Erkki Liikanen: Is a reform of banking structures necessary?

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the Highlevel Expert Group on reforming the structure of the EU banking sector, at a meeting with Finance Watch, Brussels, 20 November 2012.

* * *

Costs of the crisis and the public outcry

The global financial and economic crisis which started in 2007 is by far the worst in the Western world in the post-war history.

The European Commission estimates that from October 2008 until October 2010, it has cost 13% of the European Union's GDP in the form of public support to the region's banks.[1] Moreover, the present value of lost economic output is probably bigger by orders of magnitude than the direct support.[2]

The crisis has caused a public outcry which is justified. Regulators are responding to the pressing need to establish a financial system in which losses, not only gains, fall on the private risk takers, not on the tax payer.

In order to find appropriate solutions, we need to understand the developments leading up to the global financial crisis.

Changes in banking in the run-up to the crisis

The new landscape

In the years preceding the global financial crisis, the landscape of banking had gone through major changes. The banking sector had grown rapidly and global financial institutions had grown ever bigger in size.

Especially, European banks appear very large when measured in terms of total assets in relation to the domestic GDP.

Further, the scope and the organizational complexity of global financial institutions had increased, adding to their opacity.

There was a trend among the biggest banking institutions to strengthen their focus on investment banking, including trading operations. Part of this trend was driven by the growing demand by non-financial firms for risk management services. Partly, it was a search for new revenue streams, higher profitability and economies of scale and scope. The flip side of the coin was strong incentives for risk taking.

Commercial banking moved increasingly away from customer relationship-based banking where loans are granted and then held until maturity to the "originate and distribute" model where granted loans are pooled, then securitized and sold to investors.

As result, banks became strongly interconnected via increasingly long chains of claims as well as correlated risk exposures, arising from increasingly similar investment strategies. This

---

[1] The Final Report of the High-level Expert Group (2012).

[2] See e.g. Haldane (2010): "The $100 billion question".

shift in the business model increased traditional banks' connections to the shadow banking sector.[3]

The increasing influence of investment banking oriented management culture also spurred the focus on short-term profits in commercial banking, reinforced by short-term performance based managerial compensation schemes.

There were also dramatic changes in the liability side of banks' balance sheet before the financial crisis. The leverage of banking institutions had strongly increased and the average maturity of their own funding had shortened.

Lack of restraints from regulation, market discipline and supervision

Problems with capital requirements

Capital requirements on banks proved ineffective in restraining the strong growth in banks' leverage and balance sheet size because the Basel I and II rules required very little common equity.

Further, what was important for the global reach of the financial crisis was that much of the asset and mortgage backed securities, originating from the US, ended up on European banks' balance sheets.[4]

This was partly spurred by differences in American and European banks' capital requirements.

There were also problems with the Basel capital requirements on banks' trading book positions. Capital in the range of zero to two percent of trading assets suggests that risks were not fully covered by existing capital requirements.

In particular, the Basel rules allowed banks to lower their capital requirements by securitizing loans from the banking book and taking in effect corresponding risks onto their trading books. It has been suggested that many of the loan securitizations were motivated by such regulatory arbitrage rather than credit risk transfer.[5]

The role of overly optimistic rating agency ratings used to market the securitized assets, and used as a basis for capital requirements, should not be dismissed either.

Finally, many risk-weights used in the Basel framework to determine the effective capital requirements were simply too low, as was revealed by the crisis.

Lack of market discipline and the too-big-to-fail problem

The increasing complexity of structures and products, and the financial sector's increasing interconnectedness, along with growing size, led to reduced transparency of bank balance sheets.

This should logically have rung alarm bells among investors, especially among banks' uninsured debt holders, at some point. However, the opposite seems to have happened: the markets rewarded size by charging lower debt margins from the biggest institutions.[6]

This suggests that there was a perception among market participants that the biggest financial institutions enjoyed an implicit public guarantee. These institutions could not be allowed to fail; in other words, they had become too big, too complex or too important to fail.

---

[3] See e.g. Adrian and Shin (2010): "The Changing Nature of Financial Intermediation and the Financial Crisis of 2007–09".

[4] See e.g. Shin (2012): "Global Banking Glut and Loan Risk Premium".

[5] See e.g. Acharya, Schnabl, and Suarez (2010): "Securitization without risk transfer".

[6] See e.g. Haldane (2010): "The $100 billion question".

