

Regulatory changes in Europe: On the reasoning behind the Liikanen proposals

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Legal Colloquium: Three names for banking history:
Volcker, Vickers, Liikanen

2 December 2012 * DG/L ECB

Crisis as “*new normal*” ...

- ...my students have never seen „old-style funding markets“, let alone market discipline in banking.
- And they may be right...
- Political and public debate today
 - Finger-pointing is cheap (banker, bonus, rating agencies...)
 - Regulatory measures are taken all over the place
 - E.g., last few days
 - EU --> liability for rating statements, restrictions on timing.
 - US --> separate capital requirement for foreign banks.
- ...contributing to a sense of desorientation:
 - How to evaluate the current re-regulation?

Large number of regulatory projects under way...

Capital, leverage

CRD IV / CRR, Solvency II
G-SIB requirements

Liquidity

CRD IV / **CRR**

Reduction of contagion, complexity

EMIR, MiFID II, proposals on **CSDs** and securities law, shadow banking

Corporate Governance

CRD III, CRD IV

Transparency, data quality

Review of **IFRS** standards, audit proposals, rating agency regulation, **GLEI**, risk map

Supervision

SSM proposals, towards Banking Union

Recovery and Resolution

Resolution and crisis management proposal, **ESM**

Depositor protection

DGS proposal

Are regulatory changes coordinated?

- Emerging regulatory landscape is rich, colorful
 - Capital
 - Single supervisor
 - Deposit insurance
 - Liquidity
 - Derivatives trading
 - Recovery and resolution.
- Has several architects, e.g. FSB, BC, EC/EP, UK, US.
- Cumulative effects may be inconsistent, self-defeating.
 - Unintended consequences, e.g. Solvency II, Basel III, RRD.
 - competitive considerations, despite G-20 declarations.
- Reflection on “grand picture” needed
 - ...Politics: trade-off growth & innovation versus stability.
 - ...Industry: business model.
 - ...Investors: who is going to take the risks, if TPM* is tabooed?

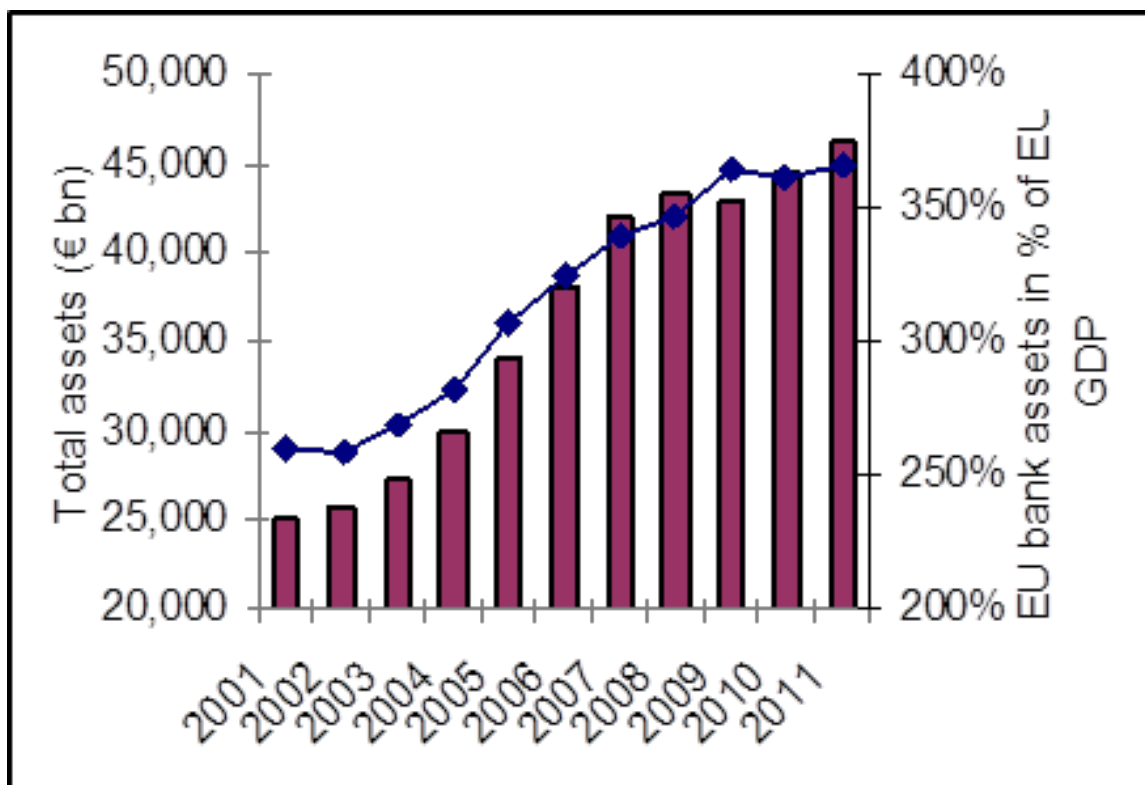
*TPM: Tax-Payers' Money

Liikanen HLEG

- Feb – Oct 2012, 11 members
 - Chairman Erkki Liikanen, plus: ex-bankers (i.a. Bänziger), ex-industry (Gallois), consumer protection, ex-supervision, ex-central bank, academics.
- At start: agreeing on a crisis narrative.
 - Crisis narrative: consistent economic explanation of why the crisis happened, and how it progressed.
 - Based on available academic and policy research.
 - Business models of major banks in Europe
- Perspective
 - Regulation needs to address Too-big-to-fail issue.
 - Establishing resolvability:
 - Reduction of complexity
 - Rebuilding creditor liability (no recourse to TPM)

