



**German Bundestag Finance Committee
Hearing on the Draft Bank-Separation Law
(Drucksache 17/12601) – 22 April 2013**

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Introduction

We welcome the opportunity to participate in the Finance Committee's hearing on the Draft bank-separation law (Drucksache 17/12601). In view of the European and wider global context in which this law is being prepared and will take effect we will focus our comments on its underlying basis, the main proposals of the *Final Report of the High-level Expert Group on reforming the structure of the EU banking sector* (October 2012, Chaired by Erkki Liikanen).

The main elements of successful reform of the European and global financial systems will be:

- Simplification of the system
- Meaningful levels of required capital in banks and other regulated financial institutions
- Ending "too-big-to-fail" by reducing bank interconnectedness and minimizing implicit guarantees
- Better incentive structures and governance arrangements for banks

The Liikanen Report

The Liikanen Report includes a number of recommendations that would contribute strongly to such reform and should be reflected in the bank-separation law. In particular:

- Separation of certain significant proprietary trading activities and asset positions, notably those relating to derivatives incurred in the process of market-making, from activities that use insured deposits as a source of funding will be a major step toward ending the too-big-to-fail problem. Assigning these trading activities to a separate, fully capitalized, subsidiary in a, preferably non-operating, holding company (NOHC) framework (i) will maintain the advantages of the universal bank model while (ii) forcing the separated trading activities to face a market cost of capital without subsidies from insured deposit funding.
- Ending the too-big-to-fail problem also requires effective and realistic recovery and resolution plans, in line with the Commission's BRR Directive. Essential elements of making these effective include (i) the existence of a resolution authority with clear power to implement the plans and (ii) triggers which enable, indeed force, intervention at an early stage, involving change in management, to avoid threats to financial stability and to minimize costs to taxpayers.

- Increasing the use of instruments explicitly not guaranteed and subject to being written down in the event of restructuring or resolution (“bail-in instruments”) will work to reduce implicit guarantees and the resulting too-big-to-fail problem by allowing a large share of funding instruments to be credibly “loss absorbing”. Increasing the clarity of the hierarchy of debt instruments will increase transparency and facilitate the work of the resolution authority. We would caution, however, that making low seniority transparent will be reflected in the attractiveness of affected funding instruments and hence in their market prices.
- We welcome most of the corporate governance reforms suggested in the Liikanen Report although we would avoid legislating issues, such as remuneration, that are best left to management. Strengthening management and boards is key, and this in turn requires getting accountability and reporting lines right. Main priorities include separating roles of CEO and Chairman, ensuring no role for the CEO in choosing Directors and providing the chief risk officer some independence from the CEO as well as direct access to the Board. If these reforms are implemented effectively operational issues such as remuneration are likely to be handled in shareholders’ interest and not at their expense.

There are two important points, however, on which the report is misguided. As regards the first of these, which relates to separation, the draft law could be adapted and framed as suggested without raising issues related to harmonization within the EU. As regards the second, relating to minimum capital standards, there is some scope for modification in the German context alone but the most effective improvements may require changes at the EU (and, preferably, global) level, notably modification of the credit requirements regulation (CRR) and CRD_IV.

Separation

The main practical challenge to workable separation is to draw a sensible dividing line between trading activities and deposit banking activities. Efforts in the United States to transpose the Volcker rule incorporated in the Dodd-Frank legislation to operational regulations have proved to be very contentious and, at this stage, no agreed draft that might serve as a useful guide to others exists. The proposed Liikanen holding company structure, by ring fencing and separately capitalizing the different activities without restricting a bank from offering a complete range of services to customers, has the advantage of achieving the separation without limiting competition. Its downside is substantially confined to any inefficiencies that arise from forcing customers to deal with separate entities of the same bank. So far so good.

However, the separation as proposed, in which most primary securities held for trading and available-for-sale are grouped with derivative positions held for market-making, raises

