Erkki Liikanen: Too-big-to-fail and a reform of banking structures

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the High-level Expert Group on reforming the structure of the EU banking sector, at a seminar at the Bank of Italy, Rome, 27 June 2014.

* * *

Original presentation is on the Bank of Finland's website. Slides

On the regulatory reform

[Slide 4 – Substantial crisis impact on the real economy]

In response to the dramatic events of the crisis, a large number of international and EU wide regulatory reforms have been launched.[1] For example new ***capital requirements*** can go a long way to ***reduce incentives to take excessive risks*** across different banking operations. Above all, they will improve banks' true loss absorbing capacity. These effects reduce the probability of bank failures.

[Slide 5 – A need to improve banks' true loss absorbing capacity]

[Slide 6 – Focus of current regulatory reforms]

The regulatory initiative, which to date most directly ***addresses the too-big-to-fail problem*** and the assumption that systemically important banks will be bailed-out by the government, is the ***recovery and resolution*** regime. When successfully implemented, the new tools enable an orderly "failure" of banks. The main tool will be the possibility to "bail-in" bank debt holders to absorb losses. Substantial social costs can thus be avoided. Moreover, the new recovery and resolution tools, provided that they are credible, will ***reduce the implicit government guarantee*** and the ***distortive risk-taking incentives*** created by public bail-out expectations and artificially low funding costs.

[Slide 7 – Funding costs are artificially low due to too-big-to-fail expectations]

[Slide 8 – Implicit subsidies remain high]

To match the geographic scope of banks, the new resolution framework has been taken to the cross-border level. ***The Single Resolution Mechanism will enable the resolution also of banks operating across the Banking Union Member States***. The importance of the political agreement on this crucial Banking Union building block cannot be overstated.

[Slide 9 – Many European banks are larger than their home country]

[Slide 10 – The banking sector is particularly large in several European countries]

[Slide 11 – Financial market liberalisation and governance must be complements]

However, I believe that there are still some ***doubts whether the largest, most complex and trading intense banks can be orderly resolved*** without risking the stability of the financial markets. Hence, pressure on providing public support in a situation like that may still remain.

We need to alter the incentives for banks to become too-big-to-fail in the first place. By removing the assumption that these banks will be bailed-out by the government in times of trouble and thus ***eliminating the implicit subsidy***, the funding costs would more

[1] For further information on the state of play of the regulatory reform in Europe see EU Commission's comprehensive review of the financial regulation agenda published in mid-May 2014 (ec.europa.eu/internal_market/finances/docs general/20140515-erfra-communication_en.pdf).

appropriately reflect the true risk of the bank. This would limit the attractiveness of excessive risk-taking and bank balance sheet growth.

[Slide 12 – Rapid growth in the EU banking sector]

[Slide 13 – The banking sector in the US is smaller than the euro area banking sector]

Moreover, the banks' ***focus should be on providing financial services to retail and corporate customers*** rather than on trading on own account or with other banks and financial institutions as primary counterparts.

[Slide 14 – Focus of operations shifted away from customers]

Therefore, while we have gone a long way in reforming the banking regulation, we have not yet gone all the way. ***Additional measures are still needed to complement the regulatory agenda***.

Many others have come to the same conclusion. For example IMF's Global Financial Stability Report from March 2014 includes an ***assessment of how big the implicit subsidy for banks seen as too-important-to-fail is***.[2] The report concludes that the ***regulatory reforms already being implemented are not sufficient***. Interestingly, estimates of the implicit subsidy based on changes in CDS spreads and equity returns decline on announcements related to structural reform. This provides a market based indication that the structural reforms envisaged would be the right way to go.

[Slide 15 – Extract from IMF's event study on regulatory announcements]

Similarly, the Advisory Scientific Committee of the European Systemic Risk Board, chaired by professor Marco Pagano, concludes in the very recent report on "overbanking" that ***the marginal benefit of additional growth European banking sector is negligible***, if not even negative.[3] The report further finds that the attention of many banks has been diverted to activities other than serving the real economy. ***The universal bank business model can be an asset and it can also be is a source of fragility*** as it contributes more to systemic risk than other kinds of banks do.

[Slide 16 – Contribution of banks to systemic risk]

According to this important report by ASC additional policy measures are needed to "reduce excessive private credit creation by banks and mitigate its risks, re-balance the EU's financial structure away from banks and mitigate the risks from banks' "non-bank" activities". Among the additional policy measures the report also ***recommends the implementation of structural reforms***.

The group's proposal for mandatory separation

I take these recent reports as providing important support for our work in the High-level Expert Group on reforming the structure of the EU banking sector. In October 2012 we proposed ***mandatory separation of a deposit bank and a trading entity*** within the banking group to ***complement, not substitute*** the ongoing regulatory reform. Two avenues as alternative ways forward were considered in the Group. We came to the conclusion that structural reform is needed.

[Slide 18 – Two alterative avenues]

The motivation for our decision was the following:

---

[2] International Monetary Fund (2014) Global Financial Stability Report, Chapter 3: How Big Is the Implicit Subsidy for Banks Considered Too Important To Fail?

[3] ESRB (2014) Is Europe Overbanked? Reports of the Advisory Scientific Committee No. 4/June 2014.