In a market environment where the price of a bank's own debt funding is insensitive to the risks the bank takes and decreases with the bank's size, the bank has a strong incentive to further increase its leverage by taking on even more debt and continue to grow in size.

The implicit subsidies also have important implications for the level-playing field in the banking sector. Currently, the competitive distortions, manifested in differences in funding costs between systemically important banks and other banks, are significant. However, our goal must be that no bank is perceived as too big to fail. As Stephen Cecchetti recently noted, "there should come a day when the Basel Committee's list of globally systemically important banks, or G-SIBs, is blank".[7]

Lack of a systemic aspect

There was clearly also a lack of a sufficient macro-prudential aspect to banking supervision and regulation prior to the crisis.

The fundamental problem is that banks themselves do not have an incentive to fully internalize the social cost stemming from their own contribution to system wide risks into their business decisions.[8]

In the absence of substitutive regulatory and supervisory measures in the years preceding the crisis, systemic risks built up in the form of ever larger, more complex and more leveraged financial institutions.

Regulatory response to the crisis

What has already been done?

In response to the crisis, a number of international and EU wide regulatory reforms have been launched. Two reform areas have been particularly relevant to the work of the High-level Expert Group; capital adequacy and liquidity requirements (Basel III as implemented in the EU through the CRD IV/CRR) and recovery and resolution (as in the Commission's proposal).

If effective, the new and still evolving capital adequacy requirements can go a long way to reduce incentives to take excessive risks across different banking operations and the use of excessive leverage.

Most obviously, higher capital requirements provide for more loss absorbency. Liquidity requirements can also reduce banks' interconnectedness by restricting the use of short-term market funding. They will also be helpful in reducing excessive leverage and building liquidity buffers.

The new capital requirement framework also reduces complexity and interconnectedness by blocking opportunities for regulatory arbitrage which previously was possible via complex securitisation structures.

Recovery and resolution regimes aim to create a framework which did not exist at EU level prior to the crisis. If successfully implemented, the new tools such as the recovery and resolution plans can greatly reduce the social costs of bank failures and thus reduce the implicit public guarantee. This means that recovery and resolution tools can reduce the distortive risk-taking incentives created by public bail out expectations.

Moreover, a number of initiatives[9] have been launched with the aim of reducing contagion and complexity in the financial market. In order to improve transparency, accounting

---

[7] See Cecchetti: "The future intermediation and regulation", remarks prepared for the Second Conference of the ESCB Macro-prudential Research Network, 30 October 2012, Frankfurt, Germany.

[8] See e.g. Richardson (2012): "Why the Volcker Rule is a useful tool for managing systemic risk".

standards are in the process of being reviewed. Banks are urged to improve risk management and corporate governance practices and new macro-prudential tools are given to international and national authorities to better tackle asset price bubbles and *procyclicality* in lending.

Proposals of the High-level Expert Group

The High-level Expert Group on reforming the structure of the EU banking sector evaluated the current regulatory reforms and came to the conclusion that they take us a long way, but not all the way, in ensuring financial system stability and strengthening banks' ability to provide socially vital financial services.

Let us first consider capital requirements. When capital requirements are truly risk-based, they will contain the excessive risk-taking incentives which result from banks' access to insured deposits. However, where risk profiles can change rapidly and where risks are difficult to measure with precision, risk-based capital requirements may not provide sufficient protection against excessive risk-taking. Asset and activity restrictions provide a more robust measure to limit risk-taking in these circumstances.[10]

Second, the High-level Expert Group came to the conclusion that many banks are still too complex for the proposed recovery and resolution regime to be truly credible and time consistent.

Hence, the High-level Expert Group concluded that there is a need for structural measures to complement the current regulatory reform. More specifically, the High-level Expert Group proposes a mandatory separation of certain trading related activities according to the following three principles.

First, if the share of proprietary trading, market making and certain other securities-related businesses in the balance sheet exceeds a given threshold, banking groups must organize these businesses to a separate legal entity ("trading entity").

The other businesses that must be separated are loans, loan commitments, or other exposures to hedge funds (including prime brokerage), SIVs and other such entities of comparable nature. Private equity investments must also be separated.

The client-driven trading positions against which the bank has hedged itself do not have to be separated. Also, securities underwriting does not have to be separated but it is important that risks in non-transitory positions possibly arising from underwriting are carefully monitored by supervisors.

