below their pre-crisis peak

Global cross-border capital flows[1]
$ trillion, constant 2011 exchange rates



1 Includes foreign direct investment, purchases of foreign bonds and equities, and cross-border loans and deposits.
2 Estimated based on data through the latest available quarter (Q3 for major developed economies, Q2 for other advanced and emerging economies). For countries without quarterly data, we use trends from the Institute of International Finance.
SOURCE: International Monetary Fund (IMF) Balance of Payments; Institute of International Finance (IIF); McKinsey Global Institute analysis

Most of the cross-border retrenchment has been in Europe

Since 2007, Eurozone banks have reduced foreign claims by $3.7 trillion, $2.8 trillion of which was intra-European

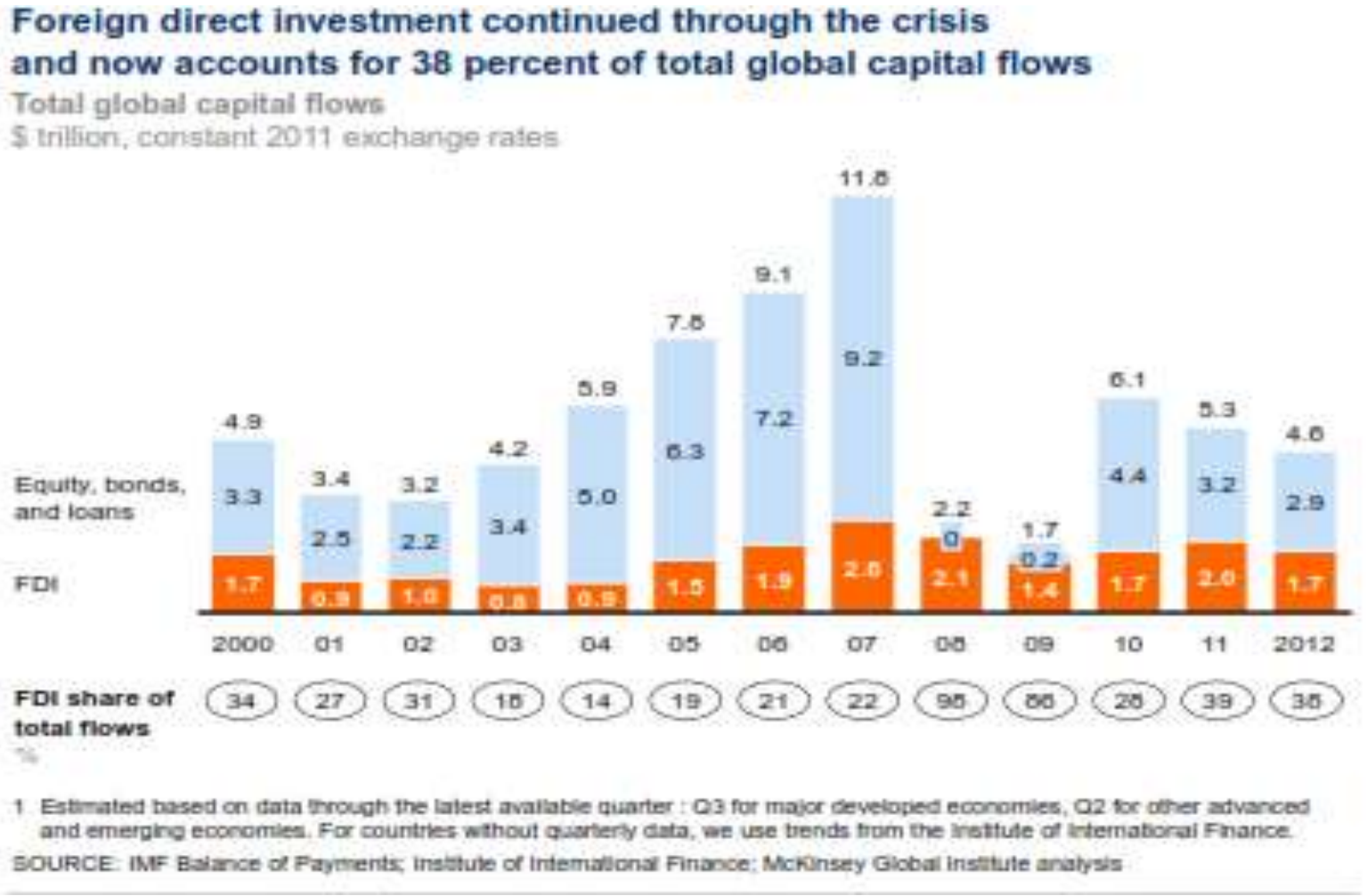
Consolidated foreign claims of Eurozone reporting banks (includes loans and other foreign financial assets)[1]
By counterparty location, constant 2011 exchange rates

Eurozone bank claims on:	Change 4Q99–4Q07 $ billion	Change 4Q99–4Q07 Compound annual growth rate (%)	4Q07–2Q12 $ billion	4Q07–2Q12 Compound annual growth rate (%)
GIIPS[2]	1,732	17	-1,176	-14
Other Eurozone	2,033	12	-665	-5
United Kingdom	1,609	16	-771	-9
Other Western Europe	291	11	-140	-7
Total Western Europe	5,665	14	-2,752	-8
United States	1,352	13	-781	-9
Other developed	509	6	-436	-9
Developing countries	1,182	13	240	3
Total	**8,737**	**13**	**-3,732**	**-7**

