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Response to the public consultation from the European Commission on a reform of the structure of the EU banking sector

Response by Finance Watch

11 July 2013

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

Finance Watch is funded by grants, donations and membership fees. It does not accept any funding from the financial industry or political parties. For 2012 and 2013, Finance Watch has also received funding from the European Union to implement its work programme (there is no implied endorsement by the EU of Finance Watch's work, which is the sole responsibility of Finance Watch).

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Finance Watch authorizes the publication of this consultation response.

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PRELIMINARY REMARKS

Finance Watch welcomes the Commission's consultation on the reform of banking structure, first because structural reform appears to be the missing piece in the set of bank regulations proposed by the European Commission in recent years; second, because national initiatives in this field have shown the risk of "legislative fragmentation" in the European Union, as such, calling for a harmonising proposal at European level.

Five years after the start of the financial crisis, the European banking sector is still dominated by a small number of very large banks whose failure would threaten not only their home country's economy and public finances but also those of the entire European Union. Making those banks resolvable must be a priority if we want to avoid in the future that hundreds of billions of public money are poured again into banks as it has been the case since 2008. This will require not only the adequate resolution framework and tools, but also measures to reform banks and to align the coherence of their activities with the public interest given the fact that they benefit from public support. This alignment will necessarily include, on top of an improvement of the loss absorption capacity of banks, a separation of commercial from investment banking activities.

Over the last 25 years Europe's largest banks have been transformed by a massive increase in financial market activities. Their balance sheets reflect this change; typically around 50% of their assets are trading assets (including derivatives). The nature of these activities creates a problem for crisis management, which has a double objective of protecting deposits and avoiding taxpayer bailouts of defaulting banks. Put simply the activities that make these banks too-big, too-complex and too-connected-to-fail make them too-big, too-complex and too-connected-to-resolve. Unless the structure in which those activities are organized is changed, bailouts cannot be avoided.

To conclude these preliminary remarks, it is striking that separating banks' commercial banking activities from investment banking activities is clearly in the interest of stakeholders: *individuals as taxpayers* have a clear interest to reduce the cost of banks' bailouts given their impact on public finances and indebtedness; *individuals as consumers* need to trust that their bank is stable enough to keep their deposits safe and does not engage in too much risky activity; *SMEs* have limited use of investment banks : they rarely need more than what a medium-sized universal bank is able to provide; *large corporations* already face multiple entry points at banks, use multiple banks and shop around, a separation would therefore not make a difference to them; *individuals as banks' employees* will benefit from a separation in the long run, as the commercial bank - which is the most labor-intensive – will no longer have to act as a buffer to absorb shocks from the investment bank, and each part would be subject to its own profitability and resource constraints; *investors* be they private or institutional will benefit from an improved transparency on banks' activities and facilitated pricing of the separated parts, which will improve the access to market funding for many banks; last but not least, *regulators and supervisors* will benefit from increased transparency as separate entities will be subject to separate reporting and governance, and constrained in terms of activities they can conduct.

For these reasons and the reasons detailed in the following pages, Finance Watch calls for an ambitious reform of the structure of banks in Europe.

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PROBLEM DRIVERS

QUESTION 1

CAN STRUCTURAL REFORM OF THE LARGEST AND MOST COMPLEX BANKING GROUPS ADDRESS AND ALLEVIATE THESE PROBLEMS? PLEASE SUBSTANTIATE YOUR ANSWER.

The European Commission's Consultation Paper powerfully and succinctly identifies the problems in Europe's banking sector that contributed to banks being at the heart of the crisis. Finance Watch believes that a structural reform of the largest and most complex banking groups can address and alleviate these problems.

The *implicit subsidy* that investment banks benefit from due to the presence of deposits in the group they belong to will be reduced if investment banking is separated from commercial banking: indeed, if an investment bank stands on its own feet, with separate funding, its activities and the related risks will be assessed and priced separately, without taking into account the potential support of the state in case of failure.

As the existence of the implicit subsidy has encouraged the *excessive growth* of market activities as well as *excessive risk-taking*, the removal of the implicit subsidy will discourage this behavior.

Again, the risks taken by the investment bank will be assessed separately for what they are, leading to appropriate pricing, discouraging at the same time the over-development of those activities for which the cost of funding would act as a deterrent. Removing the implicit subsidy that large universal banking groups benefit from will also help restore fairer competition in the European banking sector – especially as far as funding costs are concerned, thanks to an improved *market discipline.*

Trading activities (conducted by the investment banking part) are of a different nature from credit activities (conducted in the commercial banking part): whereas the first is transaction-based and short-term, the second is relationship-based and long-term; these activities require different risk assessment processes and tools, and different IT platforms; they are managed differently. Combining them in a same banking group therefore makes their assessment, supervision and management *more complex*, because activities are mingled together. Splitting them in two different parts will make it easier for investors, supervisors and managers to respectively assess, supervise and manage each of the separated parts.

Also, by having commercial banking and investment banks "under the same roof", the money creation process inherent to commercial banking enables the development of investment banking and has the natural consequence of having amounts of newly created money feeding investment banking activities, leading to the creation of asset bubbles, as experienced in the current crisis. Separation could help mitigate that issue.

Separation, if properly implemented, will also prevent contagion within groups. Firebreaks are placed between different parts of the organisation preventing losses in one unit dragging down others.

A reform of banking structure will make resolution possible for all banks - even the very largest, which greatly decreases the risk that taxpayers will once again have to bail out banks.

This analysis is shared by many, who believe that a structural reform of banks would address many of the problems facing the European banking system.

