"Reforming the Structure of the EU Banking Sector" – Assessment of the Consultation Paper Published by the European Commission

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In the wake of the financial crisis, triggered by the default of "Lehman Brothers Inc." and the subsequent budget crisis in the various countries at the forefront of saving decrepit banking systems, theorists and practitioners started looking for possible ways enabling the economy to ride out future financial crises. This was supposed to go hand in hand with disentangling a banking system essentially structured under private law and state budgets. Repeatedly, the talk in this context was the problem of banks that were "too big to fail". While on the one hand banks in Europe were legally forced to table their own plans for returning to financial health, which in the event of bankruptcy would consider corresponding protection for debtors and owners, on the other there is a debate underfoot in the EU hinging on an attempt to restructure the existing banking system. The first serious attempt here was undertaken by a High-level Expert Group chaired by *Erkki Liikanen*. The so-called Liikanen Report[1] constituted the practical and theoretically-informed study as regards a possible reform of the European banking sector to be presented to the public. After in part heated discussions the notion that a reform to the structure of the banking sector and a separation of commercial banks from investment banks could counter future financial crisis was taken up at the EU level and also within the individual member states. The remarks below will focus on the current discussion on a system separating commercial and investment banks at the EU level and a distinction of this EU legislative initiative from other attempts to reform the banking structure to avoid future crises.

Discussions at the EU level

With reference to the above-mentioned Liikanen Report, in May 2013 the European Commission published a consultation paper entitled "Reforming the structure of the EU Banking sector"[2]. Alongside statements and lists of different structuring and realization options for carving a bank up into a deposit bank and a trading entity, actual questions were addressed to all banks wishing to take part in the consultation process. Banks were asked, for example, which of the afore-mentioned options they would prefer to realize and what motivated their choice. In the further course of this remarks, the general goals and motives of the EU consultation will be discussed and a few of the issues outlined in the EU paper will be critically questioned by way of example.

[1] see: *High-level Expert Group on reforming the structure oft he EU banking sector*; Final report, 2012.
[2] see: *European Commission*; EU, Reforming the structure of the EU banking sector, 2013.

The prime objective of this EU consultation paper and its possible realization is to prevent future financial crisis and thus secure customer deposits with banks. It pursues this goal of creating a more stable financial system by creating thoroughbred trading or investment banks by separating the trading activities from the pure credit business. The thinking behind such clustering is that the respective types of business involve completely different types of risk: market and counterparty risk, on the one hand, and credit default risk on the other.

The proposed regulations are aimed at the large banks that are system-relevant and have to date carried both types of risk. In order to identify precisely these system-relevant banks, key bank balance sheet ratios were examined, specifically the IFRS categories of "Available for sale" (AfS) and "Held for Trading" (HfT)[3] assets. That said, process issues such as how to effect the proposed spin-off of the trading arm of a bank once it has been identified as being of relevance to the economic system, are discussed in the EU paper and possible solution methods suggested. The paper contrasts an "ex-ante" separation from an "ex-post" separation in terms of the process of achieving the stated threshold values. The contrast focuses on the scope that, for example, national authorities have to judge whether threshold values have been exceeded. The EU paper kicks off by putting forward a generally valid question:[4]

Question 1: "Can structural reform of the largest and most complex banking groups address and alleviate these problems? Please substantiate your answer."

It bears stating as regards this initial question that to date historically speaking systems that separate the two banking types have not proven to be less prone to crisis situations than are systems with universal banks. In fact, the opposite tends to be the case. In the recent financial crisis it was more the thoroughbred investment banks that were affected as their business activities were less diversified and no other revenue streams existed. Moreover, when discussing operational separation it bears noting that the trading entities detached from the original bank may initially not have a defined business model of their own. This would spawn the risk of oligopolistic market structures.

As the universal banking system prevails in Europe, uniting the two types of bank, the issue of which banks will in future be affected and will achieve the defined threshold values is of great importance. This leads on to

Question 3: "Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator"[5]

The chart below illustrates the four different options put up for discussion in the consultation paper. Each respective bank balance-sheet category is assigned an absolute value that may not be exceeded in the respective category:

[3] Unlike the Liikanen Report, the consultation paper speaks of "trading securities assets" and "derivatives assets".

[4] *European Commission*; EU, Reforming the structure of the EU banking sector, 2013, page 2.

