EPFSF Briefing

"Liikanen High-level expert group on structural reform"

Background

In response to the nascent debate on structural reform for the banking sector spurred by the developments in the UK with the Vickers report[1] calling for a ring-fencing of retail activities and the so-called Volcker Rule[2] in the U.S. proposing a prohibition for commercial banks to engage in proprietary trading (with certain exemptions), the European Commission in November 2011 announced its intentions to analyse the issue of structural reform further. Hence, in February 2012 the European Commission established a High-level Expert Group (HLEG) on possible reforms to the structure of the EU banking sector. The mandate of the HLEG was to consider whether there is a need for structural reforms of the EU banking sector to establish a safe, stable and efficient banking system serving the needs of citizens, the EU economy and the internal market.

Final report and mandatory separation of significant trading activities

The main recommendation in the Liikanen report is for mandatory separation of significant trading activities from other banking operations (including insured deposit taking and payments systems) into a separately capitalised "ring-fenced" entity.

Scope of the ring-fencing

The HLEG recommends that proprietary trading and other significant trading activities should be assigned to a separate trading entity if the activities to be separated amount to a significant share of a bank's business as defined by a threshold. More specifically, the HLEG defines the activities to be separated into the trading entity to be proprietary trading; market-making; loans, loan commitments and unsecured credit exposure to hedge funds, SIVs, and private equity investments. The decision of mandatory separation will be a two-step examination process, where:

a) if a bank's assets held for trading and available for sale exceeds (a) a relative examination threshold of 15-25% of the bank's total assets or (b) an absolute examination threshold of EUR100bn, the bank will advance to the second examination stage
b) where the supervisor will take the decision of the final share of trading activities to be separated into a legally separate trading entity based on a final threshold that the European Commission will have to calibrate.

What is put into question?

At this stage, given the different national initiatives in UK, Belgium, France, Netherlands and US (see annex 1) and/or considerations around structural reform of the banking system, the European Commission's attempt to coordinate approaches within Europe is acknowledged. The distinction between the different views behind the structural proposals appear to be dependent on what are the economic activities that are deemed socially useful/vital (Vickers deems retail and SME banking services crucial to the functioning of the economy, Liikanen proposal adds on corporate banking and primary markets and the French proposal adds on market-making) rather than the perceived riskiness of the business lines.

[1] http://webarchive.nationalarchives.gov.uk/+/bankingcommission.independent.gov.uk
[2] Section 619 in the Dodd-Frank act

However, stakeholder views are currently divided on how to take forward the Liikanen proposals on structural reform:

- Some agree with the HLEG's conclusions that structural reform would make banks both more resilient in the face of external shocks and more resolvable should they still become vulnerable;
- There is a concern that the proposal is too lenient, the ring-fence would capture only a small subset of universal banks within the EU and that thus the financial stability and resolution benefits may be reduced despite high costs imposed on banks;
- Some are not yet convinced that structural reform is necessary or a priority, instead arguing that the 'live' legislative banking measures need to be fully implemented and their effectiveness assessed prior to taking any further regulatory action; and
- There is also support for the conditional structural reform, a minority view in the HLEG, subject to banks' resolvability under its Recovery and Resolution Plans (RRP). With certain reservations, this view is particularly favoured by the industry as it;
    - Protects the financial systems from particularly risky operations;
    - Allows for a natural evolution of the European banking system to take place;
    - Complements other regulatory reforms that address the same systemic issues as the HLEG's structural reform; and
    - Does not increase pro-cyclicality in the system: Any measures that restrict funding flows and capital allocation for a bank should depend on the bank specific operating model rather than businesses it is engaged in, according to the proposed RRD procedures.

Economic impact

Considering that European banking is already undergoing profound change as a result of regulatory reform and of shifts in market fundamentals, it is not clear at this stage what the additional impact of the mandatory structural restrictions would be on the capacity of European capital markets and European growth at a time of subdued bank lending. According to the IMF[3] many European banks are reviewing their business strategies and making cuts to their market-making and other financing capacities, as well as retreating from non-core markets. Deloitte's recent Bank Survey (2012) reveals that the ongoing voluntary structural reform will be a lengthy process and re-sizing the industry will be achieved through a combination of natural run off, divestment and balance sheet constraint. Consequently, the industry and some Member States call for a reduction in regulatory uncertainty and are asking authorities to provide for a well sequenced and harmonised regulatory framework that allows for the ongoing adjustment process to take place, thus questioning the need for structural reform at this stage.

According to the estimates of Standard and Poor's (S&P) European institutions (sovereigns, corporates and banks) have new financing needs of $US1.9-$2.3tr and $8.6 trn in refinancing needs for existing debt by the end of 2016, equivalent to around 75% of EU GDP. S&P also estimates that European institutions have a projected annual funding gap of $US210-260bn. With bank lending in Europe having collapsed over the last five years from €685bn to a net repayment of €33bn in September 2012 according to the ECB, partly as a result of regulatory pressures forcing the industry in aggregate to shrink balance sheets, this financing gap will have to be met very largely from the capital markets.

The debt and equity issuers typically expect, as a condition of being able to underwrite or bid for securities at auction, that the dealer bank provides some type of ongoing secondary liquidity in their new issue. Therefore, some of the Member States (e.g. France allows market-making in the deposit bank under the proposed national restrictions) believe that market-making, considered to be economically useful activity, should be allowed within the "deposit bank". Splitting up of market activities in different legal entities could substantially reduce the market-making capacity of European banks and the consequent narrow-scoped trading entities may not be viable businesses against competition from institutions that do not have to comply with similar structural limitations.

