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Five Years after the Liikanen Report: What Have We Learned?

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Five Years after the Liikanen Report: What Have We Learned?[1]

*Martin R. Götz, Jan P. Krahnen and Tobias H. Tröger**

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***Summary**: The publication of the Liikanen Group's final report in October 2012 was surrounded by high expectations regarding the implementation of the reform plans through the proposed measures that reacted to the financial and sovereign debt crises. The recommendations mainly focused on introducing a mild version of banking separation and the creation of the preconditions for bail-in measures. In this article, we present an overview of the regulatory reforms, to which the financial sector has been subject over the past years in accordance with the concepts laid out in the Liikanen Report. It becomes clear from our assessment that more specific steps have yet to be taken before the agenda is accomplished. In particular, bail-in rules must be implemented more consistently. Beyond the question of the required minimum, the authors develop the notion of a maximum amount of liabilities subject to bail-in. The combination of both components leads to a three-layer structure of bank capital: a bail-in tranche, a deposit-insured bailout tranche, and an intermediate run-endangered mezzanine tranche. The size and treatment of the latter must be put to a political debate that weighs the costs and benefits of a further increase in financial stability beyond that achieved through loss-bearing of the bail-in tranche.*

JEL-classification: G18, G21, G28, K22, K23
Key words: Financial stability, banking separation, prohibition of proprietary trading, banking and treasury functions, bail-in, MREL, TLAC

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[1] SAFE policy papers represent the authors' personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

1 The Liikanen Report

The publication of the final report of the “High-level Expert Group on Bank Structural Reform”, commissioned by the European Commission and named after the group’s chairman[2], generated high expectations. The core of the regulatory measures proposed in October 2012 to complete reforms after the financial and sovereign debt crises, sought to introduce a mild form of banking separation and to create the functional prerequisites for implementing bail-in measures. Five years later, we ask in this paper how decision makers in politics and the financial sector have transposed the central recommendations of the Liikanen Report and what lessons we can draw from these observations. How successful has the implementation been in practice, how was the regulatory framework perceived during these years – and what can be derived from these experiences for a future regulatory agenda? But first, we recall the leitmotiv of the final report.

1.1 Market discipline as the overarching reform goal

The Liikanen Group built on the fresh impressions of a systemic banking crisis and tried to identify and eliminate deficiencies in the existing regulatory framework for financial institutions. The rescue efforts during the financial crisis confirmed that, in the event of a systemic crisis, there is no alternative to government intervention. Thus, when the Liikanen Report was published, its main focus was to prevent situations where (individual) banks had grown too large or too complex so that their failure would precipitate significant negative macroeconomic repercussions ("too big to fail" or "too complex to fail"; an overview of the literature is provided by Strahan (2013)). Above all, a fundamental problem had to be solved: the option of a market exit had been disabled in these scenarios and therefore had to be reinstalled by government intervention. Concurring declarations of the respective intent can be found for instance in G-20 Leaders Statement (2009) and Financial Stability Board (2010).

The significance of systemic risk is reflected throughout the line of argument and the recommendations of the Liikanen Report. If the overarching policy goal is to reduce systemic risk and if the main cause for that risk is indeed the peril of contagion between banks, then financial markets must be structured in a way that prevents reinforcing tendencies during crises. To this end, (a) the resilience of individual banks must be enhanced, (b) the likelihood and impact of contagion between banks must be lowered, and (c) the elimination of struggling financial institutions must be rapid and (largely) market-oriented.

The regulatory change that was recommended by the Liikanen Report with a view to creating stable

[2] Finnish Central Bank Governor, Erkki Liikanen.

and efficient financial markets is based on the notion that banks have to be able to exit the market. The goal is to ensure that private investors largely bear the responsibility for the losses. The option for the government to save ailing banks and thereby ensure their survival was not the underlying policy objective. Instead, appropriate regulatory interventions should restore the functional preconditions for inducing market discipline as a consequence of private sector loss bearing.

In the presentations of the report's recommendations, the simile of a greenhouse was prominently adopted, because it seemed so apt: The plants thrive particularly well in the greenhouse's microclimate if the necessary care is provided after sowing and the conditions for optimal growth are constantly monitored and ensured. Similarly, market discipline in banking results from careful regulatory intervention and does not follow naturally from market forces. Appropriate regulation is required to establish effective private liability outside of regular insolvency proceedings.