EU banking sector has grown significantly in recent past

Total assets of MFIs in EU 2001-2011



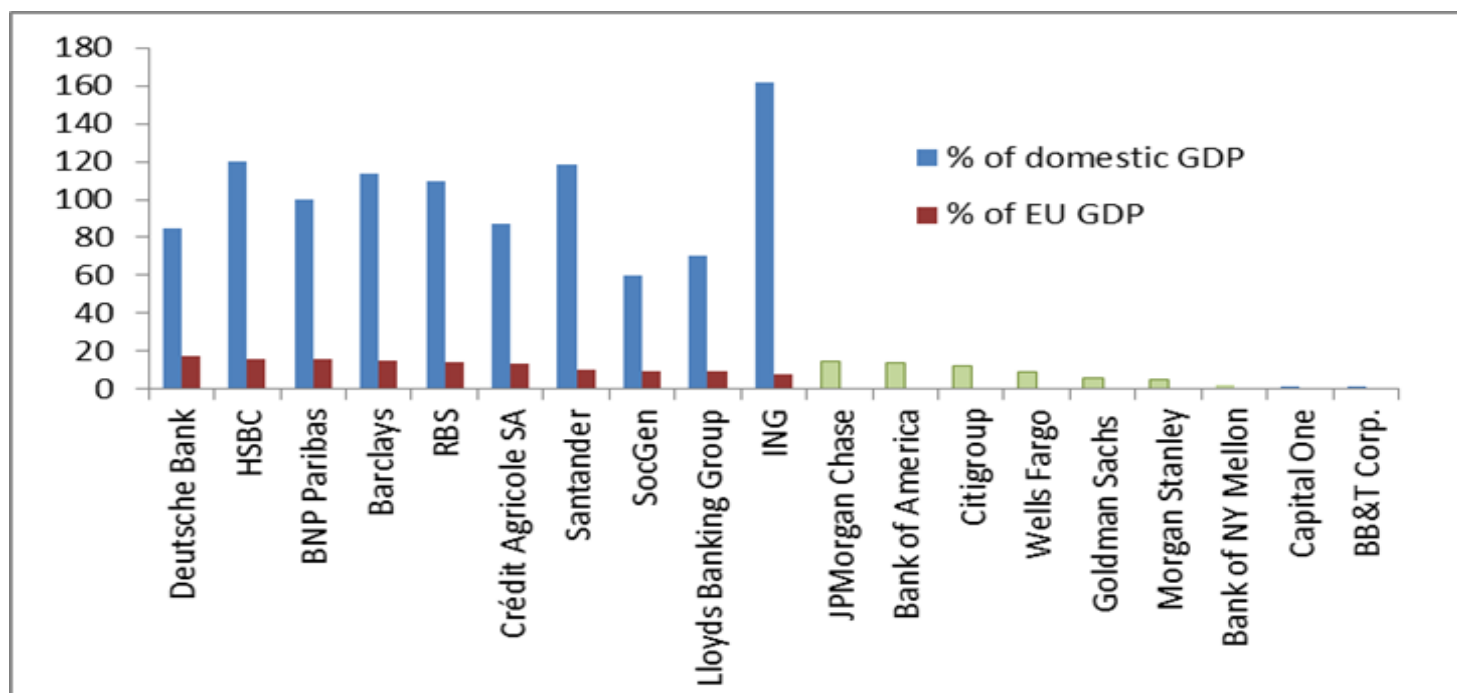
EU banking sector is large compared to US, J

Size of EU, US and Japanese banking sectors (2010)

	EU	USA	Japan
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/ GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

EU banks are sizable compared to GDP

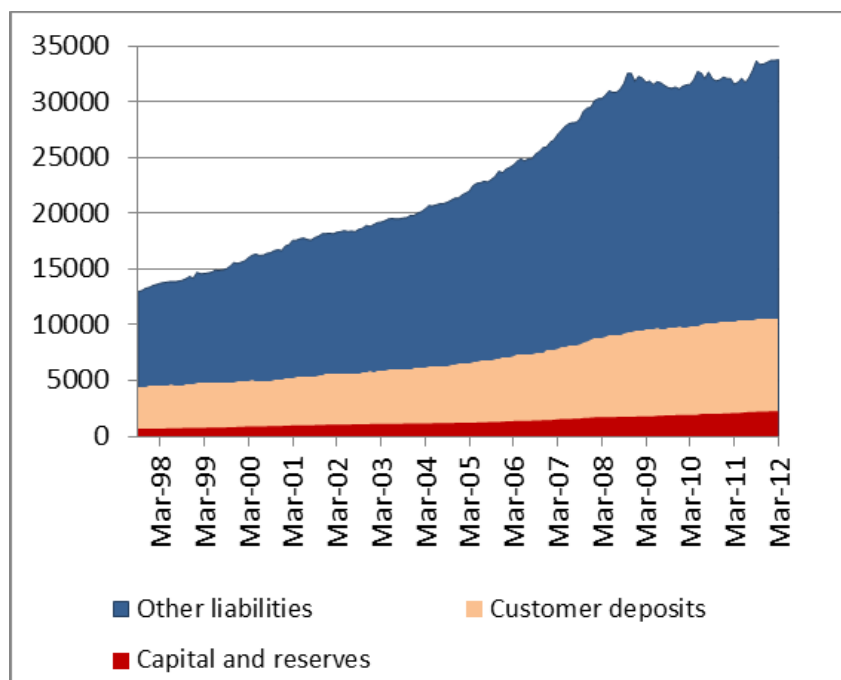
Total assets of EU and US banking groups
(2011, as % of GDP)



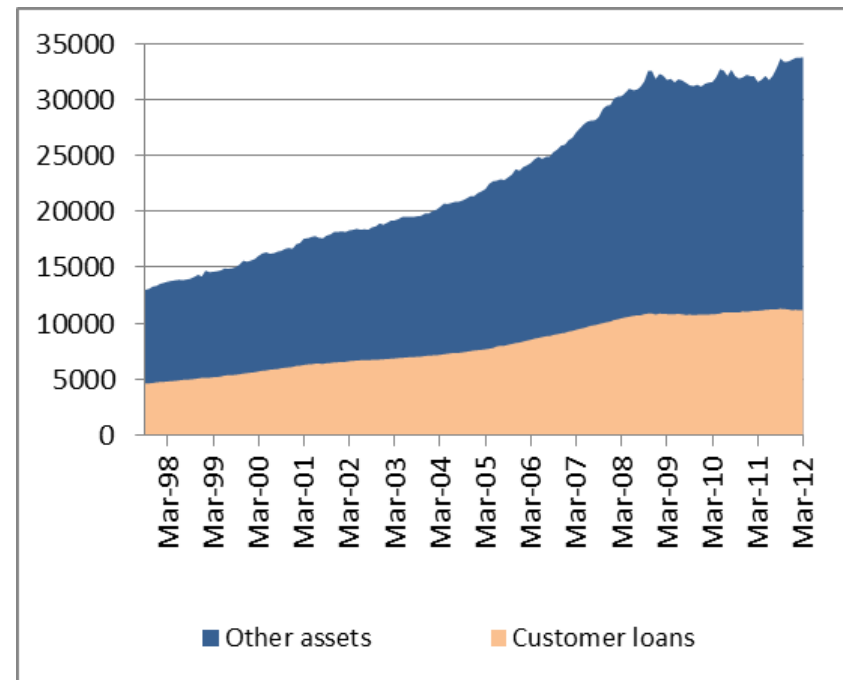
Source: SNL Financial, Eurostat for GDP.