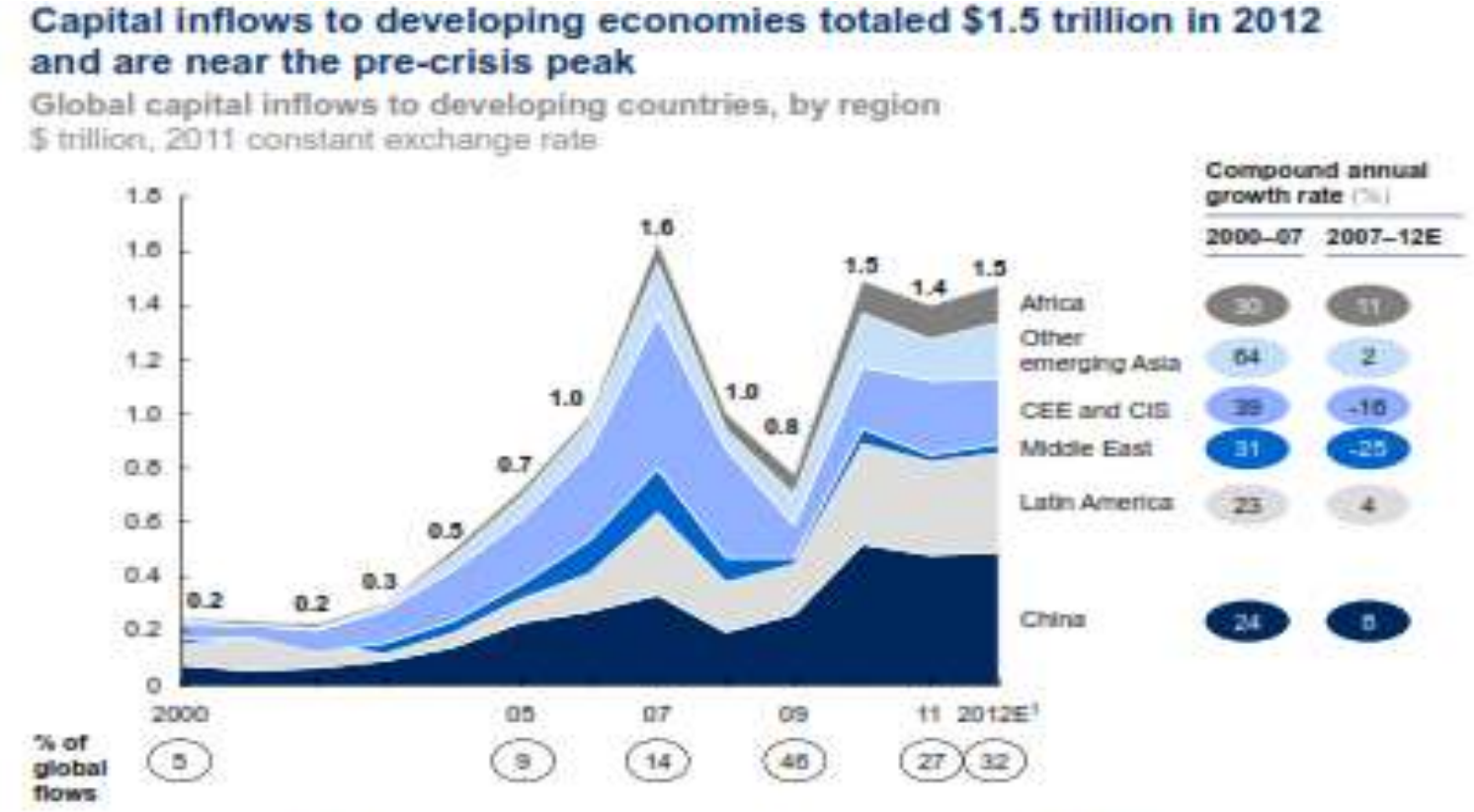
1 Includes banks from Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, and Spain.
2 GIIPS comprises Greece, Ireland, Italy, Portugal, and Spain.

SOURCE: Bank for International Settlements; McKinsey Global Institute analysis

With banks stressed, the structure of cross border flows has changed



But inflows into EMDEs are back to the pre-crisis peak



1 Estimated based on data through Q2 2012. For countries without quarterly data, we use trends from the Institute of International Finance.

SOURCE: IMF Balance of Payments; Institute of International Finance; McKinsey Global Institute analysis

Capital flows: Looking Ahead

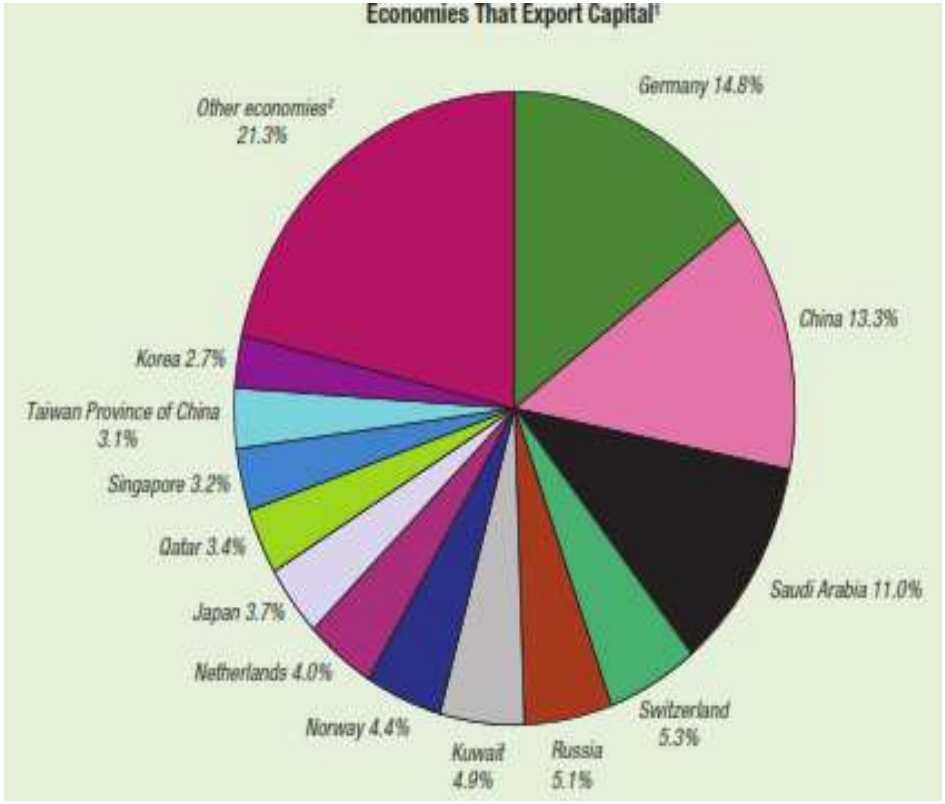
- This may change with the withdrawal of QE/accommodative monetary policy and the financing needs of reserve currency issuing sovereigns.
- Impact of Macro-economic policies in advanced economies therefore a bigger determinant of capital flows to EMEs than regulatory reform.
- However BASEL III may constrain EMEs own financial system which needs to provide rapid credit growth to sustain high levels of economic growth