Second, the trading entity must be separately capitalized and must not be funded by insured deposits.

And third, the deposit-taking part of the banking group ("deposit bank") is not allowed under any circumstances to support the trading entity either directly or indirectly by making transfers or commitments to the extent that its capital adequacy including capital buffer requirements would be endangered or that the general limits on large exposures would be violated.

All other banking businesses are allowed to the deposit bank unless firm-specific recovery and resolution plans require otherwise. Similarly, the trading entity can engage in all banking activities which are not specifically mandated to the deposit bank. For instance, the trading entity is allowed to make loans and loan commitments to its customers.

---

[9] E.g European Market Infrastructure Regulation (EMIR), Markets in Financial Instruments Directive (MiFID) second review and proposals on Central Securities Depositors (CSD).

[10] See e.g. Matutes and Vives (2000): "Imperfect competition, risk taking, and regulation in banking" and Boot and Ratnovski (2012): "Banking and trading".

Only the deposit bank is allowed to provide retail payment services.

An important objective of the mandatory separation, proposed by the Group, is simplicity and avoiding ambiguity. These facilitate implementation at the EU level.

Furthermore, banking activities which naturally belong together should be conducted within the same legal entity.

To promote these aims the proposed mandatory separation includes both proprietary trading and market making. Differentiating these from one another would be difficult[11] and, if placed in different legal entities within the same banking group, some natural synergies might be lost.

By avoiding the decoupling of proprietary trading and market making, the proposal differs from the Volcker Rule in the United States. However, the proposed mandatory separation in the EU can take place within a banking group whereas the Volcker Rule prohibits proprietary trading from the entire banking group.

When comparing the proposal of the High-level Expert Group and the proposal presented by the UK's Independent Commission on Banking (ICB) last autumn, one can say that the proposals started from different directions, but their results are qualitatively similar. Both proposals seek to prevent the use of guaranteed deposits to risky investment. However, the approach taken by ICB started from the narrow banking philosophy and sought to restrict the use of those funds. The High-level Expert Group on the other hand focused on the most volatile parts of banking business and sought to cordon off those.

The main practical difference in the position of the ring-fence is that the High-level Expert Group proposal allows securities underwriting by the deposit bank, whereas the ICB proposal forces it out of the ring-fenced deposit bank. The solution of the High-level Expert Group is based on the view that underwriting is actually closely connected with corporate finance and prohibiting it would hurt the universal banking model. Note that if a bank would feel that synergies so require, there would be no prohibition for conducting underwriting business within the trading entity to which the market-making operations have to be transferred.

Another difference which stems from the different starting points is that, in the ICB proposal, higher capital requirements are recommended for the ring-fenced deposit banks. As will be discussed shortly, the High-level Expert Group was more concerned of strengthening the capitalisation of the trading entity.

To sum up the rationale for separation as a regulatory measure, I would emphasize the following four points.

First, as already discussed above, separation is a way of prohibiting banks with insured deposits from engaging in activities whose risks are potentially high and difficult to measure precisely, and which are not essential to deposit banking. Essentially, prohibition of such activities is a way to complement capital requirements in limiting moral hazard which may arise from deposit insurance.

Second, separation of activities is the most direct instrument for tackling banks' complexity and interconnectedness. As banks become simpler in structure, recovery and resolution will also be easier.

The High-level Expert Group emphasised the importance of the recovery and resolution plans and noted that more intrusive separation might be needed to make the plans truly credible (Proposal 2).

---

[11] See e.g. Duffie (2012): "Market making under the proposed Volcker Rule".

Third, simpler structures can make it easier for the management and board to understand and manage and for outsiders to monitor and supervise banking institutions. This can enhance the effectiveness of both market discipline and financial supervision.

To facilitate the monitoring of banks further, the High-level Expert Group emphasised the need for greater transparency. In particular, the High-level Expert Group suggested that the quality, comparability and transparency of risk disclosures should be improved by requiring detailed financial reporting for each legal entity and main business lines (Proposal 5). This suggestion is in line with the suggestions presented by the Financial Stability Board's Enhanced Disclosure Task Force in the end of October.[12]

The High-level Expert Group wished to further strengthen the incentives for outsiders to monitor banks by strongly promoting the use of bail-in instruments. These would ensure that also creditors are made responsible for losses (Proposal 3).

