Pentti Hakkarainen: Debate on "Re-evaluating the universal banking model: Can the Volcker, Vickers or Liikanen rules make banks safer?"

Remarks by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the 4th Future of Banking Summit, organised by Economist Conferences, Paris, 26 February 2013.

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Thoughts on the reasons why the universal bank model exists, i.e. why it is valuable

"There are benefits from combining different business lines under one roof"

There are a number of reasons why banks combine several business lines under one roof:

- strive for optimal use of capital
- diversification of risk as distribution of profits and losses of different business lines are less than fully correlated
- synergies from combination of different expertises
- servicing the multiple needs of clients, especially in the case of corporate clients (one-stop-shopping)

There is now one way of structuring a universal bank. E.g. some universal banks have numerous business lines under one legal unit, whereas other universal banks operate as a holding group of separate companies. The business lines or legal units can be defined based on e.g. business areas or functions and/or geographical reach.

The way banks aim to be structured is crystallised in the strategy, but e.g. M&A history and ability to achieve organic growth has had a great impact on how universal banks are structured today.

"However, some banks already see the value of applying a universal bank model where various business activities are clearly structured and business lines are legally separated"

Even without regulation requiring so, many banks already manage different business lines separately, which closely resembles a structure with different legal units.

- Banks find management, risk management and HR/recruiting easier if the business is separated along logical units, i.e. functions/activities which fall naturally together.
- From a risk management perspective, portfolios are already managed separately.
- In some cases an important driver for legal separation of businesses is "Disaster management", i.e. keeping particularly risky or vulnerable business in a separate legal unit thus making it easier to divest/withdraw without exposing the rest of the operations for contagion by cutting linkages rapidly.

There are also benefits of being organised along separated business lines.

- The pricing of internal funding of business units can be arranged at arm's length with risk-adjusted transfer pricing.
- Allocation of economic capital can be done by business line and even at the level of individual customers, which support decision making and carrying out the business in an optimal way.

"Making the structure of universal banks clearer would simplify the governance of banks and improve risk management."

I have some insights from practice on what the consequences of legal separation of business lines could be.

In my view legal separation would benefit in particular the governance and risk management of banks.

– As the HLEG report states, I have also experienced that the cultures of traditional retail banking and investment banking/trading activities are very different and blended cultures can cause problems.

– The nature of the business and the attitude towards risk-taking are different. In investment banking and trading activities profits are generated by actively seeking risk-taking opportunities by opening risky positions. Whether these risk exposures had good risk-adjusted return prospects, has often been of secondary importance. Models and warning signs flagged by risk management were often disregarded; high risks were taken even if the probability of success was low and the potential downside was significant. In traditional retail banking, profits are mainly earned from interest rate margin income from long term customer relationships in a more stable manner. Credit quality assessment and pricing policy lie at the core of the business.

– Also the time horizon differs markedly. In the trading activity the results settled and assessed every single day. In retail banking profits are generated over several years time period.

– The responsibility and independence of the management is enhanced if business lines are separated to legal entities.

– Separation also facilitates management, risk management and HR/recruiting, as the objective and needs are clearer in a separately defined business unit. Aligning incentives to the strategy of the business line by means of targets included in remuneration schemes will also be easier.

– If the operations to be separated are logical units then it is most probable that required reporting systems to support governance are already in place.

Separation will also facilitate monitoring by external stakeholders thus improving market discipline, which can be seen as an extension to the internal corporate governance mechanisms.

– Specifically, separation may improve transparency and reduce uncertainty about the quality of banks as an investment opportunity thus facilitating pricing of the separated parts. This, on the other hand, would improve the access to market funding among above average quality banks

Moreover making the structure of universal banks clearer through separation of businesses also facilitates the task of supervisors and authorities responsible for resolution.

– Separation will certainly facilitate the application of recovery and resolution measures hence reducing the likelihood of public bail-outs, which would in turn have dramatic implications for e.g. funding costs.

Differences between the proposals of Independent Commission on Banking and High-level Expert Group

"The difference in the location of the ring-fence is important, ..."

John Vickers has made very insightful comments on the compatibility of the proposal of his group, the Independent Commission of Banking with the proposal of the High-level Expert Group.

I have a few comments on this theme:

– ICB and HLEG proposals started from different directions; the approach taken by ICB started from the narrow banking philosophy, whereas HLEG focused on the most volatile parts of banking business. However, the groups ended up with qualitatively similar proposals.

– As John Vickers has stated already, the main question as regards the position of the ring-fence is "Where should securities underwriting be; in the investment bank (such as in ICB) or in the deposit bank (as in HLEG)?" Another difference is that ICB's proposal includes geographical restrictions as non-EEA customers cannot be served by the deposit bank. This highlights the focus on the viability of the UK banking sector in the ICB.