[5] *European Commission*; EU, Reforming the structure of the EU banking sector, 2013, page 4.

Ill. 1: Possible threshold figure options[6]

			Quantitative threshold values	
Option	Definition	Description	bn. Euro	Share of the balance sheet total
Option 1	TSA + DA + AFS	near the original Liikanen Report	80	20%
Option 2	TSA + DA	exclude AFS	66	12%
Option 3	(TSA + TSL +DA +DL) / 2	exclude AFS + gross volume of securities and derivatives (bothe sides of the balance sheet)	62	10%
Option 4	|TSA - TSL| + |DA - DL|	exclude AFS + net volumes of securities and derivatives	37	8%

TA	Total assets	All assets as carried on the balance sheet
TSA	Trading securities	Assets part of a portfolio managed as a whole and for a short term profit taking; without derivative assets
DA	Derivatives asstes	Derivatives with positive replacement values not identified as hedging or embedded derivatives

AFS	Available for sale Securities	Total securities designated as AFS
DL	Derivatives liabilities	Derivatives with negative replacement values not identified as hedging instruments
TSL	Trading liabilities	see: TSA

These defined thresholds constitute one of the main points in the EU consultations worthy of criticism. The sole focus on balance sheet ratios is dubious and the possibilities for considering other indicators that better describe the business activities to be separated bear discussing. It is not just that balance sheet ratios rest on an understanding that is not interfaced with a regulation separating banks, for the issue of considering consolidated financial statements that may even factor in companies based outside Europe is also not above controversy. Issues of a global scope of consolidation have not or not sufficiently been addressed. And then there is the question how to deal with banks that do not prepare their statements as per IFRS.

It bears asking in detail whether the categories are suitable per se. For example, the category of AfS covers business assets that can be held long term, too, or have to be held for the purposes of liquidity management. The requirement under supervisory regulations that liquidity be maintained cannot be taken as a reason to push ahead with the separation of the system of universal banks. This context is illuminated critically in the consultation paper itself. Moreover, an exclusive focus on the assets side is inappropriate. For example, in the case of derivatives, positive values on the asset side are not netted against negative figures on the liabilities side, e.g. for a derivatives transaction with clients that is hedged in the capital market.

At this stage, additional indicators would be in order that better describe the actual goal of avoiding high-risk transactions. Thus, a distinction of activities in regulated markets from those in unregulated markets would be more meaningful as precisely these include the transactions with counterparties (hedge funds, unregulated SPVs, private equity companies, etc.) that essentially stand as symbols of the financial crisis. These transactions would be easier to identify. And precisely the balance-sheet based thresholds do not distinguish regulated from unregulated transactions.

Alongside the issue of which banks are affected there is the question which business activities will be affected by the separation. Here, the EU paper puts three options up for discussion, with the number of activities affected rising successively.[7]

[6] see: *European Commission*; EU, Reforming the structure of the EU banking sector, 2013; appendix table 1 and 2.

[7] see: *European Commission*; EU, Reforming the structure of the EU banking sector, 2013; pp. 5.

Ill. 2: Business activities subject to separation

Option		Description
Option 1	Narrow Trading Entity / Broad Deposit Bank	E.g. Proprietay trading + exposure to Venture Capital / Private Equity / Hedge Funds = (PT)
Option 2	Medium Trading Entity / Medium Deposit Bank	PT + market-making = (MM)
Option 3	Broad Trading Entity / Narrow Deposit Bank	MM + all other investment banking activities

However, specifying the above business types gives rise to further questions. For example, "exposure to" does not get more closely defined. Even if an attempt is made in a further EU Commission publication to define it, issues remain open: How to deal with receivables from companies that are "only" owned by a private equity company, for example? It is also difficult to field a general term like "exposure" if it has hitherto not been used this way and its interpretation in the Liikanen Report can only be assumed to lurk behind the imprecise definitions there of "loans", "loan commitments" or "credit exposure".

In particular given the importance of market making and a consideration of market making activities as of Option 2 one part of *Question 5* bears scrutinizing[8]:

"What are the costs and benefits of separating market-making and or underwriting activities ? [...]"

