

## Reforming the structure of the EU banking sector

### SUMMARY

The financial and economic crisis has been marked by the 'Too big to fail' problem – a number of financial institutions of a size large enough to pose a systemic problem to the economy required public support to continue operations. According to economic research this has led to implicit subsidies and a distortion of competition in banking markets.

As part of major reforms of the financial markets, the European Commission has launched a structural reform of the banking sector. In particular, this will ban Europe's largest banks from carrying out risky proprietary trading activities, and empower national banking supervisory authorities with the ability to carry out systematic reviews of banking activities.

The Commission's proposal has divided stakeholders' opinion with the financial sector fiercely opposing it, while consumer groups and financial watchdogs consider the measures are not strong enough. A few Member States have already undertaken reforms of their banking sectors, raising questions of conformity with the Single Market under the new proposed rules.



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### Glossary

**Proprietary trading:** when a bank trade on its own account, rather than on behalf of a client, with the aim of making a profit.

**Too big to fail (TbTF):** describes a financial institution whose possible collapse is perceived by the government or supervisory authorities to pose serious risk to the financial sector or economy.<sup>1</sup>

**Implicit subsidies:** gains such as lower interest rates that banks obtain implicitly due to the expectation that governments will act as guarantor of last resort during a financial crisis.

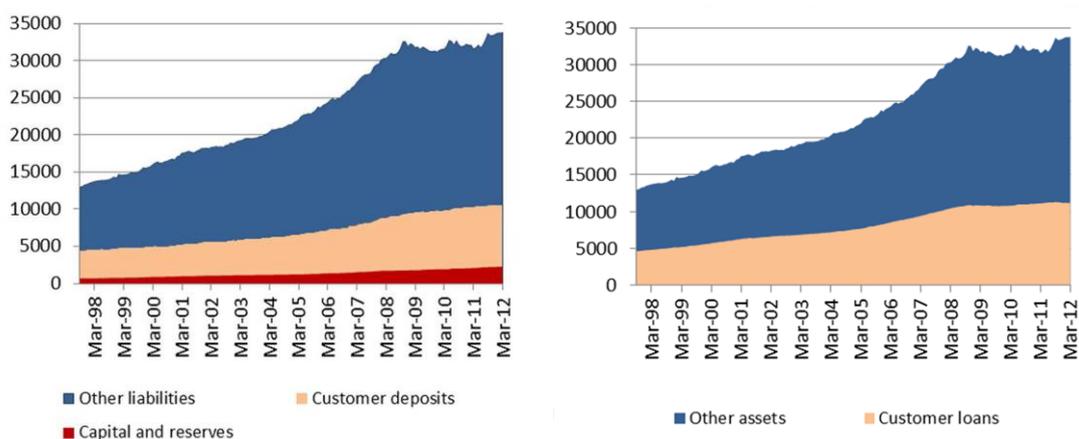
**Market maker:** an institution or individual that quotes bid and offer prices and is prepared and able to buy or sell stock or marketable securities at any time on its own account.

### Background

Prior to the 1980s bank balance sheets increased in parallel with real economic growth. In the 1980s however, they started to significantly outpace GDP growth. In the 2001-2011 period, the total assets of monetary financial institutions (MFIs) [grew](#) from approximately 270% to 370% of EU GDP. The EU banking sector is considerably larger than that of the US or Japan, which in 2010 [amounted](#) to 78% and 174% of GDP respectively. The rapid growth prior to the financial crisis has stabilised since 2008, but the crisis did not lead to substantial reductions in banks' aggregate balance sheet size or deleveraging (reducing asset volumes in relation to capital). Indeed, many of the largest EU banks are roughly the size of (or even exceed) the GDP of their home countries.

Europe's largest banks have been transformed by so-called 'financialisation' - a massive growth in the scope and volume of financial-market activities which has been a worldwide phenomenon for the last 25 years. This is reflected in the growth and composition of their balance sheets on which about [half](#) of assets are typically trading assets (such as derivatives) and less than a third represent deposits of non-MFIs and loans to non-financial corporations and households (see figure 1).

**Figure 1 - Evolution of liabilities and assets of MFIs 1998-2012 (euro area, € billion)**



Source: ECB data as presented in the [Liikanen Report](#), 2012.

For the largest banks in particular, much of this growth came from intra-financial business, dealing and market-making activities, brokerage services, and own-account trading rather than traditional lending to the real economy, (businesses and households). This shift in activities was accompanied by the growth of the 'shadow banking' sector (estimated now to be as much as a quarter of the global financial

system) and increases in the trading of complex derivatives, interconnectedness of banks and their excessive leverage. Regulators frequently apply structural separation as a method of supervising and monitoring different smaller parts of a large banking group. Apart from this, large EU banking groups have very few restrictions on how they structure themselves legally, economically, and operationally.