Fourth, separating deposit banking and trading entities can also reduce the mixing of the two different management cultures. As Andy Haldane has described, resources were diverted away from retail banking towards investment banking before the crisis and at the same time the culture of investment banking infiltrated retail banking resulting in short-termism and harmful cross-selling.[13]

To support the separation of the sub-cultures of retail and investment banking, the High-level Expert Group strongly promotes the strengthening of capabilities of boards and management to run large complex banks and use of remuneration schemes that create long-term, rather than short-term incentives (Proposal 5). I agree with Wayne Byres who notes that "ensuring that incentives are working in the right direction in the diverse and complex organisations such as today's banks is easier said than done".[14] However, separation of deposit banking and trading entities, by making organizations simpler, can help in building the right incentives.

To ensure that both the deposit bank and trading entity are sufficiently capitalised (Proposal 4), the High-level Expert Group found that there is a need to address a number of issues related to how the capital requirements on trading assets and real estate related instruments are defined. In particular it is important that make sure that the capital requirements on trading assets are adequate to stabilise the trading entities on a stand-alone basis.

To this end the High-level Expert Group expressed its support for the Basel Committee's trading book review. It should be carefully assessed by the Commission once completed. Similar capital requirements review should also be carried out by the Commission on real estate related lending as risks in these instruments were central in the crisis.

The ultimate goal of the five proposals of the High-level Expert Group is to ensure financial system stability while ensuring banks' role in financing the European economy. Or as stated in the mandate "to establish a safe and efficient banking system, serving the needs of citizens, the EU economy and the internal market". As this list shows, the High-level Expert Group did not see structural separation as a "silver bullet" for stability and security. It is not sufficient alone, but it is a necessary component of a balanced set of banking reforms.

[12] Enhancing the risk disclosure of banks, Report of the Enhanced Disclosure Task Force, 29 October 2012.

[13] Andrew G. Haldane, "A leaf being turned", speech given at Occupy Economics, "Socially useful banking", London, 29 October 2012.

[14] Wayne Byres, "Regulatory reforms – incentives matter (can we make bankers more like pilots?)", remarks at the Bank of Portugal conference on Global Risk Management: Governance and Control, Lisbon, 24 October 2012.

The role of banks in financing the European economy

To conclude, I would like to emphasise the importance of redirecting the banking sector towards strengthening its important role in the society by means of regulatory reform. The financial crisis reminded us that financial stability is a prerequisite for stable economic growth.

Banks have a pivotal role in providing financing to households and firms. It is particularly so in Europe where the banks' role in corporate finance has traditionally been large. The banks' role in corporate finance is central especially for small and medium sized enterprises (SMEs). The continuous and smooth supply of banking services to SMEs is also essential to large corporations because SMEs are often subcontractors to them.

It is of utmost importance that regulatory reforms as a whole support and strengthen the banking sector's ability to continue to provide these socially vital financial services efficiently and in a stable manner.

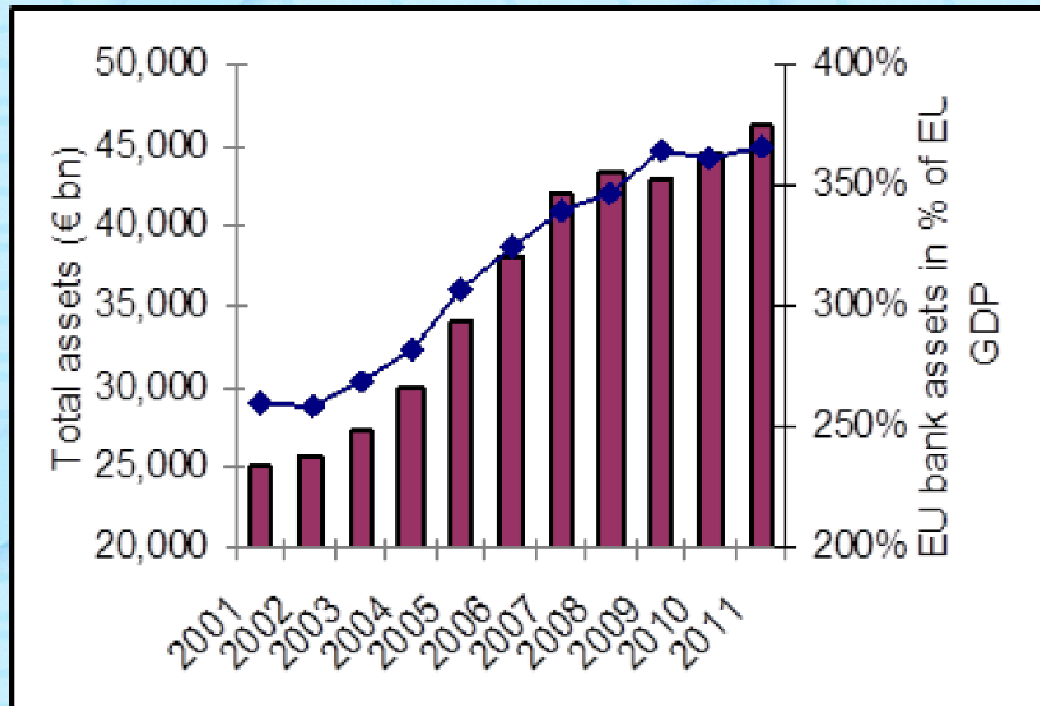
Along these lines, the High-level Expert Group recognised the value of universal banks as suppliers of a comprehensive service to their customers and their important role in financing the European economy. As a result, complete separation similar to the former Glass-Steagall Act in the US was not required. As the deposit bank and the trading entity are allowed to co-exist within a holding company structure, the banking group could still market all of the services, from its different constituent units.