Shift in bank activities and funding structures

- **Evolution of liabilities of MFIs 1998-2012 (euro area, € billion)**



- **Evolution of assets of MFIs 1998-2012 (euro area, € billion)**

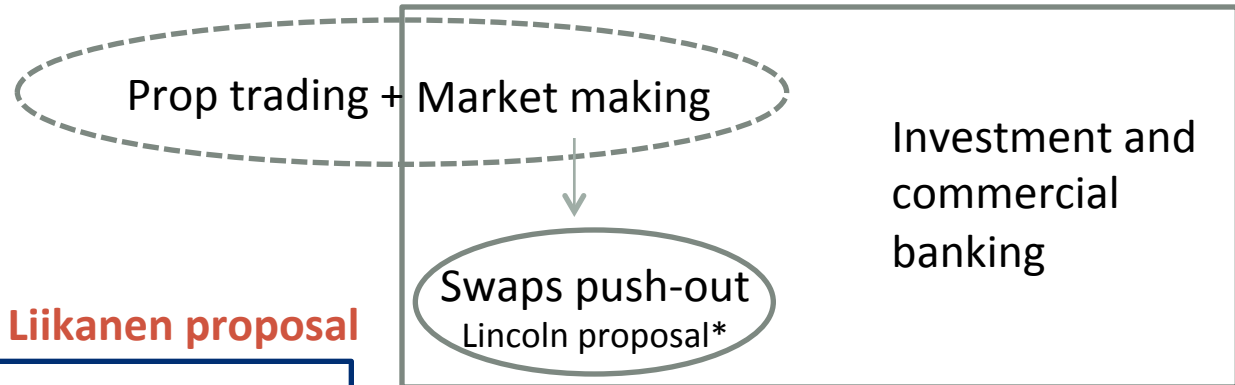


Notes: Customer deposits are deposits of non-monetary financial institutions excluding general government.
Source: ECB.

Notes: Customer loans are loans to non-monetary financial institutions excluding general government.
Source: ECB.

Separation proposals in US, UK, EU

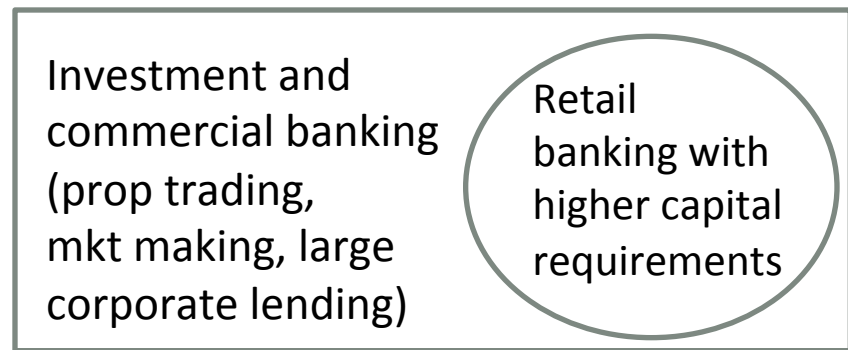
Separation in the Volcker proposal



Separation in the Liikanen proposal



Separation in the Vickers proposal



Crisis narrative, and responses: US, UK

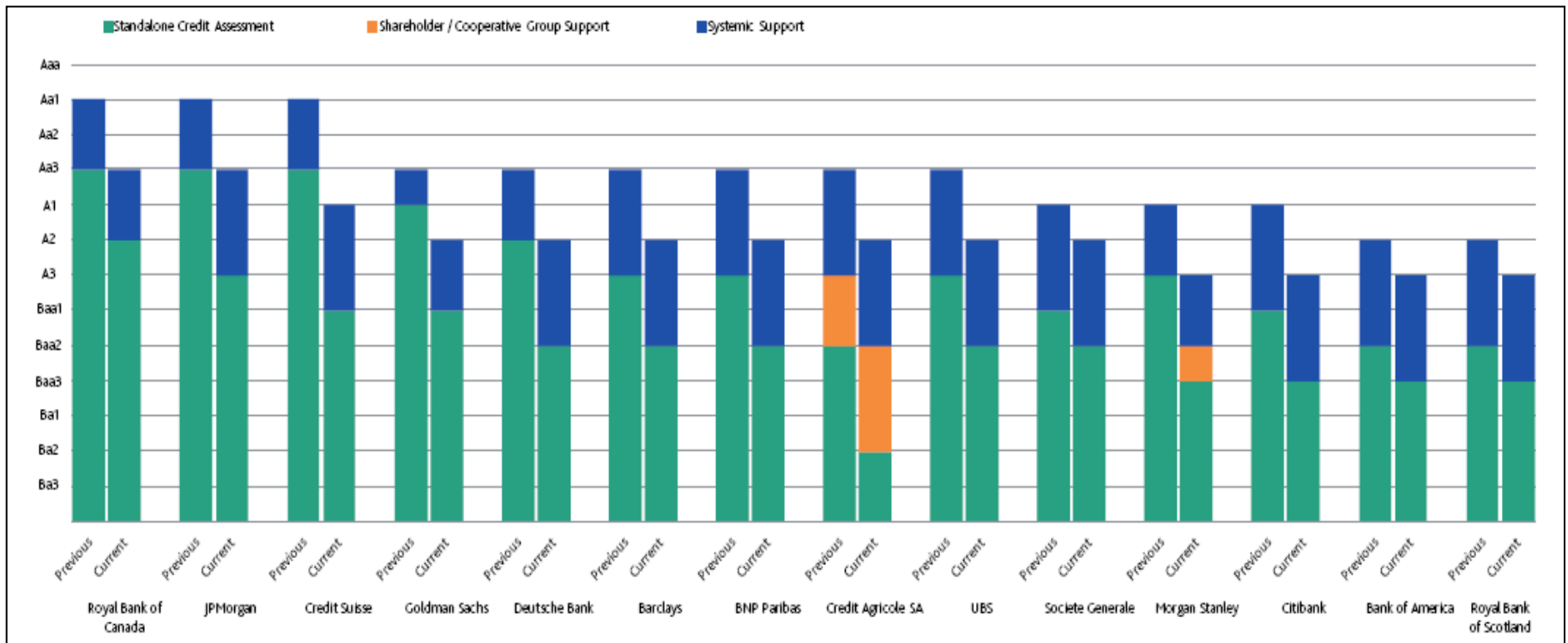
- **US (Volcker):** Excessive risk taking (through proprietary trading)
--> Spin off prop trading from deposit taking.
 - **UK (Vickers):** Excessive risk taking (through investment or commercial banking) affects economy's core financial services.
--> Ring-fence deposit taking & allow other banking activities to default w/o resort to taxpayers' money (eliminate TBTF for ring-fenced institutions).
- > **Both: systemic risk not key.**

Crisis narrative, and responses: Liikanen Report

- **Main hypothesis of crisis narrative**
 - Bank-rescue expectations and systemic risk build-up reinforce each other in a vicious circle,
 - leading to excessive systemic risk.

