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Banking after Regulatory Reforms: Business as Usual?

Key findings from a conference jointly organised by SUERF, and the Bank of Finland held in Helsinki on Thursday 13 June, 2013

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Alan Blinder (Princeton U.), Governor Liikanen (Bank of Finland) & Paul Tucker (Bank of England)

After the global financial crisis, banking regulation has gone through major changes but more might be coming. Capital and liquidity regulation has been reformed, thanks to Basel III, and new regulations to resolve systemically important banks have been developed both in the EU and the US. But structural changes in banking are still partly in progress, notably in the EU where the Commission is expected to come out this year on how it might take further the proposals of the High-Level Expert Group (HLEG).

The regulatory changes are likely to affect banks' business models, and regulations on banks' structure would interfere with business models directly. This is the broad theme around which the fifth joint Bank of Finland-SUERF conference was centered in Helsinki, 13 June 2013. *"Banking after regulatory reforms – business as usual?"* attracted one hundred registered participants to follow the one-day program with three keynotes, four invited speakers, and a distinguished panel.

The Bank of Finland's Governor, **Erkki Liikanen**, who chaired the work on the report *"High-level Expert Group on reforming the structure of the EU banking sector"*, released in October 2012, and also known as the Liikanen Report, had kindly agreed to deliver one of the keynotes in the conference. The other two keynotes were by **Alan Blinder** of Princeton University, and **Paul Tucker**, Deputy Governor of the Bank of England.

Notably, most of the members of the HLEG were present in the audience and contributed actively to the discussions during the day. Two of the HLEG members, **José Manuel Campa** from IESE Business School, and **Hugo Bänziger** (Eurex), also served as panelists.

The program started with two presentations from the regulatory side, the first by **Mario Nava** of the European Commission, and the second by **Jukka Vesala**, Deputy Director General of the Finnish FSA.

In his talk *"The current state of reforming bank structures"*, **Mario Nava** did not really anticipate the Commission's forthcoming actions on the basis of the HLEG's report but discussed at the more general level the need for structural changes in banking; "what, why, and why at the EU level?". He demonstrated the importance of the banking sector

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for the EU economy, compared to the United States, and noted that regulating banks' structure implies restrictions on banks' activities and (financial) connections between banks. He pointed out the distinction that while capital requirements target banks' incentives, structural measures can be seen as a quantity-based regulation. Nava also said that structural measures can add value by facilitating risk control; referring to the point made by the Deputy Governor, Pentti Hakkarainen of the Bank of Finland in a speech in Paris earlier this year. Moreover, structural measures may help control the size of banks, and thereby the too-big-to-fail problem. Mario Nava then commented on the banking union by saying that before the crisis, the governance of the financial markets did not keep up with the liberalization of the markets. He demonstrated this by what he called the *"Mother of all slides"* from the HLEG's report (charts 2.3.6 and 7, page 15), which shows that European banks' liabilities grew strongly via increasing leverage while the amount of banks' equity did not keep up. On the asset side, the growth took place in other activities than lending to the real sector, and Nava questioned whether this really benefited the real economy. When briefly comparing the HLEG report to the earlier structural proposals in the US ("Volcker Rule") and the UK ("Vickers Report"), Nava concluded that the HLEG landed in the middle "where virtue lies". In the floor discussion, the question of losing some positive stability effects from reduced diversification between different activities as a result of structural measures was raised. David Llewellyn (SUERF) wondered whether structural measures mainly target the (social) losses given a bank's failure, and not so much the probability of failure of a bank. Finally, the question concerning the obstacles to implementing structural reforms was raised. Mr. Nava acknowledged that strong political support will be necessary for successful implementation.