[3] International Monetary Fund (IMF): Global Financial Stability Report: The Quest for Lasting Stability, 2012

Impact assessment

The Commission, as recommended by the HLEG, will undertake an impact assessment of the policy options set out in the Liikanen Report. Public authorities as well as industry stakeholders have stressed the importance of a comprehensive analysis of the potential impact of the proposals. The impact assessment should include careful analysis of the incremental reductions in, for example, system-wide probability of default and loss given default, including the change in the cost of resolution. The suggestions also propose that the potential reduction in systemic risk need to be carefully weighed against any long-term reductions in the efficiency of the financial markets, any additional risks created in the system or decreases in competition as the result of structural regulation.

Other Liikanen proposals

In addition to the mandatory separation of significant trading activities, the HLEG also proposed:

- emphasising the role of recovery and resolution plans in informing wider separation, if necessary;
- supporting a specific bail-in instrument and restrictions on who may invest in them;
- applying additional capital for trading book and real estate assets; and
- further measures to improve governance, including on size and composition of remuneration.

The current recovery and resolution proposals contained in the Resolution and Recovery Directive (RRD) already allow the resolution authorities to force banks to make changes to their business structures in order to facilitate resolvability, so in this respect Liikanen's recommendations appear to go no further (Although, it is proposed as an additional measure, i.e. on top of mandatory separation). While the RRD does not include the suggested use of triggers to determine the acceptability or otherwise of an RRP, there are already extensive powers for the authorities to reject a bank's RRP.

The suggestion that bail-in should apply to a certain category of debt instruments is contrary to the current RRD proposals. Most stakeholders currently support a broader scope for bail-in and believe that such a scope increases loss absorbency and improves investors' incentives. The specific class of 'bail-in instruments' proposed by the HLEG implies that creditors of a bank outside of the specific bail-in instruments are remote from suffering losses on their investments and is perhaps akin to continuing the implicit guarantee on non bail-in bank debt.

In order to better capture especially tail risks and systemic risk related to trading activities the HLEG recommends that the Basel Committee considers either the introduction of a non-risk weighted capital buffer on top of Basel 2.5 + 3 requirements for banks with trading activities over a certain threshold and/or the introduction of floor for risk-based requirements. Furthermore, to address excessive risk related to real estate lending the HLEG recommends loan-to-value (LTV) and/or loan-to-income (LTI) caps as macro-prudential tools.

The HLEG's remuneration proposals may introduce fragility into the European banking system through encouraging the growth in fixed remuneration (hence making banks vulnerable in the event of a sharp decline in revenues). Also, proposals to use bail-in bonds to partially fund remuneration will; a) only play a minimal role in protecting taxpayers in the event of a bank's failure b) could have unintended consequences as employees of failed institutions would hold a continuing stake in them, after shareholders have been wiped out and, c) forces employees that cannot influence the risk-taking decisions to share the burden.

Concluding remarks

- European banks are already going through profound structural changes, as a result of the regulatory reform and changes in the market;
- A coordinated approach from the Commission on the Liikanen recommendations could help avert the risk that European banking sectors and the Single Market in financial services will be further fragmented due to national level structural reform initiatives

- Stakeholder views are divergent on whether mandatory separation of banks' trading activities at a European level is necessary. The key areas where stakeholders disagree are:
  - Whether structural reform is a key priority and whether it should be mandatory or based on the recovery and resolution plans;
  - Timing of the potential structural reform and sequencing with other regulatory initiatives; and
  - Whether there will be financial stability benefits when market capacity is reduced and costs to banks are increased.
- An impact assessment is required to analyse the economic impact of the proposed structural restrictions at a time of increased real economy borrowing requirements and reduced bank lending; and
- The other Liikanen recommendations are directly linked to other regulatory agendas that are currently debated.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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State Street
UBS AG
UniCredit Group
VISA Europe
Western Union International Bank
WKO – Vienna Economic Chamber

Annex 1:

Developments in Member States

France: The French Government is reportedly planning a two tier approach to banking reform, aiming to preserve the French universal banking model while also heavily penalising proprietary trading and other ‘undesirable’ activities. According to reports all proprietary trading will be forced to take place in a ring-fenced entity which would have to hold punitive levels of capital (undefined). In addition there would be a complete ban on banking groups undertaking “highly criticized” activities such as high frequency trading and speculation in agricultural commodity derivatives. The proposals seem to be distinguished from those of Liikanen in that they do not seek to require the ring-fencing of market making activities and are likely to lead to an intense debate over what are deemed to be undesirable activities i.e. those activities seem as not necessary for financing the real economy and therefore forced out of banking groups.

Netherlands: The Dutch government has established an expert group chaired by Herman Wijffels to examine the need for structural regulation also in light of the Liikanen report’s recommendations. The group will start its activities in December 2012 and is planning to deliver its recommendations by June 2013.

Belgium: The Belgian government has asked the Central Bank of Belgium to look into the issue of bank structure reform and to draft a report.

UK: The Vickers Report published on September 2011 suggests that banks ring-fence their retail activities from their investment banking operations.

Germany: The issue of bank structure reform is prominent in the current pre-electoral debate, the separation between investment and retail banks being a priority for the SPD.