Finance Watch
Making finance serve society

Bank Structure Reform

CONTEXT

European and national level initiatives have been presented to reform the structure of banks, including the possible separation of deposit-taking from trading activities.

LEGISLATIVE ACTIVITY

On 29 January 2014, the Commission published two legislative proposals, one on structural measures to improve the resilience of EU credit institutions (bank structure reform, or BSR) and one on securities financing transactions.

This followed the October 2012 recommendation for a form of EU bank ring-fencing by the Commission's High-Level Expert Group (HLEG) led by Erkki Liikanen, and the adoption in 2013 of a ring-fencing law in the UK and of weaker national reforms in France and Germany.

The January 2014 proposal applies only to the largest and most complex EU banks and would: 1. ban proprietary trading in financial instruments and commodities from 1 January 2017, 2. grant supervisors the power and, in certain instances, the obligation to require the transfer of other high-risk trading activities (such as market-making, complex derivatives and securitisation operations) into separate legal trading entities within the group ("subsidiarisation") from 1 January 2018.

EU finance ministers issued a statement on 2 April opposing the separation of market-making activities.

In April, the IMF published new research estimating the size of implicit subsidies to "too big to fail" (TBTF) banks at up to $300 billion in the euro area for 2012. In June, the European Systemic Risk Board's (ESRB) Advisory Scientific Committee published a report questioning the size and structure of the EU's banking sector. The European Economic and Social Committee (EESC) published a mainly positive opinion on the BSR proposal in July. In November, the ECB published a more restrained opinion with some technical amendments.

In the summer, the Parliament's new ECON Committee appointed Gunnar Hökmark (EPP, Sweden) as rapporteur, and shadow rapporteurs were appointed in September.

The FSB published a report shortly before the November G20 summit in Brisbane on the differences between bank structure reforms in different parts of the world. The FSB, together with the IMF and OECD, undertook to report again in 2016.

ECON held a public hearing on 2 December, at which Finance Watch spoke. Parliament rapporteur Hökmark submitted his draft report in late December, substantially weakening the proposal.

The Commission chose not to include BSR in a list of proposals to be withdrawn under the Better Regulation initiative, when announcing its 2015 work programme on 16 December.

Institutional negotiations on BSR continue into 2015: On 19 June 2015, after several months of negotiations, the Council has reached an agreement on its position regarding the file. The position introduced important changes to the original Commission proposal. It softens the original proposal as the proprietary trading is no longer prohibited, but separated from the core credit institution. The proposal also incorporates a more flexibility to the approach by allowing discretion of the competent authorities (toolkit of supervisory measures to address excessive risk taking in trading activates).

> "I believe there are still doubts regarding whether the largest and most trading-intensive banks in Europe can be rapidly resolved in the midst of a systemic crisis. If the structure of a bank has been simplified ex-ante, it is easier to impose resolution measures on it also in times of severe stress."
>
> **Erkki Liikanen,**
> speaking at ECON hearing,
> 2 December 2014

On 26 May the Parliament rejected the report. The report was supported by 29 MEPs, with 30 against and no abstentions, meaning that no agreement has been reached. ECON did not adopt some key compromises, including those on the negative scope (Art 4), metrics (Art 5), proprietary ban (Art 6), and the separation modalities (Art. 10). The vote showed a big discourse between political groups. Parliament will resume negotiations in September 2015. Only if the Parliament reaches the agreement, trialogues (negotiations between the Commission, the Council and the Parliament) will start in order to reach a final text.

CALENDAR

Q2 2015
Continued negotiations between ECON rapporteur and shadow-rapporteurs

21 January 2015
Amendments deadline for ECON report

18 December 2014
Draft ECON report circulated by Parliament rapporteur Gunnar Hökmark (EPP, Sweden)

16 December 2014
BSR not on a list of Commission proposals to be withdrawn
Finance Watch Webinar "*What is investment banking?*"

2 December 2014
Finance Watch participates in ECON public hearing on the BSR proposal

27 November 2014
Finance Watch letter to Financial Times urging Commission not to withdraw BSR proposal

19 November 2014
European Central Bank opinion on Bank Structure Reform

27 October 2014
FSB report on Structural Banking Reforms for November 2014 G20 Brisbane Summit

10 September 2014
Finance Watch note "*Too-big-to-fail in the EU*"

22 July 2014
Finance Watch Policy Brief "*Structural reform to refocus banks on the real economy*"

9 July 2014
EESC opinion on BSR proposal

2 June 2014
ESRB Advisory Scientific Committee report "*Is Europe overbanked?*"

2 April 2014
ECOFIN: finance ministers' statement opposing separation of market-making activities

31 March 2014
IMF Global Financial Stability Report estimates TBTF funding subsidy for Eurozone banks at $300bn

21 March 2014
Finance Watch educational unit "*Understanding Finance #1 - Splitting megabanks?*"

24 February 2014
Finance Watch Webinar "*Why separate banking activities?*"

30 January 2014
Finance Watch press release "*Bank structure proposal has right objectives but fragile mechanism*"

29 January 2014
Commission publishes legislative proposals on bank structure reform (BSR) and securities financing transactions (SFT), called the Barnier proposals

2013
France and Germany adopt weak national laws on bank structure reform and Belgium announces plans. UK adopts ring-fencing law

2 October 2012
HLEG presents its final report to the Commission

> “Utility banking must be separated from investment banking.”
>
> The Archbishop of Canterbury (and former derivatives trader), **Justin Welby**

FINANCE WATCH’S VIEWPOINT

Some bank structures can embed funding subsidies that distort and damage the market economy.

