How to improve financial stability and resilience of systemically important financial institutions after the crisis?

EBA Policy Research Workshop “How to regulate and resolve systemically important banks”

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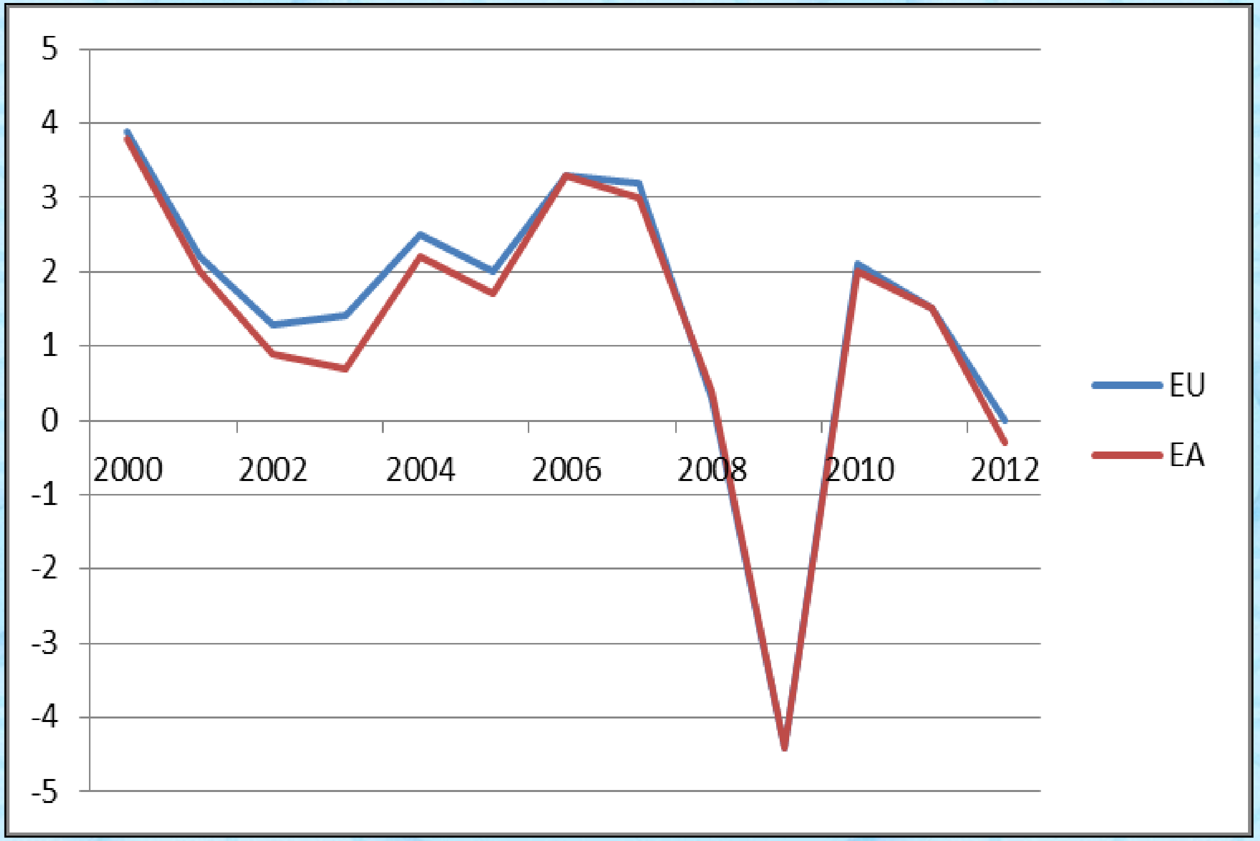
Outline

- *Heeding the lessons of the crisis*
  - Excessive financial expansion
  - Regulatory and management failures
- *Policy Reforms*
- *HLEG proposal*
- *Conclusions*

