On the size and the structure of the banking sector

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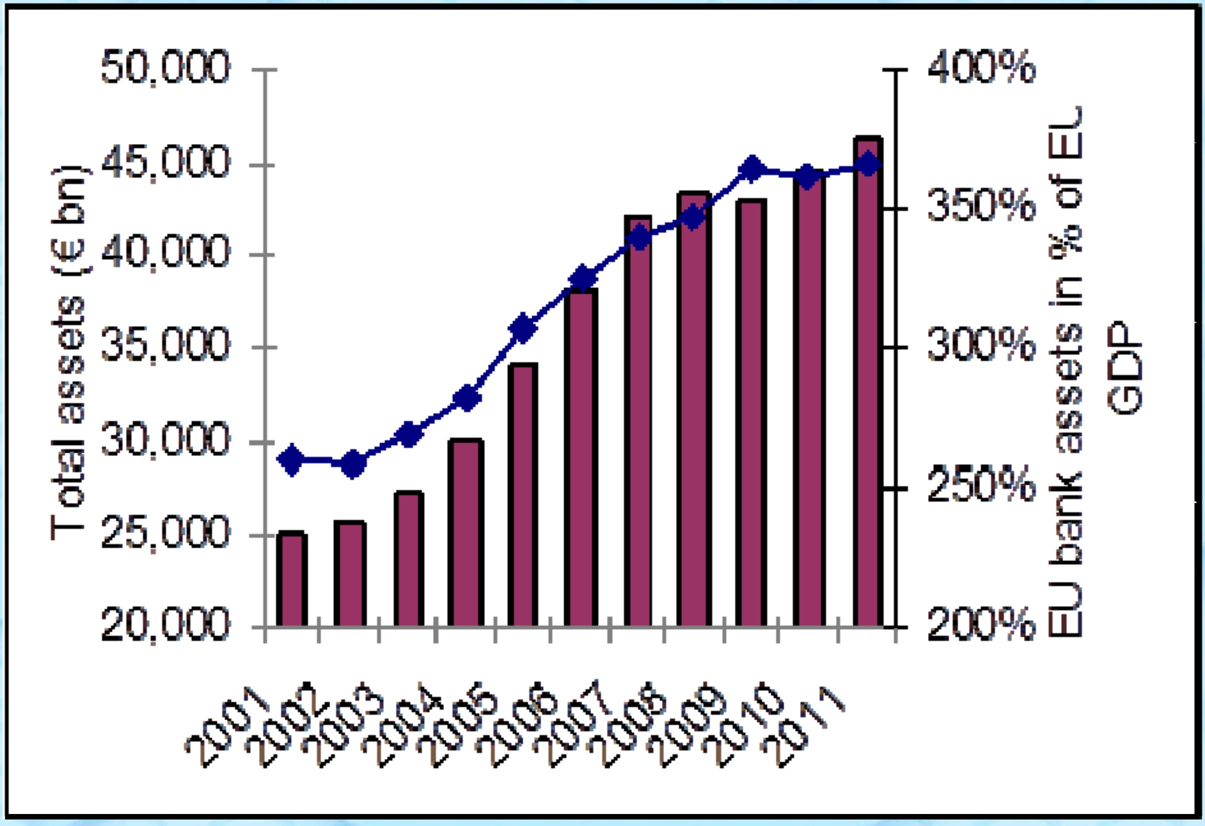
Rapid growth in the EU banking sector

