International reform proposals for splitting up banks

In the years leading up to the latest global financial crisis, the EU's banking sector grew substantially and had assets equivalent to 350 per cent of the EU's GDP by the start of 2008. In addition, several major financial institutions around the world changed the focus of their operations from traditional banking operations to operations with an increasing emphasis on trading in financial instruments. As the financial crisis has entailed major economic costs in several countries, comprehensive international reform and regulatory work has now been initiated. One proposed reform involves splitting up the banks into two clearly defined parts on the basis of those of the banks' activities that are deemed worth protecting in terms of their social benefits.

Banks provide several useful social functions as they convert savings into investments (credit intermediation), manage risk and mediate payments. These functions are central to the functioning and growth of the economy. However, certain banks also carry out other activities, such as trading in financial instruments on their own behalf (proprietary trading), which, strictly speaking, are more difficult to justify from a social perspective. The losses made by a bank from such activities may threaten the bank's survival and thereby also the useful social functions the bank contributes. This means that banking crises can result in social costs greatly exceeding those costs impacting the bank's shareholders. The idea of splitting up the banks' operations has grown from this background.

Traditional banking activities support trade in financial instruments

One problem that arises when traditional banking operations and trade in financial instruments are mixed is that the latter activity can be said to be supported by the former. This is because deposits from the general public provide the bank with stable and cheap funding, particularly as governments often guarantee deposits up to a certain amount (an explicit government guarantee). Furthermore, investors expect that, in a crisis, the government will not allow the bank to go bankrupt (an implicit government guarantee). These government guarantees give the bank as a whole lower funding costs than would otherwise have been the case. This may have resulted in the banks' own costs for trade in financial instruments becoming too low and may thus have led the banks to take greater risks than are optimal from the economy's point of view.

Splitting up the banks' operations can both ensure that the banks' trade in financial instruments is not funded by government-guaranteed deposits and isolate the risks so that they do not spill over into traditional banking operations. Advocates of splitting up the banks' operations also claim that this would simplify supervision

of the banks and make it easier, in a future crisis, to allow the operations not worth protecting to go bankrupt, as they would already have been separated from the operations worth protecting.

The banks may carry out trade in financial instruments either on their own behalf (proprietary trading) or on their customers' behalf (market making). A market participant (for example a pension company) can turn to a market maker to purchase or sell an instrument. The market maker ensures that the market is liquid and that trading can take place smoothly. Proprietary trading and market making are closely related, and there is, in practice, no simple way of separating them. There are also diverging views on whether market making by the banks should be seen as worth protecting, which is reflected by the various reform proposals.

Reform proposals

The idea of separating traditional banking operations from other operations arose as long ago as the 1930s, when the Glass-Steagall Act entered into force in the United States. According to this Act, banks could engage in either traditional banking operations or investment banking operations, but not both at the same time. The Act was repealed in 1999 to help US banks compete globally. Since the law was repealed, many US banks have again moved beyond traditional banking operations into higher-risk operations involving trade in various financial instruments.

In the wake of the crisis, proposals for a split have again been raised in the United States. Similar proposals have also been put forward in individual European countries. On the EU level, a proposal has been presented by the Liikanen group.

The United States introduces the Volcker Rule

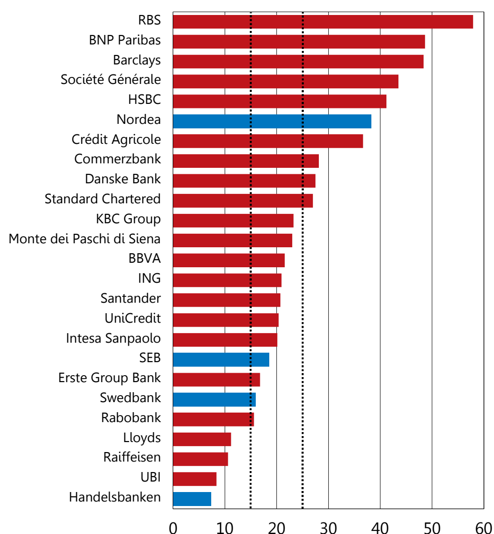
The United States has decided to introduce the much-debated Volcker Rule. The Volcker Rule stipulates that banks accepting deposits are prohibited from conducting proprietary trading on the group level. However, they may carry out transactions for customers, which includes the banks' activities as market maker. At present, the US authorities are working on developing proposals for how to separate proprietary trading from the banks' market making activities, so that the Volcker Rule can be implemented in practice.

