Liikanen Committee to overhaul European banking industry?

In early October, the Liikanen High-level Expert Group presented recommendations to the European Commission (EC) regarding additional reform measures for the European banking industry. One recommendation that received significant attention was that banks engaged in significant high-risk trading activities should be required to integrate these into a separate legal and economic entity within the banking group.[1] *Although the proposal is incomplete and it is as yet uncertain if, and in what form, the EC will implement this recommendation, it is interesting to examine how the proposal could potentially affect European banks and their customers. Will the proposal result in increased financial stability and better protection of taxpayers and savers, as intended?*

The road to Liikanen

Since the inception of the global crisis period in 2007, many new European regulations have emerged – and continue to emerge – designed to consolidate the European banking industry. More stringent capital and liquidity requirements (CRD III and IV), a more comprehensive set of anti-crisis instruments for supervisors, including mandatory recovery and resolution plans for banks (European Bank Recovery and Resolution Directive), central clearing of derivatives (EMIR), a new Deposit Guarantee Schemes Directive and proposals for European banking regulation (i.e. a banking union) are aimed, among other things, at reducing the likelihood and impact of a future banking crisis. In the wake of the Volcker Rule in the US and the Vickers report in the UK, European experts are currently also reviewing additional measures aimed at restructuring banks (Chow and Surti, 2011; Treur, 2012). A committee headed by Erkki Liikanen, Governor of the Bank of Finland, and including former Dutch banker Herman Wijffels as a member, presented its recommendations in early October at the EC's request. The Netherlands Ministry of Finance previously expressed the wish to implement a system of *separability*: in times of crisis, it should be possible to separate banks. For example, the Intervention Act was implemented in the Netherlands in June (Netherlands Ministry of Finance, 2011) for this very purpose. At the request of the Dutch Lower House, however, a committee headed by Herman Wijffels will launch an investigation by the end of this year into the need for structural reforms in the Dutch banking industry.

> **Why separate banking activities?**
> Regulators' goal in banning or separating specific trading activities within a banking group is to ensure that savings guaranteed under the deposit guarantee scheme (DGS) can no longer be jeopardised and that taxpayer risk is reduced. They also aim to reduce the complexity of, and interdependence between, banks, thereby facilitating an orderly resolution regime during a crisis, simplifying banking supervision, and allowing for increased market discipline. However, it remains to be seen to what extent these goals can be achieved (see elsewhere in this Special Report).

Liikanen's separation proposal

The Group recommends a <u>mandatory separation</u> of:
- proprietary trading[2];
- market making;
- private equity investments, and
- loans, credit guarantees and uninsured credit exposures to hedge funds, special investment vehicles and similar entities, if these activities

[1] The other recommendations represent amendments to the EC bail-in proposal (see Smolders, 2012a), a change in the capital requirements on trading assets and real-estate related loans, and strenghtening of governance and control of banks.

[2] This is a key difference with the US Volcker Rule, which aims to ban proprietary trading.

constitute a substantial portion of the bank's business or are significant in terms of financial stability.

The value of market making

Unlike proprietary trading, which involves the trade in securities (shares and bonds) and derivatives strictly for the bank's own profit (or loss), market making does serve a significant customer interest. Thanks to market making, banks are able to directly meet customers' demand for, or supply of, a specific security or derivative at a competitive rate.

Market makers ensure liquidity and efficient pricing in financial markets, since they continuously provide buy-and-sell prices for securities and derivatives and are willing to act as a counterparty at any time (see Duffie, 2012).

Market makers actively manage the risk associated with these transactions, including through limit structures, and also maintain capital buffers for this purpose. For universal banks, an appropriate amount of market making is essential, as otherwise they cannot be considered market players and will not be able to offer good prices to their customers.

