Structural Reforms and Banking Regulation Perspectives from the Eurozone

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Structural Reforms and Banking Regulation Perspectives from the Eurozone

Jan Pieter Krahnen
House of Finance (CFS), Goethe University and CEPR

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Regulatory reform in Europe…

On the one hand...

- Looks like a big mess, from a distance;
- Is perhaps an even bigger mess from close-by.
- Eurozone has come a long way
  - Common currency created 1992 (Maastricht treaty)
    - Maastricht criteria (5): Inflation, deficit, debt, Exchange Rate Mechanism, 10 yr govt bond rate.
  - All EU members obliged to join if criteria are met (except UK, DK; SWE).
  - Now 17 (A, B, CY, E, EST, FIN, FR, GER, GR, IR, I, LUX, MAL, NL, P, SLK, SLV).
    - Still not in: BUL, CRO, CZ, HUN, LAT**, LIT**, POL, ROM.
  - Eurozone is a monetary union only.
  - No fiscal & political union.
  - However: case-by-case negotiations
    - *EcoFin* – Economic and Financial Affairs Council
    - *Troika* – ECB, EC, IMF

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Regulatory reform in Europe… on the other hand

On the other hand...

- Despite doom predictions from many sides, reform process is ongoing.
- Though slowly, digressive, circumventive.
- Monetary union plus multilateral agreements, approximating a fiscal union.
  - Consider banking union (--> SRF), state solvency (--> ESM)
- Increasingly, though cautiously, seen as a potential role model: how to develop incrementally an institutional framework, respecting time consistency in a world of autonomous decison makers with common veto power.
  - Basic architecture of regulatory reform (next slide) --> sequencing matters a lot.
  - However, still on feet of clay (last section)

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Regulatory dynamics in Europe are strong

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
Recovery and Resolution	RRD, SRM, ESM
Depositor protection	DGS proposal

Banking Union

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Liikanen HLEG

- 2012: Feb – Oct , 11 members
  - Chairman Erkki Liikanen, plus: ex-bankers (i.a. Bänziger), ex-industry (Gallois), consumer protection, ex-supervisor, academics.
  - Mandate: *Consider whether there is a need for structural reforms of the EU banking sector or not, and to make any relevant proposals as appropriate, with the objective of establishing a stable and efficient banking system serving the needs of citizens, the economy and the internal market.*
- At start: agreeing on a crisis narrative.
  - Crisis narrative: consistent economic explanation of why the crisis happened, and how it progressed.
  - Based on academic literature, interview-hearings in Brussels.
- Conclusion
  - Regulation needs to address too-big-to-fail, via resolvability.
    1. Reduction of complexity
    2. Rebuilding creditor liability (no recourse to taxpayers' money)

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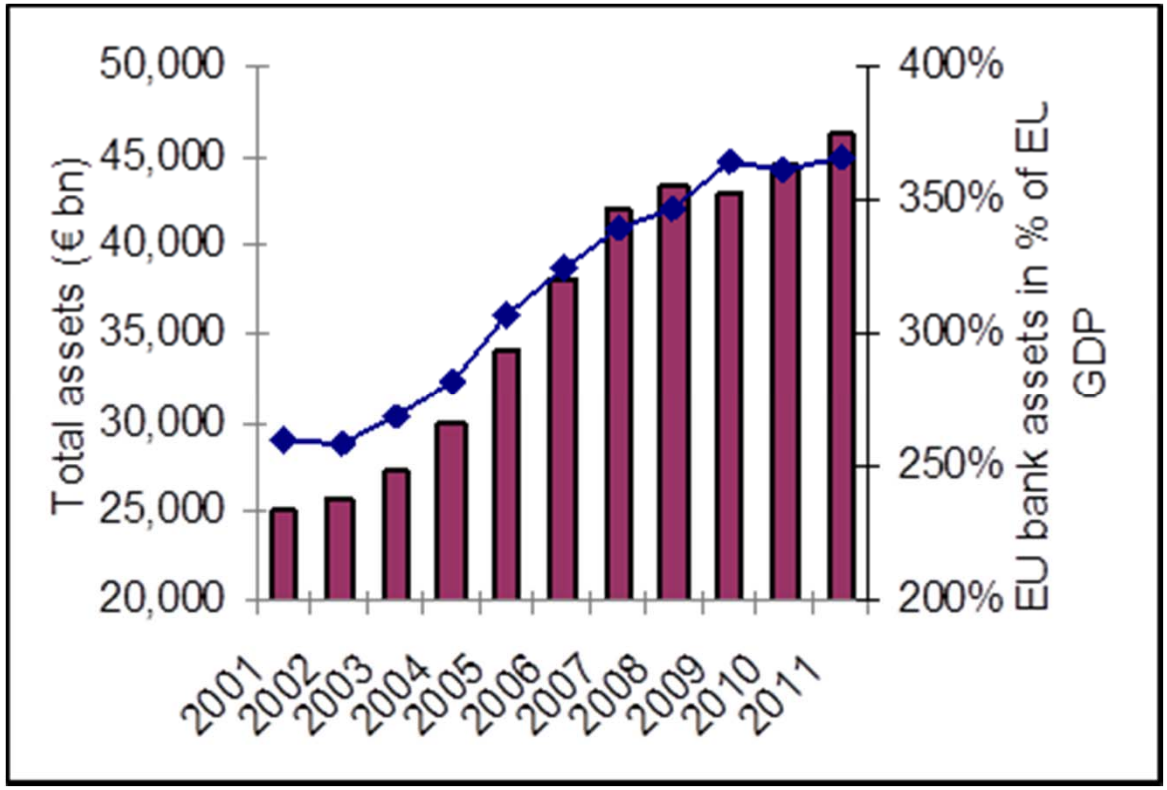
EU banking has seen rapid growth

Total assets of MFIs in EU 2001-2011



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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%

