Reforming European banks' structures

Complementing ongoing regulatory reforms in the European banking sector, the EU has started to consider possible changes to banks' structures.

"Too big to fail"

The crisis showed there is no optimal business model for a bank, with difficulties experienced by both "pure" retail (such as Spanish *Cajas*) and investment banks (such as Bear Stearns), as well as combined universal banks (e.g. RBS). Nevertheless, the complexity and interconnectedness of banks fundamentally deepened the crisis. The complexity of risk management in universal too-big-too-fail" banks led to retail clients and taxpayers bearing the losses of risky trading activities (e.g. through reduced lending and costly bail-outs).

Regulating banks' structures

So far few legal restrictions affect banks' structures. However, the US plans to ban "proprietary trading" (banks using their own money to engage in – potentially risky – trading) by banks under its Volcker rule, the UK approach would ring-fence certain "core" retail activities (such as deposit-taking) from investment arms while France and Germany propose to transfer proprietary trading to separate legal entities under specific conditions.

In the EU cases above, the two separated parts of banking (retail and investment) can stay within the same institution. Such a reform was also put forward by the high-level expert group (chaired by Erkki Liikanen) established by the Commission to investigate the EU banking sector's structural issues in its report of October 2012. Above a threshold of 15 to 25% of total assets or €100 billion (whichever is lower), assets used for proprietary trading and certain derivative businesses, should be placed in a separate "trading entity". This would not be allowed to take deposits or supply other retail services. Subsequently, under resolution plans, more activities may be ring-fenced. Other reforms proposed include using bailed-in debt for recapitalisation, toughening capital requirements on trading assets and property lending and strengthening corporate governance as well as reviewing compensation schemes. In the wake of the report, the EC published a roadmap towards a proposal for structural reform of EU banks and is expected to come forward with an initiative later in 2013.

Challenges

Finding the right threshold

Critics point out that the success of restructuring depends largely on the right asset threshold level. Not too many assets should fall outside the ring-fence, especially taking into account that trading by smaller banks also contributed to the financial crisis. On the other hand, defaults of trading activities of the largest banks or "pure" investment banks may still have significant impact.

Costly separations

Others argue the costs of structural reforms (such as of compliance and splitting entities) are disproportionate to the benefits. Some consider a clear-cut separation between proprietary trading and, for example, buying securities to sell to retail clients, is particularly challenging. Retail clients may also face negative consequences of banks' potentially reduced ability to provide credit.

Shifting systemic risks

Finally, some economists argue that reduced possibilities for liquidity transfers makes banks less resilient in times of crisis, harming financial stability. Even though systemic risks would be smaller given the entities' reduced sizes, these risks may still materialise in unregulated institutions in the shadow sector or in entities below the threshold, and, without a global approach, in entities in third countries.

European Parliament

On 18 June 2013, the Committee on Economic and Monetary Affairs adopted an initiative report (rapporteur Arlene McCarthy, S&D, UK), outlining the main principles on which structural reform should be based. The plenary vote is due to take place on 3 July.

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