



**BILL TO SEPARATE RISKS  
AND TO PLAN  
THE RECOVERY AND RESOLUTION  
OF CREDIT INSTITUTIONS AND FINANCIAL GROUPS**

**STATEMENT AND OPINION TO FINANZAUSSCHUSS IM DEUTSCHEN BUNDESTAG**

Brussels, 18 April 2013

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## ZUSAMMENFASSUNG

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- (1) **Finance Watch begrüßt die Einführung von Abwicklungs- und Sanierungsplänen als Instrumente zur Prävention und zum Management von Krisen. Abweichend vom Wortlaut des vorliegenden Gesetzentwurfs unterstreicht Finance Watch die Notwendigkeit, dass die Vorgabe der Sanierungs- und Abwicklungsplanung für jedes Institut gelten sollte.** Grund hierfür ist unter anderem, dass die vorgeschlagenen Regeln die Wahrscheinlichkeit erhöhen, dass deutsche Steuerzahler an der Rettung ausländischer Institute beteiligt werden (s. nachfolgenden Punkt (2)). Zudem gilt, dass - so der Gesetzentwurf bereits 2007 in Kraft gewesen wäre - er Steuerzahlern keinen ausreichenden Schutz vor Beteiligungen an Rettungsaktionen zugunsten von Instituten gewährt hätte, die vor der Krise nicht als systemrelevant eingestuft worden waren. In seiner jetzigen Fassung ist der Entwurf somit nicht dazu geeignet, Steuerzahler davor zu bewahren, Rettungsmaßnahmen für vergleichbare Institute zu finanzieren, sollte sich die Finanzkrise von 2008 wiederholen. Um Lehren aus der Krise zu ziehen und den Steuerzahler effektiver vor Bankrisiken zu schützen, schlägt Finance Watch deshalb vor, dass das Erfordernis einer Abwicklungs- und Sanierungsplanung künftig für alle Institute gelten soll.
- (2) **In seiner jetzigen Fassung wird der Gesetzentwurf höchst wahrscheinlich dazu beitragen, dass deutsche Steuerzahler künftig an der Finanzierung von Rettungspaketen ausländischer Banken beteiligt werden:** Finance Watch unterstreicht die möglichen Auswirkungen des vorliegenden Gesetzentwurfs auf europäische Regulierungsvorhaben – vor allem in Bezug auf die gegenwärtig auf EU-Ebene erörterten Maßnahmen in Form von Bankenunion und Sanierungs- und Abwicklungsrichtlinie. Die in diesem Kontext zu diskutierenden Sanierungs- und Abwicklungsverfahren sollten unter Beachtung der Gläubigerhierarchie folgende Regelungen zum Umgang mit Bankenschulden beinhalten: Verluste eines Institutes in Schieflage sollten zunächst von dessen Eigentümern, dann von Gläubigern in der Reihenfolge der jeweiligen Senioritätsklassen, dann von den Inhabern nicht-abgesicherter Depositen und schließlich von den hierfür jeweils eingerichteten Fonds getragen werden. Sind all diese Instrumente erschöpft, so bleiben nur die Steuerzahler, um Verluste von Banken aufzufangen. Nimmt der deutsche Gesetzgeber nicht-systemrelevante Institute von den Erfordernissen einer Sanierungs- und Abwicklungsplanung aus, so wie es der Gesetzentwurf vorsieht, sind negative Folgen für den oben genannten europäischen Gesetzgebungsprozess zu befürchten. Denn es ist zu erwarten, dass Deutschland auch auf EU-Ebene die Erfordernisse einer Sanierungs- und Abwicklungsplanung auf systemrelevante Institute begrenzen will (andernfalls müssten die in Artikel 1 geplanten Ausnahmeregelungen im Zuge der Sanierungs- und Abwicklungsrichtlinie schon bald wieder geändert und an die dann geltenden europäischen Vorgaben angepasst werden). **Durch eine Begrenzung der Sanierungs- und Abwicklungsrichtlinie auf systemisch relevante Institute würde die Richtlinie ihre Wirksamkeit verlieren. Wäre eine entsprechende Regelung z.B. bereits im Zuge der spanischen Bankenkrise anwendbar gewesen, so hätte sie angesichts der Tatsache, dass die Krise maßgeblich von nicht-systemrelevanten Instituten ausging, keinen Beitrag zu einer Stabilisierung der Finanzmärkte geleistet.**