Heeding the lessons of the crisis

Substantial crisis impact on the real economy

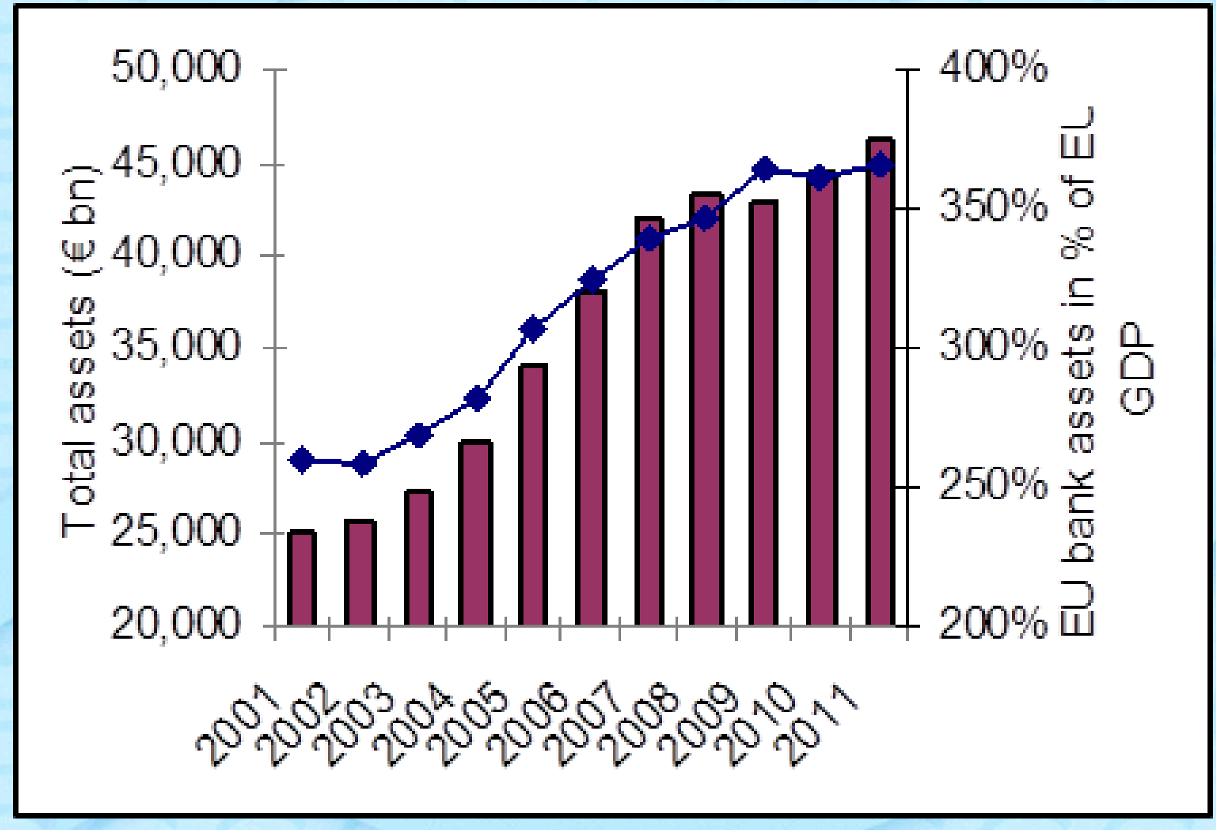
GDP growth rate (% p.a.)