The promulgation of the European Bank Recovery and Resolution Directive (BRRD) and its implementation in national law created a new regulatory environment that can be understood as a legal biotope for banks. Financial institutions that for many years became used to the idea of government bailouts should now become subject to the harsh reality of market selection and risk-adequate pricing of capital that existed at all times for companies of the real economy. Benefiting from (implicit) bailout guarantees – a deformation of fundamental principles of a market economy – banks were tempted to take excessive risks, which became evident when the levels of own funds proved far too low during the crises. This is an instance of moral hazard, or of misconduct, induced by flawed incentives. Bailout expectations also kept borrowing costs at artificially low levels.[3] Therefore, to unleash market forces, regulatory intervention was necessary in an environment in which everyone became used to bailouts and depended on them as the default reaction to banking crises. Primarily, market discipline needed to be re-established for the bank refinancing market, which ensures that (third-party) lenders are actually held liable with the funds they made available.

1.2 Bail-in as regulatory strategy

The authors of the Liikanen Report were convinced that bailing-in providers of capital in a crisis would create the desirable regulatory environment, because it compels private sector liability. The basic assumption, which we will assess in this paper in light of the experience of the past few years, is that a bail-in will produce the intended consequences only if certain conditions are met. Extraordinary efforts of the legislature and banking supervisors are required. These agents must create a cli-

[3] Empirical evidence of subsidies for the world's biggest banks through implicit government guarantees is provided by Morgan and Stiroh (2005), Ueda and Weder Di Mauro (2012), Tsesmelidakis and Merton (2012), Schweikhard and Tsesmelidakis (2012) and Santos (2014).

mate in which private liability can be credibly expected, so that market discipline can flourish.

In the discussion before and after the publication of the Liikanen Report, the special importance of sufficient equity has always been an issue, although most commentators did not distinguish between tougher and softer forms of own funds (CET1, AT1 and AT2). In a number of publications, Martin Hellwig (especially Admati, DeMarzo Hellwig and Pfleiderer (2014), and Admati and Hellwig, 2013) vigorously demanded a massive increase in the unweighted equity ratio (leverage ratio) of up to 30 per cent. The various arguments put forward by the banking industry, why "equity" was "too expensive" to refinance the lending business on a larger scale, were repeatedly rebutted by the advocates of higher capital requirements with a reference to the independence of the credit business from its refinancing business and could thereby draw on the early scholarly discussions of capital costs for companies in efficient capital markets. Hellwig’s position gained wide international attention. Nevertheless, banking policy so far approached significantly higher capital requirements only reluctantly at best.

Under the leadership of the G-20, the reform agenda instead concentrated on a significant increase in the total capital available for loss absorption. This layer of capital available for a bail-in, for systemically important global banks (currently 13 in Europe) referred to as "total loss absorbing capacity" (TLAC), comprises banks’ own funds (core and additional capital instruments) and further bail-in liabilities designated to cover losses. The European Union stipulates comparable standards for "minimum requirements for own funds and eligible liabilities" (MREL) also for smaller banks. The new minimum standards for regulatory capital under the Basel III Accord and the reform proposals in the Liikanen Report therefore concentrate on private liability, which, in addition to equity capital, also covers parts of the bank’s long-term debt.

We see that, in principle, this development is consistent with Hellwig's argument. It is about a significant increase in the liability of private investors. Banks should no longer have an incentive to assume excessive risks, because they are able to socialize losses, while they privatize returns. The increase in private sector loss-bearing can be achieved through a regulatory prescription of either more equity or an enhanced mixture of equity and debt. The goal of promoting private investor liability will certainly not be a hot-selling item; but we do not share the concern that market discipline cannot be achieved through subordinated debt, as Admati and Hellwig (2013) fear. In fact, the initial experience with the emerging bond market for bail-in capital suggests that the mandatory permanent issue of subordinated debt can attract a new generation of investors who are intensely and critically preoccupied with the risk behaviour of banks – and which, owing to the pay-out structure of bail-in bonds, are guided primarily by the risks of incurring losses in bank failures.