- (3) **Die im Gesetzentwurf vorgeschlagene Trennung unterschiedlicher Bankaktivitäten wird kaum Auswirkungen auf die Praxis haben. Dies bedeutet, dass die vorgeschlagene Regelung faktisch nicht zu einer ausreichenden Stabilisierung der Finanzmärkte und Absicherung von Steuerzahlern führen wird:** Mit dem Gesetzentwurf wird der Ansatz verfolgt, lediglich solche Aktivitäten abzutrennen, die im Rahmen von Eigengeschäften durchgeführt werden. Dabei wird Eigenhandel (im Sinne des Eigengeschäfts) als „nicht-kundenbezogen“ definiert (was das Market Making per Definition von der Liste der zu trennenden Aktivitäten ausnimmt). Zwar begrüßt Finance Watch die generelle Zielsetzung des Gesetzentwurfs ebenso wie dessen Vorschlag, Geschäfte mit Hedgefonds und andere Aktivitäten mit ähnlichem Risikoprofil in die Liste der zu trennenden Aktivitäten aufzunehmen; dennoch ist die gegenwärtige Regelung aus den folgenden drei Gründen zu eng gefasst: Erstens ist es für Aufsichtsbehörden in der Praxis unmöglich, eine stringente Trennung zwischen Market Making und anderen Handelsaktivitäten von Banken aufgrund weitreichender Ähnlichkeiten in beiden Bereichen durchzuführen. In diesem Zusammenhang verweist Finance Watch auf den Liikanen-Bericht, welcher Market Making nicht von den zu trennenden Bankaktivitäten ausnimmt. Zweitens geht der Gesetzesvorschlag nicht auf Problematiken ein, die sich aus der gemeinsamen Ansiedlung von Kreditaktivitäten und Handelsaktivitäten unter dem Dach von Großbanken ergeben. So hat der vorliegende Regelungsvorschlag z.B. keine Konsequenzen für einen Großteil der offenen Derivatgeschäfte der Deutschen Bank i.H. eines Nominalwertes von EUR 60.000 Milliarden (dieser Wert beträgt ca. das 23-fache des deutschen Bruttoinlandsprodukts). Damit verfehlt der vorliegende Gesetzesvorschlag sein Ziel, risikoreiche Geschäfte abzuspalten sowie Sparer und Steuerzahler besser zu schützen. Drittens soll eine Abtrennung von Handelsaktivitäten nach Angaben des Gesetzentwurfs nur für solche Institute notwendig sein, deren Bilanzsumme mindestens EUR 90 Milliarden beträgt und deren zu Handelszwecken gehaltene Vermögenswerte 20 Prozent der Bilanzsumme umfassen. Wäre der Gesetzentwurf bereits 2007 in Kraft gewesen, so hätte er aufgrund dieser Regelung auf Institute wie IKB, Düsseldorfer Hypothekenbank und Correalcredit keine Anwendung gefunden.

Aus Gründen der Kohärenz in Hinsicht auf die Vorgaben des Liikanen-Berichts (der Market Making nicht von den zu trennenden Bankaktivitäten ausschließt) sowie vor dem Hintergrund von Erfahrungen und Einsichten aus der Finanzkrise unterstreicht Finance Watch die Notwendigkeit, folgende Kriterien zur Trennung von Bankaktivitäten einzuführen: Aktivitäten des Market Making sollten nicht von den trennbaren Aktivitäten ausgeschlossen werden; die Eckwerte anhand derer festgelegt wird, welche Banken ihre Handelsaktivitäten abspalten müssen, sollten herabgesetzt werden.

- (4) **Finance Watch schlägt eine alternative Regel vor, die dazu geeignet ist, Steuerzahler zu schützen, ohne dass die große Mehrzahl der kleinen und mittleren Banken in Deutschland ihr Geschäftsmodell ändern muss.** Dieser Vorschlag beruht auf der Logik, Banken, die eine eigene Investmentbanking-Einheit besitzen, ein Weiterführen ihres Handelsgeschäfts zu ermöglichen. Dies soll allerdings nur unter den Bedingungen geschehen, dass alle Handelsaktivitäten in eine separate Handelseinheit ausgegliedert werden und dass die zwei Einheiten (Investmentbank und Einlageninstitut) strikt voneinander

getrennt sind. Dieses Vorgehen soll unnötige Transformationskosten vermeiden, indem es auf bereits existierenden und im ökonomischen Sinne funktionsfähigen Organisationsstrukturen aufbaut. Hierbei auftretende Transformationskosten würden aller Voraussicht nach gering sein, da sie nur in Form einmalig anfallender Reorganisationskosten auftreten. Falls keine separate Investmentbanking-Einheit vorhanden ist, würde den Einlageninstituten das Durchführen bestimmter Handelsaktivitäten innerhalb eines vorgegebenen Rahmens erlaubt sein. Diese Regelung will Kunden der Realwirtschaft die Möglichkeit geben, angebotene Handelsdienstleistungen ihrer Kreditinstitute für eigene Zwecke nutzen zu können. In diesem Kontext würde folgende Regelung gelten: (i) die Aktivitäten umfassen lediglich den Handel auf Basis von einfachen Finanzprodukten, welchen die Einlageninstitute mit ihren / im Auftrag ihrer nicht aus der Finanzwirtschaft kommenden Kunden durchführen; (ii) das Volumen der Handelsaktivitäten von Einlageninstituten sollte jeweils nicht mehr als 5% der Bilanzsumme eines Institutes umfassen, da die durchschnittlichen Handelsaktivitäten von kleinen und mittleren Banken unterhalb dieser Schwelle liegen. (iii) Sollten die Einlageninstitute ihre Handelsaktivitäten jenseits der 5%-Schwelle ausweiten wollen, so ist dies an entsprechende Erhöhungen des Eigenkapitals eines jeweiligen Instituts gebunden. Möchte ein Institut seine Handelsaktivitäten z.B. auf 6% seiner Bilanzsumme ausweiten, so ist zusätzliches Eigenkapital in Höhe von 1% der Bilanzsumme notwendig.

