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# Structural Banking Reforms: an illusionary solution

**By**

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# <u>Structural bank reforms: an illusory solution</u>

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<u>Abstract</u>

It is always dangerous to go against conventional thinking.

But I must say that the focus on bank "structural reforms" puzzles me somewhat.

So, I will try to tell you what is my own interpretation of the "structural" elements of the banking crisis of 2007-2008. This interpretation will, of course, influence my answer to the question: "what to do"?

I will focus my remarks on three themes:

- Structural diversity, understood as different banking business models, is the result of history;
- Structural aspects of the banking sector were not the cause of the crisis ;
- How to cope with the structural issue?

## I – Structural banking diversity is the result of history.

This statement may seem tautological and therefore uninteresting. But understanding history helps to discover structural fault lines as well as “non-structural” deviations. I completely share the remarks by Charles Goodhart and Enrico Perotti on the historical evolution of the banking sector. This history started, almost everywhere, with short-term, self-liquidating loans by banks to the private sector. These loans were backed by “real bills” that financed trade. That system was relatively safe, although not entirely safe. Indeed, “real bills” could suffer counterparty failures. Banks - as well as their clients - were thus exposed to cyclical economic downturns, to management mistakes, to fraud and to crises. In such a model – and this is a point that is not sufficiently emphasized in my view – **some** banks appeared more vulnerable than others. In our modern jargon we would say: “risk assessment and management were unevenly enforced”.

Several evolutions in the ways banks operated characterize the second part of the XIX° century and the XX°. I will only pick up two of these trends that will help us understand the present “structural issues”.

***1. Firstly, financial markets - equity, bonds - expanded fast, and became the main source of financing investment and corporates.***

A diversity of actors participated in the capital market boom that started in the 2$^{nd}$ part of the XIX° century: households, banks, insurance companies, fund managers … **Commercial banks played a particularly important – and increasing – role** by :

- Underwriting securities ;
- Investing in them ;
- Selling them to investors ;
- Arranging equity and debt financing …

They became "universal" by adding investment activities to their original commercial banking model.

The Great Depression revealed some of the dangers that could stem from this evolution. It was not the universal "model" in itself that was in question, as I see it, but the way it was handled. Banks got involved in "excessive" proprietary trading, they often systematically encouraged clients (as well as themselves) in "speculation". The responsibility of banks in the boom (that regulators and monetary policy completely failed to contain) and, in the bust that led to massive asset sales, heavily contributed to the Depression.

In such circumstances, we can understand why US legislators decided to bar commercial banks from engaging in securities business. It was the Glass Steagal Act of 1933 that is still haunting us today. By the way, Senator Glass was a firm believer of the "real bills" doctrine.

But it is interesting to reflect also on the reasons that led to the termination of the Glass Steagal Act. Basically, markets were changing fast in the 80s with deregulation. Besides, the Act only prevented investment banks from taking deposits, but not from granting loans. With mushrooming money market funds that provided quasi perfect substitutes for bank deposits, investment banks and “non-banks” filled the space left by commercial deposit taking banks. Competitors were taking advantage of the restrictions imposed on one single category of institutions.

Eventually, the competitiveness argument prevailed (all the more so that foreign commercial banks were thriving as they were free to engage in securities) and the Act (that had been more and more circumvented) was repealed in 1999 by the Clinton administration.

To make a long story short, it proved impossible to keep alive a regulation that went against deep market transformations and international trends, lest regulatory arbitrage would become the name of the game.

***2. The second problematic change in the original banking model came from the development of the mortgage lending activity.***

This has been encouraged, especially in anglo saxon countries, by a basic political objective: encouraging people to buy their home is good for the country. Specialized banks (savings and loans, building societies) were therefore authorized to extend long term loans (30 years) to households – who happened to be the main depositors in these institutions.

Embedded in such a model is a “transformation risk”: a maturity mismatch between short term funding and long term assets carrying fixed interest rates. A run on deposits, or a hike in interest rates, were susceptible to destroy such institutions. This happened with the SNLs in the US in the 80s. By the same token, it was also the explosion of mortgage lending and specifically subprime loans – in a context of abnormally high real estate prices and low interest rates – that triggered the 2007 crisis.

