# On the size and the structure of the banking sector

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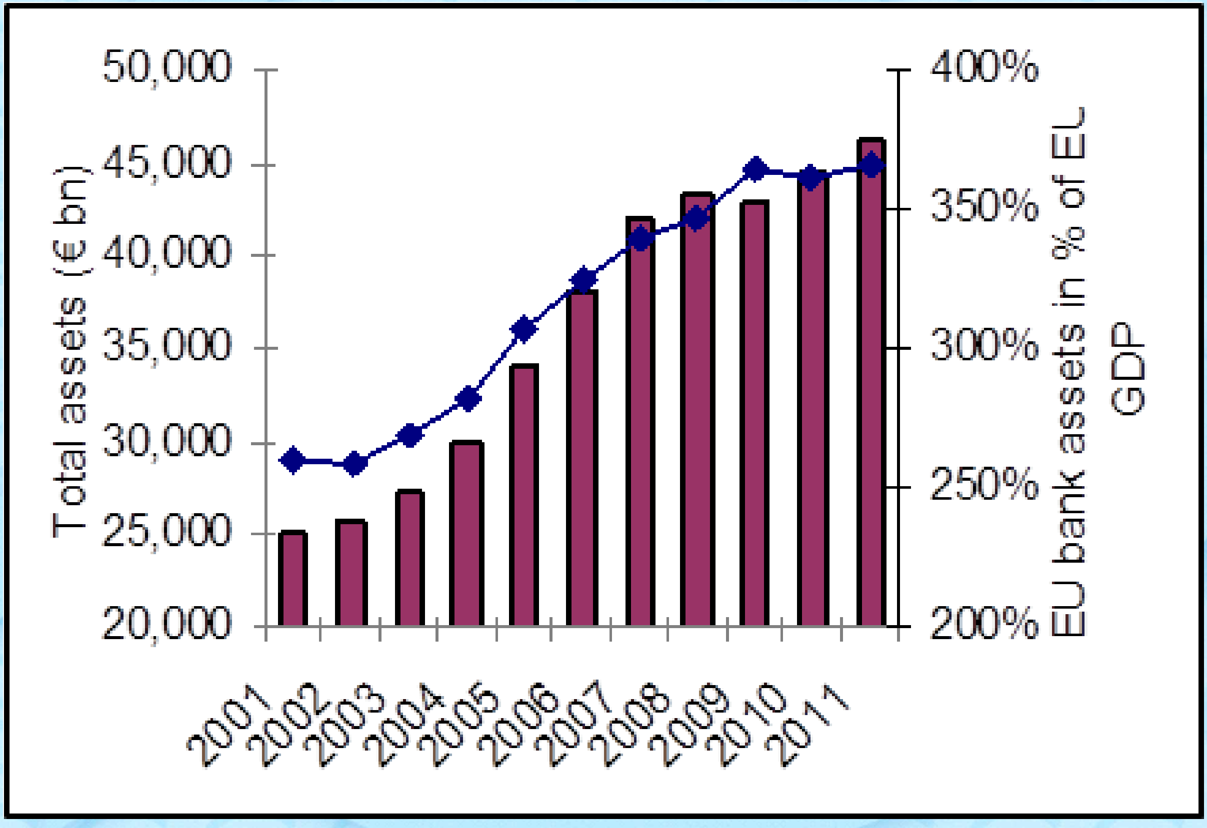
# Rapid growth in the EU banking sector

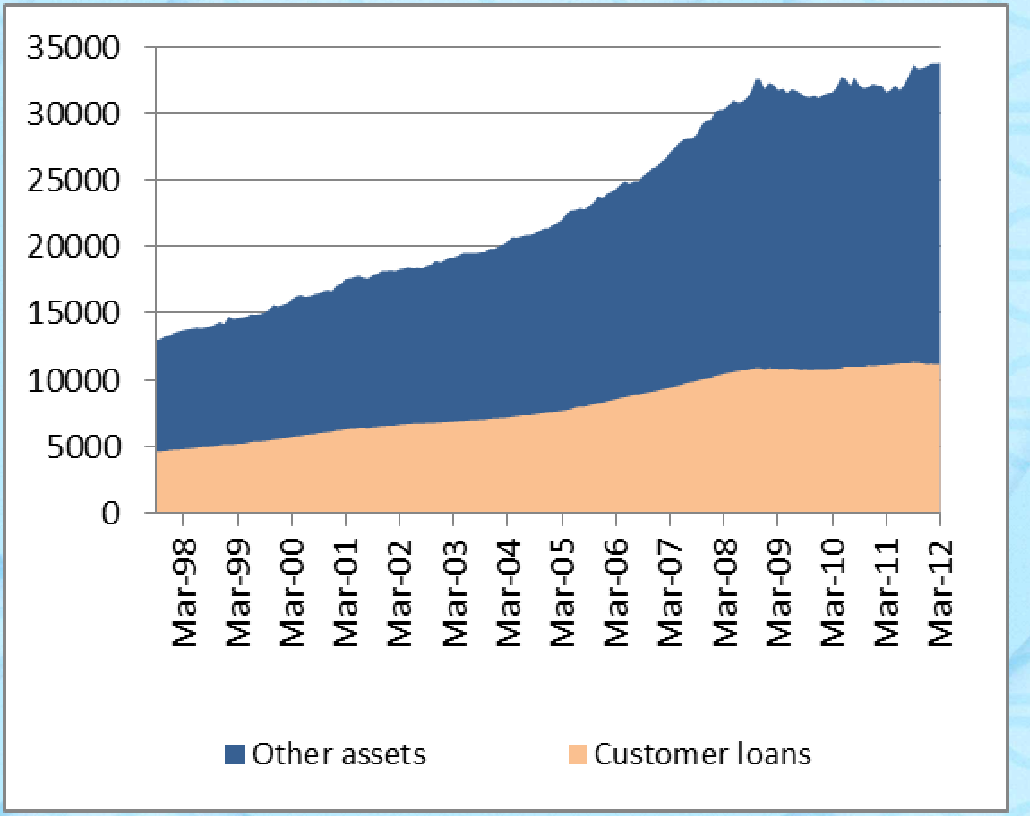
**Total assets of MFIs in EU 2001-2011**




