

## Viewpoints

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### **The Two-Stage De-Risking of Banks**

By Mohamed El-Erian

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The first stage of de-risking of the banking sector was led by the markets. Fuelled by massive concern about the banks' lax risk management practices and related over-exposure to toxic assets, the process was vicious and indiscriminate. With the market-induced contraction of the banking sector over-shooting, the highly disruptive implications for employment and economic activity forced policymakers into a "WIT" mindset – doing "whatever it takes" to stabilise the sector.

The massive policy reaction succeeded in stabilising the banking system. And while the banks are still not lending in any meaningful manner to the real economy – an issue that will become politically even more problematic as unemployment continues to rise in the industrial countries (particularly in the US and UK) – most have used the extraordinary policy support to strengthen their balance sheets and, also, take on risk.

The question is whether this is the end of the story. It is not.

There is another stage of de-risking in banks' future. This second stage will be driven by the regulatory authorities, rather than the markets. Ironically, the success of some banks in restoring huge profitability will make this phase come earlier and be more consequential for banks.

What will this de-risking look like? Widespread consensus is forming around five issues.

First, banks must be subject to higher capital requirements, with capital being defined more robustly.

Second, they should be induced to think of capital counter-cyclically, increasing it in good times so that they have a meaningful cushion for the bad times.

Third, the prudential regulation of banks should be supplemented by better consumer protection.

Fourth, "large" institutions should be subject to an additional layer of prudential regulations, given their potential to contaminate the economy as a whole.

Fifth, better resolution mechanisms are needed for those firms that stumble badly.

There is a sixth issue, which is much more controversial. Should regulatory authorities reverse the multi-year trend toward combining commercial and investment banking

## Viewpoints

October 2009

activities in single institutions? At the heart of this issue is whether to restrict the ability of banks to use government-guaranteed deposits to fund investment banking activities.

Mervyn King, the governor of the Bank of England, is pushing for such a reversal. In doing so, he is reacting to the view that, to use his colourful language adapted from Churchill, "Never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform."

Mr King's calls will face resistance. Most European countries will be reluctant to abandon the universal banking model, arguing that the crisis was primarily an Anglo-Saxon creation. The most consequential battlefield will be in the US, where the opposing camps are already digging their heels.

Regardless of what happens on this sixth issue, it is clear that the banking system will soon be taking an important step towards the "utility" end of the institutional spectrum – a likelihood that is yet to be internalised, both in market valuations and in consensus expectations regarding the medium-term prospects for growth in the US and UK, in particular.

Buoyed by the recovery in banking sector profitability, markets are pricing a return to the previous paradigm for the banking system – call it the "old normal". Yet the likelihood is for a "new normal" in which more dominant utility-like functions translate into an average return on equity (ROE) in the low teens, as opposed to the 20s.

Similarly, consensus growth projections for the US, which have been heading steadily toward 4% for 2010, underestimate the extent to which the economy's credit factories are undergoing a long-lasting contraction.

Banks are in no position to assume the critical hand-off from government stimulus in order to maintain in 2010 the rates of growth that are materialising in the second half of 2009. With credit availability lacking, consumers will be hard pressed to sustain high spending in the face of rising unemployment and weakened retirement nest eggs.

All this speaks to a critical issue that should remain front and centre on the radar screens of both policymakers and markets. The panic engendered by the crisis may be behind us, but its longer-term consequences are yet to play out fully. These – be they economic, political or institutional – will become apparent in the period ahead.

Any attempt to dismiss this process as a "flesh wound" ignores the fact that, unlike anything the world has experienced in the post-war period, the 2008 crisis struck at the core of the global system and not at the periphery.

## Viewpoints

October 2009

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Dr. El-Erian is CEO and co-CIO of PIMCO and is based in the Newport Beach office. He re-joined PIMCO in 2008 after serving for two years as president and CEO of Harvard Management Company, the entity that manages Harvard's endowment and related accounts. Dr. El-Erian also served as a member of the faculty of Harvard Business School. He first joined PIMCO in 1999 and was a senior member of PIMCO's portfolio management and investment strategy group. Before coming to PIMCO, Dr. El-Erian was a managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C. Dr. El-Erian has published widely on international economic and finance topics. His book, *When Markets Collide*, was a New York Times and Wall Street Journal bestseller and won the Financial Times/Goldman Sachs 2008 Business Book of the Year. Dr. El-Erian has served on several boards and committees, including the U.S. Treasury Borrowing Advisory Committee, the International Center for Research on Women, and the IMF's Committee of Eminent Persons. He is currently a board member of the NBER and the Peterson Institute for International Economics. He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.

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