### Issue

The economic and financial crises imposed unprecedented costs on the EU economy. Between 2008 and 2012, around €1.5 trillion of state aid was used in order to prevent the crash of the entire financial system. Part of these funds was committed to keeping afloat financial institutions considered 'Too big to fail' (TBTF), although several other large banking groups coped with the crisis well. In fact, there were [relatively few](#) direct bank failures in Europe.<sup>2</sup> Due either to lack of adequate governmental crisis management mechanisms or problems with their implementation, most banks were deemed to be TBTF, even when they were relatively small.<sup>3</sup> An oversized bank sector, which needed taxpayers' support in the form of costly bailouts of ailing banks, led to sovereign debt crises in countries such as Ireland and Spain.

According to the European [Commission](#), while the banks grew remarkably in size and importance, their ability to absorb solvency and liquidity shocks (resilience) has diminished. The problems related to the co-existence of different activities in large banking groups hamper orderly resolution and recovery and create moral hazard. They also lead to excessive growth in balance sheet and trading activities, distortions of competition, conflicts of interests within groups and the rise of short-term-profit bank culture.

The majority of research seems to conclude that larger banks engage in more risky activities or hold larger shares of risky assets in their portfolios, but there is also some contrary evidence.<sup>4</sup> According to 2014 IMF [research](#), large banks may have a more fragile business model than smaller banks due to lower capital ratios, less stable funding, more market-based activities, and greater organisational complexity.

Large European banking groups are strongly interconnected through interbank borrowing and lending and derivatives markets. In the euro area about a [quarter](#) of total balance-sheet size reflects direct exposure to other MFIs, but there is also indirect exposure stemming from common

#### Economic effects of 'Too big to fail'

Preventing TBTF firms from failing is said to create moral hazard that undermines market discipline. If TBTF firms expect to be shielded from failure, they have an incentive to take excessive risks because they are at least partially protected from the negative consequences of those risks. The gains of TBTF are privatised (paid to shareholders) but losses socialised (borne by taxpayers), increasing the social cost of bank failure. Indeed, the majority of large and complex MFIs in Europe that received state aid had excessive ratios of (more risky) trading income to total revenue.

The state guarantee of banks' existence created so-called 'implicit subsidies' which tend to increase the size of the financial sector. According to many researchers, the largest banks benefit from higher credit ratings and cheaper funding that can be partly attributed to official support from the state, since both investors and credit-rating agencies believe that governments will not allow them to fail. Evidence from the UK suggests that 90% of implicit subsidies went to the biggest institutions; these banks might therefore have benefited from cheaper funding at the expense of non-guaranteed banks, and have used resources diverted from different sectors of the economy. Studies from the US market found that funding advantages existed only in the initial period of the crisis and later declined, but the situation in the EU varies across the Member States. The 2014 IMF study finds that subsidies remain substantial in Europe even though they have declined from their crisis peak.

risks or informational or reputational contagion in the sector. In times of crisis, this inherent interconnectivity may facilitate contagion where the problems with one bank are spread to others inside and outside banking groups. The systemic risk due to banks' interconnectedness may manifest itself in liquidity hoarding (evident in the aftermath of Lehman Brothers' collapse), counterparty losses, informational contagion, exposure to the same creditors and fire sales of assets (depressing market prices). These events can all rapidly affect a market or its segments if a large bank or banks run into difficulties.

The 2014 IMF study [concludes](#) that both the increased engagement in market-based activities by the large banks and their organisational complexity contribute to the creation of more systemic risk. Empirical research by the Advisory Scientific Committee to the European Systemic Risk Board also found [evidence](#) that large banks with 'universal' scope in activities (apart from lending to the real economy they engage in derivatives trading, securities, etc.) are more systemically risky. The report argues that the average social cost of large universal banks outweighs any benefits and as such the current structure of the EU banking sector appears to be socially harmful.

The creditors of TBTF institutions accept lower compensation for being exposed to risks than in the case of other banks, because they expect state bail-outs if the institution gets into trouble. This created a competition-distorting funding advantage [estimated](#) by the Commission's Joint Research Centre (JRC), for a sample of large banks in the 2011-2012 period, to be €65-95 billion annually. The JRC also determined the existence of unintentional regulatory incentives which make banks prefer trading activities where they can earn higher returns per unit of minimum capital over traditional commercial activities (such as lending to firms and households).