Source: Eurostat data as presented in High-level Expert Group's Final Report

Rapid growth in the EU banking sector

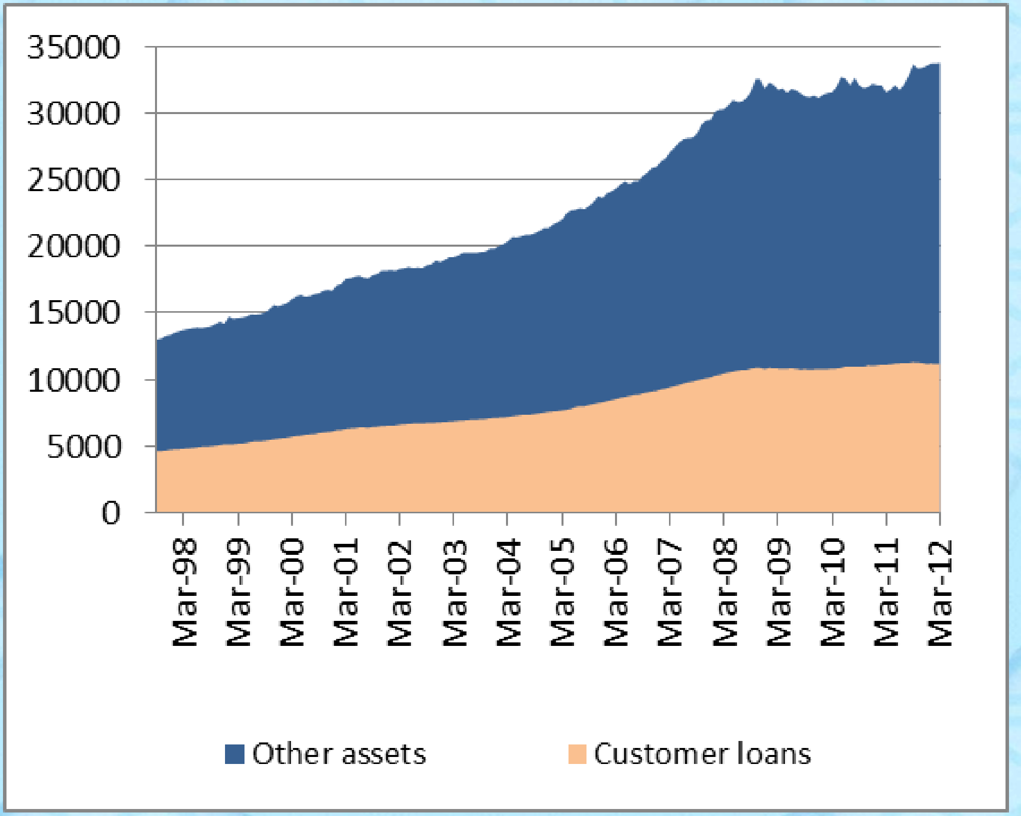
Total assets of MFIs in EU 2001-2011



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

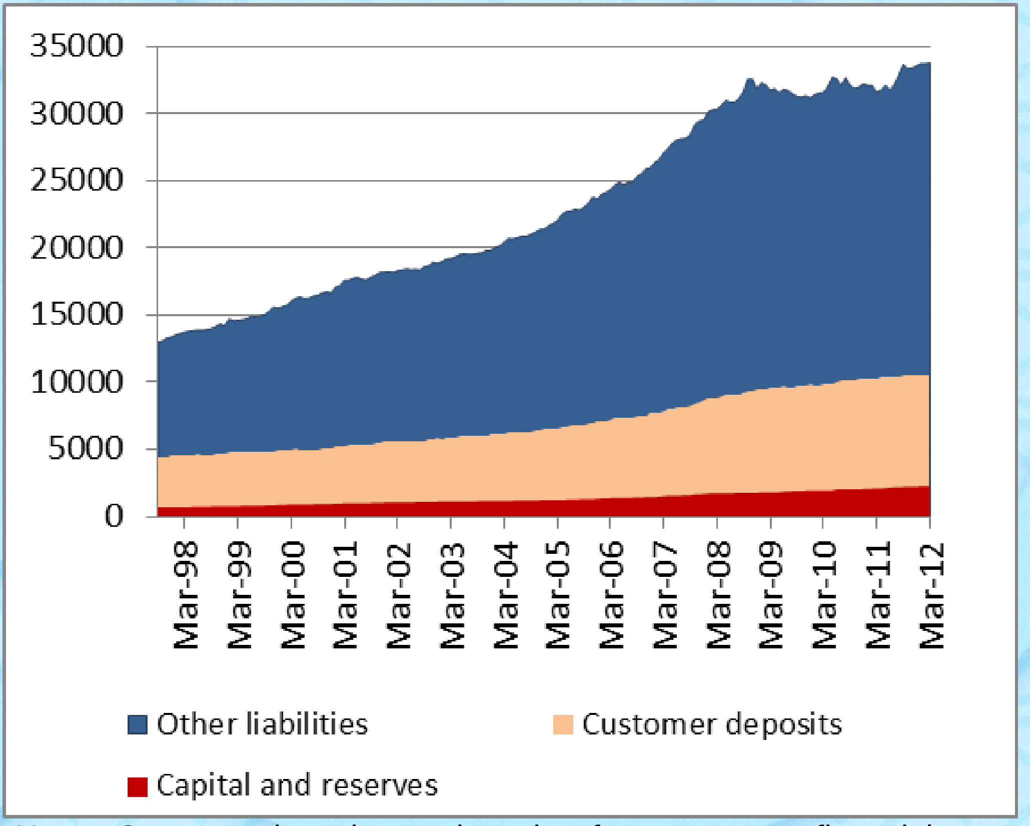
Evolution of assets of MFIs in EU the euro area 1998-2012 (€ billion)