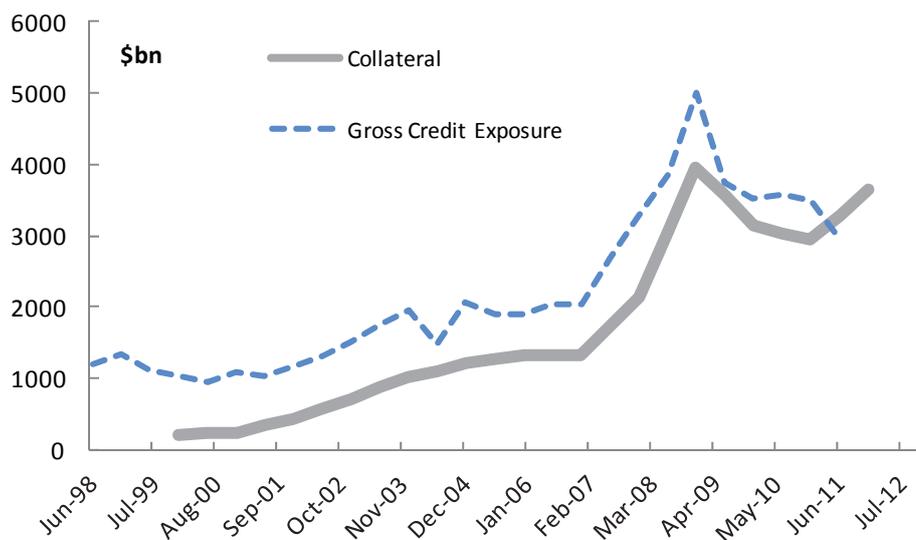
serious questions. Economic activity can be funded by issuing securities, as well as by traditional lending, and for many borrowers this may be a more efficient way of raising capital. There is likely to be a cost to discouraging it. Furthermore, a portfolio of such securities held for trading and available for sale offers a bank greater flexibility in managing its liquidity position than do illiquid loan positions. It is odd to discourage banks from taking advantage of this liquidity while at the same time establishing a restrictive new regime (in BASEL III/CRR/CRD_IV) which discourages traditional lending to enterprises in the interests of strengthening liquidity². Indeed, recent empirical work at the OECD suggests that such assets make banks safer, not more risky (see Appendix A).

Derivatives, on the other hand, fund nothing while their leverage exposes their holder to high levels of market risk arising from potentially large price movements. While banks take great pains to hedge their positions, it is often impossible to achieve this perfectly, especially given that most derivatives are not standardized and trade over-the-counter. Derivative price movements generate both winning and losing counterparties. These normally trigger cash collateral calls by winners demanding that losers' balance sheet holes created by the price movements be covered. Where price movements are large, as in 2007-08, exposures, even after counterparty netting (i.e. "Gross Credit Exposure"), and resulting cash calls can rise very sharply (Figure 1). Where an institution is imperfectly hedged, so that cash collateral payments exceed receipts, this can create a liquidity crisis which makes it impossible to operate³ even if it remains formally solvent. The OECD analytical work cited above strongly suggests that it is derivatives which should be the focus of separation efforts.

Figure 1: Gross Credit Exposure versus Collateral

² Since liquidity issues are not a focal point of the Liikanen Report we do not elaborate on this. Overall, we believe the new rules are at best unhelpful and perhaps unworkable. They have already been softened and their implementation has been delayed for four years.

³ AIG and Dexia have been recent high-profile cases in point.



Source: BIS, ISDA, OECD,

The Liikanen Report proposes a two-stage process in which banks with large holdings of assets held for trading and available for sale, i.e. more than 15-25% of total assets or EUR 100 billion, would be reviewed by supervisors with a view to mandating separation. The threshold for such a mandate would be calibrated by the European Commission. These criteria would catch banks like Wells Fargo and HSBC, large and reasonably well-capitalized banks with significant portfolios of non-derivative trading assets but generally low holdings of derivatives, that managed the crisis with fairly little problem. A better criterion would be gross market value of derivative holdings as a share of total assets. As regards calibration, we would recommend a substantially lower trigger for separation given the narrower range of assets, say 10-15%, and we see no reason why this cannot be done at the national level without the involvement of the European Commission.

Minimum Capital Standards

Chairman Liikanen's letter of submission to Commissioner Barnier notes the importance of stronger capital requirements and in this regard endorses the Capital Requirement Regulation and Directive (CRR/CRD_IV) which translate Basel III agreements to the European context. This appears to be faint praise since much of the Report's discussion concerns various weaknesses in the framework and the main proposals call for "...more robust risk weights...more consistent treatment of risk in internal models [and that] the treatment of real estate lending...should be reconsidered,..."⁴

The Expert Group should have had the courage of its convictions. The core problem is the Basel risk weighting system, designed to introduce an illusory "risk sensitivity" (Appendix B)

⁴ "Summary of the proposal", fourth item.

that relates minimum capital requirements to “risk-weighted assets (RWA)”, instead of actual balance sheets. This has evolved into a system of extreme complexity that invites regulatory arbitrage to reduce RWA relative to Total Assets (TA), defeating the entire purpose of capital adequacy rules. This arbitrage has three main sources:

- Portfolio reallocation from high to low risk weight asset classes;
- Under the internal ratings-based regime, too much scope for negotiating with supervisors and for “optimizing” models;
- Risk transfer *via* derivatives to low risk-weight counterparties.