Implicit subsidies

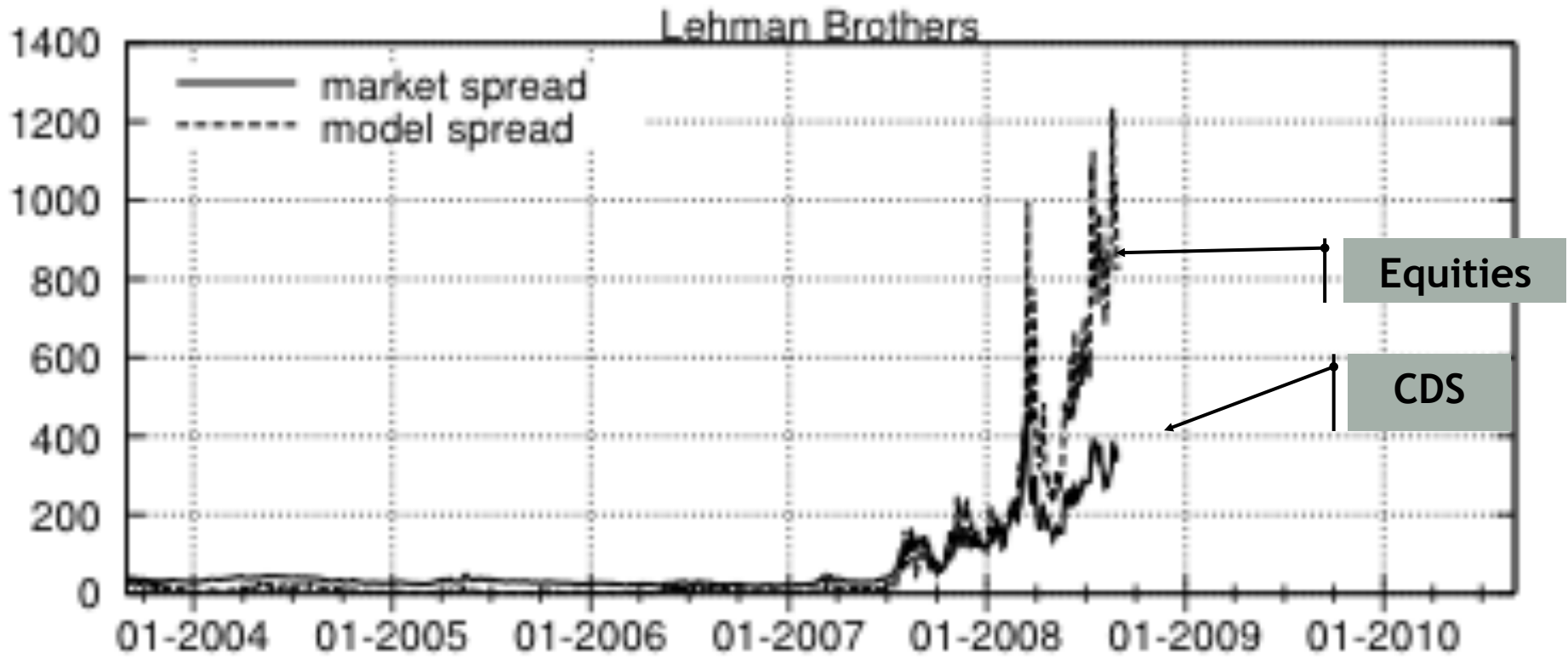
Credit ratings and systemic support uplift for a sample of EU and US banks (2012)



Source: Data from SNL Financial.

Risk underestimation: CDS@Lehman 2008

QUELLE: F. SCHWEIKHARD/Z.TSESMELIDAKIS : *THE IMPACT OF GOVERNMENT INTERVENTIONS ON CDS AND EQUITY MARKETS*, MAI 2011, CFS-WORKING PAPER.



Crisis narrative, and responses: Liikanen Report

- **Main hypothesis of crisis narrative:** Bank rescue expectations and systemic risk build-up reinforce each other in a vicious circle, leading to excessive systemic risk.
- Experience in many countries: bail-in was unacceptable as policy option,
 - because of collateral damage to other banks (contagion, systemic risk).
 - E.g. Germany: IKB, HRE, WLB
- This motivates **key structural recommendations** of Report
 - Facilitating resolvability without recourse to TPM*, through:
 - De-risking I: **Separation** of trading from universal banking (ring-fence).
 - De-risking II: Requiring all banks to build a significant layer of **bail-in-able debt** (rendering bank bond default risk *credible*) --> Re-introducing market discipline.

Summary of Recommendations

- 1) **Mandatory Separation** of Proprietary and significant other Trading activities (*first leg of proposal --> reducing overall risk*)
 - Additional Separation of other activities conditional on the Recovery and Resolution plan (*complements leg*)
- 2) Amendments to the use of **Bail-in instruments** as a resolution tool (*second leg of proposal --> reducing systemic risk*)
- 3) Review of Capital Requirements on Trading Assets and Real Estate Finance (*increasing risk weights*)
- 4) Strengthen Banks' Governance and Control (*aligning incentives*)

Separation

Separation
of trading
(prop
trading
and
market
making)

Separate legal entity (broker-dealer), holding structure, restricted joint liability, exposure limits apply.

Stand-alone funding of trading activity avoids implicit subsidization.

Resolution is facilitated.

Generous *de minimis* rule applies

Universal banking model (commercial + investment) remains largely untouched.

Bail-in-ability

Ensuring bank resolvability without recourse to TPM

All banks: **Mandatory issuance** of designated bail-in debt.

May be substituted by all-equity.

Loss absorption: Bail-in bonds are available for write-down (long-term investors can distribute bail-in losses over many periods).

Or conversion into equity (coco bonds), the Swiss example.

Incidence: Bail-in bonds are priced accordingly (**high coupon** compensates for high expected loss).

Bail-in layer may have tranches of different seniority.

Credibility: Bail-in bond investors **must be non-banks**, limiting contagion risk (eliminates the rescue imperative for the state).