Europe prefers a compromise

Instead of a US-style prohibition, applied on the group level, the European reforms propose a compromise in which those banking operations not deemed to be worth protecting can still be conducted within the same banking group, but in a separate legal entity clearly separated from other banking operations.

These different parts are to be economically independent, separately run and easily distinguishable. They are also to comply with applicable capital requirements and liquidity regulations by

Chart B2:1. European banks' held-for-trading assets and available-for-sale assets as a proportion of total assets
December 2011, Per cent



Source: SNL Financial

themselves. To ensure that the operations not worth protecting are completely separate from the other operations, it is proposed that integrated banking groups assume the form of a holding company. The various European proposed reforms are described in more detail below.

United Kingdom

In the autumn of 2011, an independent banking commission proposed that larger banks should place their traditional banking operations into a separate legal entity. It is thus the operations worth protecting that are to be separated, according to the British proposal.

The separated company may provide what are known as obligatory services. These services include receiving deposits and providing overdrafts. On the other hand, the separated company may not provide what are known as forbidden services, including acting as a market maker. Neither may they offer their services to customers outside the EEA.

The European Union - the Liikanen Report

In October 2012, the Liikanen Group presented its report, which includes the recommendation that larger banks within the EU be obliged to place activities not worth protecting in a separate legal entity.

The assessment of which banks are to be subject to the requirement for such a split is to be carried out in two stages. The first stage will examine which proportion of the banks' total assets is held for trading and which can be sold rapidly. If this proportion exceeds a threshold value suggested to range between 15 and 25 per cent of total assets, or if these assets amount to EUR 100 billion, the next stage will be entered. In the second stage, the supervisory authorities determine whether a split is justifiable.

According to the Liikanen Group's proposal, the results of the first stage of the assessment are reported in Chart B2:1, in which the Swedish banks are marked blue. According to the chart, a minimum of one and a maximum of three Swedish banks should proceed to the next stage of the assessment, depending on what is decided regarding the threshold value. The Liikanen Group is also open to there being a number of exceptions in the calculations in stage one as regards hedging against non-financial customers and other matters. Furthermore, it remains to be decided how the assessment in stage two will be made. It is thus difficult to say, at present, how the proposals in this part would actually affect the Swedish banks.

In addition, the Liikanen Group proposes that both a bank's proprietary trading and its market-making activities are to be included in the separated company. Its main argument for this is that separating these activities would be too difficult.

The European Commission has stated that it plans to produce a draft of the act, based on the Liikanen Group's proposal, in the third

quarter of 2013. At this point, the European Commission will also present an impact analysis of the proposal.

France and Germany

France and Germany launched their own reform proposals at the end of December 2012 and in February 2013 respectively. The French and German proposals are strongly inspired by the Liikanen Group. The main difference from the Liikanen Group's proposal is that the market maker side activities do not have to be placed in the separated company. However, in France, it will be completely forbidden to engage in certain types of high frequency trading and commodity speculation in agricultural products. In Germany, the German supervisory authority has instead been given a clear mandate to determine, on a case-by-case basis, whether a bank's market-making activities should not be considered to be worth protecting and should therefore be placed in the separated company. Table B2:1 below summarises the main parts in the various reform proposals.

Table B2:1. Comparison of the various reform proposals

	United States	**United Kingdom**	**Liikanen**	**France**	**Germany**
Holding companies with the various operational areas in subsidiaries	Not permitted	Permitted	Permitted	Permitted	Permitted
Deposit bank may conduct proprietary trading in securities and derivatives	Not permitted (exception for US government securities)	Not permitted	Not permitted	Not permitted	Not permitted
Deposit bank may act as market maker	Permitted	Not permitted	Not permitted	Permitted	Permitted
Geographical restrictions	No	Deposit banks face limits on customers outside the EEA	No	No	No
Maximum size for coverage	No	Yes, banks with more than GBP 25 billion in deposits (about 2–5 banks)	HFT+AFS >EUR 100 billion or >15–25% of balance sheet (about 15–20 banks)	HFT+AFS >EUR 100 billion or >20% of balance sheet (about 3 banks)	HFT+AFS >EUR 100 billion or >20% of balance sheet (about 2–4 banks)
Coming into force	2013–2014	2019	Not decided	July 2015	July 2015

Note. The deposit bank is the bank accepting deposits (that is not the company conducting proprietary trading). AFS (Available For Sale) denotes assets that can be sold rapidly, while HFT (Held For Trading) denotes assets intended for trade.

Sources: *Wholesale and investment banking outlook report*, 2013, Oliver Wyman & Morgan Stanley and the Riksbank.