Speaking about *"Regulatory and resolution measures needed to foster market discipline"*, **Jukka Vesala** first noted that he would not focus directly on structural measures, but more generally on how to move from bail-out to bail-in policy, even in the case of the largest banks, by developing the resolution mechanism. Europe has a history of bail-outs. Vesala pointed out that bank resolution is by nature discretionary, and national discretion is also what the member states of the EU currently want. In these circumstances, what can be done to enhance market discipline? The answer according to Vesala is that resolution needs clear ex ante rules and certainty of implementation when there are bank failures. He saw that two-stage bail-in instruments would be useful. First, banks should have obligatory debt instruments which at a given trigger point before the resolution point either convert into equity or absorb losses. A similar proposal is included in the HLEG's report. Second, an all-inclusive bail-in of debt instruments could take place at the resolution point. He denoted the mandatory first-stage bail-in instruments as "Tier 3 capital". Vesala stressed that bail-in debt instruments, instead of corresponding amount of equity, are needed especially for market discipline. He also supported depositor preference for the protected part of deposits, and called for higher non-risk-based capital requirements in trading activities. These should come on top of the risk-based requirements in order to retain banks' incentives to develop risk measurement further. He also said a Single Resolution Mechanism is needed in Europe for cross-border bank failures. In the discussion that followed Jean-Charles Rochet commented that the disciplining effect of debt seems largely to be an academic argument, something that practitioners do not necessarily acknowledge. Marco Mazzucchelli (HLEG member) asked who will buy the bail-in bonds if other banks are not allowed to. Jan-Pieter Krahnen (also a HLEG member) first stated that we have to make banks failable. He then said that if carefully implemented, bail-in bonds would have a market as there is a high potential demand for high coupon bonds. Andrea Enria, Chairman of the European Banking Authority (EBA), pondered whether conversion to equity would be a better mechanism than write-offs, concerning the design of bail-in bonds.

There were two presentations based on academic research papers, the first by **Steven Ongena** (Tilburg University) and the second by **Jean-Charles Rochet** (University of Zurich). In a fascinating paper, *"A Century of Firm – Bank Relationships: Did Banking Sector Deregulation spur Firms to add Banks and borrow more?"*, based on a hand-collected unique data set, Ongena studied the effects of the UK's banking deregulation of the 1970's on the number of bank-firm relationships. He found that after the deregulation (unlike before it), if a firm added a new bank relationship, this was related with increased leverage of the firm. He interpreted the result to indicate that increased bank competition (as a result of deregulation) may have had an impact on firms' leverage. Marco Mazzucchelli noted that the results suggest that "one-stop shopping" is not what firms necessarily want from banks, and thus may have implications for the universal bank model. Ernest Gnan (OeNB and SUERF) had a remark that technological development and diversification of financing risks may also be natural drivers of the increased number of firm-bank relationships.

The second academic paper by **Jean-Charles Rochet** provided a theoretical analysis of the question *"How much speculation is socially optimal?"*. His formal model included hedgers and speculators, and the possibility that a speculator defaults, which would break the hedge. In this case, perfect hedging is not socially desirable, unless there are bail outs. An optimal cash reserve requirement for the speculator would balance the cost of keeping reserves and the cost of bailing out defaulted speculators. As Rochet noted, these type of policies are already implemented for centralized trades. In the Q&A, it was brought up that it may be easier to use quantity based regulation such as reserves than price based regulation such as taxes. It was also pointed out that in the absence of bail-outs there could possibly be too little speculation, and hence too little provision of hedges.