1.3 Specific approaches of the recommendations

The business models of major banks pose an obstacle to creating the preconditions for disciplining market forces to work in the banking sector. Specifically, the interconnection of the traditional deposit taking and lending business on the one hand and (proprietary) trading of securities on the other leads to problems. At the very least, this interconnection makes the organizational structure of banks very complex. Moreover, connections between banking business and trading can cause spillovers in crisis from one area to the other. In a systemic crisis, these channels of contagion can increase uncertainty. If complexity was lower, control by supervisory authorities and market participants could be improved, the risk of contagion would be reduced in the case of systemic risks, and it would be easier to resolve credit institutions by separating ailing business units (see, for example, Chow and Surti 2011).[4]

The absence of mechanisms and rules for the resolution of ailing financial institutions has also bolstered the expectation that the government would bailout banks in the event of failure. During the financial crisis, taxpayers also had to make substantial contributions to the recapitalization of insolvent financial institutions, because an operational institutional framework for the resolution of failing banks was missing. As investors in bank capital were aware of this implicit government guarantee, they did not perform their governance functions as effectively as they would otherwise have in a market economy with private sector loss bearing in a firm's failure. This, too, is a form of moral hazard. Investors had to be compelled to devote themselves to their actual tasks, namely to the internal supervision of banks (debt governance). The incentives to do so had to result from a mandatory and significant contribution to the recapitalization of a crumbling financial institution. Therefore, the second central goal of the Liikanen Report's recommendations was to ensure that a failing bank could be liquidated and a bail-in could occur without implications for financial stability.

We take up the main theme of the regulatory agenda favored in the Liikanen Report. Section 2 takes stock of the initiatives taken in Europe to establish an effective regime for bank resolution. In section 3 we devise further recommendations for advancing the European resolution framework. In this context, we tackle two construction sites, which had already been named in the Liikanen Report, but remain unfinished so far: the effective design of the bail-in tool and the resolution regime as a whole. We conclude with several specific demands for policy makers and banks that seek to enhance the resilience of the financial system permanently.

[4] Kroszner und Strahan (2011, pp. 242-6), however, predict an even stronger link between individual financial institutions under a regime of banking separation.

2 A resolution mechanism for more market discipline

A key component of the Liikanen Report concerns the development of resolution mechanisms to liquidate failing banks without further distortions for the real economy. No bank should be "too big to fail".

2.1 Legal framework

The European Bank Recovery and Resolution Directive (BRRD), adopted in 2014, and the regulation on the Single Resolution Mechanism (SRM Regulation), create a harmonized legal framework for the resolution of failing banks in the E.U. The overarching objective is to reduce the potential for system-wide contagion among financial institutions. This goal shall be achieved by a division of labor between supranational and national authorities in a complex institutional architecture: The European Banking Authority (EBA), the Single Supervisory Mechanism (SSM) headed by the European Central Bank (ECB), and the Single Resolution Mechanism (SRM) coordinated by the Single Resolution Board (SRB). Although legal procedures and institutions have been put in place, it is an unresolved question whether these considerable efforts were sufficient to ensure the orderly resolution of failing banks regardless of their size and interconnectedness.

2.2 Creditor liability and market discipline

Bailouts during the financial crisis showed that banks are "special" and needed to be rescued since an orderly resolution was not possible under ordinary insolvency laws without severe impairments for financial stability. The BRRD has tried to rectify this by providing a bank-specific crisis intervention procedure administered by designated resolution authorities that collaborate closely with prudential supervisors.

This legal framework ensures that private investors can be held liable to recapitalize banks via a bail-in in times of distress. This should foster market discipline and restore risk-adjusted prices for bank debt. To ensure, however, that market discipline for bank debt can indeed be re-established, it is important that banks (a) have a sufficiently large level of bail-in able debt, i.e. subordinated liabilities, and (b) that debtholders stand to lose their investment in the event of bank failure (Calomiris 1999). Preliminary evidence suggests that the financial system indeed moves into the right direction. Figure 1 shows the evolution of the share of outstanding public subordinated bank notes on the total outstanding bank bonds for 42 European banks over time[5]. It indicates that European banks are financing themselves more with subordinated debt: while at the beginning of 2013, about 8 per cent of

[5] An overview of the 42 European banks as well as further information can be found on the website of the SAFE Bail-in Tracker: http://www.bail-in-tracker.eu.

outstanding bank bonds were subordinated, the share rose to around 11.5 per cent by the end of 2016.

