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Agenda

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Don't run before you can walk: EU banking reform and the need for economic analysis

In February 2012, European Commissioner, Michel Barnier, appointed a 'High-level Expert Group' to make recommendations on reforms to the structure of the EU banking sector to strengthen financial stability and market functioning. Dr Luis Correia da Silva, Oxera Managing Director, discusses how there is as yet a lack of fundamental economic analysis to inform such recommendations, in terms of both whether structural reform is required and what shape it might take

The 'Liikanen Group',[1] as the High-level Expert Group is known, has been asked to consider whether there is a need for structural reforms to the EU banking sector, and to make proposals for establishing a safe, stable and efficient banking system. The group has been asked to consider existing proposals for structural reform in other countries, including the recommendations of the Independent Commission on Banking in the UK (which have now been adopted in a UK government White Paper[2]) and policies proposed in the USA, including the Volcker Rule and other elements of the Dodd–Frank Act (as discussed below).

While there are proposals for structural reform in other countries, in order to determine whether such reform is needed for the EU banking sector it is vital to identify both the source and the size of the problem that structural reform seeks to address. The structure of the banking sector varies considerably among the EU Member States, and there is a divergence of opinion on how banks should be regulated. Systematic and fundamental economic analysis of the costs and benefits of structural reform should be conducted for the EU banking sector before firm conclusions can be drawn.

Some key issues arising from the debate are summarised in this article. They provide a basis for identifying the fundamental economic analysis that is required by the Liikanen Group in order to draw firm conclusions about the need for structural reform in the EU banking sector.

The wider regulatory context

Structural reform refers to possible changes to the organisational structures of banks. These have been required by the regulatory regime, primarily with the aim of reducing the risk of a major financial crisis such as that which has continued to affect the European banking sector since 2007.


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Structural reform is, of course, only a small part of a much wider regulatory jigsaw, which has seen considerable development at both the global and EU level.

One development, Basel III,[3] is the latest global regulatory standard on bank capital adequacy, stress-testing and market liquidity risk. It raises minimum capital levels, increases the ratio of equity to risk-weighted assets, and tightens the definition of core tier one capital. In addition, a new countercyclical capital buffer and a leverage ratio requirement are due to be introduced following the initial supervisory monitoring periods. There is the possibility of further change resulting from the fundamental review of the trading book capital rules.

A number of other measures at the European level to reform financial markets and the supervisory architecture of those financial markets include:

- enhancing transparency;
- effective supervision and enforcement;
- enhancing resilience and the stability of the financial sector; and
- strengthening responsibility and consumer protection.

Within this wider context of regulation, the need for additional structural reform should not be taken for granted. Indeed, structural reform could potentially fail to complement existing regulatory policies and proposals. For example, a Commission of Experts appointed by the Swiss authorities noted that structural separation measures would limit the economies of scale enjoyed by banking groups, and possibly exacerbate pressures to rescue non-Swiss subsidiaries, concluding that:

> For all these reasons, no specific structural measures are recommended by the Commission for systemically important banks.[4]

Structural reforms proposed in other countries

In the UK and USA some measures have been proposed that would be explicitly taken at the institutional level. In the USA, The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the 'Dodd–Frank Act') is a comprehensive package of financial regulatory reform in the USA that is intended:

> To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.[5]

Conceptually, restricting banks' operations to a manageable size could be seen to solve a host of problems that have been associated with the present crisis—absolute size limits might mitigate the problems of 'too big to manage', 'too big to supervise' and 'too big to fail'. Practically, however, it looks as if the Dodd–Frank Act will not do much to reduce existing bank size, and therefore would not do much to address the market failures currently associated with large (or 'too-big-to-fail') banking institutions. Section 622 of the Act merely proposes concentration limits to restrain future growth through acquisition, while Section 123 calls for a regular study of what the impact of introducing size limits would be—it does not require that such limits actually be introduced.