In between the two research papers, **Alan Blinder** (Princeton University) gave the first keynote on *"Guarding against systemic risk: the remaining agenda"*. His main point was that not enough has been done in reforming financial regulation and that we can do better; he sees bad habits are creeping back again. Finance has proven not to be self-regulating, and losses have most likely exceeded efficiency gains from financial engineering. He said we cannot get rid of the problem of too-big-to-fail institutions, so we have to deal with them. His list of remaining regulatory tasks included the following parts. First, a resolution authority for SIFIs (systemically important financial institutions) is needed. Second, the work of the systemic risk regulator is still in its infancy and needs to be developed. Third, more capital and liquidity are needed in the banking system. Illiquidity may actually have played a larger role in the crisis than lack of capital. Fourth, he saw that reforming the derivatives market is a slow process because the industry is fighting back. More standardization is necessary (the KISS principle; "keep it simple, stupid!" should be followed), and also global harmonization is needed because derivatives trading can easily change location. Fifth, regulating bankers' (dysfunctional) compensation has focused too much on level and less on incentives. He also noted that far too little had been done on how rating agencies are compensated, in order to correct their distorted incentives. Lastly, he commented on the structural reform proposals, saying that curbing proprietary trading may actually be more useful for preventing the next crisis than it would have been for the recent one, but that it is important all the same. He saw that the three main proposals; Volcker, Vickers, and Liikanen, are "cousins" who all seek to separate insured deposits from risky trading, an aim he agrees with. He noted that his own idea of separating trading in his 2009 paper comes closest to the HLEG report, and that keeping trading within the bank holding company, unlike the Volcker rule does, is good. Further, he thinks the Vickers approach throws too many activities out of the deposit bank. However, he noted that in the HLEG approach it would be essential to prevent downstreaming of capital from the parent to the trading subsidiary. He would not be so worried about trading moving to hedge funds as they play largely with their own money, not with other people's money. It is just important to regulate hedge funds that become SIFIs. In the discussion, Rochet noted that the level of compensation is related to incentives as well because level tends to be related to the size of the employer institution. Rochet also raised the need to put limits on sovereign debt, and called for truly independent regulators. Blinder answered that Europe needs common resolution, supervision, and deposit insurance. On the fiscal side, he saw that Europe needs a constitution (not like the first US constitution) and needs to maintain possibility for "Keynesianism" at some level. Professors Campa and Krahnen also raised the issue of rating agencies, and Krahnen noted that problems arose particularly in structured finance. Blinder replied that the KISS principle is important also for a well-functioning structured finance market. Mr. Moen from Norges Bank was also concerned about the downstreaming from parent to trading subsidiary and Blinder agreed with him that the credibility problem (ie, the parent credibly committing not to find a way to downstream capital in a crisis situation) is quite general, also concerning resolution regimes. The last question was made by Marco Mazzucchelli who asked why the US had often been a laggard, compared to Europe, in implementing new Basel regulations.

In the second keynote of the day, **Governor Liikanen** pondered *"On the size and structure of the banking sector"*, reflecting the views and ideas from the HLEG report on reforming bank structures, which he chaired. Before he started, he entertained the audience by drawing a parallel to restrictive policies on the use of alcohol in society, quoting a leading Finnish politician from the 60's, having famously said "Too much (alcohol) is too much, but moderately is absolutely too little", and wondered whether the same principle might apply in restricting banks' riskiest activities. Mr. Liikanen started his presentation by surveying views on the relationship between financial development and economic growth. The crisis itself, as well as, e.g., recent BIS research has questioned the economic benefits of expansion of the financial sector beyond a certain point. This is a markedly different view from the one that prevailed before the crisis. Concerning the factors which may drive excessive financial expansion, he mentioned several possible reasons but also market expectations of too-big-to-fail institutions. Such institutions seem to benefit from relatively cheap funding. He noted that no one knows what the optimal size of financial markets or individual institutions should be, but what should be done is to limit incentives which may drive their excessive growth. This is largely what his High-Level Group focused on in its proposals. In the Q&A, Ernest Gnan asked why there are differences between the proposals for different jurisdictions; is it because of history, prevailing bank structures, or perhaps political economy reasons. Governor Liikanen replied that Vickers approach focuses much on retail banks and enhancing competition between them, also aiming to ensure that Northern Rock type of episodes cannot repeat themselves. The HLEG proposal has to apply in many countries because it is for the whole EU. Mr. Liikanen acknowledged also that the HLEG had the follower advantage, relative to Vickers (and the Volcker rule). SUERF president Urs Birchler asked about banking sector's reactions which varied, according to Governor Liikanen, from analytical responses to "enough (regulation) is enough" type of reactions. Admittedly, Governor Liikanen, said we need to conclude the reform process soon in order to ensure certainty to the banking sector in terms of planning for the future. Ernest Gnan also asked what European banks will look like in ten years' time. In Governor Liikanen's view, they will be better capitalized, with more liquidity buffers, and there will be a single supervisor making sure not only rules but also practices are the same. There will be a recovery and resolution procedure in place, and simplicity in structures and organizations will hopefully have increased. Alan Blinder commented that perhaps subsidiarisation would indeed be good for curbing the spreading of the investment banking culture as this can be bad for compensation practices in retail banks. Finally, Mario Nava, alluding to Governor Liikanen's earlier career in the European Commission, asked what he should have rethought as a Commissioner around the year 2000. Mr. Liikanen said convergence of sovereign debt spreads within the Euro area should have warranted more consideration, and we would have needed a single banking supervisor.