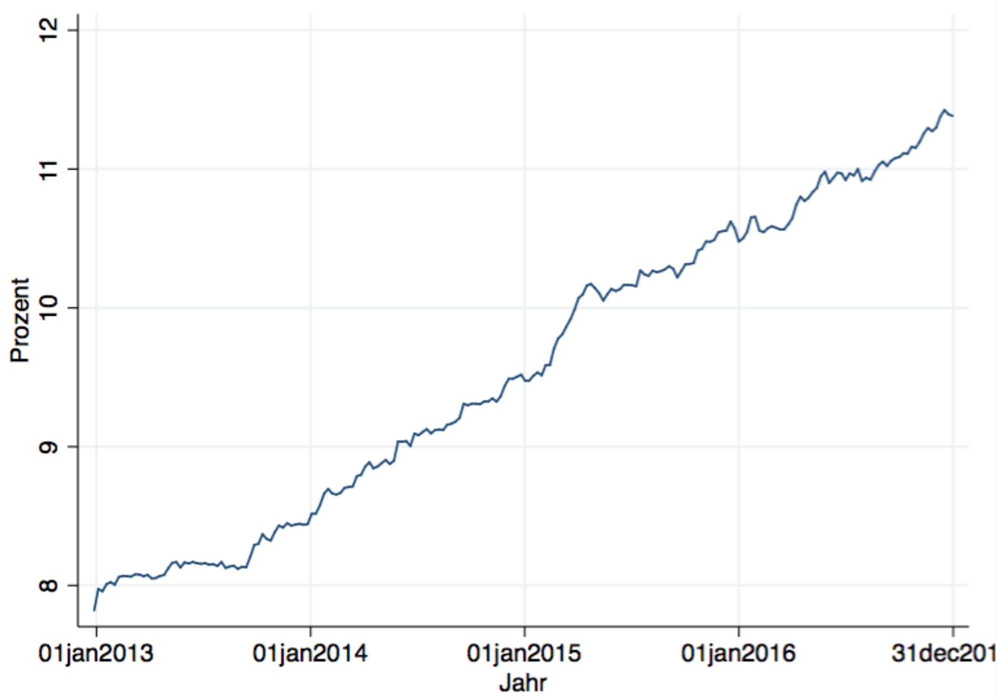

Fig. 1: Share of publicly traded subordinated bank bonds in the publicly traded subordinated and senior bank bonds of selected European banks. Source: www.bail-in-tracker.eu

Banks that are classified as G-SIBs by the FSB seem to have on average increased their share of outstanding public subordinated bonds (relative to risk-weighted assets) in recent years (Figure 2). The average relative share of public subordinated bonds in risk-weighted assets, however, is still relatively low at about 2 per cent.

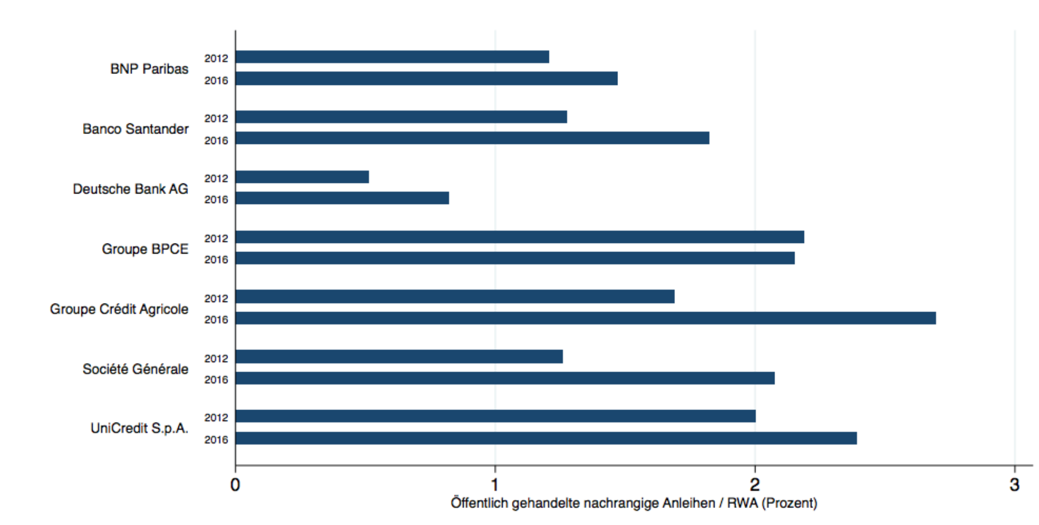

Fig. 2: Share of publicly traded subordinated bank bonds to risk-weighted assets (RWA) of European G-SIBs (DE, FR, IT, ES), deadlines 31.12.2012 and 31.12.2016.
Source: www.bail-in-tracker.eu

3 Bail-in 2.0

It seems to be common wisedom, also shared by the European legislator, that bail-in should be without limits and, in principle, should affect the whole liability side of a bank's balance sheet[6]. We think, however, that this is wrong as an unconditional bail-in of all bank liabilities may lead to a systemic crisis, because it triggers runs on essential bank liabilities. In fact, an unconditional bail-in largely misses the threat of a systemic crisis that can emanate from this well-known fragility of any banking system. Thus, we propose not only a close monitoring of investor characteristics for holders of bail-in able debt, but also a trichotomy of bank liabilities that balances a bank's moral hazard incentive and the run-risk inherent in bank investments.

