Erkki Liikanen: On a sound and growth-enhancing financial sector in Europe

Keynote speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the joint Conference "The Comprehensive Assessment, the ECB's New Role and Limits of a Common Supervision in the EU", organised by the Financial Risk and Stability Network, Deutsches Institut für Wirtschaftsforschung (DIW Berlin), European School of Management and Technology (ESMT), Jacques Delors Institut Berlin and Bruegel, Berlin, 30 October 2014.

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The social costs of the financial crisis – such as the losses in the GDP and the increases in unemployment – have been very high. If policymakers – in central banks and in governments – had not learned from the policy mistakes made during the Depression in the 1930s, the crisis could have been even more destructive.

To avoid such crises in the future, or to at least limit their likelihood, we need a more stable and resilient banking and financial system in Europe. To that end, we need better regulation and supervision of banks and other financial institutions than before. Well-designed regulation provide banks with the right incentives to choose their business model, scope, and size efficiently to best serve the society.

It is a key responsibility of our generation to make the financial system much safer than it has been. To be sure, we do not need to return to the repressive regulation of the post-war period, and we need to ensure that the financial system does not prevent the recovery from the global crisis. But we do need to find a better balance between rules and flexibility in regulation than we have had.

The rest of this speech is organised as follows. First, I take a brief look at the European financial sector and especially the banking sector before the crisis. Then I discuss the main building blocks of reforms to European financial system. Finally, I provide views on the next steps: future developments in the financial sector and necessary policy actions.

The European financial sector before the crisis

The banking sector has traditionally been and still is the dominant component in the European financial sector, and developments in banking have also been of clear relevance to the emergence of the financial crises in Europe. As the recent report by the Advisory Scientific Committee of the European Systemic Risk Board tells us, over the past 20–25 years banking systems in Europe had become too leveraged, too concentrated, and sometimes also too big.

As documented by the ESRB report, banks' domestic private lending as well as their total balance sheets had ballooned. The total assets of the EU banking sector were over three times the EU GDP in 2013. In several EU countries, the ratio is much bigger. As to the concentration, the report points out that since 2000, the share of the three largest domestic banks of the national banking system total assets had increased in all major EU countries except Italy. The increase in leverage is illustrated by the decline in the median equity to assets ratio of the largest listed EU banks to only just over 3% by 2008 from around 6% in the late 1990's.

The increases in bank sizes and bank lending were not matched by an equivalent increase in market-based financial intermediation. For example, the ratios of stock market capitalisation to bank credit decreased considerably in the 2000s in the biggest EU countries. As a result, the European financial structure became even more bank-based than before. The large reliance of European firms – especially the SMEs – on bank finance has recently been a drag on the recovery of the European economy as banks' ability to lend has been weak in many EU countries in the aftermath of the crises.

It is now obvious that many of the developments in the European banking since the 1990's sowed the seeds of the banking and sovereign debt crisis:

- Too-big-to-fail and too-big-to-save problems became more severe;
- Banks misallocated too much funds in asset markets fostering unsustainable bubbles;
- Weakly capitalised banks' resilience to shocks became poorer;
- Increased concentration of the banking system made banks more interdependent and vulnerable to contagion.

What has been done to develop the financial sector? – Lessons from the crisis

With this background in the banking sector, Europe faced the dramatic events of the financial crisis. A wide-ranging discussion emerged and has continued on the reasons and lessons of the crisis. One of the early, and one of the best accounts of the crisis was provided by Nobel Laureate Jean Tirole.[1] Professor Tirole accentuated the role of the inappropriate and poorly implemented regulation as one of the critical factors explaining the emergence of the crisis.

In response to the crisis, a large number of international and EU wide regulatory reforms have been launched. I will focus on three key areas of reform. These are new prudential regulatory requirements for banks mainly following the standards set by the Basel Committee of Banking Supervision; structural reforms planned for banks; and finally the introduction of the Banking Union in Europe, especially the Single Supervisory Mechanism, or the SSM.

New prudential requirements

Prudential requirements set for the banking sector are undergoing a thorough reform. A lot has already been achieved especially in the area of capital requirements developed by the Basel Committee and implemented in Europe by EU legislation.

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' loss absorbing capacity. These effects reduce the probability of bank failures. At the same time, sounder capital requirements support banks' credibility and ability to intermediate funding also in difficult market conditions.

Importantly, prudential regulatory requirements are increasingly set to address macroprudential, system wide vulnerabilities and risks – in addition to targeting institution-specific risks. As also pointed out in the IMF's most recent Global Financial Stability Report,[2] the introduction of macroprudential policy is a key step to promoting the soundness of the financial sector especially in times of asynchronous economic and financial risks. Within the euro area, country-specific macroprudential policy seems particularly useful as single monetary policy is conducted for the entire euro area.

