Position paper on separation of retail and investment banking

Summary
Rabobank supports further implementation of the very extensive package of new regulation, in particular Basel III, and the expansion of the measures available to supervisors. Rabobank moreover supports the limitation of non-client related high-risk activities in the spirit of the Volcker rule. Rabobank however warns against the effects of a separation of banking operations along the lines of the Vickers report. This could adversely affect the service banks could offer to their customers, especially their corporate customers, and it would mean the loss of diversification benefits so that the service would become more expensive. And what is more, the objective of increased stability will not be achieved. In Rabobank’s view, increasing the buffers to be held by banks and the introduction of bail-in will be a more effective way of increasing the stability of banks. Briefly, bail-in means that the unsecured and uninsured claims of creditors of banks, or senior debt, can be written down or converted into equity if a bank is heading for bankruptcy. Rabobank itself strives to achieve a total capital ratio on the basis of risk-weighted assets of at least 20%.

What’s it all about?
In the aftermath of the financial crisis, which peaked with the collapse of investment bank Lehman Brothers, there has been a search for ways to increase the stability of the banking system. One of the frequently suggested options is the potential separation of banks into a retail part and an investment banking part, or high-risk part. Other possibilities include a further increase in the buffers to be held by the banks, investment in better risk management, more, and especially more effective, supervision and the removal of incentives in the system that can lead to taking excessive risk. The De Wit parliamentary committee formed in the Netherlands in 2009 recommended that the retail banking business should be protected from investment banking operations. In 2012, the Liikanen Committee stated that banks above a certain size should be forced to separate the two businesses. The Wijffels Committee is analysing the structure of the banking system and will issue its recommendations at the end of June 2013. The common idea in these initiatives is that savers’ money covered by the deposit guarantee system should not be exposed to risk, and that the position of taxpayers should be better protected. However, it is important to understand that many banking risks arise from the retail business. Indeed, some of the most serious financial crises have originated from this core banking business. Take the US Savings & Loans crisis at the beginning of the 1990s, or the losses suffered by the Dutch mortgage banks in the early 1980s. The US subprime crisis also originated in the core of retail banking: the mortgage lending business. Separating investment banking may perhaps reduce some of the risks (as well as the diversification benefits) for retail banks, but it will not affect the risks inherent in retail banking itself. On the contrary, higher buffers and better risk management and supervision will have this effect. This paper discusses the implications of separating the two activities, and gives Rabobank’s views on the issue.

Background
Given the consequences of the collapse of Lehman Brothers for the banking system, the search for measures to reduce the exposure of retail banking to the risks of investment banking is entirely understandable. The term ‘retail banking’ in this context refers to banking that supports the real economy. An investment bank is a bank engaging in other banking activities, such as proprietary trading. Initiatives have been developed in the United States, the United Kingdom, Brussels (EU), France and Germany to this effect.
The US Volcker Rule is in the tradition of the Glass-Steagall Act (GSA) from 1933. Under the Volcker Rule, a retail bank is restricted with regard to trading for its own account (or ‘proprietary trading’), and may only invest in hedge funds and private equity to a limited extent. One serious problem in this approach is how does one distinguish between proprietary trading and market making or operations relating to management of the balance sheet? In order to be able to execute transactions for their customers, financial institutions must have a certain presence in the markets so that they can quote bid and offer prices and act as a market participant. This is market making. There is then the question of distinguishing between market making and transactions for customers, and proprietary trading by the bank. This distinction cannot be discerned simply from the details of the transaction. Making a distinction based on the motivation for a transaction or on the basis of the counterparty is also not a simple matter.

In the UK, the Vickers Committee put forward a different plan, with the central principle being that large banks must shield their retail operations from their investment banking business. This has been approved by the government and parliament, and work on its implementation is in progress.

In Europe, since the end of 2012 we have had a recommendation from the Liikanen Committee that has elaborated on the Vickers report. The Liikanen Committee proposes that banks with more than EUR 100 billion in “assets for trading activities” or for whom these assets represent at least 15% to 25% of the total assets should be obliged to segregate these trading activities in a separate legal entity (the “trading bank”). The “trading bank” can continue to form part of the financial group, but it may not be funded with savings, nor may it raise significant funding from the retail bank. It moreover may not provide any retail payment services. Banks whose main business is to attract savings (“deposit taking banks”) may continue to use derivative instruments to manage their own balance sheets, effect transactions for liquidity management and also offer basic hedging services. Both entities must independently meet all the capital requirements as included in the CRR and CRD IV. It remains to be seen to what extent the Liikanen Committee’s advice will be added to the measures already put in motion, such as the directive for crisis management, the CRD IV capital directive and the measures relating to strengthening the governance of banks.

Lastly, both France and Germany are currently introducing legislation based on the recommendations of Liikanen.

