EUROPE'S BANKING TRILEMMA

A successful Banking Union requires simultaneous reform of the structure of the banking sector

Finance Watch
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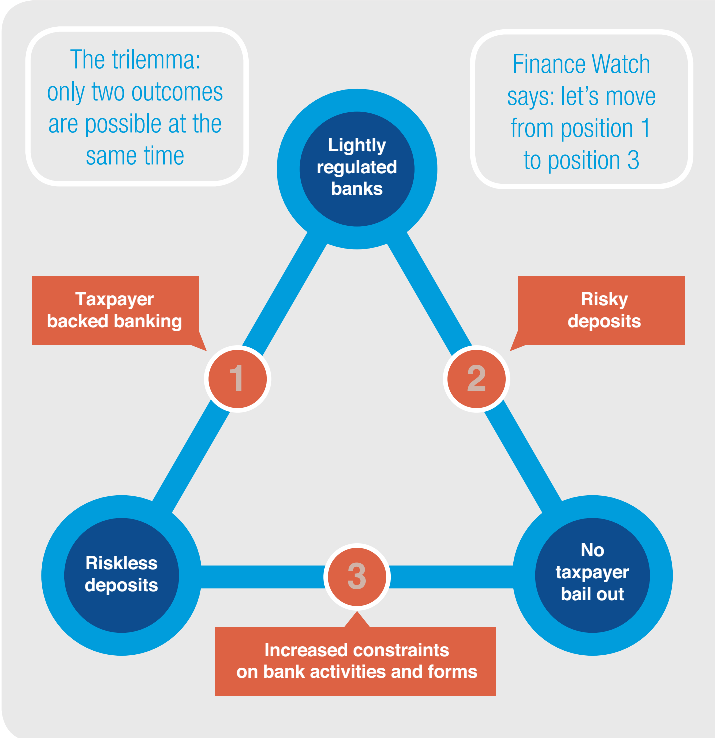
As Banking Union takes shape, the EU must act decisively to reform the structure of the banking sector if it wishes Banking Union to be effective and credible. Reforms should include an effective separation of credit activities from trading and market activities, and an increase in loss absorption capacity. Without these essential steps, Banking Union could fail to protect taxpayers in a crisis.



Europe seeks two goals for its banks – riskless deposits and no taxpayer-funded bail-outs. To achieve these, the EU is proposing new rules to deal with bank failures and to strengthen deposit guarantees and bank supervision. But unless the EU also constrains the activities of large universal banks, the first two goals will not be achieved.

Universal banking has a strong tradition in Europe. Small universal banks that offer both credit and risk management services, such as simple derivatives to hedge foreign exchange or interest rate risk, provide a useful benefit to their local economies. But Europe's largest universal banks have moved into a different business. In recent years, they have become "flow monsters", a nickname that refers to the **massive over-development of their financial trading operations**.

Total bank assets are now 3.5x larger than the EU economy and around half of these assets represent the trading and derivatives activities of large universal banks. This growth in trading activity has been fuelled by **artificially cheap funding from the wholesale markets**, where investors assume that banks with insured deposits and a trading operation capable of dragging down other banks will not be allowed to fail.

This creates a problem for bank regulators: in a crisis, regulators will not be able to impose losses on large banks' investors (a process known as "bail-in") for fear of passing on risk to other banks and institutions in the system. The EU's proposed new Single Resolution Mechanism will not solve this problem for large banks: as US experience shows, **banks that are too-big, too-complex or too-connected-to-fail cannot be resolved without public support.**

Public support will most likely include different forms of taxpayer bail-out and emergency liquidity from central banks. Once given, this kind of support makes it even harder to impose losses privately, as it reduces the amount of assets available for sale and of liabilities available for bail-in.

If investors continue to believe they will not be liable for losses, they will continue to charge an artificially low risk premium for their investment, rewarding large universal banks whose structure makes them difficult to "resolve" (resolution is the process by which authorities deal with failing banks). This cycle can be turned virtuous by adopting measures to make the resolution process credible: **the most effective measures are separating credit from trading activities and increasing loss absorbing capital.** Demanding that banks have more loss absorbing capital, for example through a leverage cap, would give resolution authorities more freedom to impose losses on banks' private investors, as they will feel that other banks in the system can better absorb the losses.

Without these reforms, Banking Union will not deliver the depositor and taxpayer protection that policymakers seek. It could even make things worse by encouraging more under-priced funding for banks' financial trading and creating a false sense of security. This could ultimately cause the public to lose confidence in Banking Union and the Eurozone when the next crisis hits.

The EU can act before that happens by (1) adopting the strong version of the structural banking reforms proposed by HLEG, the EU's High Level Expert Group led by Erkki Liikanen, and (2) committing to introduce a leverage ratio.

Further reading:

// "Europe's banking trilemma" – a Finance Watch position paper on Banking Union

// "The importance of being separated" – an introduction to bank structure reform

// Other Finance Watch papers on bank separation

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