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# Structural Reforms in the Banking Sector

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*Check against delivery.*

Ladies and gentlemen – good afternoon.

It is my great pleasure to be here with you today in Frankfurt and to have the possibility to share my views with you on the adjustments to the regulatory framework following the crisis and on structural reforms in the banking sector in particular. I am delighted to be given the opportunity to speak right after my former colleague, Joachim Nagel, with whom I have worked very closely for many years.

For me, an active dialogue between the public and the private sector is of key importance. In that sense, I am very glad to be able to build on my experiences as professor and central banker and now to add to this the perspective of the Chairman of a global bank with operations in more than 50 countries.

## Global Regulatory Reform

Let me start with a few words about the new emerging regulatory framework in general. It is clear that the financial crisis exposed the fragility of the financial system, and revealed risks stemming from misaligned economic incentives and at times ineffective regulation. One lesson of the crisis, which is also recognized by the industry, has clearly been that more effective and internationally coordinated regulation, as well as enhanced supervision, are needed. Reforms in areas such as capital and liquidity requirements, recovery and resolution planning, or central clearing, amongst others, are essential steps to enhance the stability of the financial system and to thereby rebuild trust in the financial services industry.

In the immediate aftermath of the financial crisis, this rightly induced a strong international determination to develop a coordinated global regulatory response. The G20 agreed on a variety of important initiatives. International organizations, in particular the Basel Committee and the Financial Stability Board, were leading the efforts to address shortcomings of the existing framework. Basel III is the cornerstone of this new regime and it is a major achievement. The financial industry agrees with the policy goal of increasing the resilience of the financial sector, and specifically also with the aim to ensure that no bank should be too-big-to-fail. Hence, it is important to implement resolution methods that allow the resolution of banks without causing systemic damage or a disruption of critical functions. It is of utmost importance that costs to taxpayers and the wider society and economy are minimized.

So how can we ensure that taxpayers' money is protected to the best possible degree? In my view, the main components of a stable and efficient system of controls include: strong governance and risk management practices; effective and proportionate supervision; sound micro-prudential standards that are risk-based in nature; effective recovery and resolution planning; and an appropriate level of macro-prudential oversight.

We are currently in the middle of the implementation phase for a number of regulatory initiatives that will contribute to improved financial stability. At the same time, new regulations are still continuously being developed. Also at the Basel Committee level, a good part of current discussions already focuses on adjusting the Basel III framework. This includes, for example, the recent discussion paper on "Balancing risk sensitivity, simplicity and comparability". It is essentially aiming to reform the new standards while the Basel III implementation timetable still runs until 2019. In my view, at the current juncture, priority should be given instead to ensuring the coherent and internationally consistent implementation of the agreed framework, starting with the Basel III rules. To be clear: this is a joint undertaking for the industry and authorities alike – we have shared concerns as well as a common responsibility for and interest in enhancing financial stability. Banks need to contribute their bit – and I observe good progress in this respect. According to the latest FSB report on progress and next steps towards ending "too-big-to-fail", global systemically important banks have increased their common equity capital by about 500bn US dollar, amounting to close to 3 per cent of their risk weighted assets since the end of 2009. This progress is, not the least, due to new rules and regulations already having a material impact on banks' business models and organizational structures. I can tell you that now also from my personal experience. At UBS, we reduced our funded assets as we define them by more than 50% from around 1,800 billion Swiss Francs in 2007 to 765 billion Swiss Francs at the end of Q2 2013. Our capital position is industry leading with a Basel III fully applied CET1 ratio of 11.2%. We have thus achieved the 2019 Swiss CET1 regulatory minimum for large banks 6 years early.

Another key component for enhanced financial stability is credibility and effectiveness of the regulatory framework. Focusing on proper implementation of the agreed measures will provide high marginal returns from a stability perspective – probably higher than those achieved by trying to "reform the reform" before it is actually put into practice and before an assessment of its effectiveness can be carried out. In addition, from a global bank's perspective, the remaining uncertainty on the final state of regulatory reform, including in particular regarding banking structures, prevents banks from planning ahead and slows down the necessary adaptation process.