## **EXECUTIVE SUMMARY**

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- (1) **Finance Watch welcomes the introduction of resolution and recovery plans as tools of crisis prevention and management. Contrary to the current reading of the Bill, it however urges to expand resolution and recovery planning to all banks.** The reason for this is not only the increased probability of German taxpayers having to bailout foreign banks under the current Bill (cf. point 2 below). Had the regulation as it is being proposed by the Bill been in power as of 2007 it would not have shielded taxpayers from having to rescue institutions that were clearly not deemed to be of systemic importance before the crisis. In its current form the Bill would not protect the taxpayer in the future from having to rescue comparable credit institutions in parallel circumstances should a crisis similar to the crisis of 2008 occur again. In order to draw lessons from experience and with the objective of protecting taxpayers more effectively, Finance Watch thus proposes that all banks should be required to participate in resolution and recovery planning.
- (2) **In its current form, the banking reform Bill is likely to lead to situations in which German tax payers will have to bail-out foreign banks:** Finance Watch would like to highlight the implications of the German banking reform bill for the rest of the European Union and in particular for the Banking Union mechanism and the Bank Recovery and Resolution directive currently being discussed at EU level. Under the joint Banking Union and Bank Recovery and Resolution mechanisms, the losses of a bank should be absorbed, in the following order and respecting the creditors' hierarchy: by its shareholders, by its subordinated creditors, by its junior creditors, by its senior creditors, by its non-guaranteed depositors and finally by the pre-funded fund(s) that will be implemented. Once all those "lines of defence" have been exhausted, the only solution left to cover bank losses will be taxpayers. If Germany keeps its exemption of non-systemically important credit institutions from its Recovery and Resolution regime as proposed in the Bill, there is a high risk that this will have a negative influence on the scope of the EU directive dealing with Bank Recovery and Resolution as it is to be expected that Germany will also defend the same exemption at EU level (if it failed to do so, Germany would have to change Article 1 of the current Bill soon after its adoption). **In turn, narrowing the scope of the EU directive on Bank Recovery and Resolution to systematically important credit institutions only would have the dramatic consequence of emptying this directive of its effectiveness. To illustrate this point, this would mean that, had this directive with a scope reduced to systemically important credit institutions only been in place before the current Spanish banking crisis, it would have been of no use as the Spanish credit institutions that failed collectively and led to the current crisis were not so-called systemically important institutions.**
- (3) **The proposed way of separating banking activities will only be of limited consequence in practice. De facto, the Bill will not stabilize financial markets and increase the security of taxpayers sufficiently:** the banking reform Bill takes the approach of separating proprietary trading (Eigengeschäft) activities only, with a definition of proprietary trading as "non-client facing" (which excludes, by definition, market making). While Finance Watch appreciates the general intention of the Bill including its proposal to

separate hedge fund lending and activities that bear similar risk profiles, it deems this approach to be too limited for three reasons: first, it is technically impossible for supervisors to differentiate between market making and other trading activities of banks due to inherent similarities of both types of strategies. In this context Finance Watch points out that the Liikanen Report does not exempt market making activities; second, the current proposal fails to capture the bulk of the problem, which is linked to having credit activities and financial markets trading activities of very large banks under the same roof. For instance, the vast majority of Deutsche Bank's EUR 60,000 billion (around 23 times Germany's Gross Domestic Product) underlying notional amount of derivatives outstanding will be left untouched by this banking bill despite the Bill's objective to separate risks and to protect both the taxpayer and depositors; third: separation is only required for banks with a balance sheet total of EUR 90 billion that hold assets for the purpose of trading at 20 per cent of their balance sheet total. This threshold implies that – had the Bill been in place as of 2007 – it would not have applied to banks such as IKB, Düsseldorfer Hypothekenbank and Correalcredit.

With a view to being coherent with the recommendations made by the Liikanen Report (that does not exempt market making), and so as to apply lessons learned from the crisis, Finance Watch underlines the need for separation principles that do not exempt market making and that apply lower thresholds for the determination of which banks' trading activities are to be separated.

- (4) Finance Watch suggests an alternative rule that will enhance taxpayer protection whilst allowing the vast majority of small and medium size banks in Germany to keep on serving their customers as they are today.** This suggestion rests on the logic that if there is a proper investment bank entity in the banking group, and provided that the two entities (investment bank and deposit-taking bank) are properly separated, then trading could go on as before under the condition that all the trading activities be transferred to the investment banking entity of the group. The rationale behind is to avoid unnecessary costs and to build on existing, economically viable entities. The cost of such a transfer of activities would remain low (at most one-off reorganisation costs). In the case where there is no separate investment banking entity, acknowledging that it might be possible for a deposit-taking bank to conduct limited trading activities to the benefit of its non-financial clients, some trading activities might be allowed in the deposit-taking bank. The following threefold rule would apply: (i) these trading activities must be limited to simple financial instruments undertaken with / on behalf of non-financial firms; (ii) the amount of trading activities within the deposit-taking bank should be capped at 5% of total balance sheet, given the fact that on average trading activities of medium size and small banks are below that level. (iii) Should the bank wish to increase the share of its trading activities above the threshold, then any increase should be backed by additional equity. For example, if trading activities increase to 6% of total balance sheet, then an additional amount of equity equivalent to 1% of total balance sheet would be required.