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We would quote here the recent working paper published by the Bank for International Settlements[1] that groups the benefits of separating commercial banking from investment banking in four categories:

1. "First, and most directly, it can shield the institutions carrying out the protected activities from losses incurred elsewhere.
2. "Second, it can prevent any subsidies that support the protected activities (e.g. central bank lending facilities and deposit guarantee schemes) from lowering the cost of risk-taking and encouraging moral hazard in other business lines.
3. "Third, it can reduce the complexity and possibly size of banking organizations, making them easier to manage, more transparent to outside stakeholders and easier to resolve. This in turn could improve risk management, contain moral hazard and strengthen market discipline.
4. Fourth, it can prevent the aggressive risk culture of the riskier activities from infecting that of more traditional banking business, thus reducing the scope for conflicts of interest."

Finance Watch would like to insist on the benefits of a structural reform in terms of *resolvability* of large banking groups. We indeed believe that structural reform is the vital ingredient without which large banks will not be easily resolvable:

- Separation will render banks more resolvable in the heat of a crisis. Separation helps make resolution mechanisms credible, even for the largest and most connected banks. Experience has shown that bailing-in creditors of large banks is very difficult for authorities to achieve in the midst of a crisis because of the fear of contagion linked to the high level of interconnection of the system. In addition the crisis has shown that resolution of complex banks is costly and time-consuming. Correctly implemented separation reduces complexity, interconnectedness and size, i.e. the three critical elements that make banks too-big-to-fail and therefore too-big-to-resolve.
- Second, resolution and separation together can establish a virtuous circle: credible resolution reduces the funding subsidy on the very financial instruments (derivatives in particular) that increase the complexity and interconnectedness of the financial system; and lower complexity and interconnectedness themselves further enhance the credibility of resolution.

As such structural separation is in our view an essential complement to the Bank Recovery and Resolution (BRR) directive and to the Single Resolution Mechanism (SRM) and is critical to the European regulatory framework for banks.

Separation is however not a silver bullet. While structural separation is essential for the resolvability of large banking groups, it cannot be expected to solve all of Europe's banking problems. European banks remain in dire trouble, with bank failures still happening regularly and the ECB still providing approximately EUR 700 billion liquidity to banks[2] (under normal circumstances this liquidity should be provided by the inter-bank market but it is not anymore due to a lack of trust of banks between one another).

Resolution and separation should be accompanied by further measures, not least a leverage cap.

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[1] See BIS Working Paper No 412, Structural bank regulation initiatives: approaches and implications, Leonardo Gambacorta and Adrian van Rixtel, April 2013 http://www.bis.org/publ/work412.pdf

[2] The two 3-year long-term refinancing operations (or LTRO) amounted to a total of €1.020 billion euros (€ 490 billion in December 2011 and € 530 billion in February 2012) , minus 310 billion repayments in the first half of 2013 (source: ECB).

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SUBSIDIARITY

QUESTION 2

DO YOU CONSIDER THAT AN EU PROPOSAL IN THE FIELD OF STRUCTURAL REFORM IS NEEDED? WHAT ARE THE POSSIBLE ADVANTAGES OR DRAWBACKS ASSOCIATED WITH SUCH REFORMS? PLEASE SUBSTANTIATE YOUR ANSWER.

Finance Watch is indeed in favor of a structural reform of banks at the European level and we see a lot of benefits in an EU proposal: it would avoid a race to the bottom between Member States; it would make other European initiatives in the field of banking regulation credible; and it would avoid fragmentation at a time when Europe is building a Banking Union.

Avoid a race to the bottom

In addition to the advantages listed in the consultation paper, EU legislation is essential to avoid a major “collective action” problem. Whilst individual Member States might agree that separation is the right policy to implement, it is very likely that they will only move forward in a meaningful way if a similar regulation is implemented throughout the EU.

Typically, given the impact of an evolution of banking structures on the cost of funding of certain activities (e.g. derivatives trading), it is to be excepted that the “level playing field argument” will be heard over and over again against any reform of banking structures. In that context, the broader the implementation, the less valid this argument will be, hence the need for an EU wide implementation of a reform of banking structures. Absent an EU wide scope, a “race to the bottom” is to be expected with Member States developing national legislations with little effective content.

The IMF,[3] when asking “How would a Banking Union help?” argues that European wide banking supervision would be ”less subject to capture by local interests”. Imposing a European wide law on structural separation might be thought of as achieving the same result, setting a non-discretionary standard for bank structure that would avoid a race to the bottom as described above.

Make other EU regulatory initiatives credible (BRRD, SRM)

As noted in the response to question 1 above, structural reform is essential to make recovery and resolution possible. As Europe is committing to new recovery and resolution mechanisms through both the BRR directive and the SRM, it must also reform banking structures on a consistent basis if it wants recovery and resolution legislation to be successful.

Avoid fragmentation at a time when Europe is building a Banking Union

Finally, Finance Watch notes that national initiatives in this area risk undermining the very effectiveness of a Banking Union. The difference in approaches, which are influenced by national interests, lead to a fragmentation of the European banking market, with different rules being considered in different Member States.

[3] See IMF staff discussion note “A banking Union for the Euro Area"
http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf

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Some of these national initiatives, namely the German and the French, are expected to have very little impact[4] as both banking bills take the approach of separating proprietary trading activities only, with a definition of proprietary trading as "non-client facing", which excludes, by definition, market making[5].

Given that both countries count amongst the largest banking groups in Europe, if discretion is left at national level, there is a high risk that their approach will reflect the private interests of their respective national banking industries, which in the end could have a negative influence on the implementation of a EU wide reform (race to the bottom, see above. See also our response to question 4 of the present consultation).

