Erkki Liikanen: Banking after the regulatory reforms – business as usual?

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the Highlevel Expert Group on the structure of the EU banking sector, at the Bank of Finland SUERF Conference, Helsinki, 13 June 2013.

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Slides (PPT)

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On the size and structure of the banking sector

[Page 1: On the size and structure of the banking sector]

Research findings

Before the financial crisis, the consensus view from the finance and growth research was 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.

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

Let me start with the benign view of the financial sector expansion, and the emergence of increasingly large banks, that prevailed before the crisis.

The main point 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 assumption 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 also cross-border to internationally active clients.

However, the events of the financial crisis have led us 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 indeed contribute to economic growth but only up to a point.[3] A too large 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

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

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

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

heavy output losses. Moreover, returns to scale may have accrued to bankers in the form of high compensation rather than to the stakeholders with “skin in the game”, i.e. a bank’s owners.[4] A too large and a very well paid financial sector may also have deprived other sectors of some of the most productive human resources.[5]

What makes the financial sector grow too big?

Researchers have suggested reasons ranging from banks’ failure to internalize systemic risks that stem from growth of leverage and ballooning balance sheets to rent-extraction in opaque OTC markets.[6]

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.[7]

Recent research suggests that the increasing returns to scale in banking, beyond a certain size range, may largely result from the cheaper funding costs of the presumedly too-big-to-fail banks.[8] 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.[9]

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 move their focus towards investment banking, including trading operations.

[Page 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.[10]

The relative importance of customer loans fell over time and the importance of interbank lending grew. Moreover the customer loan business was 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 were pooled, then securitized, and sold

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

5 Philippon and Reshef (2012), Skilled biased financial development: Education, wages and occupations in the U.S. financial sector, NBER Working Paper Series 13437

6 Stein (2012) and Bolton, Santos, and Scheinkman (2012), respectively

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

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

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

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

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. The increasingly long and opaque chains of claims and the exposures to entities in the shadow banking system made banks and the financial sector as a whole vulnerable to shocks.[11]

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. This was particularly true in the case of capital requirements for market and counterparty risk. Furthermore, the more frequent use of internal models resulted in lower capital requirements. 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 even more contagion channels.[12]

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

Another risk of a systemic nature is that diversification along similar lines can make financial institutions more alike by exposing them to the same risks.[13]

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.[14]

Some potential benefits of diversification may also have been lost as implementing a diversification strategy is a big managerial challenge.[15] 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 size and structure in order to redirect banking activities to support the society and the real sector in the best way possible.

No one knows what the right size of the financial sector is, but what we can do is remove any perverse incentives which could lead to an excessive growth of the sector. For example, the safety nets needed to protect depositors must not lead to the kind of moral hazard which would undermine the stability of the financial system and entire economies.

How the HLEG proposals came about?

In the High-level Expert Group on reforming the structure of the EU banking sector, 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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11 Adrian and Shin (2010), The Changing Nature of Financial Intermediation and the Financial Crisis of 2007–09

12 Shin (2010), Macroprudential policies beyond Basel III, Princeton University, policy memo

13 Wagner (2010), Diversification at financial institutions and systemic crises, Journal of Financial Intermediation 19

14 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

15 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

[Page 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 of 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. In the two avenues we put different emphasis on the most promising measures to end the too-big-to-fail problem; capital requirements, resolution regimes, and structural reform.

[Page 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, by contrast, any significant trading activities would be required to be separated from retail deposit banking. The separation proposal 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. Avenue 2 also acknowledges the risk of heterogeneous application of tailor-made separation based on the credibility of the recovery and resolution plans of individual banks. Thus avenue 2 includes uniform separation ex ante in order to facilitate resolution of large and complex banks without public funds and hence reduce the too-big-to-fail problem.

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

HLEG proposal for mandatory separation

After a long discussion, where both avenues were supported, the group decided to propose mandatory separation (or subsidiarisation as it has been labelled in the international discussion).

[Page 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 benefits from the deposit guarantee system and any implicit government guarantees to certain trading activities of banks. Even though the deposit bank and the trading entity, to which the above mentioned activities are to be separated, could operate within the same banking group, restrictions on transfers and exposures between the separated entities are imposed. Moreover, the deposit bank and the trading entity are to stand on their own merits also in terms of capitalisation and funding. Without separation, the explicit and implicit guarantees would distort the market mechanism and spur the deposit banks to unhealthy risk-taking and expansion in their trading activities.

[Page 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.

Hence, simplification of the structure of large, complex banks by means of separation facilitates the application of the ongoing regulatory initiatives in the area of corporate governance, disclosure procedures and the crucially important bank recovery and resolution framework.

