Too-big-to-fail and a reform of banking structures

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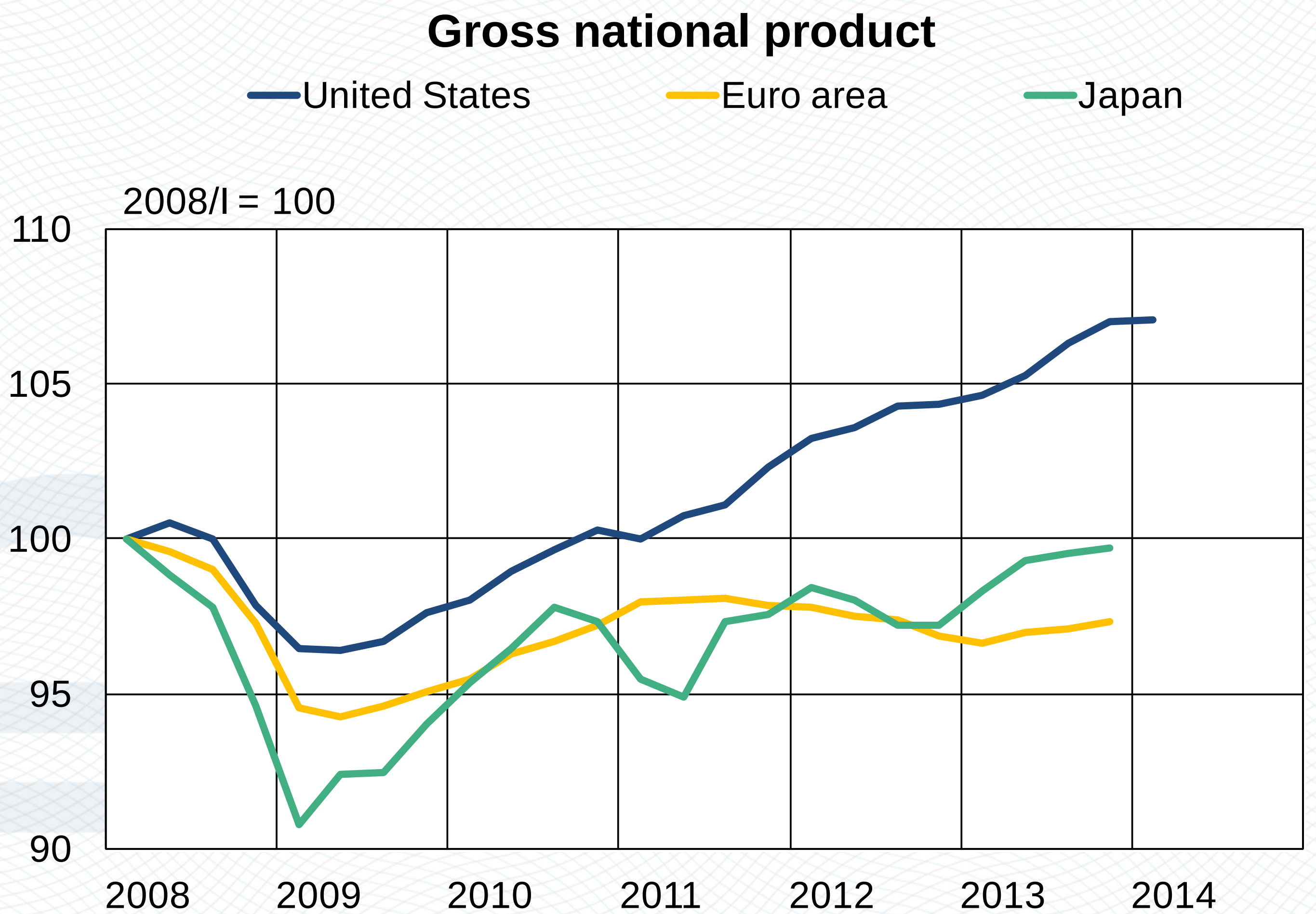
Outline

- *On the regulatory reform*
- *The Group's proposal for mandatory separation*
- *On Commission's proposal*
- *Conclusion*

On the regulatory reform

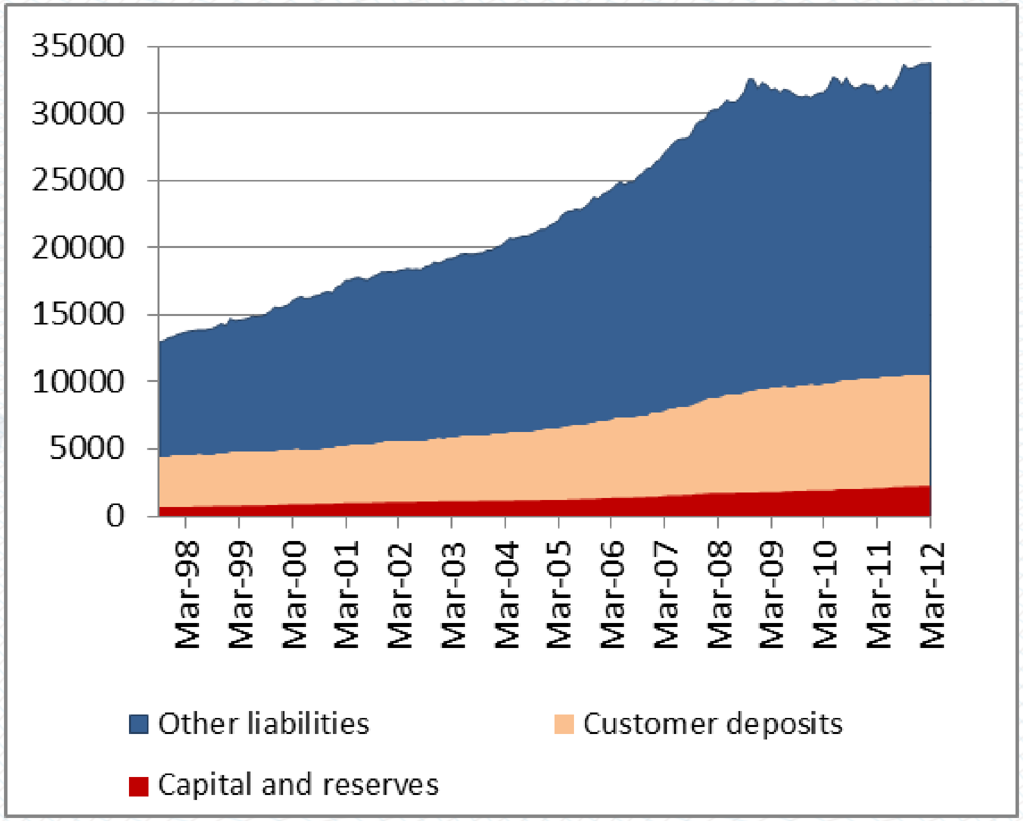
Substantial crisis impact on the real economy, particularly in Europe



Source: National statistical authorities and Eurostat.

