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### Towards a safer banking system: Is splitting retail and investment banking the answer?

Dirk Schoenmaker, Duisenberg school of finance  
Casper de Vries, Duisenberg school of finance

#### **Abstract**

This policy brief underlines the need for banking reform to reduce risk-taking in the banking sector. We do not believe that splitting banks into retail and investment banks is the appropriate answer. In Europe, banks are much more important in financing corporates than in the US. A split will hamper the financing of households and corporates, while not solving the problem (reducing risk). We propose a system of higher capital requirements, prompt corrective action by supervisors, resolution plans to unwind large banks (when in difficulties) and ring-fencing of proprietary trading. In that way, the probability and costs of potential bailouts can be reduced for the taxpayer.

#### **Introduction**

Many Western governments, including the Dutch government, spent a large amount of public money to rescue the banks during the recent financial crisis. In response, a policy debate on the appropriate structure of the banking system has emerged. The objectives of banking reform are:

- (i) to establish a safe and stable banking system serving the needs of its customers (retail consumers and corporates); and
- (ii) to minimise the use of public money in future financial crises.

Following the recommendations of the Vickers Committee, the United Kingdom is preparing legislation to split banks into safe retail banks (with public insurance) and investment banks (without public insurance). Furthermore, the European Commissioner for Financial Services, Barnier, has announced to start a European debate on banking structure. In the US, the Volcker rule, which prohibits proprietary trading (trading for a bank's own risk and account), is being implemented.

Will splitting retail and investment banking be the answer? We argue not. An overall split will harm the financing of retail consumers and corporates by increasing the cost of banking without solving the problem. The so-called safe retail banks may in practice be less safe as their business would be restricted to retail consumers and possibly small and medium sized enterprises (SME). Both housing loans (the main component of consumer finance) and SME loans are risky. Housing price bubbles are at the root of most financial crises.

We argue that there is a case for ring-fencing proprietary trading with higher capital requirements for banks with public insurance. Moreover, we propose five additional measures to restrain risk in banking:

1. more equity capital in banks reducing the incentive to take excessive risks;
2. macro-prudential supervision to prevent/mitigate loose credit conditions fuelling asset price bubbles and undue reliance on wholesale funding;
3. prompt corrective action by supervisors, when problems emerge at banks;
4. resolution plans that allow supervisors to resolve systemically important banks at low costs; and
5. improving governance in order to foster a sound risk management culture.

### **Splitting banks is not the answer**

The main argument for splitting banks is as follows. Only the retail part is crucial for the economy and relatively safe, while the investment part may give rise to undue risky transactions for profit, sometimes even labelled casino banking. Public insurance (such as deposit insurance) should only be available for the first.

#### *Underlying assumption false*

Is that argument correct? No, only very partly. First, investment banking is also needed for basic financing needs of corporates. Corporates need to manage their financial risks, such as the interest rate risk of their funding and the foreign exchange risk of their business (in case they are importing and/or exporting). This is not only true for large corporates but also for SMEs. Banks are the counterparty to these financial transactions (trading and derivatives, such as interest rate or forex swaps) with corporates. Moreover, banks do financial transactions with each other to manage their own exposures.

Another banking function is helping corporates with their external finance. Corporates are not only financed by bank loans, but also by equity and bonds. Underwriting equity and bonds is a typical investment banking function. Well functioning equity and bond markets are crucial for the growth of firms. A case in point is venture capital, where the exit, for example in the form of an Initial Public Offering (IPO), is important to attract investors for the initial financing stage.

Banks are also doing more exotic trading and derivatives as well as structured products. The aim of the Volcker rule is to ban banks' proprietary trading, which goes beyond the trading to service their corporate clients and offset their own positions.

Second and importantly, retail banking is not necessarily safe. Retail banks take deposits from, and provide loans to, households and corporates. So, it avoids the risk of trading and derivatives. But it is more exposed to housing and SMEs. Housing price bubbles are often the root cause of financial crises (Goodhart, 2012). Examples are the Savings and Loans in the USA in the 1980s and the Cajas in Spain currently (Dermine and Schoenmaker, 2010). The last time before the current financial crisis that several banks failed simultaneously in the Netherlands was in the 1980s, when the mortgage banks (Tilburgsche Hypotheekbank, Westland-Utrecht Hypotheekbank and the FGH Bank) failed because of their undiversified exposure to housing. Do we want to return to this type of mortgage banks?

#### *Difficult to split*

Even if we wanted to split the banks, can it be done? It is very difficult to have a clean separation. In the UK, the proposed border between retail and investment banks is flexible (Vickers Report, 2011). Some financial transactions (such as trade finance and project finance) could be placed either in the retail part or investment part. Moreover, it will be expensive to do a full legal separation of the retail and investment part, with separate independent boards. Finally, will the split be effective? There is an economic drive to exploit group synergies by doing intercompany transactions.