We therefore see no drawbacks but only benefits to a regulation at European level, especially in the context of a Banking Union, whereas we see a number of drawbacks to national regulations in this field.

POLICY OPTIONS

QUESTION 3

Definitions of trading activity proposed by the Commission in order to determine the scope of the institutions subject to a separation requirement

1. Using the HLEG definition (Assets held for trading and available for sale);

2. A more narrow definition that excludes available for sale assets as mostly composed of securities held for liquidity purposes;

3. A definition focused on the gross volume of trading activity, which is likely to focus on proprietary traders and market-makers;

4. A definition focused on net volumes, which is likely to only capture those institutions that have a higher share of unbalanced risk trading (proprietary traders).

WHICH OF THE FOUR DEFINITIONS IS THE BEST INDICATOR TO IDENTIFY SYSTEMICALLY RISKY TRADING ACTIVITIES? IF NONE OF THE ABOVE, PLEASE PROPOSE AN ALTERNATIVE INDICATOR.

Of the 4 alternatives proposed, Finance Watch prefers the HLEG definition (assets held for trading and available for sale), for the reasons below.

[4] See Finance Watch detailed analyses of the French and German banking bills: http://www.finance-watch.org/our-work/publications/597-position-paper-german-bank-reform and http://www.finance-watch.org/press/press-releases/305-amendments-french-bank-reform. See also our answer to question 11 of the present consultation, in particular comment on option 1.
[5] See article "A misleading argument on bank separation: the "client facing" criterion", http://www.finance-watch.org/hot-topics/blog/609

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Definition 1

The HLEG definition captures better than the three other definitions the volume of trading activities that create a systemic risk.

"Assets held for trading" and "Assets available for sale" are accounting definitions that, taken together, capture banks' financial market trading activities (whether market making or proprietary trading). They are therefore the only accounting definitions that can be used for drawing a line that makes sense for separating trading activities from commercial banking activities. Using any other definition would be equivalent to deciding not to separate or carving out "hidden" exemptions.

Another important point is that if a separation is to be implemented it must encompass all trading positions of a certain nature and this is reflected by definition in gross trading volume numbers. This is true of all trading positions but is particularly fundamental for derivative assets (see further explanation below, about definition 4), as well as the volume of assets Available for Sale (see further explanation below, about definition 2).

Definition 2

As it excludes AFS assets, definition 2 must be excluded. AFS purpose is not aimed primarily at liquidity management, but to account for the positions taken by the bank on the financial markets other than those managed in the context of trading activities (market making, proprietary trading and underwriting, in particular) and other than assets held to maturity (i.e. managed as investments).

While Finance Watch understands the importance of allowing commercial banks to manage their liquidity situation and acknowledges that some instruments held for liquidity reasons can be accounted for as AFS, it also wants to emphasize the fact that the AFS category is also used for other purposes that are typically linked to proprietary trading (for instance participations in listed companies). If anything, the amount of AFS allowed in the book of deposit-taking banks needs to be capped if regulatory arbitrage is to be avoided[6].

Finance Watch therefore believes that definitions 2, 3 and 4, which exclude AFS from the scope of trading activities, are not appropriate.

Definition 3

The arguments developed regarding definition 2 are also valid here, in particular those relating to the inclusion of AFS. There is no technical reason to move away from strict and recognized accounting definitions and apply less well defined concepts apart from for the purpose of carving out unnamed exemptions.

Definition 4

Because it is based on the net valuation of trading securities and derivatives, and not their gross amount, definition 4 does not provide a reliable evaluation of the market risk the bank is exposed to.

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[6] In this regard, a combination of definition 1 and of the approach proposed by Finance Watch (see response to question 6) in terms of activities allowed at commercial banks provides a solution to the liquidity management issue in relation to AFS: if a banking group has an investment banking entity, then all trading activities must be gathered in this entity, with no exception; and if a banking has no investment banking entity, then TA + AFS should not exceed 5% of total assets, unless TA and AFS in excess of the 5% threshold are backed by capital at 1 for 1.

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The gross amount of derivatives is critical in making banks “too-big-to-fail” in the broadest sense, most especially in rendering such banks too-connected-to-fail. This is true even when a derivatives’ portfolio has a low net market risk. The dangers for the banking system, which remain, but can potentially be masked by a low net market risk position, can be analyzed in two ways.

- First, if a bank with a large *gross* but small *net* market risk position in derivatives defaults, it still causes a large amount of disruption in derivatives markets and by extension in financial markets more generally. Its derivative liabilities represent claims on the defaulted bank by other derivatives market participants. Moreover the termination of derivatives on both the asset and liability side will result in disruptions to the market risk position of all of its counterparties. This sudden change in market risk position for the non-defaulting counterparts will require replacing trades in a disrupted market.
- Second, and by extension, the bank in question can face large problems if one of its counterparts defaults. Thus an apparently small net market risk position can become instantly and dramatically un-hedged as a result of a counterparty default. The larger the gross position the more important this effect will be. Put another way, a low total market risk exposure can mask high market risk contingent counterparty risk and/or high counterparty credit risk contingent market risk.

For this reason we believe that definition 4, which approaches derivatives on a net basis, is not appropriate.

SUPERVISORY DISCRETION FOR SEPARATION

QUESTION 4

CONTEMPLATED OPTIONS:

1. **Ex post separation subject to constrained discretion by the supervisor**
2. **Ex ante separation subject to evaluation by the supervisor**
3. **Ex ante separation**

WHICH OF THE APPROACHES OUTLINED ABOVE IS THE MOST APPROPRIATE? ARE THERE ANY ALTERNATIVE APPROACHES? PLEASE SUBSTANTIATE YOUR ANSWER

Finance Watch supports Option 3, as ex-ante separation is the only form of separation that will achieve the goal of addressing the problems identified in the opening section. A reform that would leave the actual decision to separate or the scope of separation to the discretion of supervisors risks provoking further fragmentation in the European banking sector.

