“A LUSTRUM OF REFORMS: FROM THE LIIKANEN REPORT TO BANKING UNION”

Università Federico II – Napoli
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Liikanen High Level Expert Group
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1.1 The High-Level Expert Group
The High Level Expert Group

• **High Level Expert Group** established in **February 2012** by **Michel Barnier**, EU Commissioner for Internal Markets and Services, and chaired by **Erkki Liikanen** (Governor of the Bank of Finland)

• **Mandate**
  – Issue recommendations for establishing a safe, stable and efficient banking system, serving citizens, the EU economy and the internal market
  – Reduce risks, improve financial stability and mitigate moral hazard

• **Process**
  – In depth assessment of Banking Sector structure and business models
  – Extensive hearing cycle with all stakeholder constituencies
  – Public consultation

• **Report**
  – Published on October 2, 2012
1.2 Main Findings
## EU Banking System: Too Big

### Size of EU, US and Japan Banking Sectors (2011)
*(Figure 1)*

<table>
<thead>
<tr>
<th></th>
<th>EU</th>
<th>US</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Banking Sector assets</strong></td>
<td>42.9</td>
<td>8.6</td>
<td>7.1</td>
</tr>
<tr>
<td><strong>Total Banking Sector assets / GDP</strong></td>
<td>349%</td>
<td>78%</td>
<td>174%</td>
</tr>
<tr>
<td><strong>Top 10 Banks assets</strong></td>
<td>15</td>
<td>4.8</td>
<td>3.7</td>
</tr>
<tr>
<td><strong>Top 10 Banks assets / GDP</strong></td>
<td>122%</td>
<td>44%</td>
<td>91%</td>
</tr>
</tbody>
</table>

Note: 2011 data. Absolute numbers are € tn. Top 6 banks for Japan.
Source: European Banking Federation.
EU Banks: Structurally Underfunded

Customer Loan-To-Deposit ratio of major EU banks (2011)

(Figure 2)

Note: 2011 data (in %).
Source: SNL Financial.
EU Banks: Excessive Market Risk Taking

Total Assets ‘Held-For-Trading’ and ‘Available-For-Sale’ (2011)
(Figure 3)

Note: 2011 data, as % of total Assets.
Source: SNL Financial data.
EU Banks: Insufficient Capital Buffer for Market Risk

Capital requirements as % of trading assets for major EU banks (2011)
(Figure 4)

Note: 2011 data, in % of Trading assets. Calculated as 8% of market risk RWAs.
Source: Bloomberg.
EU Banks: The Risk Weight “Arbitrage”

RWAs / Total assets of major EU banks (2011)
(Figure 5)

Note: 2011 data (in %).
Source: SNL Financial data.
Main problems behind the Banking crisis

Underlying Problems

- Excessive risk-taking (trading, lending, funding)
- Complexity (inadequate bank management, monitoring, supervision and resolution)
- Limited loss absorbency
- Intra-group subsidies
- Ineffective Governance and Control

Consequences

- Increased probability of failure
- Increased impact of failure
- Reduced internal market efficiency and level-playing field

- 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
1.3 Summary of Recommendations
1: Mandatory Separation of Trading Activity

**Mandatory Separation between ‘Deposit Banks’ and ‘Trading Entities’**

<table>
<thead>
<tr>
<th>Activities separated to the Trading Entity</th>
<th>Trading activities permitted to Deposit Banks</th>
<th>Activities permitted only to Deposit Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietary trading</td>
<td>Client-driven transactions falling within narrow risk position limits</td>
<td>Raise insured deposits</td>
</tr>
<tr>
<td>Market-making</td>
<td>Securities underwriting</td>
<td>Payment services</td>
</tr>
<tr>
<td>Loans / Loan commitments and unsecured credit exposures to Hedge Funds and SIVs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments in Private Equity funds</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1: Mandatory Separation of Trading Activity

- Mandatory Separation only if the concerned activities amount to a significant share of a bank business

- Assessment to be completed in two stages

  - ‘Held-For-Trading’ and ‘Available-For-Sale’ assets exceed:
    - a) a relative threshold of 15-25% of total assets or
    - b) an absolute threshold of EUR 100bn

- The threshold as share of a bank total assets is to be calibrated by the Commission
Separation of Funding and Capital

- Deposit Bank must be insulated from risks of Trading Entity
- Deposit Bank and Trading Entity are *separately funded and capitalised*
- Intra-group transfers are subject to **Large Exposure rules**
- Other intra-group transfers only permitted if Capital Requirements are respected

Trading Entity CANNOT be funded by insured deposits but CAN be operated within a Banking group:

**NO BAN ON UNIVERSAL BANKING**
1: Mandatory Separation of Trading Activity

Liikanen proposal vs Volcker vs Vickers
(Figure 6)

Liikanen Banking Group (2012)
- Prop. Trading & market making
- Investment & Commercial banking

Volcker Banking Group (2010)
- Prop. Trading
- Market Making
- Investment & Comm. banking
- Swaps push-out

Vickers Banking Group (2011)
- Investment & Commercial banking
- Retail banking with higher Capital requirements
  (Prop. Trading, market making, large corp. lending)
2: Broader Separation conditional on Recover and Resolution Plan

A credible and effective Recovery and Resolution Plan may require the scope of separated activities to be wider at supervisors discretion.

EBA to develop standards for triggering additional separation based on:

- Complexity of Trading instrument
- Complexity of Organisation (governance, legal structure)
- Absolute and relative size of Risk positions

Ensure Operational Continuity of Critical Functions
3: Bail-in Instruments as Resolution Tool

Support of Bail-in as a Resolution tool:

• Improves loss absorbency
• Improves market discipline
• Reduces implicit subsidy

Increase predictability of Bail-in instruments:

• Requirement explicitly attached only to a clearly defined category of debt
• Phased-in over an extended period of time
• Bail-in instruments should be held within the Banking Sector only by Non-Bank Institutional Investors
do so. This could be especially useful for smaller institutions, whose bail-in instruments could face particularly narrow markets.

The Group is also of the opinion that a clear definition would clarify the position of bail-in instruments within the hierarchy of debt commitments in a bank’s balance sheet, and allow investors to know the eventual treatment of the respective instruments in case of resolution. Detailing the characteristics of the bail-in instruments in this way would greatly increase marketability of both new bail-inable securities and other debt instruments and facilitate the valuation and pricing of these instruments.

In order to limit interconnectedness within the banking system and increase the likelihood that the authorities are eventually able to apply the bail-in requirements in the event of a systemic crisis, it is preferable that the bail-in instruments should not be held within the banking sector. This would be best accomplished by restricting holdings of such instruments to non-bank institutional investors (e.g., investment funds and life insurance companies). Bail-in instruments should also be used in remuneration schemes for top management so as best to align decision-making with longer-term performance in banks. The Group suggests that this issue should be studied further.

5.5.4 A review of capital requirements on trading assets and real estate related loans

Model-based capital requirements related to risks in trading-book assets may suffer from modelling risks and measurement errors. In particular, tail-risks and systemic risks (including the impact on market liquidity of failures of major players) are not well-accounted for. Significant operational risks are related to all trading activities as demonstrated by several incidents of substantial loss events. The current operational risk capital charges are derived from income-based measures and do not reflect the volume of trading book assets. Moreover, significant counterparty and concentration risks can be related to all trading activities.

The mandatory separation proposed by the Group leaves substantial room for customer-driven and hedged trading and risk management activities in deposit banks so as to ensure the ability of these entities to service the real economy. On the other hand, the significant risks of the separated or stand-alone trading entities warrant robust capital rules to control the risk posed to the parent group and financial system as a whole. Thus, the weaknesses in the capital requirements presented above have implications for both the deposit bank and trading entity.

The Basel Committee has launched an extensive review of trading-book capital requirements. The Group welcomes this review. In its work, the Group has identified two approaches to improve the robustness of the trading book capital requirements:

- setting an extra, non-risk based capital buffer requirement for all trading-book assets on top of the risk-based requirements as detailed under Avenue 1 in Section 5.4.1; and/or
- introducing a robust floor for risk-based requirements (i.e. risk weighted assets (RWA)).

The benefit of the first approach (an extra capital buffer) is that it would improve protection against operational risks and reduce leverage, and it would not interfere with banks’ incentives to use and further develop internal models – as it would come on top of the risk-based requirements. The benefit of the second approach (a robust floor for RWAs) is that it would more directly address the possibility of model errors in modelling market risks. The Group suggests that the Basel Committee takes into account in its work the shortcomings of the present capital requirements as identified by the Group and that an evaluation be carried out by the Commission after the outcome of the Basel

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5 Amongst the issues under consideration is a move from value-at-risk to expected shortfall measures which are less prone to tail risks. The Basel Committee is also considering a more granular approach to model approvals, limiting the capital benefits of assumed diversification. Furthermore, the Basel Committee is considering a floor or surcharge to the models-based approach.
### General

- Improve consistency of Internal Models across banks
- Fix common minimum Floors for Risk Weights
- Full endorsement of tighter unweighted Leverage Ratio Limits

