



Finance Watch

Making finance serve society

The importance of being separated

Making the public interest sovereign over banks

A Finance Watch Policy Note



Spring 2013



"Separation would make banking groups simpler and more transparent, it would also facilitate market discipline and supervision and, ultimately, recovery and resolution."

The final report of the High-level Expert Group on reforming the structure of the EU banking sector, appointed by the European Commission to examine possible reforms to the structure of the EU's banking sector, published in October 2012

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In a nutshell

Finance Watch supports structural separation of commercial and investment banking activities and believes that the size and complexity of banks should be controlled.

- Separating commercial and investment banking activity reduces systemic risk. It helps minimise the cost to taxpayers in the event of bank failure.
- Separating commercial and investment banking activity removes an unwarranted “funding subsidy” for activities that should have no need of a government guarantee. The funding subsidy is distorting financial activity – it makes trading activities profitable that otherwise would not be.
- Separating commercial and investment banking is a critical step in allowing Europe’s banks to get back to health and in reasserting the sovereignty of public interest over banks.

This document outlines the argument for separation and dispels some of the biggest myths surrounding it.

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There is an urgent need to influence the business models of systematically important banks by separating traditional banking from securities businesses (OECD Journal)

Introduction

A question of sovereignty

Banks appear to have become sovereign over the public interest: sovereigns must imperil themselves to rescue banks but banks do not want to be exposed to failing sovereigns.

Who pays when a bank fails? The answer so far has not been “the creditors” but rather “ordinary citizens”.

Reducing the amount and cost of bank bail-outs will go a long way to breaking this unhealthy relationship and separation is a critical element in achieving this. Regaining balance in the relation between banks and the rest of society will be good for banks, restoring much needed confidence, and good for society.

Three steps

One element in the battle to regain public interest sovereignty over banks is to reduce the cost and likelihood of sovereigns indebting themselves and taxpayers to bail out banks. In three steps legislation should aim to:

- Reduce the probability of bank failure
- Reduce the likelihood of government intervention
- Reduce the cost of government intervention

Separation and too-big-to-fail (tbtft) are critical

Separation is a critical component in making sure that governments and taxpayers are not saddled with a huge bill bailing out banks in the future. Accepting that banks will still fail sometimes, we need to reduce the likelihood that governments become involved. Banks should be able to fail on their own. The critical steps here are i) separating those things which must be saved (banking activities which simply cannot stop, even for one day) from the rest and; ii) putting an end to too-big-to-fail.



Infographic: Why should we reform the banking sector? © Finance Watch

How does it fit together?

With CRD/CRR legislation agreed and BRR almost complete the success of the current round of bank reforms in ending the sovereign-bank doom loop rests squarely on legislation surrounding separation.

Aim	Measure	Legislation	Main points	Is it Enough?
Reduce the probability of failure	1. Increase capital, reduce leverage, safeguard liquidity	CRD IV	<ul style="list-style-type: none"> • Limit leverage • Increase capital 	No
	2. Separate those things which can fail from those which cannot	Separation - <i>what</i> to separate	<ul style="list-style-type: none"> • Separate payment systems, lending and retail deposit taking from other banking activities. 	Tbd*
		Separation - <i>how</i> to separate?	<ul style="list-style-type: none"> • Separated banking entities must at least issue their own debt (to avoid continuing the funding subsidy) • Holding companies should be non-operational • Separated banking entities should have clearly separated governance • Liquidity and solvency support can only flow from the parent to the guaranteed entity and never from the guaranteed entity. 	Tbd*
	4. Prevent banks from becoming too-big-to-fail	None	<ul style="list-style-type: none"> • Recovery plans and resolution plans must show clearly and realistically how banks, especially SIFIs, will react to difficulties. • Authorities should have powers to force changes in activity, governance, separation if recovery plans are not realistic. 	No
Reduce the cost of government intervention	5. Ensure that private investors absorb losses	Separation & BRR	<ul style="list-style-type: none"> • In the event of bank failure private creditors must absorb losses. For guaranteed entities private creditors must be bailed-in; these losses reduce the likelihood and the cost of any eventual government bail-out. 	Tbd*
	6. Build prefunded Resolution and DGS schemes	BRR	<ul style="list-style-type: none"> • Banks should build additional buffers between their failure and taxpayer bail-out • Deposit guarantees should be honoured 	Tbd*

*Tbd: To be determined in light of the European legislative process on bank separation and on BRR expected to start in 2013

The arguments for separation

Three main arguments for separation

The arguments for separation and tackling too-big-to-fail are straightforward and can be presented in three short points: what to separate, how to separate, ending too-big-to-fail.