Is it the mortgage model – on structure – that was the cause of the crisis? I believe that it was the *way* the model was used that was at the root of the problem. Indeed what I have just said of mortgage banks is by no means the entire story. I am convinced, that if we want to understand what happened, we have to make a fundamental – but rarely expressed - distinction between two types of housing loans: the “lethal” one and the normal one.

The “lethal” mortgage lending is a *non-recourse* loan collateralized by the house that can be sold if the debtor fails to pay. The danger of this type of lending - which is usual in the US - is that banks are more interested in lending than in assessing the quality of the credit they are extending to the borrower. They feel – wrongly – that they are “secured” by being able to sell the building. They tend to believe, mistakenly, in an upswing, that real estate prices will continue to go up and that their collateral is sound. The existence of “mortgage brokers” (which took a predominant part in the search for clients, specifically in the US) proved to be a dangerous “accelerator” of the real estate boom . Brokers are not bankers since they are mainly interested in expanding the volume - not the quality - of their business. They are usually remunerated by bankers on a an origination fee basis and are not interested in loan performance. I believe the whole incentive system relative to mortgage brokers is dangerous and that it should be deeply reformed.

By contrast, the “normal” – from a continental European point of view - way of lending for housing purposes is the “recourse” method. What is important here for the bank is to make sure that the debtor will have the means to repay. Loan to value (that should always be less than 80%) and the debt service ratio to total income (that should be kept below 30%), are the main instruments of this risk containment method. I am aware that the latter method is far from being immune from risks as has been shown by the real estate credit booms in countries like Ireland and Spain. But at least such risks can, in principle, - and should - be contained by macro systemic regulation and supervision. By contrast, the first method is a true recipe for disaster. Perhaps more important than the maturity mismatch and the uncertainty on liquidity, the most significant issue relates to the non-recourse nature of the loans as well as to the incentives for banks in good days to lend more (often above 100% of the value of the house !) by “extracting capital” from real estate price increases. I am not convinced that “shared responsibility mortgages” (SRM) would, by themselves, correct entirely such fundamental diseases.

So, to sum up, if some mortgage lenders did well while many others failed, it is because something specific (non-recourse loans) and different from the basic “structure” (mortgage), was at the heart of the problem.

## II – Structural characteristics of banks were not the cause of the crisis.

My assessment of the crisis if that insufficient understanding of the nature of risks taken (including on simple classical retail loans) as well as the weakness of risk management in the prevailing non-recourse mortgage system in the US (not to mention the major imperfections of regulation and supervision) have been the fundamental common traits of bank failures since 2007-2008.

By contrast, banking structures or models were **not** per se, meaningful factors behind the crisis. Graph 1 shows that all different structures participated in the disaster.

### *1. Specialized institutions (be they pure retail or pure investment banks) were among the most severely hit*

- ✓ Retail :

Northern Rock engaged in retail with a massive maturity mismatch, as well as US retail banks or wholesale specialized banks (Washington Mutual, Countrywide).

One can cite also the very large losses incurred by the German mortgage bank Hypo Real.

- ✓ Investment banks :

Pure investment banks (Bear Stearns, Merrill Lynch, Lehman Brothers, IKB, …) were the infamous main casualties.

### *2. Some universal banks (RBS, Lloyds, UBS, City, ABN Amro, Commerzbank …) also incurred major losses for two main reasons:*

- ✓ Bad loans to “classical” clients. Those banks took advantage of excess liquidity and low interest rates to engage in more and more credit while somewhat disregarding the ability of borrowers to repay;
- ✓ A number of commercial banks derailed and engaged in heavy trading operations (slide 2 shows that the “excessive” weight – more than 30% of

total revenues – of investment banking activities increased universal bank's vulnerabilities).

In **<u>all</u>** cases there have been heavy management mistakes. The fact that Northern Rock, for example, presented such a fundamental maturity mismatch between its funding and its lending, as well as the fact that it was relying excessively for its liquidity on wholesale markets is not, in my view, explicable by a "structural defect" but by a huge disregard of common sense, sound and prudent risk management. It would have been possible to run safely Northern Rock structural model, if prudent management and risk assessment had prevailed.