Note: Bar charts show total assets, dotted line shows assets as % of GDP
Source: ECB data as presented in High-level Expert Group Final Report

# Shifts in focus of operations as illustrated by shifts in assets structures

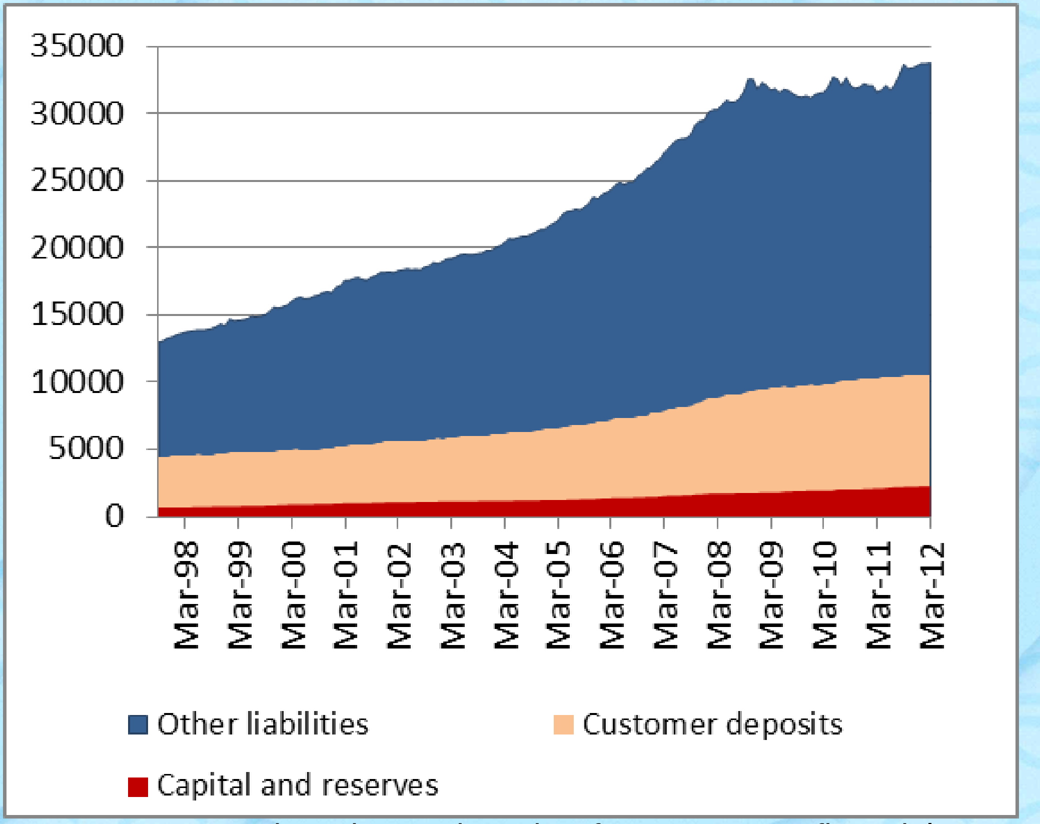
**Evolution of assets of MFIs in EU the euro area 1998-2012 (€ billion)**




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

# Increased leverage as illustrated by shifts in funding structures

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




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

# Summary of the problems in the EU banking sector identified by HLEG

**Identified problem by HLEG**

- Excessive risk-taking in trading, lending, funding
- Complexity (making bank management, monitoring, supervision and resolution challenging)
- Limited loss absorbency
- Intra-group subsidies
- Ineffective governance and control

- Interconnectedness
- Limited resolvability
- Bank-sovereign feedback loop

- Inadequate EU institutional framework
- Excessive focus on intra-financial business, as opposed to real economy
- Competitive distortions and implicit subsidies
- Inadequate consumer protection

