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Agenda

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Structural reform in the EU banking sector

The High-level Expert Group on reforming the structure of the EU banking sector presented its final report in October 2012. The Group's work, under the leadership of Erkki Liikanen, Governor of the Bank of Finland, has since remained in the limelight, with its recommendations and their underlying argumentation generating great interest. Dr Hanna Westman, who assisted Erkki Liikanen in his role as chair of the Group, discusses the report's conclusions

It is now more than five years since the outbreak of the financial crisis. It began as a 'sub-prime crisis' in the USA, developed into a 'systemic crisis' in which liquidity evaporated, and became an 'economic crisis' characterised by a deep recession in the developed countries accompanied by large-scale fiscal stimulus. Europe was subsequently plagued by a 'sovereign crisis', and finally a 'crisis of confidence'.[1]

Over recent years, the weaknesses in the financial system, and suggested scapegoats behind the developments leading up to the financial crisis, have been a hot topic in various forums. The High-level Expert Group on reforming the structure of the EU banking sector (HLEG) was no exception, although its focus was naturally on the EU banking sector. Its conclusion was that no one shortcoming was to blame, but rather that a number of factors affected the development, as follows.

Banks grew, in both size and scope. The rapid growth in size coincided with an expansion of investment bank activity, such as brokerage, trading and market-making activities, as banks moved away from customer relationship-based banking and sought new revenue streams. While some of the growth was driven by client demand, the growth in intra-financial business was even greater.

Banks became challenging to manage, supervise and resolve. Their increased size and complexity made it more difficult for the banks' management and boards of directors to exercise control throughout the organisations. It also made it more difficult for external parties such as investors and supervisors to monitor the banks effectively. The increased size, complexity and interconnectedness of banks made them impossible to resolve—ie, restructure and wind up in a timely and orderly manner, which would not endanger financial system stability. Thus it was assumed that, if faced with serious problems, banks would be rescued by the government.

Risk-taking became excessive and was fuelled by implicit subsidies. The implicit government guarantee enjoyed by banks that were seen as 'too big to fail' affected their behaviour significantly. It reduced their overall funding costs and induced them to engage in risky activities, as they would potentially see the benefits, while the government and taxpayers would cover potential losses. This spurred the banks on to grow further and to venture into new business areas.

Poor risk management, distorted incentives and lack of oversight aggravated the situation created by skewed incentives. Moreover, the mixing of the investment banking culture with retail banking resulted in short-termism and a focus on harmful cross-selling, rather than on long-term customer relationships.[2] As a result, excessive risks were taken across banking activities. This risk-taking also extended to the liability side of the balance sheet, as banks relied increasingly on short-term wholesale funding, which made them more vulnerable to market illiquidity.

The banks had limited capacity to absorb losses. They became increasingly leveraged as their balance sheets grew at a much faster pace than their capital base. The Basel capital adequacy rules failed to curb this development. The narrowing capital base could be depleted rapidly, making banks increasingly vulnerable. As the crisis escalated it was evident that a large part of this thin slice of capital was in effect unable to absorb losses.

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There was no EU institutional framework governing the single market in financial services. The increases in the size and scope of banks were accompanied by cross-border expansion. However, the institutions governing the banking sector (supervisors and resolution authorities), as well as the safety nets (such as the deposit insurance system), remained national. 'Banks are international in life but national in death', as Mervyn King, Governor of the Bank of England, coined the challenging mismatch.

Ongoing regulatory reform

A number of regulatory reforms have been initiated in order to mend the shortcomings of the financial system.[3]

Basel III, which is being implemented in the EU through the Capital Requirement Directive and Regulation (CRD4/CRR), will impose stricter capital requirements on banks. The loss absorbency of banks will thus improve, and incentives to take excessive risks across different banking operations will diminish.