More important than structures were : the exploding size of balance sheets (some banks assets climbed in a few years to 5 times their country's GDP), the concentration of risks as well as the reliance on wholesale liquidity. Those factors were often (but not in all cases) overlooked by banks as well as by supervisors.

## III – What should be done ?

If my analysis is correct, I don't see how "structural" measures could be ***the*** answer.

The situation of the banking sector as it faced the crisis was heterogeneous: a very large number of banks – be they universal or specialized – weathered the crisis well and did not rely on any form of governmental subsidies. Slide 3 illustrates that diversity of situations. Obviously, the magnitude of bank rescues (US, UK, Nederland, Germany …) explains the relative intensity of the excitement displayed by those countries on regulatory measures, in particular in the structural field.

After the crisis, the name of the game was to rein in the banking sector. Apart from capital and liquidity requirements, structural measures seemed good because they had the political advantage of "punishing" bad banks by introducing maiming separations and bans.

### ***1. Many "structural" reforms have been proposed or enforced.***

They can be summarized in the following way:

- ✓ Some (Vickers, Liikkanen) tend to separate legally commercial activities from other – investment banking – functions (or the reverse). The difficulty here lies in the question : "what happens if the investment bank part of a group fails ?" No good answer is provided to this fundamental question. Runs on deposits are not the only "systemic" risk.
- ✓ The other type of regulation (Volcker rule or French and German laws) forbids some limited operations (pure proprietary trading, private equity) or envisages the channelling of such transactions in separate entities. The difficulty here is to define precisely what is banned.

I personally believe that administrative ring-fencing measures of the first type are illusory, artificial and potentially dangerous. They disregard the fact that banks **<u>have</u>** evolved and improved their resiliency over the last years in an environment where the boundaries between banks and non-banks are often blurred. Therefore any “structural” measures on the regulated sector should be gauged in the light of banks’ balance sheets improvements (a structural reform in 2015 may well be less justified than 8 years ago). Such measures are bound to open a commercial opportunity for the unregulated sector. However let us not forget that the unregulated sector is a significant part of the global financial stability issue. And structural measures can be dangerous because they may give a false sense of security. Indeed a “ring-fenced” group is not going to be necessarily safer as a result of separation.

***<u>2. So, I would concentrate more on two aspects of the regulatory environment that had been largely overlooked before the crisis.</u>***

- ✓ <u>Reinforcing banks’ capital base</u>

Basel 3 has created a major change in this respect. In a period of three years, the equity base of the banking sector has been increased by a factor of 2 to 3 (it took a century to achieve such a result in the previous period). Slide 4 shows clearly the magnitude of the change (which has also important consequences on bank deleveraging and profitability).

- ✓ <u>The tightening of risk weighting methods</u>

Much has been done, in particular in the field of market operations where capital charges have been massively increased under Basel 2.5. But much remains to be achieved if we want a more homogeneous and meaningful system that would create a common and sound level playing field.

With these two sets of actions (not to mention the resolution regulation and liquidity constraints) the banking system is becoming more resilient. And, as a result, the so called “structural vulnerabilities” are being corrected at least in the regulated sector.

The way major banks have adjusted their business models since 2008 (without any direct “structural constraints”) is remarkable, as shown in slides 5, 6, 7 and 8. Banks have profoundly changed their business model: They become less involved in trading, in investment banking and they are diversifying carefully (into asset management for example). It is obvious that “intrusive” regulations, especially as regards RWA, are exerting a strong influence on business strategies and decisions. No need for administrative “structural” reforms. Just let capital and risk weighting regulation do its job and contribute to the reshaping of the banking sector.

A last word. If we want strong banks, we should not only look at the big casualties to establish the new rules. It is also - and perhaps more - interesting and enlightening to look at those who did well. It makes more sense from a Darwinian evolutionary perspective …

We should ask ourselves why a number of large universal banks performed soundly during the crisis (slide 9) and why others (10) - with the same structure – were unsuccessful.

## IV - Conclusion

In conclusion, *there is no "one good model"* for all banks.

During the 2007-2008 crisis and thereafter, there have only been two categories of banks : the *well managed* ones that performed relatively well and the *poorly managed* ones that failed. Each bank model is influenced by history, the regulatory and market environment of different countries.