Concluding remarks

The reputation of banks and the public trust that they rely on has been severely dented during the latest financial crisis. This has hurt not only banks themselves but also the economies and societies of Europe and the whole Western world.

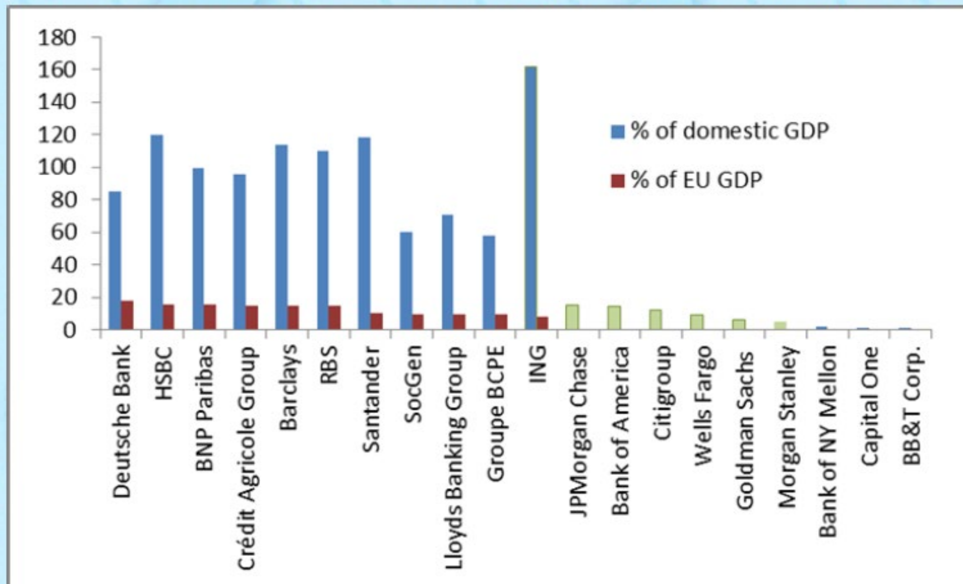
Trust and public acceptance must now be restored, and the proposals which the High-level Expert Group has submitted for the consideration of the EU Commission will contribute to this end. Achieving this important aim will benefit the banking industry and our societies at large.

Crisis impact on the real economy substantial
GDP growth rate (% p.a.)
5
4
3
2
1
0
-1
-2
-3
-4
-5
2000
2002
2004
2006
2008
2010
2012
EU
EA
Source: Eurostat data as presented in High-level Expert Group Final Report


Rapid growth in the EU banking sector
Total assets of MFIs in EU 2001-2011
50,000
45,000
40,000
35,000
30,000
25,000
20,000
Total assets (€ bn)
400%
350%
300%
250%
200%
EU bank assets in % of EL GDP
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Note: Bar charts show total assets, dotted line shows assets as % of GDP
Source: ECB data as presented in High-level Expert Group Final Report

