The challenges of the financial crisis

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Abstract: *In our paper "The Challenges of the Financial Crisis" we decided to analyze the impact of the financial crisis upon the European banking sector and also upon two important European countries, with important references, of course, to the major European countries and their economy.*

Introduction

The financial crisis has really put the trust of clients in the banking sector to the test, and that is the reason why securing client trust and satisfaction is of great importance for any bank that respects itself. In unsettling times, it is essential to strengthen the trust that clients have placed in banks as a reliable and professional partner, and to rapidly restore confidence in any areas where it has been lost.

1. Banks and the financial crisis effects

Globally active banks play a key role in society and the economy, because **banks** provide governments, companies and individuals with access to capital, manage assets, steer capital flows and evaluate risks. By doing that banks create sustained added value for their clients and make an important contribution to the functioning of the economy, to public finances and to society as a whole.

1.1. Financial crisis and the turmoil in the markets or how the confidence in the banking sector has been eroded

The financial crisis and the turmoil in the markets seriously eroded confidence in the banking sector in 2008. The decline in the value of investments has been a source of concern for bank clients around the globe. There has been particular criticism from some investors that the banks have not been able to absorb their losses, or have done so only in exceptional cases. In difficult economic times especially, preservation of a good reputation with its clients is a primary concern of banks. The bankruptcy of the US investment bank Lehman Brothers in 2008 demonstrates just how delicate the balancing of these interests can be – and just how much controversy individual cases can create among the various stakeholders involved.

1.2. Client Focus

Banks make the needs of their clients the focus of their business activities. If banks can better understand their clients and offer better services, they can generate more business and grow as a result. In Private Banking, the key is Client Centricity. This initiative helps banks to focus even more consistently on their clients, thus providing them with access to the extensive expertise of the integrated bank and offering them comprehensive advice and solutions.

At the centre of this initiative is a five-stage advisory process (**see Figure 1: Five Steps of the Advisory Process**):

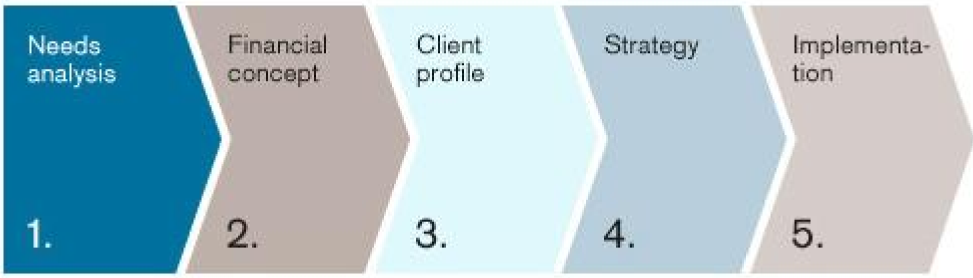


Figure 1: *Five Steps of the Advisory Process*

1. Needs Analysis: *The client's personal situation is the starting point for the consultation. At a meeting, banks establish the client's investment behaviour, the origin of the client's assets, and the client's stage of life. Further measures are then built up around this core.*

2. Financial Concept: *The assets are divided into tied and flexible portions.*

3. Client Profile: *A personal risk profile helps the client to make the right financial decisions.*

4. Strategy: *Together with the client, the advisor develops an individual investment strategy, taking the client's needs and risk tolerance into account.*

5. Implementation: *The advisor offers the client suitable individual solutions, and subsequently provides support in the monitoring and maintenance of the investment products.*

2. Euro zone members and the financial crisis effects

Greece, Portugal, Spain and other euro zone members have massive public deficits. It's one of a number of factors that are tending to drag the euro down against the dollar. More generally, difficulties in one or two credit areas around the world – such as Dubai – tend to be bad for the euro.

