Structural Reform of Banks’ Business Models

Key Considerations

Context

Following the 2008-09 global financial crisis, we have seen regulators trending towards a more protective approach to ring-fencing capital and liquidity.\(^1\) This trend, in conjunction with proposals on structural reform, risks to further divide up bank operations artificially on not only geographic but also functional (e.g. wholesale vs. retail) lines.

The OECD Secretariat is increasingly active in international discussions on the structural reform of banks’ business models. We note that the G20 Leaders’ Statement in St. Petersburg in September 2013 encouraged the OECD to work with the Financial Stability Board (FSB) in this area. We also note OECD Secretariat recommendations included in the emerging recommendations of the OECD New Approaches to Economic Challenges (NAEC) report to Ministers.

In this context, BIAC wishes to hereby contribute perspectives from the finance and non-finance sectors of the OECD business community which we believe merit significant attention in OECD work in this area. We call for independent analysis of any proposed regulations on restructuring banks’ business models, demonstrating the costs and benefits, and taking into account the impacts of the current reform programmes once fully implemented.

The reasons for structural reform of banks’ business models: How valid are they?

The roots of the 2008 global financial crisis were complex. In the context of discussions on reforming banks’ business models, we encourage the OECD and policymakers to bear in mind that:

- The underlying cause of the crisis was an unsustainable boom in lending to homeowners and not complex trading instruments, although excesses in certain instruments contributed to the crisis (excesses that have largely been corrected...

\(^1\) Such is the case with the US Foreign Banking Organisation proposals (e.g. Rule 165), the UK government as well as countries like Singapore and India requiring the incorporation of foreign bank operations.
pursuant to the G20 regulatory agenda). The view that trading activities are the principal source of risk is therefore misguided.

- Both retail and investment banks were affected by different failures in the 2008-09 global financial and economic crises.
- It is highly debatable whether there are any causal relationships between universal or other bank structures and bank failure, or between bank separation and financial stability: so far, there is no credible, scientific analysis to make any such showing. In fact, the majority of banks that failed or needed to be rescued as a consequence of the 2008 financial crisis were banks that did not have a diversified business model.
- Banking groups with ring-fenced trading entities would not automatically be regarded as more creditworthy, particularly as they may experience a loss in diversification benefits as a result of ring-fencing. Moreover, extensive ring-fencing, whether functionally or geographically, would result in a substantial net reduction in the efficiency of deployment of capital and liquidity in a global economic system.
- In some cases, problems were caused by the impact of sovereign debt defaults on banks’ balance sheets, as well as the impact of government policies on growth.

These important considerations mean that it is challenging to determine further measures to help prevent future crises, and suggest that overly-simplistic measures should not be adopted on the basis of a priori arguments without substantial empirical evidence. Stakeholders in the financial system would be better served if advocates of structural reform were to provide greater clarity on why such measures are needed on top of the foundational regulatory, supervisory, risk-management, and governance changes that have already occurred, and how they complement (and complete) each other, particularly showing how their combination impacts the overall economy. Hence, close consultation with the financial industry as well as the broader business community users of financial services should be encouraged in order to take into account specific needs of different actors.

The unintended consequences of structural reform of banks’ business models

While intended to bolster financial stability, the structural separation of universal banks could lead to numerous side-effects that should be taken into careful consideration. Specifically, we wish to highlight the following possible consequences:

- **A greater concentration of risk, less investment and less growth in the “real” economy**
  Structurally-separated retail banks would likely not be able to provide the full range of products that many SMEs need to effectively manage their risks. It is vital to consider that not all trading activities are speculative; indeed, in most firms the majority of such

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2 Changes in capital, liquidity, governance, disclosure and conduct regulations that are in course of finalisation and implementation will already cause changes in firms and markets – changes that should not be underestimated and hence would gain by full assessment ahead of final implementation. Moreover, dramatic enhancements in supervision of the largest firms, complemented by extensive new reporting and transparency requirements, as well as new thinking about macroprudential risks, need to be considered. Although not all resolution measures are as yet in place, significant changes in the major markets, as well as forthcoming additional work by the FSB, have already given assurances that major firms could be resolved.
activities are conducted to provide crucial services for corporate clients such as services on equity markets, foreign exchange markets, corporate debt markets, services in hedging, and services that facilitate the access of medium-sized enterprises to international markets, while another portion of trading activities serves to mitigate and hedge the positions that result from client transactions, or to stabilise or initiate price-setting processes for client transactions.

One of the likely outcomes of structural separation is that some SMEs will either no longer be able to access these financial products or may have to pay a substantially higher price to do so. This could inadvertently lead to a riskier SME sector due to SMEs’ being disincentivised by pricing and availability of products to properly manage and mitigate their risks, meaning that the business impact of any future market volatility could be amplified. It could also lead to business investment and exports being discouraged, as an SME would be less likely to succeed in exporting a new manufactured product to a new market if it cannot adequately manage its commodity risk relating to the raw materials used in the production of the product, or its currency risk relating to the sale of the product overseas and the repatriation of revenue. In short, structural separation intended to bolster the prudential stability of banks may unintendedly stifle the growth of SMEs and deter new business activity.

