Structural Reform of European Banking

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<u>The European Commission is continuing its fight for greater stability in the banking sector</u>

The European Commission has spent the last two years promoting a functional model of the banking union. After an April 2014 European Parliament vote, the Banking Union is now a reality. The package of directives and regulations governs all components of the Banking Union: single banking supervision, a single framework for crisis management (and resolution) and at least harmonized, though not single, deposit insurance.

Meanwhile, **doubts persist whether the Banking Union is a sufficient answer to the 2008 crisis** of the financial system. When Europe has common capital adequacy rules, common supervision standards, rules of cooperation between national supervisory authorities, instruments and instructions for crisis management, methods how to deal with systemic banks, etc., is that not enough? Enough for us to say – less than six years after the crisis – that it should suffice just enough to recapitalise banks and they will start to lend?

It doesn't seem like it. It seems that the European Commission, influenced by American, British and some European national regulators, believes that it is necessary to make one more step – a structural reform of the banking sector. And such a structural reform of the banking sector may fundamentally change banking as we know it. The **main objective is to prevent that "insured deposits finance risky operations"**, so that crises like the one from the thirties or from 2008 are never repeated. This is important especially **in the context of large systemic banks** – banks that have been or are too large or too complex for one government to rescue. This noble goal obscures a political project telling us that "taxpayers' money should never again be used to bail out failing banks". This goal can be reached in different ways: by (i) strengthening capital and liquidity rules and risk management systems of banks (which is contained in CRD IV), (ii) the creation of tools and frameworks for crisis management, even at supranational level (in the BRR and SRM directives and regulations), (iii) strengthening the confidence of depositors (in the DGS directive), or (iv) structural changes of banks themselves. But it seems that the last point on the list, the current proposal of the banking structural reform, can take us eighty years back, while at the same time open the banking sector to new competitors in unexpected ways.

The concept of "utility banking" and the war for talent

One of the consequences of the announced structural reform is to create a "safe bank" which will be financed by insured deposits and which will be absolutely safe for depositors. At the same time such a bank shall be very resistant to potential crises, as its business model should be safe. In fact it will resemble a "fast post-office" or something like a "utility" within the meaning of network industries such as electricity, gas and water. The government would then guarantee that products and services of such a utility will be always available to everyone and everywhere. In addition to the normal transaction services (payments) it would provide deposits and some loans. Everything else will be labelled a “hedge fund”.

Back to the “fast post-office”: on the liability side, security can be maintained by deposit insurance; on the assets side, however, this is not as easy. Limiting riskier business activities or reducing the amount of riskier loans necessarily falls on the bank's income, with all its negative impacts on return on capital, profitability, innovation and investment.

Indeed, is there something like a "safe business model"? Just remember Northern Rock which was using a simple business model based on maturity transformation (“borrow short, invest in long mortgages”) and was unable to cope with the sharp drop in interest rates. And Northern Rock is history today.

But there is one more unintended consequence of structural reform, namely in the area of human resources: not everyone will want to work at the post office, and not everyone will be able to work in a hedge fund. In today's war for talent, banking will suffer as a whole, as some talented young graduates will leave, yet others will not consider working here.

The impact on clients, the (un)availability of products and (reduced) liquidity

After the separation of universal banks to “deposit banks” "and "investment banks", investment banks will face new challenges that we cannot imagine today, not only demonstrated by a more difficult access to funding. At present the balance sheet of universal banks does not distinguish the sources of funding for "classic" and "speculative" activities. In other words, a universal bank does not differentiate whether deposits are used to finance “lending to the real economy” or to finance “positions in securities, commodities or derivatives”. Some universal banks even have in their internal procedures a built-in automatic regime squaring their trading positions with positions in their lending books at the end of the day so as to limit interaction with the market. This is particularly striking in the case of Czech banks with permanent surpluses of deposits. In the new regime, "investment banks" would have to acquire funds to finance their business activities exclusively from the market, i.e. at market conditions. In the event that some business lines or products would not be sufficiently profitable, an **investment bank would not want to offer them**, or at least would raise the price.