2.1. Greece Economy and the financial crisis effects

But clearly, the problem in Greece, which has made investors nervous, has resulted in a safe haven flow out of euros and into dollars. Politicians have not come up with a concrete plan to solve the situation. Politicians in France, Germany and elsewhere have signalled that they'll provide some kind of back-up support, but only when Greece has really taken tough measures – possibly more than they have done already – to get the deficit down. Although that may be unsettling to some investors in the very short term, it's clearly good news for the euro in the longer term. France, Germany and the other big countries are saying they're not going to write a blank check. They are going to require Greece, and indeed any other country needing support, to put its own house in order before receiving support from the others. This refusal to write a blank check bodes very well for the stability of the euro in the longer term. By the way, the European Central Bank is technically subject to the EU treaties. It is not allowed to bail out Greece. So it would have to come from the other countries on a bilateral basis.

The current events surrounding Greece are leading to the creation of a kind of model. This will provide at least a broad framework should other countries in the euro zone get into trouble. Portugal, Spain and Ireland may be affected, as well as Italy to a lesser extent. Hence, the Greek case is very important. It's about creating a system offering some kind of residual support for weaker countries. The euro encompasses strong economies like Germany and France on the one hand, and weak economies like Greece on the other. What recent events have shown us is that France, Germany and the stronger countries are prepared to underwrite deflation in the weak countries, but not inflation. If they'd offered support before Greece had taken tough measures, then that really would have been allowing Greece to take an inflation route. As it is, by insisting that Greece cuts the budget deficit, reduces wages, gets down prices – with limited support if this leads to severe economic problems – France and Germany are in effect underwriting deflation. That is a recipe for stability in the longer run. And by the way, it's a problem that any large currency area has to face. The US for example has stronger areas, as well as weaker ones, like California at the moment.

Experience shows us that there is opportunity in every crisis. Opportunities are both local and global. Locally, some investors are now looking at Greek bonds *(the prices of which have fallen very sharply during the crisis)* and wonder if they are now starting to offer value. As with any investment strategy, a judgment has to be made as to whether the situation will stabilize, but once this begins to look more and more likely, a case can be made for some of the bonds at lower prices. These have fallen and now offer value.

But we're also looking globally at equity prices that have fallen generally during the crisis as well as – as we said at the beginning

– the weaker euro. Taking this view from here, the worst of the crisis is now over and things will begin to stabilize.

The spring summit of the EU in Brussels was preceded by a comprehensive round of meetings and negotiations between the **Union's main members**, their aim being to identify a joint solution of the Euro states, as priority, but also of the other EU members concerning the support that must be provided to Greece.

According to media sources, the day before the summit, Paris and Bonn were in permanent contact in an attempt to end the crisis. This became even more urgent as neither the 27, nor the 16 members of the Euro zone, will be able to provide a clear answer during the summit, unless the German chancellor and the French president reach a preliminary agreement. While the latter always favoured a European solution, Angela Merkel was more cautious. Concerned with both the disputes within the ruling coalition and the nearing elections of North Rhine-Westphalia, the German chancellor seems unwilling to spend German taxpayers' money for Greece. This is precisely why she supported, on several occasions, the idea of resorting to the International Monetary Fund. Spanish Premier Zapatero, whose country holds the rotating presidency of the EU, came to Brussels one day earlier and had several meetings with European Council President Herman Van Rompuy and other leaders, in view of finding a European solution to the **Greek problem**.