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

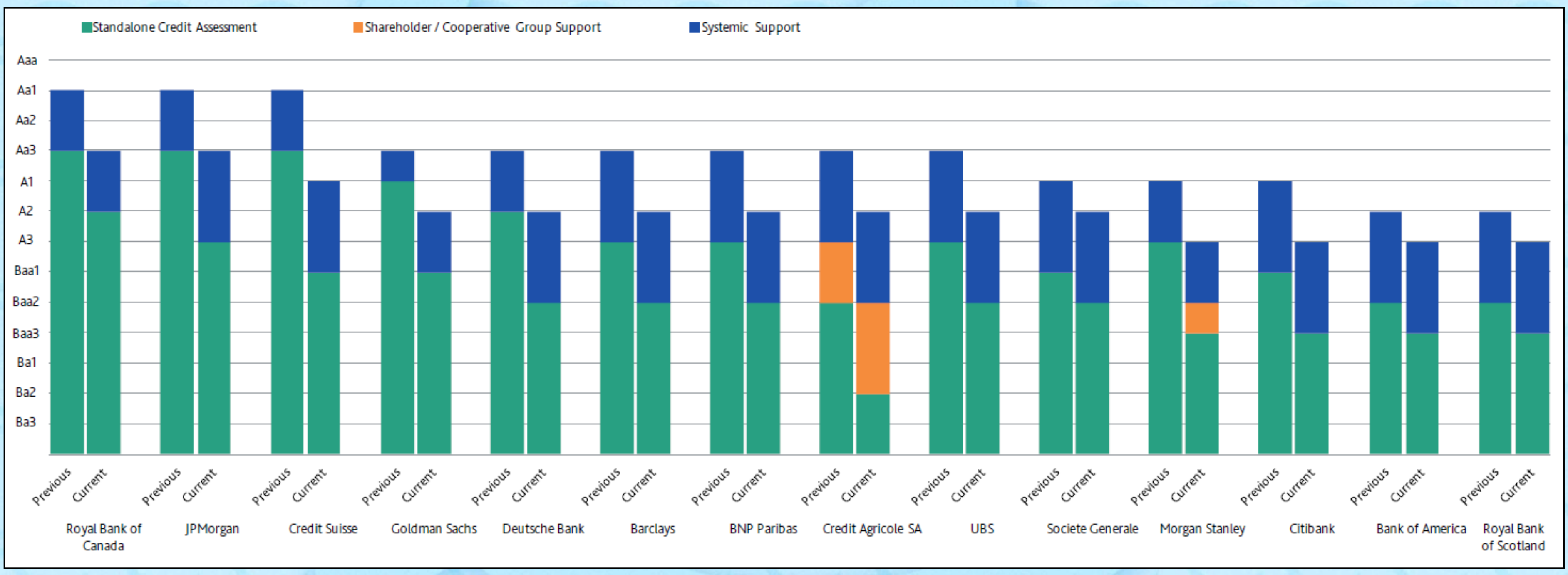
Evolution of liabilities of MFIs in the euro area 1998-2012 (€ billion)