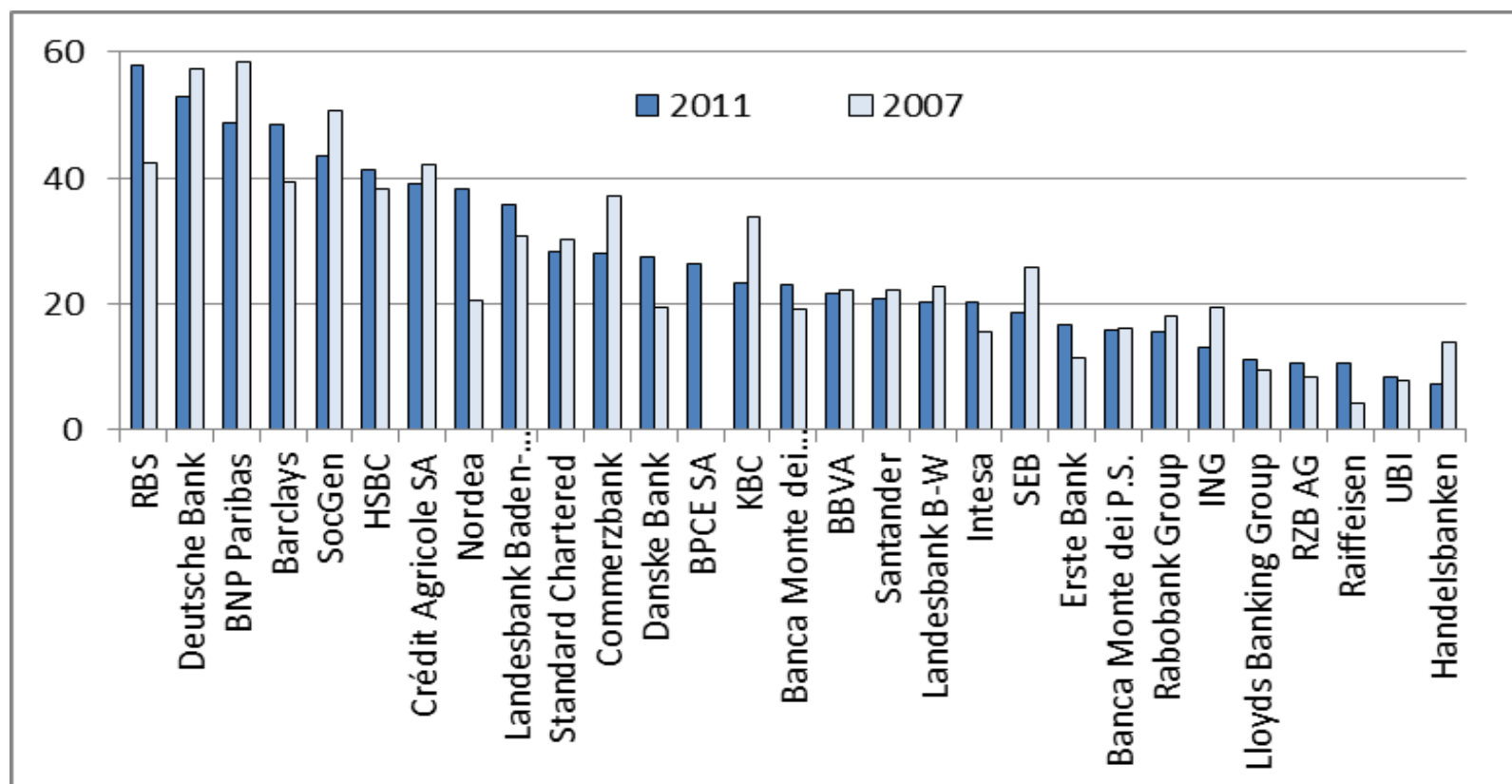
May be substituted by a 1250% risk weight.

Further Recommendations 1: Conditional Separation

- Producing an effective and credible Resolution Plan may require the scope of separated activities to be wider;
- EBA to develop standards for triggering **additional separation** based on:
 - Complexity of trading instrument;
 - Complexity of organisation (Governance, legal structure);
 - Absolute and relative size of risk positions.

“Fair Value-based” assets at major EU banks

Total assets “held for trading” and “available for sale” of large EU banks
(2011 and 2007, in % of total assets)



Source: SNL Financial

Further Recommendations 2: Capital Requirements

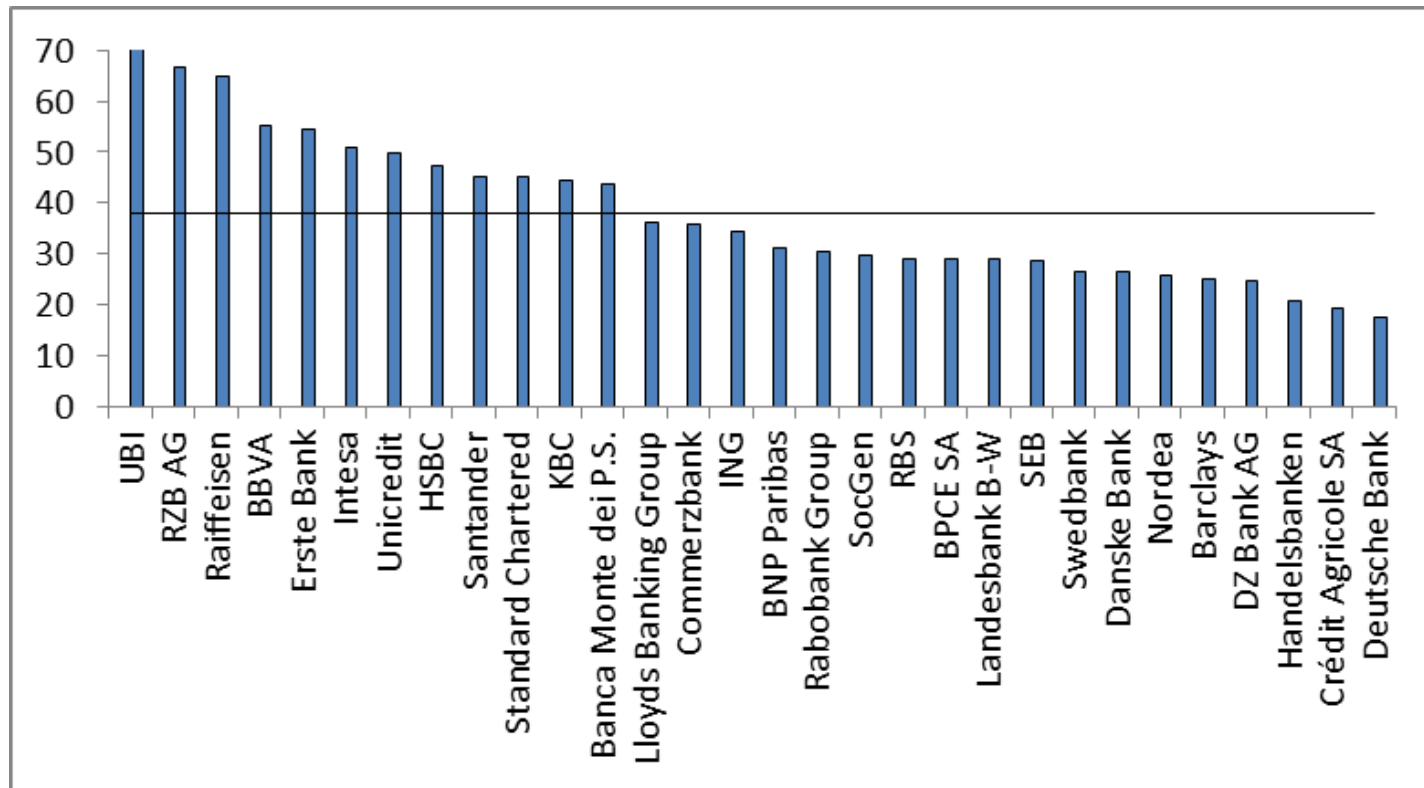
- **General:**
 - Improve consistency of Internal Models across banks;
 - Fix common minimum Floors for Risk Weights;
 - Full endorsement of stricter unweighted Leverage Ratio Limits.
- **Trading entity:**
 - Commission to assess whether Basel Committee Trading Book review will be sufficient to cover EU banks' risks.
- **Deposit bank:**
 - Supervisors to make sure that capital requirements include sufficient safeguards against substantial property market stress;
 - Strict LTV and/or LTI caps should be part of macro-prudential toolbox in all Member States.