A 2011 IMF Working Paper [suggests](#) that the participation of banks in risky and proprietary trading activities before the financial crisis was fundamental in causing financial distress (this is contrary to the banking sector figure which [claims](#) that proprietary trading was responsible for only 4% of losses from the financial crisis). The report finds that in the US and Europe, banks with large exposure to revenues from trading activities are more vulnerable to failure.<sup>5</sup> TBTF institutions tended to operate with thinner capital buffers, using complex business models and amassing systemic risks for the entire banking sector. Governments often perceived that bailing them out would be less costly than letting them close down, or restructuring their businesses.

A 2014 report from the IMF [argues](#) that the TBTF problem has likely intensified since the financial crisis. Large government interventions on the market after the collapse of Lehman Brothers in September 2008 sent a strong signal to the markets and reinforced incentives for banks to grow in size. Indeed, the ECB confirms that since 2010 (and in comparison with pre-crisis levels) market concentration has increased in both the euro area and the whole EU.

### Commission proposal

Since the beginning of the financial crisis, the EU and its Member States have launched a series of reforms to fundamentally overhaul the regulatory and supervisory framework of the financial sector. The Commission tasked a High-Level Expert Group (HLEG) chaired by Erkki Liikanen, Governor of the Bank of Finland, with examining whether additional reforms of banks' structures are necessary to reduce the probability and impact of bank failures. The HLEG recommended that proprietary trading, and

certain particularly risky trading activities (linked to securities and derivatives markets), are legally separated from deposit-taking and lending activities of the banking groups.<sup>6</sup>

Building on these recommendations and complementing the banking sector reforms already undertaken<sup>7</sup>, on 29 January 2014 the Commission proposed a [regulation](#) to improve the resilience of the banking sector. The accompanying [impact assessment](#) on the overall costs and benefits of structural banking reform detected the existence of significant implicit subsidies in relation to the size of banks and their level of interconnectedness.<sup>8</sup> The assessment recommended two models for separation. The first requires separation of proprietary trading activities from those related to deposit-taking; the ownership of entities doing one or the other must be entirely independent. The second model decouples the deposit-taking entity; it requires functional separation through the use of subsidiaries, but with tighter restrictions on intra-group links.

The main elements of the proposed regulation are:

- A ban on proprietary trading in financial instruments and commodities by a credit institution and entities within the same group (effective on 1 January 2017). The proposal would prohibit activities dedicated to taking financial positions for the purpose of generating own-account profit, when there is no connection to either client activity or to hedging (limiting or offsetting) the entity's risk. Banks covered by the ban will also be prohibited from owning or investing in hedge funds (or certificates/derivatives linked to these) or other entities engaged in proprietary trading.
- A new ability for national regulators to oblige banks to legally separate high-risk trading activities from core lending and deposit-taking activity if the former creates risks for the stability of the financial system (effective on 1 July 2018). Banks may be excused from separating activities if they can demonstrate to the supervisor that the risks generated are mitigated by other means and do not endanger the financial stability. Supervisory authorities will undertake regular systemic reviews of activities<sup>9</sup> where it is likely that proprietary trading will be carried out despite the prohibition.

The Commission estimates that these new rules will apply to only 29 of over 8 000 European banks; the affected banks, however; hold a total of 65% of EU banking assets. The rules will cover the largest and most complex banks, those considered to be of global systemic importance and engaged in significant trading activities. To fall under the rules, banks would have to exceed, for three consecutive years, the threshold of €30 billion in total assets, and their total trading assets and liabilities would have to constitute more than €70 billion or more than 10% of their total assets.

#### **Regulating shadow banking**

Shadow banking can be defined as a system of credit intermediation that involves entities and activities outside the regular banking system. Shadow banks (financial intermediaries such as hedge funds, investment banks and other securities operators) are not regulated like banks, though their operations are like those of banks, and their global assets are about half the size of those of the regulated banking sector. The October 2014 Global Financial Stability Report by the IMF [states](#) that tightening of banking regulations encourages such less-regulated non-banking activities.<sup>10</sup> In order to prevent banks from shifting some of their activities to the shadow banking sector just to circumvent new structural reform rules, EU proposals to reform the banking sector are accompanied by a proposal to improve the transparency of shadow banking.

The proposed regulation would make it mandatory to report all transactions to a central database so that the financial stability risks can be monitored by supervisors. It would also oblige fund managers to be transparent by providing to their investors detailed cyclical reports

on the operations which use investors' funds. Finally, it would require that so-called rehypothecation activities (the re-use by an institution, for its own purposes, of securities pledged to it as collateral by their owner) be covered by a contract with the owner.