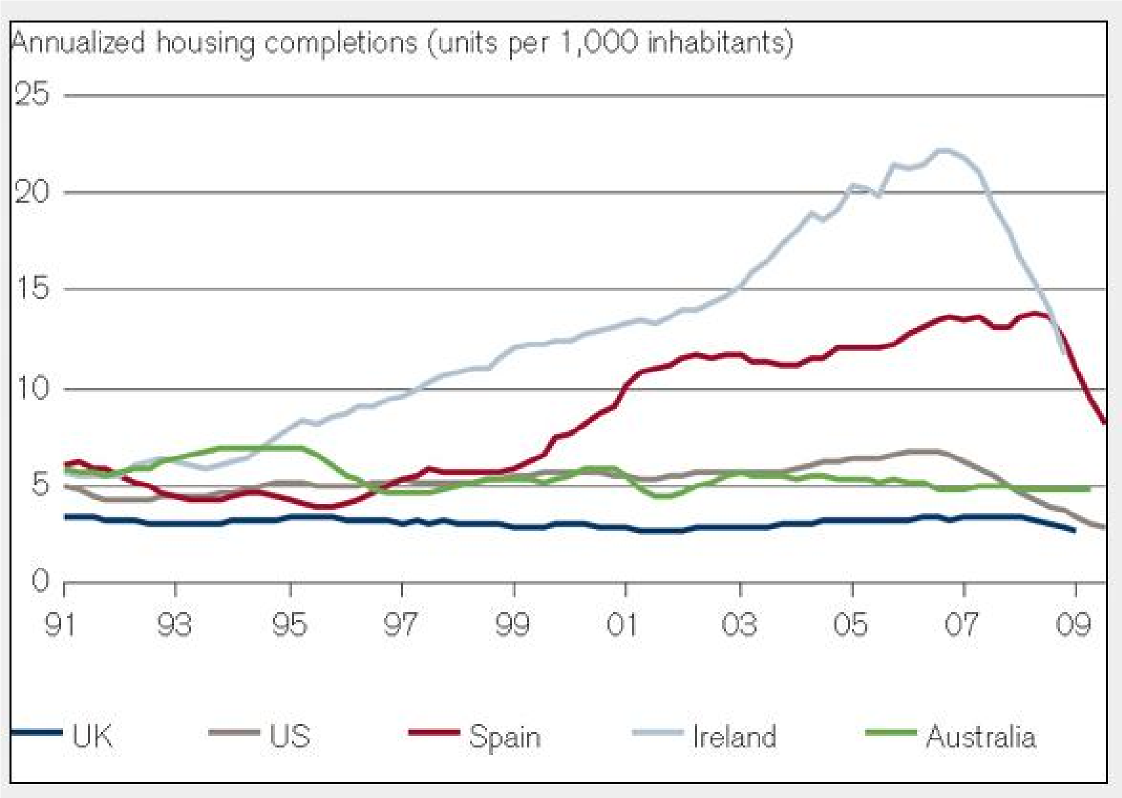
Yesterday at noon various diplomatic circles were putting forward the idea that Berlin finally accepted the creation of a European support mechanism for Athens. However nothing palpable was being said about how this mechanism will look like, and most importantly nothing was being said whether the IMF will be involved in this mechanism like the German Chancellor kept saying. As was pointed out in yesterday's issue, apart from the issue of Greece the Heads of State and the Heads of Government of the 27 EU members will also discuss the '**2020 Strategy' for economic recovery and job creation.** Likewise, they will debate consequences of the climate change conference in Copenhagen and the EU's tangible tasks in that regard.

2.2. Spanish Economy and the financial crisis effects

Spain has been facing a severe recession and major structural challenges.