The Volcker Rule is a specific section of the Dodd–Frank Act (Section 619).[6] It specifies a complex set of rules, restraining financial firms' proprietary trading activities, and their ownership stakes in alternative asset management vehicles. The Rule has two main activity prohibitions:

- a prohibition on proprietary trading—with certain exemptions for activities such as market-making and the hedging of government securities; and
- a prohibition on investing in hedge funds and private equity funds.

The Volcker Rule is intended to add something beyond increased capital requirements in providing a specific response to specific market failures in the USA banking sector. It was emphasised that investment banks that engage in speculative proprietary trading should not be designated as banks and eligible for government support, because moral hazard could induce excessive risk-taking.

The Rule has generated a flurry of responses from the industry, and even from regulators outside the USA, which have raised concerns about the impact on market liquidity. If financial institutions trade less because of the prohibition on proprietary trading then the markets that they trade in may suffer from lower trading volumes and lower liquidity, and hence higher costs of transacting. It is also feared that banks may migrate market-making activities outside the regulated banking sector and thereby undermine financial stability.

In the UK, the Independent Commission on Banking (ICB) recommended, among other reforms, the ring-fencing of the retail activities of UK banks. For the structure and activities undertaken by retail banks, this means the following:[7]

- retail banking activities should be structurally separated, by a ring fence, from wholesale and investment banking activities. Ring-fenced banks should be self-standing, or subsidiary companies in wider banking groups, with their own capital requirements;
- only ring-fenced banks should supply the core domestic retail banking services (taking deposits from individuals and small and medium-sized enterprises and providing them with overdrafts);
- ring-fenced banks should not undertake trading or markets business, or trade in derivatives (other than hedging retail risks) or supply services to non-European customers, or supply services (other than payments services) that result in exposure to financial companies;
- some activities—such as lending to large domestic non-financial companies—are to be allowed on either side of the fence.

The ICB states that it has a threefold objective in introducing the retail ring-fencing reform.[8]

- To enhance the resolvability of banks—typically resolution requires the separation of different banking functions.

- To enhance the resilience of the financial system—by insulating essential activities (eg, deposit-holding) and reducing interconnectedness.
- To influence the government's, banks' and market's incentives—by curtailing implicit government guarantees, reducing the risk to the sovereign and making it less likely that banks will run excessive risks in the first place.

If structural reform can reduce the expectation of bail-outs (and therefore curtail the implicit government guarantee), it should improve incentives for creditors to discipline banks, which should mean that risky banks face higher funding rates (as creditors demand compensation for risk that is no longer borne by the taxpayer). These higher funding rates should, in turn, incentivise banks to be less risky and ultimately improve the efficiency of the allocation of capital in the economy.

Market failures in banking

The purpose of regulation of the EU banking sector is to address market failures that are perceived to be hampering the effective process of financial intermediation in Europe. With the recent financial crisis, there are many potential market failures that may need to be addressed. These market failures have been the topic of considerable political debate, as well as the focus of financial sector regulation. A discussion of the need for structural reform in the EU should begin with consideration of the potential market failures, and the current regulatory framework that exists to address them.

While the recent financial crisis has uncovered many possible market failures, it is difficult to be exhaustive about 'what went wrong?', given the time span over which the present economic and financial crisis has slowly evolved—from localised credit concerns over rising defaults in the US sub-prime market from mid-2007, up to the present point, where there remains considerable uncertainty surrounding banks' exposure to sovereign debt. The approach of Oxera is to explore how the many different issues can be summarised in an economic framework for market failures, which is summarised in Table 1 below.