*Success always results from the right strategic options, as well as from prudent and rigorous risk management.*

No mandatory reshaping of banks can ensure profitability nor guarantee financial stability. It is better to let banks define their own business models within a sound regulatory framework, than for regulators to prescribe detailed structural rules.

***Jacques de Larosière***

**STRUCTURAL BANK REFORMS:**

**AN ILLUSORY CONCEPT**

**Jacques de Larosière**

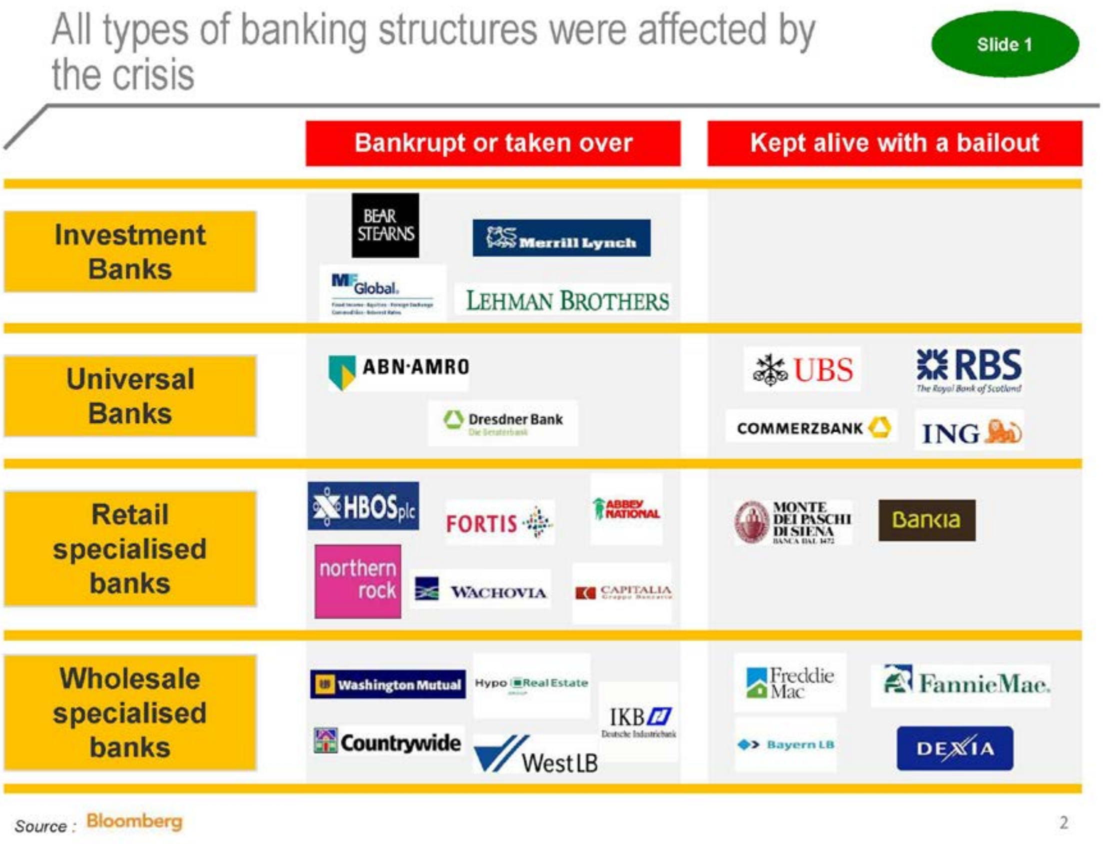
***London Financial Regulation Workshop on Structural Bank Reforms***