De-minimis rule

- Mandatory Separation only if the concerned activities amount to a significant share of a bank business.
- Assessment to be completed in two stages:
 - 1) Identify banks whose assets “held for trading “ and “available for sale” exceed:
 - a. a relative threshold of 15-25% of total assets;
or
 - b. an absolute threshold of EUR 100bn
 - 2) Supervisors decide case-by-case on the basis of the assets to which the separation requirement applies.
The threshold is to be calibrated by the Commission.

Dispersed Risk Weights at major EU banks

RWAs / Total assets of large EU banks (2011, in %)



Source: SNL Financial data.

Further Recommendations 3: Governance and Control

- **Governance and control:**
 - **Fit and Proper** tests to ensure Boards and Management competence in running large and complex banks.
- **Risk management:**
 - **Risk and Control** management functions **dual reporting** to Risk & Audit Committee and CEO.
- **Incentive schemes:**
 - Substantial Share of variable remuneration should be paid in Bail-in bonds;
 - Assess **further restrictions** on level of variable income vs fixed remuneration;
 - Stipulate **absolute limits** to overall compensation pool.

Governance and Control (cont'd)

- **Risk disclosure:**
 - **Detailed financial reporting** for each legal entity and main business lines;
 - Full disclosure of **bottom-line profitability for each activity**;
 - Presented in easily understandable, accessible, meaningful and comparable formats.
- **Sanctioning:**
 - Effective sanctions for Executive failure: **lifetime professional ban** and **claw-back** of deferred compensation.

Summary & conclusion

- The Liikanen proposals want to achieve this: **De-risking** the financial system without sacrificing **benefits of European universal banking**.
- Consistency still an issue: e.g., Draft Report on Recovery and Resolution Directive, EP.
- Further challenges
 - How to develop a sufficiently large market for bail-in debt?
 - Ca. volume € 1-1.5 trn.; splitting in junior/senior possible.
 - Designing understandable trigger rule, easing market valuation.

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House of Finance

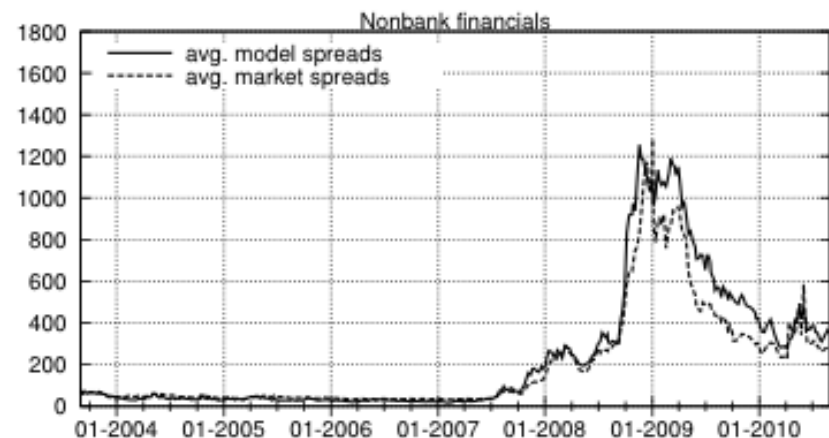
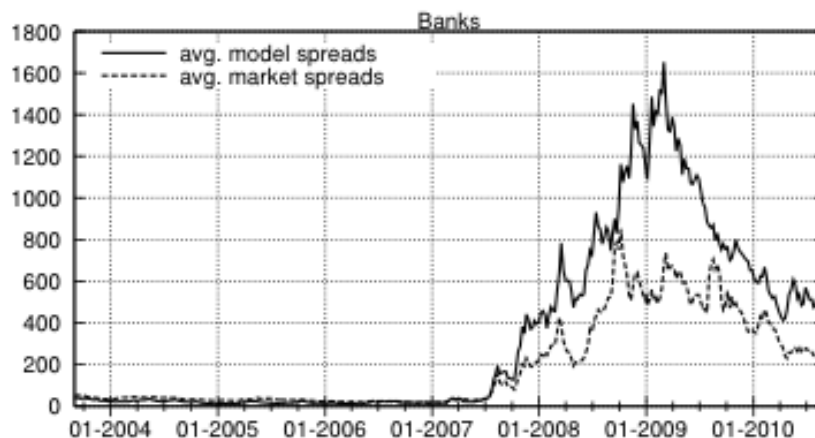
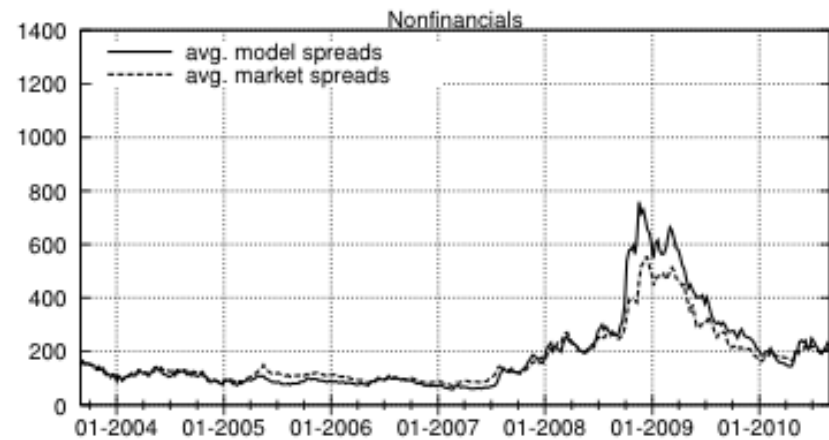
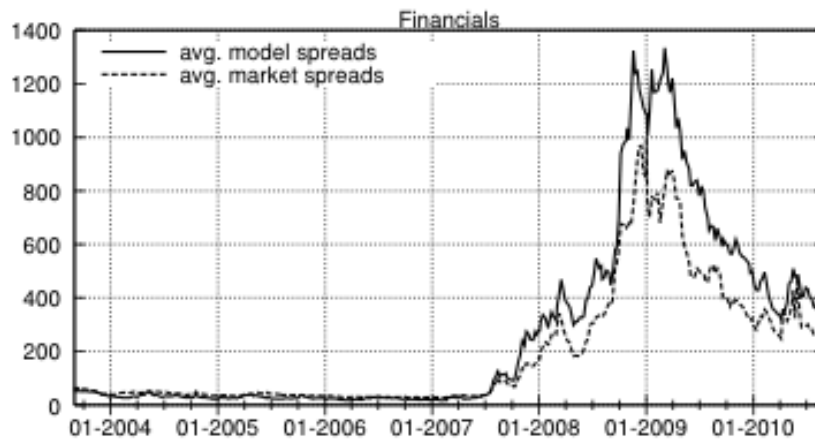
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Risk underestimation: CDS@Banking

