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Structural reform to refocus banks on the real economy

Why the European Commission's proposal on the structural reform of banks is a 'must have' regulation and should be a top priority for the Council and new Parliament.

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A well-designed and effective structural reform is one of the most important measures to safeguard financial stability, ensure the effectiveness of the new resolution and supervision mechanisms, and to refocus banks on their core activity of lending to the real economy. Therefore the Commission's proposed Regulation should be on top of the Council and new Parliament's agenda.

"It is no use saying, 'We are doing our best.'
You have got to succeed in doing what is necessary."

Winston Churchill

KEY POINTS

- European banks provide less than 30% of their resources to customers outside of the financial system[1], while the issue of lack of long-term, sustainable credit supply to the European real economy is widely recognized.[2] And yet **none of the legislative measures implemented so far aims at refocusing megabanks[3] on their core business of serving the needs of the economy**.[4] The structural reform of banks will achieve this since it removes the implicit subsidy for speculative activities and encourages lending – a deposit-taking bank[5] after separation will by definition be limited to traditional banking activities.
- **The cost of credit and other banking services to the real economy will decrease following structural separation.** There is strong empirical evidence that less risky banks have a lower cost of funding. As a result, separated deposit-taking, commercial banks will benefit from an even cheaper funding than existing megabanks.
- **Megabanks are too big, too interconnected and too complex for the prudential and resolution tools (Banking Union) to be effective and credible.** Their size, interconnectedness and complexity result from their transaction, short term oriented business model. Indeed, such model requires holding large inventories of financial instruments on the asset side and reliance on wholesale funding provided by other financial institutions on the liabilities side. As a consequence, the application of bail-in tools would result in a domino effect, which any supervisor would want to avoid.

For these reasons, the European Commission's proposal for a regulation should be a top priority for the new Parliament.

As we argue in the last part of this note, although the text of the European Commission's proposed Regulation sets the right ambition, it can be improved – requiring amendments by the Parliament and Council.

> "As any reasonable architect will tell you, if you don't get the structure right, your edifice will be dysfunctional and is likely to collapse altogether."

Benoît Lallemand, Co-Head of Policy Analysis at Finance Watch

1) Serving the real economy should not be a "nice to achieve" but a "basic requirement" objective for the European banking sector

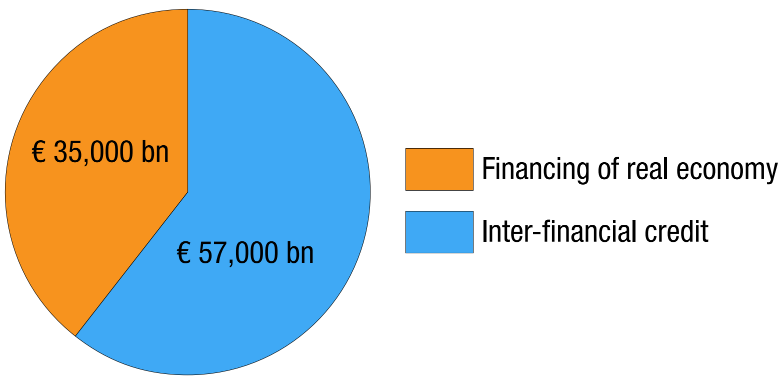
The banking industry will argue that there is no need for structural reforms since so much has been achieved already. Establishing a Banking Union was indeed a challenging project with the right objectives. Important supervisory changes will take place in the coming months (see section 3, below). However, none of the legislative acts adopted so far aims to revive banking dedicated to serving the real economy. The framework takes the banking system as it is, with the existing model of megabanks and their focus on transaction, fee-based and short-term oriented business. **It does not address the shift of megabank activities away from the relationship-based, long-term oriented banking that society needs for sustainable, non-cyclical financing.**

Banks – as any private business – allocate their resources to the most profitable activities. However the most profitable activities might not always be the most socially useful. Typically, megabanks will favor trading activities over lending to corporates and households due to the higher return of the former.[6] The implicit subsidy provides them with cheap funding to develop short term speculative activities, resulting in a vicious circle that leads them further away from commercial banking, while the real economy's access to finance remains an important concern.[7]

The general concept of separation is to split universal banks into a deposit-taking entity (which will be allowed to take deposits and should be concentrated on traditional retail banking activities) and a trading entity, which should not be allowed to take deposits and should be concentrated on providing market-related services (market making, underwriting etc.) and allowed to conduct proprietary trading, which is extremely difficult to separate from these services anyway.

