KRAMER LEVIN

'Liikanen Report (October 2012)': a lot of noise for nothing ?

by Hubert de Vauplane

Introduction

- Commissioner Barnier established a High Level Expert Group on Structural Bank Reforms in February 2012.

- Mandate : to assess whether additional reforms directly targeted at the structure on individual banks would further reduce the probability and impact of failure, ensure the continuation of vital economics functions upon failure and better protect vulnerable retail clients.

- Report was published on October 4, 2012

Introduction

- Hearings with a large number of stakeholders (banking services, consumers of banking services, investors, policymakers, academics)
- In evaluating the European banking sector, the Group had no pre model in mind and has found that no particular business model fared particularly well, or particularly poorly, in the financial crisis

Excessive Risk taking

- The analysis revealed excessive risk taking – often in trading highly complex instruments or real estate lending – and excessive reliance on short term funding in the run-up to the financial crisis;
- The risk-taking was not matched with adequate capital protection, and strong linkages between financial institutions created high levels of systemic risk.

On going regulatory reforms

- Structural reforms are in the pipe in some countries :
  - Activity restriction or prohibition (Volcker Rule)
  - Structural separation of certain activities (Vickers Report)

Vickers Report

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The Vickers or ICB Report

- Vickers (or UK Independant Commission on Banking) recommends that large UK banks should ring-fenced their retail bank operation into separate legal subsidiaries with their own prudential safeguards
- The UK government formally welcomed the ICB's report in December 2011 and in June 2012 realsed a White Paper for consultation on how to implement the recommendations.

The Vickers Report

- Basic concept : deposits from and overdrafts to individuals and SMEs have to be provided by a ring-fenced entity (*mandated services*).
- Other services cannot be provided by the ring-fenced entity (*prohibited services*). The prohibited services were not exhaustively defined but ICB provided a set of objectives.
- Activities that are necessary for the efficient provision of mandated services may be provided by the ring fenced bank (*ancillary services*).

The Vickers Report

- ICB set out detailed requirements to ensure that the ring fenced bank **can be isolated** from the group in a few day and can continue to provide services without solvency support;
- ICB also proposed detailed requirements on **economics links** to ensure that the ring fenced bank's relations with other parts of the group take place on third party basis; and that the ring fenced bank should not be dependant on the group's continued financial health for its solvency or liquidity.
- ICB proposed a number of requirements as regard **prudential safeguards** : more equity, sttricter leverage limits, bail in, depositor preference, primary loss absorbing capacity….

The Vickers Report:

- The Vickers Report brings an English answer to an English problem:
  - Some retail banks have suffered considerable losses in the mortgage market
  - The significant amount of English bank deposits explains why UK government focuses on them
  - The Vickers Report's recommendations aim to create a more competitive basis for UK banking in the long term and do not increase the burden of investment banks' equity capital

The Vickers Report: pros & cons

- The Vickers Report meets English needs but is not tailored to the European context:
  - It does not seem compatible with the EU framework (Resolution draft directive)
  - It does not provide a clear solution regarding the risk of a retail bank's liquidity crisis
  - It does not take into account the limitation of financial speculation

The Vickers Report does not meet European needs

- The existence of intra-group agreements between retail banking and the rest of the group will render the risk of non contagion illusory;

- It envisages a radically different market model comparing to the one that most of the EU countries have (Universal banking model)

The Vickers Report does not meet Europe needs

- The Vickers Report is too complex to implement, because it is difficult to determine the exact rights of the retail banking sector;
- The Vickers Report does not give any consideration to the problem of branches operating in Great Britain
- It is impossible to ring-fence banks' retail operations without adapting the rules to the particular case of cooperative banks

The Vickers Report does not meet European needs

- In certain countries the implementation of the Vickers Report will lead to the tightening of financing conditions
- A lack of independent non-executives and experts is feared (because separate corporate governance for the ring fenced entity)
- The implementation **schedule** turns out to be particularly slow (2019 !)

Volker Rule

Volcker Rule

- Section 619 of the DFA, known as the Volcker Rule, restricts deposit taking banks from engaging in certain types of market oriented activity.
- The underline intention of the rule is to safeguard the core banking system, i.e the « commmercial banks ».

Volcker Rule

- The rule **prohibits** any banking entity from engaging as principal in **short term trading** in securities, derivativves, or commodity futures, i.e activities judged as incompatible with the appropriate risk profile and customer driven mission of banking entities.
- The rule is subject to **exceptions** for market making, hedging, trading in US governement securities, and other activites

Volcker Rule

- The Rule was suposed to enter into force on July 21, 2012 but the Federal Reserve issued a statement clarifying the two year compliance for bank entities to July 2014

The Volcker Rule: pros & cons

- The fact of prohibiting an insured depository institution from engaging in “proprietary trading” and acquiring any interest in a hedge fund or private equity fund seems theoretically quite easy to do
- The Volcker Rule appears **more suited** to the needs to limit the speculative transactions
- By limiting potential exposure to certain speculative instruments, the Volcker Rule **addresses directly the root causes** of the financial crisis

The Volcker Rule: pros & cons

- The Volcker approach is more criticized for its method than its substance:
  - Either an outright ban of certain activities, but it raises the question of how to define such activities;
  - Or only a limitation of the most risky ones.
- In both cases however, failure to comply with these requirements should give rise to disciplinary measures and financial penalties.

Liikanen Proposal

Liikanen proposal : mandatory separation of proprietary activites

- The group proposes that **proprietary trading** and all assets or derivative positions incurred in the process of market making **must be assigned to a separate legal entity** within the banking group.
- Any loan, loan commitments or unsecured credit exposures to hedge funds (including prime brokerage), SIVs and other such entities of comparable nature, as well as private quity investments should also be assigned to the trading entity.

Liikanen proposal

- The Group suggests that the separation would only be mandatory
  - **if the activities** to be separated amount to a significant share of bank's business, or
  - **if the volume** of these activities can be considered significant from the viewpoint of financial stability

Two steps

- The group suggests that the decision to require mandatory separation should proceed in two stages :
  - In the first stage, if a bank's asset held for trading and available for sale, as currently defined, exceed (i) a relative examination threshold of **15-25 % of the bank's total assets** or (ii) an absolute examination threshold of **€100bn**, the banks would advance to the second stage examination;
  - In the second stage, supervisors would determine the need for separation based on the sharre of assets to which the separation requirements would apply. The threshold is to be calibrated by the Commission
- When a bank exceeds the final treshold, all activities concerned should be transferred to the legally-separated trading entity.
- Smallest banks would be considered to be fully excluded from the separation requirement.

Permitted activites

- The permitted activites provided by the « deposit bank » include lending to large as well as SME companies, trade finance, consumer lending, mortgage lending, interbank lending, participation in a loan syndication, plain vanilla securitisation for funding purposes, private wealth management and asset management, and of course payment services.

Objectives of Liikanen proposal

- Limit a banking group's inccentives and ability to take excessive risks with insured deposit;
- Prevent the coverage of losses incured in the trading entity by the funds of the deposit bank;
- Avoid the excessive allocation of lending from the deposit bank to other financial activites ;
- Reduce the interconnectedness between banks and shadow banking system
- Level the playing field in investment banking activites between banking groups ans stand alone investment banks.

Conclusion

- Expectations on Liikanen report were high. The result is quite disappointing :
  - Proposal is a mix between Vickers and Volckers rule ;
  - Proposal will not limit speculative activities ;
  - Proposal will create issues between US and EU structure for banks having activities in two sides of Atlantic;
  - Last but not least, the separation of activities will not take safe the non trading bank as trading entity is fully owned entity.