While EU Member States have designated macroprudential authorities, and the ECB also has been assigned a new role in macroprudential policy in the SSM Regulation, it is important to note that the financial system would benefit more if all actors in the financial

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[1] Published in English in Balancing the Banks – Global Lessons from the Financial Crisis, co-authored by Mathias Dewatripont, Jean-Charles Rochet and Jean Tirole, Princeton University Press, 2010.

[2] International Monetary Fund: Global Financial Stability Report: Risk Taking, Liquidity, and Shadow Banking – Curbing Excess while Promoting Growth, October 2014.

sector, supervisors, banks and their customers alike, paid more attention to systemic risks emanating for example from excessive credit growth and leverage or misaligned incentives in the financial system.

Closely linked and complementary to prudential requirements, the introduction of the new recovery and resolution regime will help avoid bank bail-out or make it a rare exception. When successfully implemented, it will provide for a set of tools to enable an orderly "failure" of banks. The main tool will be the possibility to "bail-in" bank debt holders to absorb losses. Moreover, the new recovery and resolution tools, provided that they are credible, will reduce the implicit government guarantee and distortive risk-taking incentives created by bail-out expectations and artificially low funding costs.

Structural reform

While the improved capital and liquidity requirements and the new resolution regime take us a long way in addressing the too-big-to-fail problem, they do not take us all the way.

In October 2012 the High-level Expert Group on reforming the structure of the EU banking sector proposed mandatory separation of a deposit bank and a trading entity within the banking group to complement, not to substitute the ongoing regulatory reform.

The motivation for our decision to propose separation was the following:

- First, to limit the spill-over of benefits from the deposit guarantee system and any implicit government guarantees to certain trading activities of banks.
- Second, 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.
- Third, to make it easier to impose recovery and resolution measures if a bank would nevertheless get into severe problems. Simplifying the structure of the bank ex-ante would also serve this purpose. It is crucial to make credible the resolution also of the largest and most trading-intense banks.
- Fourth, 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.

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 should not enjoy the benefit of the implicit government guarantee.

Because the difference between proprietary trading and market making is hard to distinguish, the Group proposed to keep them together in the separated trading entity. In this way, market making would be provided on equal terms by trading units within banking groups and entities outside the regular banking sector.

The High-level Expert Group 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 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.

In January 2014 the European Commission presented its proposal for a Regulation on structural measures improving the resilience of EU credit institutions.

The Commission proposal would cover the largest and most trading-intense banks in Europe. 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.

The Commission proposal leaves an important role for the future judgment of the competent authorities (which in most cases would be the ECB), 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 without compromising the level playing field in banking and the integrity of the internal market.

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.

The Commission proposal is now in the hands of the Council and the European Parliament.

Banking Union

Today, our focus is on the Single Supervisory Mechanism, an important element in the European Banking Union. The changeover to the Banking Union is definitely the biggest change in the European financial regulatory framework since the adoption of the euro. With the SSM taking its fully operative role in just a few days, this conference could not be better scheduled to discuss the developments in supervision.

The decision on the creation of the common supervision was taken by the European Council only two years ago in June 2012. The idea of common European supervision was not new, but it had been debated in various forms and fora. One of the proponents of common supervision was Professor Jean Tirole who proposed integration of supervision with the ECB as an early lesson from the financial crisis.

On Sunday, the first core project of the SSM was finalised, when the results of the comprehensive assessment were published. This exercise provides a very good starting point for both the European banking sector and the ECB as a common supervisor. For banks, the comprehensive assessment was intentionally designed to be very tough and demanding. In comparison to previous supervisory actions, the comprehensive assessment included not only the stress test, but an asset quality review to ensure that the basis for stress testing is robust and the results comparable.

I believe that this strong exercise as a whole helps the European banking sector repair its credibility by enhancing transparency and improving the resilience of the banking sector through corrective measures. In this way, the comprehensive assessment supports banks' ability to provide funding to non-financial economy, which is a necessary condition for restoring growth in Europe.

However, prompt action is vital to further harmonise banking regulations in Europe. In particular, making the quality of bank capital consistent across Member States should be a priority, also for the SSM.

Also to make the SSM operational, the comprehensive assessment has been a very useful exercise. During the past months, the national competent authorities and the ECB have got the first flavour of acting closely together. The comprehensive assessment also provides the ECB with a deep knowledge of the major banks to be under its direct supervision.

After thorough preparations since last year, the SSM will assume its supervisory tasks next week. I am confident that due to the SSM, we will have a more effective and efficient supervision, making the banking sector safer and helping it fulfil its tasks in the economy.

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For the ECB, taking over the responsibility on banking supervision is a big challenge. An important question is how the ECB will reconcile its primary task of monetary policy and the tasks assigned to it by the SSM regulation. It is crucial that the tasks of the ECB related to micro-prudential banking supervision are clearly separated from the ECB's primary monetary policy function. The separation of the policy functions is essential for safeguarding the independence of monetary policy, and it also helps the supervisory function achieve its objectives.