> "For large banks (i.e. too big to fail), a ban on proprietary trading and the obligation to separate other trading activities from their core business will make it more costly for banks to speculate with financial products and it will make their traditional lending business more attractive."
>
> Gerhard Huemer, Economic Policy Director at UEAPME, the European Association of Craft, Small and Medium-sized Enterprises.

Size of inter-financial credit in relation to the financing used by the real economy[8]



Data : European Commission (2014a)

The size of inter-financial credit amounts to € 57,000bn **(6.5x Euro area GDP)**, almost twice the financing used by the real economy (€35,000bn).

If the external sector and the governments are also taken into consideration, the financial sector provides less than 30% of its resources to the real economy and more than 70% circulated within such an "extended" financial sector.[9]

2) A separation should decrease the cost of funding for the real economy

A bank's creditworthiness is one of the major elements determining its cost of funding, together with market conditions. But because megabanks are perceived to benefit from public backstops (their deposit-taking part must be rescued when they run into trouble) they benefit from a lower funding cost for their capital market activities than pure investment banks. This in turns gives them a competitive advantage enabling them to gain market share and develop their activities. Also since the larger the bank, the more likely that it will be bailed-out in case of trouble, the implicit subsidy of trading activities further incentivizes a growth in megabanks' size.[10]

Recent studies show the size of implicit subsidy[11] has actually risen significantly since the beginning of the crisis.[12] The implicit subsidy estimated by the Commission is in the range of EUR 72-95 billion and EUR 59-82 billion in 2011 and 2012, respectively. In relative terms, this **implicit subsidy amounts to 0.5 % to 0.8 % of annual EU GDP and between one-third and one-half of the banks' profits.**[13] Most important is the fact that implicit subsidy declines following concrete proposals and government endorsement of structural reform initiatives (e.g. UK).[14]

So what might actually happen to banks' cost of funding if the trading activities were separated? The deposit-taking banks after separation should be safer than universal banks before, especially from the macroeconomic perspective. Their assets should be less risky since there will be smaller inventory of financial instruments. All things being equal, this should be priced into the cost of funding, which should become lower for the deposit-taking bank.[15]

An IMF study[16] showed that increased bank resilience (determined by higher capital levels and lower asset riskiness) has a positive impact on long term funding costs. The lower cost of funding of the separated deposit-taking entity[17] will result in cheaper services to the real economy.

Now, the separated trading entity should see its cost of funding increase since the implicit subsidy will be removed – addressing moral hazard and re-introducing market discipline (fair pricing by investors of activities and their potential negative externalities). This might lead to the investment entity becoming smaller and more easily resolvable.[18] It will also make the investment banking landscape (hence capital markets) more competitive.

It should be noted as well that the vast majority of commercial banks are out of the scope and will remain able to provide market-related services to corporations and households. The universal banking model is not challenged, only the too-big-to-fail model is.

> “The logic for separation is simple enough. A retail bank will be safe and boring – boring is “good” when it comes to the deposits of unsophisticated investors and “bad” when it comes to the profitability and bonus targets of bankers.”
>
> Adrian Blundell-Wignall, OECD

3) The structure of megabanks hampers the Banking Union and Single Rulebook tools

The Banking Union is, legally speaking, completed. The European Central Bank will take over its supervisory functions as prudential supervisor in November: this will mark the operational start of the Single Supervisory Mechanism (SSM). The Single Resolution Mechanism (SRM),[19] setting up a resolution[20] framework for banks under SSM, will be up and running from 2015. Supervision and resolution, which constitute the core pillars of Banking Union, come on top of the already implemented enhanced Single Rulebook[21] comprising new capital rules.