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## I. MAIN POINTS AND PROPOSALS

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- **On implementing a recovery and resolution mechanism (Article 1)**

Recovery and Resolution plans are essential to protect society and the taxpayer from the negative consequences of failing credit institutions. Recovery and Resolution plans are also, ultimately, about deciding who, between creditors and tax payers, will bear the losses in case of a bank default.

The German bill takes the approach of implementing a recovery and resolution plan for systemically important credit institutions only.

In Finance Watch's view, this approach is too limited as it fails to recognize the fact that, as witnessed over the past few years by the examples of Ireland, Spain but also Germany, failing small or medium size credit institutions can create a heavy burden for taxpayers if society needs to bail them out and, as in the Irish and Spanish cases, can be the cause of a systemic crisis.

**With a view of protecting the German taxpayer against the consequences of banking crises, Finance Watch recommends therefore that the Recovery and Resolution mechanism organised by Article 1 of the bank Bill cover all credit institutions and not only those institutions deemed systemically important.**

- **On ring-fencing risk through the separation of banking activities (Article 2)**

The German bill takes the approach of separating proprietary trading (Eigengeschäft) activities only, with a definition of proprietary trading as "non-client facing" (which excludes, by definition, market making).

In Finance Watch's view, the general intention of Article 2 is to be welcomed as is its proposal to separate hedge fund lending and other activities with similar risk profiles. However, as the Bill exempts market making activities from operations that need to be separated, it proposes a measure that will not be realizable. This is due to the fact that supervisors cannot differentiate sufficiently between market making and non-market making activities in practice. Given its focus on client facing vs. non-client facing activities we further deem the approach of the Bill to be too limited as it fails to capture the bulk of the problem linked to the fact of having credit activities and financial markets trading activities of very large banks under the same roof. This is a major difference between the Bill and the Liikanen report, which makes a clear case for not exempting market making from the activities of banks that need to be separated.

For instance, the vast majority of Deutsche Bank's EUR 60,000 billion (around 23 times Germany's Gross Domestic Product and equivalent to world GDP) underlying notional amount of de-

derivatives outstanding<sup>1</sup> will be left untouched by this banking bill despite the Bill's objective to shield risk and to protect both the taxpayer and depositors.

Moreover, the threshold for separating proprietary trading activities proposed by the Bill (total trading activities above EUR 100 billion or 20% of balance sheet if the balance sheet total is (above) EUR 90 billion) is so high that it misses the target of protecting the German taxpayer on pure speculative activities.

**Finance Watch recommends therefore separating all trading activities, including client facing trading activities, above a threshold fixed at 5%.** This would have the result of protecting the German taxpayer much better against the risk of having to bail-out defaulting banks whilst preserving the ability of German banks to serve the needs of their corporate clients, including on financial markets activities.

- **On setting up separated trading entities (Article 2)**

Finance Watch welcomes the general approach applied by Article 2 of setting up Financial Trading Institutions as financially independent entities, which are subject to specific supervisory rules and requirements. As Article 25f BA-D remains imprecise as to the question of the relationship that shall prevail between the credit institution and the separated Financial Trading Institution, Finance Watch holds that this relationship should be subject to rules that avoid a situation where the interests of the investment bank would be mingled with those of the deposit-taking bank. These rules include the provision that each entity should have separate executive teams, with no overlap between the two.

- **On implementing a criminal liability regime (Article 3)**

Finance Watch welcomes the objective of ensuring responsibility of banks' managers. However, it does not consider itself as adding sufficient value on the specificities of the rules and procedures proposed by Article 3 of the Bill to comment in a meaningful manner.

- **On the implications of the German banking reform Bill for the European Union**

Finance Watch would like to highlight the implications of the German banking reform bill for the rest of the European Union and in particular for the Banking Union mechanism and the Bank Recovery and Resolution directive currently being discussed at EU level.

Under the joint Banking Union and Bank Recovery and Resolution mechanisms, the losses of a bank should be absorbed, in the following order and respecting creditors' hierarchy, by its shareholders, by its subordinated creditors, by its junior creditors, by its senior creditors, by its non-guaranteed depositors (fraction of deposits above the € 100 000 guarantee, with the additional question of depositors' preference) and finally by the pre-funded fund(s) that will be implemented. Once all those "lines of defence" have been exhausted, the only solution left to cover bank losses will be taxpayers. Given the general state of public finances in the EU and the

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<sup>1</sup> Liikanen, Erkki et al.: 2013. High-level Expert Group on reforming the structure of the EU banking sector,



low political acceptability of having taxpayers bailing-out credit institutions, it is essential that the “lines of defence” put in place be strong enough.

If Germany keeps its exemption of non-systemically important credit institutions from its Recovery and Resolution regime, there is a high risk that this will have a negative influence on the scope of the EU directive dealing with Bank Recovery and Resolution as it is to be expected that Germany will also defend the same exemption at EU level (if it failed to do so, Germany would have to change Article 1 of the current Bill soon after its adoption).

