Introduction: why bank separation?
Since the devastating financial crisis of 2007, public and political awareness has grown for the need for banks to face tighter regulation. The socialisation of billions in losses in the banking sector has shown what effects society faces when banks are “too big to fail”. German Chancellor Angela Merkel announced in the aftermath of the crisis: “One of the tasks that we will dedicate ourselves to and that is also being taken into consideration elsewhere is how to make sure that banks and financial institutions do not become so large that they ultimately pose the potential risk of exerting pressure on countries.”

Over the past few years, laws have been introduced to increase banks’ equity and for a better handling of insolvent banks. However, some risks have not been reduced, or at least not enough:

1. The above-mentioned risk of being “too big to fail”,
2. Systemic risks such as those created by bank networking, and
3. Risks of contagion (transfer of risks from trading activities to credit business).

The fact that banks no longer work efficiently when obtaining a certain size, nor offer added value to the rest of the economy has been noted in many studies. Although recent studies define such a size as being much larger, these also consider a bank having several off-balance sheet assets as positive – although this is what led to the financial crisis. A study by the Bank of England (Davies/Tracey 2012) also demonstrates that when a bank has total assets amounting to 100 billion US dollars, it only brings the advantage of receiving a better rating because it is “too big to fail” and can thus finance itself under more favourable conditions.

The financial crisis has also shown that regionally demarcated banking structures, such as the German savings banks, were more resilient than large banks in the crisis. Conversely, one of the reasons for banking crises has been the regional delineation of banking systems as local “savings banks” (“cajas”) in countries such as the USA and Spain.

Thus, any reforms in the banking structure need to be accompanied by a separation of banking business and size limits, in order to cover a full range of risks and to ensure a well-functioning banking system.

What could such a separation look like?
There are different proposals and approaches as to how bank separation or structural reform could be carried out.

For the separation of risky activities, two models are usually discussed (see illustration). The first assumes that the deposit and lending operations must be strictly separated from all investment/trading business. In other words, a bank cannot operate both at the same time. The investment business primarily consists of trading for the own account (“proprietary trading”, i.e. not on behalf of a customer), as well as relations to investment funds, such as hedge funds and private equity funds.

The second model is weaker. It proposes to allow banks to continue operating both their deposit/lending and investment/trading business, but these must be legally separated within a holding structure. Often there is talk of “ring-fencing”. If the second model is selected, it is at least important that in case of loss on the part of the investment and trading unit, its creditors cannot lay claim to any portion of the deposit-lending unit of the bank holding company.

Beyond such a separation, size limits for all banks would make sense, although these do not currently exist, as well as spatial restrictions, as they exist for German savings banks.

Laws enacted and suggestions
Some EU Member States, including France, Belgium, Germany and Great Britain, have meanwhile adopted national banking structural reforms. In January 2014, the EU Commission published a legislative proposal. This was accompanied by the draft report of the rapporteur in the European Par-
significance of exemptions for both trading and funds. Laws are not as comprehensive. All laws contain while the USA prohibits any relation, the European funds are always limited, but in varying degrees: little trade. Bank relations to risky investment trade readiness for markets that otherwise have thresholds vary significantly in terms of amount until the autumn of 2015. Comparing laws and proposals (see table), one can see that they range from complete separation to prohibition, holding or mixed models. The thresholds vary significantly in terms of amount and measurement means. Always included is a separation or a prohibition on proprietary trading, and, in most cases, so-called market making, i.e. trade readiness for markets that otherwise have little trade. Bank relations to risky investment funds are always limited, but in varying degrees: while the USA prohibits any relation, the European laws are not as comprehensive. All laws contain significant exemptions for both trading and funds.

Current political debates

Although the European Commission’s draft law has been criticised by civil society as being too weak, the banking lobby wants to weaken it even further or stop it altogether. It claims that banks would no longer be able to fulfil their role as “market makers” in key markets. What’s more, corporate financing activities would be reduced. But for the reasons named above (systemic risk, efficiency), separation is indispensable and would also be likely to reduce borrowing costs.

Further information:

European Commission: Information on reform.
Finance Watch (2013): Europe’s banking trilemma. Why banking is essential for a successful Banking Union.
Henn, Markus (2014): Lecture on Bank separation.

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Table: Comparison of laws and proposals on bank separation

<table>
<thead>
<tr>
<th></th>
<th>Prohibition or holding?</th>
<th>Thresholds</th>
<th>Proprietary trading included</th>
<th>Hedge Funds &amp; Private Equity separated</th>
<th>Other separations/prohibitions</th>
<th>Important exceptions</th>
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<tbody>
<tr>
<td><strong>USA: Law (“Volcker Law” in Dodd-Frank Act)</strong></td>
<td>Prohibition</td>
<td>No threshold values</td>
<td>Yes (but strictly defined)</td>
<td>Ownership, funding (sponsoring) &amp; other relationships</td>
<td>US government bonds; risk-mitigating hedging; market creation; funds: joint venture, complete possession, etc.; various customer services (e.g. as broker/agent, etc.)</td>
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<td><strong>UK: Law or “Vickers Commission” Report</strong></td>
<td>Holding</td>
<td>£25 billion in deposits</td>
<td>Yes</td>
<td>Probable: Relations to non-deimited (“non ring-fenced”) units</td>
<td>Market creation, Securitisation, etc.</td>
<td>Not yet clear (second law is still pending); probably easier to trade in derivatives; convertible bonds; securitisation, etc.</td>
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<td><strong>EU: Liikanen Report</strong></td>
<td>Holding</td>
<td>Trading assets €100 billion or 15-25% of all assets</td>
<td>Yes</td>
<td>Shares &amp; linked instruments</td>
<td>Market making</td>
<td>Price hedging; simple securitisation; money market funds; asset management; interbank loans</td>
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<td><strong>EU: Proposed legislation of the EU Commission</strong></td>
<td>Mixed solution (partly prohibition, partly holding)</td>
<td>1. Prohibition: € 30 billion in assets and € 70 billion in trading assets, 10% of total assets; European and global SIFIs 2. Holding: list of criteria, certain degree of supervisory autonomy</td>
<td>Yes (also indirect prohibition, but narrowly defined)</td>
<td>Shares &amp; linked instruments (prohibition, also indirectly)</td>
<td>Market making, high-risk products (holding)</td>
<td>EU government bonds; services for clients; money market activities; funds: closed-end, non-leveraged, long-term, venture capital funds</td>
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<td><strong>Germany: Law</strong></td>
<td>Holding</td>
<td>1. Trading assets € 100 billion or trading assets of 20% in total assets and assets of € 90 billion 2. Individual cases</td>
<td>Yes (but only short-term)</td>
<td>Securitisation &amp; guarantees Optional: Market making, high-risk products</td>
<td>Risk-mitigating hedging (customer deals, interest rate, currency, liquidity); long-term holdings; non-speculative trading</td>
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