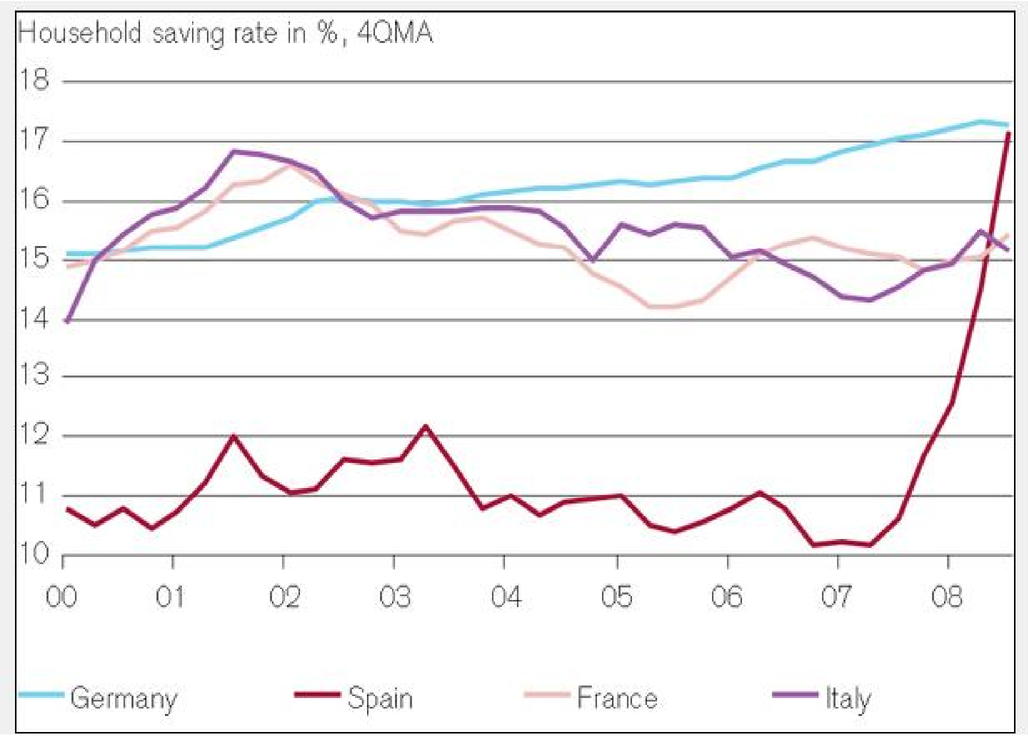
For many years, the Spanish economy has outperformed its Euro area peers in terms of growth performance. Over the past decade, the growth of the Spain's gross domestic product (GDP) averaged 2.8 per cent compared to only 1.5 per cent in the Euro area as a whole. Even during the recent crisis, Spanish GDP has contracted somewhat less than in other Euro area countries, e.g. Italy or Germany. However, the relatively mild decline in GDP clearly masks the severity of the downturn. Domestic demand was down 12 per cent in the third quarter, compared to the third quarter in 2008. And the unemployment rate has surged from 8 per cent in 2007 to more than 19 per cent. While some of the larger Euro area economies exited recession already in the second quarter of 2009, the Spanish economy continued to contract in the third quarter **(see Figure 2: Annual housing completion in Spain).**

***Figure 2:** Annual housing completion in Spain*



Similar to the USA and the UK, Spain has experienced a housing boom. At the peak, 14 houses per 1000 inhabitants were built in Spain, compared to only 7 in the USA and 3 in the UK. This construction boom was financed to a significant extent by foreign borrowing. In 2007, the current account deficit to GDP ratio reached a peak of 11 per cent, which is very high by international standards and even far exceeded the US deficit. In particular, Spanish non-financial corporations took up significant amounts of credit: during 2007, their net borrowing reached minus 11 per cent of GDP. The debt of households also increased markedly. The ratio of household liabilities to disposable income in Spain has become the highest among the large Euro area countries in recent years **(see Figure 3: "The evolution of household saving rate in major European countries")**.

Figure 3: *"The evolution of household saving rate in major European countries"*



This high leverage is now being unwound. Spanish households have increased their savings markedly and the savings rate has risen from around 10 per cent of disposable income at the beginning of 2008 to 18 per cent in the third quarter. Non-financial corporations have also lowered their dependency on external finance somewhat. As a result, the current account deficit has narrowed dramatically to around minus 3.5 per cent in the third quarter of 2009. At the same time, employment has been cut very sharply *(minus 7.2 per cent in the third quarter of 2009, compared to the third quarter in 2008).*

