Erkki Liikanen: The case for structural reforms of banking after the crisis

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 European Commission, Brussels, 2 October 2012.

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Changes in banking in the run-up to the crisis

In the years preceding the financial crisis that started in 2007, global financial institutions had grown ever bigger in size and scope and their organisational complexity had increased. Their leverage had strongly risen and their average debt maturity had shortened.

Behind these trends were forces that intensified competition in banking, driven by technological development. An entire shadow banking sector had developed, comprising a chain of non-bank institutions which were able to provide similar financial intermediary services as traditional banks.

In this environment, regulatory reforms were partly a response to the changes and allowed banks to cope with the increasing pressure from non-bank competitors. Banks sought for economies of scale and scope and strived to take advantage of diversification benefits from multiple sources of income.

Commercial banking had increasingly moved 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. This shift in the business model increased traditional banks’ connections to the shadow banking sector.

The expansion of banks’ balance sheets partly reflected the growing global imbalances, supported by the accommodative monetary policy stance in the early 2000s.

Regulation, supervision and market discipline failed to counter the developments in the financial sector. The Basel capital requirements on banks proved ineffective in restraining the strong growth in banks’ leverage and balance sheet size. For example, the Basel rules effectively allowed banks to lower their capital requirements by means of securitizing loans.

This is an important reason for how and why banks became strongly connected with the shadow banking sector. The increasing complexity of structures and products, as well as the financial sector’s increasing interconnectedness and 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, but the opposite seems to have happened: the markets rewarded bank size by charging lower debt margins from the biggest institutions. This suggests that there was a perception among market participants that the biggest financial institutions enjoyed an implicit public guarantee; in other words, they had become too big or too important to fail.

Public reaction to the crisis and the need to rebuild trust

The huge cost of the financial crisis, both in terms of direct public support to banks and lost economic output has sadly fallen to tax payers, causing an understandable and justified public outcry.

Trust needs to be rebuilt between banks and the general public, and the role of internationally co-ordinated regulatory reforms is central in this process. Also in banking not only gains but also losses must fall on the risk-takers.

Regulatory response to the crisis

The problems in banking, as revealed by the crisis, can be summarized as excessive risk-taking, leverage, complexity, inadequate capital, extensive interconnectedness, and very limited possibilities to resolve failed banks.

In response to these problems, regulatory reforms have been focused on two crucial areas: capital adequacy and liquidity requirements, as in Basel III, and recovery and resolution, as in the Commission's proposal.

These reforms can go a long way toward increasing loss absorbency, reducing incentives to take excessive risks and increase leverage, and reducing the social costs of bank failures and the need for implicit public guarantees.

The High-level Expert Group was requested to consider whether there is a need for structural reforms of the EU banking sector or not and to make any relevant proposals as appropriate, with the objective of establishing a stable and efficient banking system serving the needs of citizens, the economy and the internal market.

The proposals of the High-level Expert Group

The Group recommends a set of five measures that augment and complement the set of regulatory reforms already enacted or proposed by the EU, the Basel Committee and national governments.

1. Proprietary trading and other high risk trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank's business and are above a certain threshold. This would ensure that trading activities beyond the threshold are carried out on a stand-alone basis and separately from the deposit bank. As a consequence, deposits, and the explicit and implicit guarantee they carry, would no longer directly support risky trading activities. The long-standing universal banking model in Europe would, however, remain untouched, since the separated activities can be carried out in the same banking group. Hence, banks' ability to provide a wide range of financial services to their customers would be maintained.

Within the Group, some members expressed a preference for a combination of measures: imposing a non-risk-weighted capital buffer for trading activities and leaving the separation of activities conditional on supervisory approval of a recovery and resolution plan, rather than a mandatory separation of banking activities. Both basic alternatives and their motivation are presented in the report.

2. Second, effective and realistic recovery and resolution plans must be drawn up and maintained by the banks, as proposed in the Commission's Bank Recovery and Resolution Directive. The resolution authority should request a wider separation than the considered mandatory separation above if this is deemed necessary to ensure resolvability and operational continuity of critical functions.

3. The use of designated bail-in instruments is strongly supported by the Group. The position of bail-in instruments within the hierarchy of debt commitments in a bank's balance sheet must be clear so that investors know the eventual treatment in case of resolution. Banks should build up a sufficiently large layer of "bail-inable" debt. Such debt (or an equivalent amount of equity) would increase the overall loss-absorptive capacity, decrease risk-taking incentives, and improve transparency and the pricing of risk.

4. The Group proposes to apply more robust risk weights in the determination of minimum capital standards and more consistent treatment of risk in internal models. Once the Basel Committee has concluded its review of the trading book, the Commission should assess whether the results would be sufficient to cover the risks of both deposit banks and trading entities in Europe. Also, the treatment of real estate lending within the capital requirements framework should be reconsidered, as well as maximum loan-to-value (and/or loan-to-

income) ratios included in the instruments available for micro- and macro-prudential supervision.

5. Finally, the Group considers that it is necessary to augment existing corporate governance reforms by specific measures to 1) strengthen boards and management; 2) promote the risk management function; 3) rein in compensation for bank management and staff; 4) improve risk disclosure, and 5) strengthen sanctioning powers.