A. What to separate?

Separate those activities that cannot be interrupted and so must be saved, from those that can fail like any other business.

Action

Deposits and payment systems (and with them bank lending) cannot be interrupted for a day – therefore governments must intervene to save them when other routes have failed. These activities should be clearly separated from other banking activities that can be interrupted.

Differentiation of banking activities

Justification

- Modern economies are reliant on many essential banking services. Those relating to bank credit money, payment systems and deposits in particular, require continuous maintenance.
- Governments are obliged to rescue these activities in the event of a bank failure. The recent nationalisation of SNS Reaal in the Netherlands was prompted by the fact that even short interruptions of essential banking services could bring the entire economy to a halt and cannot be tolerated.
- Banks also perform other activities, many of which are important for the economy. These other activities are not provided continuously (e.g. securities underwriting) and / or the failure of one bank need not interrupt the activity for the whole system (e.g. market making and underwriting). They do not require a government guarantee.
- To prevent systemic crises, in the event of a bank failure governments should rescue just what they need to and not more.
- Bank reform should therefore separate those activities that must be continued (and therefore must be rescued) from those that can be interrupted.

Whoever takes on the risks, must deal with them

This will:

- ➔ reduce the potential cost to the taxpayer
- ➔ reduce the possibility of a systemic crisis (e.g. by reducing the possibility of contagion between the two banks).
- ➔ remove distortions to bank's activities by altering their incentives (see below).

Similar nature of all trading activities

What about market making?

All trading activities (market making included) are an inherently and categorically similar activity and should, as far as possible, be grouped together. Because of their inherently similar nature attempts to split trading activities will result in complications. For example, attempts to split proprietary trading from other trading under the so-called Volcker rule in the U.S. have led to extremely complex legal code and reports of easy evasion and regulatory arbitrage.

To provide liquidity, market makers must take positions on their own account. Doing so always involves, as all own account trading does, a proprietary element.

In addition all trading activities including proprietary trading, market making and underwriting, as well as being economically similar are reliant on the same payment/settlement/clearing infrastructure.

The point is not how useful or not these activities are. Market making can be important for firms raising large-scale finance but the economy will not cease to turn should one investment bank fail. First, there is no disruption to money and payments in the economy. Second, these other activities are not provided continuously (e.g. securities underwriting) and / or the failure of one bank need not interrupt the activity for the whole system (e.g. market making and underwriting which are provided by several banks and/or in syndicates). Provided they are not too-big-to-fail the failure of one such bank will not risk the system as a whole.

All trading activities, including market making should be clearly separated from commercial banking activities. If deposits and payments cease, even for a day, economies face catastrophic consequences.

What about lending to hedge funds?

Lending to hedge funds is a trading based activity. Hedge funds generally use leverage to undertake trading activities which seek gains from very short-term price moves in financial markets. They achieve leverage by borrowing against the positions they take.

Lending to hedge funds therefore overwhelmingly occurs against the collateral of trading instruments (e.g. securities). Banks also provide the custody and processing of those instruments. A bank's relationship with a hedge fund typically involves both elements: lending and collateral management.

Banks manage the collateral they hold against these loans in a way which is very similar to managing own account positions in trading e.g. using models which account for the price volatility and liquidity of the collateral. In short, when banks lend to hedge funds the lending decision is more akin to a proprietary market position than it is to a traditional long-term lending decision. This raises a policy question about whether bank deposits should be used to fund speculative trading.

Private Equity: Lending to leveraged funds, including private equity funds, should be treated as lending to hedge funds. Typically however in private equity deals lending is to the acquisition target (i.e. the company the fund invested in) and not to the fund. The location of banking activities facing the acquisition will depend on the instrument being used as per the separation described above, i.e. arranging lending to the acquisition using securities will belong in the Investment Bank, lending to the acquisition using bank loans will belong in the commercial bank.

