The impact of financial reforms on the business model of banks and their social implications: a dialogue between the Finance Stability Board, business leaders and union leaders

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Issues for discussion- jointly prepared by ITUC, TUAC & UNI Finance

Too-big-fail groups: the unfinished financial reform agenda

Implementing the G20-agreed financial reforms is a slow process. One of the priorities is the G20 commitment to “ending too-big-to-fail” (TBTF) institutions, as identified by the official list of the G20 Global Systemically Important Financial Institutions. These large and complex financial conglomerates were at the heart of the 2008 financial crisis. Arguably they enjoy excessive market power in key global market segments in many large OECD and emerging economies – such as securities and derivatives trading as well as in asset management and consumer credit. Financial concentration has in fact increased since the 2008 crisis, perhaps because the TBTF business model is still “tolerated”.

The current G20 / Financial Stability Board (FSB) reform agenda on TBTF broadly consists of four pillars: (i) strengthening prudential regulation (Basel III), (ii) introducing additional capital charge for TBTF groups specifically, (iii) increasing supervision and (iv) introducing new resolution frameworks. Structural measures aiming at the mandatory separation of certain banking activities were initially part of the package of reforms in the early stage of the G20 process in 2009-2010. However it was dropped out at a later stage and has never re-appeared in the G20 agenda. But some governments and policymakers have taken action.

What the structural reforms are about

Various structural reforms have indeed been enacted or are in the process of being developed in the US and in Europe. They have a more limited scope than the historical US Glass-Steagall Act, which prohibited retail and investment banking activities within the same institution. When implemented they would nevertheless have far-reaching implications for global banks’ organisation and structure:

- In the US, the Volker rule, which is part of the Dodd Frank Act, prohibits proprietary trading and other in-house activities (e.g. hedge funds) within retail banking institutions;
- In France, the Loi Bancaire also limits proprietary trading;

- In the UK, the Vickers reform requires "ring-fencing" of retail and investment banking activities; and
- At EU-level, the European Commission "Barnier proposal" would consist in some combination of the Vickers and the Volker reforms.

In addition to some form of separation, structural reforms would in most cases require foreign banks to set up a stand-alone subsidiary entity for their local activities (by opposition to the loser "branch" regime). "Subsidiarisation" of international banking group would help improve direct supervision and oversight of foreign banking activities and would facilitate the resolution in case of a Lehman Brothers-type failure of the bank (and hence avoid a costly bailout by government).

TBTF banks played a pivotal role in fuelling and spreading the 2008 crisis across the global financial system. For many within the labour movement the goal of structural reform is to try to fundamentally disconnect the "transmission belt" that globally integrated TBTF groups may play when a financial crisis occurs.

The intent of reforms is not to "break up the banks". The re-organisation of banking groups into decentralised structures and subsidiaries might alone considerably improve mitigation of risks of bank failure. Subsidiaries – by opposition to branches – can be dealt with separately without engaging in wholesale bailouts. In doing so, structural reforms could contribute to reduce the explicit and "implicit" public support that TBTF banks benefit. These government "contingent liabilities" generate substantial funding costs savings for TBTF banks and other large banks. According to recent OECD estimates, they are equivalent to EUR50bn of annual costs savings, for a sample of more than 100 large European banks, and across the OECD, to 1% of GDP, rising to 3% in crisis situations.

Structural reforms may well generate additional transaction costs within banking groups and, in the end, increased costs of financial services for companies and households. At the same time it is commonly agreed that a more stable financial system than the one that prevailed in 2007 will require that financial services – or some of them – become more expensive than they used to be.

Rising concerns from the banking industry

It is fair to say that current structural reforms are not being met with great enthusiasm by the banking industry. Several arguments against structural reforms are put forward:

- *It is a distraction*. There have been many financial reforms in the past years and the current package consisting of (i) prudential regulation (Basel III), (ii) increased supervision (EU banking union) and (iii) resolution frameworks is well enough to address financial stability concerns that were raised post-2008.

- *It creates regulatory uncertainty*. Structural reforms are either in the early stage of implementation (Volker, Vickers, Loi Bancaire) or they are at the preliminary stage of proposal (Barnier proposal), and many details are missing. And they may well conflict with each other, which in turn would create serious complications for banks.

- *Robust ex ante impact assessment is missing*. Before embarking in any new legislative framework, the full implications of current reforms – including the cumulative effect of reforms on banks – should be identified and measured.

- *Universal banks are being unfairly targeted*. Structural reforms basically torpedoe the very concept of the universal bank because, in the end, these reforms are about "de-

diversification" of banking businesses, both on asset and liability sides. And yet diversity of financial systems still prevails and still is desirable (continental European and bank-led "intermediated" financial systems versus Anglo-American market based systems).

- *Customers and the real economy will pay the price*. Simple transactions and basic financial services will become more complex and more costly because economies of scale are becoming prohibited as result of structural reforms and of ring-fencing measures.

- *It will reduce competition and increase market concentration*. The idea of a generic response, a one-size-fits-all approach, to bank structures, will hit smaller banks and specialised banks. Commercial banks might dismiss trading activities for example, if they were to be separated as a result of structural reforms, because they do not have a sufficient volume of trading which would justify the setting of a standalone trading entity.

- *Emerging countries' access to financial services will be restricted*. Structural reforms will lead to a "balkanisation" of global OECD-based banks into separate subsidiaries which will limit the latter access to liquidity and financial services. In emerging markets, local banks may fill the gap, but only partly. Some banking services require large international banking have not been taken by the local actors.

What future for the banking industry?

The banking landscape is changing fast, as a result of the global financial crisis of 2008 that turned out into a global economic recession, but also as a result of the wave of structural reforms that followed. There are many unknowns with regard to the future of the banking industry, and its structure: the balance between global and domestic banks, between bank-based and market-based finance and between banking and "shadow" banking.

To help structure the conversation on the future of the banking industry, and looking specifically at the impact of structural reforms, a number of considerations, and challenges, should be taken on board, including:

- *The employment and governance impact*. If indeed structural reforms are to force a shift from highly integrated global banking groups (headquarters and branches) to more decentralised structures (headquarters and stand-alone subsidiaries), what are the employment and corporate governance implications?

- *Shadow banking*. The shifting toward "less sophisticated" banks, as proprietary trading and other in-house activities (e.g., hedge funds) are shifted away from top-tier banking institutions, and from bank-based to market-based finance could feed the growth of the shadow banking system.

- *The costs of compliance*. To the extent that structural reforms would increase the cost of capital of banks, the cost of financial services and of broader access to finance for customers (non-financial companies and households) could increase.

- *The effects on market concentration and on governments' exposure to bank risk*. Structural reforms should lead to less concentrated banking sectors, and to less government (and "taxpayers") exposure to the risk of bank failure.