3.1 Minimum requirements for investors in bail-in able debt

To ensure that market discipline can emerge, one has to make sure that a bail-in does not lead to a systemic crisis, which may ensue if investors do not have sufficient loss-bearing capacity. Ideally an investor of bail-in able debt exhibits the following properties:

- Storm resilience: In case of a bail-in, an investor is not facing the threat of a run on his liabilities. This implies that the investor is not a provider of liquidity. Storm resilience is satisfied for life insurance companies, pension funds and other long-term oriented capital funds. Banks, on the other hand, are not suitable investors. Moreover, retail investors are also not suitable due to their fixed consumption needs.
- Provisioning: A bail-in investor should build up sufficiently high levels of reserves from coupon payments of bail-in able debt over time to be able to suffer potential losses without imperilling her own economic viability.
- Incidence of liability: A bail-in investor should be the bearer of the default risk. Any risk transfer (for example, via credit insurance or a credit default swaps) must be taken into account when considering the aforementioned requirements.
- Economic diversification: A bail-in of shareholders of a failing bank should not increase the systemic risk any further. Thus, a system-wide diversification of investors is desirable.

"Storm resilience" and "provisioning" are two characteristics that a prudent supervisor should assess

[6] Cf. Article 44 (1) of the BRRD: "Member States shall ensure that the bail-in instrument can be applied to all the liabilities of an institution...".

and continuously monitor. This ensures that market participants have rational expectations and can realistically assume that they may become liable in case of bank distress. These key properties are, however, not sufficiently recognized as requirements for purchasers of bail-in capital who are subject to supervision within the framework of the SSM. The implementation of the TLAC standard will move into the right direction, as it will introduce rules that largely destroy incentives to build up positions in other banks' bail-in capital on the asset side of the balance sheet of banks. Yet, since the TLAC standard is only binding for the largest banks in the world (and will be limited in pertinent respect to Europe's globally significant institutions), it does not ensure a system-wide rectification of incentives for financial institutions. We propose instead that the two aforementioned requirements of "storm resilience" and "provisioning" are included in the catalogue of the central tasks of the supervisory authorities, and/or of resolution authorities.

3.2 Maximum requirements for an effective bail-in

The idea that bail-in may encompass all bank liabilities is due to the desire that a country shall never again bailout failing banks. While this idea seems valid since the insolvency of industrial enterprises and service providers potentially also results in the total loss of all investments, we think the desire to treat financial firms equally misses its target. The error in reasoning lies in the neglect of a fundamental difference between (non-financial) companies and banks: the risk of a run on a bank's liabilities. Banks are exposed to this risk to a large extent due to their rescheduling of liquidity differences between assets and liabilities. Internationally operating major banks, for instance, whose liabilities are in large part due to the cash reserves of large corporations and the liquid assets of institutional investors, and which also offer short-term refinancing on a large scale are constantly exposed to the risk of a sudden withdrawal. Economic theory (Diamond and Rajan 2000) regard the fragility of the banks – due to the possibility of a run by investors – as an instrument to self-discipline banks. From this point of view, a high degree of short-term debt can serve to attract depositors and thus promote the performance of the overall process of intermediation. This positive, incentive-oriented interpretation, however, disregards the possibility of contagion effects among banks and the role of systemic risks (see Allen et al., 2017 and Cordella et al., 2016)

This last point, however, challenges the positive impact of the run threat on banks. It gains momentum from the fact that the run on bank liabilities may occur without fundamental reason (panic driven runs). Due to deposit insurance schemes, the run-risk is no longer related to savings deposits, but remains real for all unsecured or incompletely secured senior deposits. These positions account for a large portion of big international banks' liabilities. Since investors in these positions may run (fast) in case of bank distress, the restructuring process for failing banks is under a lot of time pressure.

