# Too Big to Fail: Should we Break Up The Banks?

## Panel Contribution - Jan P. Krahnen

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SAFE
House of Finance
Goethe University Frankfurt

CENTER FOR FINANCIAL STUDIES

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# Agenda

1. What crisis?
2. Basic repair job done (CRD IV, BRRD, SSM, SRM, SRF).
3. Liikanen add-on
4. Conclusion: Stepwise upgrading of supervisory measures

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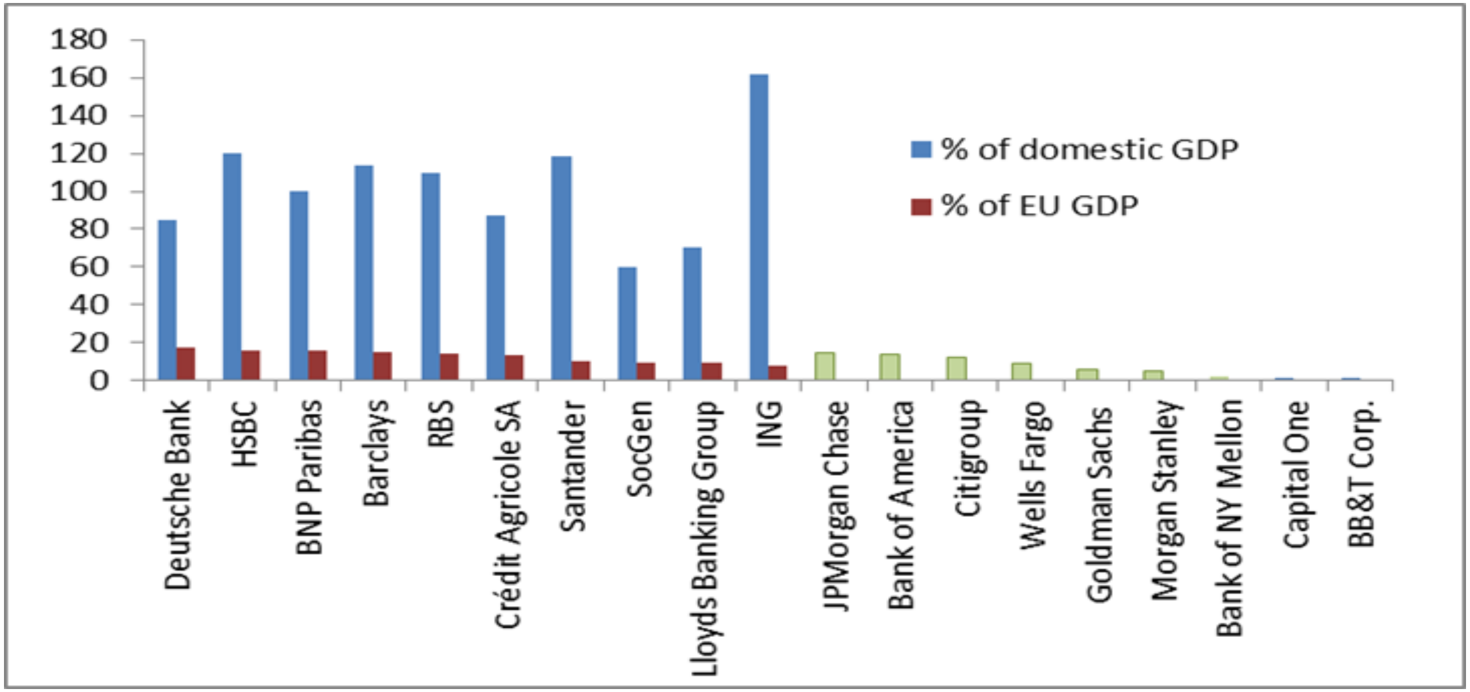
- At start: agreeing on a crisis narrative.
  - Crisis narrative: consistent economic explanation of why the crisis happened, and how it progressed.
  - Based on academic literature, interview-hearings in Brussels.
- If banks were big, risky, interconnected etc. BUT could be resolved one-by-one in a crisis without damaging the economy (shutting down payment system and credit provision),
- then we would have no problem with TBTF.
- Market discipline would deliver.
- But it does not.
- Why not?