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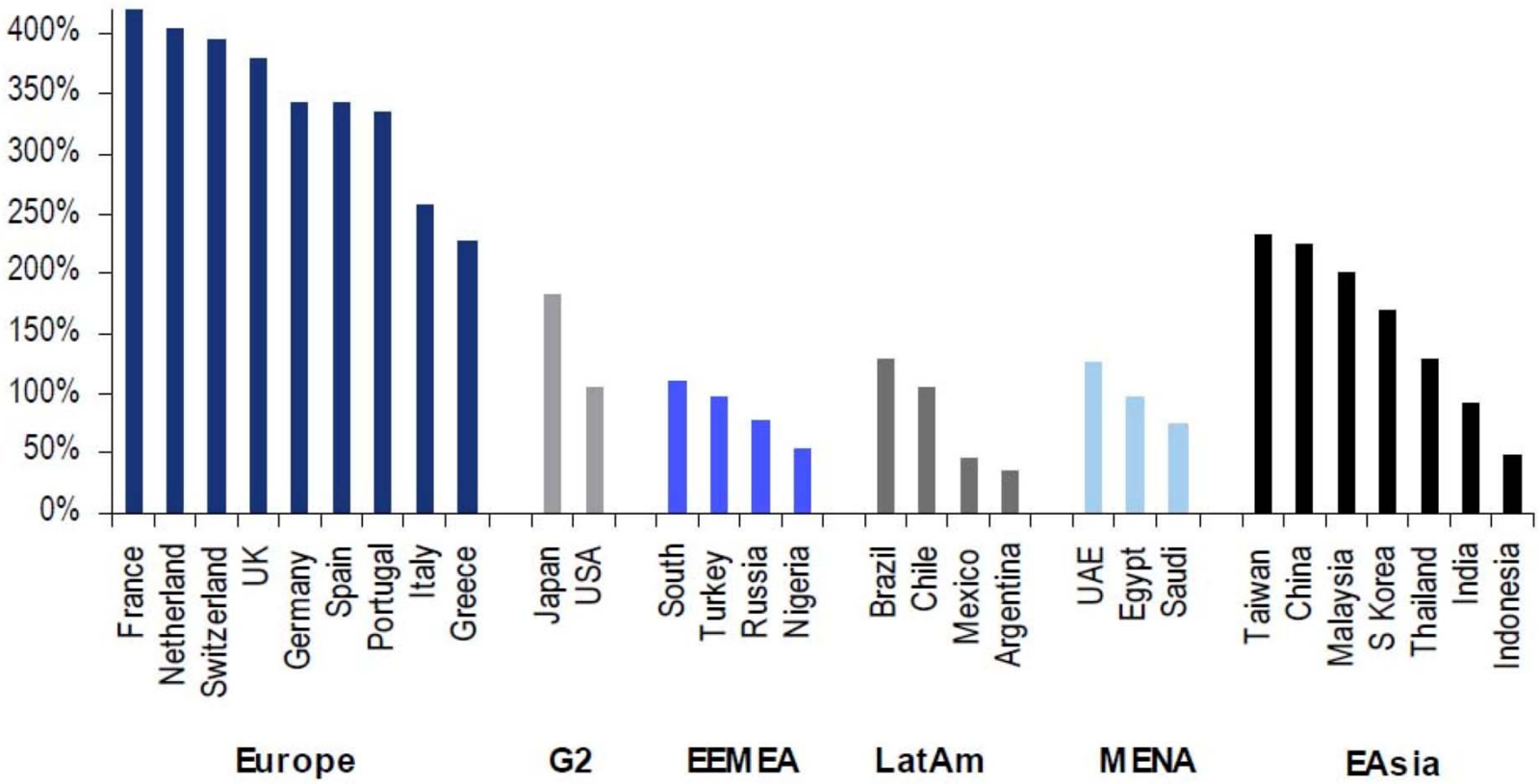
Total banking assets as % of GDP



Link: http://www.zerohedge.com/news/2013-05-18/spot-odd-continent-out-total-bank-assets-gdp

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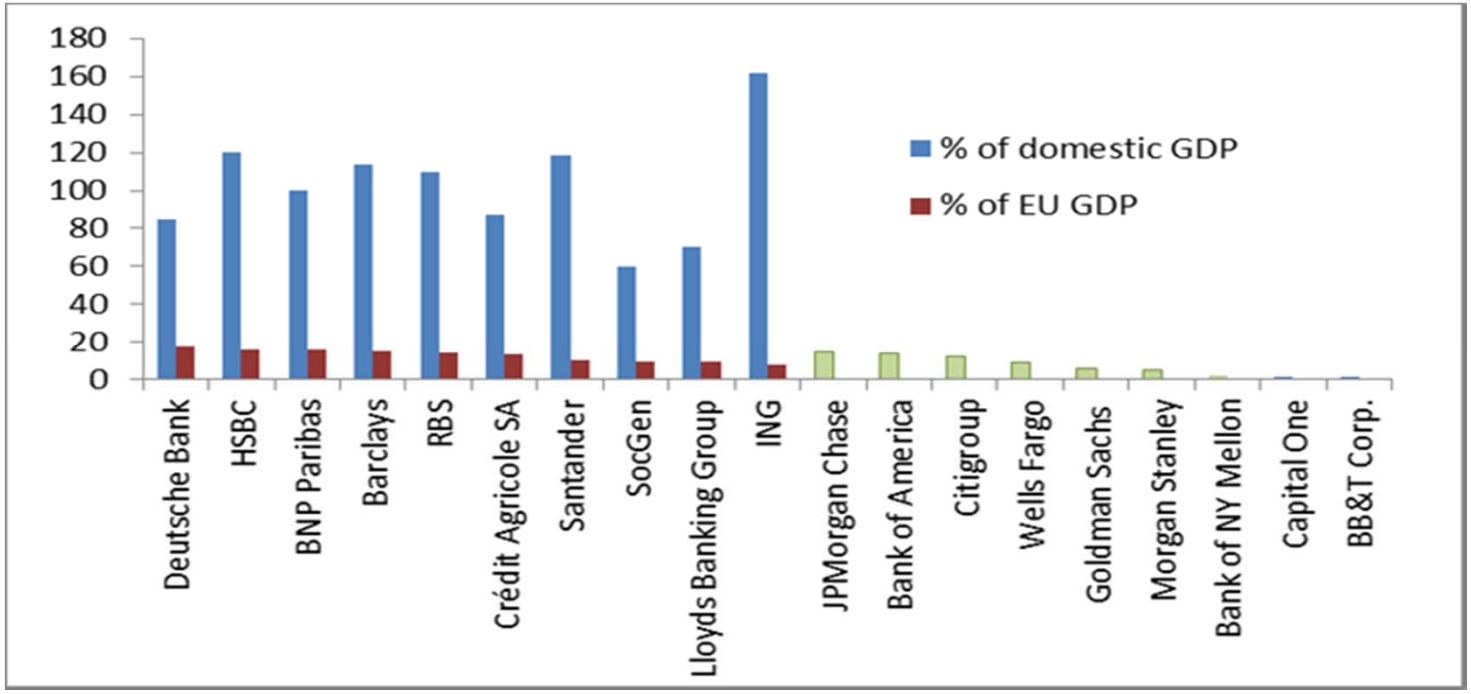
Even worse for EU countries: bank size to GDP



Source: SNL Financial, Eurostat for GDP.