**Structural reform measures – state of play**

In this context, the question that I would like to address today in greater detail is therefore: what specific aspects do we need to consider when discussing the role of structural measures?

In the next few minutes, I will discuss some conceptual pros and cons of structural measures and will come to the conclusion that, overall, the key issue is to ensure resolvability of large banks. Banking frameworks have long been diverse. Europe, for example, has a long tradition of universal banking, while the United States have long had a separation between broker-dealers and deposit-taking entities. Yet, over the last few years, regulators on both sides of the Atlantic have proposed a number of specific measures designed to impose fresh restrictions on banking structures. Internationally, the three most important structural frameworks currently under discussion are the proposals of the Independent Commission on Banking (ICB), chaired by Sir John Vickers, in the UK; the recommendations of the High-

level Expert Group on possible reforms to the structure of the EU banking sector led by Erkki Liikanen and related developments in the EU; as well as the Volcker Rule in the US.

But other rules also have structural components, including for example the so-called US FBO 165 / 166 proposals. The idea behind most such proposals is similar: to isolate some critical banking services (in particular deposits) from some form of "risky investment banking activities" and thereby to facilitate resolution. There are two main, albeit conceptually different, approaches: The first one aims to "ring-fence" specific activities (e.g. UK ICB). The idea is to build a „ring-fence" around critical activities, such as retail deposit-taking and thereby to insulate these critical banking services from shocks in the wider financial system. A second goal is to ensure the continuous provision of these services also in a crisis. The alternative approach seeks to "push out" certain activities (e.g. Liikanen report), such as trading / specific "risky" investment banking activities to a separate organizational entity. The reasoning includes that deposits, protected by the common guarantee schemes, would no longer directly be available to support or cross-subsidize such "risky activities".

**Positive aspects of structural measures**

As a result of these different starting points, there are still diverging views on which side of the fence certain activities should be placed. General consensus seems to exist only on retail deposit-taking activities on one side and proprietary trading on the other, for the rest the debate is on-going.

Conceptually speaking, structural separation can help. First, it can in theory shield institutions carrying out protected activities, e.g. retail deposit-taking, from losses incurred elsewhere in the institution. Similarly, it may prevent benefits available to protected activities (e.g. central bank lending facilities and deposit guarantee schemes) from being channeled to lower the cost of risk-taking in other business lines. Secondly, it can reduce the complexity of banking organizations, making them more transparent to outside stakeholders and, if rightly aligned with a bank's specific organizational structure, easier to resolve.

These mechanisms can thus potentially help to limit taxpayers' exposure to financial sector losses. An essential pre-condition is, however, that governments do not have to step in to prevent losses on protected activities. Given that many of the financial crises that occurred over the past few decades had their origin in the real estate sector, this is likely to be a bold assumption, even with a hard separation of traditional banking activities from the rest.

**Risks and undesirable outcomes related to structural measures**

Against that background, it has to be said that one-size-fits-all structural measures also have important flaws. First, we must remember that specific business models and banking structures were not a main cause of the crisis. A number of firms that failed during the crisis were in fact not universal banks, but rather investment banks (Lehman Brothers, Bear Stearns), retail banks (Washington Mutual), banks focused on narrow business lines (IKB, Hypo Real Estate) or even insurance companies (AIG). As rightly recognized by the analysis included in the Liikanen Expert Group's final report, where problems occurred, it was often poor risk management and funding policies that were at the heart of the individual institutional crises. Second, diversified sources of revenues and funding are key stability factors. Integrated universal banks are more resilient and can better absorb shocks than a specialized entity can do. They benefit from risk diversification across a group's businesses, efficient liquidity management,