From a broader point of view, functional and geographic ring-fencing could constrain the efficient deployment of capital and liquidity resources needed globally, either to meet businesses’ needs or to respond to emerging economic challenges. This is because multiple fenced-off entities would need much more capital and liquidity resources in aggregate than global groups to meet the new capital and liquidity requirements (the basic provisions of which are not disputed), subsequently limiting the efficient reallocation of resources.

- **Banks are now more resolvable**
  Now, with recovery and resolution reforms having already been implemented in a number of jurisdictions, banks will be held accountable to prove and ensure their resolvability while creditors will be requiring a higher premium on new bail-in instruments, and the most appropriate means for assuring sufficient levels of bail-in-able instruments are now under debate in the official sector. Arguably, the need for structural separation is therefore substantially weaker as bank resolvability has been improved since the introduction of recovery and resolution measures, and depositors will be protected as new investors step in to purchase bail-in instruments with a higher premium which is reflective of their level in risk in the creditor hierarchy.

- **Greater concentrations of risk in the banking sector**
  The argument that the failure of large global banks poses a threat to the stability of the global financial system ignores the fact that a number of large globally active banks in fact proved to better-equipped to weather the stresses of the global financial crisis, and smaller domestic banks had limited recourse to international capital markets or funding and in turn were more seriously impacted. Larger banks with a broader geographic reach, a more diversified income structure but also activities in both the retail and
wholesale investment space, found themselves to be more diversified and ultimately more resilient.

Universal banking models work to benefit from their access to global financial markets in order to diversify risks. A structural separation could, among others, lead to concentration of risks in retail banks on the one hand and in trading entities on the other. The concentration is both on the assets and on the liabilities’ side. For example, what happens to retail banks if there is abundant or, on the contrary, insufficient deposit funding available, and what happens to trading entities if there is not enough investor appetite for long-term debt given lower estimated return on equity? Ring-fencing of trading activities could ultimately lead to a greater concentration of risk and trapped pools of liquidity in the retail/wholesale space. This could lead to short-termist behaviours as banks and actors in the financial sector are less able to see through business cycles.

Furthermore, retail banks seeking to diversify their risk may be urged to purchase risk management services from external parties (as opposed to in-house services in the universal model), which in turn could lead to new counterparty risks and operational complexities in the system.

It is also possible that liquidity could become trapped in retail banks if their ability to make the most productive use of deposits is restricted by structural requirements (on top of the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements that will apply to all banks. This would be an issue especially in countries where deposits are abundant, and thus where banks might even have to make distinctions between more and less desirable deposits. Conversely, if structural separation were applied in countries that for market reasons tend to be short of deposits, the retail model could have to be changed dramatically to remain viable. Under either scenario (or depending on specific restrictions on top of the existing Basel and other requirements), it could become difficult for retail banks to provide attractive investment opportunities for some clients, resulting in inefficiencies and under-funding of productive economics actors/investments.

The fact that both parts of what are now universal banking groups (investment and retail banking parts) will be constrained in their funding source options may mean that they are more brittle in periods of stress.

- **Ability of banks to achieve synergies between wholesale/retail operations**

Banks naturally derive a certain degree of economies of scale from being able to efficiently stream funding between retail and wholesale operations and effectively achieve synergies across these operations. With the cost of funding for banks already much higher due to the raft of regulatory reforms (e.g. capital and liquidity, recovery and resolution, derivatives regulation, etc., however justifiable the basic post-crisis programme may be), further restrictions on synergies could put further pressure on banks’ balance sheets and therefore constrain funding to the rest of the economy. This may occur not only through classic lending channels, but also through market
channels, because of the substantially increased costs of participation in short-term equities and other markets, quite apart from any direct restrictions on proprietary trading.

- **Banking diversity**
  The majority of proposals on structural separation have failed to take into consideration that the global financial system is comprised of a diverse pool of banking models and that therefore a 'one size fits all' solution is not appropriate. In particular, the archipelago model, where the bank in question is a group made up of separately-capitalised legal entities which are independently resolvable through the multiple point of entry (MPE) model, has not been adequately considered. There is merit to both this structure as well as integrated structures resolvable through single point of entry (SPE) models, and the resolution strategy for each is different. Regulators should take these differences into account and ensure that legislation is flexible enough to recognise the structure and the resolvability of the firm in question. Why any further structural requirements would be helpful has not been demonstrated.

Furthermore, the separation of banks along functional lines through one legislative formula could lead to a banking industry with homogenous business models, making it more vulnerable and potentially undermining the intention to create a more robust financial sector.