Table 1 Market failures in banking that are often highlighted

Market failure	Examples
Negative externalities	**Coordination problems**: the maturity transformation role of banks—ie, converting short-term liabilities (eg, deposits available on demand) into long-term assets (eg, 25-year mortgages)—can create a problem of coordination (a liquidity crisis), which can make a sound bank fail **Contagion and systemic risk**: there is the danger of systemic risk owing to contagion from the failure of an entity, which may give rise to a strong negative externality for both the financial sector and the real sector of the economy
Asymmetric information	**Agency problems**: banks may in theory have excessive incentives to take risk in the presence of limited liability (for shareholders and managers) and moral hazard (non-observable risk on the asset side). This may be exacerbated by government guarantees to support the banking sector **Moral hazard and adverse selection**: banks face both adverse selection and moral hazard problems when lending, as they have limited information about risk. For example, in the money markets in early August 2007, lack of transparency about the extent of exposure to 'toxic' mortgage-backed assets prevented market participants from distinguishing good banks from bad banks, leading to a decline in market confidence
Inefficiencies in capital markets and pricing	**Inefficient liquidity provision**: financial markets have not provided liquidity effectively amid the crisis and central banks have repeatedly stepped in to provide liquidity to the banking system, as well as to individual institutions in difficulty. The basic problem is that banks can be reluctant to lend to other banks during times of crisis **Mispricing of assets and limits to arbitrage**: if markets are efficient, market prices can be trusted because they reflect asset fundamentals correctly. In the turmoil of the financial crisis, however, securities became mispriced and created 'toxic assets'
Lack of effective competition	**Acquisition of failing firms**: banks in difficulty have been absorbed by stronger banks (eg, Lloyds TSB acquired HBOS in the UK, JP Morgan absorbed Bear Stearns in the USA); this has reduced post-crisis competition in banking markets. Interventions under the European state aid rules have had to strike the difficult balance between allowing some banks to be supported and maintaining effective competition (with some measures actually constraining banks from trying to gain market share) **Barriers to entry**: switching costs (real or perceived) in products such as current accounts continue to be an issue in financial services markets, before and after the crisis
Market failure exacerbated by regulatory failure	**'Lender of last resort' and deposit insurance**: these are two of the basic instruments on which the stability of the banking system rests. However, through these instruments, blanket insurance can be perceived to be offered to banks and depositors according to the 'too-big-to-fail' phenomenon. This can create a moral hazard issue if bankers are encouraged to take on excessive risk **Insufficient supervision of 'shadow' banking**: in the years leading up to the crisis, there was significant growth in the 'shadow' banking system—ie, financial institutions outside the traditional banking system that provide very similar services

Source: Oxera.

Cost–benefit analysis

Analysis of market failures provides a framework for identifying the potential benefits of structural reform. However, to determine whether structural reform is appropriate, not only should the potential benefits be identified, but they should also be quantified and compared with the potential costs. This is cost–benefit analysis, which should be at the heart of this debate.

One area in which Oxera has been involved is the debate on the implicit subsidy provided to the banking sector through government guarantees.[9] In the UK press and other forums in 2010–11, there was significant discussion of the state support to the banking sector, often referring to estimates that the value of the annual subsidy to banks exceeds £100 billion (£55 billion), based on Bank of England estimates for 2009.[10] Oxera's own analysis showed that the annual value of state support is likely to be considerably lower, and can be expected to fall further once the existing reforms at industry and regulatory level have taken effect. The latest analysis from the Bank of England,[11] which contains extensive consideration of the Oxera analysis, suggest estimates for 2010 that vary between £30 billion and £120 billion.

From a policy-making perspective, it matters whether the source of the underlying problem is quantified as around £100 billion or a much lower value. Structural reform can create significant costs for banks, their customers and hence the whole economy. This important cost–benefit analysis is considered in the latest UK government White Paper on Banking Reform,[12] which makes a start at the cost–benefit analysis that is crucial for this debate.

However, the debate in Europe regarding possible options for EU wider structural reform also requires a fundamental analysis of the costs of the market failures, to allow comparison with the costs of different regulatory options, in order to assess whether new regulation should be introduced. There is an ongoing discussion of this trade-off in the UK. It is vital that the Liikanen Group also considers cost–benefit analysis.

Analysis of the EU banking sector

A fundamental economic analysis for Europe would necessarily be more complex than for the UK only, however, owing to the diverse nature of the EU banking sector. Nevertheless, this analysis is still required—perhaps more so—before any decision on structural reform can be made. What issues would need to be considered?

