"Financial structure: the issues"
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Structural reform in the EU banking sector

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Structural reform in the EU banking sector

- *What?*
- *Why? Why at EU level? Why in addition to regulatory reform agenda? Why (only) now? Who should it be applied to?*
- *Stylised classification of structural reform initiatives*
- *Concluding remarks on impact assessment of structural reform*

What is structural reform?

1. **Restrictions** on the **activities a deposit-issuing entity is allowed to perform** (within a large and complex banking group)

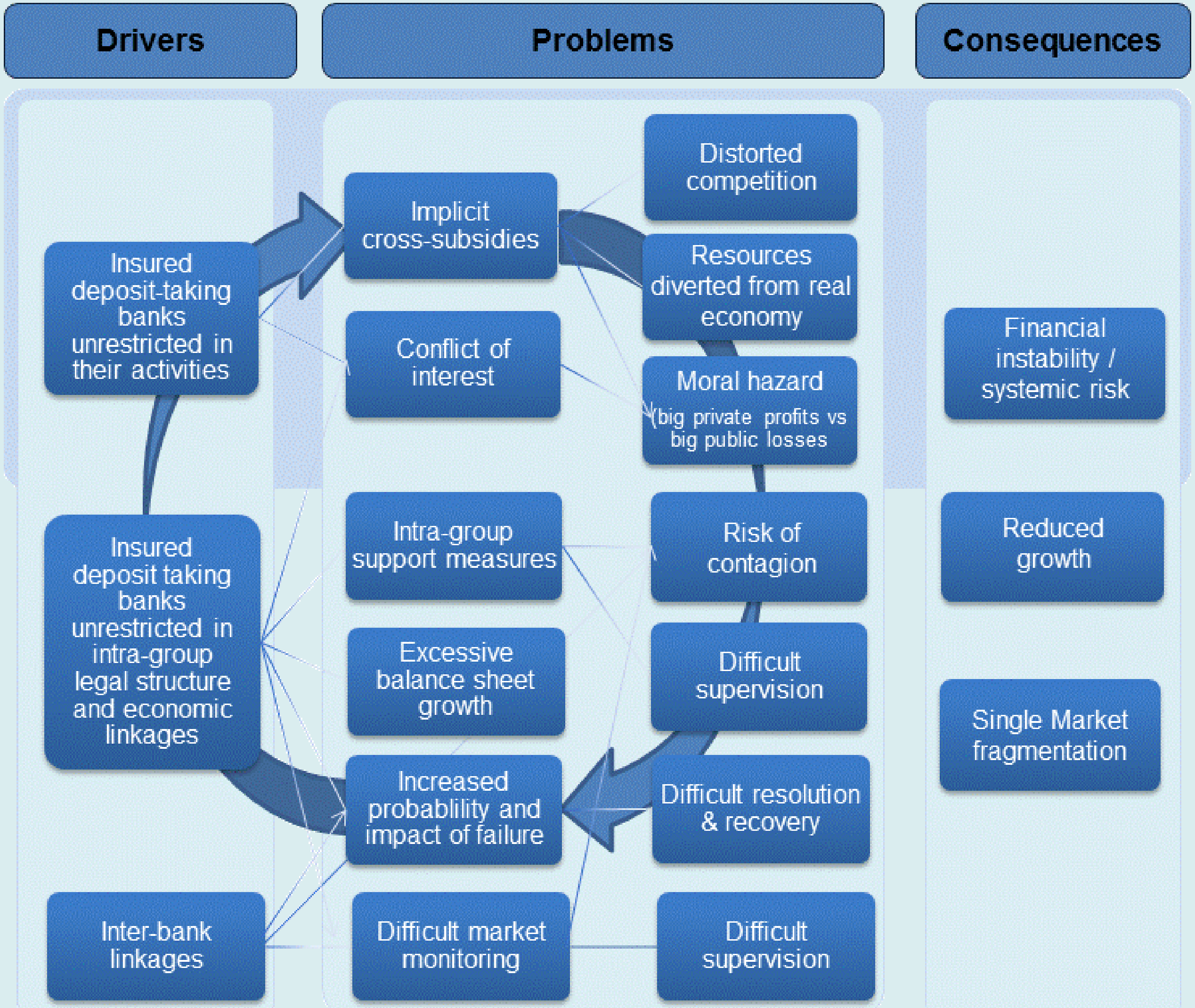
2. **Restrictions** on the **economic, operational and legal links** between entities within a large banking group

3. **Restrictions** on the **connections** within and between banking groups

Why **structural reform? (1/4)**

1. To **facilitate**
   - **a.** **recovery and resolvability** in the bad times; but also
   - **b.** **supervision, management,** and **market monitoring** in the good times.
2. Address **TITF, TCTF, TITF, TBTF** concerns and resulting **implicit taxpayer subsidies** and **cross-subsidies**
   - a. Risk-taking;
   - b. Unintended promotion through safety net of trading and capital market activity (transaction-oriented banking);
   - c. Unintended balance sheet expansion;
   - d. Competition distortions.
3. To reduce **probability** and **impact of failure**.
4. To reduce **problems of mixed cultures** and **conflicts of interests**.

