# Erkki Liikanen: On the structural reform

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 the Securities Industry and Financial Markets Association (SIFMA), New York, 19 April 2013.

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*Clearly detailed accompanying slides can be found at the end of the speech. Original charts are on the Bank of Finland's website*

## Research findings

Before the financial crisis, the consensus view from the finance and growth research was at that time that financial development not only follows economic growth but contributes to it.[1]

However, after the financial crisis, the other side of the financial sector growth has received increasing attention.

Now it is recognised that before the crisis, the financial sector had grown to quite massive proportions in many countries. And at the same time, the sector had become more and more concentrated as the biggest institutions had increased their market share.

[Slide 2: Rapid growth in the EU banking sector]

Let me start with the benign appraisal of the expanding financial sector and the emergence of increasingly large banks that prevailed before the crisis. I will then consider the more malign diagnosis that has emerged after the crisis.

The predominant view in the benign story is that growth of the financial sector improves overall economic growth opportunities by mobilising resources to finance investment projects and by facilitating risk management.[2] The key is that a well developed financial system helps allocate productive resources more efficiently, both by channelling funds to growth sectors and by pulling resources from declining ones.

At the level of individual financial institutions, the growth of bank balance sheets was seen as reflecting increasing returns to scale and scope from combining a wide variety of financial services and providing them cross-border to internationally active clients.

It is also possible that returns to scale in the largest banks stem from leveraging the superior skills of high-performing teams of bankers. This argument offered an explanation to the conspicuous compensation levels observed before the crisis. Because in the banking industry such teams are relatively mobile and hence their bargaining power is strong, much of the returns may accrue to bankers in the form of high compensation, rather than to banks' owners.[3]

Nonetheless, the question was raised later, whether the productivity of the top human resources in banking had been so much higher than in other industries as the increase in bankers' compensation over the years suggested.

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1 Levine (2005), Finance and growth: Theory and evidence, in Handbook of Economic Growth, edited by Aghion & Steven Durlauf.

2 King & Levine (1993), Finance and growth, Schumpeter might be right, Quarterly Journal of Economics 108; King & Levine (1993), Finance, entrepreneurship and growth, Journal of Monetary Economics 32.

3 Anderson and Joeveer (2012), Bankers and bank investors: reconsidering the economies of scale in banking, CEPR Discussion Paper 9146.

The events of the financial crisis have led to also consider the malign diagnosis of the massive size of the financial sector and of the single financial institutions that dominate the banking sector.

Some recent research at the BIS suggests that finance does contribute to economic growth but only up to a point.[4] Too large a financial sector may imply too high risk-taking, which results from over-investment and too much leverage in some sectors of the economy, typically the real estate related sector. This increases the frequency of crises which involve heavy output losses.

Too large and a very well paid financial sector may also deprive other sectors of some of the most productive human resources.

What makes the financial sector grow too big?

Researchers have suggested reasons ranging from banks' failure to internalize systemic risks that stem from growth in leverage and ballooning balance sheets to rent-extraction in opaque OTC markets.[5]

However, the most natural explanation may be the explicit and implicit public guarantees which have led to lower funding costs to the largest institutions which the markets expect to be "too-big-to-fail".

Pursuing such a status in the eyes of the market, and the ensuing cheaper funding, can give a strong incentive to grow. Given the size of the largest banks' balance sheets, even a relatively small advantage in the funding spread means a big hidden flow of subsidy from the taxpayers to those banks.[6]

Recent research at the Bank of England suggests that the increasing returns to scale in banking, beyond a certain size range, may largely result from the cheaper funding costs of the presumed too-big-to-fail banks.[7] An interesting aspect of the research is also that the social cost of too-big-to-fail banks, due to increased systemic risk, appears to be significantly higher than the benefits from the economies of scale.[8]

However, not only the size of the financial sector and that of the banks is important, but also what the sector actually does.

In the run-up to the crisis there was a trend among the biggest banks to strengthen their focus on investment banking, including trading operations.