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

Implicit subsidies remain high

Credit ratings and systemic support uplift for a sample of EU and US banks
(before and after the downgrade in 6/2012)



Source: Moody's (2012) as presented in High-level Expert Group Final Report

Market discipline vs. structure of banks – a “chicken-and-egg” problem to be solved

Eliminating inefficient structures

Market discipline

“Optimal” size and structure of banks

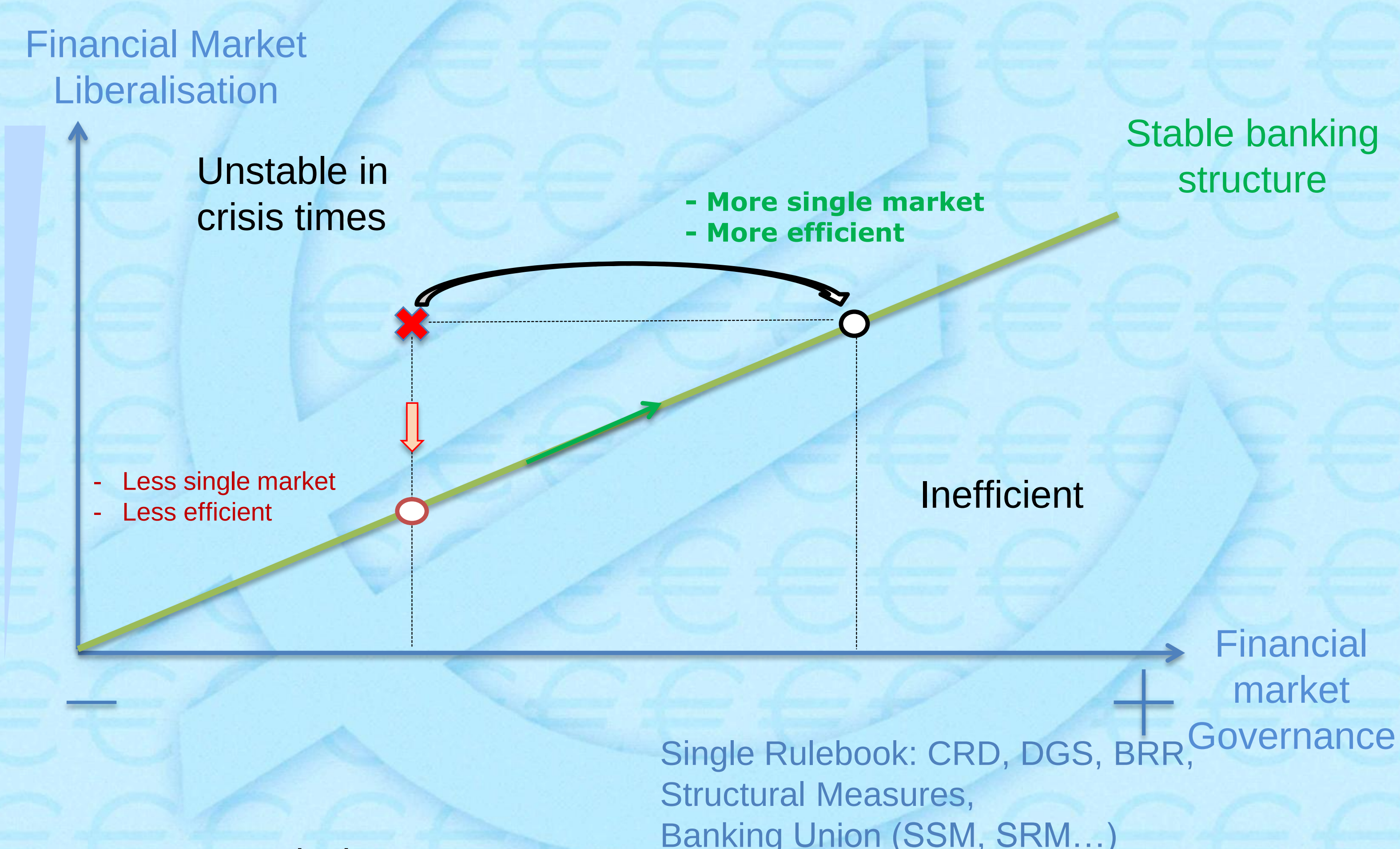
*Making **resolution credible** and eliminating the TBTF assumption*