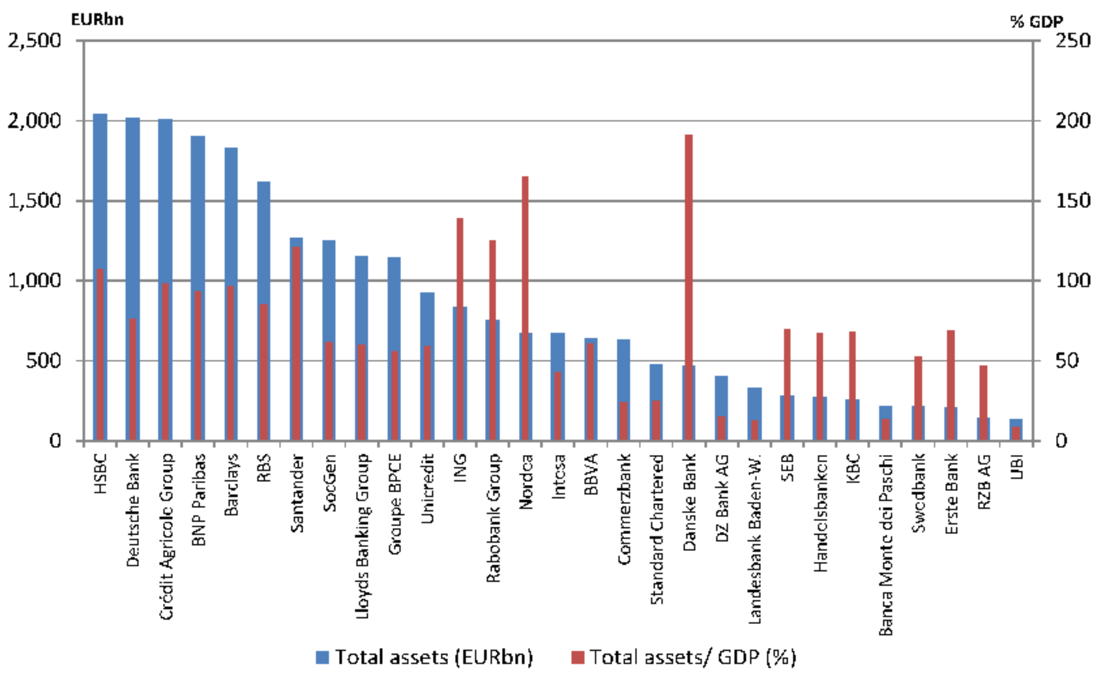
The measures undertaken so far aim at strengthening banks' resilience to shocks (decreasing the probability of failure via capital requirements) and minimizing the cost of bank failures to taxpayers (minimizing the impact of failure via resolution tools). Therefore they should also reduce the problem of moral hazard, which occurs when the investors take profits but don't bear losses.

However the scale, complexity and interconnectedness of megabanks might once again leave competent authorities disarmed, including the Single Supervisor within the Banking Union.

CRD IV/CRR[22] determines the amount of capital needed to cover material risks resulting from banking activities. Regulatory capital should serve as the first line of defense absorbing losses; it is a buffer maintained by banks. This framework addresses some of the flaws of its predecessor, concentrating on quality of capital, adding capital buffers and setting higher capital ratios.[23, 24] The problem, as shown by a recent OECD study,[25] is that **large complex and interconnected banks need very little capital in good times, but can never have enough in an extreme crisis**.[26] In other words, in a systemic crisis there is no level of capital that would prevent the large, complex, interconnected banks from falling.