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

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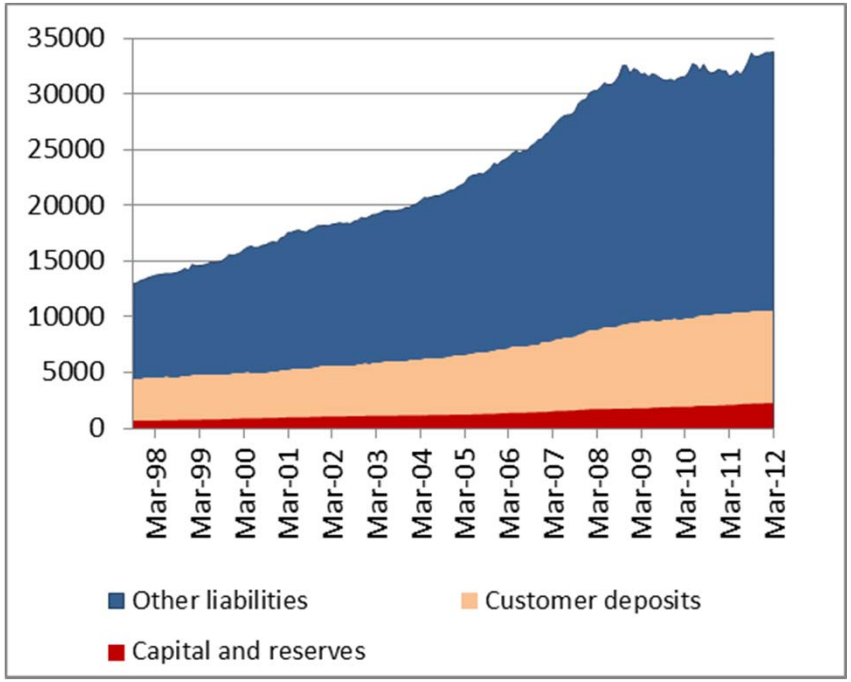
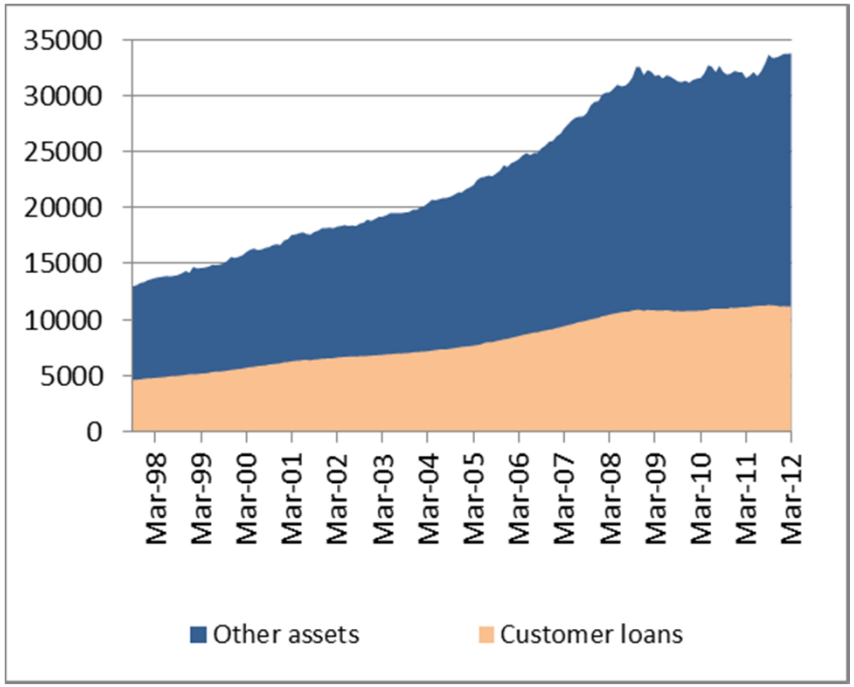
Shift in bank activities and funding structures

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



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

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



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

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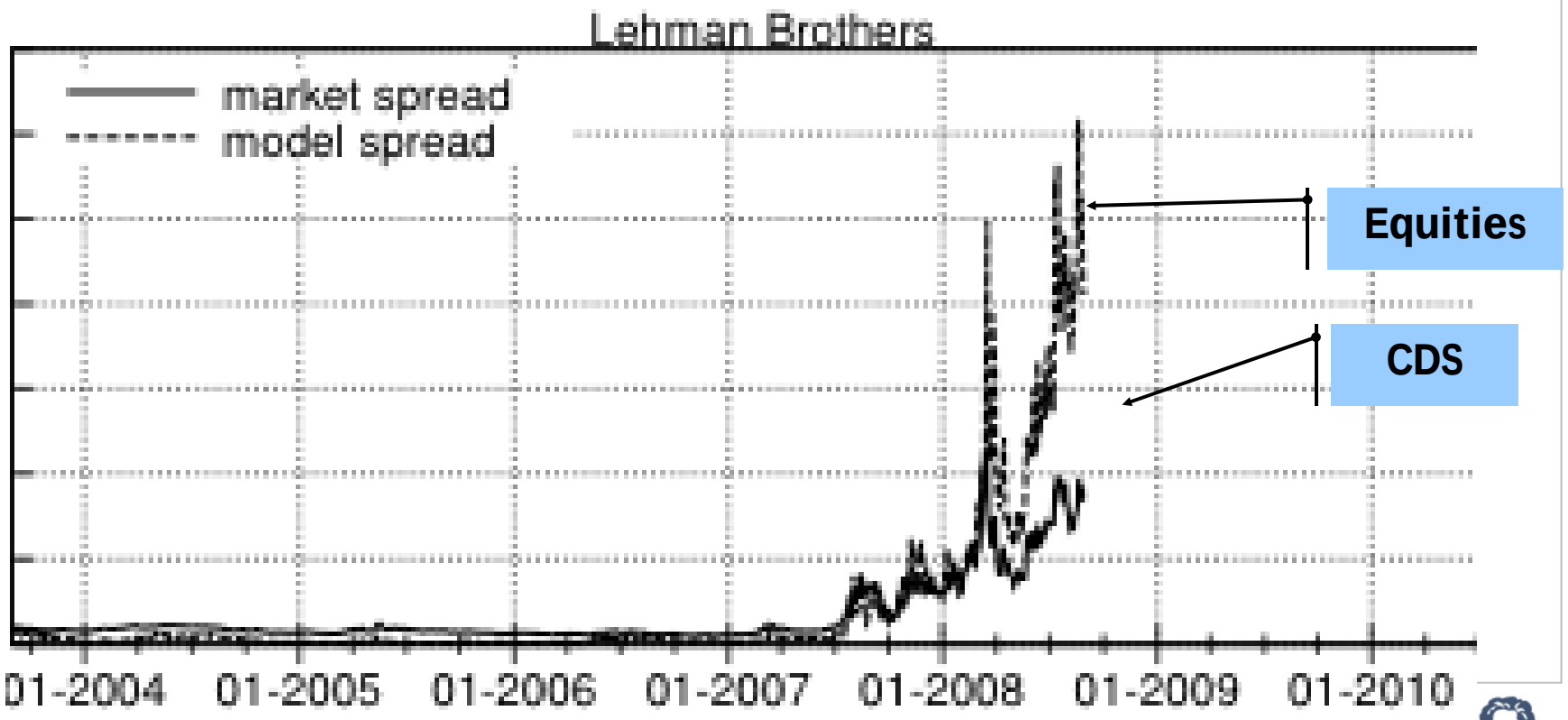
Market prices underestimate risk: CDS@Lehman 2008

F. Schweikhard/Z.Tsesmelidakis : The Impact of Government Interventions on CDS and Equity Markets, Mai 2011, CFS-Working Paper.