Need for clear rules

Ex-ante clarity is better for banks to operate, as it increases the clarity of the rules by which they have to play, whereas leaving discretion to the supervisors (especially as described in option 1

where the actual decision to separate is left at their discretion) would make it unclear what the rules in a given Member State are.

Provide a level-playing field for all European banks

Ex-ante rules will provide a level-playing field at European level (see also our answer to question 2 of the present consultation) and limit the risks of fragmentation due to different national implementations.

Avoid the risk of forbearance

Leaving discretion to national supervisors leaves them with a risk of forbearance. In this regard, we believe that technical standards would not be enough to mitigate that risk if the final decision to separate or not and how to separate is left to national supervisors. The risk of forbearance is indeed often stronger at national level and EU rules could contribute to mitigate that risk.

Make other EU regulatory initiatives credible (BRRD, SRM)

Ex-ante rules will improve considerably the effectiveness of resolution tools. Indeed, the major role of separation is to make clear that investment banking activities will not be bailed-out and that investors and creditors in these businesses will face losses like in any other business, be it through insolvency or through bail-in. In the absence of ex-ante separation there will remain a doubt that separation could or would be achieved in the midst of a bank crisis and therefore some, or all, of the funding subsidy will remain. Addressing the funding subsidy issue is critical, not least because subsidizing investment banking activities contributes to too-big-to-fail and therefore to too-big-to-resolve (see also our answer to question 1).

Tackle excessive complexity

Ex-ante separation will also greatly contribute to tackling excessive complexity of large banking groups. Europe's largest banks are indeed too-complex-to-resolve, too-complex-to-supervise-and-regulate and too-complex-to-manage. Ex-ante separation helps to tackle this complexity

- *Too complex to resolve.* In Europe the largest banks operate in very complex legal structures. Anecdotal evidence suggests, for example, that a recent "living will" exercise at one large European bank revealed the existence of numerous legal entities for which there was insufficient centralized knowledge. Separation reduces complexity and therefore increases ease of resolution.
- *Too-complex to manage*. A continuing litany of trading accidents and cases of mis-selling suggests that the top management of those institutions simply cannot understand let alone control such sprawling entities. This has started to be reflected in bank analysts and activist shareholders calling for banks to break themselves up. The implications of such calls are that even the private benefits of such complexity are being questioned; let-alone the public benefits. The fall in price-to-book ratios below 1 after the crisis (just as they did after the 1929 crisis) shows the limits of too large and complex groups from an investor perspective.
- *Too complex to supervise*. The multiplicity and heterogeneity of activities and legal entities at large universal banks also reduce the ability of public authorities to control them efficiently. Separation makes the structure of large universal banks simpler and clearer. It will therefore make it easier for supervisors (as well as for resolution authorities) to accomplish their mission. As a consequence, it will improve the ability of supervisors and resolution authorities to intervene early enough when a bank faces difficulties or engages in operations that could threaten the stability of the system.

To conclude, not only would options 1 and 2 generate additional issues (fragmentation, legal uncertainty, risk of forbearance) but they would also fail to deliver the expected benefits of a reform of banking structure as listed by the Commission.

ACTIVITIES TO BE SEPARATED

QUESTION 5

WHAT ARE THE COSTS AND BENEFITS OF SEPARATING MARKET-MAKING AND/OR UNDERWRITING ACTIVITIES? COULD SOME OF THESE ACTIVITIES BE INCLUDED IN, OR EXEMPT FROM, A SEPARATION REQUIREMENT? IF SO, WHICH AND ON WHAT BASIS?

Market making and underwriting are both trading activities. As such, they must be separated from the deposit-taking bank.

Market making and underwriting are complementary activities

Market making (as well as proprietary trading) is about trading on the secondary market, whereas securities underwriting is about trading on the primary market. Primary market teams need to work with secondary market teams to price, distribute and trade primary market operations. This implies that separating primary from secondary market operations is not functional. We therefore recommend that both primary market and secondary market activities be kept in the trading entity. Another reason for this is that trading activities use a common infrastructure, which is very different from that used by commercial banks for credit, savings and payment operations. In general, trading activities are all inherently similar (which goes beyond market making and underwriting).

Trading activities do not require public support

By nature, neither market making nor underwriting require public support: should one market maker fail, another can take its place; the same is true for underwriting as this activity is usually undertaken in ad hoc syndicates - should one member of the syndicate fail, the other(s) can take its place. Because these activities do not require public support, there is no reason to keep them in the same banking entity as deposit-taking activities.

Separating market making will not increase the cost of services to the real economy

An argument is often made by banking lobbies that separating market making activities would lead to an increase in their cost of funding that would in turn make them too expensive to run and therefore detrimental to the economy. A distinction must be made here between making markets in securities (shares and bonds) and making markets in derivatives.