[Slide 3: Shifts in focus of operations as illustrated by shifts in assets structures]

Part of this trend was driven by the growing demand by corporate customers for risk management services. To a significant extent, however, the growth in investment banking activities was driven by the banks themselves in search for new revenue streams and higher profitability. In many banks the proportion of trading assets in the balance sheet increased substantially as securities and derivatives trading provided a relatively fast and flexible way to grow.[9]

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4 Cecchetti and Kharoubi (2012), Reassessing the impact of finance on growth, BIS Working Paper 381.

5 Stein (2012) and Bolton, Santos, and Scheinkman (2012), respectively.

6 Noss and Sowerbutts (2012), Bank of England FS Papers Series, FS Paper No 15.

7 Davies and Tracey (2012), Too big to be efficient? The impact of implicit funding subsidies on scale economies in banking. Bank of England mimeo.

8 Boyd and Heitz (2012), The social costs and benefits of too-big-to-fail banks: a "bounding" exercise, University of Minnesota working paper, February.

9 Boot and Ratnovski (2012), Banking and trading, IMF Working Paper 12/238.

The relative importance of customer loans fell over time and the importance of interbank lending grew. Moreover the customer loan business transformed as many banks particularly in the US moved away from the "originate and hold until maturity" model to the "originate and distribute" model where granted loans are pooled, then securitized and sold to investors, including European banks. Securitization was motivated by the desire to economize on capital buffers, but it turned out later that the assumed benefits of diversification were vastly outweighed by the increasing propensity to contagion.

Big risks followed, also at the systemic level, as balance sheet growth was often matched with dramatic changes in the liability side of banks' balance sheet. Firstly, banks became increasingly leveraged as the solvency rules allowed this to happen without a proportionate addition of fresh capital. The loss absorption capacity weakened. Second, banks relied increasingly on short-term wholesale funding, typically from the repo market, which made them more vulnerable to market disruptions. Thirdly, the rapid balance sheet growth also required more interbank financing, which resulted in more interconnectedness in the financial network, thus creating contagion channels.[10]

[Slide 4: Increased leverage as illustrated by shifts in funding structures]

Another risk of a more systemic nature is that diversification along similar lines can make financial institutions more similar to one another by exposing them to the same risks.[11]

And indeed, the benefits of diversification appear to have been offset by the greater risk banks were exposed to as the share of activities outside the traditional retail banking operations was increasing.[12]

Some potential benefits of diversification may also have been lost as implementing a diversification strategy is a big managerial challenge.[13] It is particularly challenging in a banking group because of the differences in management cultures and risk profiles of the different entities.

The challenge at hand is to reform the financial sector and banks towards a more healthy structure and size in order to redirect banking activities to support the society and real sector in the best way possible.

The key is to remove any perverse incentives, which could lead to an excessive growth of the financial sector. For example, the inevitable safety nets needed to protect depositors must not lead to moral hazard which would undermine the stability of the financial system and entire economies.

### How the HLEG proposals address the identified challenges in the size, structure and conduct of the business of banks

In the High-level Expert Group on reforming the structure of the EU banking sector, nominated by Commissioner Barnier about a year ago, we detailed the different phases of the crises, analysed the characteristics of the banking sector and identified a number of weaknesses, which we thought the ongoing regulatory reform would resolve only partially.

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[10] Shin (2010), Macroprudential policies beyond Basel III, Princeton University, policy memo.

[11] Wagner (2010), Diversification at financial institutions and systemic crises, Journal of Financial Intermediation 19.

[12] Stiroh and Rumble (2006), The dark side of diversification: the case of US financial holding companies, Journal of Banking & Finance 30; Mercieca et al. (2007), Small European banks: benefits from diversification? Journal of Banking & Finance 31.

[13] Stiroh (2004), New evidence on the determinants of bank risk. Journal of Financial Services Research 30; Acharya et al. (2006), Should banks be diversified? Evidence from individual bank loan portfolios. Journal of Business 79.

[Slide 5: Summary of the problems in the EU banking sector identified by HLEG]

We also identified strengths that needed to be maintained in the prospective structural changes on European banks. For example, we thought it would be very important to accommodate the diversity of business models of banks in the European market place.