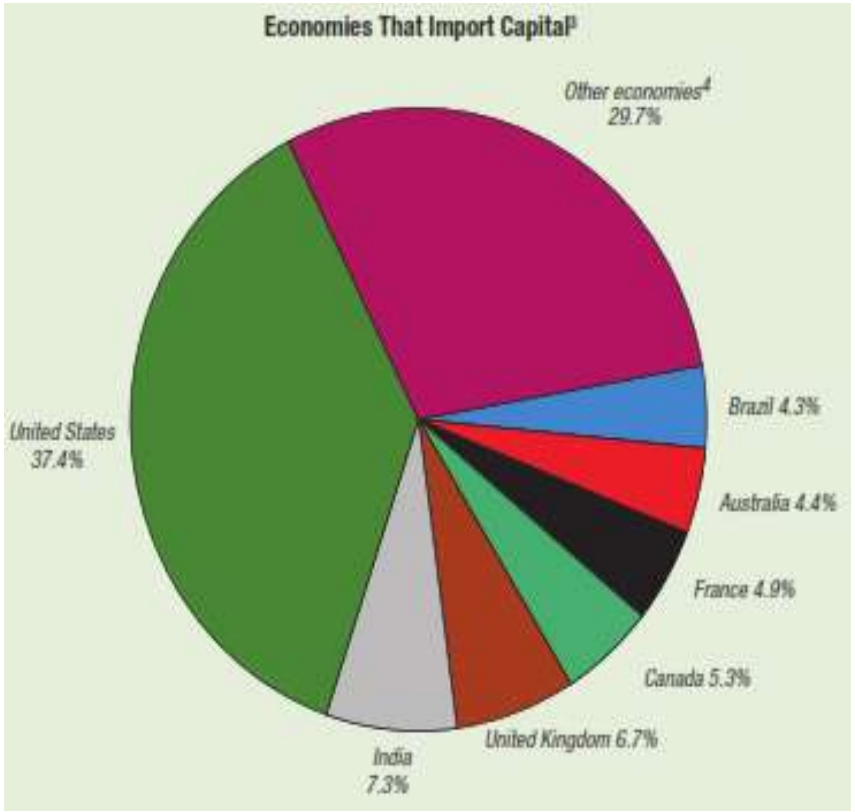
EMEs net exporter of capital despite fall since the crisis because of rebalancing

Emerging Markets		
Year	CAD $B	CAD % of GDP
2005	367	3.6
2006	511	4.2
2007	507	3.5
2008	541	3.1
2009	329	2.0
2010	356	1.8
2011	257	1.1
2012	288	1.2
2013	209	0.8
2014	229	0.8

