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Press Article

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On the European Commission's Proposal for a Structural Reform of Banking[1]

Jan P. Krahnen[2]

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The proposals for a separation of commercial and investment banking activities in the United States, the United Kingdom and the European Union are surely among the topics most controversially debated during the last months within the banking world. While a separation of proprietary trading has already been put into law in the US and a ring-fencing of the deposit-taking business is pending in the UK, the position of the EU towards the question of separating bank activities remained to date an open one. This changed on Wednesday with the publication of EU-Commissioner Barnier's law proposal. At first glance, this proposal clearly seems to fall behind more ambitious objectives. But in truth, it leaves a number of options to the supervisory entity. Everything therefore depends on the implementation.

What is the Barnier proposition about?

The draft law, published on January 29, proposes a ban for proprietary trading by big banks in Europe. According to the law, it shall be strictly forbidden for the institutions in question – and only for these – to trade on own account for the sole purpose of making profits for the bank. (This prohibition is also valid for economically congenial investments in hedge funds.) These types of trading activities may entail the risk of capital losses, for which a safeguarding through deposit guarantee schemes cannot be justified. Other forms of trading, like market making activities as well as hedging transactions for the banks'own accounts, remain allowed.

The permission to continue with other high-risk trading activities can, however, be revoked by the supervisory authority, if problems occur that potentially put the whole bank and the wider financial system at risk. In these instances, the proposal grants the responsible supervisor the power to require the separation of all trading activities. For systemically important banks falling under the Single Supervisory Mechanism, this will be the task of the ECB. Barnier's proposal therefore provides the separation requirement as *ultima ratio* in case a bank's ability to manage its risk properly is doubted by the supervisory authority. The conditions for intervention refer to financial stability in general terms – they give the authority wide discretion.

Comparison with the Liikanen-Report of 2012

The Liikanen-Report presented in October 2012, and developed under the direction of the President of the Finnish Central Bank, Erkki Liikanen, raised the question of the pros and cons of a separation of banking activities in Europe. The High-level Expert Group was appointed by Commissioner Michel Barnier to examine the need for structural reforms in the European Banking Sector. The final report contained two essential recommendations. First, big and internationally active banks should be required to separate their trading activities into a legally independent company (proposal of bank separation). This should include all trading activities, not only proprietary trading, but also market making (business with and for clients), and hedging operations for the bank's own risks. Second, all banks should be required to issue debt with an explicit loss absorption capacity in times of crisis

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(e.g., convertible bonds with a holding restriction for banks). The latter proposal is known under the header “bail-in debt”, and it is discussed as a part of the Bank Recovery and Resolution Directive. Both ideas were supposed to contribute to solving the Too-big-to-fail problem and to avoiding an implicit state guarantee, derived from subsidized bank funding rates. In a situation of crisis, the recovery and resolution of banks should be facilitated without having to take recourse on taxpayer money. The separation proposal was meant to enable the supervisory authorities to undertake necessary short-term interventions effectively and timely.

Assessment

What is the assessment of the Barnier proposal from an economic perspective? First, it is noted with satisfaction that a proposal for a structural reform has been put forward by the European Commission at all. At first sight, the Barnier proposal may have limited reach. Regarding the scope of separation, (which only includes proprietary trading), it remains behind the suggestions by the Liikanen commission. At second sight, however, the Barnier proposal may prove to be more effective than many believe today. It all depends on the implementation. More precisely, the task to limit trading activities as causes of systemic risks has been delegated to the supervisor. To take on this task, the supervisor is likely to insist on the preparation of effective recovery and resolution-plans. In other words, the Barnier proposal puts risk assessment at the center of the supervisory work – risks on an institutional level and risks of a systemic nature. If the risks are assessed as too high, the activities of every single bank can be split – in such a case, a separation decree will be enacted.

The question therefore becomes: how will the risk assessment come about? The technical guidelines in the proposal are phrased in general terms, so they give no clear direction. A more concrete specification is to be prepared by the European Banking Authority. Even if, to date, we do not know the requirements in detail – it is already conceivable that the room for discretion will remain wide.

Both the supervisory authority and the banks in question arguably have a high interest in transparent and binding guidelines. This leads to the expectation that the operations in the trading department will come close to a factual separation – even when separation has not been requested. The fencing of the trading business from other banking activities may play a crucial role in signaling stability and resolvability vis-à-vis the supervisor.

The supervisory body does in fact possess the power to push the bank in the direction of a credible and risk reducing business model. It thereby lies in the hands of the respective bank to decide on how to implement this claim in an externally visible way. It is therefore quite possible that when the Barnier proposal is implemented there will be a factual separation in the self-interest of the financial institutions, rather than a forced one.

On first appraisal, the Barnier proposal therefore seems well-suited to complement the numerous innovations in regulation – from Basel III to the Banking Union – and to increase its coherence. It further allows finding a flexible answer to systemic risks. These risks can stem from the trading activities of large banks – both from proprietary trading and from market making – and from the complexity associated with them. In this light, the flexibility of the proposed solutions seems to be an appropriate approach. The question if it will foster the development of altered business-models, with corresponding organizational structures in banks, will be the crucial litmus test of this proposal for regulation.