- *Separating securities market making* activities will have no impact on their cost of funding as those activities are routinely refinanced through repurchase (repo) agreements that are structurally the most flexible and cheapest source of funding available.
- *Separating derivatives market making activities* will have an impact on their cost of funding as those activities cannot be financed through repo agreements and must typically do so by borrowing on the interbank market. However, this increased cost of funding of derivatives

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activities should be seen by public authorities as a benefit as it will have the consequence of stopping the artificial feeding of the growth of derivatives markets through a funding subsidy which is effectively a rent extracted from society. It has to be borne in mind that the situation we are in today where the notional amount of outstanding derivative contracts is equal to twelve times world GDP and where 7% only of derivatives transactions are dealt between banks and non-financial entities indicates clearly that the bulk of derivatives have ceased to be hedging tools to become an end in themselves. Most importantly, the exponential growth of derivatives volumes has the consequence of developing the interconnectedness of the financial system thereby making it extremely fragile. In this situation, separating derivatives activities would have the enormous benefit of making that activity pay for its true cost of funding instead of seeing its growth artificially subsidized by the taxpayer. This may be one of the most fundamental arguments in favour of the separation of banking activities as the overdevelopment of derivative markets fed by the implicit support of society is one of the most dangerous time bombs that exists in our financial system.

Separating trading activities could decrease the cost of lending to the real economy

Large universal banks, which combine trading activities and commercial banking activities (lending, deposit-taking and payment services), rely to a large extent on wholesale funding. This is mostly due to the funding needs of the investment banking part. As a consequence, if activities are split, each part will have its own funding structure, which would benefit the commercial bank: on average, European banks lend 115 euros for 100 in deposit; the funding gap of 15 euros is filled by own resources (equity) and wholesale funding. Wholesale funding costs for this part of the activity is however higher when commercial banking and investment banking are mingled together, as investment banking activities increase the average level of risk of the bank as a whole, hence the price investors would lend to them. We can therefore expect that the cost of funding of pure commercial banks, once separated, will decrease, which should in turn diminish the cost of lending to the economy. The graph below provides an illustration of this assumption.

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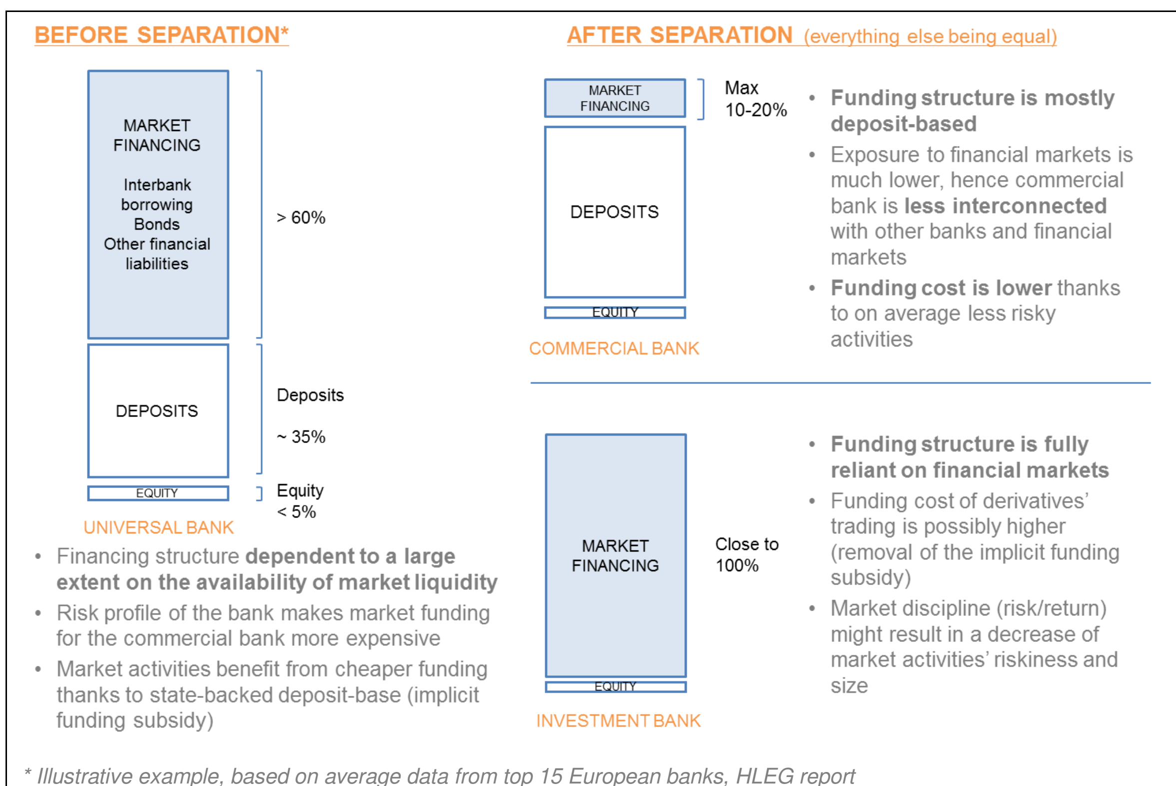

The need for simple rules

The difficulty of distinguishing between trading activities provides a strong argument for simplicity, with regard to proprietary trading but also in the way activities are separated. Aside from the possibility of losses, a complex definition of permitted trading activities, either inside the deposit-taking entity or elsewhere in the group, will be subject to attempts of regulatory arbitrage and to degradation over time. Simple rules, on the other hand, would simplify the choices of investors in commercial and investment banks with their respective risk profiles.

Simple rules that group trading activities in an investment bank, separated from commercial banking activities, would aid regulatory control, including addressing public interest concerns across a range of investment banking activities. For example market making involves activities that might not be fully in the public interest. The "real" economy might need investment banking (to raise large scale finance) but, funding subsidies aside, one can reasonably ask how much investment banking needs the "real" economy. The majority of investment bank trading appears to be directed elsewhere. Again, less than 10% of OTC derivative notional outstanding faces non-financial firms. World trade is less than 5% of foreign exchange activity. In short, the vast majority of financial market activity is not concerned with financing the "real" economy. Nevertheless it is banks, and only banks, that organize the issuance of these securities and make markets in them. It is therefore all finance-to-finance securities and derivatives trading that should be forced to stand apart from (implicit) public support.