The resolution regime is a crisis management framework where, in case of bank failure (i.e. when the level of loss absorbing capital determined by CRD IV/ CRR was insufficient), banks are supposed to have a resolution plan in place (living will) and authorities, equipped with resolution tools, are able to impose bank losses on their investors/creditors (via the bail-in tool). Shareholders and creditors should contribute to the maximum extent in the restructuring of a bank before turning to taxpayers' money.[27] As megabanks' funding is mostly provided by other financial institutions, they are highly interconnected. They are also very large (see chart below). **Hence, transferring the losses via bail-in tools would contaminate other banks and risk creating a domino effect. Actions to avoid this would lead once again to taxpayers absorbing the losses.**

The solution to address stability concerns, make new rules effective and address moral hazard is therefore to change the megabank business model through structural reform.



Size of selected EU banks (2012 assets in € billion and as % of national GDP).

Source: European Commission (2014c)

4) The proposed Regulation could be stricter

The European Commission's proposal for a regulation of the European Parliament and of the Council "on structural measures improving the resilience of EU credit institutions" (European Commission 2014d; hereafter: the Proposal) is the Commission's follow up to the recommendations of the High Level Expert Group on reforming the structure of the EU banking sector chaired by Erkki Liikanen.[28]

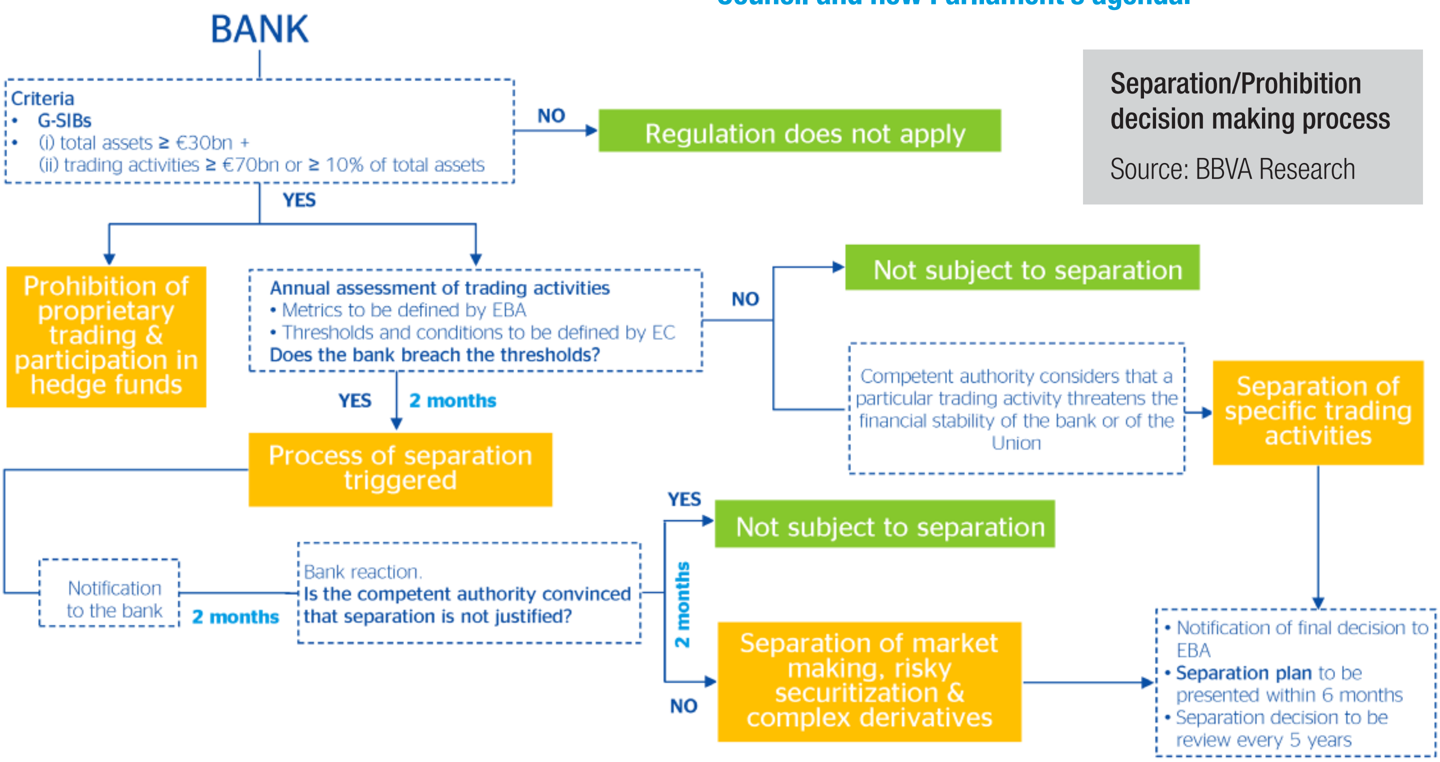
Although the HLEG recommended a mandatory separation of proprietary trading and certain trading activities such as market making, the European Commission decided not to follow this recommendation fully in the proposed Regulation. According to the Proposal, **an ex-ante prohibition** for the largest banks and entities within their group[29] **will apply to proprietary trading only**.[30]