***10th June 2015***

***Financial Markets Group***

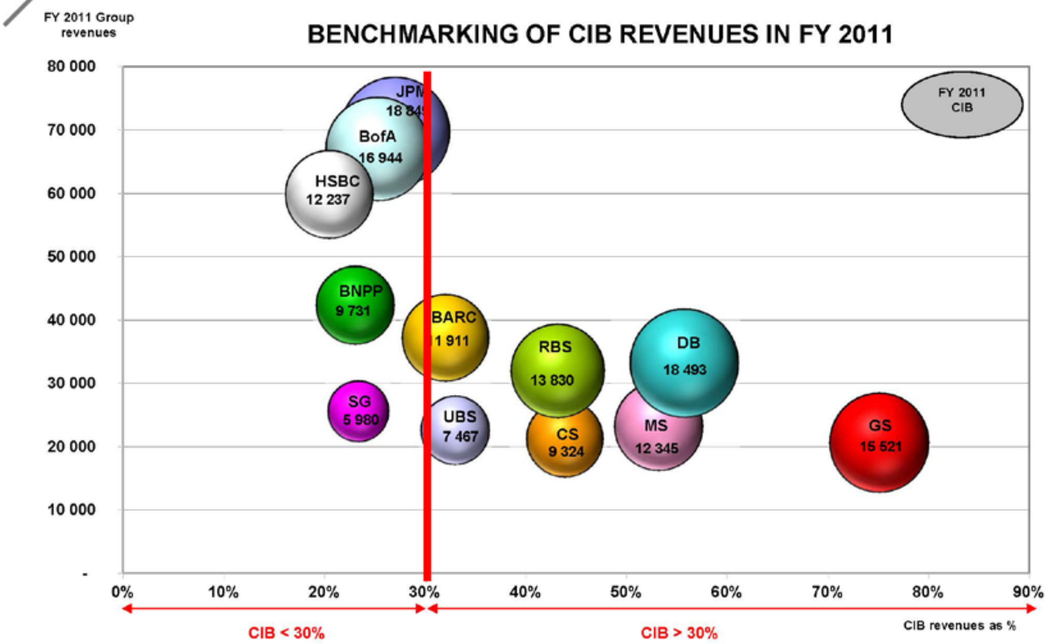
***London School of Economics***

# CONFERENCE SLIDES



# Excessive weight of CIB increases banks' vulnerability

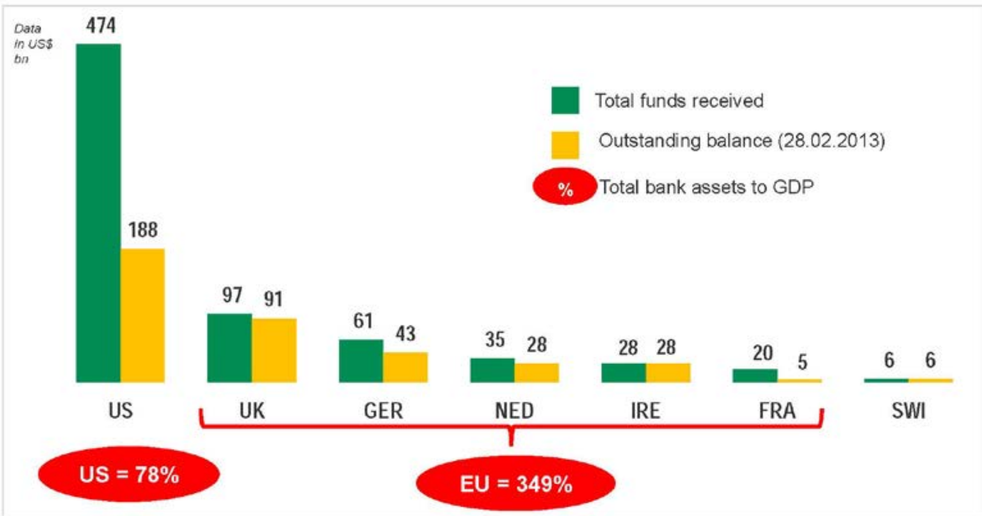
Slide 2






# The magnitude of banking rescues explains the excitement of wounded countries on banking reforms

Slide 3



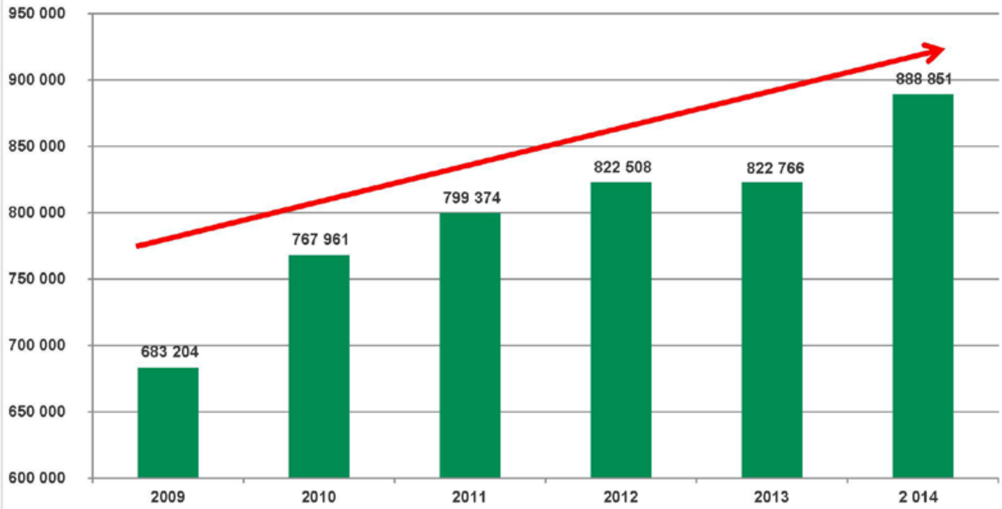

Source : Bloomberg KPMG

**Given the smaller weight of US banks vs. EU (1/4), the size of US rescues is huge**

# Regulation has led to massive increases in bank capital for European Banks since 2009

Slide 4

**Total Common Equity Tier 1 of a sample * of European Banks (in € mln)**




(*) EU banks: SG, BNPP, BBVA, Santander, Deutsche Bank, Commerzbank, Intesa Sanpaolo, Unicredit, HSBC, Barclays, RBS, Lloyds, UBS, Credit Suisse



# Case study **UBS**: Reshaping business model towards more Asset Management …

Slide 5

## Progress in Global Asset Management and the Investment Bank

### Global Asset Management

**Stronger performance fees and good cost control**

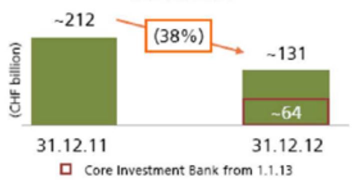
Adjusted pre-tax profit


- Delivered stronger investment performance to our clients
  - Especially in Fixed Income and Alternatives
  - Collective funds stronger vs. peers[1]: 62% of fund assets in first or second quartile over one year vs. 54% a year ago
- Profit growth driven by increased performance fees especially in A&Q

### Investment Bank

**Maintaining client focus while reshaping our business**

Basel III RWA




- IBD: 16% revenue growth, increased market share in DCM, ECM and GSF; attracting top tier talent