Hedge fund lending and collateral management

Lending to hedge funds belongs with other trading activities



What about one-stop shopping?

It's worth noting that those who advocate a "free market" in financial services also tend to argue that maintaining more than one relationship with financial service providers in this "free market" is a problem.

It is also important to note that households and small and medium sized non-financial firms have limited use for investment banking services, which are primarily used by large corporations and, overwhelmingly, by the financial industry.

Finance Watch proposes a simple solution:

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.

What about the small, local banks and the diversity of Europe's banking?

In general, the largest banks tend to have the largest proportion of trading activities. Smaller, local banks tend to have much less trading activity – reflecting perhaps the very small proportion of trading activity that is undertaken by non-financial firms (the vast majority of financial market activity is in financial instruments between financial firms – see below). Therefore the exception to strict separation discussed in the previous bullet point would apply to many banks.

Small deposit banks, without a separate investment banking group, would be allowed to do a small amount of a specific type of trading (i.e. simple instruments with non-financial firms); larger banks would be required to separate all trading activities into a separate entity. Small / local investment banks would be allowed but not guaranteed.

Finance Watch supports a diverse and competitive European banking sector, including but not limited to co-operative banks, savings banks, commercial banks, niche investment banks, peer-to-peer lending, and so on; and believes separation is a key part of achieving it. Today in Europe the banking sector is dominated by a few megabanks (15 of them totalling 43% of the market), that benefit from an implicit state support, restrict new entry to the sector, reduce diversity, and **distort competition**.

Any exceptions?

Diversification of European banking sector

B. How to separate?

They should be separated prior to a crisis and should have separate funding and governance. This will go a long way to preventing moral hazard and a funding subsidy for non-guaranteed activities.

Action

Commercial banking activities which benefit from a guarantee should be separated from those which do not prior to any crisis. They should be carried out by separate legal entities, with separate capital structures and governance and with no possibility of any support from the guaranteed entities to the un-guaranteed.

Justification

- Separation of bank activities in the midst of a crisis is i) not practical and ii) not sufficient. Crisis resolution of complex banking organisations is more difficult and more costly. Separation must occur in advance.
- Investors and management must be clear whether they are guaranteed or not before the guarantee is invoked.
- If not there is a danger that trading activities are undertaken in the belief that losses are guaranteed by the government. This results in cheaper funding, e.g. from bond holders, who believe they will be able to gain from trading profits but will not lose from trading losses.
- Such “perceived implicit guarantees” lower the cost of funding for trading activities, provide the wrong incentives to bankers, direct capital away from other uses in the economy, and increase the amount of trading activity.

How would such a banking group be organised?

Finance Watch proposes some form of the non-operational holding company (NOHC) approach proposed by the OECD.¹

- **The parent:** ‘Under the NOHC structure proposed, the parent would be non-operating, raising capital on the stock exchange and investing it transparently and without any double-gearing in its operating subsidiaries... that would be separate legal entities with their own governance.’ (OECD, 2009:22). No double gearing means that the parent does not raise debt finance, this is raised by the subsidiaries only.
- **The subsidiaries:** Subsidiaries would each issue equity, held by the parent, and pay dividends to the parent, which it pays on to external shareholders of the NOHC. Debt would only be raised at the subsidiary level and the commercial and investment banks would raise separate debt. **In this way the cost of funding of the commercial bank and the investment bank would be separated and the benefit of the government guarantee of commercial banks would not be reflected in the funding cost of the investment bank.**

Implicit guarantee and its consequences

“The Elephant in the Room: The Need to Deal with What Banks Do”

¹ For example see sections V and VI of their paper “The Elephant in the Room: The Need to Deal with What Banks Do”, 2009, <http://www.oecd.org/finance/financial-markets/44357464.pdf>

'With a NOHC structure, technology platforms and back-office functions [could] still be shared, permitting synergies and economies of scale and scope.' (OECD, 2009:22)

'Such a transparent structure would make it easier for regulators and market players to see potential weaknesses.' (OECD, 2009:22)

Transparent structure

Furthermore this transparent structure would make crisis management simpler. Only that which must be rescued would be rescued, investment banks would be allowed to fail or continue separately depending on circumstances.

But don't the profits from trading subsidise lending to the 'real economy'?