The other trading activities of EU banks within the scope will be subject to an annual supervisory assessment (especially those relating to market making, securitization and derivatives trading). If they exceed the thresholds set for the metrics[31] (as outlined in the proposal), the supervisory authority will start an administrative procedure to separate these activities (ring-fencing). The process of ring-fencing should also be initiated if the thresholds are not surpassed but the competent authority still considers that some activities pose a threat to financial stability, "taking into account the objectives set in Article 1". In both cases, **the competent authority has some discretion over the decision** and the proposal leaves explicit room for negotiation between banks and their competent authority. This could weaken the process and make it more opaque, especially given the explicit opposition of some national supervisors to any separation beyond proprietary trading.[32]

Finally, while we have highlighted above the many benefits of structural reform (all listed in Article 1 as objectives of the Regulation), **the discussion around the need to separate will essentially focus on financial stability,** "taking into account the objectives referred to in Article 1". **This is a weakening of a previous version of the text** that referred to a situation that would "compromise any of the objectives referred to in Article 1".

While the Commission's proposal is well balanced, it can still be improved.

A well-designed and effective structural reform is one of the most important measures to safeguard financial stability, ensure the effectiveness of the new resolution and supervision mechanisms, and to refocus banks on their core activity of lending to the real economy. Therefore the Commission's proposed Regulation should be on top of the Council and new Parliament's agenda.



Separation/Prohibition decision making process

Source: BBVA Research

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NOTES

1. European Commission (2014a)
2. European Commission (2013)
3. We refer to megabanks as large universal banks. The largest universal banks are recognized as Globally Systemically Important Banks (GSIBs) however among GSIBs there are also large banks with more narrow retail focus (e.g. Nordea). The Basel Committee on Banking Supervision (BCBS) measures the global systemic importance of a bank in terms of the impact that a failure of a bank can have on the global financial system and wider economy. BCBS takes into account the following indicators of systemic importance: 1) size of banks, (2) their interconnectedness, (3) the lack of readily available substitutes or financial institution infrastructure for the services they provide, (4) their global (cross-jurisdictional) activity, and (5) their complexity.
4. Which might be worth incentivizing before promoting more market based credit intermediation, as proposed in the European Commission's Green paper on Long Term Financing.
5. Deposit-taking bank is defined in the European Commission's proposal as a core credit institution.
6. Universal banks might allocate too much capital to trading, compromising banks 'relationship' business and its stability. Boot, A. and Ratnovski, L. (2012).
7. European Central Bank (2014)
8. European Commission (2014a)
9. Ibidem
10. The 29 largest European banks have assets greater than 50% of their domestic GDP and seven European banks have assets greater than their domestic GDP. ESRB Advisory Scientific Committee (2014)
11. As we discuss in paragraph 3, the new resolution framework, which was to deal with implicit subsidy, has not removed it because the framework is not credible in the case of megabanks.
12. Prior to the crisis, the 29 most systemically important global banks benefited from just over one notch of uplift from the ratings agencies due to expectations of state support (for example from AA to AA+ or from A+ to AA- for S&P and Fitch ratings or from Aa3 to Aa2 for Moody's ratings). Today, those same banks benefit from around two or three notches of implied support on average, although results differ across banks, Member States, and time. European Commission (2014b)
13. European Commission (2014b)
14. Ibidem
15. Blundell-Wignall, A., Atkinson, P. and Roulet, C. (2014)
16. Babihuga, R. and Spaltro, M. (2014)
17. Blundell-Wignall, A., Atkinson, P. and Roulet, C. (2014)
18. Ibidem
19. **Framework for the recovery and resolution** of credit institutions in EU comprises of BRRD and SRM. The BRRD constitutes a single rulebook for the resolution of banks (and large investment firms) in all EU Member States. It introduces harmonized tools for dealing with bank crises both to prevent failure and to restructure banks if they do face failure. The Single Resolution Mechanism implements the BRRD in the Eurozone and any other Member State participating in Single Supervisory Mechanism.