And because a **deposit bank would not be allowed to offer them**, clients will suffer – either the final product will be expensive, or it will be available only sometimes and or for certain clients, or even unavailable. Price increases will be reflected in the form of spreads widening between "bid" and "ask" prices in securities, commodities or derivatives, limiting return or participation in structured products, or by increasing fees. Price increases and unavailability of products will then impact directly on projects in the real economy: some projects will also have to raise the price of output, and some projects may not even be started.

There are some exceptions announced, but they are a weak compensation: government bond trading, simple exchange rate-, credit- and interest rate derivatives with central clearing and settlement, or client-requested trading. But **there is no "good" and "bad" market-making**; market-making either exists or it does not exist as a correct price discovery mechanism. Any attempts to limit free pricing will negatively impact the economy in the form of suboptimal cost allocation.

In addition, the draft European banking structural reform is designed primarily for banks in the Euro area. As such this is quite asymmetric, because banks and their clients from countries outside of the Eurozone must also deal with one extra dimension: the exchange rate risk and the need to hedge against it. If the reform leads to a price increase of hedging instruments for **companies from countries outside the Eurozone, their behaviour could change**. They will either incur increased costs of exchange rate hedging, which they will further transfer to their final prices (and thus will become less competitive against their Eurozone peers) or they will resign, not hedge the exchange rate risk and will become more risky – for their shareholders as well as for other parts of their supply chain.

Critique of Practical Unreason

We will now leave the political project aside and try to focus on the content of the proposal in the theoretical and practical aspects.

One of key considerations of the proposal is the belief that the recent financial crisis was caused by large, global, universal systematically important banks, and that separation will ensure stability. But this does not hold either in the case of Lehman Brothers and AIG (they were not universal, so they could not have been the object of separation), or in the case of American, British, Irish and Spanish banks which had been financing real estate assets (they were not global). Is then the “systemic stability” such an important inherent value of the system that we have to protect it through structural reforms?

Or is there something else that could justify the proposal? Splitting a universal bank into two entities (within a holding company or otherwise) will necessitate new sources of market funding for the "investment bank". However, **for an investment bank, this is a riskier business model** as the market for financing collateral in derivative positions or financing securities positions (through repo) is by definition less stable than funding via deposits. Moreover, to completely eliminate counterparty risk, this cannot be fully achieved by the mandatory use of central counterparties for clearing and settlement, nor by the use of various forms of netting.

Ironically, the Liikanen report states that there is no evidence that some business models are more - or less - resistant to crises than other business models.

In addition, the separation of a universal bank is a very **complicated process**, not only in terms of a "cut" in the balance sheet, but also from a tax context and all the implications of corporate governance. And after a complete separation of all activities is achieved, will we not by chance resurrect the spirit of the Glass-Steagall Act? Do we not go eighty years back in time?

In addition, the creation of subsidiaries captures and freezes liquidity and capital and also contributes to further fragmentation of the market. Opportunities for regulatory arbitrage will emerge at a global level because of inconsistencies between various proposals. Some banks will be tempted to utilize relative merits of the regulatory regime e.g. in the US or in the UK, or even elsewhere in the world. This could strengthen competition between nations, but perhaps it is not entirely desirable.

And meanwhile, somewhere else, new capitalists are following our debate in order to prepare soil to attack our positions. They can either be banks from third countries through branches, or non-banks.

Conclusion

The draft structural bank reform is probably the most important text from the European Commission workshop after the banking union. The proposal has a great ambition to solve alleged problems with the stability, size and complexity of European banks. However, the problem is being solved through mechanisms known from Basel and the banking union project. Economic recovery in the EU is on its way, healing processes in banks have just been exposed in November 2014 after the announcement of the results of stress tests and after subjecting banks under the single supervision of the ECB. At the same time the European Commission wants to use all the experience of structural reform acquired in the United States and in the United Kingdom. To achieve its goal – to reform European banks and thus strengthen them – the Commission chose a combination of restrictions and orders, with far-reaching and perhaps unexpected consequences for business models and the competitiveness of European banking. Whether and how this objective can be enforced at the political level will be the most important issue in the European debate in the financial services area for the rest of this year and for the coming year.