Institute of International Finance, June 2013

With some notable exceptions



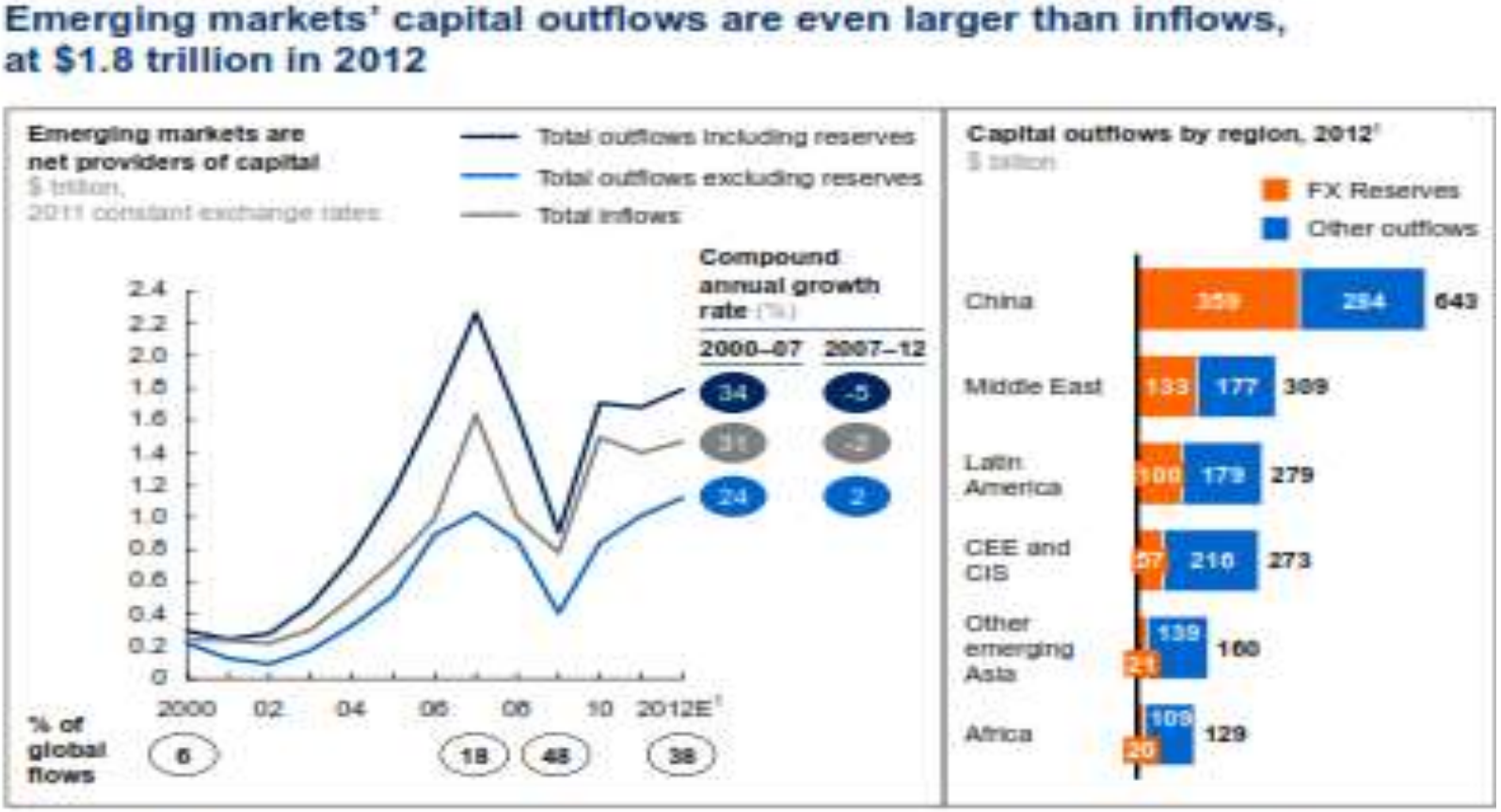


Major Exporters and Importers of Capital in 2012 (*IMF* **GFSR** April 2013)

South-South Flows

- EMEs, especially those in Asia, have high savings – with productivity improvements can sustain high growth with minimum capital inflows.
- There are no reasons, other than geopolitical and relatively shallow financial markets, why South-South flows cannot take care of intra-EME deficits.
- The BRICS Bank and reserve pooling arrangements to be seen in this light.

But excluding Reserves, EMEs still import capital



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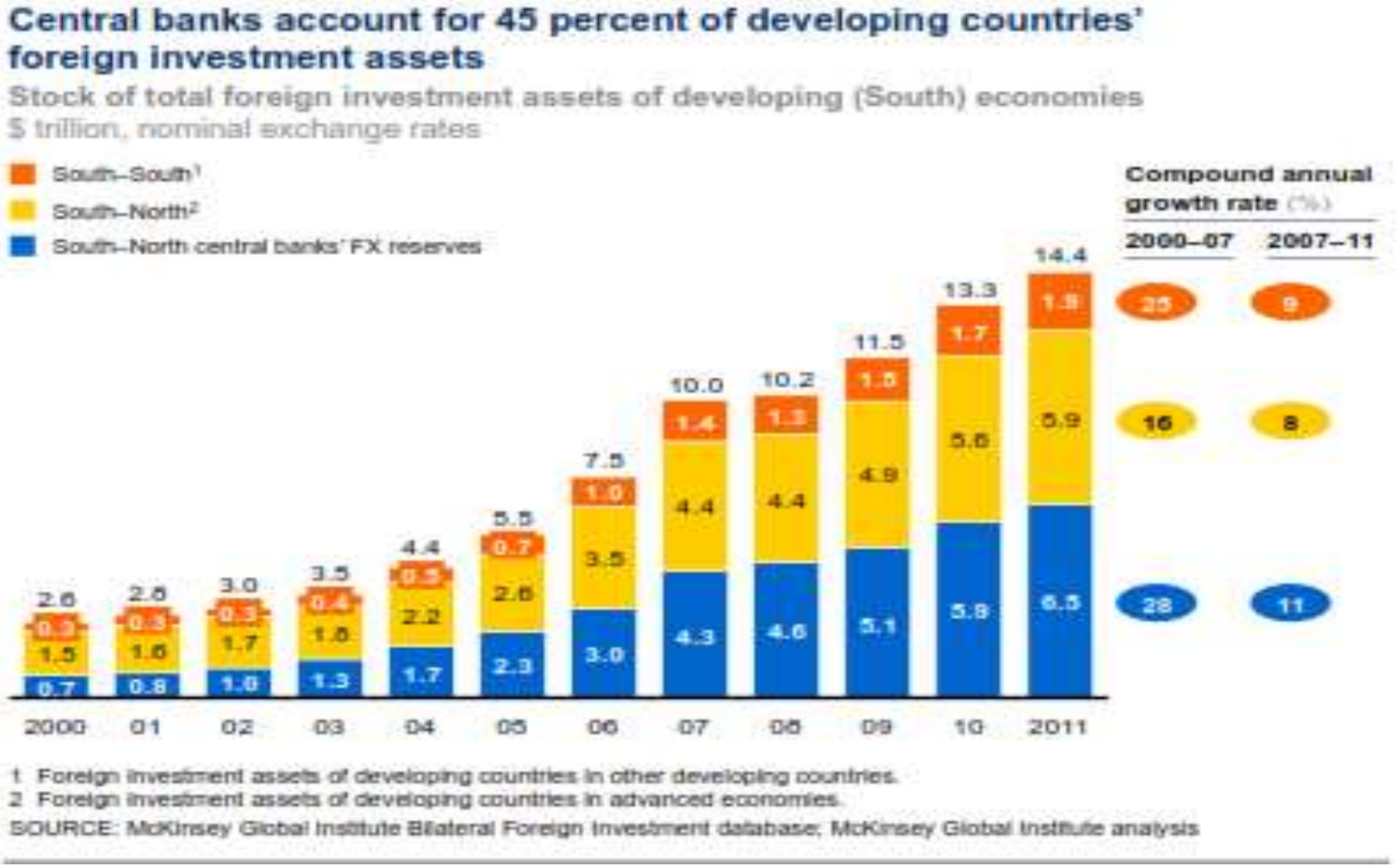
SOURCE: IMF Balance of Payments; Institute of International Finance; McKinsey Global Institute analysis