– HLEG is based on the view that underwriting is closely connected with corporate banking and thus naturally belongs to the deposit bank. From the corporate client's perspective, issuing a bond is an alternative way of financing to taking a bank loan. From the bank's perspective, there are similar elements in both, because both involve a customer credit quality assessment, although in underwriting the bank's own position taking is normally quite limited.

– It is true that a promise of market making can be an important complement to a successful underwriting of a bond. However, separate entities within the bank group can well provide the underwriting and market making services without any additional cost to the customer.

HLEG did emphasise the importance that authorities require additional separation if that is needed to make the recovery and resolution plans credible, a measure that would bring the HLEG separation proposal closer to the ICB ring-fencing proposal.

The proposals are also somewhat different with respect to the height of the ring-fence. The ICB included restrictions on cross-ownership, for example. As suggested by the Parliamentary Commission of Banking, tasked with the pre-legislative review of the bill, the ring-fence will now be "electrified" by giving authorities reserve powers to require full separation.

"... but the difference in capital requirements imposed on retail banking may have greater implications for banks."

However, in my view the fundamental difference between the two proposals is the difference in capital requirements.

– ICB imposes an extra capital requirement on the ring-fenced retail bank (~deposit bank).

– The HLEG was more concerned of strengthening the capitalisation of the trading entity and therefore suggested a review of capital requirements on trading book requirements. It also suggested a review on capital requirements on real estate related lending. HLEG did, however, not make any explicit requirement on imposing higher capital requirements.

– I do recognise that the requirement to issue designated bail-in instruments can be interpreted as higher capital requirements. These would, however, apply across business lines not only to the deposit bank.

Some banks might be able to implement separation without significant costs as many banks already have the needed governance system in place, whereas suggested changes to the funding structure (tougher capital requirements) could entail additional costs.

I tend to agree with the critiques that it can be challenging for the ring-fenced banks to remain viable as the relatively narrowly defined operations might not be sufficient to generate the profits needed to build up the required level of capital. On the other hand, the HLEG proposal would not separate more activities than mandated, and this might be the voluntary outcome in some banks.

It would also be very important to ensure that capital requirements are aligned globally to ensure the level playing field of banks. Now ICB proposal will set the UK banks and foreign subsidiaries in a disadvantaged position in comparison to foreign banks' non-subsidiary operations in the UK and with non-UK banks which can provide UK customers with financing elsewhere.

Finally, I would like to highlight the importance of sufficient loss absorption capacity across business areas. As highlighted in recent work by Anat Admati and Martin Hellwig, imposing higher capital requirements has a positive impact on bank incentives and behaviour. Among other things, well-capitalised banks maintain their lending also during downturns.

Proprietary trading and market making – is the question whether they are separable or whether they should be separated?

The first argument for the approach taken by HLEG is based on the desired scope of the safety net.

– It is important to note that in the proposed separation, the question is not whether certain type of market making supports the real economy or not; as a starting point, all banking activities support the real economy. Instead, the question is whether there is a market failure of some degree in certain banking activities so that those activities need to be publicly supported by giving them access to insured deposits as a funding base. I.e., is it so that market making cannot be carried out in a profitable manner without cheap funding from deposit taking? If that is the case, then it means that market making is cross-subsidized.

– To draw on a recent comment by Darrell Duffie "the more limited the types of risks that are legally permitted by those within the safety net, the less opportunity for moral hazard" I would like to highlight the importance of ensuring that as small a fraction of banking activity as possible, preferably only the activities essential to the functioning of the society, i.e. the deposit taking, payment system, and perhaps lending to households and SMEs, ought to benefit from a government safety net.

– When deciding what activities are allowed to be funded with insured deposits, there may of course be a question of level playing field between different jurisdictions. But that should be addressed via sufficient harmonisation of the structural measures taken, not by being too lax about extending the use of deposits.

– In short, there appears to be no clear case that market making, excluding few exceptions, ought to benefit from explicit or implicit government guarantees. So, market making should not have access to insured deposits.

The second argument underlying the HLEG proposal relates to whether it is possible to make the distinction between proprietary trading and market making.

- From a regulatory and supervisory perspective it is very challenging to draw a clear line between proprietary trading and market making. E.g. in the US the implementation of the Volcker rule has been delayed as a result and when implemented the supervisors will have to rely on tedious transaction-by-transaction supervision.
- In its pure form, market making is not about taking open positions and the price spreads given re very narrow. Only when things do not go as planned inventory is building up and this is when we get closer to the territory of proprietary trading.
- At the level of the trading floor, it is relatively easy to distinguish the proprietary trading and market making.
- However, things can also be hidden if so desired, hence making the supervision potentially very difficult.