Precisely in Europe, where the economies tend to be geared to the banking system for financing (and not to a capital market), for SMEs it is a tall order to have to rely on services such as underwriting or to install price and currency hedged transactions and the corresponding products. Moreover, banks should not place all their deposits in loans but opt for healthy risk diversification and thus also go for low-risk securities. To this end, precisely scope in the capital market is needed and this should be possible for a deposit bank, too. This includes market making. Which brings us to the question whether post-separation the essentially smaller trading entities, whose sole purposes to trade for their own account, will not tend to go for highly speculative deals? This would open up a unique playing field for transactions that should really be subject to more stringent regulation, and it would be hard to manage it.

Moreover, one key point is neglected: Many small banks in the savings bank and credit cooperative sector depend (on behalf of their clients, too) on respective central banking institutions. And precisely these central banking institutions require a certain scope that is exclusively to the benefit of their primary banks. The cooperative or savings bank financial systems could in other words be weakened; their focus has always been on securing their private clients' deposits and they emerged from the last financial crisis unscathed, too. Should market making, provisioning services and underwriting pass to an independent trading entity post-separation from a deposit entity, precisely these banks could forfeit know-how and the requisite expertise. Customer-focused services can only be provided and developed in an innovative fashion if advisory and support come from a single source.

The EU paper also discusses the separation in terms of ownership rights and the process involved. Once again, various forms of separation are put up for debate. Firstly two different functional forms of separation and secondly "ownership separation", as captured in the following question[9]:

[8] *European Commission*; EU, Reforming the structure of the EU banking sector, 2013, page 6.
[9] see: *European Commission*; EU, Reforming the structure of the EU banking sector, 2013; page 8.

Question 9: "As regards full ownership separation, what are the associated costs and benefits".

In addition to the unclarified issue of how existing ownership rights will be affected, when considering this question who invariably thinks of the topic of refinancing? The macroeconomic and monetary policy impact of full ownership separation are unclear and the issue arises, if the refinancing option via client deposits is no longer possible for the trading entity (and would only be open to the deposit banks), how the trading entities would be able to survive at all. They would the presumably rely on even more risk-laden speculative deals and an even more risk-intensive banking market would arise parallel to the existing one. In addition to these market-policy aspects, the banks would face immense transaction costs, such as set-up costs, technical adaption costs etc. And then there would be the parallel restructuring of the risks in the two entities, which would entail a not negligible batch of costs. Here again one could argue that in the past full ownership separation (Glass-Steagall)[10] did not prove robust (see Lehman Brothers).

Differences between the EU consultation, Liikanen and the German act on bank separation

While the EU consultation in question focuses entirely on separating the high-risk transactions it identifies in banking from the activities of the deposit bank, the Liikanen Report is a comprehensive and essentially exhaustive account of the reform of the banking industry. The Liikanen Report thus also covers other aspects of a possible restructuring. It addresses issues of capital requirements for certain banking transactions and even HR matters, such as remuneration systems or the qualifications of managers. Precisely the report's all-in approach caused a real stir in the banking sector. At the European level, all these aspects are also being discussed, albeit as regards different elements (e.g., CRR, CRD, brief for the EBA etc.).

If only the afore-mentioned points for the separation of the banking system are considered, then there are some differences between the Liikanen Report and the EU consultation paper. The EU proposal with its four options is more differentiated, in particular on the issue of which banks are affected (i.e., which thresholds must be exceeded for the regulations to apply). And not just in that regard, but also on the issue of what products or "trading activities" in the respective balance-sheet categories are affected and as regards whether the items are on the assets or the liabilities side of the bank balance sheet. Since the Liikanen Report can be regarded as having triggered the EU consultation on the separation of banks and the latter refers to the former, I shall now briefly discuss the act now enacted in Germany[11] which is commonly termed the bank separation act.