# Some EU banks are very large compared to *national* GDP

**Total assets of EU and US banking groups** (2011, as % of GDP)



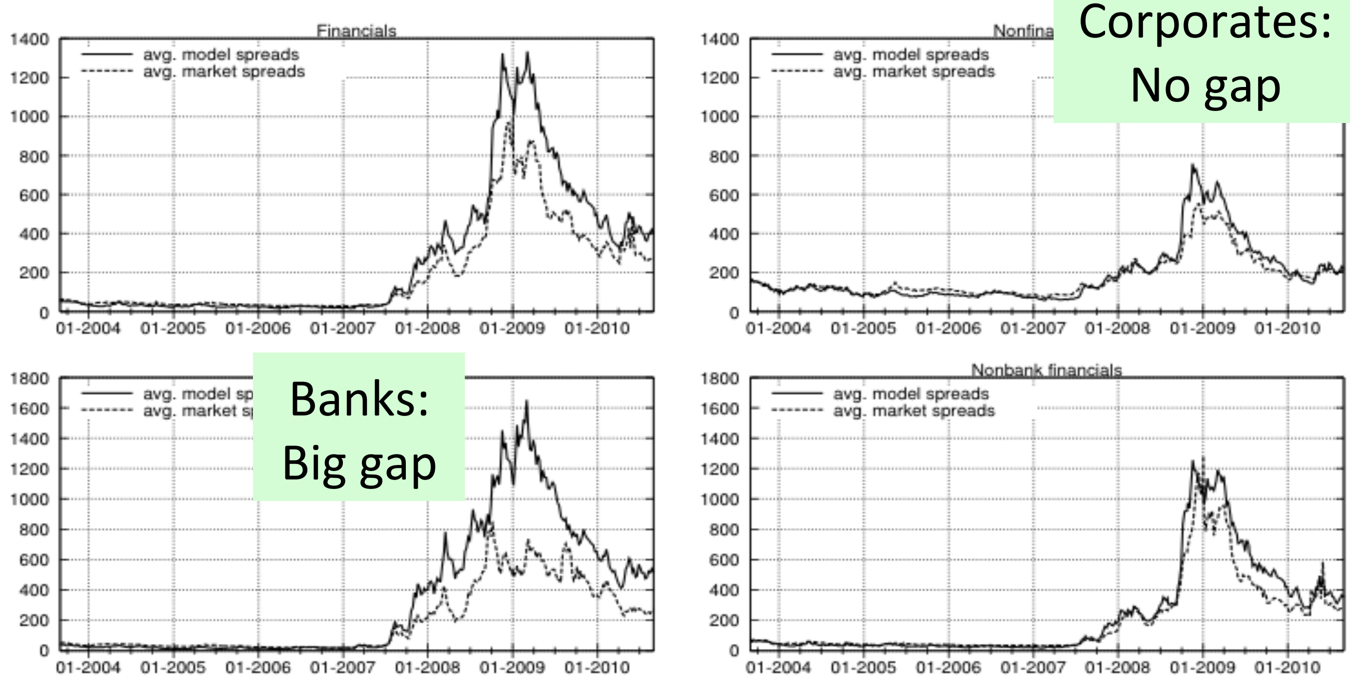

Source: SNL Financial, Eurostat for GDP.

# Credit risk is underpriced for banks, not corporates

Solid line: equity
Dotted line: debt

**Figure 2: Predicted versus observed CDS spreads - sector aggregates**

These charts depict the evolution of weekly averages of CDS market (solid line) and model spreads (dashed line) in basis points for sector aggregates during the period 2004 to 2010. Model predictions are based on the basic calibration scheme outlined in Subsection 4.1.




F. Schweikhard/Z.Tsesmelidakis : The Impact of Government Interventions on CDS and Equity Markets, Dec 2012, CFS-Working Paper.

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## Crisis is featured by persistence of systemic risk

- Bank rescue expectations (implicit government guarantee) lead to debt mispricing and increased systemic risk.