EU bank assets are sizable compared to home country GDP

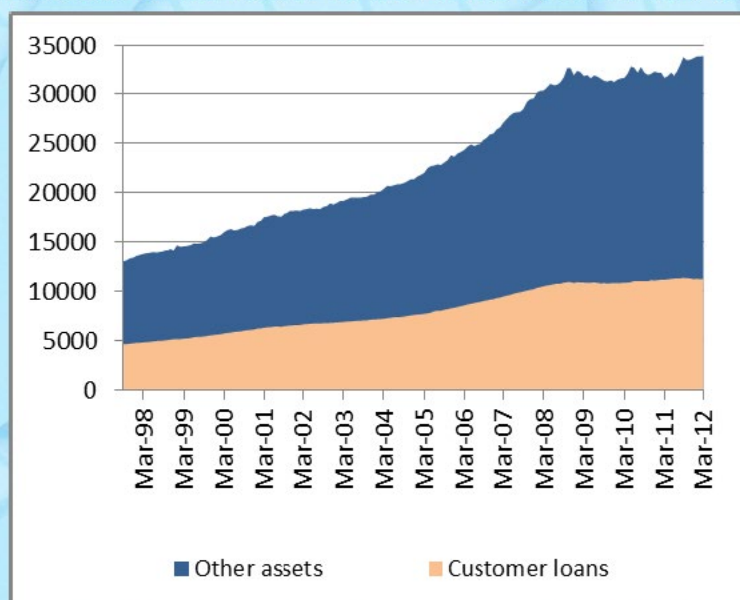
Total assets of EU and US banking groups (2011, in % of GDP)



Source: Data from SNL Financial. Eurostat for GDP data as presented in High-level Expert Group Final Report

Shifts in focus of operations as illustrated by shifts in assets structures

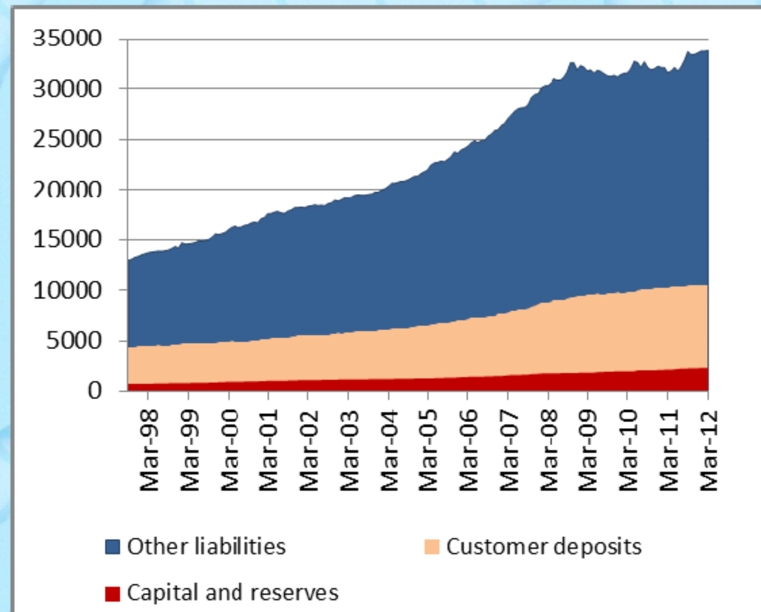
Evolution of assets of MFIs in EU the euro area 1998-2012 (€ billion)



Notes: Customer loans are loans to non-monetary financial institutions excluding general government
Source: ECB data as presented in High-level Expert Group Final Report