- *There is a “bad” and “good” steady state equilibrium:*
  - Weak market discipline and suboptimal bank size and structure from the point of view of the society (TBTF and inefficiency).
  - Efficient market discipline and bank size and structure more beneficial for the society (no-TBTF and improved efficiency).

→ *Push from authorities needed to orchestrate the shift from bad to good equilibrium.*

Policy reforms

Financial market liberalisation and governance must be complements



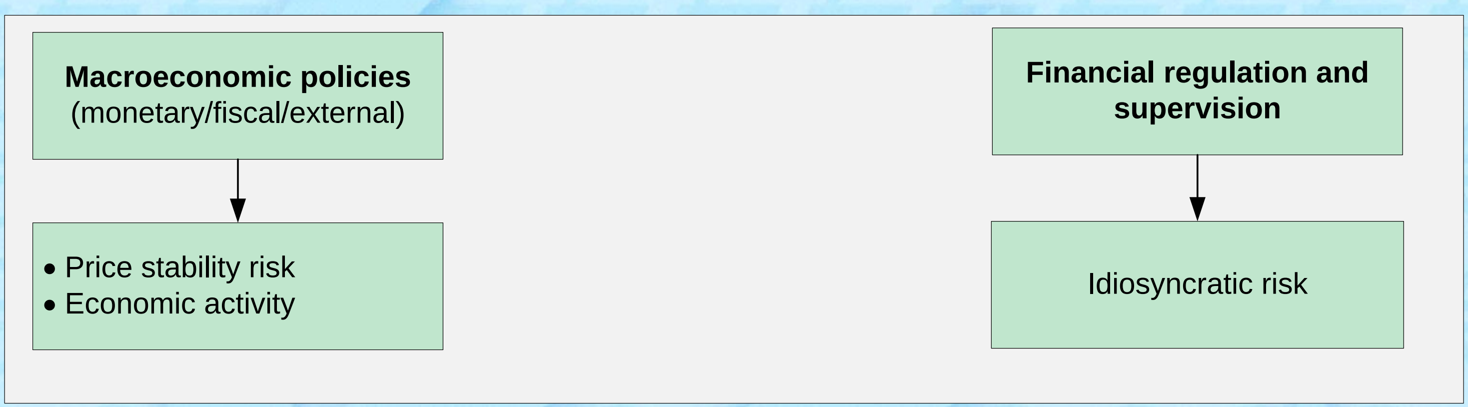
Source: European Commission

Focus of current regulatory reforms

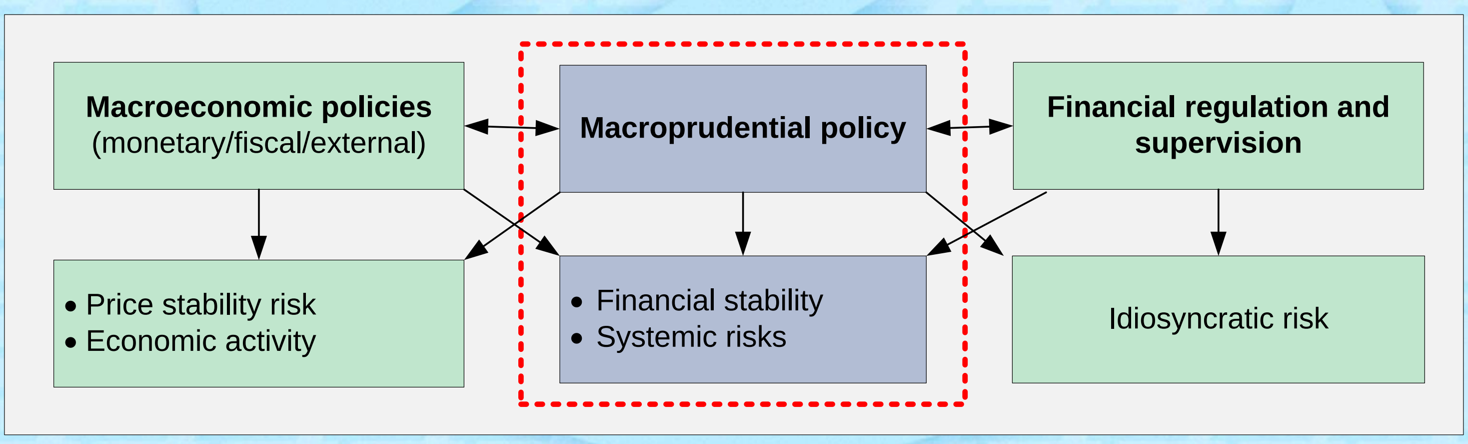