A need to improve banks' true loss absorbing capacity

Liabilities of MFIs in the euro area 1998-2012 (billion euros)



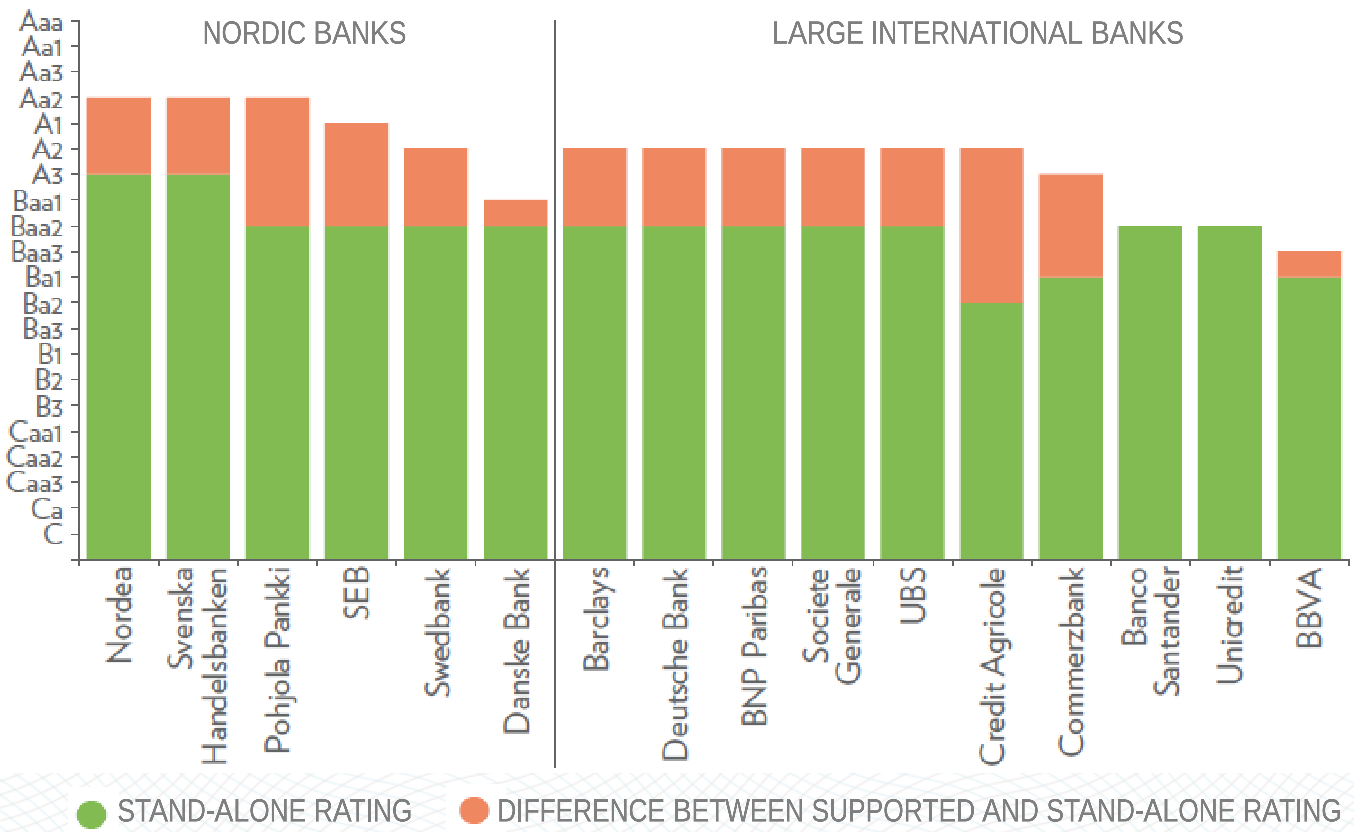
Source: ECB data as presented in High-level Expert Group Final Report
Notes: Customer deposits are deposits of non-monetary financial institutions excluding general government.

Focus of current regulatory reforms

- ***Regulatory reforms have focused on two crucial areas***
  - **Capital adequacy and liquidity requirements** as set by Basel III and implemented in EU by means of regulation and a directive
  - The Commission's recovery and **resolution framework**
- ***These regulatory reforms are major steps to***
  - improve the resilience of banks,
  - reduce incentives for excessive risk taking and leverage,
  - reduce complexity and interconnectedness and
  - reduce the social costs of bank failure and the need for implicit government guarantees

Funding costs are artificially low due to too-big-to-fail expectations

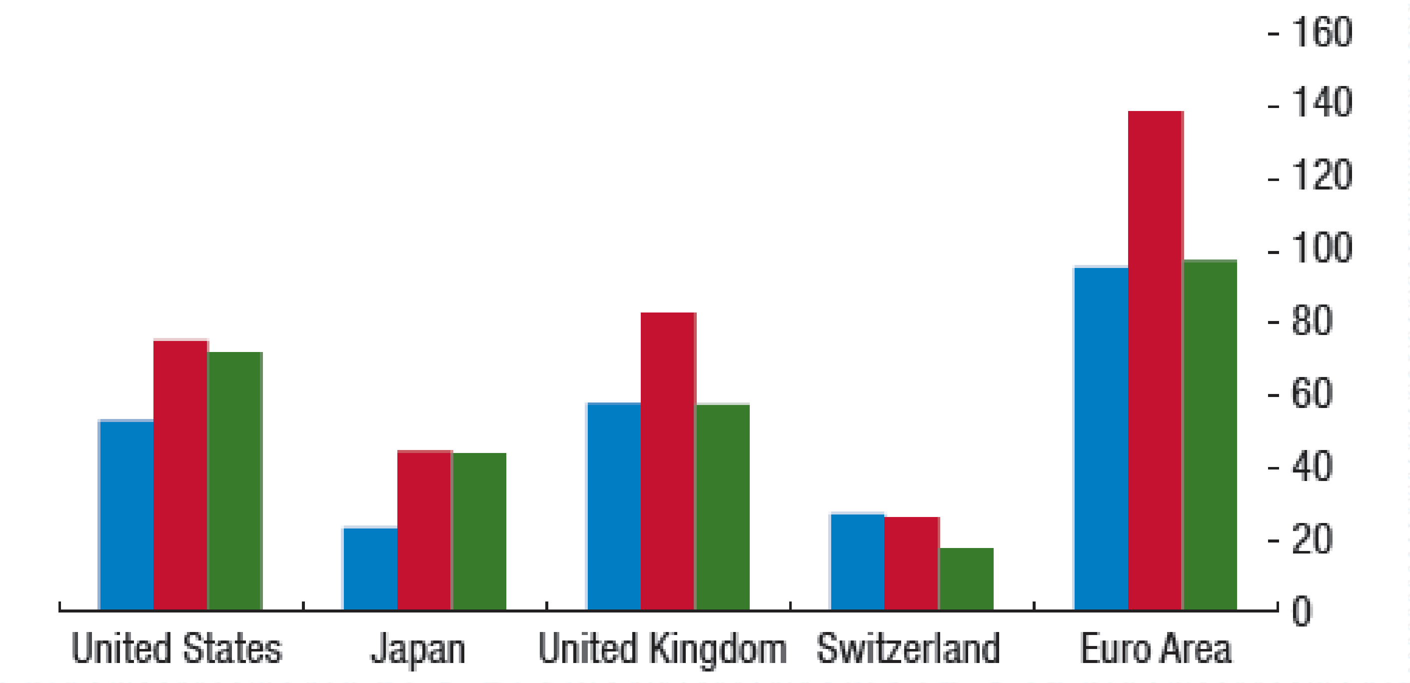
Moody's credit ratings for selected Nordic and European banks



Source: Moody's Investor Services (data as of 9 April 2013). Note: For Pohjola and Credit Agricole, the assumption of intra-banking group support is reflected in difference between the supported and stand-alone rating.