Increased leverage as illustrated by shifts in funding structures

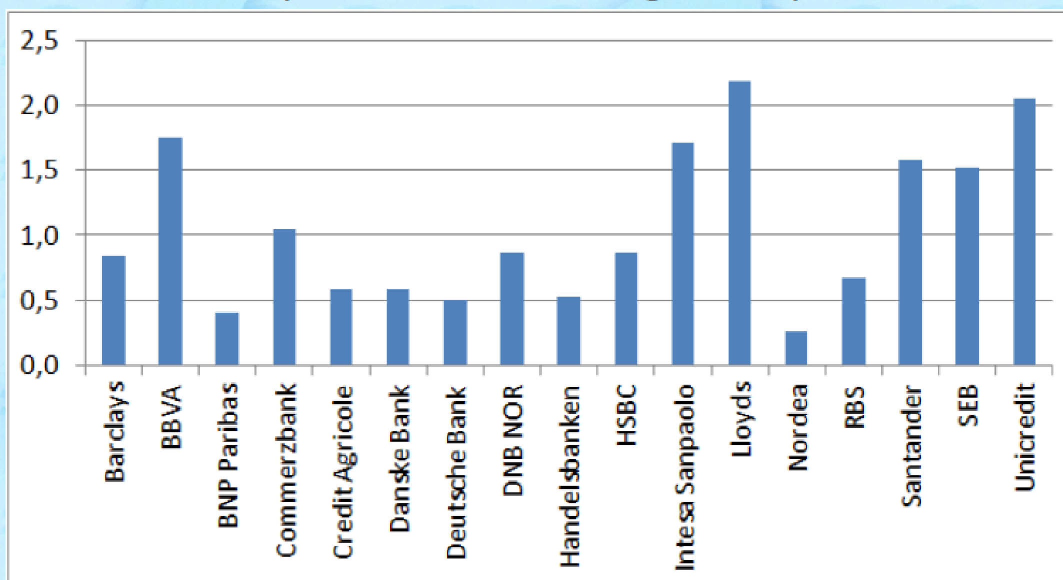
Evolution of liabilities of MFIs in the euro area 1998-2012 (€ billion)



Notes: Customer deposits are deposits of non-monetary financial institutions excluding general government.
Source: ECB data as presented in High-level Expert Group Final Report

Insufficiencies in capital requirements on trading book positions

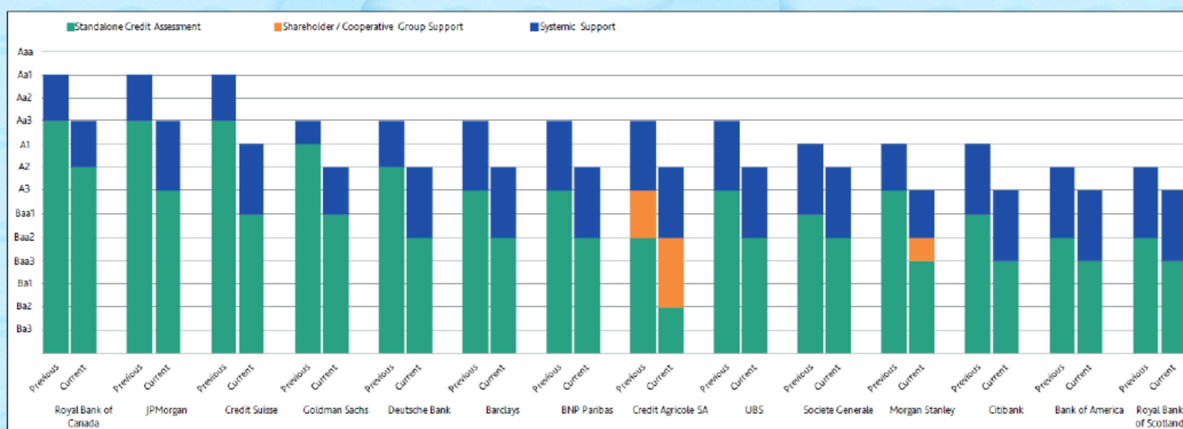
Capital requirements for market risk for large EU banks (2011, as % of trading assets)



Notes: Capital requirements calculated as 8% of RWA for market risk
Source: Data from Bloomberg as presented in High-level Expert Group Final Report

Implicit subsidies remain high

Credit ratings and systemic support uplift for a sample of EU and US banks (previous and current after downgrade in 6/2012)