**In turn, narrowing the scope of the EU directive on Bank Recovery and Resolution to systematically important credit institutions only would have the dramatic consequence of emptying this directive of its effectiveness.** To illustrate this point, this would mean that, had this directive with a scope reduced to systemically important credit institutions only been in place before the current Spanish banking crisis, it would have been of no use as the Spanish credit institutions that failed collectively and led to the current crisis were not so-called systemically important institutions.

**Finance Watch recommends therefore that Article 1 of the Bill be amended to include all German credit institutions. Failing to do so will imply that German taxpayers will not be protected from the risk of failing German credit institutions. Even more importantly, it will also imply that the EU will run the risk of adopting a directive on Bank Recovery and Resolution with a scope so limited that it will put all European taxpayers at risk in case of default of credit institutions.<sup>2</sup> Given the pre-eminence of Germany in EU public finance issues, this would clearly put German taxpayers at risk of having to bail-out in the future non-German failing credit institutions.**

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<sup>2</sup> This would be the case if the Bill led to alterations of the current draft of the crisis management framework directive as the Draft Directive is making its way through the European legislative process. Resolution and Recovery plans as suggested by the Draft Directive should apply to all banking institutions, irrespective of their size and complexity.

## II. RECOVERY AND RESOLUTION PLANNING

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### 1. Recovery Plans

#### 1.1. Recovery plans are useful Instruments for reducing uncertainties; yet, limiting Recovery planning to SIFIs underestimates the dynamic nature of crises and does not protect society.

Article 1 of the Bill foresees that recovery plans are drawn up by credit institutions and the parent undertakings of groups of financial institutions, which the Federal Financial Supervisory Authority (BaFin) determines to be of systemic importance on the national and/or global level.<sup>3</sup> The goal of recovery plans is to avoid the disastrous consequences of bank failures and to give supervisors the tools to intervene before default happens in order to protect banks' customers and society. In the recovery plan, the respective credit institution has to describe scenario-based options for action that can be undertaken by senior management in case of severe stress situations, in order to stabilize the economic situation of the credit institution/financial group and ensure its survival, without relying on stabilization measures funded with taxpayer money. In order to ensure that recovery plans are operational, BaFin may request revisions and impose further measures. Also, if BaFin identifies obstacles to recovery it may request changes to risk profiles or management of the respective credit institutions, and measures to address refinancing and recapitalization.

Finance Watch welcomes the introduction of recovery plans into the German Banking Act (BA). In 2011, the German legislator reacted to lessons learned in the crisis by introducing the Credit Institutions Reorganization Act as ad-hoc instrument of crisis management. As recovery plans represent legal instruments that allow managers, regulators, and investors to assume a long-term perspective complementary to existing ad-hoc instruments they seem to be appropriate tools for enhancing systemic stability.

However, questions remain with regard to the effectiveness of the current formulation of Article 1 of the Bill. These questions result from existing limitations with regard to recovery planning obligations that the Bill only demands to be implemented only for credit institutions that represent a systemic danger (cf. Article 47 1 of the German Banking Act – Draft (BA-D)). Limiting obligations of recovery planning only to a certain group of financial institutions underestimates the potentially disastrous impact of smaller financial institutions failures in times of crisis, the dynamic nature of systemic crises and the interconnectedness of the banking system. If one lesson can be drawn from the current Spanish banking crisis, it is precisely that small banks also can be the catalyst of systemic crises and their disastrous consequences for society. **Finance Watch therefore recommends that all financial institutions should be required to**

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<sup>3</sup> Article 48b (2) BA extended by Article 48 (2) BA-D refer to the principles that shall help supervising authorities to identify systemically important institutions. These principles do refer to a number of qualifying characteristics that determine systemic importance of an institution. The current text refers to the term of "systemic importance" in analogous terms.

**draw up recovery plans.** This recommendation is based upon the following three points of reasoning:

- **Historical evidence of the recent crisis suggests that it is not the largest banks that cost taxpayers the most money.** In fact, the crisis did not “hit the largest or most sophisticated banks hardest. The most severely affected, Hypo Real Estate, IKB and LB Sachsen (all of whom effectively collapsed) are relatively small.”<sup>4</sup>
- **By limiting the obligation of recovery planning to institutions that are deemed systemically important by BaFin at singular points in time, the Bill does not account for the dynamic nature of systemic relevance.** It also conflicts with existing rules such as Article 48b 2 (5) BA that introduces the current state of financial markets as contingency for defining the systemic relevance of financial institutions. Thus, Article 48b 2 (5) BA acknowledges the fact that the question whether an institution is of systemic relevance may be answered differently depending on whether the economy and financial markets are in an upswing or downturn. A decisive lesson of the years 2007 - 2009 has been that when a bank crisis hits and given the current high level of interconnectedness between banks, it becomes impossible to differentiate between systemically important and systemically irrelevant institutions. In that context, it is indispensable that all credit institutions should file recovery plans and be subject to the possibility of resolution.
- **By limiting the obligation of recovery planning to institutions that are deemed systemically important by BaFin at singular points in time, the Bill is internally inconsistent in its reasoning.** This becomes evident with regard to the assessment of institutional resolvability (Article 47d 1 BA-D). According to Article 47d 1 BA-D, BaFin has to carry out these assessments with regard to all credit institutions and financial groups, irrelevant of the question whether these entities are of systemic relevance or not. The Bill justifies its decision to not differentiate between financial institutions by arguing the potential for a given institution to create systemic risks is subject to fluctuating market contingencies. Hence, limiting obligations in contexts with resolvability assessments to particular institutions would imply that there would be no sufficient preparation for the case of crisis.<sup>5</sup> The Bill proposes both the instruments of recovery plans and resolvability assessments as means for ensuring institutional and systemic stability. Differentiating between systemically *relevant* and systemically *irrelevant* institutions in context of one of the two instruments (recovery planning) while treating all institutions equally in context of the other of the two instruments (resolvability assessments) would thus be inconsistent with regard to the internal logic of the Bill as well as with regard to achieving its objectives.