<table>
<thead>
<tr>
<th>Trading Entity</th>
<th>Deposit Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commission to assess whether Basel Committee Trading Book review will be sufficient to cover EU banks risks</td>
<td>Supervisors to make sure that Capital requirements include sufficient safeguards against substantial property market stress</td>
</tr>
<tr>
<td>Strict “Loan-To-Value” and / or “Loan-To-Income” caps should be part of macro-prudential toolbox in all Member States</td>
<td></td>
</tr>
</tbody>
</table>
## 5: Strengthen Banks Governance and Control

<table>
<thead>
<tr>
<th>Competence Assessment</th>
<th>- <strong>Fit and Proper</strong> tests to ensure Boards and Management competence in running large and complex banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Management</td>
<td>- <strong>Risk and Control</strong> management functions <strong>dual reporting</strong> to Risk &amp; Audit Committee and CEO</td>
</tr>
</tbody>
</table>
| Incentive schemes     | - Substantial share of variable remuneration should be paid in **Bail-in bonds**
|                       | - Assess **further restrictions** on level of variable income vs fixed remuneration
|                       | - Stipulate **absolute limits** to overall compensation pool |
| Risk disclosure       | - **Detailed financial reporting** for each legal entity and main business lines
|                       | - Full disclosure of **bottom-line profitability for each activity**
|                       | - Presented in easily understandable, accessible, meaningful and comparable formats |
| Sanctioning           | - Effective sanctions for Executive failure: **lifetime professional ban** and **claw-back** of deferred compensation |
2.1 Capital & Liquidity Standards
**Capital and Liquidity standards: Basel III / CRD IV**

(Figure 7)

<table>
<thead>
<tr>
<th>Capital</th>
<th>Liquidity</th>
<th>Leverage</th>
<th>Counterparty Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>- More and better capital (40% increased severity)</td>
<td>- Liquidity Coverage Ratio (Short Term)</td>
<td>- Unweighted Leverage Ratio</td>
<td>- Capital charge for CVA</td>
</tr>
<tr>
<td>- Higher Risk Weights</td>
<td>- Net Stable Funding Ratio (Long Term)</td>
<td>- TLAC (G-SIFIs)</td>
<td>- New standards for CCPs</td>
</tr>
<tr>
<td>- Conservation and Countercyclical buffers</td>
<td></td>
<td>- MREL (Euro Area)</td>
<td></td>
</tr>
</tbody>
</table>
Improving Capital and Liquidity standards: Basel III / CRD IV

(Figure 8)
2.2 The European Banking Union
The EU Banking Union

(Figure 9)

- **Capital Requirements (2012)**
  - CRR (EU)
  - CRD IV (EU)

- **Single Supervision (2014)**
  - SSM (EA)
  - EBA (EU)

  - BRRD (EU)
  - SRM / SRB (EA)

- **Deposit Protection (2017?)**
  - DGSD (EU)
  - EDIS (EA)
From Bail-Out to Bail-In

### Recovery & Resolution Directive: Capital Structure and Bail-in

(Figure 10)

<table>
<thead>
<tr>
<th>Category</th>
<th>Bail-in Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inter-bank liabilities (&lt;7 days maturity)</td>
<td>Excluded from bail-in</td>
</tr>
<tr>
<td>Covered deposits</td>
<td></td>
</tr>
<tr>
<td>Secured debt including covered bonds</td>
<td></td>
</tr>
<tr>
<td>Liabilities to employees</td>
<td></td>
</tr>
<tr>
<td>Commercial claims</td>
<td></td>
</tr>
<tr>
<td>Liabilities arising from a participation in payment systems</td>
<td>Subject to 'bail-in' up to 8% of total liabilities including own funds before national regulator has discretion with resolution fund</td>
</tr>
<tr>
<td>(&lt;7 days maturity)</td>
<td></td>
</tr>
<tr>
<td>Non-covered deposits (&gt;€100k)</td>
<td></td>
</tr>
<tr>
<td>Non-eligible deposits (large corporates)</td>
<td></td>
</tr>
<tr>
<td>Senior unsecured debt</td>
<td></td>
</tr>
<tr>
<td>Other ineligible subordinated debt</td>
<td></td>
</tr>
<tr>
<td>Qualifying Tier 2 instruments</td>
<td></td>
</tr>
<tr>
<td>Qualifying Tier 1 instruments</td>
<td></td>
</tr>
<tr>
<td>Preference shares</td>
<td></td>
</tr>
<tr>
<td>Common equity</td>
<td></td>
</tr>
</tbody>
</table>