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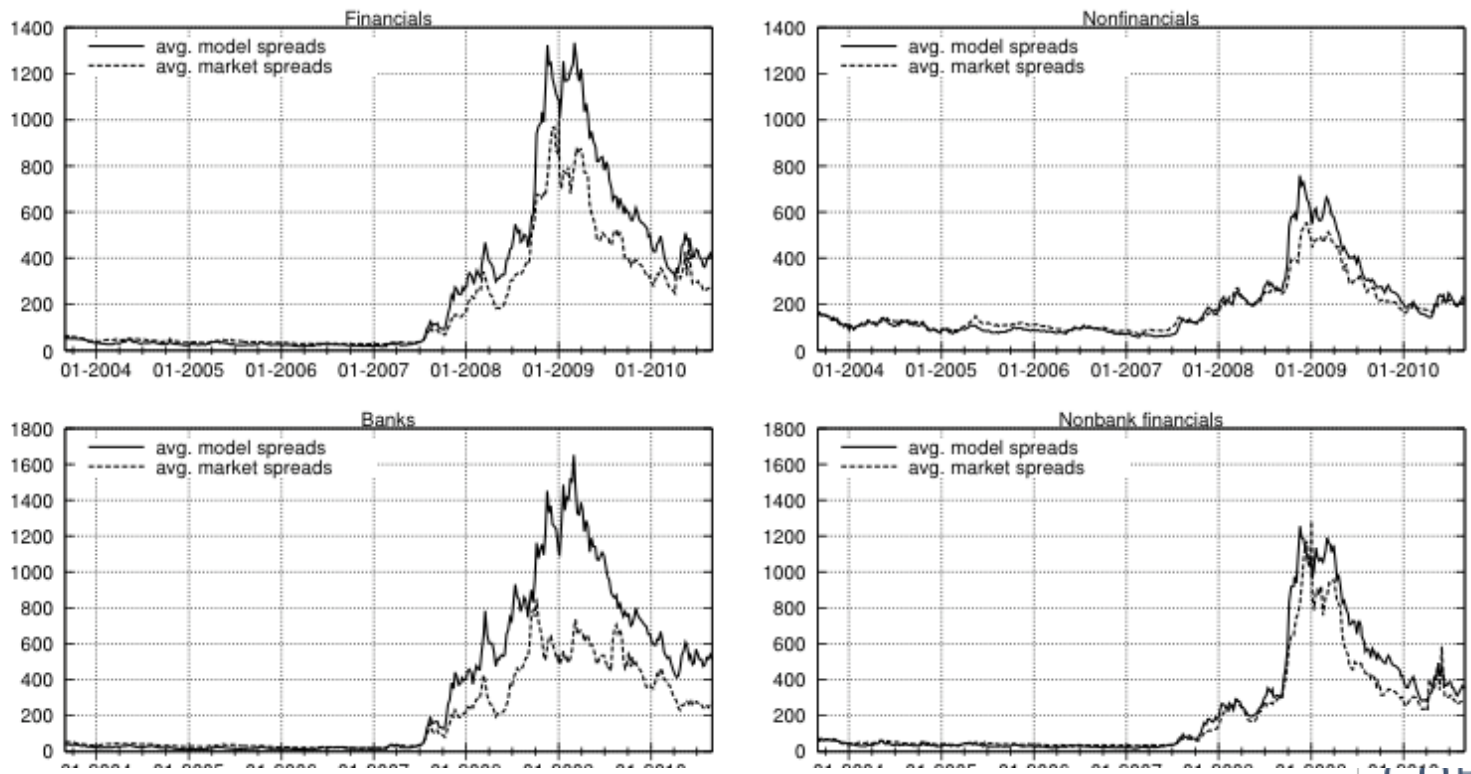
Risk underestimation: CDS@Banks & Nonfinancials

F. Schweikhard/Z.Tsesmelidakis : The Impact of Government Interventions on CDS and Equity Markets, Mai 2011, CFS-Working Paper.

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.



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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 risk taking and systemic risk.
- Experience in many countries: bail-in was unacceptable as policy option,
  - because of expected damage to other banks (contagion, systemic risk).
  - E.g. Germany: IKB, HRE, WLB.
  - All across Europe: even tier 2-capital largely untouched.
- This motivates key structural recommendations of Report