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<sup>4</sup> Hardie, Ian, Howarth, David: 2009. Die Krise but not La Crise? The Financial Crisis and the Transformation of German and French Banking Systems, in: Journal of Common Market Studies, Vol. 47 (5), pp. 1017 – 1039, pp. 1028 – 1030. Also note that SOFFIN measures carried out by FMSA with regard to smaller institutions (total balance sheet assets < EUR 90 billion.) exceeded EUR 70 billion between 2008 and 2012 (own calculations based on data from FMSA: 2013. Historischer Überblick über die Maßnahmen des Soffin. <http://www.fmsa.de/de/fmsa/soffin/index.html>).

<sup>5</sup> Bundesregierung: 2013. Entwurf eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen (in the following: Gesetzesentwurf), p.41.

## 2. Resolution Plans

### 2.1. Resolution plans are useful Instruments for reducing uncertainties; yet, limiting Resolution planning to SIFIs underestimates the dynamic nature of crises and does not protect society.

Article 1 of the Bill further foresees that BaFin will draw up resolution plans so as to make sure that institutions can be resolved in times of crisis without burdening taxpayers or endangering other institutions and market participants. In this context, BaFin can apply measures with regard to financial institutions so as to make sure that the latter do not face obstacles to resolution. BaFin applies these measures on the basis of resolvability assessments. While all financial institutions are to be assessed with regard to their resolvability, BaFin only draws up resolution plans for systemically important institutions.

Finance Watch welcomes the introduction of resolutions plans into the BA. In 2011, the German legislator reacted to lessons learned in the crisis and the resolution of institutions such as West LB by introducing the Bank Restructuring Act as ad-hoc instrument of crisis management. As restructuring plans represent legal instruments that allow managers, regulators, and investors to assume a long-term perspective complementary to existing ad-hoc instruments they are indispensable tools for enhancing systemic stability.

As already stated above for recovery planning, Finance Watch holds that differentiating between systemically important and systemically irrelevant institutions when it comes to resolution planning does not comply with the general purpose of the Bill nor with its internal consistency and the general objective of restructuring plans as instruments of financial stabilization. Hence, Finance Watch argues that the requirement of resolution plans should apply to all credit institutions.

The Spanish banking crisis is a good illustration of the fact that several small and not systemically important credit institutions failing together can cause a systemic crisis and put society and tax payers at risk. The essential piece of regulation missing to deal with the current banking Spanish crisis without impacting taxpayers has been a strong resolution mechanism covering the failing institutions. As a consequence, public authorities have been obliged to bail-out the defaulting banks at society's expenses.

Finally, it must be noted that if one lesson can be drawn from the US experience on the issue of bank resolution, it is precisely that a strong bank resolution mechanism can work effectively and therefore protect society from the failure of small to medium size banking institutions when it is usually much more problematic for large banks. It would therefore be paradoxical for Germany to implement a resolution mechanism that not only does not address the key issue of protecting society against the consequences of banks failures but also applies only to the fraction of banking institutions for which it is less effective.

### III. SEPARATING RISKY ACTIVITIES

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#### 1. Threshold Criteria

##### 1.1 The current proposal provides insufficient protection to taxpayers and society

Article 3 Paragraph 2 Section 3 of the German Banking Act Draft (BA-D) prohibits banks to carry out highly risky trading activities, defined as proprietary trading, if these banks surpass the thresholds defined in Article 3 Paragraph 2 Sections 1 and 2 BA-D. The prohibition does not apply if highly risky trading activities are carried out by a ring-fenced entity as defined in Article 25f BA-D. In detail, Article 3 Paragraph 2 Sections 1 and 2 BA-D foresee that separation requirements apply to banks which draw up their balance sheet in accordance with IAS and IFRS or German GAAP, if the assets classified as held for trading and available for sale exceed the value of € 100 billion or exceed 20 per cent of the balance sheet total provided the balance sheet total for the three preceding years reaches € 90 billion.