Megabank structures, for example, allow the funding benefits of implicit state support to be extended to investment banking, subsidising its cost of capital and leading to the overdevelopment of risky trading activities and systemic risk.

Separating trading from credit at such banks would cut this link and is a vital step in ending too-big-to-fail banking. It would help banks to focus more on serving the real economy and give credibility to the EU’s plans for dealing with large banks in trouble, reducing the chances of further taxpayer bail-outs. Existing measures such as CRD, SSM, BRRD and SRM, while positive, are not enough to protect taxpayers because they have a micro-prudential focus (they make individual institutions more robust) whereas BSR has more of a macro-prudential focus and concentrates on the systemic risks posed by large trading-oriented banks (risk of joint default, risk of contagion).

In our view, prevention is better than cure. To achieve its goals, we think BSR must separate substantially all trading - including market making and derivatives - from deposit banking activities.

While the public benefits of this measure are well established, BSR is strongly opposed by the banking lobby and by certain member states protecting national champion banks.

A successful BSR would focus banks on serving the economy and help capital markets to be competitive and subsidy-free. This in turn should support the EU’s ambition for a capital markets union.

Why should citizens care?

Citizens pay three times over for financial firms that are too-big-to-fail: in good times through distorted markets and misallocation of resources, in bad times through taxpayer bail-outs, and most severely through deeper recessions after a financial crisis. Citizens get very little in return. Opinion polls show that a large majority of citizens in different EU countries would like to see smaller, less powerful and properly separated banks.

If BSR is not effective, the next financial crisis could be as painful for citizens as the last and undermine faith in the democratic process. Additionally, the economy may not get enough of the types of finance it needs for stable growth.

ACTIONS OF FINANCE WATCH

On the day the Barnier proposal on bank structure was published we hosted a conference call with Members and issued a press release the following day with our first impressions of the text.

We hosted a public webinar on **24 February 2014** entitled “*Why separate banking activities?*” and published a 12 page multimedia dossier “*Understanding Finance #1 - Splitting megabanks?*” on 21 March in English, French and German, containing a non-technical overview on the issue of bank separation and explaining Finance Watch’s position for the wider public.

For policymakers, we published on **22 July** a 10 page Policy Brief “*Structural reform to refocus banks on the real economy*” to help draw the link between BSR and the jobs and growth agenda.

Acting Secretary General Benoît Lallemand spoke at a European Economic and Social Committee study group on “*Reform of the structure of EU banks*” on **10 April**. The EESC published a positive opinion on BSR three months later.

For incoming MEPs, on **10 September** we published a 12 page overview, “*Too-big-to-fail in the EU*”, of the various EU financial regulations relating to too-big-to-fail and our assessment of what remains to be done.

“Too-big-to-fail in the EU” - Policy Brief, 10 Sept 2014

In November, we urged the Commission to maintain support for BSR following calls from the financial industry to withdraw the proposal. This was supported by a letter in the Financial Times on 27 November and an open letter to outgoing Commissioner Michel Barnier the previous month.

Senior analyst Paulina Przewoska spoke at a public hearing on the Structural Reform of Banks at the Parliament’s ECON Committee on **2 December**. Before the hearing, we coordinated with FW Members on publications, letters to MEPs and media contacts to encourage MEPs to support a strong reform.

We hosted another public webinar on **16 December**, “*What is investment banking?*”, and started technical work on the Hökmark report ahead of the amendments deadline on **21 January 2015**.

Relevant materials were tweeted throughout the year under the hashtag #SplitMegaBanks. Finance Watch was mentioned in 32 press articles about banks structure and published eleven blogs and external articles about BSR during the year.

OUTCOMES

The Commission’s original proposal has the right objectives (among others: more competition between banks, more credible resolution of banks in trouble, less misallocation of resources, fewer conflicts of interest) but a fragile mechanism, such as potentially giving supervisors too much discretion to avoid separating banks. The text has since come under sustained attack from some member states and some political parties seeking to weaken it, creating doubts about its final effectiveness.

Public and academic support for bank separation remains strong and the OECD and IMF published further evidence during the year that adds to the case for structural reform. The ECB and FSB gave largely neutral responses on the reform.

BSR survived a bank lobby call for it to be withdrawn as part of the new Commission’s “clearing the decks” exercise but it continues to face strong opposition from several EU member states and the Parliament rapporteur, who are acting to weaken the proposal.

The proposal faces further challenges to its progress and content in 2015, both in Parliament and Council.