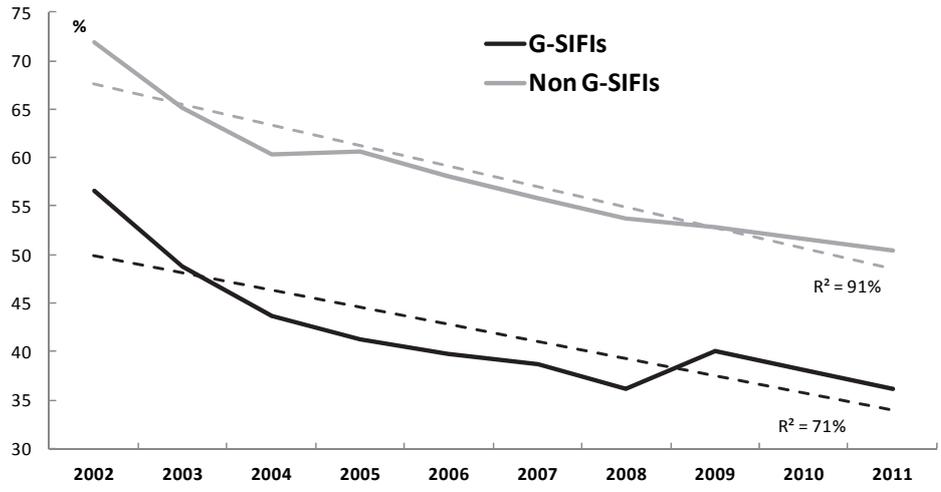
The result has been the pronounced downward trends in the ratio of RWA to TA for 28 banks designated by the FSB as “global and systemically important (GSIFIs)” and for 368 other US and European banks shown in Figure 2, below. So long as capital requirements are based on RWA, whose relationship to the actual balance sheet is effectively a management tool, many banks and the system as a whole are likely to be under-capitalized. Both Basel III and the Liikanen Report contain specific measures which can be welcomed as “strengthening the system” on the basis that all else unchanged, they will increase capital requirements. But “all else” responds to incentives rather than remaining unchanged so such measures achieve little.

CRR and CRD_IV are part of an EU framework which obviously limits the extent to which national deviation is possible or desirable. First best would be to scrap the risk-weight system at both global and European levels in favor of something vastly simpler and more effective. Failing that, the equivalent can be achieved by strengthening the role of the (non-risk-weighted) leverage ratio, now envisaged as a relatively weak “backstop” of uncertain eventual status, to the point where it overrides the risk-weight system⁵. This should include giving the leverage ratio clear Pillar 1 status, measuring the asset base using IFRS rules for derivative positions, making the required capital measure core Tier 1 (which is all equity) rather than (the wider) Tier 1 and raising the minimum from the proposed 3% to 5% or higher⁶.

Figure 2: Ratio of RWA/TA for GSIFIs and More Traditional Banks

⁵ The Expert Group sympathetically considered moving in this direction, notably as regards trading-book assets (see especially Avenue 1 in Section 5.4.1), but contented itself with encouraging the Basel Committee to take its concerns into account and that the European Commission review the matter carefully.

⁶ Elsewhere we have suggested supplementary design features to reward diversification.



Source: Bloomberg, OECD

Appendix A

Which trading assets make banks risky?

The study “Business models of banks, leverage and the distance-to-default”, by Adrian Blundell-Wignall and Caroline Roulet is a technical paper whose results suggest that trading and available-for-sale securities raise the distance-to-default, i.e. make banks safer rather than riskier. In brief comments on the Liikanen Report the paper concluded (p.25): “A better criterion for stage 1 would be the GMV of derivatives share where there is no ambiguity.”

The underlying analysis is available at www.oecd.org/daf/fin/BanksBusinessModels.pdf. The central technical point to be noted in this context is that the signs, i.e. directions, of estimated effects on distance-to-default of trading assets and gross market value of derivatives are the opposite of each other.