Implicit subsidies remain high

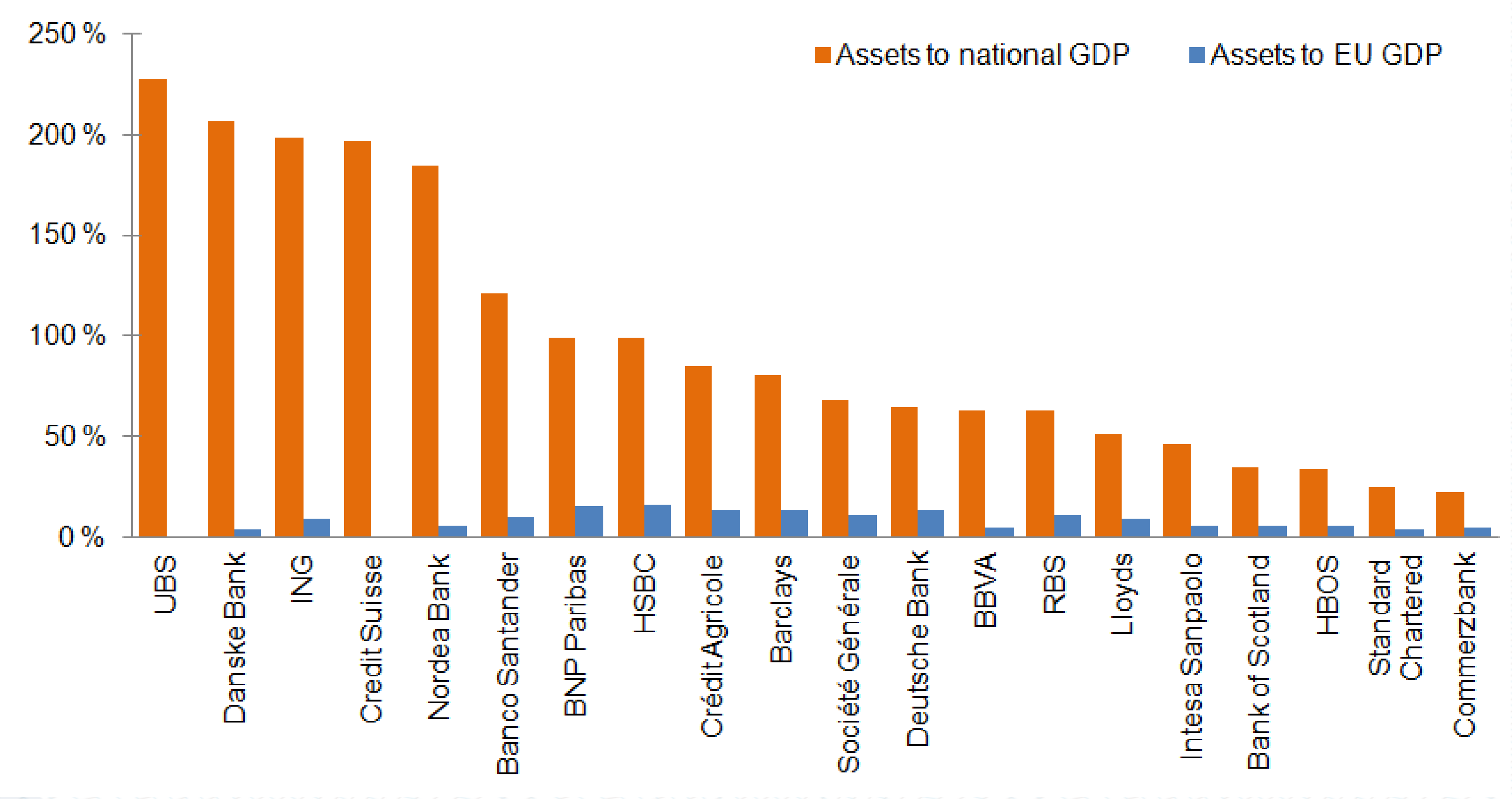
Implicit subsidy for globally systemically important banks (billions of US dollars) using ratings-based approach with recent estimates



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

Many European banks are larger than their home country

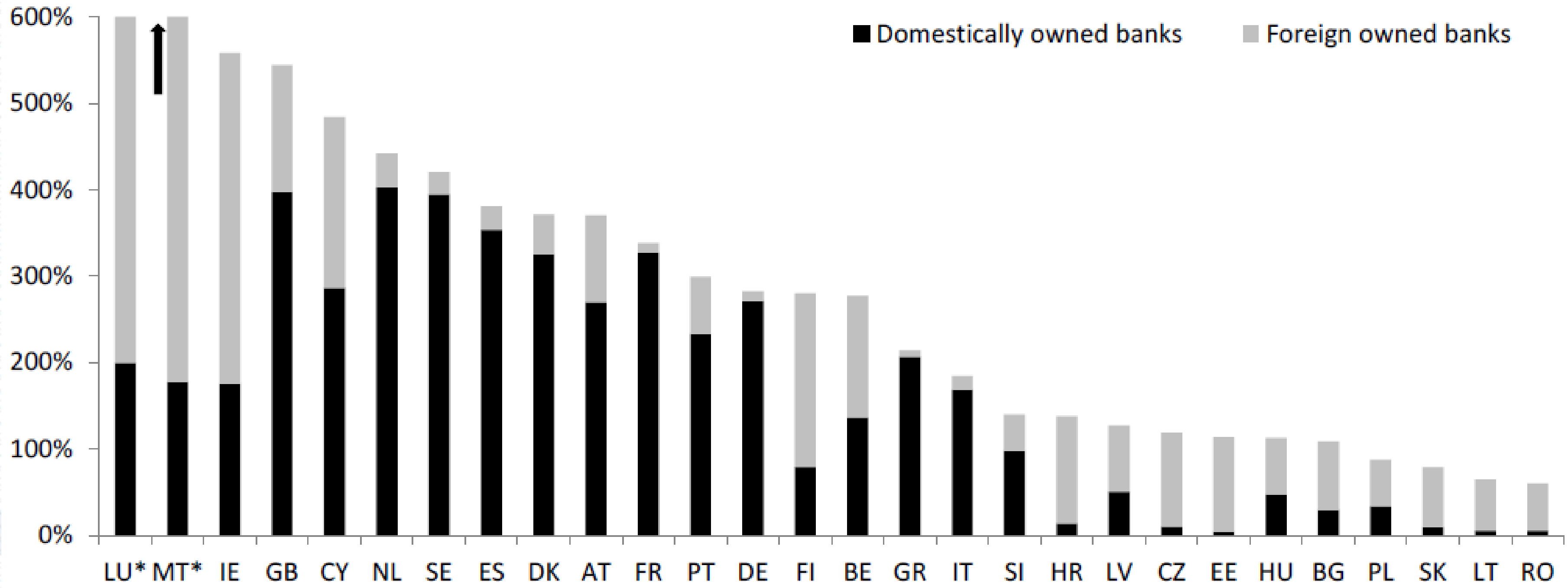
Bank's assets 2013 (% of national and EU GDP)



Source: Bankscope and Eurostat

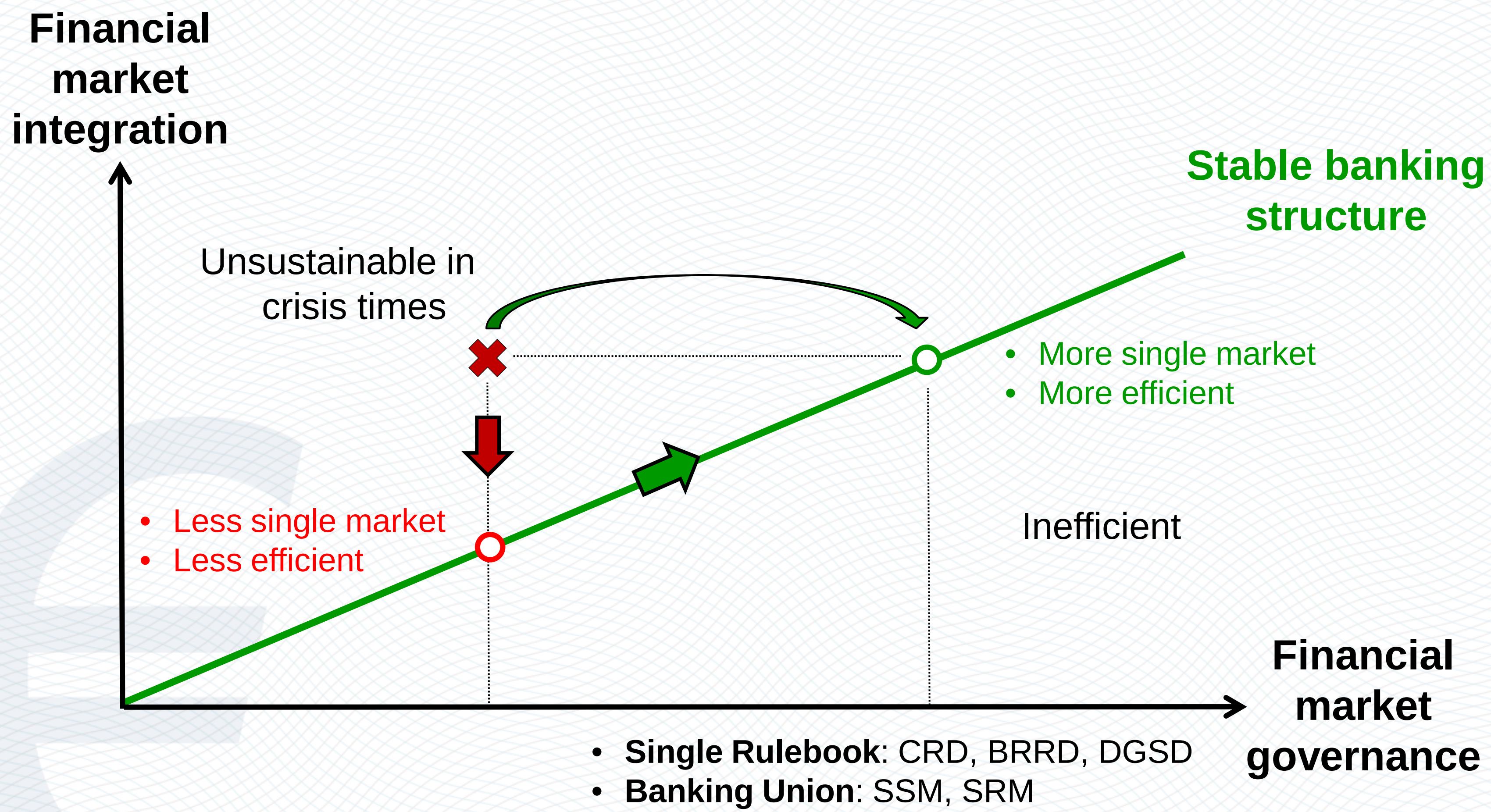
The banking sector is particularly large in several European countries