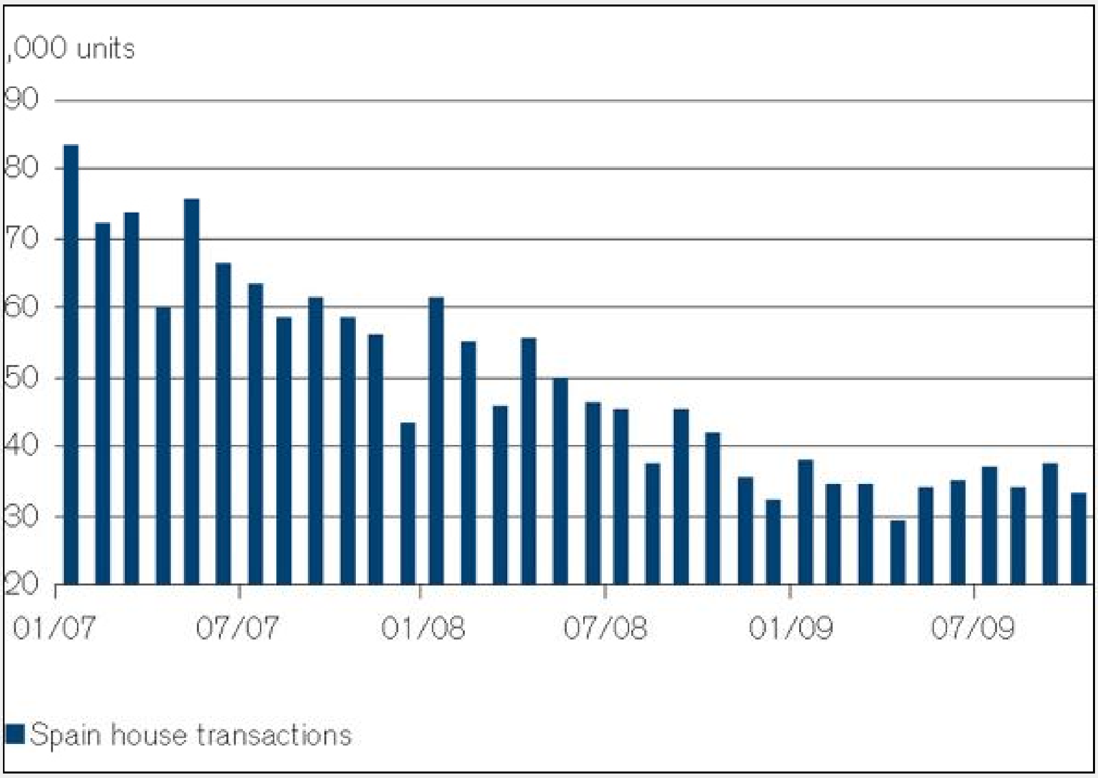
We think the sharp deterioration reflects two factors:

➤First, Spain has the highest share of temporary workers in the European Union, and these can be dismissed easily. Indeed, the share of temporary employment has fallen from around 34 per cent in 2006 to only 26 per cent in 2009.

➤Second, the downturn in the housing market has had a pronounced effect on construction employment. Construction employment has been falling for two years now, and accounts for around half the drop in total employment.

Recent figures show that unemployment is now stabilizing at a very elevated level, and we think it could start falling in coming months. Business surveys have improved. However, the improvement was clearly less pronounced than in other European countries, and as the process of debt reduction has further to run, we expect the road to recovery to be bumpy. The planned VAT hike from 16 per cent to 18 per cent next July and the abolition of the annual tax rebate of 400 Euro (per household) to reduce the budget deficit **(see Figure 4: "Spain house transactions")**.

Figure 4: "Spain house transactions"