The Committee believes the decision-making process for separation should be completed in two stages. If a bank conducts trading activities that – measured as *held for trading* and *available for sale*[3] – constitute more than 15-25% of the bank's total assets or 100 billion euros, the bank proceeds to the second stage. During this stage, regulators determine the need for separation based on a threshold, which has not yet been determined. It is therefore as yet unclear which banks should be required to separate based on the Liikanen proposal.

Under the recommendation, banks required to separate must integrate the above-mentioned trading activities into a separate legal trading entity within the banking group/holding company and finance and capitalise it separately (this is known as 'ring-fencing').

In this sense it differs from the Vickers proposal, under which the retail activities are ring-fenced.

While the trading entity is also authorised to perform other activities, it is not permitted to fund itself with insured deposits and it is not allowed to supply retail payment services. This is reserved for the banking group's other entity: the deposit bank. This part of the banking group is therefore permitted to engage in activities other than the trading activities to be separated[4], unless the bank's recovery and resolution plan requires otherwise. For their own liquidity and risk management, deposit banks are also authorised to use derivatives and trade in assets. Within narrow position risk limits, they are finally also allowed to provide hedging services to non-banking customers, along with underwriting services[5]. By allowing deposit banks such a wide scope, the Liikanen Committee acknowledges the value of specific trading activities to customers, and distinguishes itself expressly from the British Vickers proposal, under which the scope of retail banks is significantly smaller.

The permitted transfers of funds and risks between the deposit bank and the trading entity are limited: they must be conducted on market-based terms, fall within the large exposure regulation[6], and the capital adequacy of the deposit bank must not be endangered as a result.

Another key focus of the Liikanen Committee is facilitating the establishment of credible and effective recovery and resolution plans de-

[3] Oddly enough, under this measuring method activities for the benefit of the deposit bank (e.g. liquidity books and derivatives for balance sheet management) are included in the calculation.

[4] For example: lending to large, small and medium-sized companies; trade finance; consumer lending; mortgage lending; interbank lending; participation in loan syndications; plain vanilla securitisation for funding purposes; private wealth and asset management and exposure to regulated money-market funds.

[5] Providing assistance in rights issues or bond issues.

[6] Banks must monitor and manage their risk concentrations in relation to one counterparty or group of affiliated counterparties.

signed to guarantee the continuity of critical banking services. The Committee refers to the options available to regulators under the proposed European Bank Recovery and Resolution Directive to require that banks change their legal or operational structure (conditional separation). The Expert Group also believes that the scope of the activities to be separated in this situation can be wider than described above.

The separation proposal in practice

Although it is as yet uncertain whether the EC will implement the Liikanen separation proposal, according to some sources (see Reuters, 2012), implementation would mean that approximately 20 European universal banks would be *required* to separate. Committee member Herman Wijffels has publicly stated that this does not include Dutch banks, as they engage in relatively little trading. However, the proposal for *conditional* separation to facilitate the recovery and resolution plan leaves significant scope for regulators to also demand separation of other banks.

Banks required to separate will be faced with higher costs (see Netherlands Ministry of Finance, 2011). Separation will result in reduced synergy and diversification benefits in the long term, as well as adjustment costs. In addition, capital and funding costs, which have increased due to the continued turmoil in the financial markets and stricter capital and liquidity requirements, will increase further for these banks.[7] Investors in the money and capital markets, on which the trading entity will become dependent for its funding, will regard the trading entity as more high-risk due to the loss of diversification benefits with the rest of the banking group and the generally more volatile income from trading activities. As a result, they will require higher interest compensation and demand more capital buffers.[8] This effect will be enhanced when the credit ratings of the deposit bank and the trading entity within a banking group start to diverge (further) as a result of the separation, as predicted by Fitch Ratings (2012). This will increase the required return on trading activities. While the cost of implementing the Liikanen proposals has not yet been estimated, the impact assessment made of the British Vickers proposal shows that a form of separation within a banking group involves substantial expenses: the non-recurring adjustment costs for British banks are estimated at 2.5 billion pounds; the consistently higher costs are estimated at 4 to 7 billion pounds per year (HM Treasury, 2011).