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QUESTION 6

SHOULD DEPOSIT BANKS BE ALLOWED TO DIRECTLY PROVIDE RISK MANAGEMENT SERVICES TO CLIENTS? IF SO, SHOULD ANY (WHICH) ADDITIONAL SAFEGUARDS/LIMITS BE CONSIDERED?

Deposit banks can be allowed to directly provide risk management services to clients, provided that these services are offered to non-financial clients only and are limited to simple instruments aimed at meeting fundamental needs such as the hedging of interest rate and foreign-exchange risks.

Small and medium-sized banks with local/regional reach provide local businesses with a range of products that include – in addition to traditional banking services – hedging of the risks they take in the context of their commercial activities. The point is that this model corresponds to the needs of non-financial customers and, to a large extent, generates a manageable level of risk for the banks involved.

As an illustration, the table below shows the comparative balance sheet structures of European domestic banks depending on their size.

Average share of total assets Number of banks in the sample	Small banks ~3000 banks	Medium-sized ~500 banks	Large banks ~30 banks
ASSETS			
Financial assets held for trading	0%	3%	26%
Derivatives held for trading	0%	2%	16%
LIABILITIES			
Derivatives held for trading	0%	2%	10%

Source : ECB consolidated banking data, end 2012

It shows that small and medium-sized banks clearly have a different business model, and that even if many of them are so-called “universal banks”, able to sell hedging and capital market products to their clients on top of lending them money and providing payment services, they are marginally exposed to financial markets compared to their large international competitors (the large banks).

Finance Watch suggests an approach that would apply to all banks. As such, it should do away with the need for a *de minimis* rule and provide a clear framework to European banks without imposing unnecessary constraints on small and medium-sized banks. The approach is as follows:

If a deposit bank is in the same group as an investment bank, all trading should be with the investment bank. There should be no problem with undertaking commercial banking activities with one entity and trading activities with the other:

- Large corporations already shop around and maintain relations with several banks;
- Small and medium sized corporations should have no problem signing a separate contract for trading activity, whether occasional or frequent;

- The vast majority of financial market trading activity occurs between financial firms who maintain trading relations with many different entities in the market.

If a deposit bank is not in the same group as an investment bank it might be possible to allow limited trading activity in the guaranteed entity.

- The type of such trading activity should be limited to simple financial instruments undertaken with / on behalf of non-financial firms.
- The amount of such trading activity within the guaranteed entity should be capped at 5% of the total balance sheet of the bank (on average, small European banks have less than 1% trading activities, medium-sized banks have less than 5%).
- Should the size of trading activities go beyond this cap, then an equivalent amount of equity should be allocated to the additional trading activities on a 1:1 basis. In other words, the additional equity “covers” the additional trading activities and related risks that go beyond the imposed threshold. Any loss that incurs above the threshold is therefore unlikely to threaten the solvency of the bank; moreover, the management of the commercial bank remains fully responsible in front of its shareholders for the risks taken in the context of its trading activities.

As Europe’s small and medium sized banks have not more than 5% of their balance sheets as trading assets (see table above), a rule such as this would mechanically exempt most banks (in particular most small and medium-sized banks) from the necessity of separating activities. Conversely as Europe’s large banks typically hold more than 5% of assets as trading assets this would force them to separate.

Finance Watch anticipates that such a rule would target much the same group of banks that the Commission’s work identifies as being captured under the various definitions proposed. Finance Watch urges the Commission to evaluate such a proposal.

STRENGTH OF SEPARATION

QUESTION 7

AS REGARDS THE LEGAL DIMENSION OF FUNCTIONAL SEPARATION, WHAT ARE THE COSTS AND BENEFITS OF REGULATING INTRA-GROUP OWNERSHIP STRUCTURES?

The fundamental similarity between all trading activities and their difference from commercial banking activities is one reason why Finance Watch is convinced that, in the absence of full ownership separation, a strict functional separation that would keep all trading activities including market making and client-facing ones separated from vital banking activities is essential.

As identified by the Commission, in order to address the problems identified in section 1, separate funding must be achieved for the deposit taking and the trading entities. One of the main purposes of separation is indeed to avoid that funding resources and capital can ”leak” from one activity to the other, and that the deposit-taking bank subsidises the investment bank (this is one of the key objectives of separation which is of course not an end in itself).

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Only solutions that achieve this can be supported. This includes “ownership separation” and should include most solutions that could fall under “functional separation with tighter restrictions on economic and governance links”: for the latter, we would refer to the Non-Operating Holding Company model as developed by the OECD[7].

Other benefits

With separate funding, commercial banking and investment banking would each stand on their own feet, with their own risk profile, nature of activities and culture. It would become easier for investors to assess the risk they take, commercial banking would come at a lower cost, which would benefit consumers, be they individuals, SMEs or corporates.

A separation would also make the structure of banks less complex, hence removing the public costs associated with complex supervision and resolution of too complex banking activities and structures.

Potential costs

Potential costs would be those linked to the reorganization of banking entities. Those would clearly be private costs and should in any case be considered not only in the light of the obvious public benefits that would come from a separation but also of the privilege given by society to banks through the money creation privilege they have been granted and which necessarily comes with obligations and duties attached. It is also to be noted that large banking groups engage regularly in reorganizations and mergers[8].