- Equities: exchange market share stable
- FX & precious metals: investments in e-trading led to market share gains in lower volume markets
- Credit revenues up 27% and steady Rates performance
- Basel III RWA reduced by ~CHF 81 billion
- Headcount down more than 1,100

UBS

Refer to slide 61 for details about adjusted numbers, IAS 19R, pro-forma Basel III estimates and FX rates in this presentation
1 Swiss, Luxemburg, German and Irish domiciled wholesale funds versus Lipper peer rankings

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# Case study **UBS**:
# … and less Investment banking

Slide 6

## Basel III – Risk-weighted assets

**~CHF 43 billion reduction in Basel III RWA in 4Q12**


- **Sales and reduced exposures contributed ~84% of RWA reduction** in the Investment Bank and the Legacy Portfolio since 30.9.11
- **Legacy Portfolio:** down ~CHF 11 billion QoQ
  - ~CHF 9 billion on sales and reduced exposure
  - ~CHF 2 billion on model changes
- **Investment Bank:** down ~CHF 31 billion QoQ
  - ~CHF 25 billion on reduced exposure
  - ~CHF 6 billion on model changes
- **Other businesses:** down ~CHF 1 billion QoQ
  - ~CHF 4 billion decrease in Wealth Management, Wealth Management Americas and Retail & Corporate
  - ~CHF 3 billion increase in Corporate Center – Core Functions

UBS

Refer to slide 61 for details about adjusted numbers, IAS 19R, pro-forma Basel III estimates and FX rates in this presentation
1 RWA associated with UBS's option to purchase the SNB StabFund's equity (treated as a participation with full deduction from CET1 capital starting 2Q12)