The proposed banking structure reform will apply to EU credit institutions and their EU parents, subsidiaries and branches, including those in third countries. It will likewise apply to EU branches and subsidiaries of banks established in third countries.

### International context

Legislation on structural reforms of banks has been developed in the US, UK, France Germany and Belgium (Denmark and the Netherlands are considering measures). The US **Volcker Rule** prohibits banks from engaging in proprietary trading (defined more widely than in the Commission proposal) and investing in hedge funds and private equity funds. It covers all US financial groups containing insured depository institutions and foreign banks with a US branch or agency (with certain exemptions). Compared to the Commission's proposal, Volcker's scope is wider in terms of institutions and activities covered. It is too early to assess its effects on the banking industry (the rule became effective in April 2014 but until 21 July 2015 no penalties for non-compliance will be imposed), however first [assessments](#) point to implementation difficulties due to lack of [clarity](#) in defining the scope of activities covered, since they overlap and often very difficult to differentiate (a challenge also recognised by the Commission).

The UK based its legislation on the **Vickers Report**. This recommended ring-fencing (creating different subsidiaries) retail banking and investment-banking activities in all institutions accepting deposits (at least £25 billion worth) and other payments, as well as facilities for money withdrawal and overdraft (some types of entities are excepted). The Vickers model is conceptually similar to the Liikanen report, using separation rather than prohibition. It will come into force in January 2019. France and Germany have also passed legislation which requires the separation of proprietary trading from deposit-taking activity to be effective in July 2015 and 2016 respectively. These two proposals are broadly similar and seem to offer more flexibility to the banking sector than the Commission's proposal, as they offer some exceptions and allow retail arms to engage in market-making (subject to conditions or thresholds). Banks from all three countries may be exempted from EU legislation if the Commission assesses they are subject to national regimes meeting similar standards.

Some [analysts](#) claim that this proliferation of uncoordinated national reforms poses a threat to the correct functioning of the single market and creates uncertainty for banks. Also, many commentators stress that the implementing legislation will be crucial for further clarification, and as such the possible effects of the reforms are hard to predict.

### Stakeholder views

Formal stakeholder consultation by the Commission highlighted the division of opinion, with banks overwhelmingly against the proposal, and consumers and non-bank financial companies<sup>11</sup> largely in favour. Corporate customers of banks recognised the need to address the TBTF problem but opposed the proposal due to concerns about its negative impact on the cost of financing. Some cooperative banks, consumer associations, non-bank financial companies, and public authorities were in favour of the inclusion of smaller banks and the shadow banking sector in the proposal.

Proponents of structural reform argue that after the separation of trading activities funding of these activities will reflect the inherent riskiness rather than expectations of

implicit subsidies, and the incentive to excessively expand such activities will be weakened. In effect it may therefore limit balance-sheet growth and restore market discipline. They also suggest that a simpler organisational structure will allow for more efficient regulation and supervision of financial markets.

The [European Economic and Social Committee](#) strongly supported the proposal and considered it the most crucial of all the financial sector reforms pursued since the crisis. However, the Committee argued that more consideration should have been given to the impact of the proposed legislation on jobs and that there are serious concerns that its costs will be passed on to employees, resulting in banking job cuts.

Many non-profit organisations argue that the proposal is significantly weaker than the Liikanen report, that it comes too late and that it offers only watered down measures. They doubt whether the narrow definition of proprietary trading applied will solve the TBTF problem, and [change the structure](#) of the banking industry. They also see [weakness](#) in the provision that the competent authority has discretion over the separation decision as it gives room to large banks, and governments of Member States who support the creation of European champions in banking, to influence their decision.

On the other hand, opponents of the reform argue that structural reform will in fact reduce financial stability, as homogenous banks will not be able to diversify operations and risks, and hence will be less resilient. Furthermore, after the reform, single large banks may still collapse causing reputational contagion. Given the large size of the separated entities, they may still need to be bailed out if a crisis reoccurs. Other negative consequences may include weakening some of the benefits of the universal banking business model (such as economies of scale), making bank borrowing and lending more difficult and more expensive, and creating competitive disadvantage for EU banking groups relative to global competitors.

Among the banks' arguments<sup>12</sup> is that there is no need for further regulation as the financial laws already passed address the TBTF problem. The focus should therefore be shifted to implementing the recent laws. They consider the impact assessment to be weak and that it does not demonstrate the need for structural separation. Instead they call on the Commission to carry out an impact assessment analysing the cumulative effects of the recent reforms on the banking sector. Furthermore, they argue that the proposal will reduce liquidity on markets and in many assets, the costs of which are likely to be passed to end-users and negatively affect the financing of the real economy.