Total consolidated assets of domestic and foreign owned banks to GDP (H1/2013)



Source: ECB consolidated banking data and the IMF World Economic Outlook as presented in European Systemic Risk Board, Is Europe Overbanked? Reports of the Advisory Scientific Committee No. 4/June 2014
Note: The values for Luxembourg and Malta are 1719% and 798% respectively

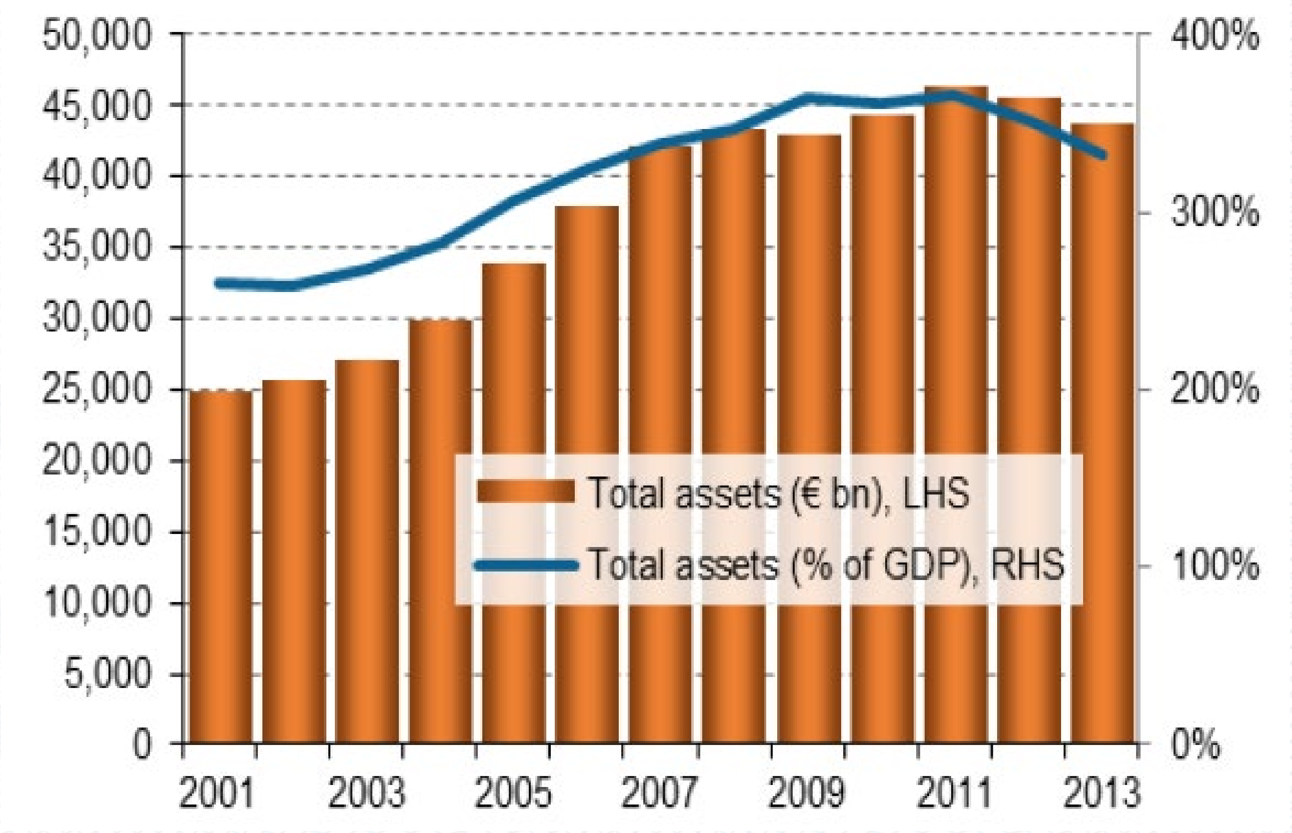
Financial market integration and governance must be complements



Source: European Commission, some modifications by Bank of Finland

Rapid growth in the EU banking sector pre-crisis

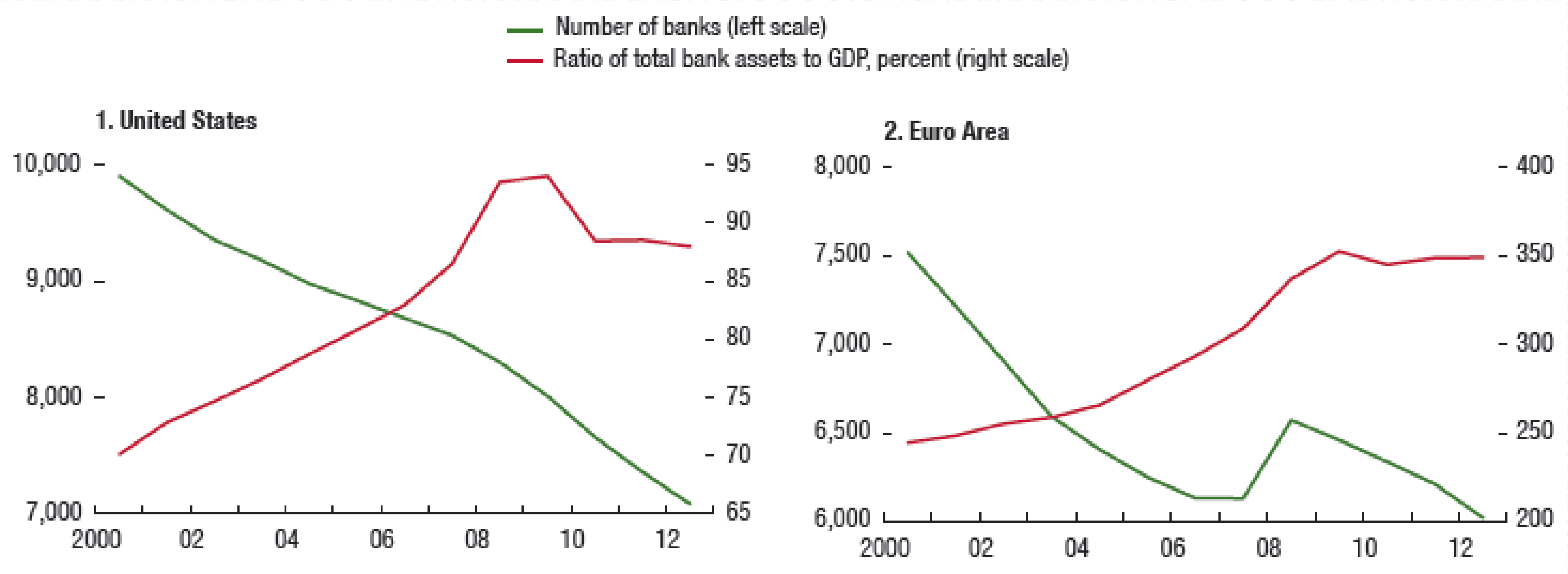
Total assets of EU monetary financial institutions