25



# Case study **RBS**:
# Reshaping business model towards more retail

Slide 7

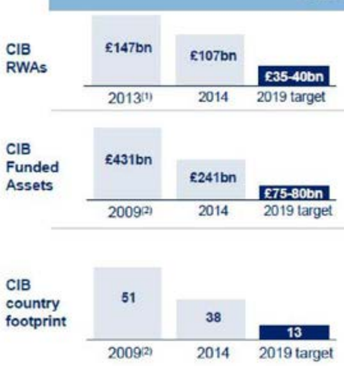
## Reshaping our CIB business

RBS

**Drivers of changes**

| Returns are too low<br>Costs are too high | Capital usage<br>is too high | Operating risks are outside of<br>our go-forward risk appetite |
|---|---|---|

Creating a more focused corporate and institutional bank built on existing product/service strengths




- RWAs reduced substantially over recent years with pace of reduction to be maintained. Intend to reduce by around 2/3rds by 2019
- Targeting >£25bn reduction in 2015

- Funded Assets down 44% since 2009
  Intend to reduce by a further ~70% by 2019

- Selling or running off operations in 25 countries

[1] CRDIV basis as at 1 Jan 2014. [2] 2009 refers to the Global Banking and Markets (GBM) division.

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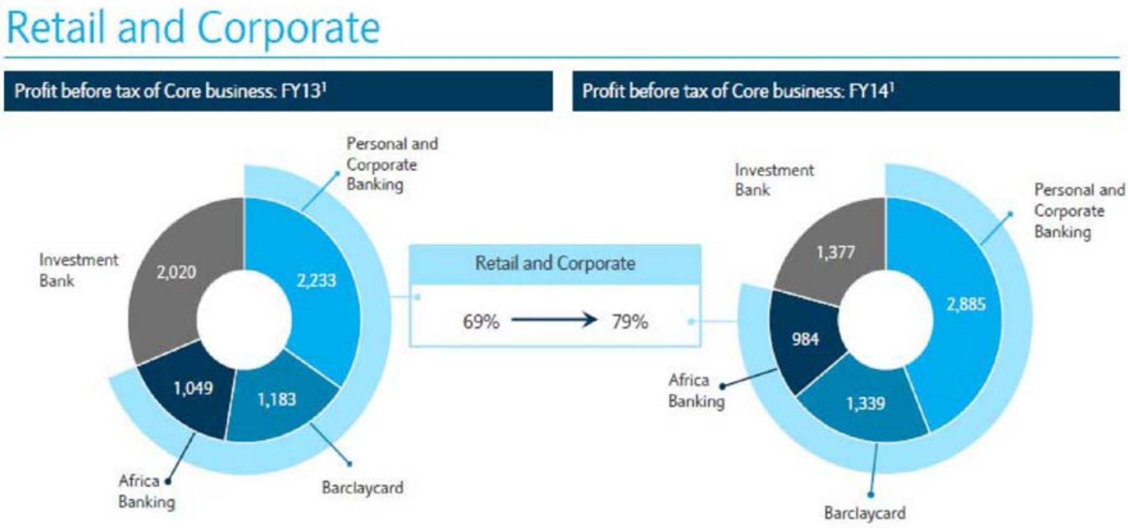
**Massive deleveraging of CIB activities planned until 2019**