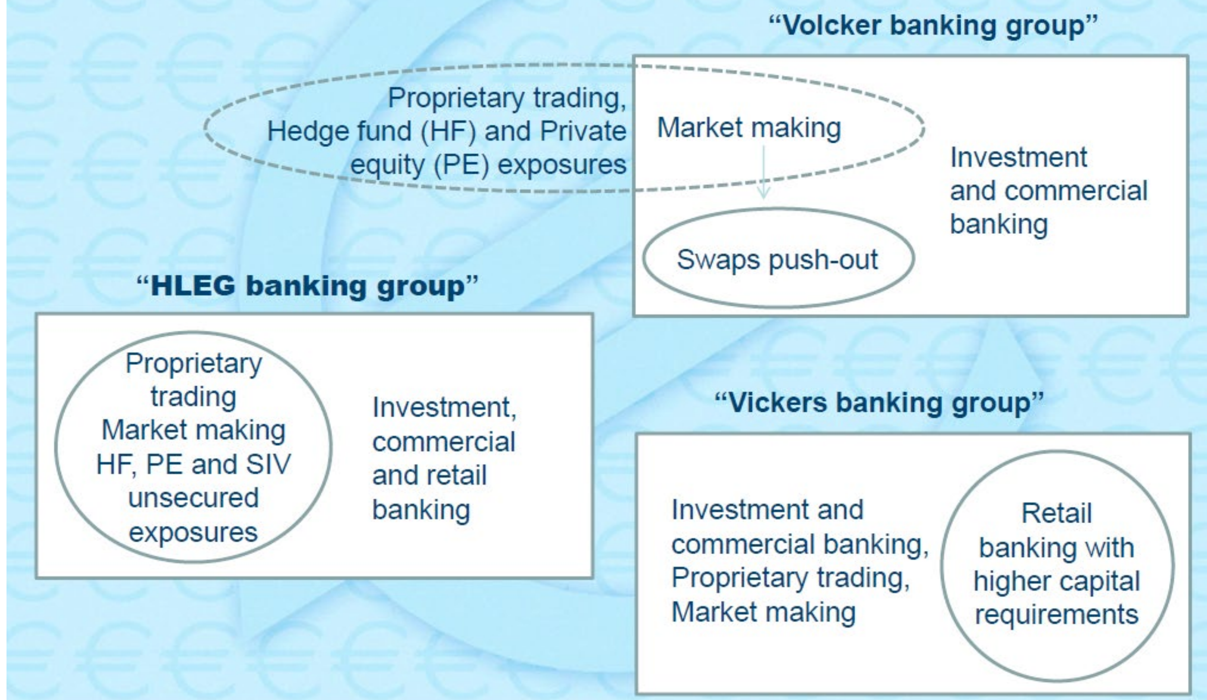
Source: Moody's (2012) as presented in High-level Expert Group Final Report

Focus of regulatory reform

- *Regulatory reforms have been focused on two crucial areas*
  - Capital adequacy and liquidity requirements as set by Basel III and implemented in EU by means of regulation and a directive
  - The Commission's recovery and resolution framework
- *The regulatory reform will, at least to some extent*
  - improve the resilience of banks,
  - reduce incentives for excessive risk taking and leverage,
  - reduce complexity and interconnectedness and
  - reduce the social costs of bank failure and the need for implicit government guarantees

The High-level Expert Group's proposal for mandatory separation

- *Activities separated to the "trading entity":*
  - Proprietary trading and market-making
  - Loans, loan commitments and unsecured credit exposure to hedge funds, SIVs, and private equity investments
- *Activities that are permitted to "deposit banks":*
  - Hedged, client-driven transactions that fall within narrow risk position limits
  - Securities underwriting
- *Activities which are prohibited to the "trading entity":*
  - Insured deposits and supply of retail payment services
- *Restrictions on transfers between the separated entities*
- *The entities can be operated within a banking group*



Rationale for the High-level Expert Group's proposal on mandatory separation

- *Prohibit banks with insured deposits from engaging in trading activities whose risks are potentially high and difficult to measure precisely*
- *Reduce complexity and interconnectedness, especially between banks and shadow banking system*
- *Make recovery and resolution easier*
- *Make banking groups simpler and more transparent, which facilitates market discipline, supervision, and improves risk sensitivity of funding costs*
- *Reduce mixing of management cultures*

The five proposals of the High-level Expert Group

1. *Mandatory separation to deposit bank and trading entity*
2. *Additional separation requirement*
   - If the recovery and resolution plan otherwise not credible
3. *Bail-in instruments*
   - Pre-defined scope and terms to facilitate pricing and liquidity
4. *A review of capital requirements on trading assets and real estate related loans*
5. *Strengthening the governance and control of banks*
   - Including the use of bail-in instruments in compensation

On the role of banking

- *Banks play an important role in the society*
  - Provide payment services to ease trade
  - Mobilise and pool savings and allocate these to prosperous investments
  - Engage in maturity mismatching
  - Manage risk on behalf of less sophisticated stakeholders
- *Banks have a pivotal role in providing finance to the real sector particularly in Europe*
- *Strengthening the banks' ability to provide socially vital financial services efficiently and in a stable manner benefits our societies at large*