Why structural reform? (1/4)



Why structural reform *at the EU level*? (2/4)

Why structural reform *at the EU level*? (2/4)

1. Avoid the costs for cross-border banking groups of **uncoordinated, divergent** and **national reforms**.
2. Avoid **circumvention** and ensure the **effectiveness** of reform
3. Avoid **competition distortions** and safeguard the **EU internal market** in financial services.
4. Ensure the success of EU **Banking Union** (≈ mutualisation of risks).

=> **Mandate** for structural separation follow-up given in the European Commission **College debate** of 6 March 2013. Need highlighted for a sound **impact analysis** that focuses on

- **Comparison** of different structural reform options**.**
- Assessment of **complementarity relative to reform agenda.**

Why structural reform ***in addition to everything else*****? (3/4)**

- **Ambitious and broad reform agenda**: CRD IV/CRR, BRRD, EMIR, FTT, MiFID, fundamental review trading book capital requirements, Banking Union (« three pillars »), etc.

=> Key to demonstrate **complementarity,** i.e. ability to increase the credibility and effectiveness of the regulatory reform agenda:

- **BRRD**: increase resolution options to authorities upon failure, target a broader set of objectives (facilitating supervision, management, and market monitoring, aligning incentives, etc.)
- **CRD IV/CRR**: reducing complexity and interconnectedness directly at root, target broader set of objectives, correct for too low level.
- **Banking Union**: mutualisation of risk increases implicit subsidies and the corresponding distortions, all else equal.

Why structural reform (only) *now*? (4/4)

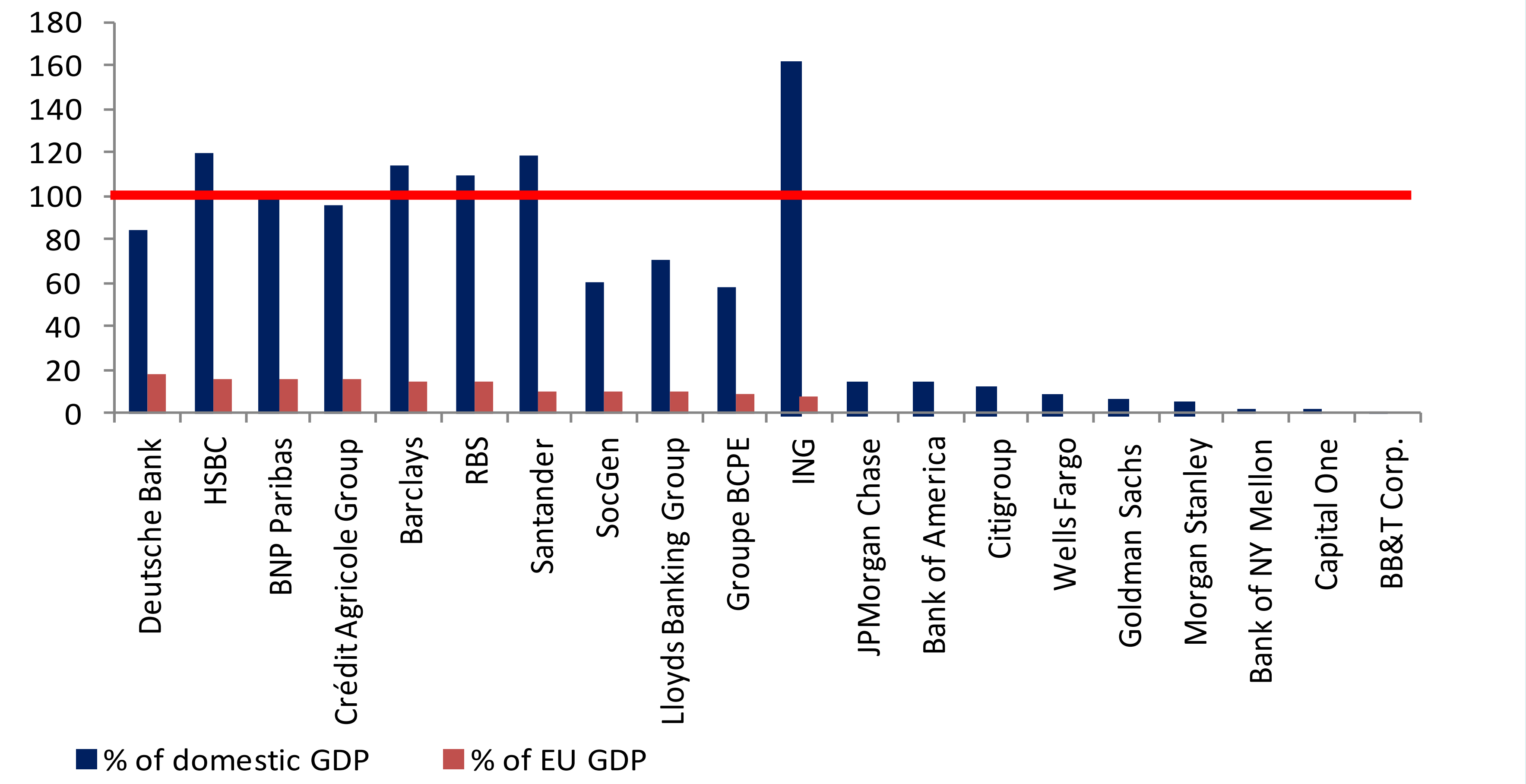
- « **Mother of all market failures** »: EU financial system, dominated by large and complex universal banking groups, would have *imploded* due to a system-wide cascade of banking failures without the extraordinary and on-going taxpayer and central bank support (40% EU GDP, EUR 5.1 trillion committed).
- **5 years on**, P/B ratios are still historically low, interbank markets have not yet fully recovered, modest restructuring to date, etc.