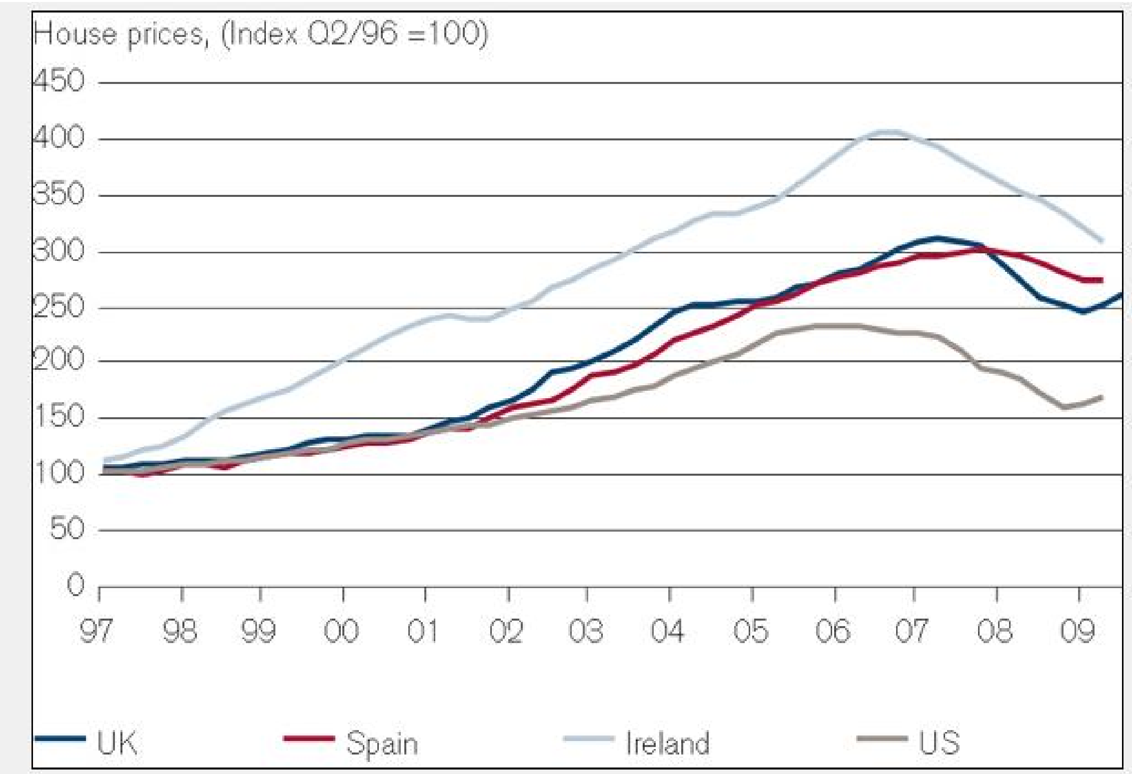


Spanish competitiveness has deteriorated in recent years as unit labour costs have risen more strongly than elsewhere. A devaluation of the currency is not possible in a currency union, so competitiveness has to be regained through an increase in productivity or lower relative prices. Both seem to be happening: While unit labour costs are surging in most of the other large Euro area countries due to the sharp cut in employment, they are falling in Spain. And while core inflation in Spain used to be highest among the larger Euro area countries in recent years, it has fallen close to zero in recent months. Deflationary tendencies are becoming increasingly visible: In the producer price index, prices for consumer goods were down 0.5 per cent in December *(compared to December 2008).*

The prospects for Spain's housing market are also expected to be poor in the next few years. A recovery is nowhere in sight due to the challenging economic outlook, tighter credit, weak housing demand and the significant supply overhang in residential markets.

The decline of housing demand in Spain started in 2007 and has intensified since then. For instance, the number of new and existing home sales is currently about 50 per cent to 70 per cent lower than their peak level. A pick-up in housing demand is unlikely in the short term given the high unemployment rate and credit constraints. During the past boom, banks have been willing and able to generate lending, which has fuelled housing demand. However, for the time being, we think that mortgage credit growth is likely to remain sluggish **(see Figure 5: "House prices all over the world").**

Figure 5: *"House prices all over the world"*



At the current sales numbers of about 400,000 units per year, it would take four years to absorb all the stock. Most of these units are located in coastal regions and satellite towns close to large cities where construction has been the most active during the housing boom. Moreover, there are some risks that this oversupply situation could worsen as Spanish saving banks have recently started selling off their property portfolios due to regulatory changes. **Banks and savings banks became large real estate owners in Spain** by taking over thou-sands of homes used as collateral on defaulted loans. **Bank of Spain** decided last October to increase provision requirements on real estate assets held by financial institutions for more than a year from 10 per cent to 20 per cent, which is likely to lead to the sale of some of the bank's real estate holdings. However, detailed data on the bank's real estate holdings are scarce and it is difficult to assess the importance of this effect.

Overall, we thus expect an increase in the **supply/demand imbalance** and further house price declines. So far, **Spain's house price index has declined by only 9.5 per cent since its peak in the first quarter of 2008.** According to some indicators, such as house price to disposable income, residential properties in Spain are still substantially overvalued.

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