- ***Regulatory reforms have been focused on two crucial areas***
  - Capital adequacy and liquidity requirements as set by Basel III and implemented in EU by means of regulation and a directive
  - The Commission's recovery and resolution framework
- ***These regulatory reforms are major steps to***
  - 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

Authorities should foster the stability of the entire financial system

Pre-crisis



…and post-crisis



Source: IMF.

HLEG proposal
for structural banking reform in Europe

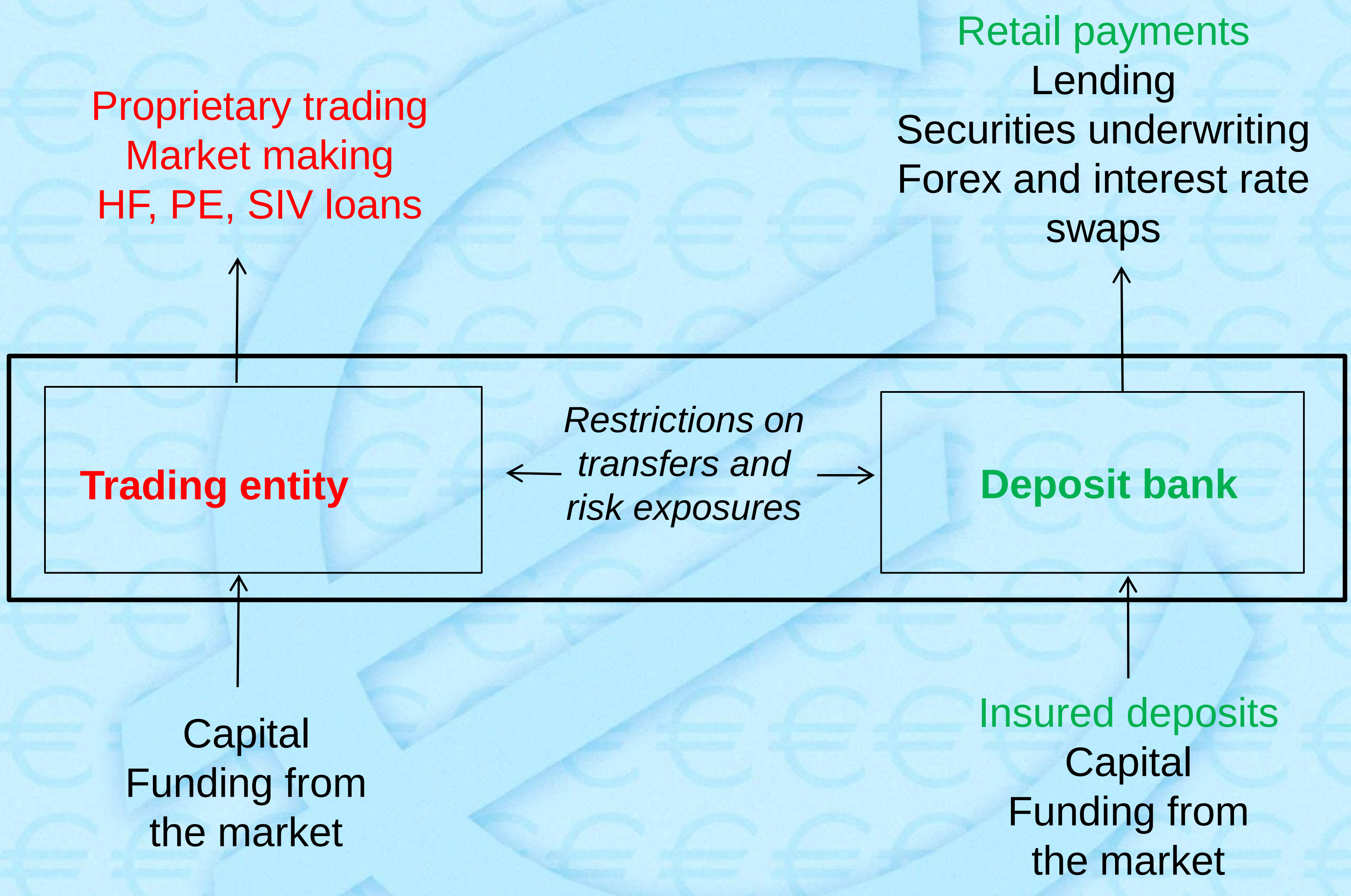
Two avenues as a possible way forward were considered

