Contribution to the Consultation by the European Commission on the Structural Reform of the Banking Sector

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The Sustainable Finance Lab is a Dutch network of academics and experts, promoting a stable and robust financial sector that supports a socially and environmentally sustainable economy (see www.sustainablefinancelab.nl). We submit this contribution as a group of citizens. In our contribution, we focus on a selection of the questions posed by the Commission.[1] For further information about this contribution, please contact Francis Weyzig (f.weyzig@uu.nl, tel +31 30 2533684).

1. **Can structural reform of the largest and most complex banking groups address and alleviate these problems?**

Structural reform can address the problems outlined by the Commission. We would like to highlight the potential of structural reforms to align private incentives with social goals as outlined in the consultation.

Proprietary trading is a risky activity with a purely speculative character, that does not serve the interests of clients. Such an activity is inappropriate for banks with an (implicit) government guarantee. Banks or banking units that provide essential public services, such as managing retail deposits, should therefore not be allowed to carry out proprietary trading. This is now a fairly widely accepted premise. Of course, banks also face risks in their lending to companies and households.

[1] See Consultation paper "Reforming the structure of the EU banking sector".

However, these risks arise from lending to the real economy and therefore serve a social purpose. This is not the case for purely speculative activities.

Apart from the problem that speculative activities may threaten the provision of public services, the combination of speculative activities and bank services in a single entity also leads to market distortion. If savings and market funding attracted by a bank can be used for risky trading activities, the risk of such activities is not priced properly in the bank's financing costs. This creates an incentive for banks to carry out speculative activities, which provide a higher expected return on the same funding, and expand these at the expense of banking services. [2] Cultural differences within a bank tend to reinforce this process. [3] This has a negative effect on lending to the real economy and on other bank services, especially in good times, when trading is very profitable.

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.**

A definition based on accounting categories brings the risk that banks will reclassify certain assets or adjust their liquidity management to remain below the threshold. In addition, some derivative positions can pose large financial risks, but have initially only a limited market value and thereby constitute a small percentage of total assets. Risk-based standards, such as Value at Risk, have other important limitations. These are usually based on historical risks and therefore may not reflect future risks accurately. Value at Risk is also pro-cyclical because historically observed risks increase after a sudden market shock.[4]

A more fundamental problem with asset or activity thresholds is that banks have a perverse incentive to maximize trading activities within these limits. This may lead some banks to allocate some of the most risky trading activities within the deposit bank.

Moreover, speculative activities are difficult to define. As a consequence, the Volcker rule has become very complex. In any case, proprietary trading, private equity investments and loans to hedge funds should be considered speculative activities. Investment banking activities, such as trading on behalf of clients and underwriting of security issues, do have a social value, but a bank can take speculative positions in these activities as well. This also applies to trading activities for the purpose of liquidity management and to the use of derivatives for asset liability management (ALM). ALM programs usually aim to reduce market risks arising from banking activities, in particular the risk of interest rate changes. In May 2012, however, JP Morgan made a multi-billion loss as a result of transactions to hedge credit risks that were part of the bank's ALM programme.[5]

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[2] A.W.A. Boot & L. Ratnovski (2012). "Banking and Trading", IMF Working Paper WP/12/238;

[3] See e.g. FT, "Restoring trust after Diamond", 3 Jul 2012.

[4] J. Danielsson, P. Embrechts, C. Goodhart, C. Keating, F. Muennich, O. Renault & H.S. Shin (2001). "An Academic Response to Basel II", LSE Financial Markets Group Special Paper No. 130.

[5] G. Shorter, E.V. Murphy & R.S. Miller (2012). "JP Morgan Trading Losses: Implications for the Volcker Rule and Other Regulation", US Congressional Research Service .

Thus, defining risky trading activities and setting a threshold is inherently problematic. We therefore propose that separation should apply to all investment banking activities, regardless of their size. These activities do fulfill an important function in the economy, but trade-related banking services provided to customers are difficult to distinguish from speculative trading. Lending to large corporations is not a trading activity and thus belongs to the deposit bank. The need for restructuring possibilities requires that ALM activities remain possible in each bank entity

4. **Which of the approaches outlines above is the most appropriate? Are there any alternative approaches?**

Ex ante separation is crucial. Making separation contingent on a discretionary decision by supervisors can lead to an undesirable situation where supervision authorities come under great pressure to allow certain activities within a single entity.

5. **What are the costs and benefits of separating market-making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?**

See the answer to question 3. In practice, market-making and/or underwriting activities cannot be fully distinguished from proprietary trading.

6. **Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?**

Risk management services and other trade-related banking services should not be provided directly by a deposit bank, because such services can be difficult to distinguish from speculative trading. Under functional separation (with tighter economic and governance restrictions on links), a banking group as a whole can continue to offer the same services to clients. However, the separation can cause certain business services to become more expensive. Because trading activities in a separate banking unit are no longer (implicitly) guaranteed by the government, the financing costs of these activities will increase to a level more commensurate with the actual risks.

Bankers and their clients may perceive an increase in costs as something undesirable. However, the higher costs would reflect the risk-return ratio of the services more accurately, which ultimately leads to a better allocation of scarce financial resources. Moreover, it is possible that the deposit banking unit will be able to fund itself at a lower cost. Debt security holders and shareholders will have more certainty about how a deposit bank employs its funding and because of the reduced risks, they may accept a lower return.

See also the answer to question 3.

11. **Which option best addresses the problems identified? Please substantiate your answer.**

Option H would be preferable.

Important advantages of this approach are the high credibility of restructuring possibilities, reduction of market distortions, relative simplicity, and transparency.

- If a bank gets into trouble, it should be possible to separate trading activities from deposit taking, payment systems, and lending to households and non-financial companies. Without stricter functional separation, resolution plans will not be credible. If speculative trading and investment banking activities do not have their own funding, this is an obstacle to separation during a crisis.
- Addressing market distortion also requires stricter functional separation. Moreover, if restructuring possibilities are not credible, risky trading activities will still benefit from an implicit government guarantee and market distortions will remain.
- The implementation of this approach does not require very complex rules, such as the Volcker rule in the US. Moreover, it does not require the definition of a limit for trading activities in a deposit bank, as in the HLEG proposal. This prevents all kinds of problems regarding the definition of risky trading or speculation, the calibration of threshold values, and the position of the supervisor.