View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Archive of European Integration

ECRI COMMENTARY
European Credit Research Institute

The Impact of Banking Structural Reform on Household Retail Finance

Sylvain Bouyon*

ECRI Commentary No. 13, 7 October 2014

1. Overall objectives of the structural reform

On the basis of some of the findings of the Liikanen report on the EU banking sector (2012),[1] on 29 January 2014 the European Commission (EC) adopted a proposal for a regulation to address the risks of complex business models combining retail and investment banking activities. Within these new rules, supervisors will be granted the power to forbid proprietary trading and to require the separation of other trading activities (such as 'market making') from traditional commercial and retail banking activities. If adopted by the European Parliament (most likely this autumn) and the EU Council, the new regulation on the structure of banking could be the last significant piece of regulation of the Commission's extensive reform agenda for financial services.

There are two main objectives behind this proposal. On one hand, structural reform aims to enhance financial stability (the *financial stability objective*); on the other hand, the separation between high-risk trading activities and retail activities should be designed so as to support economic growth, by promoting lending to the real economy (the *economic efficiency objective*).

Financial stability objective

The explicit objective behind the proposal for structural reform of the EU banking union is to strengthen the stability of the financial system as a whole, notably by lessening the harmful effects of the 'Too big to fail (TBTF)' or 'Too connected to fail (TCTF)' status of some banks in the European Union. According to that theory, which was supported by numerous academic contributions,[2] TBTF and TCTF banks have high incentives for risk-taking, owing to the guarantee of a state intervention in the event of a financial bankruptcy.[3] This 'implicit

---

* Sylvain Bouyon is a CEPS-ECRI Research Fellow. The author gratefully acknowledges comments by Karel Lannoo, Diego Valiante and Willem Pieter De Groen.

[1] Published in October 2012, this report was prepared by the High-level Expert Group on reforming the structure of the EU banking sector. The Group chaired by Erkki Liikanen was established by the European Commission.

[2] See Gertler et al. (2012) and Fahri et al. (2012).

[3] The setup of the Single Bank Resolution Fund should help break sovereign-bank nexus; however, moral hazard in banking could also arise with this new guarantee.

ECRI Commentaries provide short analyses of ongoing developments affecting credit markets in Europe. ECRI researchers as well as external experts contribute to the series. External experts are invited to suggest topics of interest.

Available for free downloading from the ECRI website (http://www.ecri.eu)
ECRI © 2014. All rights reserved.

subsidy' leads TBTF and TCTF banks (including some deposit-taking banks) to engage in high-risk activities, which pose significant threats to overall financial stability.

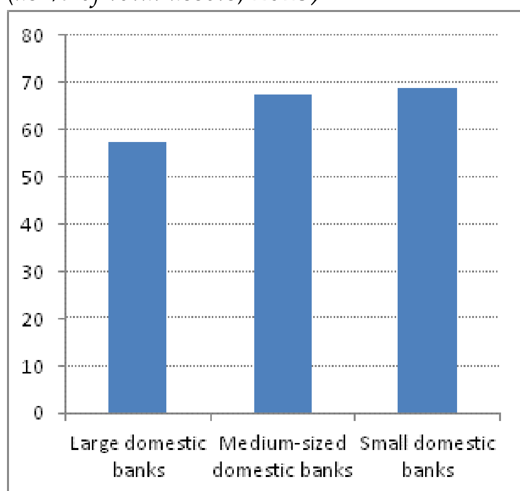
As a consequence, the separation of high-risk activities from low-risk activities is expected to concern only the systemically important European banks and the entities with significant trading activities (according to early estimates, the new regulation will apply to around 29 European banks).[4] Supervisors will have better control over the overall financial risks taken by TBTF and TCTF banks by performing an annual examination of the trading activities that could trigger the separation.[5]

If they judged it necessary, supervisors can require banks to transfer their high-risk trading activities to separate legal entities within the group (subsidiarisation).[6] By reducing interconnectedness between banking segments when needed, regulators will be able to limit the channels of financial crisis transmission, leading to downside systemic risks in the financial sector.

Economic efficiency objective

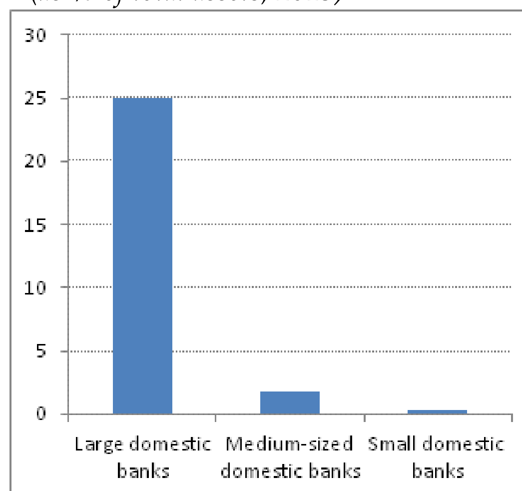
The second objective is to support economic growth by trying to refocus the main activity of largest banks on supporting the real economy and serving consumers. Regulators will further encourage large banks to adjust their balance sheets towards lending to the real economy rather than towards intra-financial-sector borrowing and lending (see Figure 1 and Figure 2). As such, the structural reform should help repair the damage to potential output caused by the financial crisis.