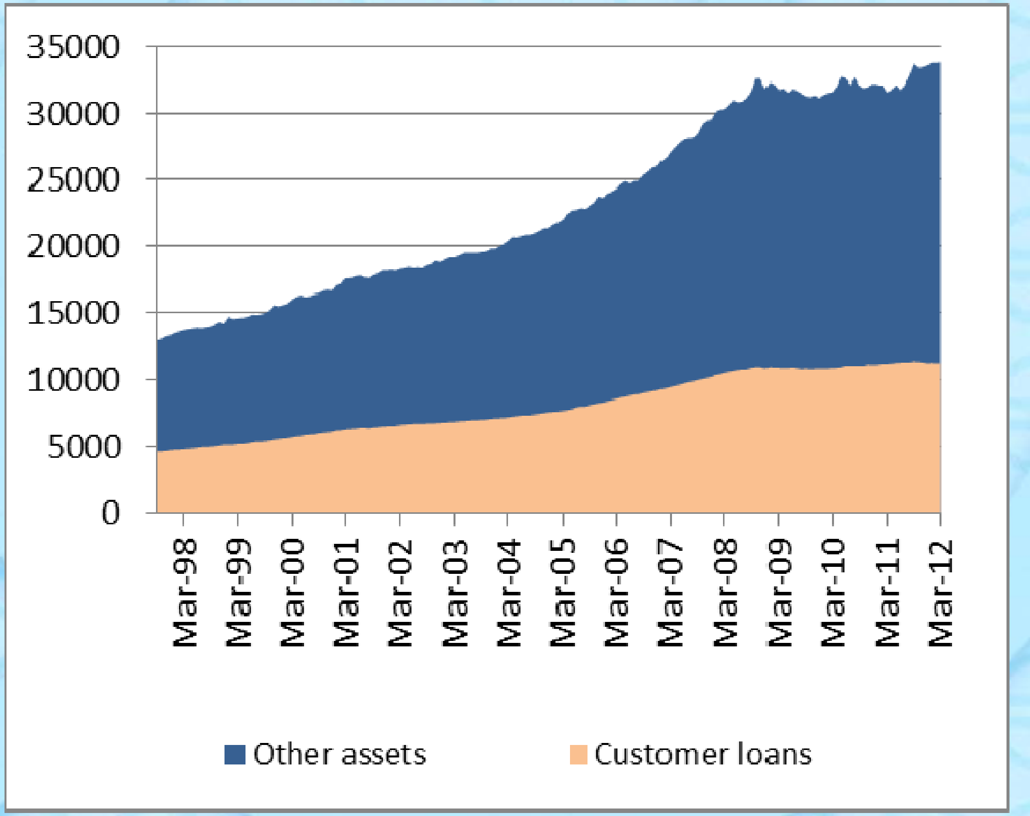
Total assets of MFIs in EU 2001-2011



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)

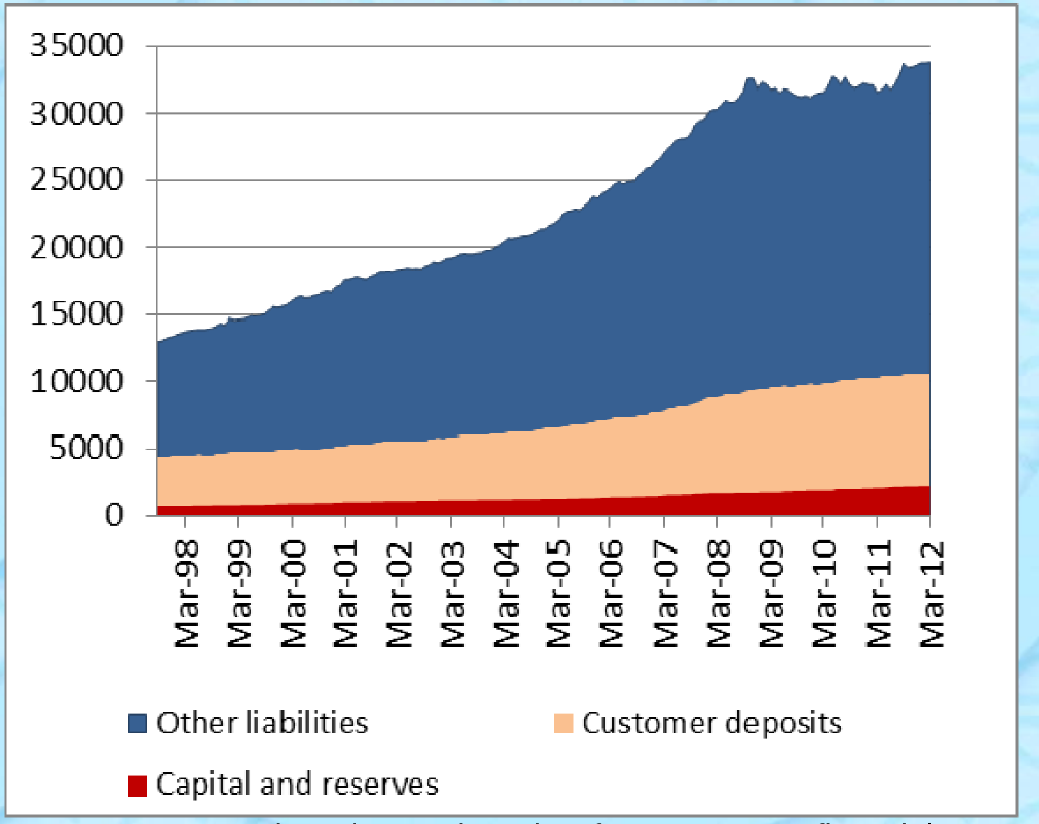


Notes: Customer loans are loans to non-monetary financial institutions excluding general government