- **International consistency**
  As different jurisdictions roll out their own versions of structural separation (US Volcker rule, UK Vickers report, separate French and German legislation on structural separation, and the European Commission proposals to implement the Liikanen report), a number of inconsistencies are emerging. For instance, the definition of market-making is understood very differently in each jurisdiction, the choice of whether to ring-fence retail or trading activities differs (and indeed the choice of what constitutes the latter also differs), and the decision whether to provide exemptions for national sovereign debt while excluding 3rd country debt varies. Such inconsistency ultimately makes for an un-level playing field which introduces significant disruptions to the smooth functioning of the banking sector and the provision of finance to corporates, pensions/insurance intermediaries and clients. As already noted, it could make international markets less productive and more brittle by interfering with the natural deployment of capital and liquidity in response to needs and opportunities.

- **Emphasis on alternative financing for corporates**
  Policymakers are increasingly recognising the need to transition from what has traditionally been a predominantly bank-funded business model of corporates, notably in Europe, to a model driven more by capital markets. Any move to introduce structural reform needs to be analysed with careful attention to the role of banks in markets. Existing Basel capital and liquidity requirements will already profoundly affect the incentives of banks to participate in such markets, and many have argued that such requirements, while increasing the resilience of banks, are likely to make markets themselves more volatile and less deep. Further restrictions in the form of structural requirements could impinge on the ability to carry out a smooth and orderly transition
as universal banks would be less able to carry out their controlled maturity transformation function using transfer pricing processes as efficiently or effectively. The access of any type of banks is of course unknowable at this stage, but could be constricted, further hampering the transition. This could further impede the potential for much-needed alternative sources of financing for growth, including for smaller companies which could encounter struggle to access capital markets.

- **Competitive distortions**
  The structural reform of banks’ business models is being pursued by some jurisdictions but not others. Moreover, there is significant inconsistency in regulatory approaches between different jurisdictions (for instance, US, UK, German and French recent laws and the latest European Commission proposal). In particular the separation of market-making activities proposed by the European Commission would create a significant competitive distortion relative to non-EU regimes, such as the Volcker rule, which provide exemptions for market-making and other client-facing activities. Lastly, the majority of proposals are geared towards including solely banks with large trading operations.

Such international and other inconsistencies would likely lead to competitive distortions. This could be particularly troublesome in Europe, where universal banking funds a large part of the economy. Export-oriented European businesses are particularly likely to be affected by a separation of banking activities, because apart from requesting loans, these companies could face a more limited choice of advanced financial products for their activities and thus may be less able to benefit from financial innovation.

Furthermore, in Europe, the implementation of the Banking Union (asset quality review and stress tests) currently underway could result in EU banks having to raise capital from the private sector later in 2014, a task made far more difficult by the uncertainty that would be created by these new structural reforms.

- **Difficulties in implementation**
  Exactly how the structural separation of banking activities would be implemented in practice is not clear and the difficulties to agree on a common global standard underline the complexity of such a requirement. In addition to differing views about which market-making activities should be ring-fenced or not, structural separation also comes at significant costs. The costs in terms of setting up new legal entities, the costs of separation (including re-documentation for thousands of Know-Your-Client contracts) and operational costs could prove to be too massive for some banks to bear. Furthermore, if a large number of major banks were to engage in this restructuring at the same time, there could be a significant disruptive impact in markets and economies.

  Given the higher funding and operational cost, scale will be required to make the segregated entities economically viable. This generates even more concentration, especially of trading activities. The likely result may well be oligopolistic trading
markets with pricing and other consequences for the issuance and placement of long
term debt by corporates and sovereigns.

- **Cumulative side-effects**
  Measures to structurally reform banks’ business models should not be considered in
  isolation from the myriad other financial regulatory measures being proposed and
  introduced since the 2008-09 global financial and economic crises (prudential rules,
  bank resolution, derivative market rules, the new banking union in the EU, etc.). The
  cumulative impacts of these various measures being introduced at the same time,
  which either diverge from or gold-plate the internationally agreed regulatory
  programme, could significantly dampen economic growth.

**Directions for more balanced financial regulatory approaches**

BIAC calls for any regulations on restructuring banks’ business models to be supported by a
strong independent analysis, demonstrating the costs and benefits, and taking into account
the impacts of the current reform programmes once fully implemented. The time is now past
when radical measures can be justified by examining pre-crisis conditions alone. Any new
requirements should be supported by independent analysis demonstrating the measures to
be necessary after considering the trade-offs that must be confronted. Moreover, any new
requirements should be clear, designed in co-operation with the private sector, and
harmoniously implemented for a genuinely level playing field within an appropriate time
horizon. Crucially, this calls for due emphasis on risk management, including liquidity
management and capital planning, where efforts should be directed on improving the quality
of supervision in jurisdictions.

We strongly recommend the OECD to take the above considerations into account when
developing its advice on the structural separation of banking activities. More generally, there
needs to be greater balance between financial stability, economic growth and the investment
environment. A comprehensive view is needed that takes into account not only structural
reform of banks’ business models, but also the multiple other regulatory measures being
phased in, and which also considers not only the possible impacts upon the finance sector,
but also the knock-on impacts for the non-financial sectors of the economy.