- Experience in many countries: bail-in was unacceptable as policy option,
  - Because of damage at other banks (interbank lending and ownership, derivatives, correlations). E.g. Germany: IKB, HRE, WLB.
  - Case studies: Anglo Irish, Hypo Real Estate, Amagerbk, Bankia, Dexia, SNS Reaal Group, Cyprus Popular Bk (Laiki), Alpha Bank (Duebel 2013)

- Liikanen recommendations
  - ➢ Facilitating bank resolution *subject to imminence of systemic risk*.

## Meanwhile, govts have learned the Lehman lesson

- *Better rescue fast*, to avoid systemic event with high costs for taxpayer and economy.
- Liikanen puts the Lehman lesson back on its feet:

  *Better ensure resolvability* of even the biggest banks, avoiding systemic risk and limiting TPM.
- Note the focus: Liikanen is on ex-ante effects, not on ex-post rescue (which is left to BRRD etc.)

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# Regulatory action has been enormous since 2008

| | |
|---|---|
| Capital, leverage | CRD IV / CRR, Solvency II<br>G-SIB requirements |
| Liquidity | CRD IV / CRR |
| Reduction of contagion, complexity | EMIR, MiFID II, proposals on CSDs and securities law, shadow banking |
| Corporate Governance | CRD III, CRD IV |
| Transparency, data quality | Review of IFRS standards, audit proposals, rating agency regulation, GLEI, risk map |
| Supervision | SSM |
| Recovery and Resolution | BRRD, SRM, ESM |
| Depositor protection | DGS proposal |

Banking Union



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# Summary of Recommendations

1) Mandatory **Separation** of Proprietary and significant other Trading activities (*resolution easier*)

2) Additional **Separation** of other activities conditional on the Recovery and Resolution plan

3) Amendments to the use of **Bail-in** instruments as a resolution tool (*less systemic risk*)

4) Review of **Capital** Requirements on Trading Assets and Real Estate Finance

5) Strengthen Banks' **Governance** and Control

# Liikanen report: basic rationale

Objective

No recourse to taxpayers' money
(pushing systemic risk to tail of distribution)

Strategy

Ensuring resolvability of banking institutions

Instruments

Separation of trading activities from universal banking
(***reduce complexity***)

Junior bank debt, held outside banking system
(***ensure bail-in-ability***)

Result

Re-habilitating debt market discipline in banking

## Complexity

- Interaction of banking and trading leads to higher level of interdependence, difficult to resolve within few days (the proverbial weekend).
  - Complexity has been rising for large international universal banks.
  - Counterparty services  to customers tend to be internalized, hedging is for the entire portfolio, order flow (size) is key.

## Incentives

- Interaction of relationship banking and transactional trading may result in cross subsidization.
  - Profitability is shifted from low risk to high risk segment
  - Effect may be exacerbated if there is a deposit guarantee.

# Separation to facilitate resolution (Liikanen)

| | |
|---|---|
| Separation of trading (prop trading *and* market making) | Separate legal entity (broker-dealer), holding structure, restricted joint liability, exposure limits apply. |
| | Stand-alone funding of trading activity avoids implicit subsidization. |
| | Resolution is facilitated. |
| | Generous *de minimis* rule applies (15-25%, €bn 100). |
| | Universal banking model (commercial + investment) remains largely untouched. |

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# *De-minimis* rule

- Mandatory Separation only if the concerned activities amount to a significant share of a bank business.
- Assessment to be completed in two stages:
  - Identify banks whose assets “held for trading “ and “available for sale” exceed:

a. a relative threshold of 15-25% of total assets;

<u>or</u>

b. an absolute threshold of EUR 100bn

2) Supervisors decide case-by-case on the basis of the assets to which the separation requirement applies.

The threshold is to be calibrated by the Commission.

# Mandatory Separation of Trading Activity

**Implications for funding and capital:**

- Trading Entity cannot be funded by insured deposits (but: position limits)
- Deposit Bank must be insulated from risks of Trading Entity (but: reputation risk)
- Deposit Bank and Trading Entity are separately capitalised (Is this costly?)
- Intra-group transfers are subject to Large Exposure Rules (What is the impact on coop and savings banks groups?)