- **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

Rationale for mandatory separation

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



HLEG proposal

Stylised classification of structural proposals: activities and strength

Strength separation / Activities to be separated	Subsidiarisation (current restrictions)	Subsidiarisation"+", (stricter restrictions)	Ownership separation
"Narrow" Trading Entity / "Broad" Deposit Entity	≈ FR, DE (baseline)		≈ US Volcker
"Medium" Trading Entity / "Medium" Deposit Entity	≈ FR, DE (if wider separation activated)	**≈ HLEG (Liikanen)**	
"Broad" Trading Entity / "Narrow" Deposit Entity		≈ UK ≈ US BHC	≈ Glass Steagall

Source: European Commission, "Reforming the structure of the EU banking sector", 16 May 2013

To conclude:
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!

The Group's mandate

- *Assess whether banking structures need changes in order to*
  1. achieve a safe, stable, and efficient banking system,
  2. which provides for the needs of the EU citizens, the EU economy and the Internal Market

- *Take account of the on-going regulatory reforms*
  - especially capital adequacy regulations and the Commission's recovery and resolution proposal

- *Assess the existing structural reform proposals*
  - Vickers report, Volcker rule/Dodd-Frank Act

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

Unprecedented state support to banks

Parliamentary approved amounts of state aid in the EU (10/2008-10/2011)

	Guarantees	Liquidity measures	Recapitalisation	Impaired assets	Total	
Years	€ billion	€ billion	€billion	€billion	€ billion	% of GDP
2008	3097	85	270	5	3457	27.7
2009	88	5	110	339	542	4.6
2010	55	67	184	78	384	3.1
2011	49	40	34	0	123	1
2008-11	**3290**	**198**	**598**	**421**	**4506**	**36.7**

Source: European Commission (2011a).

Amounts of state aid actually used (10/2008-12/2010)
- €1.6 trillion (13% of EU GDP) (€409 billion for recapitalisations and asset relief measures, plus €1.2 trillion for guarantees and other liquidity measures)

Additional liquidity support by central banks
- More than € 1.1 trillion of total eurosystem lending to euro-area banks in form of monetary operations (by mid-2012)