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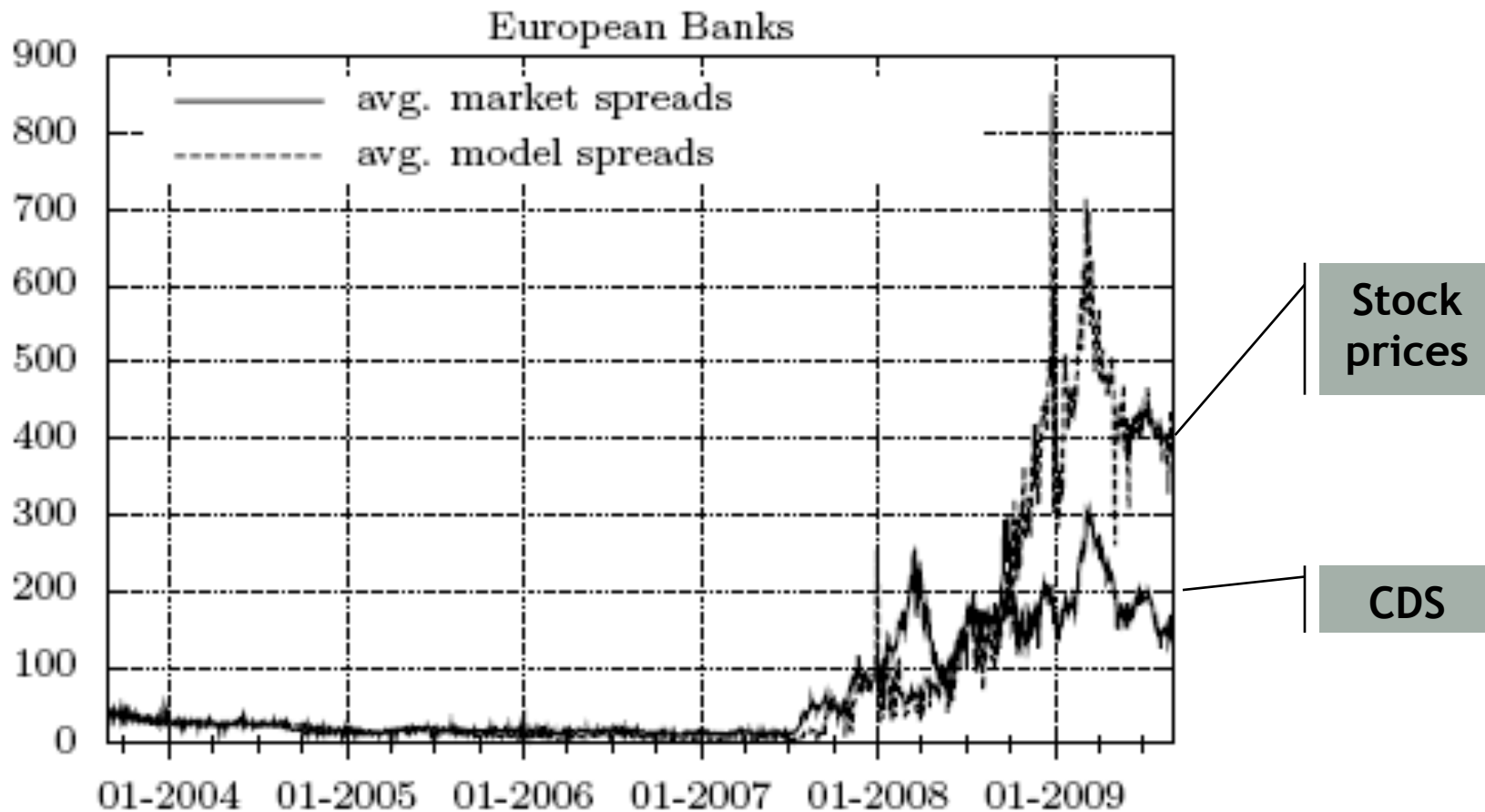
Figure 2: Predicted versus observed CDS spreads - sector aggregates

These charts depict the evolution of weekly averages of CDS market (solid line) and model spreads (dashed line) in basis points for sector aggregates during the period 2004 to 2010. Model predictions are based on the basic calibration scheme outlined in Subsection 4.1.



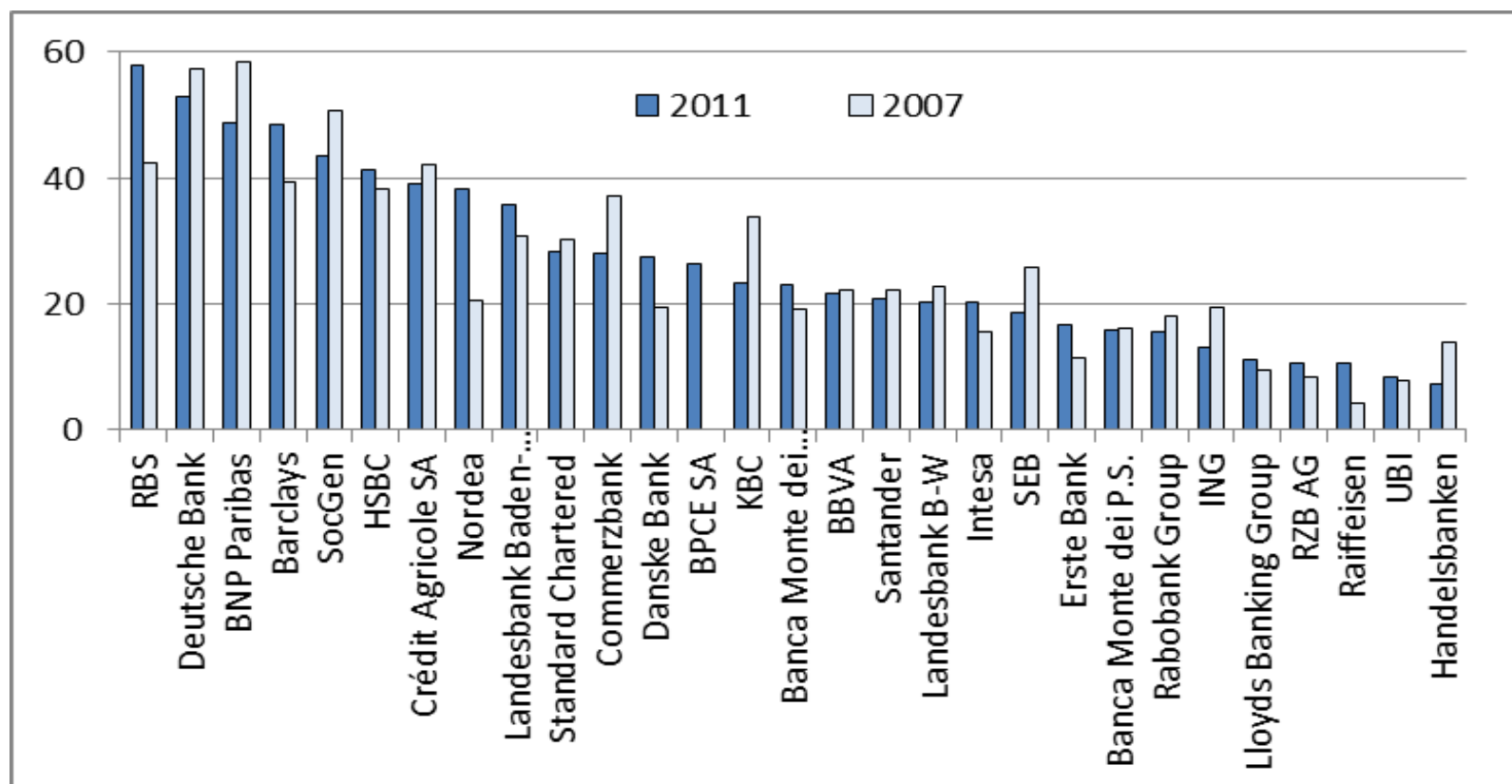
Risk underestimation: European banks, too