Source: ECB data as presented in Commission Staff Working Document Accompanying the Commissions Communication “A reformed financial sector for Europe” 15 May 2014

The banking sector in the US is smaller than the euro area banking sector

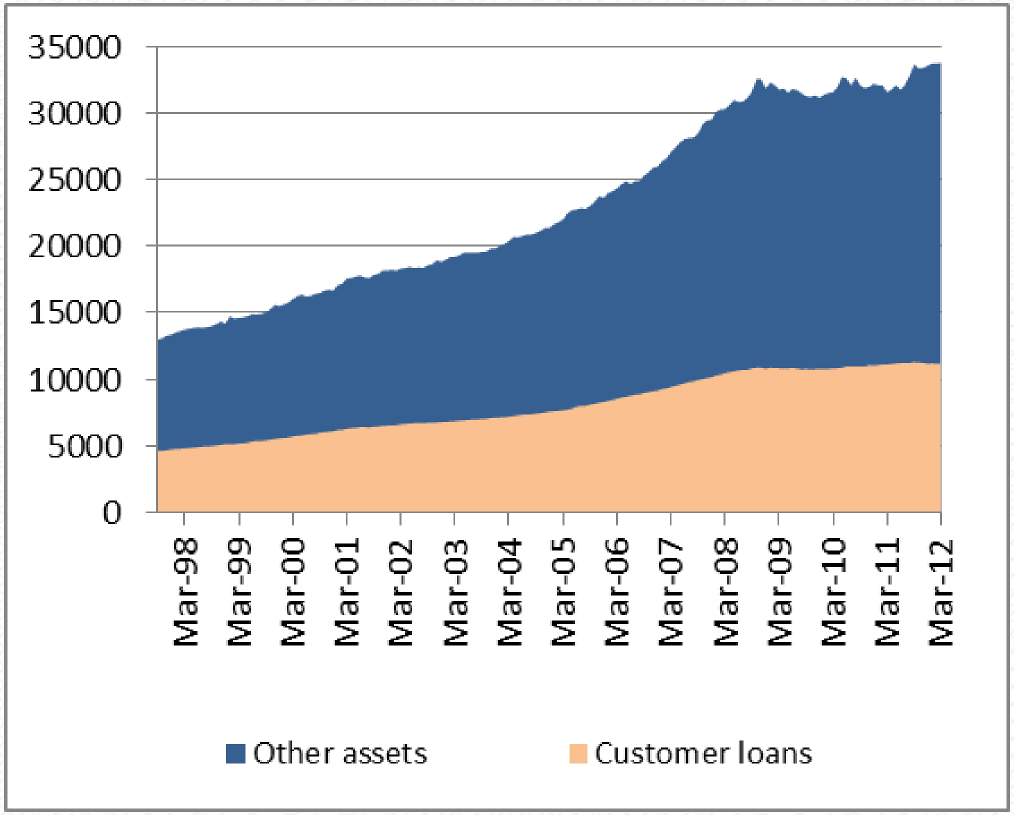
Number of banks and size of the banking sector



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

Focus of operations shifted away from customers

Assets of MFIs in EU the euro area 1998-2012 (billion euros)



Source: ECB data as presented in High-level Expert Group Final Report
Notes: Customer loans are loans to non-monetary financial institutions excluding general government

Extract from IMF's event study on regulatory announcements

Table 3.2. Event Study

Events	Date	Abnormal Returns: CDS Spreads (Basis points)	Abnormal Returns: Equity Returns (Percent)	
		Constant Mean	Constant Mean	Market Model
United States				
Blueprint of the reform bill presented by President Obama	June 17, 2009	36.36**	–0.0286***	–0.0241***
Announcement of the Volcker Rule	Jan. 21, 2010	12.53***	–0.0366***	–0.0307**
U.S. banks set to lose lobby fight on swaps	June 11, 2010	25.24***	0.0078	–0.0011
Dodd-Frank Act signed by President Obama	July 21, 2010	–2.28	–0.0182	–0.0033
New leverage ratio requirement adopted	July 9, 2013	–10.38***	0.0062	–0.0022
United Kingdom				
Announcement of the Volcker Rule in the United States	Jan. 21, 2010	10.98***	–0.0478**	–0.0379**
Appointment of the Vickers Commission	June 16, 2010	–8.26**	0.0082	0.0014
Barclays warns to leave the U.K. in case of a bank break-up	Aug. 5, 2010	–7.08**	–0.0140	–0.0042
Publication of the Vickers Report	Sep. 12, 2011	30.30***	–0.0686***	–0.0271*
E.U. statutory bail-in requirement	Aug. 1, 2013	–7.14*	0.0338*	0.0246
Euro Area				
Announcement of the Volcker Rule in the United States	Jan. 21, 2010	12.10***	–0.0258***	–0.0230***
Commission Proposal for Bank Recovery and Resolution Directive	June 6, 2012	–4.73*	–0.0205***	–0.0123***
Commission Proposal for Deposit Guarantee Scheme	July 12, 2012	11.25**	0.0425***	0.0234***
Eurogroup's approval for Spanish bank recapitalization	July 20, 2012	2.65	–0.0440***	–0.0438***
Commission Proposal for Single Resolution Mechanism	July 10, 2013	–0.42	–0.0038	–0.0034
E.U. statutory bail-in requirement	Aug. 1, 2013	–15.29***	0.0309**	0.0318**
Switzerland				
Appointment of the "too-big-to-fail commission"	Nov. 4, 2009	1.17	0.0392	0.0184
Announcement of the Volcker Rule in the United States	Jan. 21, 2010	11.10*	–0.0119**	–0.0087**
Press conference on preliminary too-big-to-fail report	Apr. 22, 2010	23.69	–0.0301	–0.0152
Press conference presenting final report on too-big-to-fail	Oct. 4, 2010	–6.85*	0.0305*	0.0190*
E.U. statutory bail-in requirement	Aug. 1, 2013	–2.63	0.0286*	0.0224