In our deliberations we considered two avenues as possible ways forward.

[Slide 6: Two avenues as possible ways forward were considered]

In the first avenue, additional, non-risk-weighted capital requirements on trading activities and credible recovery and resolution plans for banks would have been the main instruments.

We acknowledged that the measurement of risks inherent in trading assets is prone to a significant "model risk". Robust capital requirements which do not rely on complicated models are one way to tackle this issue (as are limits on risk concentrations and counterparty exposures). Avenue 1 was based on this approach.

The possibility of structural measures did enter Avenue 1, but only as a conditional instrument. The idea was that if a bank was not able to prove that the required recovery and resolution plans were credible, separation of trading activities was to be imposed by authorities.

In the second avenue, any significant trading activities would be required to be separated from retail deposit banking. The separation proposal (or subsidiarisation as it has been labelled in the international discussion) outlined in Avenue 2 was based on the notion that capital requirements are not by themselves sufficient to limit excessive risk-taking incentives induced by deposit insurance if risks are difficult to measure and risk profiles can be changed rapidly, as in trading activities.

Further, a sufficiently wide separation of trading activities would avoid definitional problems which arise, for example, if the dividing line had to be drawn between proprietary trading and market making.

After a long discussion, where both avenues were supported, the group decided to propose mandatory separation.

[Slide 7: The High-level Expert Group's proposal for mandatory separation within a banking group]

First, the group wanted to limit the spill-over of the effects of the deposit guarantee system and any implicit government guarantees to the trading activities of banks. The deposit bank and trading entity are to stand on their own merits also in terms of capitalisation and funding, even though they could operate within the same banking group. Without separation, the explicit and implicit guarantees would distort the market mechanism and spur the deposit banks to unhealthy expansion in their trading activities.

[Slide 8: Rationale for mandatory separation]

Second, we saw the need to simplify the structure of large, complex banks. Reducing complexity by means of separation facilitates management. Steering effort to the right direction by means of incentive schemes, for example, is easier in a less complex organisation, where the organisational units are more homogeneous. Separation also facilitates supervision and monitoring by outside stakeholders such as shareholders, bank creditors and other market participants, thus reinforcing market discipline. Finally, separation makes it easier to impose recovery and resolution measures on failing banks.

Third, we further emphasised the need to strengthen the governance of banks by altering the management culture. Separating retail banking and trading activity would reduce the mixing of two very different management cultures. They are intrinsically different in the customer-based deposit and commercial banking field and in the "transaction-based" trading activities. In the former, the relevant horizon is long and the role of trust in the customer relationships is

essential. The latter has a different logic – that of beating the market and collecting transaction fees. Profits often come from counterparts instead of customers.

The choice of where to draw the line between the deposit bank and the trading entity was aimed so as to enable banks to service the real economy in the best way possible. We concluded that allowing the deposit bank to provide non-banking clients with customer-initiated hedging services with basic instruments such as forex and interest rate futures and swaps as well as to undertake securities underwriting would leave sufficient room for deposit banks to service corporate customers and thus fulfil their role in financing the real economy.

Moreover, while seeking to correct the problems which result from the mixing of trading with deposit banking, we wanted to preserve the universal banking model at group level. Hence, we allowed the separated entities to operate under the same roof. This would keep the trading units within the supervisory umbrella of the bank supervisors. It would also be less disruptive of the European banking market than a complete divestment of certain trading activities and would allow "one–stop banking" to continue where it is to the benefit of customers.

Our work was facilitated by the structural proposals which had been previously made in the US and the UK. The general orientation of all three proposals – the American Volcker rule, the British Independent Commission on Banking (Vickers) proposal, which is taken forward in the form of draft legislation, and our proposal is similar. However, they do differ in some respects.