It should be noted that there are considerable differences in banking business models and market features—such as ownership, concentration, and lending ratios—across the EU Member States. These differences will constrain the adoption of 'one-size-fits-all' structural reform measures across the EU. For example:

- the universal or diversified banking model is popular in some countries, such as France or Switzerland, where large organisations provide retail, commercial and investment banking services;
- there are differences in the extent to which Member States have retail-oriented bank businesses as opposed to investment banking-oriented businesses. In general, the Eastern European and Nordic states have more 'traditional' or retail-focused business models in banking;
- there is a relative predominance of state ownership of banks in some Member States—for example, in several Eastern European states and in Germany (eg, landesbanken); and
- foreign subsidiaries are relatively predominant in Eastern Europe, whereas in other countries the banking sector is much more national and less connected through ownership (eg, Greece).

In general, banking sectors tend to be relatively larger for the countries with higher than average GDP per head, although certain countries (eg, the UK, Luxembourg) have much larger banking sectors than their economies would suggest, as they provide significant financial services to other countries.

In this context of considerable diversity, it might be argued that the specific structural reform options applied elsewhere are not applicable in the EU. For example, the Dodd–Frank Section 622 proposals for concentration limits may hinder an objective of greater financial integration in the EU. The Volcker Rule on activity prohibition may be seen as undermining the diversification benefits from universal banking, and similar arguments may obtain against activity separation as per the ICB proposal to ring-fence retail operations.

Concluding remarks

It is important to avoid any disconnect between the policies or rules that are being considered and the underlying problems in the market. There is a pressing need for fundamental economic analysis to support policy recommendations for structural reform at the EU level. The debate on structural reform needs to include, at the very least, a consideration of what problems are being addressed and how big they are. Regulation should be focused on those areas where markets fail to deliver efficient outcomes. For intervention to be successful, this requires an assessment of the full costs and benefits of reform proposals.

Dr Luis Correia da Silva

Luis Correia da Silva joined Oxera as a Senior Consultant in 1996. He considers Oxera's greatest achievement to be the fact that it has managed, over the past 30 years, to hold on to and adhere to its original values, independence and company mission.

He says: '30 years ago, I was spending my time on a football pitch, playing football and dreaming of becoming a great footballer. Now I spend my spare time on a football pitch, coaching football and dreaming of finding a great footballer.'

[1] Named after Erkki Liikanen, Governor of the Bank of Finland and a former member of the European Commission, who was commissioned to chair the group.
[2] Department for Business Innovation and Skills (2012), 'Banking Reform: Delivering Stability and Supporting a Sustainable Economy', June.
[3] This is the latest of the Basel Accords, as agreed by the Basel Committee on Banking Supervision in 2010–11, which includes central bank governors from numerous leading economies.
[4] Swiss Commission of Experts (2010), 'Final Report of the Commission of Experts for Limiting the Economic Risks posed by Large Companies', September 30th, pp. 46–7.
[5] One Hundred Eleventh Congress of the United States of America (2010), 'Dodd-Frank Wall Street Reform and Consumer Protection Act', Washington, January 5th.
[6] The Rule remains under discussion and is not expected to be introduced in 2012.
[7] UK Independent Commission on Banking (2011), 'Final Report Publication, Opening Remarks, Sir John Vickers', September 12th, pp. 2–3.
[8] UK Independent Commission on Banking (2011), 'Final Report, Recommendations', September, pp. 24–5.
[9] See Oxera (2011), 'The Cost of Supporting the Banks: Lower than Expected?', *Agenda*, July.
[10] The estimates are provided in Haldane, A.G. (2010), 'The $100 billion Question', comments given at the Institute of Regulation.
[11] Bank of England (2012), 'The Implicit Subsidy of Banks', Financial Stability Paper No.15, May.
[12] Department for Business Innovation and Skills (2012), 'Banking Reform: Delivering Stability and Supporting a Sustainable Economy', June.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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