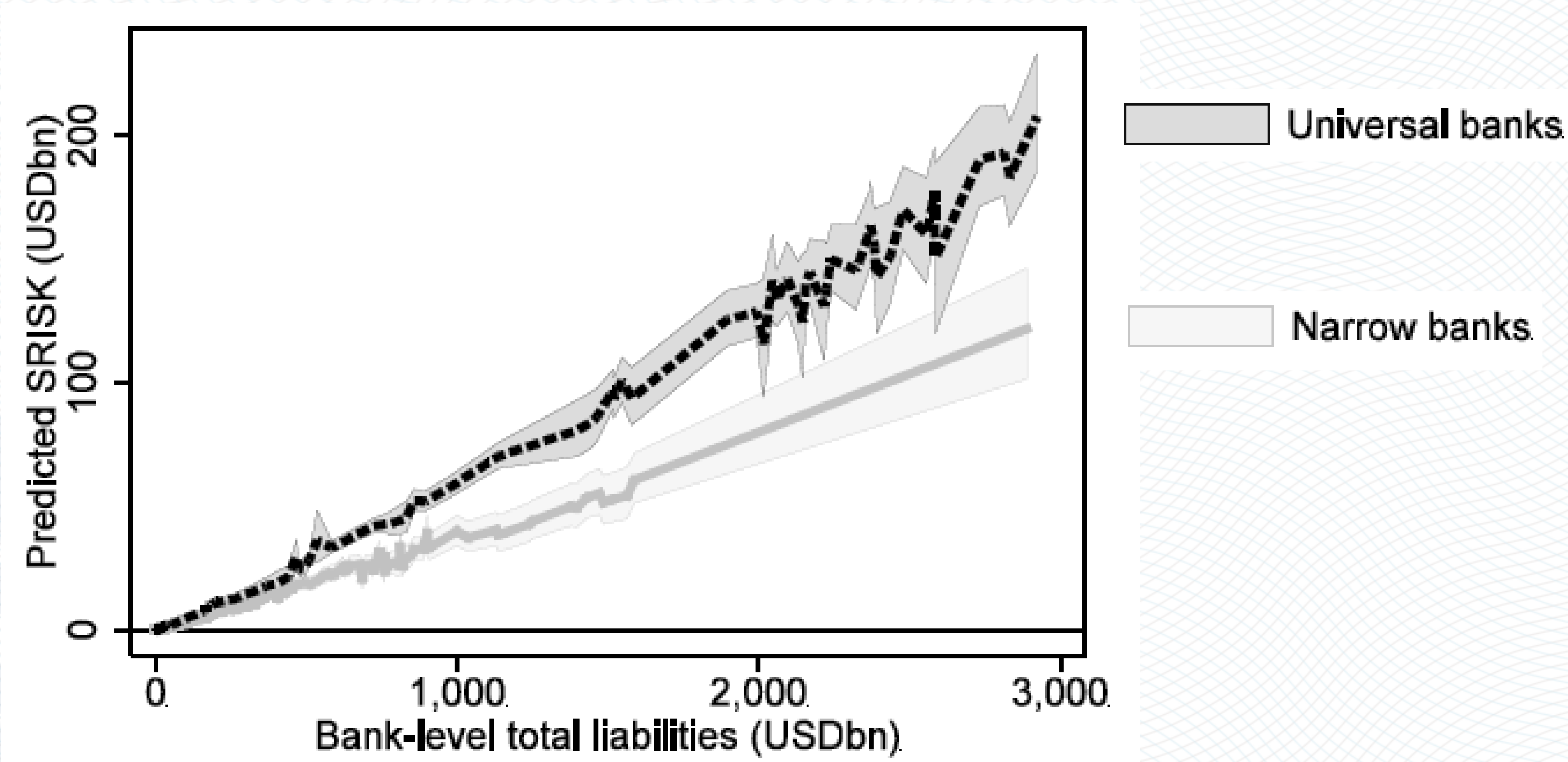
Source: IMF staff estimates.

Note: ***, **, * = statistically significant at the 1, 5, and 10 percent levels. The event date is defined as the day of the policy event or the closest date in case the announcement was made on a date for which market data are not available. CDS spreads and abnormal returns in the constant mean model are estimated based on a two-week window prior to the event. The market model is estimated on a six-month sample period before the event. Since G-SIBs generally make up a large share of overall stock indices, a nonfinancial index or an industrial index is used (when the nonfinancial index is not available). Note that the estimates from the market model should be considered as a lower bound of the effects of the policy announcements as policy initiatives likely have some impact on nonfinancial corporates through the credit channel. CDS = credit default swap; E.U. = European Union; G-SIB = global systemically important bank.

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

Contribution of banks to systemic risk

Predicted SRISK of universal and narrow banks



Source: ECB consolidated banking data and the IMF World Economic Outlook as presented in European Systemic Risk Board, Is Europe Overbanked? Reports of the Advisory Scientific Committee No. 4/June 2014.
Note: The lines show the point estimates and the shaded areas show the 95% confidence intervals.

The Group’s proposal for mandatory separation

Two alternative avenues

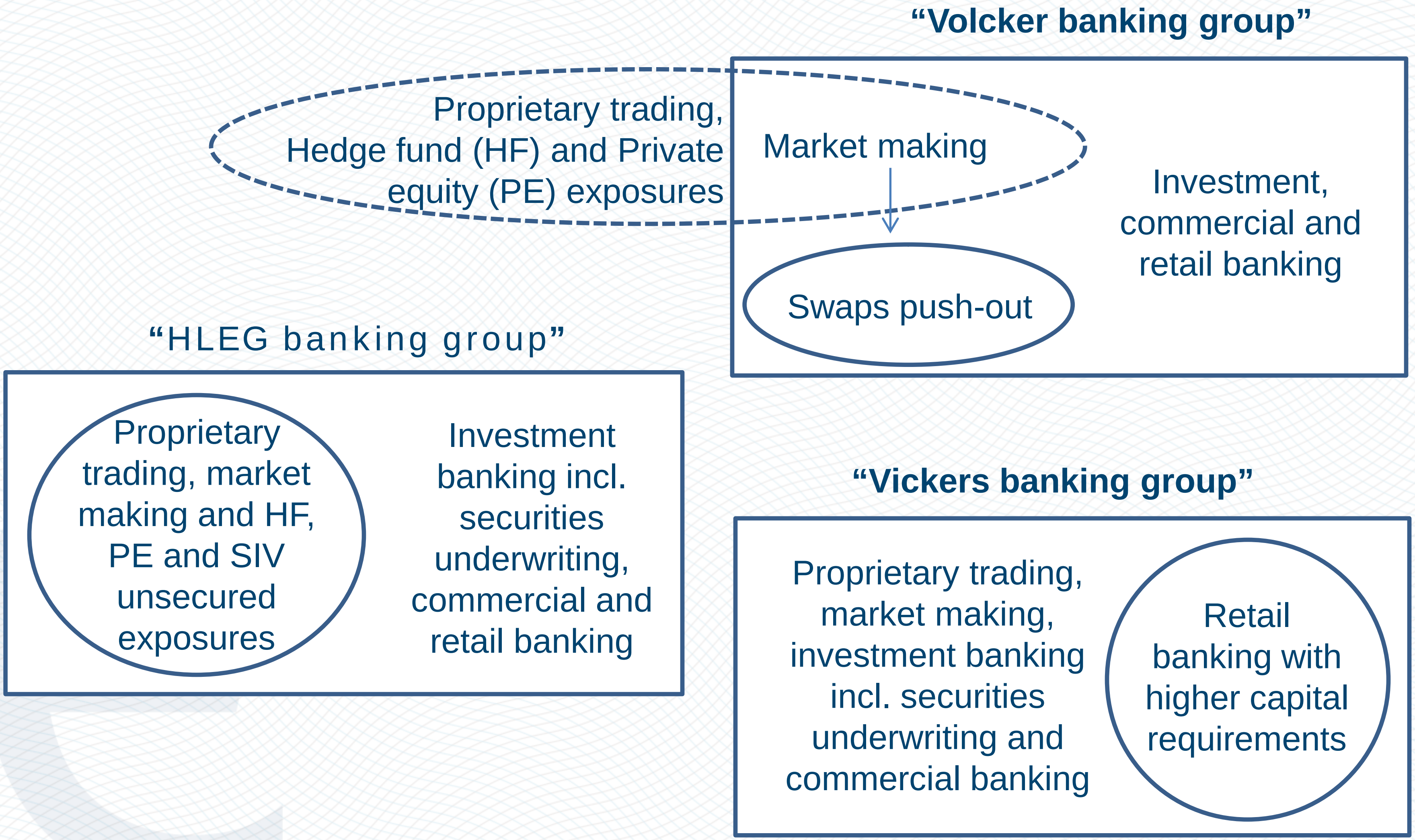
- **Avenue 1**
  - A non-risk weighted capital requirement is imposed on trading activities.
  - Conditional separation of activities is imposed, if the bank cannot prove that the required recovery and resolution plan is credible.
- Cf. Darrell Duffie

- **Avenue 2**
  - Mandatory separation of retail banking and investment banking is imposed on banks.
- Cf. Alan Blinder