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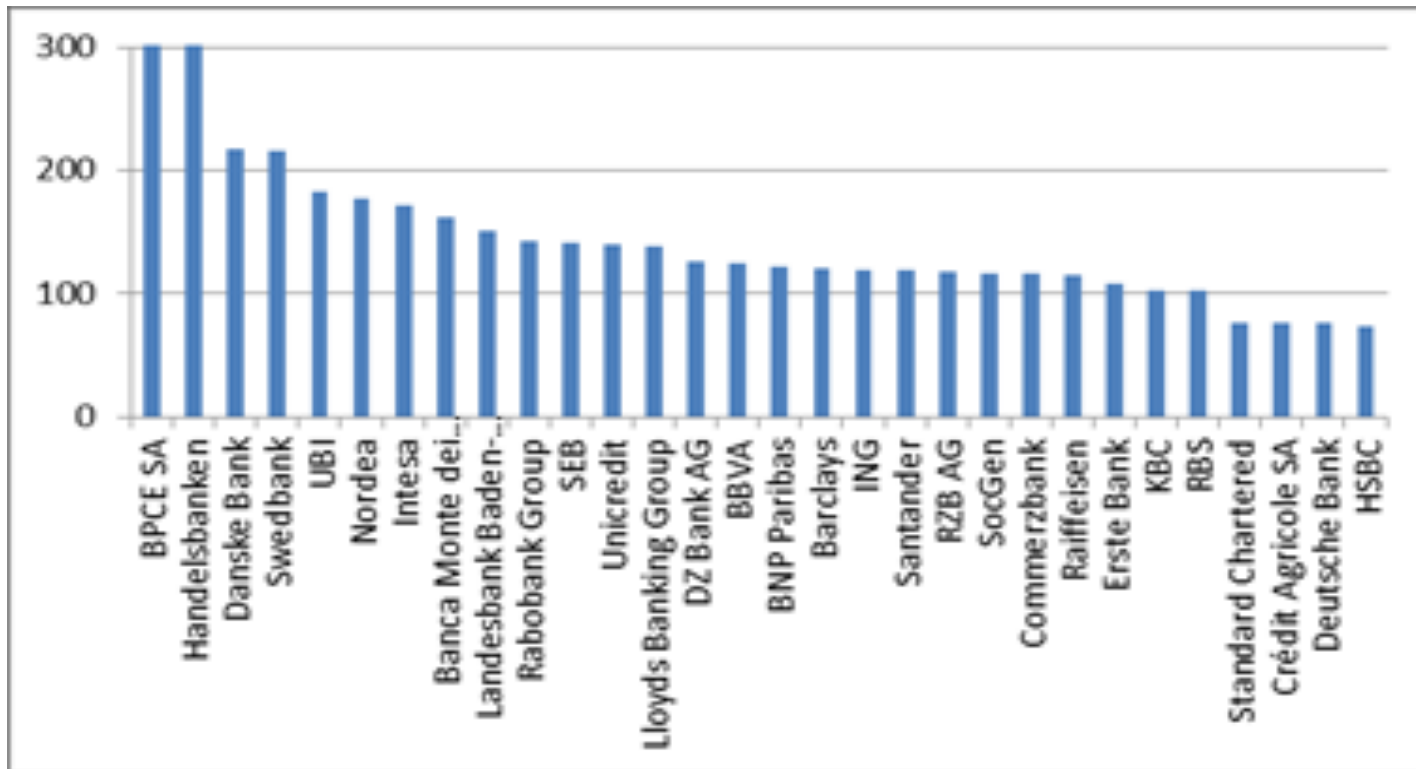
Source: SNL Financial

Remarks on Recovery and Resolution Directive (RRD) currently under discussion in Strassburg

- Separation
 - RRD may require additional separation of other activities, conditional on RR plan.
- Bail-in-ability
 - Bail-in is a core issue in the RRD – however, the Credibility issue is not included.
 - With bail-in bonds in place, the corporate governance of banks will be strengthened. I.a., debt-holders activism, market discipline: pricing signals from bail-in bond markets.
 - Performance-related compensation tied to bail-in-able debt.
- Implicit subsidy is reduced, explicit costs of debt likely go up.
 - Evidence Credit Suisse, upon issue of bail-in-able (coco) debt: reduced costs of senior debt, increased shareholder value (source: self reported).

EU banks operate with high Loan-to-Deposit ratios

Customer Loan-to-Deposit ratios of large EU banks
(2011, in %)



Source: SNL Financial.

Academic research important for HLEG process

- Looking back at work done in Liikanen Group, 03-10/2012
- Finding a convincing crisis narrative as key (first) step.
 - Crisis narrative: consistent economic explanation of why the crisis happened, and how it progressed.
- Bank business models in the crisis.
 - E.g., interaction of investment and commercial banking; role of bank size (assets), proprietary trading, market making, relationship banking.
- My take on today's topic:
 - Role of science for financial stability: Evidence-based assessment of policy options.
 - But, access to quality-checked academic debate difficult today.
 - Wanted: Finance+macro+law at one location, dedicated to research and policy advice

Starting January 2013: Center of Excellence S·A·F·E – Sustainable Architecture for Finance in Europe

Project partners: Goethe University Frankfurt and CFS (Center for Financial Studies)

Main characteristics of S·A·F·E :

- **Funding** by the Hessian Research Excellence program „LOEWE“.
- **3+3 yrs.**

Research agenda on the “big” financial challenges: stability, growth, distribution, imbalances.

Research cluster on Finance, Macro and Law (+ Math, Soc, Pol) **Staff (Sen/Jun):** from 25+30 to 45+60 by IV/2013.

European perspective extends focus in finance research on US markets: e.g., SAFE data project.

Independent, research-based policy advice to support the development of a sustainable financial architecture

In **Frankfurt (and Brussels)**, at the regulatory centers of EU/Eurozone

S·A·F·E Research & Policy: a two-way communication