As far as cost of funding is concerned, structural separation could lead to an increase in investment banking funding costs. However, as stated in the Liikanen report, « to the extent that part of the funding cost increase is due to the removal of an implicit subsidy, this may not present a social cost ». This increase in the cost of funding for investment banks should also trigger a better allocation of funding resources and a decrease in the average risk profile of investment banks. Last but not least, the increased cost of funding of some but not all trading activities would impact those activities with the least relevance for serving the real economy. As already explained, the cost of making markets in shares and bonds (whether corporate or government bonds) would not be impacted by a separation of trading activities. Moreover, the cost of funding of commercial banking activities would decrease. (See also our answer to question 5)

[7] OECD, 2009, The elephant in the room : the need to deal with what banks do, http://www.oecd.org/finance/financial-markets/44357464.pdf

[8] As an illustration, ECB reported that between 1992 and 2001, there were 262 completed deals, of which 55 cross-border deals (Working paper n°398, October 2004, http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp398.pdf). Ayadi and Pujals commented on a sample of 151 M&A transactions announced and completed (including 31 cross-border) by banking institutions headquartered in the EU, over the period 1994–2000 (“Banking Mergers and Acquisitions in the EU: Overview, Assessment and Prospects”, 2005, http://www.suerf.org/download/studies/study20053.pdf). Today, and despite a decrease in M&A activity since the beginning of the financial crisis, the M&A activity in the European banking sector is expected to boom again (see in particular : http://www.bloomberg.com/news/2013-02-20/european-banks-to-see-consolidation-kpmg-study-says.html)

QUESTION 8

WHAT ARE THE RELEVANT ECONOMIC LINKS AND ASSOCIATED RISKS BETWEEN INTRA-GROUP ENTITIES?

Because commercial banking and investment banking activities are so different by nature, few synergies are to be found between the two. The only relevant economic link is related to the use of capital and liquidity, i.e. to the realisation of the implicit subsidy that the investment bank can benefit from thanks to the presence of deposits in the same banking group.

In a recent report, the IMF[9] provides the following descriptions:

- *(Commercial) banking* is relationship-based, not scalable, long-term oriented, with high implicit capital, and low risk thanks to the law of large numbers.
- *Trading (Investment banking)* is transactions-based, scalable, short-term, capital constrained, and with the ability to generate risk from concentrated positions.

Based on these descriptions, one could question the rationale for a commercial bank to engage in trading[10]. The same IMF report gives evidence that the objective is to use ‘spare capital’ (put otherwise: to “take advantage of the balance sheet of the bank”) in order to improve profitability by means of increased trading activities.

As described in our response to question 1, this leads to many distortions and fundamental problems such as the over-development of trading activity, the increase in the leverage and risk profile of banks, the cost of banks bailouts for taxpayers, to quote just a few.

QUESTION 9

AS REGARDS FULL OWNERSHIP SEPARATION, WHAT ARE THE ASSOCIATED COSTS AND BENEFITS?

We believe that, even though some forms of functional separation could achieve partially the objectives set in section 1, full ownership separation achieves the cleanest separation with i) the least possibility for leakage of public support to trading activities and ii) lower possibilities for “cheating” and hence lower supervisory requirements.

We would quote here the UK Parliamentary Commission on Banking Standards in their first report[11]: “One of the arguments for full structural separation compared with a ring-fence is that full separation would entail fewer rules and therefore less monitoring and enforcement, because the two entities would be separately owned and would have no more incentive to create interdependencies than any other two banks. Paul Volcker’s main doubt about the effectiveness of a ring-fence was that they “tend to be permeable over time”. He added: If you really want to separate some operations very clearly and decisively, you put them in different organizations. In my experience, you do not put two functions in the same organization and say that they cannot talk to each other or interact.”

[9] Banking and Trading, IMF working paper, October 2012, http://www.imf.org/external/pubs/ft/wp/2012/wp12238.pdf
[10] See also Pentti Hakkarainen, February 2013 : http://www.bis.org/review/r130305h.pdf
[11] UK PCBS first report, December 2012, http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/98/9802.htm, page 43-44

As far as costs are concerned, private costs involved must be balanced with the social benefits of such a separation, primarily the lower cost of future banking crises for taxpayers and for the general economy.

Finance Watch calls for the European Commission's ongoing impact assessment to assess not only the short-term costs of structural reform but also to include the substantial long-term public benefits of reducing the scope for banks to cause financial and economic crises as a result of their too-big-to-fail, too-complex-to-fail, or too-interconnected-to-fail structures. A strong reform of bank structure would bring a significant reduction in the funding subsidies associated with investment banking, removing a distortion in the way that assets and credit are allocated. As with any industry, hidden subsidies distort markets in ways that can harm the general interest, this cost should also be factored into the impact assessment.

OPTIONS TO BE CONSIDERED

QUESTION 10

DOES THE ABOVE MATRIX CAPTURE A SUFFICIENTLY BROAD RANGE OF STRUCTURAL REFORM OPTIONS?

No. Several more options could and should be considered concerning the structure of banks and the banking sector.

These options go further than those presented by the Commission. As explored further below, Finance Watch considers Option E to be the minimum to address the problems; conversely it does not consider option I to be the "maximum".

In the dimension of activities, several possibilities can be imagined which would further address problems of systemic risk, moral hazard, inter-connectedness and so on which are at the heart of the problems identified by the Commission. *In addition* to separating all trading activities from deposit banks the following might be considered:

- Stand-alone, separately capitalized derivatives entities. These entities might further separate derivatives trading from other investment banking activities with derivatives positions remaining in other banking entities serving hedging needs of non-financial clients only.
- Separation of payment systems into stand-alone bankruptcy remote vehicles potentially operated by and / or on behalf of the banking sector as a whole.
- The last 25 years have seen a gradual expansion of what a bank can do. In some areas this expansion could and should be stopped and reversed. For example, food speculation and high frequency trading might be considered areas where limits on activities should be considered for banks. Another area could be the provision of finance, and in particular credit, to some other areas of finance, for example to hedge funds.