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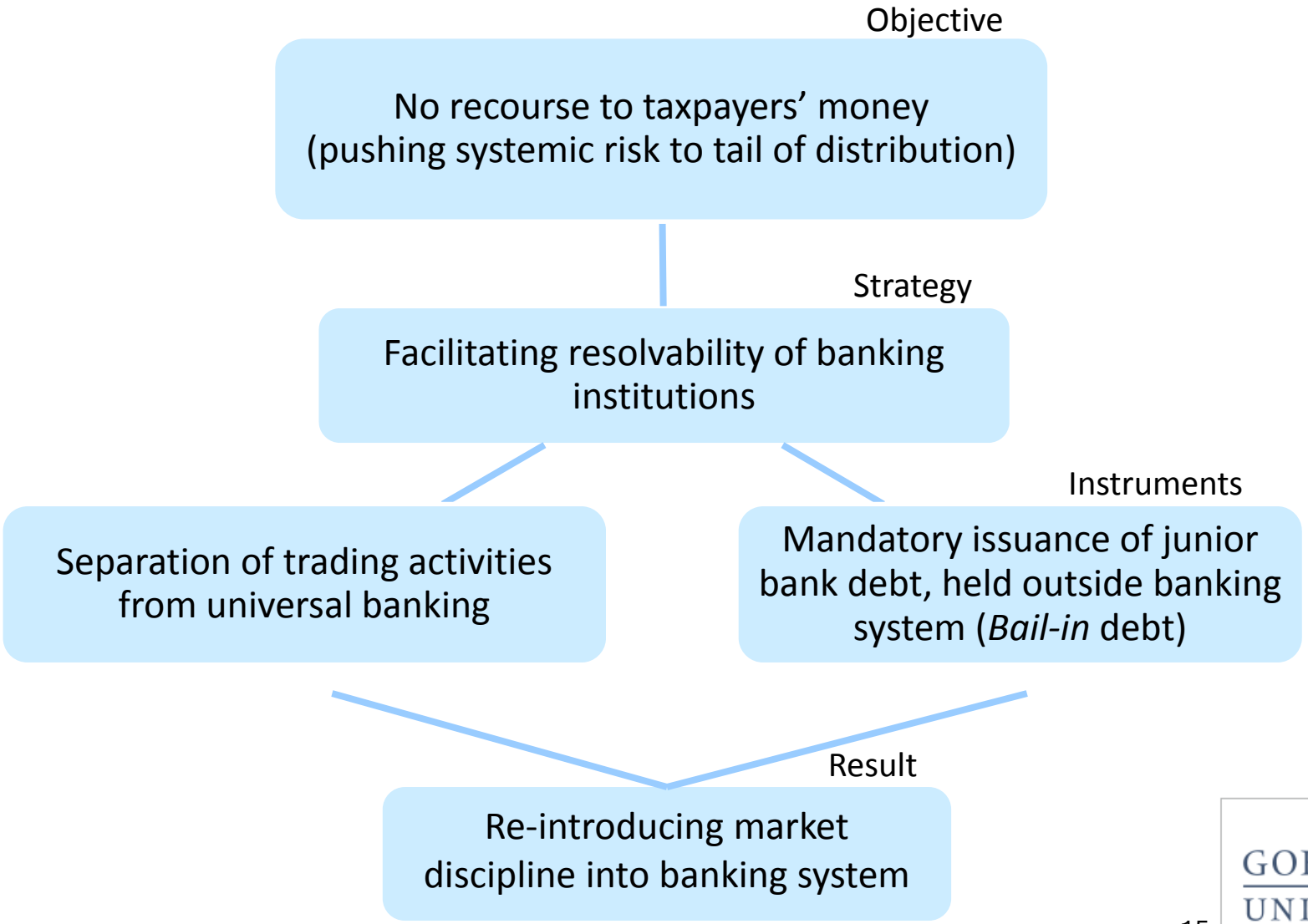
Liikanen Proposal: basic approach



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Dialectics of business models and regulation

- Regulatory measures are motivated by observed business models.
  - E.g., Volcker rule
- Business models are formed by existing regulation.
  - E.g., SPV as a means of regulatory arbitrage.
  - Similarly, development of internal risk models eyeing risk weights.
- Understanding business models and their response to regulatory change is needed for preserving its impact.
  - Academic knowledge on business models has halted somewhere in the eighties.
  - Today, scale and scope economies estimation in much of the literature relies on rather simple models of the banking firm.
  - Progress, in my opinion requires collaborative effort of academics and practitioners/supervisors.

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Plan for today

- Two cases illustrate dialectics of regulatory intent and expected business response (which typically is not part of the regulatory debate)
- **First, mandatory bail-in debt issuance with holding ban.**
  - Possible effects on profitability, prices, and market development.
  - Implications for supervision
- Second, separation of proprietary trading from universal banking.
  - Volcker rule; recent French and German regulations.
  - Liikanen proposal, and its possible implications, in comparison.

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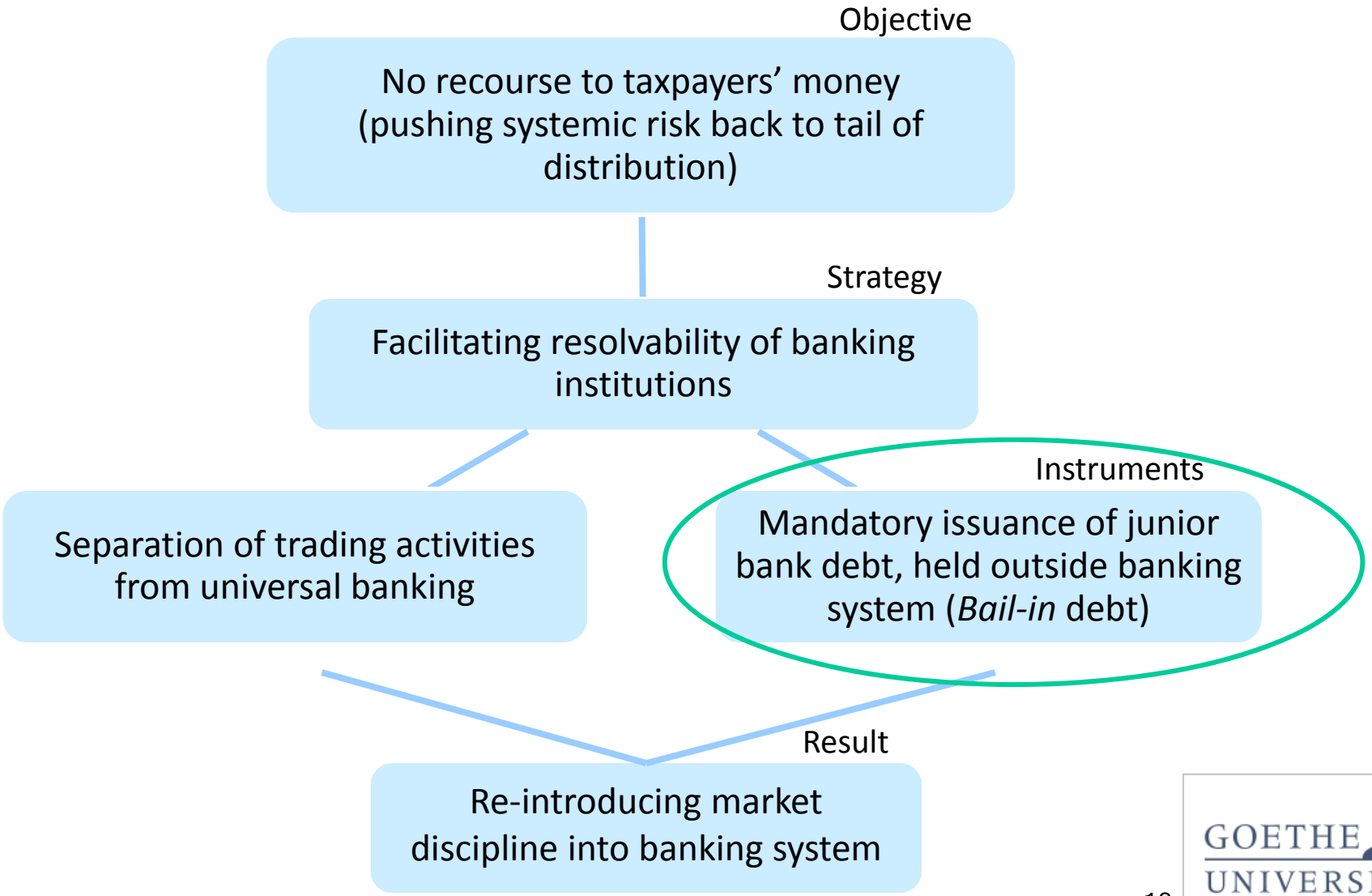
Recapitulate basic approach in Liikanen proposal