Finance Watch welcomes the introduction of principles of Banking Separation into the German Banking Act (BA) in general terms. **However, we hold that the threshold criteria are set too high in order to fulfill the general objectives that stand behind the introduction of Article 2 of the Bill.** These objectives contain the goal to “guarantee the stability of financial markets in a sustainable manner”, as well as the aim to prevent taxpayers from having to pay for speculative behaviors of financial institutions.<sup>6</sup>

Table 1 below clarifies our reasoning. It catalogues banks that received government funds from the German Financial Market Stabilization Fund (SOFFIN) in form of equity and guarantees between 2008 and 2012 at volumes of more than EUR 200 billion.<sup>7</sup> 4 out of 9 banks listed in Table 1 (excluding SdB) carried balance sheet totals with volumes that were below the threshold-volume of EUR 90 billion as defined by Article 3 Paragraph 2 Sections 1 and 2 BA-D. This implies that – had the rule already been in place in 2008 – it would not have prevented these banks from continuing their high risk trading activities under one roof. Given this kind of counterfactual historic evidence, we conclude that the threshold set in Article 3 Paragraph 2 Sections 1 and 2 BA-D is an insufficient instrument for minimizing public burdens that can result from the speculative behavior of banks. Since this measure does not prevent banks from taking speculative risk at taxpayers’ costs it seems necessary to come up with alternative and more effective measures to resolve existing disincentives within the financial sector.

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<sup>6</sup> Bundesregierung 2013, Gesetzentwurf, p.2 and p.30.

<sup>7</sup> This number includes only equity provisions and guarantees provided to institutions with a balance sheet total of < EUR 90 billion.

Institute	First year in which Soffin-capital/guarantee – measures applied <sup>1</sup>	Balance Sheet Total in the respective year in EUR billion <sup>2</sup>	Would have had to ring-fence risky trading activities due to EUR 90 billion-Threshold
Aareal Bank	2009	41.7	NO
BayernLB	2009	415,613	YES
Commerzbank	2008	625,244	YES
CorrealCredit	2009	11.4	NO
DüsseldorfHyp	2009	27	NO
HRE/FMS-WM	2008	419.7	YES
HSH Nordbank	2008	208.4	YES
IKB	2009	44.7	NO
Portigon (former West LB)	2009	242.3	YES
SdB (for the rescue of Lehman Brother Customers)	2009	N.A.	NO

Table 1: Balance Sheet Totals of Institutions that Received SOFFIN Measures within the Period of 2008 – 2012 (own Table) (Sources: <sup>1</sup>FMSA (2013); <sup>2</sup>Annual Reports of the respective banks and years in question).

## 1.2 Alternative measures can close gaps within Article 3 Par. 2 Sect. 1 and 2 BA-D

As alternative measures to the rules defined in Article 3 Par. 2 Sect. 1 and 2 BA-D we would like to propose the following:

The **amount of trading activities, whether proprietary trading or client facing trading, within deposit-taking banks should be capped as a % of total balance sheets independent of the size of the respective bank.** Based on the data provided in the Report by the High Level Expert Group on Reforming the Structure of the EU Banking Sector,<sup>8</sup> we would suggest **a 5% threshold.** This threshold minimizes the legislative consequences for medium sized and small banks given the fact that on EU-average medium sized-banks' trading activities are below that level and small banks are far below (less than 1% on average (cf. above). At the same time it closes gaps within Article 3 Par. 2 Sections 1 and 2 BA-D by preventing risk taking activities of banks, which in the past entered into high-risk contracts at costs of society and which are currently excluded from the separation requirements laid out in the current Bill.

Should a given bank wish **to increase the share of its trading activities above the threshold**, then any increase should be **backed by additional equity.** For example, if trading activities increase to 6% of total balance sheet, then an additional amount of equity equivalent to 1% of total balance sheet would be required.

This approach of this “*de minimis*” principle has a number of advantages that can be summarized as follows:

<sup>8</sup> Liikanen, et al. 2013, p.35 Chart 3.3.4.

- The 5% threshold would **allow medium and small-sized commercial banks to provide plain vanilla hedging / trading services to their non-financial business clients**. These banks would therefore not be challenged in their current business model;
- The additional equity would “cover” the additional trading activities and related risks that go beyond the imposed threshold. Any loss incurred above the threshold would therefore be unlikely to threaten the solvency of the bank; moreover, **the management of the bank would remain fully responsible in front of its shareholders** for the risks taken in the context of its trading activities;
- **Large banking groups with significant trading activities** would be able to pursue those activities in a separate entity (existing or to be created), which should not represent more than relatively **minor reorganization costs**.
- **Trading activities would only be pursued in a separate entity if they are economically sustainable on a stand-alone basis**, i.e. without benefiting from the implicit guarantee from the state; they would gain in size only if the business model is deemed sustainable by shareholders and investors.

## 2. Trading Activities

### 2.1 Separation of banking activities should impact proprietary trading but not only proprietary trading

Article 3 Paragraph 2 Section 3 BA-D defines the activities that banks will have to separate under the new Bill. These activities include (i) proprietary trading (“Eigengeschäft”, i.e. trading in financial instruments for their own account that does not represent services to third parties), (ii) lending and guarantee business with hedge funds and their managers, funds of hedge funds and their managers, EU and Non-EU AIFs and their managers if they use leverage on a substantial basis, and (iii) High Frequency Trading with the exception of market making.