In the dimension of ownership, more consideration might be given to a diversity of ownership and governance models, among others, co-operative models of ownership and governance where customers and employees are represented and contribute to ownership and governance.

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In terms of structure, size caps and other measures aimed at tackling too-big-to-fail could also be considered[12].

QUESTION 11

WHICH OPTION BEST ADDRESSES THE PROBLEMS IDENTIFIED? PLEASE SUBSTANTIATE YOUR ANSWER.

Finance Watch believes that any option that fails to separate all the trading activities needs to be excluded, as well as those options where separate funding cannot be achieved. This calls for the exclusion of Options A, D, G, B, C; Options E (HLEG) is the minimum approach to be considered, and Options H and I are the preferred approaches.

About options A, D and G

Functional separation 1 cannot achieve the goal of addressing the problems of section 1 as it will not impose further limits to capital and liquidity flows from one entity to the other, which is one of the objectives of structural reform. Thus options A, D and G must be excluded.

About options A, B and C

The solution which separates the “narrow trading entity” from the “broad deposit bank” will not meet the goals either.

This approach indeed supposes a separation of only part of the trading activities (proprietary trading and lending to hedge funds) whereas market making and other trading activities would remain with the deposit-taking bank. We would oppose this approach for the following reasons (see also our response to question 5):

- First, it is technically impossible for supervisors to differentiate between market making and other trading activities of banks due to inherent similarities of both types of strategies. Trading is trading.
- Such an approach fails to capture the bulk of the problem, which is linked to having credit activities and financial markets trading activities of very large banks under the same roof. For instance, the vast majority of Deutsche Bank’s (largest EU bank) EUR 60,000 billion underlying notional amount of derivatives outstanding would be left untouched.
- Market making necessarily involves taking a view on how prices are going to move, and necessarily involves holding an inventory. These are also the two essential elements of proprietary trading. All market making (as opposed to broking) involves an element of proprietary trading.
- Making markets involves standing ready to buy and sell, and communicating to others in the market the prices at which you are willing to do so. Deciding on those prices requires deciding how willing, or not, one is to have the instrument in question on one’s book and adjusting bid and ask prices accordingly. Market making does not involve simply adding a margin to a (hypothetical) mid-price, it involves adjusting your price to buy and your price to

[12] See also our response to the HLEG consultation, June 2012, http://www.finance-watch.org/our-work/publications/480-finance-watch-response-liikanen-hleg-consultation.

sell to “win” or “miss” client trades and to adjust your inventory accordingly, all the while bearing in mind your reputation.[13]

- Similarly hedging necessarily involves transforming rather than eliminating risks. Simply put the only way to eliminate a risk is to sell the source of that risk. A hedge, by definition, is something other than selling the underlying source of risk. Therefore hedging always involves taking a proprietary view e.g. on counterparty risk, on the movements in an index vs. the price moves of a component, on movements in prices of similar instruments with different maturities and so on.[14]
- Managing derivatives positions implies by definition opening risk positions on multiple parameters (market level, interest rates, volatility, correlation, etc…) and in the reality of a trading operation there is very little, if any, economic difference between “pure proprietary trading” and the management of client facing derivatives positions that require the bank to take a view on the evolution of those market parameters.

The fundamental similarity between all trading activities and their difference from commercial banking activities is one reason why we prefer full ownership separation to functional separation; and, in the absence of full separation, strong requirements that would keep all market making activities out of the subsidized deposit-taking entity.

Options A, B, C must be excluded[15].

About the other options

Option E, the HLEG solution, is therefore the minimum that should be considered. Depending on the details of implementation, options E, F, H, I should all be capable of achieving the aims of separation. We insist that a broad trading entity (i.e. options H and I) would however be preferred as they would not only include market making, proprietary trading and lending to hedge funds but also all the other capital market activities including underwriting. (See also our response to question 5)

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[13] This might be thought of as a traders view. A more theoretical view might argue that the separation of proprietary trading from market making (and for that matter of arbitrage from hedging from speculation) is a theoretical separation, which relies on the hypothetical idea of complete markets. In such markets a single pure market price exists at which markets clear. This theory is adjusted through various market imperfections to account for market makers and their bid-ask where market makers add a margin to the pure or mid-price. But this logic is in fact inverted. The perfect market does not and cannot exist, except as an abstract and mathematical idea. For the market to exist requires market makers. With this theoretical starting point, the first and fundamental prices to exist are the bid-ask prices of those that make the market. Any “mid” price is then derived from bid-ask (and not the other way around).

[14] Even insurance i.e. against a specific and even deliverable loss involves taking counterparty risk, as counterparts to US *monoline* insurers and to AIG found in the recent financial crisis.

[15] See also Finance Watch detailed analyses of the French and German banking bills: http://www.finance-watch.org/our-work/publications/597-position-paper-german-bank-reform and http://www.finance-watch.org/press/press-releases/305-amendments-french-bank-reform.

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Strength / Activities	Functional		Ownership separation
	Current requirements	*Stricter requirements*	
Narrow trading entity/ Broad Deposit Bank	Option **A** (~FR, GE)	Option **B**	Option **C** (~US)
Medium trading entity/ Medium deposit bank	Option **D**	Option **E** (~Liikanen)	Option **F**
Broad trading entity/ Narrow deposit bank	Option **G**	Option **H** (~UK)	Option **I**

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