Reserves are recycled back to EMEs

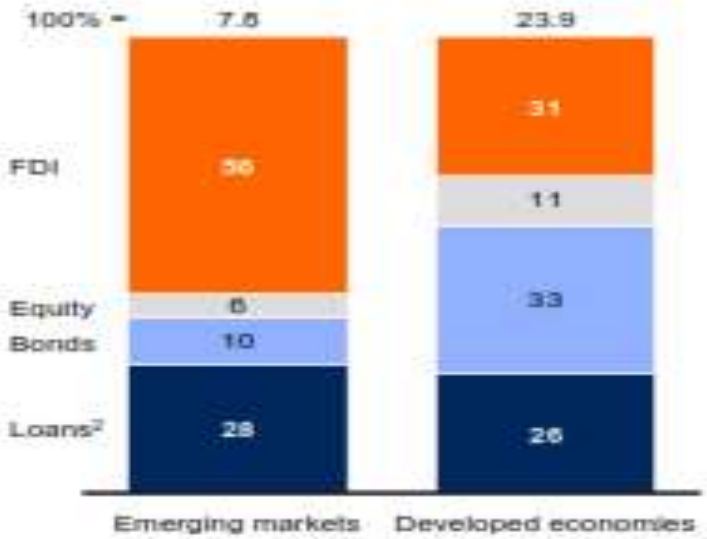


Preponderance of FDI in capital flows to EMDEs: FDI – most stable: TNCs awash with liquidity – returns higher in EMEs because of productivity growth

Foreign direct investment is a much larger share of capital inflows to emerging markets than to developed countries

Cumulative capital inflows, 2007–12E[1]

%; $ trillion, 2011 constant exchange rate



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2 Includes primarily loans, currency, and deposits, as well as a small share of trade credit.
SOURCE: IMF Balance of Payments; Institute of International Finance; McKinsey Global Institute analysis

Global FDI Flows

	Outflow			Inflow			Net		
US$ Mill.	*World*	*Advanced*	*EMDEs*	*World*	*Advanced*	*EMDEs*	*World*	*Advanced*	*EMDEs*
2007	2272	1890.4	330	2272	1320	589.4	0	-570.4	259.4
2008	2005.3	1600.7	344	2005.3	1026.5	668.4	0	-574.2	324.4
2009	1149.8	828	273.4	1149.8	613.4	530.3	0	-214.6	256.9
2010	1504.9	1029.8	413.2	1504.9	696.4	637.1	0	-333.4	223.9
2011	1678	1183.1	422.1	1678	820	735.2	0	-363.1	313.1
2012	1390.9	909.4	426.1	1390.9	560.7	702.8	0	-348.7	276.7

UNCTAD, **World Investment Report, 2013**

EMDEs' share of Inward and Outward FDI has increased

	Advanced	
	Inflows	Outflows
2007	58.1%	83.2%
2008	51.2%	79.8%
2009	53.3%	72.0%
2010	46.3%	68.4%
2011	48.9%	70.5%
2012	40.3%	65.4%

Aid Flows to EMEs are stagnant

US$ Mill	IFIs	Bilateral	TOTAL
2005	-37,899	-24,618	-62,517
2006	-25,660	973	-24,687
2007	5,827	43,408	49,235
2008	25,955	35,592	61,547
2009	52,114	15,562	67,676
2010	34,884	36,998	71,882
2011	16,829	44,446	61,275
2012	4,113	26,835	30,949
2013	5,864	36,768	42,632

Institute of International Finance, June 2013

While Net Portfolio Flows to EMEs are very volatile

Year	US$ Billion
2003	28.4
2004	39.3
2005	45.6
2006	39.3
2007	-13
2008	-105
2009	133
2010	200
2011	5
2012	125