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First-in-line/Bail-in-ability

Ensuring bank resolvability without recourse to TPM	All banks: **Mandatory issuance** of designated first-in-line debt.	May be substituted by all-equity. Does not imply other debt to be bail-out debt.
	Loss absorption First-in-line 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: First-in-line bonds are priced accordingly (**high coupon** compensates for high expected loss).	First-in-line layer may have tranches of different seniority.
	Credibility: First-in-line bond investors **must be non-banks**, limiting contagion risk (eliminates the rescue imperative for the state).	May be substituted by a 1250% risk weight.

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Bail-in debt (anchor bonds): policy implications

- Bail-in debt addresses head-on the reason for TBTF: fear of contagioin within banking system
- Holding outside financial system is key: anchor bonds.
- Risk is shifted to whom, eventually?
  - Life insurance, pension funds, hedge funds, SWF.
  - Impact on corporate governance.

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Debating bail-in

- Instruments to be bailed-in
  - Cocos, Debt write-down, With pre-determined trigger, With pre-determined conversion formula, respecting seniority
- Tribute to Paul Tucker: All instruments are bail-in able, legally.
  - Need for special debt layer is justified by experience: Resolution authorities do not dare enough.
- Tribute to Admati/Hellwig; Why not simply more equity?
  - Repairing debt pricing is key for proper risk management
  - Asset substitution incentive intact, even if equity is increased
  - Role of banks in the economy: producing safe, liquid, fixed income assets – rather than information-sensitive, risk-sharing instruments.
  - Bail-in debt may incentivate debt holder activism.
  - Bail-in debt allows for external anchoring of banking.

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Summary: Bail-in

- Re-introducing market discipline via bank funding.
- New role for fund industry (as anchor of banking system).
  - Market probably large enough – bail-in debt design details are key.
  - With corporate governance implications (via compensation, via debt-holder activism.
- New role for supervisor: ensuring bail-in ability.
  - Raising bail-in debt may be difficult for banking groups (Verbünde) with implicit deposit guarantee schemes.
  - Complement to raising equity, not substitute.
- Compliant with market-enabling *Ordnungspolitik*.

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Plan for today

- Two cases illustrate dialectics of regulatory intent and expected business response (which typically is not part of the regulatory debate)
- First, mandatory bail-in debt issuance with holding ban.
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- **Second, separation of proprietary trading from universal banking**.
  - Volcker rule; recent French and German regulations.
  - Liikanen proposal, and its possible implications, in comparison.

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Recapitulate basic approach in Liikanen proposal

Objective

No recourse to taxpayers' money
(pushing systemic risk to tail of distribution)

Strategy

Facilitating resolvability of banking institutions

Separation of trading activities from universal banking

Instruments

Mandatory issuance of junior bank debt, held outside banking system (*Bail-in* debt)

Result

Re-introducing market discipline into banking system

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Justifying separation

- Complexity: Interaction of banking and trading leads to high level of interdependence, difficult to resolve within few days (the proverbial weekend).
  - Complexity has been rising with the advent of platform strategy at large international universal banks (flow monsters).
- Incentives: Interaction of relationship banking and transactional trading may lead to cross subsidization.
  - Effect may be exacerbated if there is a deposit guarantee.

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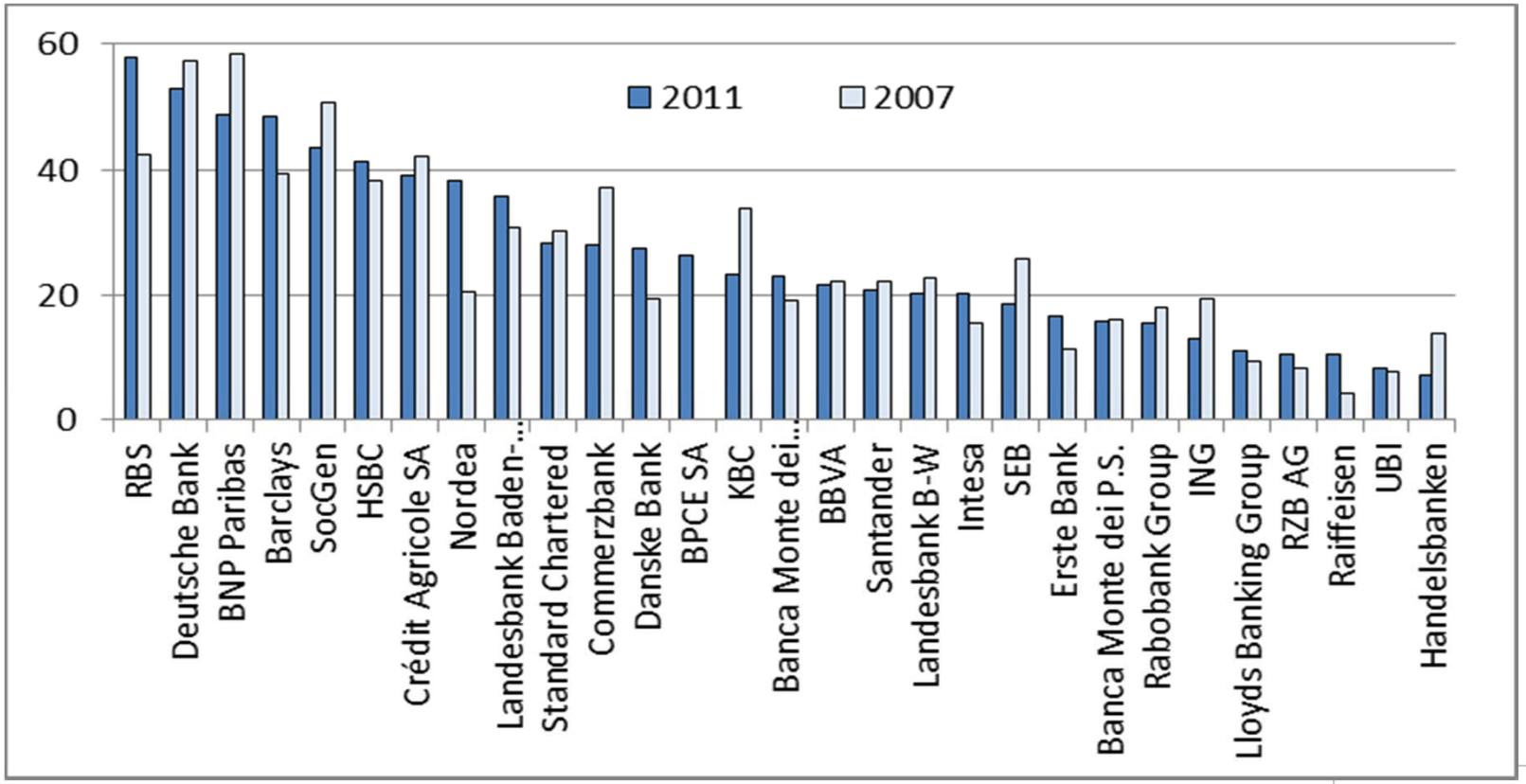
Total assets “held for trading” and “available for sale” of large EU banks