The third keynote of the conference was provided by Deputy Governor **Paul Tucker**. His speech was titled *"Banking Reform and Macroprudential Regulation: Implications for banks' capital structure and credit conditions"*. He emphasized two things: a richer capital structure for banks, and the use of macro-prudential policies in accordance with prevailing credit conditions. Further, resolution is the necessary antidote to the too-big-to-fail problem, and requires proper legal rights. On bank capital, Mr. Tucker first noted that the famous Modigliani-Miller irrelevance theorem does not literally hold for banks in particular, mainly because of the tax advantage of debt, and the property of deposits that they are a liquidity product. These factors give rise to incentives to high leverage in banking. However, bankruptcy costs are especially high for banks, taking also account of their social aspect. Because of these costs, standard capital structure theory advises to decrease bank leverage. He then sketched a capital accord for the future to be four-layered: first, equity would provide primary loss absorbing capacity (LAC); second, contingent capital bonds (CoCos) with a high trigger point would provide for recovery; third, CoCos with a low trigger point would facilitate resurrection, and finally, long term debt (bonds) could also be bailed in in a resolution phase. Mr. Tucker stressed that long-term debt can provide a basis for market discipline. He then moved to macro-prudential policy, saying that it should function as economy's memory. He presented a heuristic analysis of the effect of the UK's Financial Policy Committee's (FPC) hypothetical decision to change the overall capital requirement on banks, hinging upon the market's view of the FPC's current analysis of the credit conditions in the economy. He concluded this highly interesting analysis by inviting academic research to complement it in a more formal manner. Overall, Tucker concluded that as we reduce the too-big-to-fail problem, there will be more diversity in credit supply as more non-banks start providing long-term finance. He predicted that banks' capital and debt structure will be richer in the future. Macro-prudential policies should take the edge off busts by enhancing resilience. During the discussion, Mark Flannery (University of Florida), a well-known expert on CoCos, and Tucker exchanged views on the triggers used in CoCos. Prof. Flannery pointed out the problem of book value based triggers being too slow and backward-looking to react early enough, while Mr. Tucker said that overreaction is the problem related to market value based triggers. Prof. Krahnen observed that Mr. Tucker's views on the future debt structure of banks and CoCos resembled the HLEG's views. Mr. Tucker added his view on regulating bank structures by saying that systematic across the board measures are needed but they need to be complemented by bespoke restructurings which should not stop with the (systematic) measures of the HLEG, Vickers, and Volcker. Finally, in his view, the Vickers approach focused on making retail banks domestically super resolvable, while the HLEG report and the Volcker rule were mainly about bringing down banks' probability of default.

The conference ended with a panel including expertise from the academia, financial sector, regulation, and central banking. The chairman, **David Llewellyn** (Loughborough University, SUERF, and EBA) invited the panelists to express their views on whether banks in the future will be smaller, whether banking will be more costly (which may be good because it better reflects the true trade-offs in banking), and whether the volume of bank credit will be lower and capital markets bigger. He himself saw that European banking is still in transition, it has not reached the new steady state yet.