No, it is the other way around: Profits from trading are artificially boosted by the regulatory protection for essential banking services. **Separation is part of a general solution that can restore lending to the "real economy" to the heart of bank's profit strategy.** (It is worth noting in this regard that today, European banks allocate on average only 28% of their assets to lending).

Myth that trading supports lending



1. The implicit but unwarranted guarantee lowers the funding cost of trading activities, making profitable many trades which would not be viable if they were not guaranteed.
2. Other regulatory measures, such as capital requirements, have been slow to react to "financial innovation", resulting in lower capital requirements for trading activities. Changing these incentives will result in more balanced bank behaviour.

C. How to end too-big-too-fail?

Banks should not be so big that their failure causes problems for the whole economy and therefore requires the government to rescue them.

Action

Put an end to too-big-too-fail. A whole range of measures might be considered, including but not limited to:

- implement a strict bail-in regime that will see all creditors bear the risk of absorbing banks' losses whilst respecting creditors hierarchy and deposit guarantees
- put a cap on bank leverage,
- empower recovery and resolution plans and authorities to tackle tbtf,
- separate commercial and investment banking activities,
- consider caps on size.

The fact that many banks are deemed to be “too big to fail” creates moral hazard

Justification

- Even those activities which might be interrupted may require a government rescue if the bank is so big (and / or so connected) that its failure will cause a systemic problem e.g. if credit losses through the economy would cause contagion.
- Separation can be one amongst many tools that are used to put an end to too-big-to-fail.
- If banks are prevented from being too-big-to-fail there is more chance that they can fail via normal insolvency proceedings without causing problems for the wider economy, i.e. like any other firm and without government bail-out.

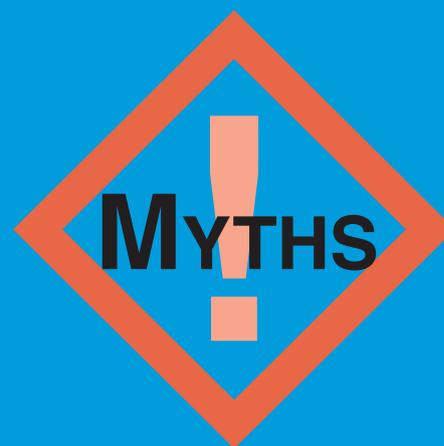


Won't separation produce two systemic banks in place of one?

This line of argument does not hold: it indeed suggests that we would, in fact, be safer by merging too-big-to-fail banks into one definitely-much-too-big-too-fail bank!

- Separation, sensibly approached and in conjunction with other measures, will create two or more smaller banks where before there was one bigger one.
- Separation will decrease contagion possibilities as firebreaks are put between commercial and investment banking activities in the same group.
- Separation will decrease interconnection, as the separated commercial bank will mostly rely on its deposit-base for its funding needs, being therefore less exposed to market funding/liquidity risk.

Some Myths around Separation



1 Any gains in stability from separation must be weighed against an increased cost for the real economy.

This argument effectively acknowledges that the funding subsidy exists. It goes on to say that without the funding subsidy banks would have to charge higher costs to the “real” economy.

Rebuttal: The trade-off presented is a false one.

- Such an argument ignores the current state of Europe's banks: European banking remains in dire shape (partly in public hands and often in receipt of central bank liquidity provision). Measures to stabilise the sector and bring a return of confidence are more likely to decrease bank funding costs (i.e. without government / central bank support) than to increase them.
- Such an argument ignores the cost that the current banking system has imposed on the “real economy”: the current banking system has cost Europe very dear: in direct bail-outs, in increasing indebtedness of sovereigns as a result and in the effects of the continuing credit crunch. It is scarcely plausible that a reformed banking sector could possibly cost more.
- A false comparison between today's banking system after separation and a purely hypothetical healthy banking system operating in well-functioning economies serves no purpose in assessing our current options.
- In fact, lending might even get cheaper: lending to the real economy is likely to be considered less risky and therefore be less costly than trading activities. In addition lending to the real economy is likely to be from an entity benefiting from a government guarantee of deposits. Lastly, increased clarity and transparency on the operation of banks is likely to lower, not increase, funding costs.

Many other myths are a form of this one, some examples are:

Investment banking serves the real economy.