(2011 and 2007, in % of total assets)



Source: SNL Financial

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Liikanen on 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.

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Why separating (prop) trading? Complexity and cross-subsidization

Banking

- Relationship business
- Not scalable
- Safe, if lending book is large and diversified.
- Franchise value via LT pricing.

(Prop) Trading

- Transactional business
- Scalable, with DRTS.
- High risk-return strategy possible.
- No franchise value.

Banking-cum-trading: Too much, too risky

- Time inconsistency: Banks may allocate too many resources to trading, undermining relationship business.
- Risk shifting: Trading may be used to increase risk, to the benefit of shareholders.
- Effect magnified with DGS or government guarantee.

Boot/Ratnovsky 2012

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Why separating prop trading? Policy implications

- Segregating resources within the universal bank (firewalled subsidiaries)...
  - …solves time inconsistency problem: because capital remains in relationship business.
  - ...solves risk shifting problem: because trading funding is fully risk-sensitive. Not subsidized.
- Volcker, Vickers, Liikanen.
  - All agree on a *de-minimis* rule,
  - Because banking-trading interaction is presumably beneficial if carried out at moderate level.

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Why separating *all* trading, not only prop?

Traditional investment banking

- Broker-dealer, active in a defined set of markets. E.g., M&A, corporate loans, foreign exchange products, bond issues, IPOs.
- Personal relationships and repeat interaction matter.
- Bank matches demand and supply.
- Moderately-sized balance sheet – leverage is a by-product of the brokerage role.
- Income source mostly fees and commissions.
- If spread income, then from prop trading desk.

Modern investment banking (MIB)

- Upgrading into risk-engineered, high value-added services of a central counterparty.
- Real synergies bw. investment banking and commercial/retail bkg.
- "Platform model"

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From match-finder to provider of counter-party services (1)

Platform model explained

- Platform: set of basic products (e.g. options, swaps, CDS, bonds) and processes (structuring, syndication, internalization, net-ting, electronic crossing networks, dynamic hedging w/factor models)
- E.g., using structured finance to produce credit risk of a particular rating quality, duration, currency.

Balance sheet growth

- With capacity in place to deliver platform services, the bank can start to leverage its generic customer business.
- Building on customer order flow, bank takes other side of many transactions.
- It makes the market, entering exposures into its trading book.
- Balance sheet reflects accumulation and holding of inventories.

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From match-finder to provider of counter-party services (2)

Emergence of Flow Monsters

- Banks with large flows of customer business facilitating market making.
- Platform costs are largely fixed, suggesting increasing returns to scale.
- Flow Monsters turn into Stock Monsters, banks with large balance sheets.
- High leverage is by-product of market making, not intended risk strategy.

Policy conclusion

- Market making is functionally equivalent to a sequence of prop trades (e.g. factor hedging, London Whale) --> how to distinguish?
- Own capital is at risk, although no prop trading.

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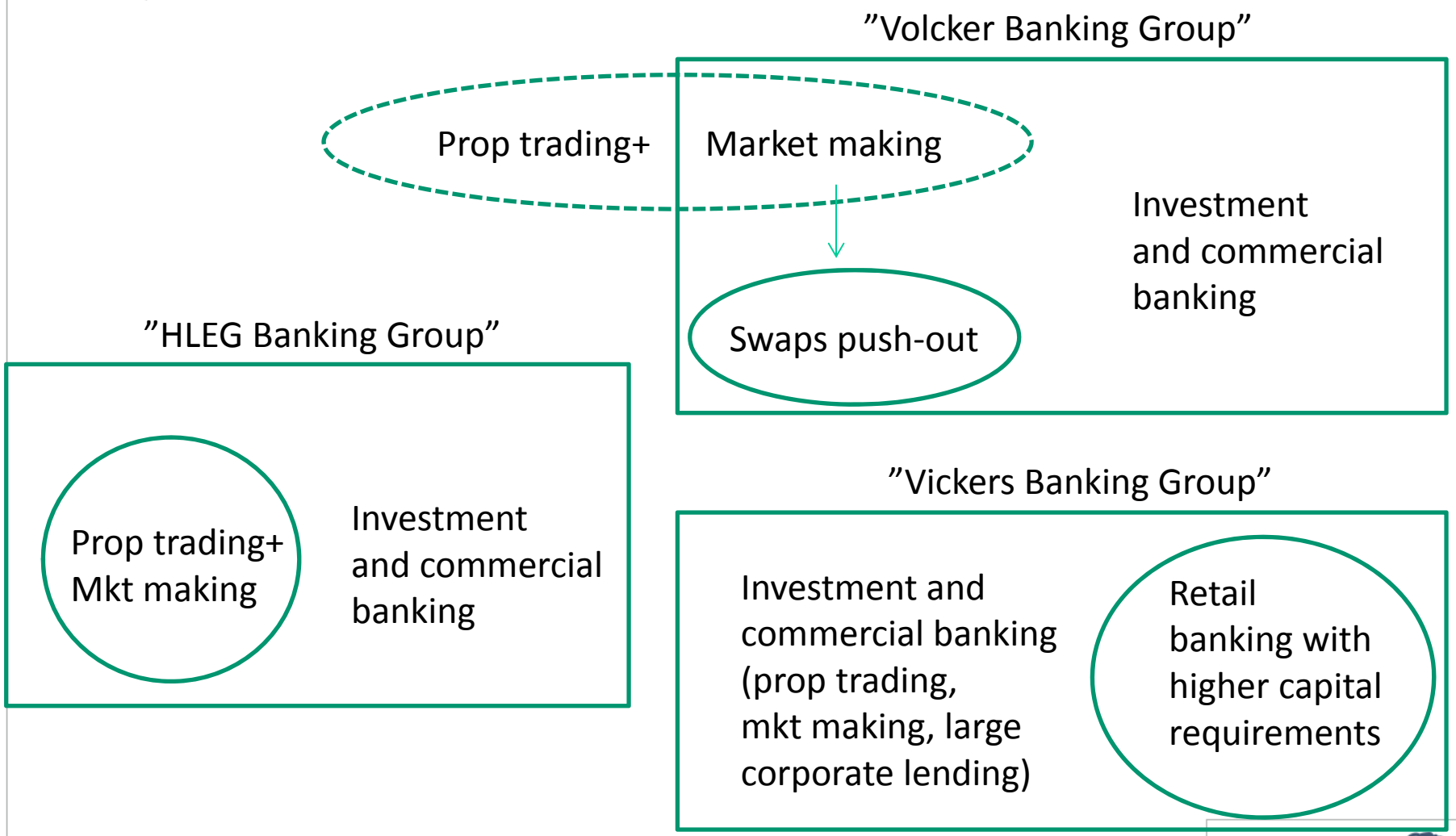
Proposal by HLEG Banking Group in comparison