[Slide 9: Comparison of suggested structural reforms]

The Volcker rule is the most narrow, but also most radical in that it targets mainly proprietary trading, but requires of banking groups to wholly divest their proprietary trading activities – they cannot be continued even in separate subsidiaries of banking groups. The Vickers and High-level Expert Group proposals are wider in scope, seeking to regulate more trading activities than the Volcker rule, but are in a sense less radical in the implementation of the separation as they allow separation within the banking group. However, the UK government has proposed to give authorities reserve powers to call for full separation, meaning disallowing even the group structure, in case banks try to circumvent the ring-fence.

By avoiding the challenging segregation of proprietary trading and market making, our proposal differs from the Volcker Rule. Our proposal prevents market making to become a way to circumvent the prohibition of proprietary position-taking in securities market.

When comparing our proposal with the proposal to be implemented in the UK, one can say that the proposals started from different directions. The Vickers proposal started from the narrow banking philosophy and sought to restrict the use of those funds. We on the other hand focused on the most volatile parts of banking business and sought to cordon off those so as to protect the traditional universal banking model, as we used to know it, from engaging in excessive risk-taking. The end results as to where the line is drawn between the entities to be separated are, however, not totally different.

The main difference in where the line between the separated entities is to be drawn is that we would allow the deposit bank to engage in securities underwriting whereas this activity would be separated in the UK. As I already mentioned, our solution is based on the view that underwriting is closely connected with corporate finance.

Earlier this year also the French and German governments published proposals for structural reform in the banking sector. These national level initiatives can be seen as adoptions of our proposal as they apply the same "subsidiarisation" model. The activities to be separated are somewhat narrower as proprietary trading ought to be separated to the trading entity, but not market making. However, there would be supervisory powers to limit the open positions taken in the course of market making. Hence, the French and German proposals can be seen as an intermediate position between our proposal and separating only proprietary trading in the narrow sense.

Continuing with a few words on the rest of our proposals.

[Slide 10: The five proposals of the High-level Expert Group]

Our analysis of capital requirements also found its way to our final recommendation. Here we acknowledged the important work done by the Basel Committee on Banking Supervision in reviewing the trading book capital requirements. Moreover, we highlighted the importance of the evaluation of the capital requirements on real estate related lending, an issue which is currently on the agenda of for example the European Banking Authority (EBA).

Bail-in lies at the core of tackling the "too-big-to-fail" problem as it improves the loss absorbency of banks, ensures that investors rather than taxpayers take on the responsibility for losses in the face of resolution, and further enhances creditors' incentives to monitor banks. In the High-level Expert Group we foresaw a two tier system for the bailing in of investors in bank debt.

The bail-in process which is outlined by the Commission in the proposed Bank Recovery and Resolution Directive plays a key role in ensuring orderly restructuring or winding-up of banks without the prolonged bankruptcy proceedings. We proposed that there would be an additional layer of designated bail-in instruments to further improve the loss-absorption capacity of banks. We believed that this would best combine loss absorbency and market discipline with legal certainty and the stability of markets. The designated bail-in instruments would have clear pre-specified terms and holding restrictions, which would prevent other banks from holding these debt instruments.

In addition, we proposed that the governance and control of banks ought to be strengthened further. Particular attention ought to be given to the ability of management and boards to run large and complex banks, the powers of the risk management function and the quality, comparability and transparency of risk disclosure, the possibility to use designated bail-in instruments in remuneration schemes, and the appropriateness of imposing caps on variable as well as overall compensation.

## How the HLEG proposals address the challenges of the financial sector discussed in the beginning

Subsidiarisation of trading facilitates resolution, thus making bail-in rather than bail-out a credible option. The recommendation that banks should have a layer of designated bail-in instruments further supports the aim of making bank bail-out at taxpayers' risk only a rare exception. Only functions that are essential to the functioning of the society, i.e. the deposit taking and payment system, would benefit from a government guarantee. As a result, the separated trading activities will be funded from the market at a price better reflecting the true riskiness of the operations. This is expected to restrain incentives for excessive growth and risk taking in the trading entity.