**The consequences for the Netherlands and the banking sector**

When studying the various proposals, one should bear in mind that each of them originates from a different institutional context. For instance, the banking system in the US is very different to that in Europe, where there is more bank intermediation. The US and the UK moreover have larger investment banks than most of the EU countries, and certainly in comparison to the Netherlands. This means that the risks that may originate from investment banking are relatively lower in the Netherlands. The second consequence, if banks here are somehow forced to divest their investment banking businesses and incorporate them in separate entities, is that these entities will very likely be too small to be able to continue to exist independently. Larger Dutch corporate customers will thus become dependent on foreign investment banks and specialist banks for a large proportion of the services they take.

There is another factor in the Netherlands, namely that the volume of freely available savings is significantly less than the outstanding loans. The Netherlands has a high volume of contractual savings, much of which is invested abroad. There is thus a liquidity gap, and banks are partly dependent on foreign investors to fund their core businesses. If banks were able to tap in to the contractual savings at insurers and pension funds more effectively, for example, if the pension funds were to accept securitised mortgage
loans as an attractive investment, this would help the banks to lend more and reduce their dependence on the financial markets. In any case, as a result of the current relatively limited availability of freely disposable savings, Dutch banks are more dependent on the international capital markets than banks in other countries. If they had to completely separate their investment banking operations from their retail business, it would make it significantly more difficult for them to raise this funding.

Moreover, if things go wrong in the investment banking operations, separation will not necessarily prevent serious damage. A collapse by an investment bank can also damage ordinary banks, simply due to the loss of confidence that will ensue. During the crisis, supervisors considered it necessary to save investment banks by means of a forced merger with an ‘ordinary’ bank. Whether the bankruptcy of specialist investment banks can be settled in a controlled manner in a situation of separation is debatable.

In our view, the disadvantages of the Liikanen approach of segregating different operations compared to increasing buffers are that synergy and diversification benefits will be lost, and the costs of funding will rise. On the other hand, it should be noted that Liikanen focuses on the more serious risks and takes account of the volume of the trading activities in proportion to the balance sheet. It is important that an exception with regard to the separation requirement is made for banks with limited trading, to meet the objection that separation will lead to entities that are not individually viable. The Liikanen Committee also recommends that restructuring and settlement plans are formulated, and that bonuses should be partly paid in the form of bail-in-able bonds. These are measures that the European Commission has included in its draft directives and that are now going through the decision-making process.

What would Rabobank like to see?

Rabobank advocates increasing the stability of the banking sector by increasing the capital buffers, introducing bail-in and improving supervision. Rabobank does not support the complete separation of banks. This could adversely affect the service banks could offer to their customers, especially their corporate customers, and it would mean the loss of diversification benefits so that the service would become more expensive. And what is more, the objective of increased stability will not be achieved. Rabobank would however support a measure to separate or further limit proprietary trading (which is relatively low in the Netherlands) as long as this is properly defined. Rabobank moreover has the following considerations it would like to add:

1. Above all, banks need robust buffers and long-term funding. Rabobank therefore supports the introduction of higher and better-quality buffers and the new liquidity requirements (the net stable funding ratio for instance), which possibly go further than Basel 3 in due course. Rabobank itself strives to maintain a total capital ratio based on risk-weighted assets of at least 20%. Strong buffers promote confidence, and thus have a preventive effect. Secondly, they are needed to absorb stress in times of crisis. Lastly, banks’ balance sheets should be constructed so that if things do go wrong, the taxpayer is kept out of the equation for as long as possible. Longer-term average funding for banks would contribute to this: banks will be better able to cope with situations such as a sudden freezing of the interbank lending market, as happened at the peak of the crisis.

2. Rabobank is a supporter of bail-in. In times of stress, senior debt would be converted into risk-bearing capital or equity. Rabobank prefers the so-called “comprehensive approach”, in which all senior debt would be eligible from a point in time to be determined.

3. Activities that are exclusively designed to increase the bank’s profitability but which are not driven by customer interests should in our view not fall under the
government guarantee that implicitly applies to banks of systemic importance. *Securities trading that is exclusively for the bank’s account can thus be restrained.* The use of high-risk instruments (such as certain complex products) for liquidity management should also be avoided. This would significantly improve a bank’s risk profile.

4. Rabobank *supports the expansion of the supervisory measures available* as a result of the Intervention Act. The proposed new legislation and regulation in relation to the restructuring and settlement of problem banks will significantly increase the powers of the supervisor to include taking effective corrective action and ensuring orderly settlement where necessary.

**Conclusion**

Rabobank is confident that these measures will strengthen the robustness of the banking sector. The expansion of the supervisory measures available is moreover an investment in prevention. Rabobank additionally considers it important that good impact studies are carried out to see how the measures work in practice and the potential implications of interaction between them.

For more information, please contact: Bouke de Vries, Public Affairs, Rabobank Nederland.
Telephone: +31(0)30 – 21 61195 or email: Y.B.Vries@rn.rabobank.nl

10 June 2013