Figure 1. Total loans and advances (as % of total assets, 2013)



Source: ECB consolidated banking data.

Figure 2. Financial assets held for trading (as % of total assets, 2013)



Source: ECB consolidated banking data.

[4] Metrics and thresholds to determine the scope of banks will be defined later on by delegated acts.

[5] As stated in the impact assessment, a special focus will be placed on deposit-taking banks to ensure that these banks "are not unduly influenced by a short-term trading culture".

[6] Should the option 'subsidiarisation' be chosen, the separation will mean that the trading entity and the retail entity will have to maintain self-standing reserves of capital and of loss-absorbing debt, as well as to comply with other prudential and legal requirements on an individual, sub-consolidated or consolidated basis.

2. Impact on household retail finance

Much has been written about the possible effects of the three main structural reforms (inspired by Volckers, Vickers and Liikanen) on the whole banking sector, but by considering only retail activities few studies comment the impact. Given that safer and more efficient retail activities are one of the main concerns behind the structural reform, an approach based exclusively on household retail activities can help to fine-tune the priorities of future macro-prudential policies.

Positive effects

Regarding the objective of a safer banking system, the separation between the capital supporting trading activities and the capital funding core retail services will help alleviate damaging contagion within banking organisations (Vickers, 2012). Owing to the separation, deposit-taking businesses will be better protected from adverse financial events occurring in trading activities.

In addition, the structural reform should improve the resolvability of retail banks in the event of failure. By lowering the complexity of the business models of largest banks, supervisors will be more able to reduce resolution costs of retail activities. However, cross-border resolution regimes need to be sufficiently harmonised for an efficient resolution of international retail banks. This may improve with the implementation of the EU's Bank Recovery and Resolution Directive (BRRD) by early 2016.

Economic efficiency is likely to be enhanced through a common EU legislative framework regarding the structural reform and decreased incentives of the larger banks to take risks.

Many of the banks within the scope of the structural reform operate large household retail activities across borders and typically have economic interests in different EU domestic markets. A common legislative framework on structural reform should help these banks to expand their retail activities across the EU, since it should notably increase the effectiveness of the Single Supervisory Mechanism.

Finally, as incentives of the largest banks for risk taking are expected to decrease, the insolvency risks of largest banks and the number of ensuing bail-ins will most likely decrease, resulting in fewer fiscal shocks on states and household balance sheets: household disposable income should therefore be more stable. In this context, it can be argued that private consumption and household investment will be less volatile and the demand for retail financial products, such as mortgage and consumption credits, should be more resilient. As such, the structural reform of the banking system should indirectly contribute to more dynamic retail banking activities.[7]

Negative effects

The implementation of the structural reform could trigger several effects, directly or indirectly damaging the stability of household retail activities.

Decreasing diversification as a result of separation could noticeably increase the risk of retail banks' bankruptcy.[8] In a specific context, a separate domestic retail bank would fail (for

---

[7] This potential positive effect on the household retail activities was not assessed in the impact studies of the proposal.

[8] In Ayadi et al. (2014), authors assess the default risk of four banking models (investment, wholesale, diversified retail and focused retail). Findings confirm the low default risk of the diversified retail banking model, while the focused retail banks face the highest default risks.

example, because of a domestic property market crash), while it could have survived if it had been part of a banking group with wider geographical and/or functional scope (Vickers, 2012).

Furthermore, already existing systemic risks could be simply transferred and not reduced, because targeted banks could shift some of their businesses towards less regulated and supervised markets in order to alleviate their regulatory costs. Some of these market migrations could even increase systemic risks, especially when markets migrate to spheres with very low supervision and control (FTI, 2014). All banking activities, including household retail financial services, could eventually be affected by global upside systemic risk.

Finally, retail banks may still remain subject to some reputational risk and group contagion: the failure of a trading subsidiary could potentially lead to a loss of confidence in the whole group. The structural reform admittedly did not aim to alleviate reputational risk; nevertheless, this persistent channel of financial crisis transmission is likely to impede the objective of financial stability.

On the other hand, the expected positive effect on economic efficiency could be partially undermined by significant implementation costs and higher borrowing costs for households.