Institute of International Finance, June 2013

EMEs and BASEL III

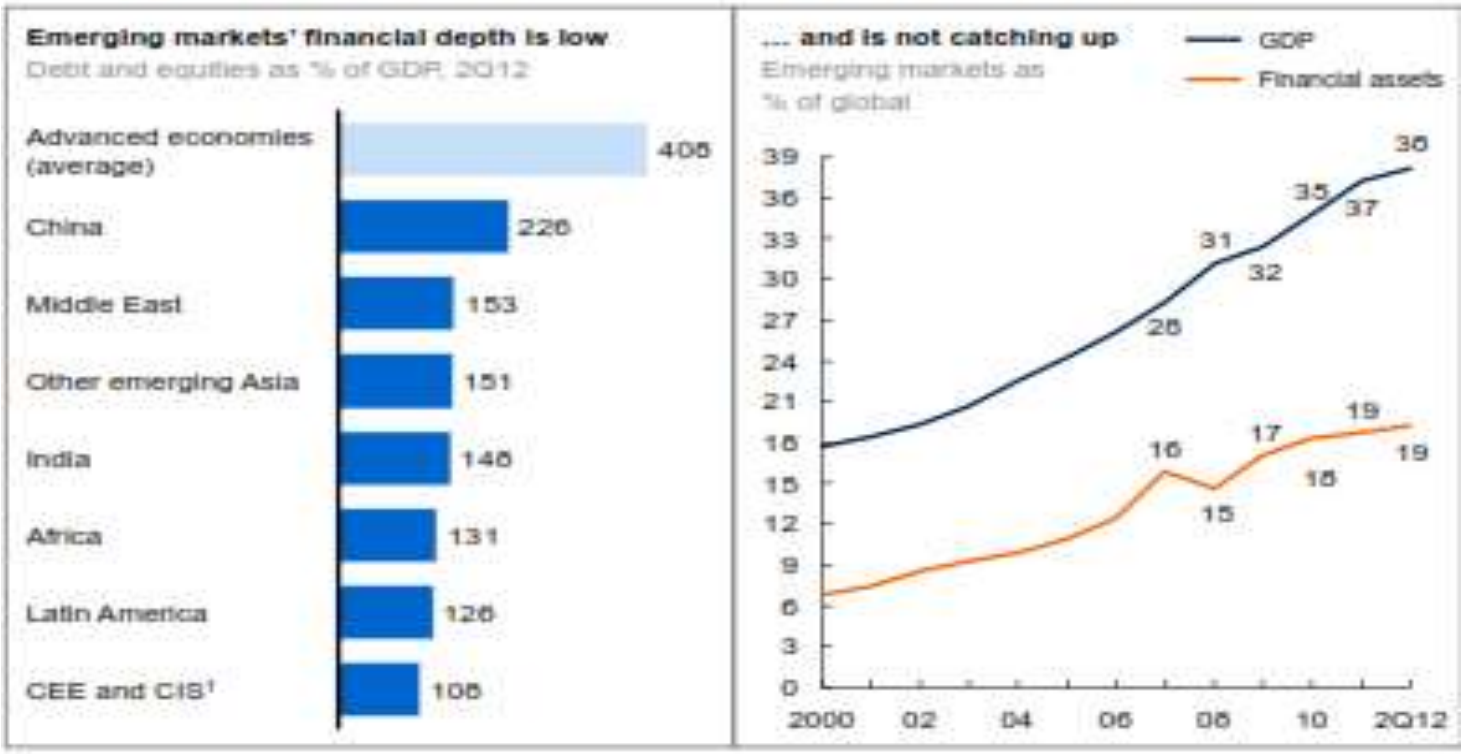
- EMEs not actively engaged in G 20 and FSB debates on financial regulatory reform because their own financial systems are still mostly deposit based and tightly regulated and held up well during the crisis.
- Shadow banking exists because of financial repression, but not deeply interconnected with the banking system to bring down the payments system.
- Conventional banking has deposit insurance and liquidity buffers to prevent bank runs.
- Relevance of BASEL III at this stage of their economic and financial development not clear.

What drives Leverage?

- Primary drivers of leverage in AMEs and EMDEs different: in the latter to increase returns through trading in claims (=financial assets) on real assets; in the latter for financing investment in real assets.
- Their present concerns more developmental than regulatory: Increasing savings deriving from rapid income growth need to be invested in financial assets which in turn is available for investment in the real sector for a virtuous cycle of rising incomes, savings, investment and growth.
- Because primary driver of leverage different, financialization in EMEs linked more to growth, whereas in AMEs it is racing far ahead, even as trend growth has declined.

Financialization

Emerging markets have low financial depth—and they are no longer closing the gap with advanced economies



1 Central and Eastern Europe and the Commonwealth of Independent States.

SOURCE: McKinsey Global Institute Financial Assets Database; McKinsey Global Institute analysis

Financialization and Growth

- **The correlation between economic growth and greater financialization is complex.**
- The financial system in AMEs at the time they were growing much faster was characterized by several features of financial repression of the kind currently associated with fast growing EMEs.
- Following the Global Financial Crisis it is becoming clearer that historically the **relationship between the growth of the financial system and economic growth is non-linear**. In other words, growth of the financial system is associated with accelerated economic growth only up to a point. Beyond a certain threshold, the impact on growth is far overshadowed by the risks involved.

The Underlying Narrative

- Even as there was a rapid ‘financialisation’ of the economy in AMEs, real economy activities increasingly shifted shifted to EMDEs to exploit lower costs and productivity gains.
- These rapid productivity gains led to a **global consumer price deflation**.
- This process was largely driven by TNCs through FDI