[Slide 19 – Rationale for mandatory separation]

1. We wanted to limit the spill-over of benefits from the deposit guarantee system and any implicit government guarantees to certain trading activities of banks. 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.
2. We saw the need to ***simplify the structure of large, complex banks***. Reducing complexity by means of separation ***facilitates management*** and implementation of incentives and it ***facilitates supervision and monitoring*** by outside stakeholders such as shareholders, bank creditors and other market participants, thus ***reinforcing market discipline***. This will reduce the probability that the bank gets into trouble in the first place.
3. If a bank would nevertheless get into severe problems, it is ***easier to impose recovery and resolution*** measures if the structure of the bank has been simplified ex-ante. It is crucial to make credible the resolution also of the largest and most trading-intense banks in Europe.
4. 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.
5. We emphasised the need to ***reduce the mixing of two very different management cultures*** in 1) the customer-based retail and commercial banking and 2) the transaction-based trading activities. The aim was to ***shift the focus from short-term to long-term***, which is more in line with the interests of the real economy and society at large. We also wanted to ***address the pre-crisis presumption that profits are private, but downside risks are public***.

The choice of ***where to draw the line between the deposit bank and the trading entity*** was made so as to enable banks to ***service the real economy*** in the best way possible, while separating the ***activity that*** we thought ***should not enjoy the benefit of the implicit government guarantee***.

Because the difference between ***proprietary trading and market making*** is hard to distinguish, we in the Group ***proposed to keep them together*** in the separated trading entity. It is better to err on being too prudential than supporting potentially risky activities with insured deposits.

[Slide 20 – Comparison of structural reforms]

We also suggested that ***exposures to shadow banking entities*** such as hedge funds ought to be separated from deposit-taking and lending activities.

Finally, we wanted to ***preserve the universal banking model*** at group level and keep the trading activity within the bank supervisory umbrella. This would also reduce the risk of migration of activities to the shadow banking system. Having the deposit bank and trading entity under one roof would also allow “one–stop banking” to continue where it is to the benefit of customers.

[Slide 21 – “One-stop shopping” still possible in the proposal for structural reform]

On Commission's proposal

On January 29th 2014 the European Commission presented its ***proposal for a Regulation on structural measures*** improving the resilience of EU credit institutions.[4]

[Slide 23 – From idea to proposal on Regulation on structural measures in two years]

The Commission proposal has ***the same objectives*** as the Group's recommendations.

[Slide 24 – The objectives of Commission's proposal for structural reform]

The set of activities which the proposal would affect are also similar. The proposal ***obliges the competent authority to review trading activities and empowers the competent authority to require separation of market-making, risky securitisation and complex derivatives*** when specific conditions prevail.

[Slide 25 – The Regulation takes elements from structural reforms previously proposed]

[Slide 26 – Banking groups are to be structured in two sub-groups]

The Commission proposal leaves an ***important role for the future judgment of the competent authorities***, which in most cases would be the European Central Bank, the EBA and the Commission itself in detailing the separation process and metrics to be used. Here ***transparency, predictability and public accountability are crucial***. Moreover, the elements of discretion need to be implemented so that the objectives of the Regulation are achieved without compromising the ***level playing field in banking and the integrity of the internal market***. Provided that this is achieved, I do believe that the proposed Regulation could bring about needed structural changes as envisaged by our Group.

In some respects, ***the proposed Regulation does also differ*** from the Group's recommendations. The Commission's proposal includes ***an outright ban on organised proprietary trading*** instead of requiring it to be assigned to a separate and separately capitalised legal entity. Even though the definition of proprietary trading is rather narrow, the Commission proposal ***resembles the structural reform implemented in the United States***. This would allow for regulatory convergence at the international level. International consensus on the key features of structural reform is warranted in order to prevent regulatory arbitrage. Thus, I warmly welcome international coordination of structural reform proposals tasked to the ***Financial Stability Board***.

The Commission proposal would cover the largest and most trading-intense banks in Europe. These are the banks that have benefitted the most from the implicit government guarantee and where there still are doubts whether they could be resolved in an ordinary fashion. It is thus natural that the structural reform is targeted at them.

[Slide 27 – G-SIBs and banks exceeding limits on trading activity would be affected]

Moreover, competent authorities or Member States may decide to impose ***similar measures also on smaller banks, or exempt some qualifying banks from the requirement*** if these banks can demonstrate that they do not compromise the objectives of the Regulation or threaten financial stability.

In implementation of the Regulation, ***the Commission could grant individual credit institutions derogations*** from application of the Regulation if national primary law in their home country is already adopted and considered at least as stringent as the Regulation itself.

The elements of discretion entrust the competent authorities, the EBA and the Commission with a ***significant responsibility*** for ensuring that the objectives of the Regulation are

---

[4] European Commission (2014) Structural Reform of the EU banking sector. Press release 29 January 2014 (europa.eu/rapid/press-release_IP-14–85_en.htm?locale=en).

achieved without compromising the ***level playing field in banking and the integrity of the internal market***. It is important that the Regulation is implemented in a coherent manner throughout the EU.

To conclude

I welcome the Commission's proposal and supporting impact assessment. They give a profound base for fruitful discussions on the intriguing topic of structural reform. ***It deserves a fair debate and parliamentary discussion***. I am happy that the negotiations have already started in the Council working group and are scheduled to continue throughout the summer. But naturally the pace will pick up only in the autumn, when the new Commissioner and Commission have been selected and the new Parliament starts its work.

The proposed Regulation would ***give the authorities powers to implement a structural reform*** that would prevent depositor protection from becoming an incentive for banks to engage in excessive risk-taking.

Together with the EU framework for bank recovery and resolution and the ***Single Resolution Mechanism***, the proposed Regulation would ***reduce the pervasive too-big-to-fail and too-complex-to-fail problems*** also among the largest and most trading-intense banks in Europe. Moreover, 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***.

If consistently implemented, structural reform would ***improve market discipline*** and redirect the European banking sector towards ***better serving the real economy***.

[Slide 29 – Measures are needed to improve market discipline]

We need to take the necessary actions to achieve financial sector stability while ensuring economic sustainable growth and prosperity in the EU.

[Slide 30 – On the role of banking]

Thank you!