The question is whether banks' trading activities, e.g. the trade in derivatives, will be viable enough by that time (see Deutsche Bank, 2012). Due to new regulations relating to derivatives, and the central clearing thereof (EMIR and Dodd-Frank), the infrastructure requirements – and, therefore, the cost of trading activities – have already risen sharply.[9] Mandatory separation will only add to this, while the competitive disadvantage also has a strong impact. It will be tough for European banks to deal with competing US and Asian banks that are not required to implement these separations, or to a lesser degree. Although the Liikanen Committee aims to support the universal banking model with its proposal, the unintended result will be that only the largest European players that have sufficient scale will continue to engage in trading activities; smaller players will reduce these activities, as they will not be viable in the long run. The latter is a realistic scenario, for example, if Dutch banks were required to separate their limited trading activities.

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[7] The Liikanen Expert Group aims to further increase capital requirements for market risk.

[8] To a lesser extent, this will also apply to the deposit bank, as it will lose diversification benefits while at the same time having access to more stable deposit funding.

[9] Two major international banks (Singapore-based DBS and Sweden's Nordea Bank) have already announced, for this very reason, that they will not register in the US to trade swaps (TWSJ, 2012).

So how will the proposal affect customers?

Large companies that require trading services for their risk management processes, in particular, will notice the impact, and will increasingly need to procure these services from other (foreign) banks. Specifically, some banks that are reducing their trading activities will decide to continue as retail banks, providing limited services to major companies.[10] Trading services will also be more expensive than before, both due to the high costs associated with the separation and new regulations and to the fact that the Liikanen proposal makes market making more expensive and therefore has a discouraging effect. Less market making in securities and derivatives means less liquidity in the market and, as a result, higher and more volatile prices. Under the Lilkanen proposal it will therefore become more expensive for businesses and governments to fund themselves with bonds and shares. Finally, major companies for which private equity represents an important source of funding may be affected as well. The Liikanen proposal discourages investment by banks, as these investments must occur fully within the trading entity. However, given the current tightening of bank lending, it is important that companies continue to have access to multiple funding sources.

Will financial stability increase?

The disadvantages of implementing the separation proposal may be justified if the benefits of financial stability provide sufficient compensation. However, opinions vary as to whether the proposed benefits can actually be achieved through some form of bank separation (Netherlands Ministry of Finance, 2011; Chow and Surti, 2011; Goodhart, 2012). If the Liikanen proposal is implemented, the trading entities will be more vulnerable than before, as they will depend completely for funding on the more unstable money and capital markets. Besides, both the trading entity and the deposit bank will have fewer diversified activities and income. However, income diversification reduces the a bank's risk (ECB, 2011). Since trading activities will be concentrated among several larger players, systemic risk will increase accordingly. This will make the impact of bankruptcy of a trading entity greater than currently estimated, which, in turn, will make it more difficult for the deposit bank to remain immune. Another very substantial risk is that risks will shift to the less regulated shadow banking system. Since this system is closely intertwined with the regulated banking system, a crisis in this industry would have a major contagion effect on banks (Chow and Surti, 2011). A well-known example is the credit crisis (2007-2008), which originated in the shadow banking system (see Smolders, 2012b).

Conclusion

If the EC decides to implement the Liikanen separation proposal, this, combined with other regulations and unlevel playing field, will create a situation where only a handful of major players will be able to conduct trading activities on a profitable basis. This will reduce the accessibility of trading services for European banking customers and will make them more expensive than before. At the same time, it is highly doubtful whether benefits in the form of greater financial stability would outweigh these disadvantages. Curbing high-risk trading activities that serve no customer interest (i.e. proprietary trading) in the spirit of a workable Volcker Rule where market making in the service of customers remains possible, would be a better alternative. Continuing to build stronger buffers and create credible resolution plans, whose contribution to financial stability is significantly more assured, also remains essential.

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[10] An alternative for them would be to pay to use the trading activities of other banks.

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