Rebuttal:

While capital markets can be important for non-financial firms to raise large scale finance only a small percentage of investment banking activity relates to non-financial firms. Less than 10% of debt securities issued, less than 10% of OTC derivatives and less than 5% of foreign exchange trading is used by the real economy.

Furthermore, it is not clear at all that this small percentage of investment banking activity would become more expensive. For example, investment banks might choose to reduce their margins, and a decrease in the risk profile of investment banks combined with more transparent operations could lead to cheaper funding.

Separation will cause government bond yields to rise

Rebuttal:

For some essential activities like making markets in government bonds, funding of inventory is not dependent on the funding rate of the bank, funding is achieved via collateralised borrowing against the inventory of bonds held (using repo agreements). There is therefore no relationship between the cost of state funding and the structure of banks.

The crash was caused by residential lending and has nothing to do with separation.

2

Yes, there was a housing bubble at the heart of the crisis but...

Rebuttal:

- This housing bust, unlike most before it, threatened to become a Great Global Depression and if Depression was averted in many countries the cost is set to be a prolonged period of recession or zero growth with a heavy impact on employment and public finances. This latest housing boom and bust was more serious than previous ones largely because of the interaction of commercial and investment banking and the immediate transformation of loans into tradable assets that created a housing boom of unprecedented proportions, the explosion of which affected instantaneously the whole financial system, hence the global economy.
- This housing bust, unlike most before it, imperilled sovereigns because governments were obliged to bail out not only deposit banks but also banking activities that they should not have had to. This was because commercial banking activities were not easily separated from trading activities.
- Separation will strengthen reforms already proposed, and in particular the reform on bank recovery and resolution: by separating certain functions we can be sure that the reform will be applicable.

We need a rest – all this bank reform is exhausting – we should pause and see what we have done.

3

Some have argued that we have done enough bank reform for now and that we should wait and see what we have achieved.

Rebuttal:

- The experts appointed by the European Commission found exactly the opposite. The European Commission appointed a High Level Expert Group containing many bankers and central bankers and headed by an eminent central banker, Erkki Liikanen, to see what remained to be done in the bank reform process. The result of their deliberations, amongst other things, was no, we have not yet done enough and, yes, bank separation is a very important and missing piece of legislation.
- Separation is complementary to the other legislation that is being considered so far and not an alternative.
- In fact legislation so far has not gone as far as it might, the prime example being the failure to impose meaningful leverage caps on banks.

It's all about culture.

4

This line of argument reasons that if you can change the culture you would not need separation.

Rebuttal:

- Finance Watch agrees that changing the culture in banks is important and that culture stems directly from activities and incentives.
- Commercial banking typically involves long-term lending relations, trading typically involves a short-term perspective. The nature of the activities drives the culture.
- Separation would separate the cultures and would avoid a situation where the short-term oriented, deal-based, investment banking culture can negatively influence the long-term, relationship-based culture of commercial banking.

In summary

Banks should not be sovereign over public interest. Structural separation is a key component of regaining the sovereignty of public interest over banks.

Getting rid of **too-big-to-fail**, and implementing **a structural separation** of commercial banking and investment banking activities, are critical ways to reduce the possibility of taxpayers footing the bill when a potential bank failure threatens the whole economic system.

This separation must split those activities which cannot be interrupted, and which a bank failure would interrupt, from those which either could be interrupted or which a bank failure would not interrupt. **In short it must separate deposits and payment services from financial market trading activities.**

This separation must be affected **prior** to crisis as the only way to reduce moral hazard and the implicit funding subsidy that trading arms of large universal banks today benefit from. Separation will **offer investors a clear and meaningful choice** between commercial banks and investment banks.

European banks are on life support – far from increasing funding costs for banks and therefore the rest of the economy, structural separation offers European banking a lifeline through a return to stability and confidence.

In short, analysis shows that, notwithstanding short-term political manoeuvres, structural separation is the end game for European banking: it is at once the way for European banking to get back on its own feet and for the public interest to regain sovereignty over banks.

Abbreviations

CRD/CRR and CRD IV	Capital Requirements Directive and Regulation
BRR	Bank Recovery and Resolution
DGS	Deposit Guarantee Scheme
NOHC	Non-operating Holding Company
OTC	Over The Counter
SIFI	Systemically Important Financial Institution
tbtf	too big to fail

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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