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# Avenues 1 and 2

- Two roads to separation
  - Avenue 1: first, higher capital buffer (not risk-weighted) for banks with large trading book. Then RRP*. Second, if RRP not accepted by supervisor, separation is mandatory.
  - Avenue 2: Immediate separation, upon crossing a defined threshold (e.g., trading assets)
- Producing an effective and credible Resolution Plan may require the scope of separated activities to be wider;
- 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.

* Recovery and Resolution Plan

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# Where do we stand?

- Given the progress under CRD IV, BRRD, and Banking Union project,
    - Avenue 1 seems preferable.
    - Recovery and resolution planning first, **then** stronger capitalization of trading activities, **then** enhanced bail-in able capital structure **and** new supervisory role in markets for bail-in debt.
    - Then decision about full separation.

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# Separation proposals in US, UK, EU

### Separation in the Volcker proposal

Prop trading + Market making

Swaps push-out
Lincoln proposal*

Investment and commercial banking

### Separation in the Liikanen proposal

Prop trading + Mkt making

Investment and commercial banking

### Separation in the Vickers proposal

Investment and commercial banking (prop trading, mkt making, large corporate lending)

Retail banking with higher capital requirements

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# Summary of structural measures under Liikanen (1)

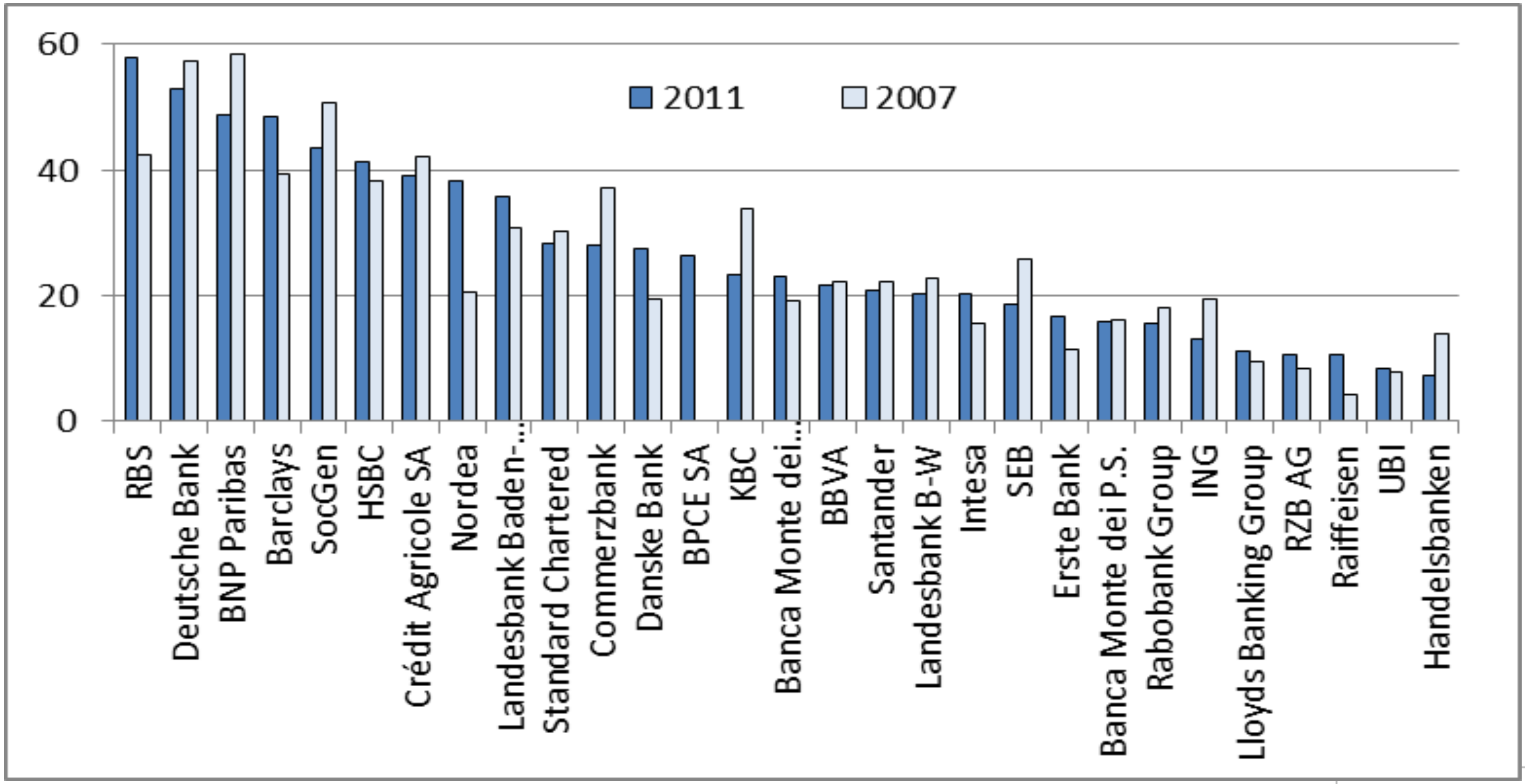
- Separation
  - Proposal is <u>not</u> about separation of deposit and investment banking - but about ring-fencing of significant trading activities.
    - <u>Reducing complexity</u> s/th RRD can be applied.
    - <u>Avoiding cross-subsidization</u> (from deposit guarantees), forcing trading book activities to be cost covering.
  - New kids on the block: small number of broker-dealers with expanded portfolios.
    - Overall trading activity may <u>decline</u>, because it is more expensive.
    - Overall universal banking may <u>gain</u>, because it is less expensive.
    - Possible effects on large banks and large groups may be smaller than expected, but needs <u>impact study</u>.
  - <u>Not</u> fully compliant with *<u>Ordnungspolitik</u>*.