What follow are excerpts from the paper’s “Concluding Remarks” (p.25-26):

“The determinants of the distance-to-default in a panel sample of 94 banks over the period 2004 to 2011, controlling for the market beta of each bank, consisted of house prices at the macro level, and relative size, simple leverage, the GMV of derivatives exposure, trading assets, and wholesale funding. The G-SIFI subsample found these same variables were very important and, in addition, cross-border revenue was found to be a positive diversifying factor. For the subsample of nationally focused non-GSIFI banks, beta, the simple leverage ratio and house prices were the only variables that found support in the data. The Basel Tier 1 ratio found no support as a predictor of the distance-to-default whatever sample was considered.

While these results are preliminary, it was encouraging that the out-of-sample predictive power of the model improves systematically as each year of new observations is added.

As decisions continue to be made in an uncertain environment where the mechanisms that influence the distance-to-default are not well understood, the paper also attempts to provide some preliminary comments on some of the policy decisions and propositions that have been made to date. The results appear to be consistent with an approach to policy that focuses on the un-weighted leverage ratio for all banks, and on policies that address directly the apparent size-derivatives-leverage and wholesale funding nexus for some very large G-SIFI banks.”

Appendix B

The risk weighting system: conceptual issues in measuring “risk-sensitivity”

The core of the Basel system is a capital charge which is calculated at an internationally agreed rate applied to the “risk-weighted” value of assets and cumulated across the entire portfolio to derive minimum capital requirement to cover credit risk⁷. The starting point for this calculation is the assumption that some assets classes are more risky than others. This is easy to accept. But the calculation involves three further steps that undermine any claim to being “risk sensitive” in any meaningful way.

First, “correct” risk weights are difficult to determine. In practice, they have been mostly arbitrary, favoring sovereign lending, interbank claims and residential real estate at the expense of lending to enterprises. Basel I, the original accord announced in 1988, simply set the weights as politically agreed parameters negotiated in Basel, establishing sovereign bonds of OECD countries as zero risk and weighting secured residential real estate at 50%, i.e. half of the rate for lending to enterprises. The standardized regime in Basel II, published in 2004, reduced some of the parameters (residential real estate fell to 35%) and used ratings from recognized agencies (in effect, Moody’s, Standard and Poors and Fitch) to introduce an empirical element to the determination. But even ratings must be transposed into politically agreed parameters. Basel II also allowed large banks to determine their own ratings based on approved model methodologies and formulae (i.e. dispensing with the agencies), and effectively calculate their own risk weights. This has the advantage of making the system more empirically based. But it also makes it both sensitive to biases of the bank staff who may be tempted to “optimize” their models and vulnerable to regulatory/supervisory capture. Furthermore, it results in widely differing risk weights for the same assets across banks, raising questions about the consistency of the system. Basel III does not materially change these elements of the Basel II framework.

Second, to make the system manageable the risk weights (and hence capital charges) are assumed to be “portfolio invariant”, i.e. that they are not affected by whatever else is in a bank’s portfolio. This is obviously true where the weights are parameters but the assumption is also imposed where formulae are used to calculate the weights. As a result, diversification plays no role, for better or worse. On this basis the calculation can move from the riskiness of individual assets in isolation to the riskiness of a portfolio that contains these

⁷ We leave market and operational risks aside here as credit risk normally dominates the calculations. We also leave aside the various tiers of capital, changes to their definition and changes to calibration being phased in. Under Basel I and II Total Capital of 8% of risk-weighted assets was required. Changes now under way envisage requirements for a new core Tier 1 Capital amounting to 7% of risk-weighted assets by 2019.

assets, a large jump, by simply cumulating the charges for each asset linearly across the portfolio.

Third, the portfolio invariance assumption raises the question whether the conditions that must be assumed for the calculations to be valid are reasonable. This question was asked during the preparation of Basel II and it was answered with a very good piece of analysis carried out at the Federal Reserve Board⁸. One key condition which must reasonably hold is very strong and improbable: there can be only one “systematic” risk factor, proxied by the world economic cycle. This effectively denies the possibility of sectoral, national or regional risks against which a bank might prudently wish to diversify which do not move in parallel with the global industrial cycle. The analysis concluded that “...if there are indeed pockets of risk” imposing portfolio invariance “may significantly” bias minimum capital requirements downwards for a regional or specialized lender. It seems likely that every bank in the world is regional or specialized when considered in a global context.

⁸ M. D. Gordy, “A Risk-Factor Model Foundation for Ratings-Based Capital Rules”, *Journal of Financial Intermediation*, vol.12, 2003.