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Prop trading bans and ring-fences

- Banning generic prop trading (Volcker)
  - Does not erase flow prop trading, unless market making is defined very restrictively (i.e. high-liquidity markets)
- Ring-fencing commercial and retail banking (Vickers)
  - Investment and commercial banking are intertwined, even if there is no speculation. “Ancillary” services , like risk management, are permitted inside the fence, raising similar concerns as above.
  - May affect MIB severely, because of exposure limits.
- Banning prop trading and market making (Liikanen)
  - Flow prop trading significantly reduced.
  - May affect MIB severely, because of exposure limits.

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Summary of structural measures under Liikanen

- Separation
  - Proposal is not about separation of deposit and investment banking - but about ring-fencing of significant trading activities.
    - Reducing complexity s/th RRD can be applied.
    - Avoiding cross-subsidization (from deposit guarantees), forcing trading book activities to be cost covering.
  - New institutions in Europe: small number of broker-dealers with large balance sheets.
    - Overall trading activity may decline, because it is more expensive.
    - Overall universal banking may gain, because it is less expensive.
    - Possible effects on large banks and large groups may be smaller than expected, but needs impact study.
  - Not fully compliant with *Ordnungspolitik*.

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Back to the where we started: Regulatory reform in Europe … on feet of clay

- Despite doom predictions from many sides, reform process is ongoing though slowly, digressive, circumventive.
- Monetary union plus multilateral agreements, approximating a fiscal union.
- Increasingly seen as exemplary for other parts of the world, too.
  - Basic architecture of regulatory reform (next slide)
  - However, still on feet of clay (last section)
- Now facing the credibility cliff
  - AQR --> pre-requisite for SSM
  - SSM, SRM, SRF --> impartiality and ‚solvency' of supervision and resolution process
- This is today's front line in the battle against TBTF in Europe.
  - Serious AQR doubtful unless capital backup exists.
  - Consolidation plan needed, too (DG Competition).

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Thank you for your attention

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Appendix - 1

1. De-minimis rule under Liikanen separation proposal
2. Other features of Liikanen's separation proposal
3. Separation: what will be market response?
4. Separation: less liquidity?
5. Separation: less risk transfer
6. Proposals and their narrative
7. One-page summary

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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.

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Other features of Liikanen separation proposal

- Higher capital charges were discussed as an alternative to separation.
- Broker-dealer
  - and universal bank under one holding.
  - has own funding, equity and debt
  - cross guarantees uni-directional (from TB to UB, but not reverse)
- Prop trading not prohibited for holding company (at TB, not at UB)
- Two roads to separation
  - Avenue 1: first, higher capital buffer (not risk-weighted) for banks with large trading book. Then RRP. Second, if RRP not accepted by supervisor, separation is mandatory.
  - Avenue 2: Immediate separation, upon crossing a defined threshold (e.g., trading assets)

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What will be the market response?

- Market response is a general equilibrium issue.
- Emergence of broker-dealers – as independent arms of Sifis.
  - Need to fulfill capital requirements as well, including bail-in *(first-in-line)* debt.
- Will smaller institutions (below-*de-minimis*) grow their trading business, taking over from the broker-dealers?
  - Probably not, assuming fixed costs in trading to be significant.
  - Rather, and for the same reason, broker-dealers may take over business from smaller institutions.

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Will there be less liquidity?

- What happens to platform strategy of "flow monsters"?
  - Possibly, financial engineering advisory will continue as before, now provided by the broker-dealer, only execution of resulting net positions is outsourced to one/more broker-dealers.
  - Thus, conceivably, platform strategy can be largely maintained.
  - However, broker-dealer has to pay funding costs commensurate with its stand-alone risk.
- Profitability of market making-cum-prop trading likely to shrink
  - (General equilibrium adjustment is complicated to forecast, however)
- Effect on trading volume and liquidity
  - Thakor (US Chamber of Commerce, 2011): Volcker rule will reduce liquidity, increase spreads, lower credit volume, lower economic growth.
  - Does not consider general equilibrium repercussions, e.g. new entrants (broker-dealers), new price level, new market models.

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Will there be less risk transfer?

- Securitization of the loan book was the early success story of a cooperation between commercial and investment banking. Will this be made impossible?
- Probably no material change, if one allows structuring expertise to be outsourced (to the ring-fenced trading house, for instance).
- Consider the joint effect of separation and bail-in debt issues.
  - Bail-in debt transfers the most junior debt layer in the bank balance sheet to private investors outside the banking system, making it more resilient against shocks.
  - More risk transfer than before the crisis likely.

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Proposals and their narratives

US (Volcker): Excessive risk taking (through propietary trading)

→ *Spin off prop trading*

UK (Vickers): Excessive risk taking (through investment or commercial banking) affects economy's core financial services.

→ *Ring-fence core services*

EU (Liikanen): Systemic risk as the key challenge for prevention and intervention (no banking type was safe).

→ *Ring-fence complex trading*
→ *Ensure debt is bail-in able*

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Summary

- Separation
  - New kids on the block: small number of broker-dealers with expanded portfolios.
  - Overall trading activity may decline, because it is more expensive.
  - Overall universal banking may gain, because it is less expensive.
  - Possible effects on large banks and large groups may be smaller than expected, but needs impact study.
- Bail-in
  - Key feature to bring back market discipline to banking
  - Market probably large enough – bail-in debt design details are key.
  - Raising bail-in debt pose a problem for Groups with implicit deposit guarantee schemes.
  - New role for fund industry (as anchor of banking system).
  - New role for supervisor: ensuring bail-in ability.

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