## Case study **Barclays:** Reshaping business model towards more retail

Slide 8

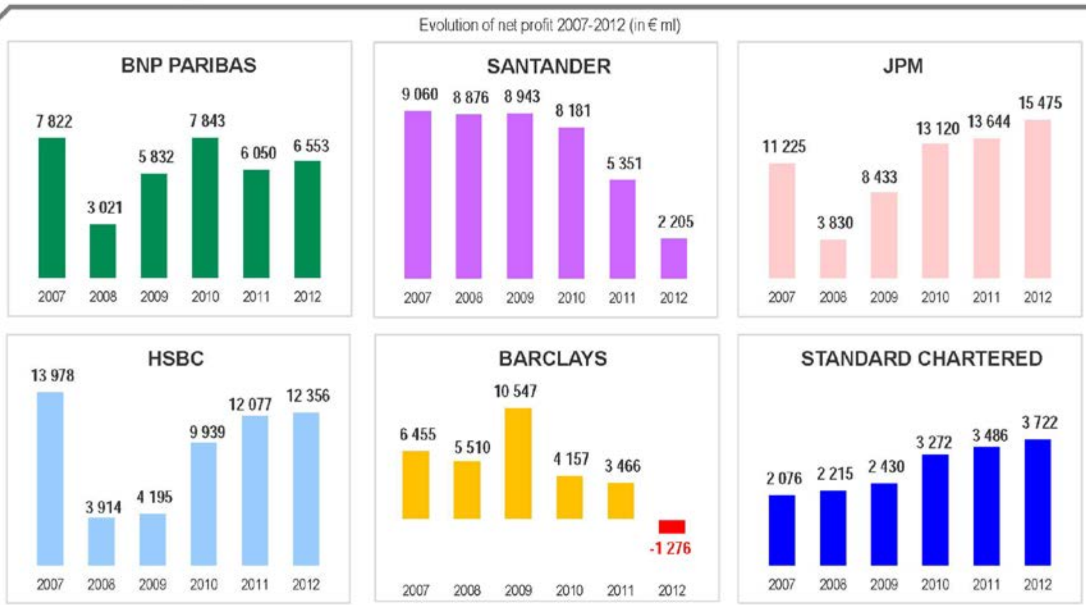



**Strong reduction in CIB revenues between 2013 and 2014**



## Universal banking: a model that has performed well during the crisis

Slide 9

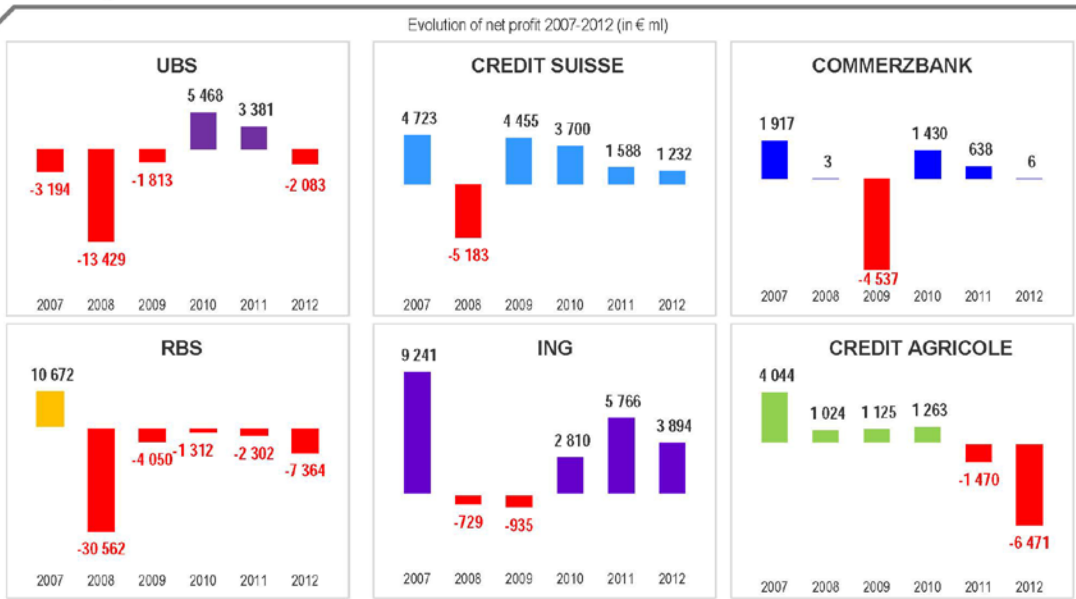



**Some universal banks have perfectly withstood the crisis…**

*Source :* Bloomberg

## … but universal banks were not always successful

Slide 10




Source: Bloomberg

**Bad strategic choices, management mistakes or insufficient supervision are at the origin of reported losses**



## Conclusion

Slide 11

- **In conclusion, there is no «one good model»** for all banks
- During the 2007-2008 crisis and thereafter, there have only been **two categories of banks: the well managed ones and the poorly managed ones**
- Each bank model is influenced by history, the regulatory and market environment of different countries
- **Success always results from the right strategic options, prudent and rigourous risk management**
- **No mandatory reshaping of banks can ensure profitability, nor guarantee financial stability**
- **It is better to let banks define their own business models**, within a sound regulatory framework, than for regulators to prescribe detailed structural rules