Finance Watch

Making finance serve society

What are the consequences of different options for structural reform?

European Parliament, Committee on Economic and Monetary Affairs:

Finance Watch contribution to Public Hearing on Bank Structural Reform

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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It is an honour for me as a representative of Finance Watch to participate in this hearing on Bank Structural Reform.

The subtitle refers to the consequences of different options for structural reform. Due to the time constraints I would like to concentrate on an effective reform and its consequences from Finance Watch's perspective. If there were only three things I had to tell you it would be that:

- **First of all - effective bank structural reform aims at addressing systemic risk, it has more of a macroeconomic focus and is complementary to microprudential regimes such as capital requirements and resolution. Those two regimes take the perspective of single institutions and naturally fail to address some of the systemic risks.**

- **Secondly - the main systemic risk to be reduced by structural reform is the contagion risk, in other words the spillover of risk from trading activities to the core banking activities – deposit-taking and payment systems. Those core activities need to be protected and should be covered by the public safety net.**

- **And last but not least - structural reform aims at the vulnerabilities of the TBTF business model and does not threaten small and medium-sized universal banks. Just the opposite - it will enhance market discipline and competition by removing market distortions caused by implicit subsidies.**

Before I go into the details of an effective reform and its consequences let me start with the so called regulators' paradox.

1) *Regulators' paradox*

Finance Watch is convinced that banks still need more common equity capital and less leverage to withstand future shocks and to continue servicing the real economy. A larger buffer of truly loss-absorbing capital, which is common equity, reduces the chances of banking crises which, as both past history and recent events show, can generate substantial economic costs.

However, large, interconnected, systematically important banks can never have enough capital in a crisis, mainly due to counterparty risk stemming from their derivatives businesses. Leverage and fragility stemming from wholesale funding also add to systemic risks. In good times, TBTF banks might need very little capital but in a system-wide stress there is no reasonable ex ante amount of capital that would protect them from falling. This phenomenon, called the **regulators' paradox,** was described in one of the brilliant studies made by Adrian Blundell-Wignall, Paul Atkinson and Caroline Roulet from the OECD.

These vulnerabilities should be tackled by structural reform.

2) *Effective structural reform in Finance Watch's view*

In Finance Watch's opinion, an effective structural reform is one **that insulates critical banking functions (deposit-taking and payment systems) from excessive risk stemming from extensive trading and especially derivatives trading.** It may seem a remote danger now but in 2008 there was a genuine fear of societal breakdown. Why? Because money, which is overwhelmingly made up of bank deposits, and the banks payments services, seemed threatened. **Bank structural reform addresses the systemic risk of risk spillovers from trading to core banking functions.**

Trading is trading. Finance Watch fully agrees with the HLEG report in this respect and does not differentiate between market making and proprietary trading since both strategies require holdings of inventories of trading assets.

Moreover an effective reform would **reduce the interconnectedness** of TBTF banks because it would result in the **proper pricing of trading risk**, thus removing market distortions.

An effective reform **may still allow the separated activities to stay within the same group** (to allow for synergies) but reform would have to set the ring-fence high enough not to allow the creditors of the trading entity to reach out for the deposit-taking entity's assets to cover trading losses.

Effective reform should **set clear ex-ante rules and minimize discretion, in order to enhance confidence and transparency** in the single market. In other words, two credit institutions in the same situation should be treated in the same way - within the Banking Union or outside, in any given Member State, under any given supervision. An additional benefit of clear ex ante rules would be to reduce regulatory uncertainty, which is damaging to the industry.

3) *The alleged negative consequences of an effective reform*

There are different concerns around the consequences of an effective structural reform. First, it must be noted that concerns concentrate mostly on the impact on individual institutions or the banking sector (they concentrate on private costs) and the overall consequences are often not taken into account.

Let me address briefly the alleged negative consequences that are most often brought up.

The first group of concerns is that, should trading activities be separated, the continental universal bank business model would be harmed. Such banks would

lose a diversified source of income, their risk diversification advantage in general would disappear and economies of scope would evaporate.

To address this concern, I have to start with a short description of the underlying banking sector. Europe's banking system is not only large but also highly concentrated and even a brief look at the ECB's consolidated data shows that there is clear water between around 20 largest banks and the rest of the sector. The structural reform aimed at those biggest banks aims at the vulnerabilities of the TBTF business model. It does not negatively affect small and medium-sized universal banks, which are outside the scope.

On the risk diversification point – from the microprudential perspective, which dominated supervision in the run up to the crisis, banks with different business lines are supposed to benefit from the diversification advantage. However, a financial system in which individual banks appear individually sound might still be unstable because they are exposed to common risks. Typically, highly diversified universal banks may be more correlated with one another, creating a higher risk of joint bank default. This is a major point as what matters is not so much when one bank is in trouble, but rather when they all experience difficulties at the same time.

A sound macroprudential framework is needed to observe and control such risks; microprudential supervision simply fails in this regard.

Additionally, since an effective reform still allows the trading entity to be placed in a banking group the diversified source of income would stay. Only the implicit subsidy for trading would disappear, bringing the positive side effects of increasing competition and market discipline.

Furthermore, the literature on economies of scale [1] shows mixed evidence. For example, some recent research shows that when public subsidies are taken into account, any strong evidence of economies of scale disappears.

Secondly it is argued that if trading activities are separated, the business model of the trading entity would not be viable (because the cost of funding would rise), the services would be more expensive for clients and the trading entity might even pull out of the market.

When addressing this kind of argument I am always tempted to mention how the US investment banking business blossomed under Glass-Steagall. In addition, the deposit-taking entity after separation might still be allowed to conduct some trading activities, especially for its non-financial clients. Plain vanilla derivatives, relatively easy to hedge, are enough if we think about SME's needs.

The trading entity would not be financed by deposits covered by deposit guarantee schemes. The main source of funding would be equity and wholesale markets. In the case of an effective separation this would mean that the activities would be fairly re-priced and the cost of funding might rise (all other things equal). But the fair pricing of

[1] Recent analytical contributions were summarized in the Report of the Advisory Scientific Committee to the ESRB, 'Is Europe Overbanked?'

risk should be nothing to fear in a market economy, especially when compared to costs of systematic miss-pricing.

Moreover, since the trading entity and deposit-taking entity might stay in one group at the consolidated level, banks would still benefit from diversification of income.

To conclude - the fact that we are discussing "how" to implement structural reform and not "whether" to do so shows that ECON members have recognized the need for reform. This is very positive but the reform needs to be meaningful and effective to create the changes demanded. If the thresholds or metrics are too generous, the ring-fence too low or if there is too much discretion, Bank Structural Reform risks being just a red tape measure leading to more regulatory uncertainty.

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