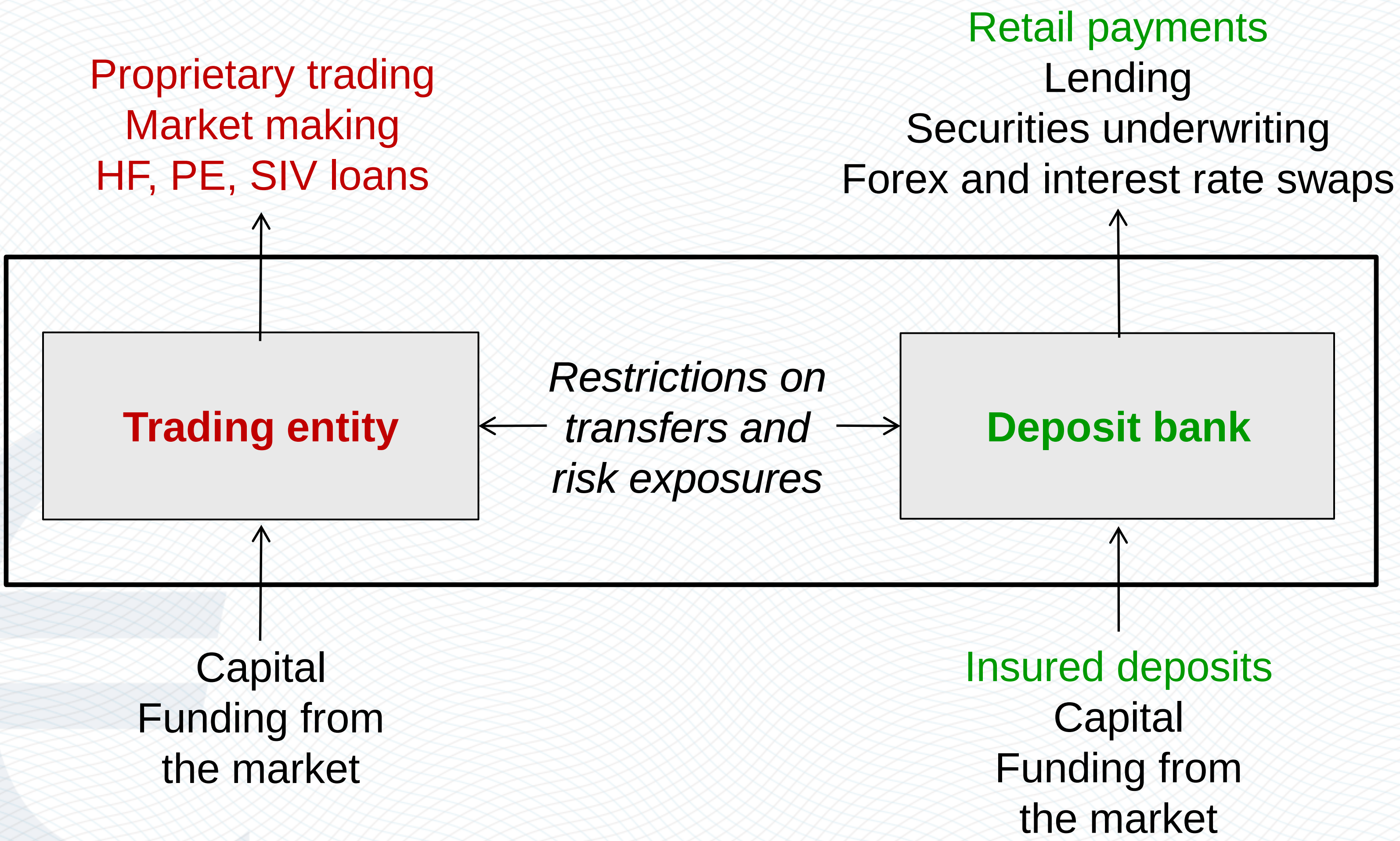
Rationale for mandatory separation

- ***Prohibit banks with insured deposits from engaging in trading activities where risks might be high and difficult to measure precisely***
  - Complements risk-based capital requirements
- ***Reduce complexity and interconnectedness***
  - Enhances bank management and supervision
  - Makes the pricing of funding of the separated entities more efficient and risk-based
  - Facilitates recovery and resolution and thus helps make it credible
- ***Reduce mixing of management cultures***

Comparison of structural reforms



"One-stop shopping" still possible in the proposal for structural reform



On Commission’s proposal

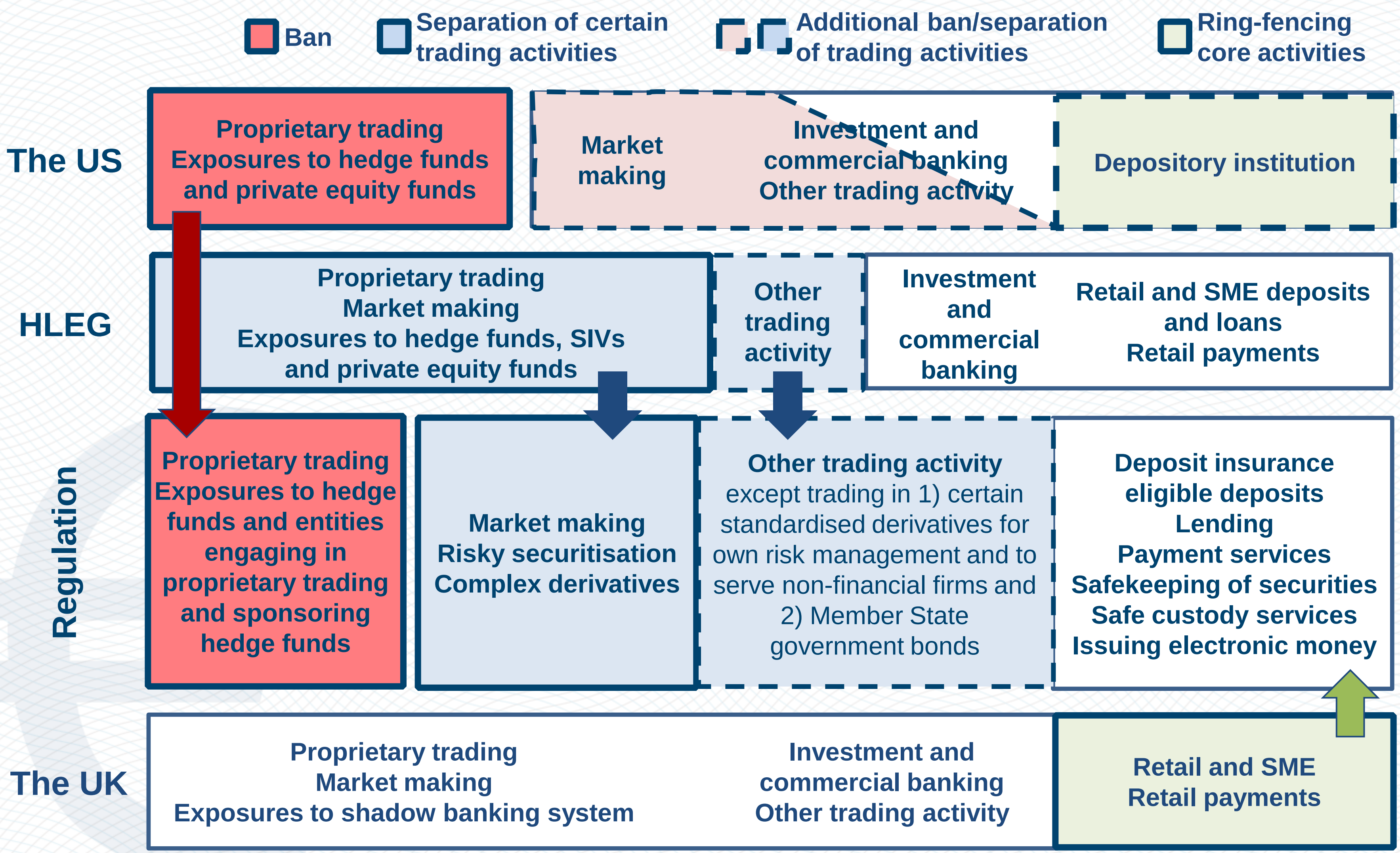
From idea to proposal on Regulation on structural measures in two years

- **November 2011**: Commissioner Barnier announces the setting up of a group to assess the need for structural reform of the EU banking sector
- **January 2012**: Commissioner Barnier appointed the High-level Expert Group (HLEG)
- **October 2012**: The HLEG presented its Final Report to the Commissioner
- **End of 2012**: Commission consultation on HLEG Final Report
- **May 2013**: Commission consultation on ”Reforming the structure of the EU banking sector”
- **July 2013**: The European Parliament adopted the initiative report ”Reforming the structure of the EU banking sector”
- **January 2014**: Commission proposal on “Regulation on structural measures improving the resilience of EU credit institutions”