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

Summary of the problems in the EU banking sector identified by HLEG

Identified problem by HLEG

- Excessive risk-taking in trading, lending, funding
- Complexity (making bank management, monitoring, supervision and resolution challenging)
- Limited loss absorbency
- Intra-group subsidies
- Ineffective governance and control

- 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

Result

Increased probability of failure

Increased impact of failure

Reduced internal market efficiency and level playing field

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.
- Cf. Darrell Duffie

- **Avenue 2**
  - Mandatory separation of retail banking and investment banking is imposed on banks.
- Cf. Alan Blinder

The High-level Expert Group's proposal for mandatory separation

- ***Activities separated to the "trading entity":***
  - Proprietary trading and market-making
  - Loans, loan commitments and unsecured credit exposure to hedge funds, SIVs, and private equity investments
- ***Activities which are permitted to "deposit banks":***
  - Hedged, client-driven transactions that fall within narrow risk position limits
  - Securities underwriting
- ***Activities permitted <u>only</u> to "deposit banks"***
  - Insured deposits and supply of retail payment services
- ***Restrictions on transfers and exposures between the separated entities***
- ***The entities can be operated within a banking group***

Rationale for mandatory separation

- ***Limit the spill-over of the effects of the deposit guarantee system and any implicit government guarantees, to the trading activities of banks***
  - Makes the pricing of funding of the separated entities more efficient and risk-based
- ***Reduce complexity and interconnectedness***
  - Enhances bank management
  - Facilitates supervision and monitoring thus reinforcing market discipline
  - Facilitates recovery and resolution and thus helps make it credible
- ***Reduce mixing of management cultures***

Comparison of suggested structural reforms

"Volcker banking group"

Proprietary trading,
Hedge fund (HF) and Private
equity (PE) exposures

Market making

Swaps push-out

Investment,
commercial and
retail banking

"HLEG banking group"

Proprietary
trading, market
making and HF,
PE and SIV
unsecured
exposures

Investment
banking incl.
securities
underwriting,
commercial and
retail banking

"Vickers banking group"

Proprietary trading,
market making,
investment banking
incl. securities
underwriting and
commercial banking

Retail
banking with
higher capital
requirements

Structural reform on the international regulatory agenda

A stylised comparison of selected structural reform proposals

	Volcker	Liikanen	Vickers
Broad approach	**Institutional separation** of commercial banking and certain investment activities	**Subsidiarisation:** proprietary and higher-risk trading activity have to be placed in a separate legal entity	**Ring-fencing:** structural separation of activities via a ring fence for retail banks
Deposit-taking institution may:			
- deal as principal in securities and derivatives	No	No	No
- invest in hedge funds and private equity	No	No	No
- engage in market-making	Yes	No	No
- perform underwriting business	Yes[1]	Yes	Restricted
- hold non-trading exposures to other financial intermediaries	Unrestricted	Unrestricted	Restricted (inside the group)
Holding company with banking and trading subsidiaries	Not permitted	Permitted	Permitted
Geographical restrictions	No	No	Limitations for ring fenced banks in the UK to provide services outside the European Economic Area

[1] Underwriting in response to client/counterparty demand.

Extract from the BIS-report, which was discussed during the spring meeting

Table 1. Comparing the Structural Reform Proposals

	Liikanen group report	United Kingdom	United States
Holding company with banking and trading subsidiaries	Permitted	Permitted	Not permitted
Deposit taking institution dealing as principal in securities and derivatives 1/	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted
Deposit taking institution investing in hedge funds and private equity	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted
Deposit taking institution providing market making services	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Permitted
Deposit taking institution's non-trading exposures to other financial intermediaries	Unrestricted	Restricted	Unrestricted
Higher loss absorbency rule 2/	Yes, via leverage ratio for trading business that exceeds size threshold	Yes, as add-on to the conservation buffer for UK ring-fenced banks	For SIBs with substantial US footprint
Size threshold for application	Yes; applies to all banks with trading books larger than €100 billion, or trading assets more than 15-25% of balance-sheet	Yes; applies to all banks and building societies with deposits greater than £25 billion	No
Enacted into law	No	Scheduled for completion by 2015	Yes
Implementing regulations finalized?	No	No	No

Extract from the IMF-report, which was discussed during the spring meeting

Source: Structural bank regulation initiatives: approaches and implications, BIS Working Papers 412; Act Local But Think Global: Can the Volcker, Vickers, and Liikanen Structural Measures Create a Safer Financial System? IMF Staff Discussion Note 13/4.

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

Thank you!