20. **Resolution** means the restructuring of a bank by a public authority (resolution authority) when the bank is failing or likely to fail and there is no private solution that can restore the bank to viability within a short timeframe, and normal insolvency proceedings would cause financial instability. Thanks to resolution tools (exercising the power to sell or merge the business with another bank, to set up a temporary bridge bank to operate critical functions, to separate good assets from bad ones, and to convert into shares or write down the liabilities of failing banks) the continuity of banks' critical functions is guaranteed and financial stability is preserved.
21. **Single Rulebook** – term used by European Council to describe the need for a unified regulatory framework. The single rulebook was introduced to address the problems with European banking legislation which was previously based on Directives. Implementation of Directives left room for significant divergences in national rules, resulting in legal uncertainty and in institutions exploiting regulatory loopholes. Hence the Single Rulebook is based on Regulations, which are directly binding and need no transposition into national rules.
22. Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV); and Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR).
23. However CRD IV/CRR still allows banks to use internal models to calculate the capital requirements and some of the requirements are not phased in until 2018/2019.
24. The leverage ratio was supposed to be a binding measure but CRD IV/CRR left its implementation to a later decision. This is a missed opportunity as it is a better determinant of the riskiness of a bank (measured by the Distance-to-Default) and it vastly outperforms the CRD IV/CRR Tier 1 ratio. Blundell-Wignall, A and Roulet, C. (2013)
25. Blundell-Wignall, A., Atkinson, P. and Roulet, C. (2014)
26. Risk weighting of assets, a core pillar of the capital requirements framework, does not address the structural business model issues that lead to default risk. Megabanks are highly leveraged and heavily engaged in derivatives markets. Leverage and derivatives are shown in this study to interact in ways that simply cannot be addressed by a reasonable single capital rule. It has been described as the bank regulators' paradox - large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis. Blundell-Wignall, A., Atkinson, P. and Roulet, C. (2014)
27. If creditors and shareholders bear consequences of their investment decisions (''skin-in-the-game") the moral hazard risk should be mitigated and the implied subsidy removed.
28. HLEG (2012)
29. Meaning a bank (or its EU parent) identified as a Global Systemically Important Institution or which for 3 years has had total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.
30. The definition of proprietary trading is quite narrow – it is a bank using its own capital or borrowed money to purchase, sell or otherwise acquire or dispose of a financial instrument or commodities for the sole purpose of making a profit for its own account and without any connection to actual or anticipated client activity or without the purpose of hedging the entity's risk as a result of actual or anticipated client activity. There are limited exemptions to the ban on proprietary trading such as regarding sovereign debt or cash equivalent assets used for cash management process.
31. The description of metrics is already provided in the Proposal (e.g. relative size of trading assets; leverage of trading assets etc.) See article 9 (2) of the Proposal. The EBA will develop technical standards to specify how the metrics will be measured and their details but the relevant limits will be determined by the Commission (see article 35 (5)).
32. Under the SSM, large banks will be overseen by a joint supervisory team comprising staff members from the ECB and national supervisors.

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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