The objectives of Commission's proposal for structural reform

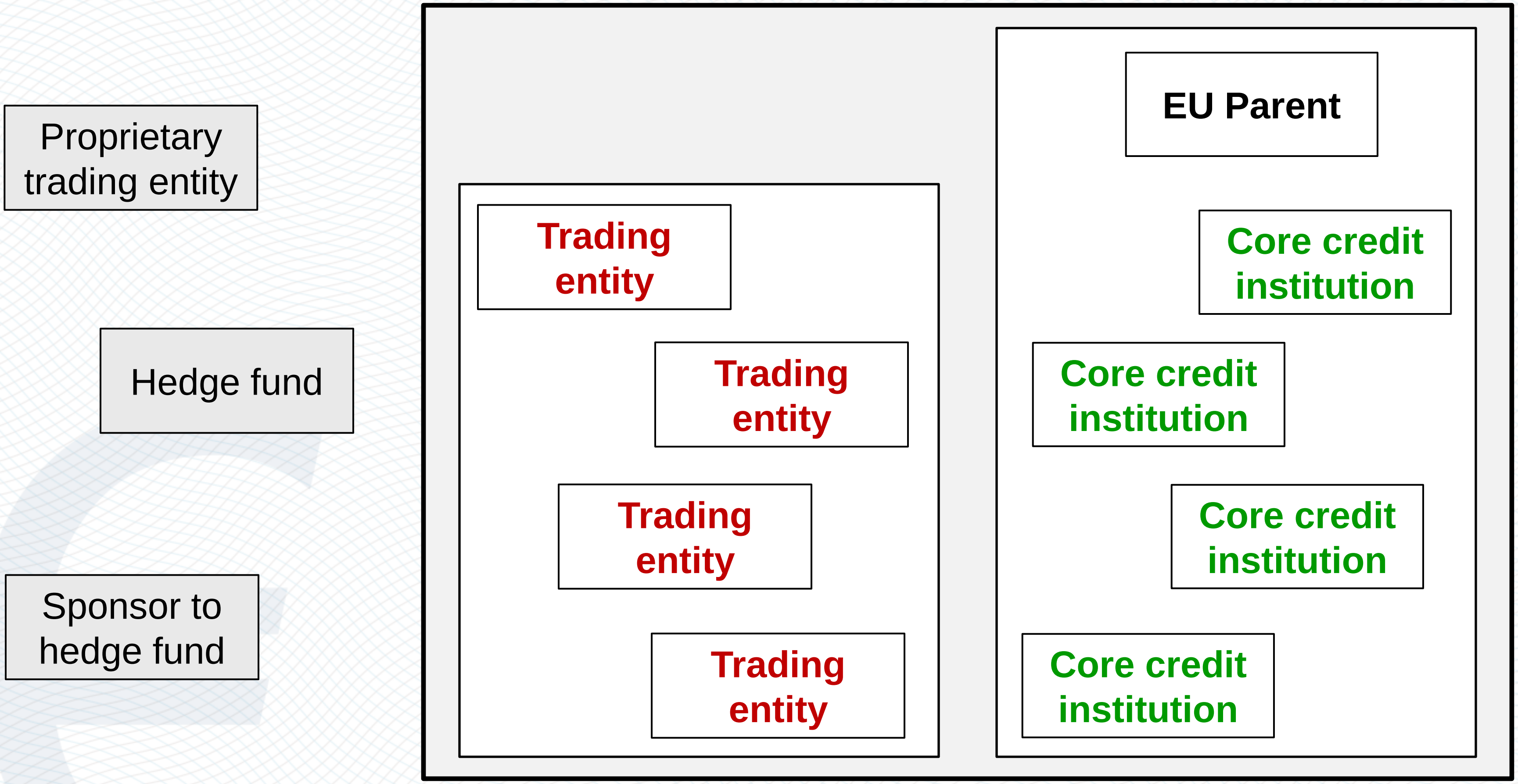
- ***Reduce excessive risk taking***
- ***Remove material conflicts of interests in the bank***
- ***Avoid the misallocation of resources and encouraging lending to the real economy***
- ***Ensure undistorted conditions of competition***
- ***Increase transparency and reduce interconnectedness within financial sector***
- ***Facilitate efficient management, monitoring and supervision***
- ***Facilitate recovery and orderly resolution***

The Regulation takes elements from structural reforms previously proposed



Banking groups are to be structured in two sub-groups

EU banking group after "subsidiarisation"



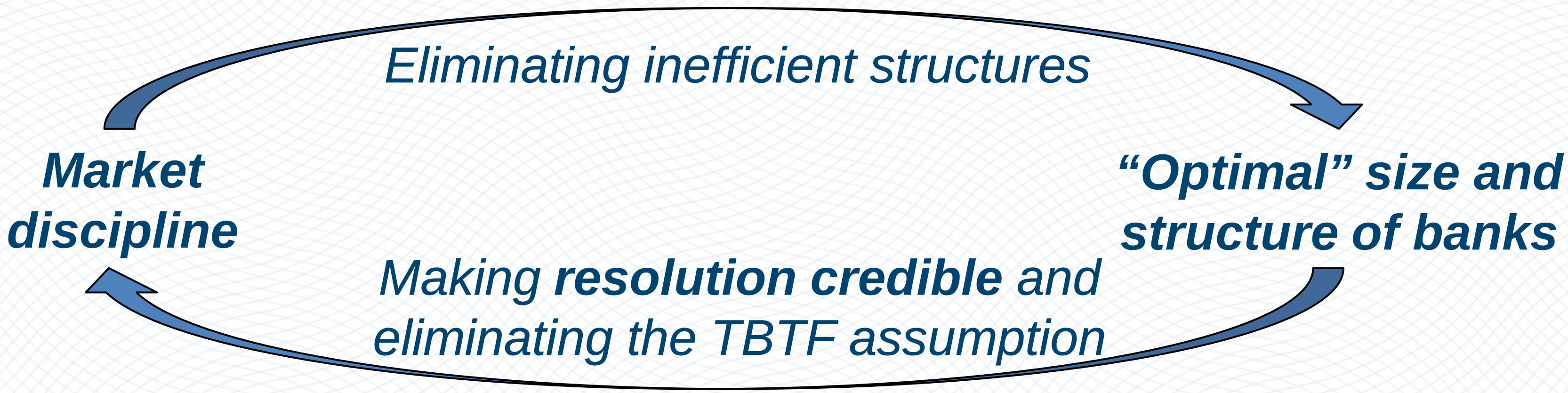
Note: The EU parent can belong to the sub-group of core credit institutions or to the sub-group of trading entities. The Regulation also apply to 1) foreign subsidiaries and branches of EU banks and 2) EU subsidiaries and branches of foreign banks. Prudential requirements apply on individual but also on sub-consolidated level.

G-SIBs and banks exceeding limits on trading activity would be affected

- *All globally systemically important banks*
- *Banks where the trading activities exceed 70 billion euro or 10 % of total assets*
- *A de minimis rule of 30 billion euro in total assets*
- *The supervisor can decide to extend the separation requirement to banks below the thresholds*
- *Based on current data, the Regulation would apply to about thirty banks*

To conclude

Measures are needed to improve market discipline



- ***A “bad” and “good” steady state equilibrium:***
  – Weak market discipline and suboptimal bank size and structure from the point of view of the society
  – Efficient market discipline and bank size and structure more beneficial for the society
- ***Push from authorities needed to shift from bad to good equilibrium***

On the role of banking

- ***Banks play an important role in the society***
  - Payment services
  - Allocate savings to investments
  - Risk management services

- ***Banks have a pivotal role in providing finance to the real sector particularly in Europe***

- ***Strengthening banks' ability to provide socially vital financial services efficiently and in a stable manner benefits our societies at large***

Thank you!