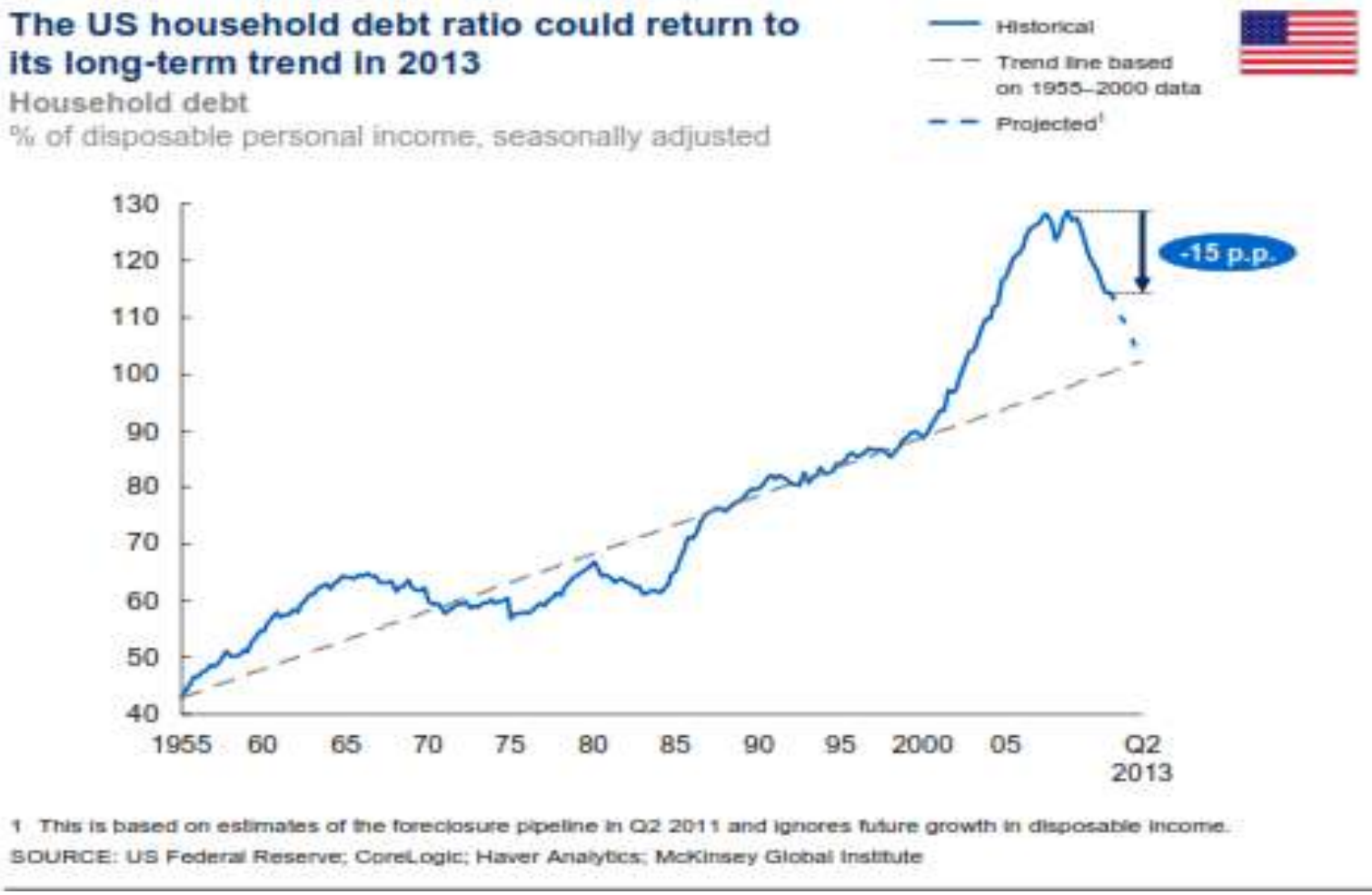
The Underlying Narrative…contd

- EMEs became more reliant on external demand to increase growth and started running huge current account surpluses, exporting excess savings to AMEs.
- This, along with consumer price deflation, drove down interest rates and returns to capital. Monetary policy in AMEs targeted consumer prices and ignored asset prices. In in a bid to raise returns, financial market actors turned increasingly to leverage and greater financial innovation.
- Since returns on real sector investment were higher in EMEs, savings imported into AMEs were invested in financial assets and into a highly financialized housing sector, **inflating asset prices**. Housing prices in particular rose spectacularly.
- Financial innovation that allowed leveraging of equity gains generated by asset price appreciation led to a consumption boom, even as returns to labour were declining in the real economy, leading to record levels of economic growth.

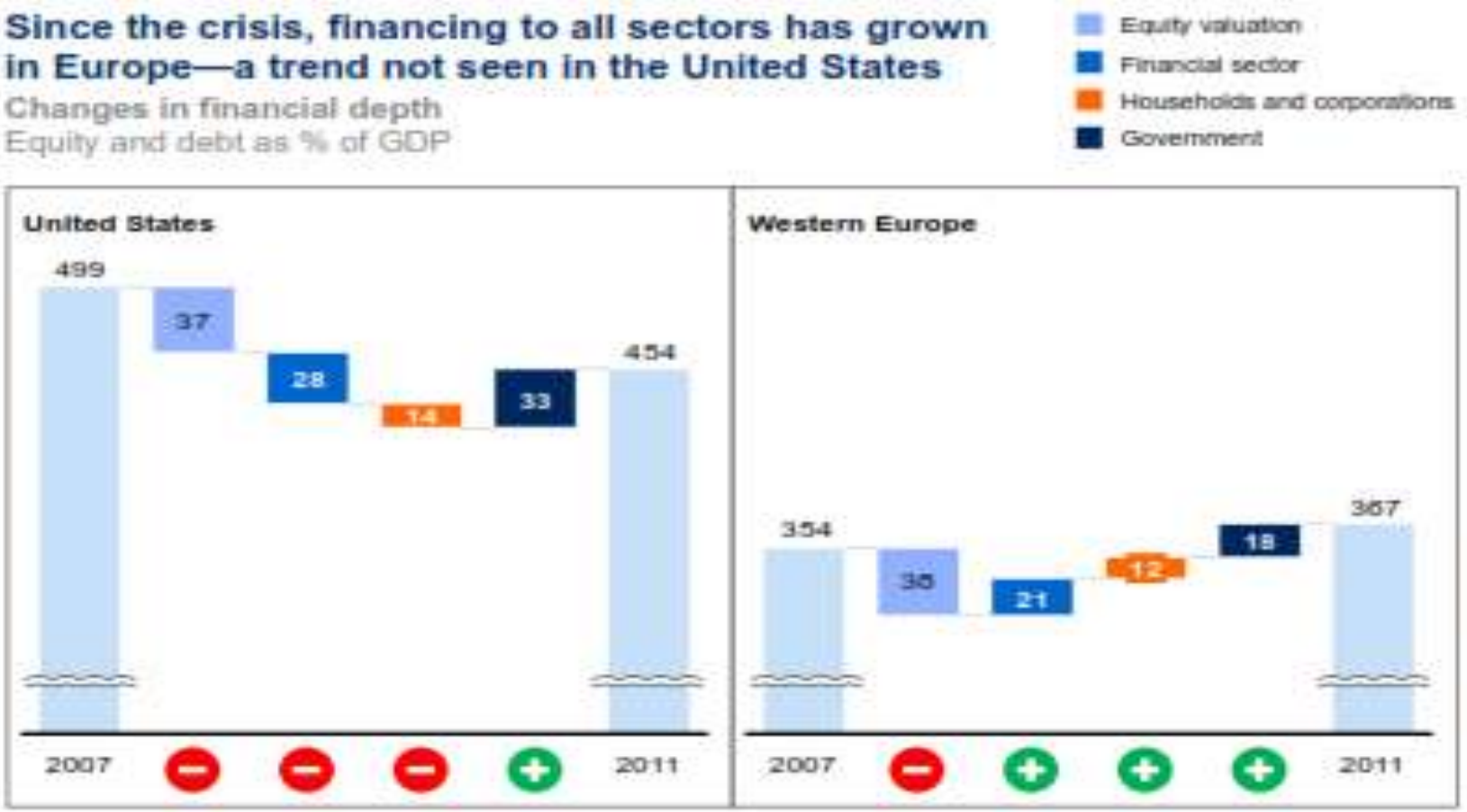
Is the narrative changing in AMEs?