- **Reform agenda** does not *directly* address inappropriately wide coverage of public safety nets (cross-subsidy), complexity, interconnectedness, etc.
- **National « package » approaches**

Who?

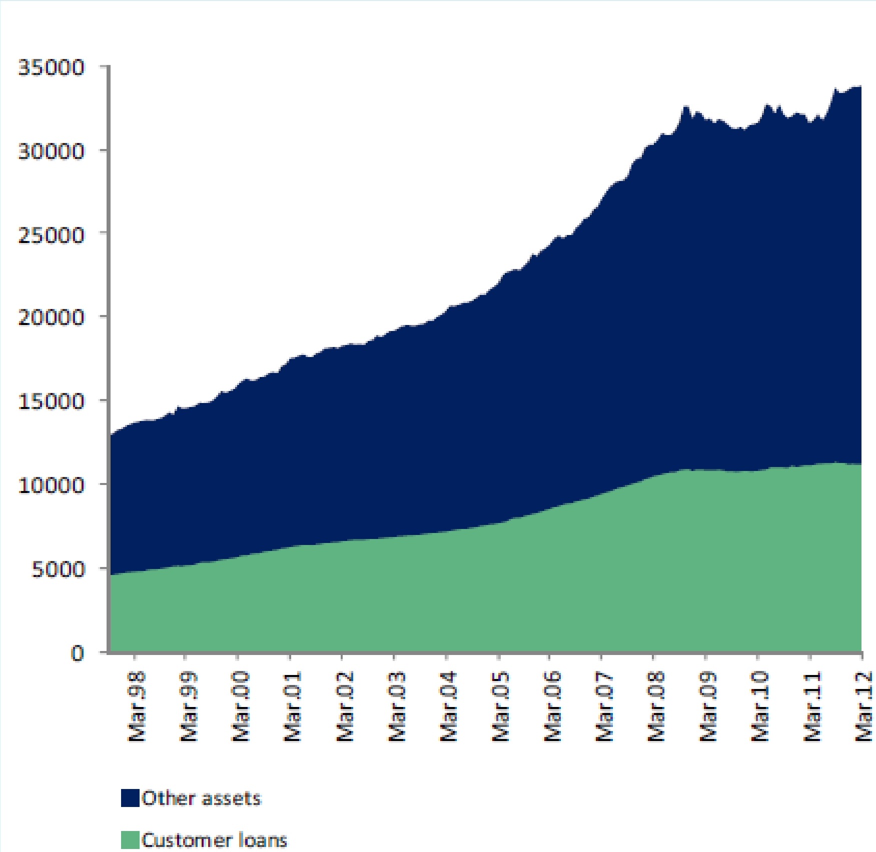
EU banking groups are large, complex, and "*international in life, but national in death*"