A new recovery and resolution regime for banks has been presented in the proposed Bank Recovery and Resolution Directive (BRR). The new tools will enable the orderly restructuring or winding-up of banks without prolonged bankruptcy proceedings, and are therefore at the core of tackling the 'too big to fail' problem and ensuring that taxpayers' money is no longer used to support troubled banks. Two important tools in the new regime are the recovery and resolution plans. In these plans, banks will have to define measures to ensure the continuity of functions crucial to society, such as the payment system. If these plans are not credible, the authorities will have the power to demand structural changes.

A number of initiatives have also been launched with the aim of reducing contagion and complexity in the financial markets and improving the corporate governance of banks, among other objectives.

Structural reform at the EU level—the HLEG's proposal

The view that the ongoing regulatory reform takes us only part of the way in restoring financial stability is gathering ground. Those promoting the need for further structural changes have been vocal, particularly in countries with a large banking sector.

The discussion took a new turn as the HLEG made proposals for structural reform to be implemented across all 27 EU Member States. Its five recommendations, below, constitute an intertwined package, and complement the current regulatory reform.

1. The **mandatory separation** of proprietary trading, market-making, loans, loan commitments and unsecured credit exposure to hedge funds, structured investment vehicles (SIV) and private equity investments from the deposit-taking banking activities. The deposit bank would be able to provide hedging services to non-banking clients (for example, using foreign exchange and interest rate options and swaps) within narrow position risk limits, and securities underwriting. The two separately capitalised and funded entities could operate within the same banking group.

2. An **additional separation** conditional on the credibility of the recovery and resolution plans to ensure the resolvability of the banks and the operational continuity of critical functions.

3. A requirement for a sufficiently large **layer of designated bail-in instruments** so as to increase the overall loss-absorption capacity and reduce risk-taking incentives. Holding restrictions would prevent banks from investing in these instruments.

4. A **review of capital requirements on trading assets and real estate-related loans** that would ensure their sufficiency across the EU, and an effort to make the treatment of risk in internal models more consistent.

5. A **strengthening of the governance and control of banks** by augmenting existing corporate governance reforms. Particular attention ought to be given to the ability of management and boards to run large and complex banks; the power of the risk management function, and quality, comparability and transparency of risk disclosures; the possibility to use designated bail-in instruments in remuneration schemes; and the appropriateness of imposing caps on variable as well as overall compensation.

Recommendation 1: separation

Two aspects need to be taken into account when assessing the proposed structural reform: first, the impact on identified market failures that endanger financial system stability; and second, the impact of structural reform on how the banking sector is able to serve citizens, companies and society. This is particularly important in Europe, where banks have a central role in corporate and household finance.

At first glance, the two objectives might appear contradictory. However, in the long run this is not necessarily true. Even though regulatory measures taken to stabilise the financial system may have a negative impact on the real economy if financial intermediation is (temporarily) constrained, the impact is positive in the long run. The measures taken to stabilise the financial system aim at making financial crises less likely, and at reducing their impact on the real economy.

Impact on financial stability

Separation is a way of protecting the key banking functions by prohibiting banks funded with insured deposits from engaging in activities that are not essential to retail banking and whose risks are potentially high. Alternatively, higher capital requirements could be imposed. However, as some of the risks in the trading activity are next to impossible to quantify accurately, capital requirements based on these estimations will fall short in times of severe stress (these challenges are acknowledged as far as possible in Recommendation 4). Ex ante separation of activities is therefore a way of complementing capital requirements when risk is difficult to model and quantify.

Separation of activities is the most direct instrument for tackling banks' complexity, which would make recovery and resolution easier. It therefore supports the proposed BRR Directive by facilitating its application, particularly when it comes to the largest and most complex, interconnected banks. Recommendation 2 acknowledges that mandatory separation might not be sufficient to enable speedy recovery and resolution.

Only functions that are essential to the functioning of society would benefit from the explicit and implicit government guarantee, as separation would facilitate resolution of the trading entity. Risky trading activities would therefore be funded from the market at a price reflecting their true riskiness. This would restrain incentives for excessive growth and risk-taking in the trading entity.