A related issue is reputation risk. Simplification of corporate structures will help supervisors to get a better overview of, and a more effective handle on, large banking groups. However, markets tend to regard the strength of a banking group as a whole, ignoring the legal structure. As witnessed in the case of Lehman Brothers in 2008 and earlier of Drexel Burnham Lambert in 1990, solvent subsidiaries (separated legal entities) of a banking group can hardly survive when the parent company or a major subsidiary is in serious trouble. The name is then contaminated in the market, and market players cease to do business with the remaining solvent parts due to reputation risk (Freshfields, 2003).

#### *Will it reduce bail out costs?*

One of the assumptions is that the retail part will be saved, while the investment part will be allowed to go bankrupt. Would we really let investment banks go bankrupt? Remember that light regulated investment banks such as Bear Stearns and insurance companies such as AIG and Aegon were also rescued during the last financial crisis because of their interconnections with commercial banks. In the case of an idiosyncratic failure such as Barings Bank, authorities can let an investment bank go. But that is even true for retail bank such as DSB bank. In the latter case of a retail bank, depositors will be paid out up to the insured amount.

Next, the less regulated part may become riskier absent tough regulation. In times of crisis, authorities may then still face the bill of bail out costs that are then unchecked.

#### *Diversification is important*

In the last financial crisis, diversification did not work. All asset markets went down together, as there was a strong correlation among asset classes. Moreover, different financial institutions (banks and insurance companies) also went down simultaneously. However, in previous crises diversification did work. In an empirical study of banking and insurance from 1992 till 2003, we find that banking and insurance provide diversification benefits (Slijkerman, Schoenmaker and De Vries, 2005). It is very dangerous to base policy on only the last crisis. As argued above, undiversified retail banks experienced severe difficulties in the housing crisis of the late 1970s/early 1980s.

#### **But need for reform**

The banking reform debate rightly argues that there is a need to reduce risk in banking. What should be on the reform agenda? We argue for the following elements:

1. *Substantially higher equity capital.* There is broad consensus among academics and policy makers that banks need substantially more equity capital to reduce the probability of failure. The extra surcharge for the Systemically Important Banks is supported to constrain the too-big-to-fail problem of large banks. Although very important, it can be questioned whether higher capital requirements on their own are sufficient to counter the incentive to take risks for bank managers (Boot, 2011)? So, more is needed.
2. *Macro-prudential supervision.* The psychological component: the concept of 'disaster myopia' indicates that the subjective probability of default decline during an economic boom (no major defaults), while actual probabilities remain constant (Guttentag and Herring, 1984). Risk is thus underestimated in boom times. The purpose of macro-prudential supervision is to tighten credit conditions during a boom to slow down rising asset prices. Another aim of macro-prudential is to constrain undue reliance on unstable wholesale funding during boom times (Perotti and Suarez, 2011).
3. *Prompt corrective action.* Prompt corrective action by supervisors is important to minimise deposit insurance losses and mandate supervisory action as capital declines (Nieto and Wall, 2006). As swift action may be needed, in particular before the bank is balance sheet insolvent, a special resolution mechanism (akin to the recently adopted Special Resolution Regime in the UK and the new Intervention Law in the Netherlands)

is necessary. The new culture towards more pro-active supervision by DNB is helpful in this respect.

4. *Resolution plans.* A resolution plan is a plan drawn up ex ante with the purpose of using it if a bank gets into difficulties. The objective is to put in place conditions (such as reducing the complexity of the legal structure) that would allow a wider range of options other than having the whole bank rescued. It may allow systemically important banks to fail or, at least, to be unwound in an orderly manner without imposing disproportionate costs on the taxpayer (Avgouleas *et al*, 2012). Resolution plans are monitored by supervisors and complement the new requirements to increase capital substantially forcing the (large) banks to internalise the systemic externalities they generate. Higher holdings of core equity reduce the probability of failure, while resolution plans reduce the impact of a possible systemic failure. Both elements can reinforce each other to reduce the too-big-to-fail problem.
5. *Improve governance.* There is a clear need to strengthen risk management, as argued by the Commissie Maas (2009). The governance of financial institutions, in particular the role of the supervisory board overseeing the executive board, is crucial to foster a sound risk management culture. But there are limits to what regulation can achieve in this field (Winter, 2011).
6. *Ring-fencing proprietary trading.* Any risks of proprietary trading should be fully internalised by higher capital requirements (beyond the levels mentioned under point 1). Moreover, the proprietary trading unit with its higher capital charges should be fully separable under the resolution plan (point 5). In a crisis situation, this trading unit can thus be sold off or liquidated without deposit insurance. In that way the public purse can be protected against the risks of proprietary trading. Both the profits and losses will then stay in the private domain.

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