Total assets/GDP ratio of major EU and US banks (end 2011) **Source : Liikanen Report**

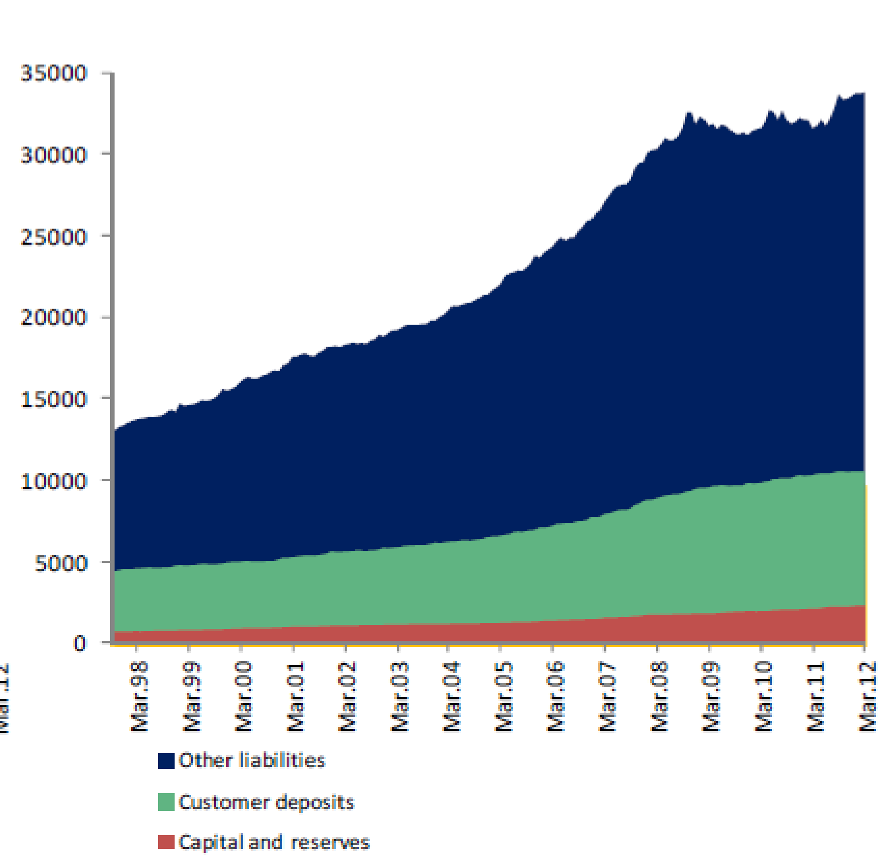


Has significant balance sheet growth benefited the real economy?

MFI assets structure



MFI liabilities structure



Note: Customer loans and deposits are from non-financial institutions (Government excluded) of Euro area, in € bn
Source: ECB., SNL Financial.

Stylised classification: strength and location of fence

Strength fence Location fence	"Weak" (Subsidiarisation, current restrictions)	"Medium" (Subsidiarisation"+", stricter restrictions)	"Strong" (Ownership separation)
"Narrow" Trading Entity/ "Broad" Deposit Entity E.g. Proprietary trading + exposures to VC/PE/HF (PT)	≈ FR, DE (baseline)	≈ US swaps push-out	≈ US Volcker
"Medium" Trading Entity/ "Medium" Deposit Entity e.g. PT + market-making (MM)	≈ FR, DE (if wider separation activated)	≈ HLEG (Liikanen)	
"Broad" Trading Entity/ "Narrow" Deposit Entity E.g. all investment banking activities		≈ US BHC ≈ UK	≈ Glass Steagall

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Impact assessment

- There are **limitations to quantitatively modelling the costs and benefits of structural reform**.
- ***Social* costs and benefits** are relevant, rather than private ones (but are more challenging to measure).
- **Questions for discussion**
  - Do public safety nets need to cover (i.e. promote) WIB activities?
  - Can links between RCB and WIB be a source of financial instability, rather than of economies of scope (pre-crisis conventional wisdom)?
  - How high do social costs need to be, in order to outweigh the social benefits of introducing more safety and soundness in the banking sector?
  - Do we need to strive for global convergence in bank corporate structure?

Relevant references

- European Commission (2013), "Structural reform in the EU banking sector: motivation, scope and consequences", Chapter 3 of the *European Financial Stability and Integration Report 2012*, April.
- Liikanen (2012), "High-level Expert Group on reforming the structure of the EU banking sector", final report, 2 October.
- European Commission public consultation documents (17 May 2013).