On the structural reform

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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

<table>
<thead>
<tr>
<th>Identified problem by HLEG</th>
<th>Result</th>
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<tbody>
<tr>
<td>• Excessive risk-taking in trading, lending, funding</td>
<td>Increased probability of failure</td>
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<td>• Complexity (making bank management, monitoring, supervision and resolution challenging)</td>
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<td>• Limited loss absorbency</td>
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<td>• Intra-group subsidies</td>
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<td>• Ineffective governance and control</td>
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<td>• Interconnectedness</td>
<td>Increased impact of failure</td>
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<td>• Limited resolvability</td>
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<td>• Bank-sovereign feedback loop</td>
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<tr>
<td>• Inadequate EU institutional framework</td>
<td>Reduced internal market efficiency and level playing field</td>
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<tr>
<td>• Excessive focus on intra-financial business, as opposed to real economy</td>
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<td>• Competitive distortions and implicit subsidies</td>
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<td>• Inadequate consumer protection</td>
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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 only 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
- Investment and commercial banking

“HLEG banking group”
- Proprietary trading
- Market making
- HF, PE and SIV unsecured exposures
- Investment, commercial and retail banking

“Vickers banking group”
- Investment and commercial banking, Proprietary trading, Market making
- Retail banking with higher capital requirements
- Swaps push-out

Retail banking with higher capital requirements
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!