According to [observers](#), at least 10 Member States (including Germany, France, Spain, Poland and Denmark) oppose the reform on the grounds that supervisors do not have enough room for manoeuvre when deciding on separation, and that the scope of covered activities is too wide (particularly inclusion of the market-making activities). France and Germany question the need for the new EU rules since they have already undertaken similar domestic reforms. Some [analysts](#) predict that resistance from the

#### European Parliament

In a [resolution of 3 July 2013](#), the EP supported decoupling of riskier trading activities from more conservative lending. It called for separation of the sources of funding for, and the balance sheets of, retail and investment activities, and the prevention of capital shifting between the two. MEPs also called for reducing excessive risks, safeguarding of competition, and reducing the complexity and interconnectedness of banks. The EP asked for the new rules to ensure that retail activities are not negatively affected by the investment arms of banks, and that implicit subsidies or guarantees, bailouts or use of insured deposits do not encourage risky trading and investment activities.

banking sector and those Member States which have already introduced national reforms is likely to delay implementation of the new rules indefinitely.

## Main references

[European Financial Stability and Integration Report](#), European Commission, April 2013.

[Systemically Important or 'Too Big to Fail' Financial Institutions](#), Congressional Research Service, September 2014.

[High-level Expert Group on reforming the structure of the EU banking sector](#), High-Level Expert Group chaired by Erkki Liikanen, 2 October 2012.

## Endnote

- <sup>1</sup> It is also meant to cover institutions that are too important to fail, too interconnected to fail and too complex to fail. For details see Chapter 3 of the EC's [European Financial Stability and Integration Report](#), April 2013.
- <sup>2</sup> The Liikanen report notes that main bank failures occurred due to over-reliance on short-term wholesale funding, excessive leverage and trading/derivative/market activity, poor lending decisions or weak corporate governance.
- <sup>3</sup> Formal liquidation cases included Fionia Bank (DK), Roskilde Bank (DK), EIK (DK), Amagerbanken (DK), Kaupthing Bank (FI, LU), Anglo Irish (IE), and Bradford & Bingley (UK).
- <sup>4</sup> For details see e.g. Chapter 3 of IMF Global Financial Stability [Report](#) 2014, Deutsche Bundesbank Discussion Paper No 33/2012 '[Which Banks are more risky?](#)' or Federal Reserve Bank of New York's 2014 Economic Policy Review Volume 20 Number 20 '[Large and complex banks](#)'.
- <sup>5</sup> This is the case for US and European banks, but does not seem to be so for Asian ones. This could be explained by regional effects such as the different economic cycle in Asia, and different quality of assets and earnings. Nevertheless the paper says that the hypothesis that trading was largely responsible for the financial crisis is therefore conditional and requires further assessment of other possible factors.
- <sup>6</sup> The other recommendations included that recovery and resolution plans may require separation of additional activities, that the 'bail-in' (banks' creditors funds) are used for banks' resolution, further reviews of capital requirements and measures strengthening the governance and control of the banks.
- <sup>7</sup> Other reforms to the same end include reinforcing banks' solvency (Capital Requirements Regulation and Directive, CRR/CRDIV); ending banks 'bail-in' paradigm (the Bank Recovery and Resolution Directive, BRRD); enhanced deposit guarantees (revised Deposit Guarantee Schemes directive, DGS); addressing the risks of derivatives and improving market infrastructures (European Market Infrastructure Regulation, EMIR, and revisions to the Markets in Financial Instruments Directive, MiFID). Furthermore, the Commission has launched a Banking Union, including the single rule book for all EU banks, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).
- <sup>8</sup> The Ex-Ante Impact Assessment Unit of the European Parliamentary Research Service carried out an initial [appraisal](#) of the impact assessment finding it in general a useful tool for policy makers but nevertheless drawing attention to some minor shortcomings.
- <sup>9</sup> These include market-making, investment in/sponsoring of securitisation and trading of certain derivatives.
- <sup>10</sup> Shadow banking is dealt with in the international context with the Financial Stability Board monitoring the trends and producing policy recommendations endorsed by the G20 Leaders.
- <sup>11</sup> Some have also argued that the proposal [contradicts](#) other legislation already approved (e.g. EMIR).
- <sup>12</sup> See e.g. positions of [European Banking Federation](#), [European Savings and Retail Banking Group](#), [Association for Financial Markets in Europe](#) or [European Association of Co-operative Banks](#).

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