From an investor's point of view liabilities that are above TLAC/MREL and below covered savings deposits are secure insofar as they can be withdrawn very quickly. This self-defence, however, can in fact force a bank into insolvency and may endanger the stability of the system as a whole, not only in the event of a panic-driven crisis. Therefore, the increased run-risk of investors does not necessarily contribute to a bank's stability. Requirements prescribing the level of bail-in able liabilities may only restore desired market discipline up to a certain point. It is important to consider the extent to which the disciplining, positive effect of the marginal run-risk outweighs the negative effects due to increased systemic risk because of an inefficient liquidation of banks. Considering the negative effects, it is beneficial to restrict the bail-in threat to those investors that are invested in the TLAC/MREL portion of a bank's liabilities. Thus, an upper limit should be set in addition to a regulatory minimum requirement for the amount of bail-in able capital. An a priori bailout guarantee on the other hand, undermines market discipline and incentivizes banks to take on too much risk as it precipitates moral hazard.

Efforts should be made to strike a balance between these two risks. The BRRD in its current form only provides for a highly discretionary and unspecified possibility to exclude certain liabilities from bail-in. In particular, where "the exclusion is absolutely necessary and it is appropriate to ensure the continuity of the critical functions and core business areas, so that the ability of the institution that is in the process of liquidation is maintained to allow it to continue the main business, services and transactions" (Article 44 para 3 letter b of the BRRD). This exception could be interpreted in the aforementioned manner, but an ex ante clear regulation would be preferable. This would shape market expectations without ambiguities.

Our thought experiment leads us to divide the liability side of a bank's balance sheet into three parts for the purpose of loss bearing: (1) a liable (TLAC/MREL), (2) a non-liable (secured) and between those two (3) a conditionally liable segment. We consider the latter part a mezzanine-like intermediate tier because its risk-return trade-off places it between TLAC/MREL and savings deposits. It is important to stress that this mezzanine-type loss absorption zone can also be set to zero – depending on the inherent cost-benefit trade-off.

We think that this structure limits the detrimental effect on systemic risk, stemming from the run-risk, but it leaves private liability in place.

Our proposal of a trichotomy of bank liabilities corresponds to a regulatory requirement that is more sophisticated than a straightforward complete potential bail-in of all liabilities since it ideally reduces the unintended danger of an unfounded bank run. Thus, we fully endorse the enforcement of a bail-in within the scope of a TLAC/MREL requirement, but we argue that outside the TLAC/MREL framework, a stringent avoidance of externalities needs to be implemented.

4 A consistent regulatory response

Five years after the publication of the Liikanen Report, the overall balance remains positive. In retrospect, it is possible to detect a persuasive thread in the regulation of these years. It pursues the goal of a market-oriented institutional framework for financial markets, in particular with the restoration of private liability as the indispensable correlate to private property and to private profit participation. The loss of private liability in view of the threat of systemic risk had characterised the initial situation of these years. Having been able to provide a consistent regulatory response is not a small achievement.

In this essay, we used the image of the greenhouse to show clearly that the traditional notion of market discipline, under the conditions of today's global financial markets, is an artificially created framework. Anyone who adheres to the idea that markets can be governed by regulation, which corresponds to the basic direction of European legislation since 2009, can be blamed for a certain degree of idealism with regard to the free market. We agree with this attitude. However, we are also aware that the microclimate, which targets market discipline in the banking sector, can only emerge and function if there is a responsible gardener who closely observes and supports the development and stability of this microclimate. In the European Union, this gardening role is performed by a large number of authorities that are responsible for various aspects of banking supervision, including resolution. Our first important conclusion from the analysis presented here is to expand the list of tasks of banking supervisors with regard to bail-in. We consider such an expanded notion of supervision a priority, and also more important as a further expansion of the monitoring and control of typical banking business models. In a nutshell: Supervision should focus primarily on the liabilities side of bank balance sheets and less on the assets side.

Our second conclusion is also based on the idea of reintroducing private investor liability in the banking industry. We propose to divide the liabilities of a bank into three segments for which there should be a clear regulation and, as a result, an accompanying supervisory practice, in order to ensure the proper functioning of the regulatory framework. According to our diagnosis, there is still a need for improvements at all levels, which is most distinct in terms of definition, conception and determination of the mezzanine-like intermediate segment.

Both extensions of the regulatory framework, owing to their impact on investors and depositors alike, would be able to exert pressure on banks and the business decisions of their management much more strongly than the market pressure of today. This would correspond to the order of the financial markets, as suggested in the Likkanen Report, and would contribute to render the corresponding policy orientation reliable.

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