- This bubble has been pricked, but the underlying narrative has not.
- Households and private Corporates (especially in the financial sector) are deleveraging, but this is being countervailed by public sector leveraging, assisted by accommodative monetary policy.
- The revival of the housing sector in the US is not led by rising incomes but the return of housing mortgaging activity entire underwritten by government owned entities.

Household deleveraging in the US

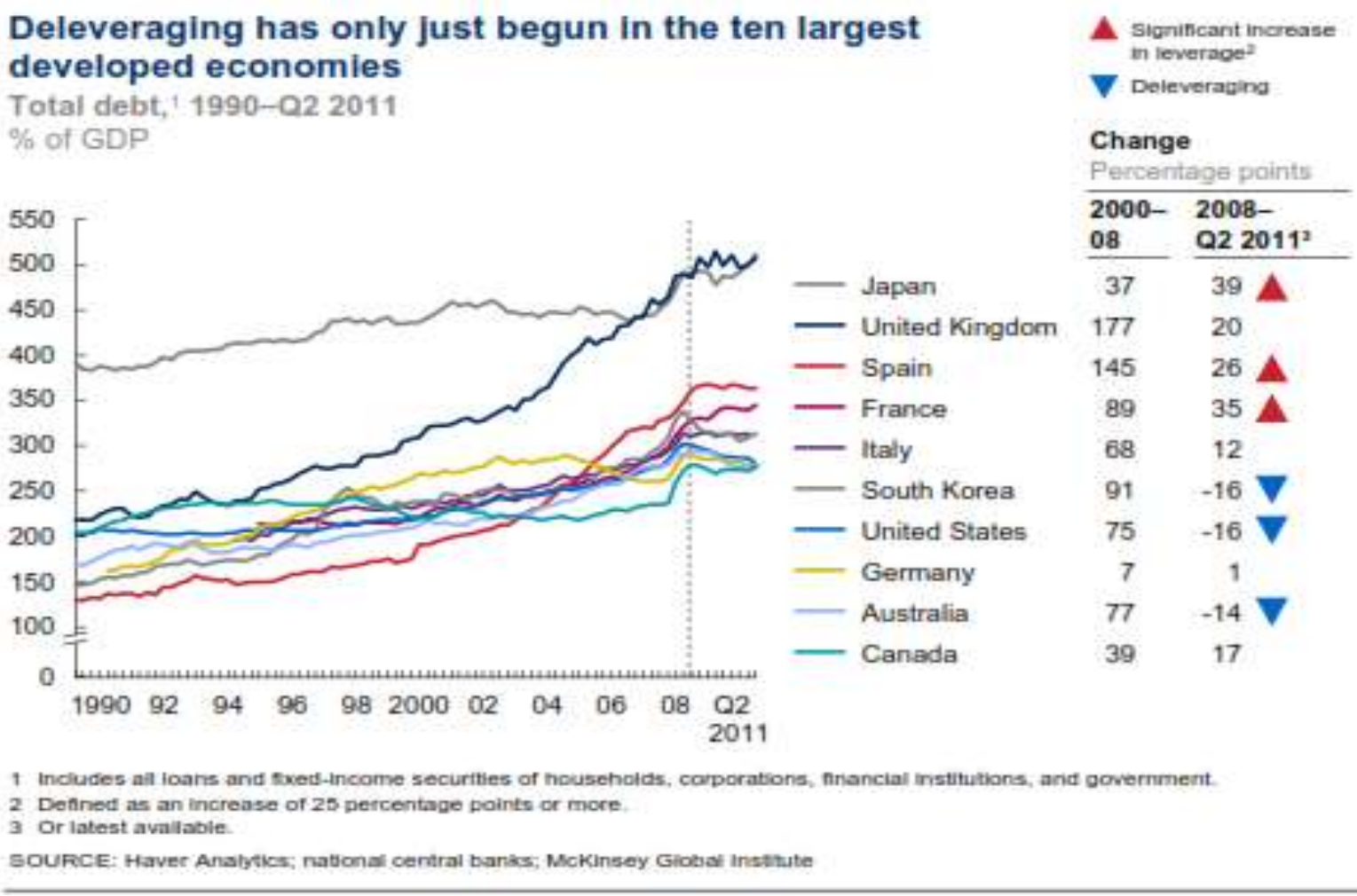


Europe has actually levered up



NOTE: Numbers may not sum due to rounding.
SOURCE: McKinsey Global Institute Financial Assets Database; McKinsey Global Institute analysis

Overall, little deleveraging



Is the narrative changing in EMEs

- EMEs trying to rebalance by turning to internal sources of growth?
- But is the decline in their Current Account Surplus due to collapse of external demand or rebalancing?
- Recent EME growth trends indicate that it could be the former.
- Danger of a Bretton Woods III?: public deficits in AMEs replacing private deficits even as imbalances return.

Lessons for EMEs

- Need to develop their financial system to intermediate their own savings for growth and development.
- This was the original role of the financial sector.
- Need to keep their financial system strongly tethered to real economic activity.
- The western financial system should no longer be the role model, especially as current regulatory reform initiatives do not have this as their primary objective.
- Carry out structural reforms to attract more FDI and rebalance their economies to sustain high growth.