# Summary of structural measures under Liikanen (2)

- Bail-in
- Re-introducing <u>market discipline</u> via bank funding.
- New role for <u>fund industry</u> (as anchor of banking system).
  - Market probably large enough – bail-in debt design details are key.
  - With corporate <u>governance</u> implications (via compensation, via debt-holder activism.
- New role for <u>supervisor</u>: ensuring bail-in ability.
  - Raising bail-in debt may be difficult for banking groups (<u>Verbünde</u>) with implicit deposit guarantee schemes.
  - <u>Complement</u> to raising equity, not substitute.
- Compliant with market-enabling <u>*Ordnungspolitik.*</u>

# “Fair Value-based” assets at major EU banks

**Total assets “held for trading” and “available for sale” of large EU banks**
(2011 and 2007, in % of total assets)




Source: SNL Financial

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## Further Recommendations 2: Capital Requirements

- **General:**
  - Improve consistency of Internal Models across banks;
  - Fix common minimum Floors for Risk Weights;
  - Full endorsement of stricter unweighted Leverage Ratio Limits.
- **Trading entity:**
  - Commission to assess whether Basel Committee Trading Book review will be sufficient to cover EU banks' risks.
- **Deposit bank:**
  - Supervisors to make sure that capital requirements include sufficient safeguards against substantial property market stress;
  - Strict LTV and/or LTI caps should be part of macro-prudential toolbox in all Member States.

# Proposals and their narratives

**US (Volcker):** Excessive risk taking (through propietary trading)

→ *Spin off prop trading*

**UK (Vickers):** Excessive risk taking (through investment or commercial banking) affects economy‘s core financial services.

→ *Ring-fence core services*

**EU (Liikanen):** Systemic risk as the key challenge for prevention and intervention (no banking type was safe).

→ *Ring-fence complex trading*
→ *Ensure debt is bail-in able*

# Capital Requirements

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- **Governance and control:**
  - **Fit and Proper** tests to ensure Boards and Management competence in running large and complex banks.
- **Risk management:**
  - **Risk and Control** management functions **dual reporting** to Risk & Audit Committee and CEO.
- **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.

## Governance and Control (cont'd)

- **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.