consumer choice, and fulfill the needs of long-term banking client relationships. The integrated universal banking model, however, also implies an efficient organization of the banking group, inter alia in terms of capital, funding and risk diversification which would be strongly undermined by a mandatory adjustment to banks' legal structures. Third, there are risks that banks may respond to the reforms by shifting activities beyond the perimeter of consolidated regulation. This could in turn lead to increased systemic risks accumulating in the shadow banking sector. Fourth, structural requirements might result in the creation of a large number of banking groups that strongly resemble each other in terms of business models and risk profiles, likely leading to unidirectional behaviour in a broader crisis situation. Fifth, structural requirements will create large implementation difficulties and costs. For example, it will be extremely difficult to differentiate between banks' risk exposures stemming from hedging or market-making activities versus risks from proprietary trading in a more narrow sense. In addition, unwinding and decoupling integrated businesses will be very challenging and create operational risks. Sixth, it is possible that structural requirements lead to the emergence of business models that could become more difficult to supervise and resolve. For example, if global banks are subject to increasingly unaligned restrictions on their business models at the national level, resolution strategies at the global level may be complex to design and implement. Finally, there is the risk that diverging structural measures imposed by different jurisdictions may have an impact on the integration process across national or regional markets. In this context, I strongly agree with a recent FSB recommendation that countries should monitor and discuss potential cross-border spill-over effects that may result from different approaches in this context.

**Conclusions – and what can be done?**

The question is thus: how do these risks and benefits balance? In my view, the primary objective and hence the guiding principle against which to assess specific proposals for structural measures, must be to ensure that large banks can be resolved without causing systemic damage or a disruption of critical functions and without causing any costs to taxpayers. Large banks in many jurisdictions are already required to produce recovery plans and resolution planning materials; UBS for example submitted plans and planning materials to the Swiss FINMA and we submitted initial recovery and resolution planning documentation to authorities in the UK, the US and Germany. Work must continue and progress further on cross-border resolution. I acknowledge that there are large challenges to overcome related to effective cross-border resolution, such as recognition of third country legal contracts or confidentiality issues around cross-border information-sharing. Nevertheless, from a bank's perspective it is essential to establish internationally aligned and agreed regimes that ideally should be formalized into legislation or regulatory mandates. In the absence of such regimes and their enforceability, effective international bank resolution will remain cumbersome or not possible at all –independently of whether any structural measures are enacted ex ante.

One of my key concerns is the lack of consistency of and support for a global resolution strategy for G-SIFIs under the lead of the Crisis Management Groups. Efficient planning relies on consistent standards and requirements across jurisdictions and a balanced approach towards achieving improved resolvability for G-SIFIs, while at the same time avoiding excessive local requirements. Furthermore, work must also continue to develop bail-in as a key tool to facilitate the safe restructuring and recapitalization of banks. International standards must be developed with regard to resolution approaches that reflect different G-SIFI structures. The resolution strategy must follow the business model, not the other way around. At the same time, a firm should not have to comply with both Single Point of Entry (SPE) and Multiple Point of Entry (MPE) strategies. At UBS, we consider the SPE approach superior to any other resolution strategy

as it is considered most feasible to execute. Further, since the parent company is likely to have more comprehensive financial reporting to the capital markets compared to its subsidiaries, an SPE approach at the parent company level will likely be more transparent to creditors who would then be better placed to judge the parent's creditworthiness. The SPE bail-in approach will build on subordinated debt at Parent / Group level, sufficient to cope with tail risk events and which can be effectively executed based on contractual bail-in terms in such newly issued debt. In addition to maintaining regulatory capital in subsidiaries in keeping with local requirements, the parent / group company would invest into debt issued by the subsidiary under local terms which can be bailed in by local authorities. Such capital and debt structures will allow for an effective SPE top-down bail-in strategy, while it will also provide host authorities with the power to act on their own if the execution of a global resolution strategy is not possible for any reasons.

To conclude, structural measures can only complement enhanced work on cross-border resolution. As recently recognized also by the IMF, targeting structural measures to reflect firm-specific risk profiles increases their effectiveness relative to the one-size-fits-all approach envisaged by recent structural reform proposals. Having all banks in a given system with a similar structure and risk profile will most probably not improve financial stability overall. Any structural measure should thus not be prescriptive, but adapted by banks to their own resolution strategy and existing structure. In this way, they may under some circumstances help improve resolvability.  Ladies and Gentlemen, let me close on a positive note. The fact that we are discussing this topic today is in itself a positive development. Regulators and the industry are moving towards a common understanding of the challenges ahead and together we will find the best way to address these them.

Thank you very much for your attention and let me now open the round for questions.