Targeted banks will have to face the reorganisation of their trading activities and technical difficulties to integrate the new piece of legislation within the ongoing large-scale regulatory implementation. In addition, further costs will be sparked by the substantial compliance and reporting requirements (Chow et al., 2013). Overall, all these new costs would imply a reallocation of resources, which could be detrimental to numerous banking activities, notably retail household finance.

Secondly, if the proposal were to be accepted in the EU, interest rates of retail loans to households could be on the upside for two main reasons: the decreasing diversification of the funding base of banks and scarcer liquidity.

As a consequence of the separation of trading business from retail activities, diversification of the funding base of the targeted banks would probably drop, potentially resulting in an inappropriate distribution of exposures to borrowers and higher-than-optimal concentration risk. There could therefore be a risk of greater volatility in revenues, which could imply, if properly priced, higher average funding costs for banks. Under the assumption of significant pass-through, interest rates on household retail loans would increase.

Furthermore, ensuring continuous liquidity is likely to be more challenging for large banks, given the new restrictions on trading activities and the progressive implementation of the price-based regulations reforms such as the liquidity ratios. As a result, funding costs could be on the upside, which might also raise the borrowing costs of households.

Finally, the implementation of the structural reform could weaken the sales business model of universal banks, whose main strength is to offer multiple financial services almost simultaneously (concept of 'one-stop-shopping'). However, this characteristic of universal banks primarily concerns specific banking segments, such as private banking and corporate finance for large non-financial corporations (especially large multi-national companies, whose specific needs can involve a vast range of financial services), and has few links with household retail finance.

3. Recommendations

If it is implemented, the banking structural reform should reinforce the stability and economic efficiency of household retail activities through lower contagion, better resolvability in the event of failure, more harmonised supervisory practices across the EU and more resilient household demand for retail loans. However, it could also trigger counterproductive effects that could partly undermine the expected benefits. These potential negative effects are not appropriately assessed in the impact study of the proposal published in January 2014 and will require further consideration in the coming months.

In particular, more emphasis should be placed on the following:

Financial stability objective

- bankruptcy risks of retail banks;
- transfer of existing systemic activities towards less regulated and supervised markets;
- reputational risk;

Economic efficiency objective

- implementation costs;
- borrowing costs for households (impacted by the decreasing diversification of the funding base of banks and scarcer liquidity).

A thorough analysis of these five channels could help fine-tune the priorities of future macro-prudential policies and help regulators to achieve the objectives of safer and more efficient retail activities.

References

Abascal, M., S. Chaïbi and A. Fraile (2014), "European Commission's proposal on structural reforms", BBVA Research, Regulatory Watch, Madrid, 12 February.

Ayadi, R. and W.P. de Groen (2014), "Banking Business Models Monitor 2014: Europe", Montreal, Centre for European Policy Studies (CEPS) and International Observatory on Financial Service Cooperatives (IOFSC) publication (forthcoming)

Ayadi, R., E. Arbak and W.P. De Groen (2012), "Regulation of European banks and business models: towards a new paradigm?", Financial Markets, CEPS Paperback, Centre for European Policy Studies, Brussels, June.

Ayadi, R., E. Arbak and W.P. De Groen (2011), "Business models in European banking: a pre- and post-crisis screening", Financial Markets, CEPS Paperback, Centre for European Policy Studies, Brussels, September.

Chow, J., M. Erbenova, A. Narain, J. Surti, C. Pazarbasioglu and J. Viñals (2013), "Creating a safer financial system: will the Volcker, Vickers, and Liikanen structural measures help?", IMF Staff Discussion Note, May 2013, SDN/13/4.

EBF response to the European Commission consultation on reforming the structure of the EU banking sector, July 2013.

Elliott, D., S. Salloy and A.O. Santos (2012), "Assessing the cost of financial regulation", IMF Working Paper WP/12/233, International Monetary Fund, Washington, D.C.

European Commission (2014), "Economic Review of the Financial Regulation Agenda", Commission Staff Working Document, May.

Fahri, E. and J. Tirole (2012), "Collective moral hazard, maturity mismatch, and systemic bailouts", *American Economic Review*, Vol. 102, No. 1, pp. 60-93.

FTI Consulting (2014), "Volckers, Vickers, Liikanen: Structural reforms of the banking sector – Quo Vadit Europe?", 28 January.

Gertler, M., N. Kiyotaki and A. Queralto (2012), "Financial crises, bank risk exposure and government financial policy", *Journal of Monetary Economics*, Vol. 59, Supplement, 15 December, pp. S17-S34.

High-level Expert Group on reforming the structure of the EU banking sector (2012), Final report, Chaired by Erkki Liikanen, 2 October 2012.

Vickers, J. (2012), "Some economics of banking reform", Department of Economics, University of Oxford, Discussion Paper Series, No. 632, November.