Source: BRRD.
3.1 The Journey post Liikanen
The Journey post Liikanen

<table>
<thead>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Impact Assessment</td>
<td>EC Proposal for BSR Regulation</td>
<td>ECB Opinion</td>
<td>EU Parliament reject proposal</td>
<td>EU Council Agreement</td>
</tr>
</tbody>
</table>

- Proposal broadly reflects Liikanen with some important mitigations
- Scope: G-SIFIs and any Bank with
  - Total assets $\geq \text{€30 bn.}$ and
  - Trading activities $\geq \text{€70 bn.}$ or 10% of Total assets
- Distinction between Proprietary Trading vs. Other Trading Activity and formal ban of the former
- Derogations to separation requirements if existing national legislation is deemed having an “equivalent effect”

Main difference vs Proposed Regulation:
- **Mandatory separation of Prop. Trading** instead of prohibition
- Banks with Retail Deposits $< \text{€35 bn.}$ deemed to be out of scope
- Banks in scope split into two Tiers depending on last three years trading activities: threshold fixed at $\text{€100 bn.}$
- **For Top Tier Banks** (14), authorities can decide separation, capital add-on or other prudential measures (risk-based approach)
- UK exempted as national legislation deemed equivalent
The Current Parliamentary Stalemate

- European Parliament unable to approve a text due to disagreement on “automaticity” of separation

<table>
<thead>
<tr>
<th>Centre - Left</th>
<th>Centre - Right</th>
</tr>
</thead>
</table>
| Insists on a reversal in the burden of proof:  
  - Banks have to convince supervisors on absence of systemic risk contribution | Supports a broader discretion for regulators in lieu of pre-set triggers |

- Nevertheless, regulators already have separation powers under new Recover and Resolution Rules
3.2 Why BSR still matters
Persisting Difference in Views

October 2015
“The impact of structural reform could potentially damage banks’ ability to undertake market-making and provide other services in support of their corporate clients”

[Frédéric Oudéa, President European Banking Federation, CEO Société Générale]

November 2015
“We were wrong about two main things about Universal Banking: the belief that the larger the bank, the more efficient it would be; and that cultures in traditional and investment banking could be compatible. The universal banking model is inherently unstable and unworkable. No amount of restructuring, management change or regulation is ever likely to change that.”

[John S. Reed, Former Chairman and CEO Citicorp – Citigroup]
Focus vs. Diversification: Empirical Evidence

Link between Revenue Diversification and RoE

Global banks’ average RoE (by asset size†, %)

Note 1: Diversification ratio calculated as Non-Interest income vs Total Income.
Note 2: Diversification leads to RoE enhancements, but effects are “non-linear” and volatility increases too.

Source: Economist.com (Bloomberg).
Banks have increased their Capital Buffer...

(Figure 13)

**Fully-loaded CET 1%, European Banks**

- **Source**: RBS Macro Credit Strategy, EBA.
... and thus improved their leverage ratios,

(Figure 14)

Leverage ratio (fully loaded / fully phased in), Q2 2015

Note 1: (*) not explicitly mentioned whether the leverage ratio is fully loaded or not.
Note 2: For AIB, the leverage ratio excluding the 2009 Preference Shares is considered. The ratio including the 2009 Preference Shares, was 7.9% at 30 June 2015.

Source: RBS Macro Credit Research, Company filings.
however they are still too big in aggregate

(Figure 15)

Bank assets (% GDP)

and not profitable enough to carry additional capital

(RoA)(bps)

Return on Assets for Top Italian Banks

Note: Net Income / Average Total Assets; sample of 12 largest Italian Banks.
Source: RBS, Macro Credit Research.
3.3 Winners and Losers
Winners and Losers

• Few banks have yet adapted to the New World: structural overcapacity, digital revolution and demographic trends impose radical adjustment to business models

• **Losers** are the old-style monolithic, vertically integrated organisations, unwilling to embrace change

• **Winners** are those ready to invest in technology, knowledge, diversity ("long optionality")

• BSR can help making EU Universal Banks easier to manage, to supervise, to resolve

• However, only a US-style single, large and sophisticated capital market can make them profitable again

• EU Capital Markets Union project is pivotal: we must integrate private money if we aspire to do the same with public finances one day
4. Final Remarks
The Way Forward

- EU Regulatory Framework is now broadly “fit for purpose”

- Single DGS backstop would secure the macrosystem further, however TLCA / MREL will underpin the microstructure

- BSR remains an important pillar to financial stability, all the more so at a time when private implementation costs are manageable

- Banks profitability is now the real issue: from “too big to fail” to “too unprofitable to survive”?

- EU banking system should endorse BSR against the promise of a “regulatory freeze” and a swift implementation of Capital Markets Union