Of particular interest is naturally whether an EU wide structural reform could have implications for the functioning of the banking union currently under construction. First of all, I think it is safe to say that the simplification of the large, complex European banks would facilitate the task of the Single Supervisory Mechanism. Secondly, resolution of banks currently seen as too-big-to-fail, needs to become a credible option, whether or not the responsibility for resolution lies on a national or European authority. Third, we saw the need to shield the deposit taking bank from excessive risk-taking in trading activity and from exposures to entities in the shadow banking system.

Fourth, we 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 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 for them 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 would allow 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 forced 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.

[Page 9: Comparison of suggested structural reforms]

The Volcker rule is the most narrow, but also most radical in that it targets mainly proprietary trading, and 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 in the form of subsidiarisation 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.

The EU High-level group wants to separate not only proprietary trading in the narrow sense, but also market making. So, avoiding the difficult segregation of proprietary trading and market making is one way 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.

The treatment of market making in structural regulation has become a point of some controversy. In addition to the problem of circumvention, the debate concerns a question of principle: is there some market failure in the supply of liquidity through market making, which justifies use of insured deposits to fund the market making inventory? It is not at all obvious that there is.

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.

About half a year ago the French and German governments published national proposals for structural reform in the banking sectors of those countries. These initiatives can be seen as adaptations of our proposal as they apply the same "subsidiarisation" model. The activities to be separated are somewhat narrower as proprietary trading would 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.

During last spring, structural reforms were put on the agenda of the international regulatory community. The issue has been discussed both at the Bank for International Settlements and at the International Monetary Fund.[16] Simultaneously, the European Commission has worked on an impact assessment and recently launched a consultation where two alternative scenarios for structural reform in EU are to be assessed by the banks; one scenario is close to our proposal while the other is somewhat broader both in terms of its scope and the depth of the gorge between the entities to be separated.[17]

[Page 10: Structural reform on the agenda of the international regulatory community]

On the other HLEG proposals

Now let me continue with a few words on the rest of our proposals.

[Page 11: The five proposals of the High-level Expert Group]

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[16] Gambacorta and van Rixtel (2013), Structural bank regulation initiatives: approaches and implications. BIS Working Paper 412. Vinals et al. (2013), Act local but think global: Can the Volcker, Vickers, and Liikanen structural measures create a safer financial system? IMF Staff Discussion Note 13/4.

[17] European Commission (2013) Consultation by the Commission on the structural reform of the banking sector (http://ec.europa.eu/internal_market/consultations/2013/banking-structural-reform); See also European Financial Stability and Integration Report 2012, April 2013, for further detail on the background to the impact assessment done by the Commission.

The proposal for an additional separation requirement supports the goal that supervisors should have effective tools to make sure that banks' recovery and resolution plans can actually work. If supervisors see that banks try to test the separating line, say, between proprietary trading and the permitted parts of market making, hence also endangering the resolution and recovery plans, a more far-reaching separation of trading activities could be imposed on such banks. In the group we highlighted the importance of the European Banking Authority's (EBA) role in ensuring that the recovery and resolution plans and the integral resolvability assessments are applied uniformly across Member States.

Our analysis of capital requirements was also reflected in our final recommendations. 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 EBA.

Investor 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 was outlined by the Commission in the proposed Bank Recovery and Resolution Directive plays a key role in facilitating 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. The holding restrictions would reduce the risk of contagion within the banking sector and thus constrain the fear of triggering a systemic crisis at the time of a capital conversion or a write-down.

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. We also saw the need to enhance the sanctioning powers of supervisors so as to ensure enforcement of risk management responsibilities.

How the HLEG proposals address the malign diagnosis of the size and structure of the banking sector

Subsidiarisation of trading facilitates resolution by making bail-in rather than bail-out a more 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. First of all the proposals reduce the distorted incentives which endangers socially optimal allocation of resources. For example, as the subsidy of the implicit government guarantee is reduced, competition particularly in the trading activity is revitalised, which will improve the allocation of funds in the economy. Moreover, 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 better.

The interconnectedness within the banking sector and thus the complexity of the financial sector will be affected too. As intra-group financing and transfers of capital or risks between the deposit bank and the trading entity will be limited, there will be fewer channels of contagion. Further, limits on trading activities will reduce the counterparty risks of deposit banks. There is, however, need for further research on financial networks, focusing on the effects of structural reform. These issues are notoriously difficult to measure. So we need to know more about how the complexity of the financial system can be monitored and effectively reduced.

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. I would also like to emphasise the importance of eliminating the presumption that profits are private, but downside risks are public. In the future risk-takers will also have to take into account the potential losses from their bets.

Efficient market discipline as well as active and timely supervision must help ensure that the financial sector and banks in particular find a more healthy size and structure. Our recommendations seek to facilitate this 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 for separation not only facilitate monitoring by supervisors, but the additional layer of designated bail-in instruments which we propose should also increase large creditors' incentives to monitor banks and thereby improve 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. I have emphasized the increased attention paid to incentives and risk taking. 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 sustainable economic growth. Structural reforms of banking should support these aims by helping to weed out distorted incentives from finance.