**Result**

Increased probability of failure

Increased impact of failure

Reduced internal market efficiency and level playing field

# Two avenues as a possible way forward were considered

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

- Cf. Darrell Duffie
- Cf. Alan Blinder

# The High-level Expert Group's proposal for mandatory separation

- ***Activities separated to the "trading entity":***
  - Proprietary trading and market-making
  - Loans, loan commitments and unsecured credit exposure to hedge funds, SIVs, and private equity investments
- ***Activities which are permitted to "deposit banks":***
  - Hedged, client-driven transactions that fall within narrow risk position limits
  - Securities underwriting
- ***Activities permitted <u>only</u> to "deposit banks"***
  - Insured deposits and supply of retail payment services
- ***Restrictions on transfers and exposures between the separated entities***
- ***The entities can be operated within a banking group***

# Rationale for mandatory separation

- ***Limit the spill-over of the effects of the deposit guarantee system and any implicit government guarantees, to the trading activities of banks***
  - Makes the pricing of funding of the separated entities more efficient and risk-based
- ***Reduce complexity and interconnectedness***
  - Enhances bank management
  - Facilitates supervision and monitoring thus reinforcing market discipline
  - Facilitates recovery and resolution and thus helps make it credible
- ***Reduce mixing of management cultures***

# Comparison of suggested structural reforms

**"Volcker banking group"**

Proprietary trading,
Hedge fund (HF) and Private
equity (PE) exposures

Market making

Swaps push-out

Investment,
commercial and
retail banking

**"HLEG banking group"**

Proprietary
trading, market
making and HF,
PE and SIV
unsecured
exposures

Investment
banking incl.
securities
underwriting,
commercial and
retail banking

**"Vickers banking group"**

Proprietary trading,
market making,
investment banking
incl. securities
underwriting and
commercial banking

Retail
banking with
higher capital
requirements

# Structural reform on the international regulatory agenda

**A stylised comparison of selected structural reform proposals**

| | Volcker | Liikanen | Vickers |
|---|---|---|---|
| Broad approach | **Institutional separation** of commercial banking and certain investment activities | **Subsidiarisation:** proprietary and higher-risk trading activity have to be placed in a separate legal entity | **Ring-fencing:** structural separation of activities via a ring fence for retail banks |
| Deposit-taking institution may: | | | |
| - deal as principal in securities and derivatives | No | No | No |
| - invest in hedge funds and private equity | No | No | No |
| - engage in market-making | Yes | No | No |
| - perform underwriting business | Yes[1] | Yes | Restricted |
| - hold non-trading exposures to other financial intermediaries | Unrestricted | Unrestricted | Restricted (inside the group) |
| Holding company with banking and trading subsidiaries | Not permitted | Permitted | Permitted |
| Geographical restrictions | No | No | Limitations for ring-fenced banks in the UK to provide services outside the European Economic Area |

[1] Underwriting in response to client/counterparty demand.

Extract from the BIS-report, which was discussed during the spring meeting

**Table 1. Comparing the Structural Reform Proposals**

| | Liikanen group report | United Kingdom | United States |
|---|---|---|---|
| **Holding company with banking and trading subsidiaries** | Permitted | Permitted | Not permitted |
| **Deposit taking institution dealing as principal in securities and derivatives 1/** | Not permitted (but other group companies may do so) | Not permitted (but other group companies may do so) | Not permitted |
| **Deposit taking institution investing in hedge funds and private equity** | Not permitted (but other group companies may do so) | Not permitted (but other group companies may do so) | Not permitted |
| **Deposit taking institution providing market making services** | Not permitted (but other group companies may do so) | Not permitted (but other group companies may do so) | Permitted |
| **Deposit taking institution's non-trading exposures to other financial intermediaries** | Unrestricted | Restricted | Unrestricted |
| **Higher loss absorbency rule 2/** | Yes, via leverage ratio for trading business that exceeds size threshold | Yes, as add-on to the conservation buffer for UK ring-fenced banks | For [illegible] with substantial US footprint |
| **Size threshold for application** | Yes; applies to all banks with trading books larger than €100 billion, or trading assets more than 15-25% of balance-sheet | Yes; applies to all banks and building societies with deposits greater than £25 billion | No |
| **Enacted into law** | No | Scheduled for completion by 2015 | Yes |
| **Implementing regulations finalized?** | No | No | No |

Extract from the IMF-report, which was discussed during the spring meeting

Source: Structural bank regulation initiatives: approaches and implications, BIS Working Papers 412; Act Local But Think Global: Can the Volcker, Vickers, and Liikanen Structural Measures Create a Safer Financial System? IMF Staff Discussion Note 13/4.

# The five proposals of the High-level Expert Group

1. ***Mandatory separation to deposit bank and trading entity***
2. ***Additional separation requirement***
   - If the recovery and resolution plan otherwise not credible
3. ***Bail-in instruments***
   - Pre-defined scope and terms to facilitate pricing and liquidity
4. ***A review of capital requirements on trading assets and real estate related loans***
5. ***Strengthening the governance and control of banks***
   - Including the use of bail-in instruments in compensation

Thank you!