The recommendations will not only have an impact on the size of the financial sector, but also on what kind of operations there will be. For example, separation restricts banks with insured deposits from engaging in high-risk trading activities which are not essential to deposit banking. The efforts of the deposit bank are thus expected to be redirected towards servicing the needs of households and SMEs.

And, finally, the recommendations will have an impact on how banking business is conducted in the future. The primary aim is to shift the focus from short to long term, which is more in line with the interests of the real economy and society.

Efficient market discipline as well as active and timely supervision will ensure that the financial sector and banks find their way to a more healthy size and structure. Our recommendations will also facilitate their task. Simpler structures will make it easier for both investors and supervisors to monitor banks. Moreover, the recommendation to improve the quality, comparability and transparency of risk reporting will further facilitate monitoring of

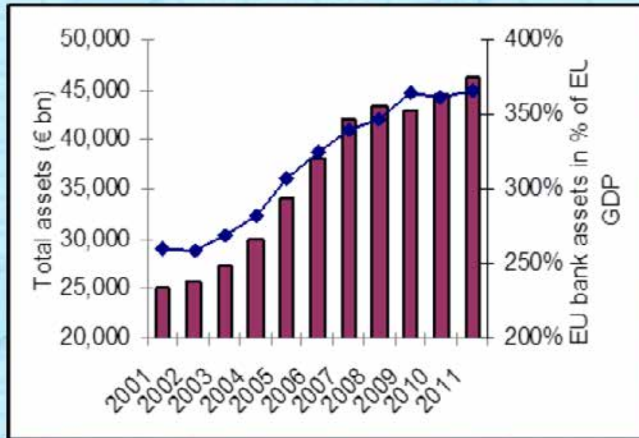
banks. Our recommendations not only facilitate monitoring, but the additional layer of designated bail-in instruments will increase also creditors' incentives to monitor banks and thereby improves market discipline.

## Concluding remarks

As major regulatory reforms are planned after the crisis, it is important to take in account what research has to say. Before the crisis the consensus view held, with some qualifications, that growth in finance promotes economic growth. After the crisis, the possibility that the financial sector can also grow too big has been taken more seriously. Accelerated growth of the financial sector may indicate a looming crisis. Therefore restrictions may be needed, and we need to make sure that distorted incentives within the financial sector are minimized. Improving the quality of finance continues to be a key priority in promoting economic growth. Structural reforms of banking can support these aims by helping to weed out distorted incentives from finance.

## Rapid growth in the EU banking sector

**Total assets of MFIs in EU 2001-2011**

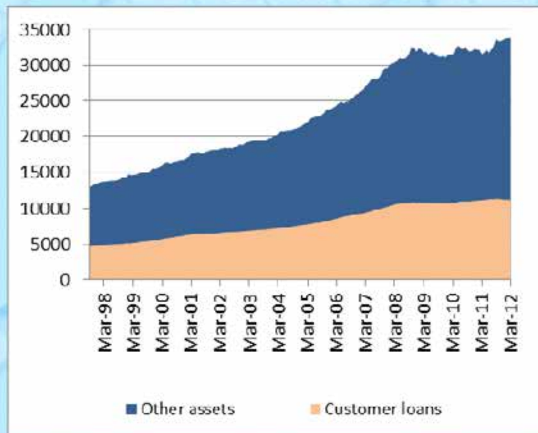



Note: Bar charts show total assets, dotted line shows assets as % of GDP
Source. ECB data as presented in High-level Expert Group Final Report



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

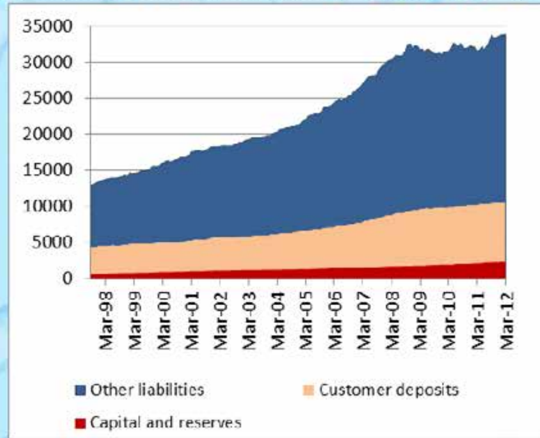
**Evolution of assets of MFIs in EU the euro area 1998-2012 (€ billion)**