The separation of the supervisory function is required by the SSM legislation the provisions of which require, for instance, strictly separated decision-making arrangements of the Governing Council for different policy functions, but also separation of the supervisory staff from the staff for monetary policy and other policy functions.

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The other main pillar of the banking union is the Single Resolution Mechanism, or SRM, that better enables the resolution also of banks operating across the Banking Union Member States.

The legislation on the SRM was approved earlier this year. Now it is of utmost importance that the institutional framework is promptly implemented for the SRM to be fully operational by January 2016.

The next steps for the financial sector in Europe?

How is the European financial sector developing now, and what are the new policy challenges? Given the legacy of the crisis, the policymakers still face several challenges in financial market policies.

In the short term, one challenge is that we must first find ways to boost bank lending especially to SMEs to invigorate economic growth in Europe. There are issues on the demand side but also on the supply side.

A special market segment has drawn attention during last months, it is the state of the European securitisation markets. Public issuances in the European ABS markets remain low, trading is thin in some market segments and the whole market carries a stigma in spite of the fact that most European structured finance products performed well throughout the crisis.

In the short term, we have a clear need to stimulate ABS markets to stimulate credit creation. In the longer-term the revitalisation of ABS markets would, among other things, (i) allow better risk sharing among investors (ii) help banks to diversify their funding structure thus increasing their resilience, and (iii) make firms less reliant on bank finance.

Concerning short term-challenges in the economy, the Governing Council of the ECB has recently published decisions on targeted longer-term refinancing operations (TLTROs) as well as ABS and covered bond purchase programmes. Together, the aim of these measures is to further enhance the transmission of monetary policy. Their aim is to facilitate credit provision to the euro area economy.

Turning to more longer-term developments, I am confident that if the planned regulatory reforms are properly implemented, they will make the European financial sector sounder and better able to fulfil its tasks in the economy, channelling funds from savers to borrowers in a healthy manner.

Key financial sector reforms in the EU have focused on the banking sector. Banks' reputation and the public confidence towards banks have suffered since the financial crisis. While making banks more resilient, better structured and better supervised, the regulatory reforms also advance the aim of rebuilding the confidence on banks.

At the same time, banking sector will very likely be complemented by financial markets and other institutions in allocating funds to final customers. The new ECB report on banking structures[3] points out that the expansion of the traditional banking sector in the euro area has slowed down since the beginning of the crisis whereas the growth has continued in the non-banking financial sector, especially in shadow banking.

The diversification of the financial system in Europe is a healthy development. However, more attention needs to be drawn to the alternative funding channels to achieve two goals. To remove any undesirable impediments to their efficient functioning. And to ensure that they do not create new threats to financial stability.

Several new initiatives have been taken in the areas that go beyond banking.

These include the public consultation[4] in early summer by the ECB and the Bank of England to stimulate discussion on how to build a better functioning securitisation market in the European Union. In particular, this consultation highlighted a suggestion to create standards for the so-called qualifying securitisations to identify low-risk ABS products that are simple, robust and transparent. The responses, published earlier this month,[5] broadly supported this initiative.

In January 2014, the Commission published a proposal for a regulation aimed at increasing transparency of certain shadow banking transactions. The aim of this proposal is to improve the reporting and increase the efficiency of supervision on securities financing transactions so that the links to the banking sector are properly understood.

In his Political Guidelines for the next European Commission, President-Elect Jean-Claude Juncker called for a Capital Markets Union to develop and integrate capital markets, also with the aims of developing alternatives for bank funding, especially for SMEs, and making Europe a more attractive place to invest.

These and other initiatives to develop functioning of shadow banking and financial markets are very welcome. Work on this field still needs more systematic and serious reflection, but we already have a good starting point.

Concluding remarks

Banks play a particularly important role in the financial sector in Europe, as the most important source of finance for small and medium-sized enterprises. Banks also played a critical role in the background for the financial crisis. The crisis initiated a comprehensive reform of regulatory and supervisory framework of the banking sector, including new capital requirements, structural changes, as well as the Banking Union with the Single Supervisory and Resolution Mechanisms.

The regulatory and supervisory reforms are still partly ongoing, and they need to be carefully completed and implemented. With the good progress achieved this far, the banking sector seems to become more sound and resilient over time, thereby better able to provide loans and other services without compromising financial stability.

At the same time, to complement bank finance in providing for adequate growth potential in the real economy, alternative ways of funding need to be enhanced. But we also need to

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3 European Central Bank: Banking Structures Report, October 2014.

4 Bank of England and European Central Bank: The case for a better functioning securitisation market in the European Union – A Discussion Paper, May 2014.

5 Bank of England and European Central Bank: The case for a better functioning securitisation market in the European Union – A Discussion Paper – Responses, October 2014.

improve our understanding of risks going beyond the traditional banking sector and to be able address any threat they create to financial stability.

Both of these elements are important. Combining a better regulated and supervised banking sector with a strengthened non-bank financial sector will contribute to financial stability and improve the long-term growth prospects of the European economy and thus the welfare of European citizens.