Simpler structures make it easier for a bank's management and board to understand and manage the bank. Separation can also reduce the mixing of two cultures. To support the separation of retail and investment banking sub-cultures, Recommendation 5 emphasises the need to strengthen management capabilities and the importance of creating long- rather than short-term incentives by means of remuneration schemes.

Simpler structures also make it easier for supervisors and investors to monitor banks, thus enhancing both supervision and market discipline. Through separation within the banking group, activities will not transfer outside the supervisory reach. To further facilitate the monitoring of banks, the need for greater transparency and improved risk reporting were emphasised in Recommendation 5. The need to increase creditors' incentives to monitor banks was acknowledged in Recommendation 3, where the use of designated bail-in instruments was suggested.

It has been argued that structural reform can aggravate the situation at either end of the spectrum of banking activities, to the extent that a systemic crisis is triggered. The economist and former central banker, Charles Goodhart, for example, has pointed out that ring-fencing will force retail banks to concentrate even more on the UK retail market, thus increasing their vulnerability to asset price bubbles, and that the investment bank entity will become more vulnerable as it will face more expensive and difficult funding conditions.[4] However, by cutting the link between the deposit bank and the trading entity through separation, drivers that induce behaviour which can develop into a systemic crisis are restrained. As mentioned above, the trading entity needs to base its operations on more correctly priced market funding, and the focus of the deposit bank is shifted from short-termism to customer relationships. The HLEG also emphasised the need to ensure that both the deposit bank and the trading entity are sufficiently capitalised (see Recommendation 4).

Impact on the real economy

The HLEG made a number of decisions to ensure that the EU banking sector would support the real economy in its role as financial intermediator and provider of risk management services, even if a fairly restrictive structural reform were implemented. First, the core of corporate finance was maintained by allowing the deposit bank to engage in customer-related trading activities, albeit within limited risk positions and in securities underwriting. To balance this, Recommendation 2—where the importance of conditional separation according to harmonised standards was emphasised—was defined as a backstop. Second, the customer interface was to remain untouched, by allowing the separated activities to be carried out within the banking group.

Comparison with other structural reform proposals

Structural reforms can best be compared along two dimensions: first, where the location for the separation should be on the spectrum from traditional retail banking to investment banking and trading activity; and second, how severe the required structural changes are. The latter can be understood as the height of the ring-fence or as the depth of the gorge between the separated entities.

The USA retains part of the Glass-Steagall Act.[5] The deposit-taking institutions are, for example, prohibited from dealing, underwriting and market-making in anything other than US government and agency securities, and buying and selling securities other than debt and equity securities for hedging purposes. The Volcker Rule, which is part of the Dodd-Frank Act,[6] builds on these activity restrictions. It prohibits any banking entity from proprietary trading, and restricts investments in hedge and private equity funds. The Rule is subject to exemptions for market-making, hedging and trading in US government securities.

The distinction between prohibited proprietary trading and exempted market-making is challenging, and the authorities have to rely on transaction-by-transaction scrutiny and a detailed compliance regime. To avoid this supervisory burden, the HLEG proposed separation of both proprietary trading and market-making. Another difference relates to the depth of separation. The HLEG proposal may take place within a banking group, whereas the Volcker Rule prohibits proprietary trading from the entire banking group. The Glass-Steagall Act and the HLEG proposal, on the other hand, are closer in terms of depth, although they differ in terms of the location of securities underwriting.

In the UK, the Independent Commission on Banking (ICB), led by John Vickers, proposed that relatively narrowly defined UK retail banking activities ought to be separated from other banking activities by a ring-fence, and that capital requirements on ring-fenced activities should be tightened.[7] In December, the Parliamentary Commission on Banking Standards, which was tasked with the pre-legislative review of the Banking Reform Bill, called for the ‘electrification’ of the ring-fence by giving authorities reserve powers to require full separation.[8] The proposal is now part of the recently published draft Bill.[9]

In terms of the depth of separation, both the HLEG and the ICB allow separation within a banking group. As to the location, the HLEG proposal would enable deposit banks to operate on a slightly broader basis than banks subject to the ICB proposal, as securities underwriting would be allowed in the deposit bank.