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

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## Summary of the problems in the EU banking sector identified by HLEG

| Identified problem by HLEG | Result |
|---|---|
| • Excessive risk-taking in trading, lending, funding<br>• Complexity (making bank management, monitoring, supervision and resolution challenging)<br>• Limited loss absorbency<br>• Intra-group subsidies<br>• Ineffective governance and control | → Increased probability of failure |
| • Interconnectedness<br>• Limited resolvability<br>• Bank-sovereign feedback loop | → Increased impact of failure |
| • Inadequate EU institutional framework<br>• Excessive focus on intra-financial business, as opposed to real economy<br>• Competitive distortions and implicit subsidies<br>• Inadequate consumer protection | → Reduced internal market efficiency and level playing field |

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## Two avenues as a possible way forward were considered

- **Avenue 1**
  - A non-risk weighted capital requirement is imposed on trading activities.
  - Conditional separation of activities is imposed, if the bank cannot prove that the required recovery and resolution plan is credible.
- **Avenue 2**
  - Mandatory separation of retail banking and investment banking is imposed on banks.
- Cf. Darrell Duffie
- Cf. Alan Blinder

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## 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 which are permitted to "deposit banks":***
  - Hedged, client-driven transactions that fall within narrow risk position limits
  - Securities underwriting
- ***Activities permitted only to "deposit banks"***
  - Insured deposits and supply of retail payment services
- ***Restrictions on transfers and exposures between the separated entities***
- ***The entities can be operated within a banking group***

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## Rationale for mandatory separation

- ***Limit the spill-over of the effects of the deposit guarantee system and any implicit government guarantees, to the trading activities of banks***
  - Makes the pricing of funding of the separated entities more efficient and risk-based
- ***Reduce complexity and interconnectedness***
  - Enhances bank management
  - Facilitates supervision and monitoring thus reinforcing market discipline
  - Facilitates recovery and resolution and thus helps make it credible
- ***Reduce mixing of management cultures***

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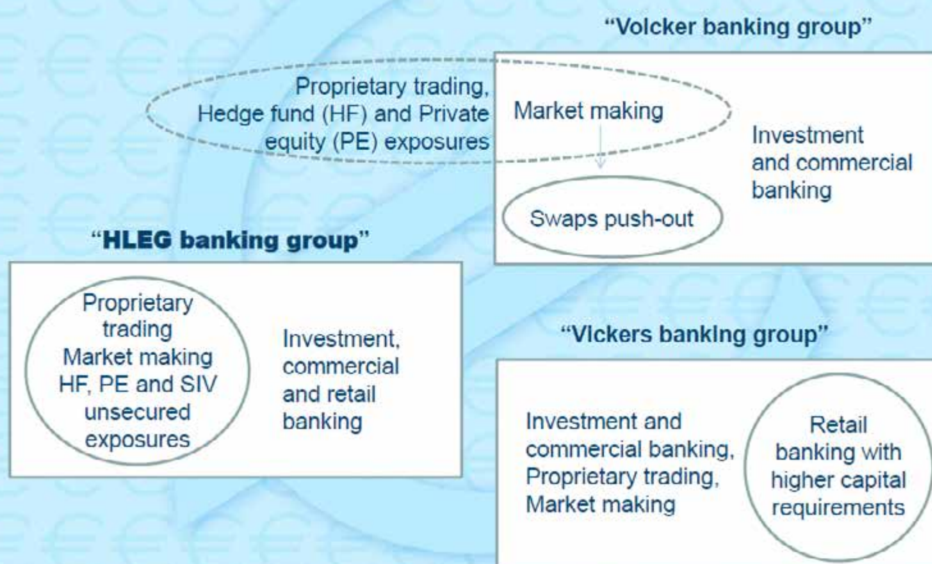


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## The five proposals of the High-level Expert Group

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

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