Andrea Enria (EBA) reminded in his opening statement that the G-20 reform package is quite radical; it called for more bank capital, liquidity, smaller and simpler institutions, and less interconnectedness. He then made observations of the current landscape in European banking; e.g., trading book sizes are still largely the same as they were before the crisis. However, banks do not yet trust each other (in the aftermath of the crisis), which shows up as less inter-banking. Consequently, there is more home bias in balancing assets and liabilities so that banks have become increasingly national in structure.

José Manuel Campa (HLEG member) started his statement by asking what we wouldlike banks to look like in the future. He pointed out that the sector grew a lot in the 10 years preceding the crisis. Maybe not all of that was good, and did not support the real economy. In his view, banking needs industrial restructuring, as has happened in many other industries over the years.

Hugo Bänziger (HLEG member) provided in his remarks a decomposition of the universal bank business model and considered the likely changes to come. He predicted that proprietary trading will be greatly reduced because shareholders do not actually like it. He then brought up the effect of the best execution requirement as part of the MiFID regulation, and said this might reduce investment banks' role in asset management. Moreover, OTC derivatives markets would lose ground as a result of high costs. He thought that in retail banking asset management can be profitable if done properly; it is about technology. Overall, he said that much of the recent investment banking business is not sustainable in the longer run. On bank structures he said that bank resolution plans will work only if there will be a structural change to subsidiarisation (as, e.g., proposed by the HLEG).

Philipp Hartmann (ECB, SUERF) ended the opening round with his account of the European Banking Union project which comprises the single supervisor, recovery and resolution, and deposit insurance. Banking Union's rationale is to break the bank-sovereign loop by bringing back private (market) discipline on banks. The industry should benefit from the single supervisor in particular. He saw that a single resolution mechanism would need to be developed in parallel with the single supervisor. That would involve two things: a European resolution fund and a single resolution authority. Harmonized deposit insurance is also highly important.

In the floor discussion, Natacha Valla (Goldman Sachs, SUERF) reflected on the need for having more liquid assets and for having more instruments as liabilities, saying that most notably there will be the challenge as to the kind of investors in such instruments. Urs Birchler asked how bankers see the future of the banking union. José Manuel Campa replied by pointing out that we need to get rid of national supervisors' home bias and they need to build a trust in the single supervisor. Morten Balling (Aarhus School of Business and SUERF) made a concrete suggestion that a group of experts should make a model prospectus for bail-in bonds, an issue dealt with by several speakers during the day.

David Llewellyn concluded the panel (as well as the entire successful conference day) with a bit of dark humor by pondering what would happen if risk managers in financial institutions and nuclear power plants changed places: there would no longer be financial crises, but that would not help much as we would all be dead by the following week.

Papers & Presentations: www.suerf.org/helsinki2013

2013 SUERF Annual Lecturer - Lex H. Hoogduin

Lex Hoogduin is professor of monetary economics and financial institutions at the University of Amsterdam and guest professor at the Duisenberg school of finance as well as an independent director of LCH.Clearnet and chairman of its risk committees, professor of complexity and uncertainty in financial markets and financial institutions at the State University of Groningen and advisor to Accenture. His academic work focuses on monetary theory and monetary policy and the impact of complexity and uncertainty on financial stability, risk management and strategic planning. Lex is also advisor to the Board of the Duisenberg school of Finance, a member of the Supervisory Board of Statistics Netherlands and a member of its audit committee. He is a consultant both nationally and internationally in the financial sector. Since 1980 he has had several spells at the Dutch Central Bank (DNB) as a public finance economist, deputy head and then head of the economics department and latterly as head of the monetary and economic policy department and head of the research department. Most recently, between 2009 until June 2011, he was executive director, responsible for economic policy and research, financial stability, financial markets, payment systems, statistics and information. Between 1997 and 2001 he was the personal adviser to Wim Duisenberg (first President of the European Central Bank) in Frankfurt at the EMI and ECB. From 2005-2008 he was Chief Economist of the Dutch asset manager Robeco and also head of IRIS, at that time the joint investment research company of Rabobank and Robeco.