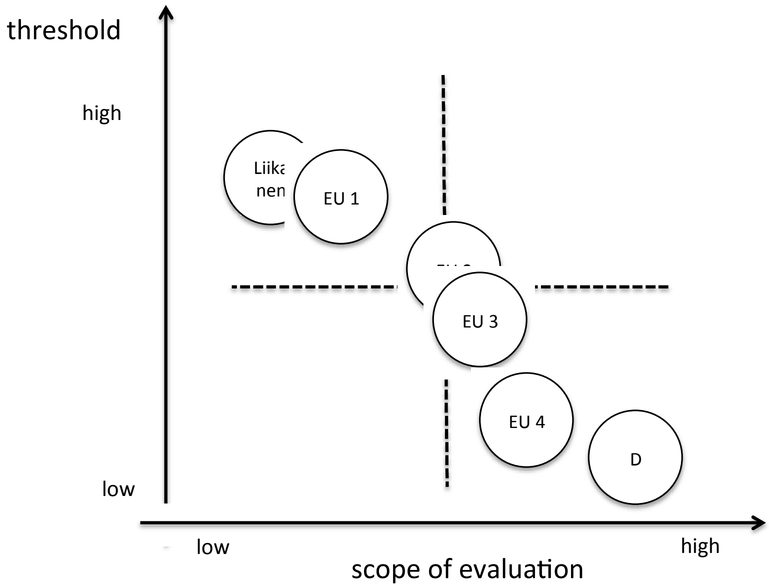
This act's prime objective is likewise to bundle the high-risk transactions in a single entity of their own. However, the approach and the goals in terms of structural policy are different. The afore-mentioned entrance threshold, i.e., the number of banks affected, is set very restrictively. This means that the act applies to a whole host of German banks. However, the bank activities to be separated under the terms of the act are defined very broadly, meaning that the banks have great scope in deciding what activities to spin off later on down the road. Basically, a small number of trans-

[10] see: *Deutscher Bundestag*; Glass-Steagall Act, 2010.
[11] see: Bundesgesetzblatt; Bundesgesetzblatt, Gesetz zur Abschirmung von Risiken, 2013.

actions are “forbidden”. Moreover, exceptions allow banks to conduct transactions in the future that can be shown to be in their own or their clients’ interests, irrespective of the categorization. This applies specifically to transactions that serve internal bank management, to secure liquidity or are in the interest of the corporate group or financial system.

The above shows that the German act may share the aims the EU and Liikanen originally had, but takes into account the universal banking system that prevails in Germany and other EU countries.[12] Breaking up this system, which has withstood crises, is not desired here. This contrasts with the original statements in the Liikanen Report and Options 1 and 2 in the EU consultation. There we can assume that the highest priority is to separate the banks into an investment and a credit bank. In light of my remarks above it can be doubted whether this can go hand in hand with the wish to create a future stable and crisis-proof banking system. Options 3 and 4 of the EU consultation are somewhere in-between Options 1 and 2, on the one hand, and the German bank separation act, on the other.

Ill. 3: Assessment of the various initiatives



Outlook and conclusion

Given the strong attention it received and the pronounced willingness of European banks to take part in the afore-mentioned consultation, the EU Commission published a separate paper in which the FAQs from the consultation were to be answered. [13] However, the answers given were in many places lacking the unequivocalness all sides wanted. For example, the question whether in future a “deposit unity” would be allowed to use hedging activities for its own asset-liability management purposes or to hedge interest rates, was answered in the positive, yet the criticism voiced beforehand was not eliminated. It remains open how the use of such largely derivative products should be classified. This is especially true of macro- and portfolio hedge positions that cannot be assigned to a specific task. Another question

[12] see: *Krahnen, J. P.*; Rettung durch Regulierung?, 2013; pp. 8.
[13] see: *European Commission*; EU, Template - Frequently Asked Questions, 2013.

in this context is how trading in separated products differs from those acquired or to be acquired to clients' orders or in the sense of client business.

Normally, after such a consultation phase at the EU level we can expect that the EU Commission will publish a definitive paper and table it through the EU Council to the EU Parliament for resolution. Should this not have happened by the new elections to the EU Parliament in 2014, formally speaking all activities that have not passed through the legislative process will be "sent back to the beginning". There is no saying whether a (new) consultation paper then again gets published or instead the EU Council and EU Parliament pass a resolution based on the prior insights.

The only option for banks in Europe at present is to wait and see what further steps the EU Commission takes. This is an unsatisfactory situation for the European banking industry, as unlike the well-known legislative initiatives in the various member states, some of the options stated in the EU paper could trigger hefty changes in the industry. And irrespective of all the in part mentioned problems this constitutes a severe and massive intervention in a healthy banking system and will have considerable implications for the clients, whereas it was they which this initiative set out to protect. Should the EU Commission also have the objective of advancing the separation of certain activities, then it should opt to promote a minimum harmonization of the existing laws and allow each individual EU member state to resort to its respective national authorities to consider country-specific banking structures when separating the universal banks into investment and deposit banks.

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