In 2012 the Belgian central bank was commissioned to assess the need for structural reforms to the Belgian banking sector. As mandatory separation was seen as having too dramatic an impact on Belgian banks, separation conditional on recovery and resolution plans was suggested instead. Extended intra-group exposure limits to subsidiaries, and higher bank-specific capital requirements set by the supervisor on trading activities, were also proposed. The Belgian proposal is thus similar to one of the avenues for structural reform that the HLEG contemplated before making a final decision. In this avenue, separation was conditional on the recovery and resolution plans, and the capital requirements on trading activities were to be tighter.[10]

In the Netherlands, too, there is wide support for making banks ‘ring-fence-ready’ rather than imposing separation ex ante. Regulation passed in early 2012 makes it possible for authorities to intervene in a bank’s organisational structure by, for example, splitting up the bank.[11]

There are also voices supporting a ban on risky trading activities. In autumn 2012 a commission chaired by HLEG member, Herman Wijffels, was asked to consider whether structural changes are needed to enhance the robustness of the financial system in the Netherlands.

In France, the draft Financial Stability bill calls for the separation of proprietary trading and operations with risk exposure to money-market funds or similarly leveraged investment vehicles. Market-making, and hedging for clients and for its own purposes, will be allowed for the deposit bank. The separated entity is therefore narrower than in the HLEG proposal, where market-making is restricted to the trading entity. The proposal is similar to the HLEG proposal, as the separated subsidiary cannot be funded by guaranteed deposits and the entity cannot provide payment services to deposit clients.

The draft law also prohibits French banks from engaging in high-frequency trading and dealing with financial instruments where the underlying asset is a raw food material.

In early February, a draft law on structural changes similar to that proposed in France was published in Germany.

Concluding remarks

The structural reform initiatives proposed at a national level are similar in nature, but do have some divergent characteristics which, if implemented, could endanger the efficiency of the Single Market. The implementation of a harmonised approach across all Member States, as outlined in the HLEG Final Report, is therefore of great importance. The European Commission is expected to publish a legislative proposal and an underlying impact assessment in September 2013.

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[1] For a more detailed description of the five waves of the crisis, see High-level Expert Group on Reforming the Structure of the EU Banking Sector (2012), 'Final Report', October 2nd, chapter 2, available at: http://ec.europa.eu/internal_market/bank/group_of_experts/index_en.htm.
[2] Haldane, A.G. (2012), 'A Leaf Being Turned', speech given at Occupy Economics, 'Socially useful banking', panel discussion, London, October 29th. Volcker, P. (2012), 'House of Commons Oral Evidence taken before the Joint Committee, Parliamentary Commission on Banking, Wednesday 17 October 2012', available at: http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/c606-ii/c60601.htm.
[3] An assessment can be found in High-level Expert Group on Reforming the Structure of the EU Banking Sector (2012), op. cit., chapter 4.
[4] Goodhart, C.A.E. (2012), 'The Vickers Report: an Assessment', *Law and Financial Markets Review*, **6**:1.
[5] The Glass–Steagall Act of 1933 restricted affiliations between commercial banks and investment banks.
[6] The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 introduced significant changes to financial regulation in the USA.
[7] Independent Commission on Banking (2011), 'Final Report: Recommendations', September 12th.
[8] Parliamentary Commission on Banking Standards (2012), 'First Report of Session 2012–13', December 21st.
[9] Speech by the Chancellor of the Exchequer, Rt Hon. George Osborne MP, on the Reform of Banking, January 4th 2013, available at http://www.hm-treasury.gov.uk/speech_chx_040213.htm.
[10] The two avenues contemplated are presented in Chapter 5.4 of High-level Expert Group on Reforming the Structure of the EU Banking Sector (2012), op. cit.
[11] van Oyen, M. (2012), 'Ringfencing or Splitting Banks: a Case Study on the Netherlands', *Columbia Journal of European Law*, **19**, 6.