Erkki Liikanen: The future of central banking – proposed bank structures

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the High-level Expert Group on the structure of the EU banking sector, at a conference on "The future of central banking", Copenhagen, 30 January 2013.

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Introduction

In the process of reaching the final proposal, our group considered ***two avenues*** as a possible way forward.

In the first avenue, the main instruments were additional, non-risk-weighted capital requirements on trading activities and banks' credible recovery and resolution plans, subject to supervisory approval.

Such measures would be in line with the ideas of academic researchers who have suggested that a review of capital requirements is the best way to tackle risks in trading, and who have emphasized the need to develop bank resolution and recovery mechanisms.

The possibility of conditional structural measures entered this avenue in the following way: if the bank were not able to prove that its required recovery and resolution plan was credible, separation of certain activities could be imposed.

In the second avenue, immediate separation of retail and certain trading-related activities would be imposed. Separation would be consistent with research which emphasizes that capital requirements are not sufficient to limit excessive risk-taking incentives induced by deposit insurance if the risks are difficult to quantify and risk profiles can change rapidly, as in trading.

A sufficiently wide separation of trading activities would also avoid definitional problems that arise, for example, when pursuing the dividing line between proprietary trading and market making.

Eventually, our group converged to propose mandatory separation, an outcome based on Avenue 2.

The rationale for mandatory separation

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

Firstly, as I have already suggested, separation is a way of preventing banks with insured deposits from engaging in activities whose risks are potentially high and difficult to quantify precisely, and which are not essential to deposit banking. Moreover, as the separated trading entity is not allowed to finance itself with insured deposits, the price of its funding will better reflect its true risks and hence curb incentives to excessive risk-taking.

Secondly, separation of activities is the most direct instrument for tackling banks' complexity and interconnectedness. As banks will become simpler in structure, recovery and resolution will also be easier. Moreover, as intra-group financing and subsidies between the deposit bank and the trading entity will be strictly limited, there will be fewer channels of contagion. Limits on trading activities will also reduce the counterparty risks of deposit banks.

Thirdly, 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.

Fourthly, separating deposit banking and trading entities can also reduce the mixing of the two different management cultures. Returning to a culture where the relationship to the customer is highly valued and the focus is on the long-term viability of the business is of great importance.

Compatibility with other regulatory initiatives

It is important to understand that our proposals to the Commission are meant as complementary to already on-going reforms. Let me give two examples.

On one hand, the mandatory separation of proprietary trading and market making from deposit banking, which we proposed, complement capital requirements: both can serve to restrict deposit banks' risk-taking.

On the other hand, mandatory separation can support the Commission's proposal for the Bank Recovery and Resolution Directive by making it easier to apply in practice.

More generally, the three elements – capital requirements, recovery and resolution, and structural measures – were central to the thought process of our group.

Comparison of mandatory separation and other suggestions

By avoiding the decoupling of proprietary trading and market making, the proposal differs from the Volcker Rule in the United States. 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), we can say that the proposals started from different directions but their results are qualitatively similar. The approach taken by the ICB started from a narrow banking philosophy, while the High-level Expert Group focused on the most volatile parts of banking business.

The main 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.

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 focused on strengthening the capitalisation of the trading entity.

Conditional separation

The general idea of conditional separation from Avenue 1 was actually adopted into our second proposal, which says that a credible recovery and resolution plan for a bank may require, based on supervisory judgment, a more extensive separation of trading activities than laid out in our first proposal on mandatory separation.

Bail-in

If a sufficiently simple and separate organizational structure is one precondition of successful recovery and resolution, the other is a sufficient amount of liabilities that can be bailed in.

Our third proposal aims to complement the Commission's plans on this front. We proposed that a layer of designated bail-in debt instruments could be considered. This would further increase and add transparency to the loss-absorbing capacity of banks.

Secondly, clear contractual terms of what would trigger the bail-in would facilitate the creation of a market for such instruments.

Thirdly, we recommended that these instruments be held by investors outside the banking sector in order to reduce contagion and hence systemic risks in a crisis situation. It is important to note that this would also strengthen investors' belief that recovery and resolution would indeed be implemented in a crisis.

It is also important to note that solving the too-big-to-fail problem by a credible recovery and resolution system, including bail-in and facilitated by the structural measures, will level the playing field between smaller and larger financial institutions.

Review of capital requirements

Our analysis of capital requirements, central to Avenue 1 of our thought process, found its way into the fourth of our proposals.

The measurement of risks inherent in trading assets is prone to a significant "model risk"; the risk that the model used in risk measurement is itself inaccurate.

The severity of model risk stems largely from the presence of "tail risks" in trading assets. These are risks that cause catastrophic losses but that materialize with a very low probability. Moreover, tail risks are intertwined with the severe liquidity shortages that occur in systemic crises. Hence, almost by definition, tail risks are difficult to model and measure.

The mandatory separation of the riskiest trading activities from deposit banking is a key step for limiting the impact of these risks.

Robust capital requirements which do not heavily rely on models are another. Furthermore, limits on risk concentrations and counterparty exposures can also be strengthened.

Our group acknowledged the important work of the Basel Committee on Banking Supervision in reviewing the trading book capital requirements.

We recommended that the Commission carry out an evaluation of whether the resultant amendments would be sufficient at EU level.

Further, the Commission should also evaluate the sufficiency of the current capital requirements on real-estate-related lending, which has been the major source of losses in many financial crises, including the most recent one.

Corporate governance of banks

Finally, we also wanted to promote the strengthening of corporate governance and control of banks. Actions in the following areas were suggested: 1) strengthening boards and management; 2) promoting the risk management function; 3) reining in compensation for bank management and staff, and shifting performance-based incentives more for the long term; 4) improving risk disclosure and 5) strengthening sanctioning powers.

Conclusions

Banks are the backbone of the financial system, and their health is vital to regaining solid growth in the EU-wide economy.

The structural proposals our group made rest on the idea of maintaining the possibility to supply all financial services within a single banking group. The aim is to leave it up to bank boards and management teams to decide what the best business model is in the future.

Against this backdrop, our proposed bank structures should be viewed as strengthening the general conditions which are needed to reduce conflicts of interest and distorted incentives that could lead to inefficient business decisions from the point of view of society, and endanger financial stability.