Finance Watch welcomes the general approach to separate different activities of banks in Germany so as to protect the essential deposit taking and credit functions provided by banks. In particular, Finance Watch supports the proposal of separating lending to hedge funds as well as High-Frequency Trading. Separating risky trading activities from banks’ deposit business is necessary for increasing transparency with regard to the question whether and at what scope banks subsidize these activities by leveraging deposits.<sup>9</sup> As the current proposal foresees that banks refinance ring-fenced trading activities independently (Article 25f BA-D), costs of refinancing risky trading activities will reflect the true economic risks associated with these kinds of activities and thus stabilize markets.

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<sup>9</sup> Hackethal, Andreas, Krahn, Jan Pieter: 2013. Kommentierung des “Entwurfs eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen” vom 06. Februar 2013. Center of Excellence Safe Sustainable Architecture for Finance in Europe, Policy Letter Series No. 3.

Banks that face artificially low costs of financing their risky trading activities will expand these activities beyond their true economic value.<sup>10</sup> Table 2 shows how market vulnerability of major German banks was amplified in the years before the crisis due to increased trading activities. In particular, this is the case with regard to derivatives trading. Standard economic models foresee that “derivatives are used to reduce the risks from both credit ... and interest rate mismatches.” (However, in most banks listed below the “volume of derivatives traded massively exceed[ed] that required for hedging purposes.”<sup>11</sup> The steep increases in derivative trading activities before the crisis were not related to banks’ risk management for own or customer positions. Rather, banks increased their market exposures in context with proprietary trading.<sup>12</sup>

Institute	Increased Trading Activities
Commerzbank	Trading assets peaked at 24.0 per cent in 2004 and fell thereafter. Notional derivatives volume* 10.9 times total assets in 2007 (9.6 times in 2003).
Deutsche	Trading assets 45.9 per cent of total assets in 2006 (30.9 per cent in 2000). Notional derivatives volume 24.5 times total assets in 2007 (35.4 times in 2006, 19.3 times in 2002).
Dresdner	Trading assets 32.0 per cent of total assets in 2007 (21.4 per cent in 2000). Notional derivatives volume 13.4 times total assets in 2007 (7.7 times in 2002).
Bayerische LB	93.7 per cent of derivatives activity for trading purposes in 2007 (76.4 per cent in 2003).
Helaba	Notional derivatives volume 3.4 times total assets in 2007 (3.1 times in 2003).
HSH Nordbank	Proportion of securities held for trading purposes 55.7 per cent in 2006 (11.0 per cent in 2002). Trading assets 13.4 per cent of total assets in 2006. Notional derivatives volume 3.7 times total assets in 2007 (1.5 times in 2002).
LBBW	Proportion of securities held for trading purposes 30.9 per cent in 2006 (12.5 per cent in 2002). Notional derivatives volume 4.4 times total assets in 2007 (2.1 times in 2002).
LB Sachsen	Proportion of securities held for trading purposes 15.3 per cent in 2007, more than triple 2003 figure. Notional derivatives volume 0.7 times total assets in 2007 (1.1 times in 2003). Derivatives mostly to hedge.
NordLB	Notional derivatives volume 1.7 times total assets in 2007 (1.7 times in 2002).
WestLB	Proportion of securities held for trading purposes 41.7 per cent in 2006 (28.4 per cent in 2000). Trading assets 32.5 per cent of total assets in 2007. Securities held for trading purposes peaked in 2002 at 51.3 per cent. Notional derivatives volume 9.0 times total assets in 2007 (8.5 times in 2002). Peak 10.3 times in 2005.
DZ Bank	Proportion of securities held for trading purposes 58.0 per cent in 2007 (21.2 per cent in 2002). Trading assets 30.1 per cent of total assets in 2007. Notional derivatives volume 3.2 times total assets in 2008 (2.0 times in 2002).
Hypo Real Estate	Notional derivatives volume 2.8 times total assets in 2007 (1.6 times in 2003).
IKB	Notional derivatives volume 1.0 times total assets in 2007 (0.8 times in 2004).

Table 2: Increased Bank Trading Activity (Source: Hardie & Howarth, 2009)

The reported market activities – and in particular derivatives trading of German banks as well as non-German banks - were to a large extent not related to the real economy. This is evidenced by global numbers which show that less than 10% of OTC derivatives are traded with a non-financial counterpart, leaving the rest - more than 90% - as trading instrument for and by the financial sector (c.f. Figure 1 below).<sup>13</sup>

<sup>10</sup> Friedman, Benjamin: 2010. Is our financial system serving us well? In: Daedalus Journal of the American Academy of Arts & Sciences, On the financial crisis and economic policy, Fall, pp. 9-21.

<sup>11</sup> Hardie & Howarth 2009, p.1022.

<sup>12</sup> Hardie & Howarth 2009, p.1023.

<sup>13</sup> cf. Bank for International Settlements (BIS): 2010. Triennial Central Bank Survey, Foreign exchange and derivatives market activity in 2010, [http://www.bis.org/publ/otc\\_hy1011.htm](http://www.bis.org/publ/otc_hy1011.htm) (own calculations).



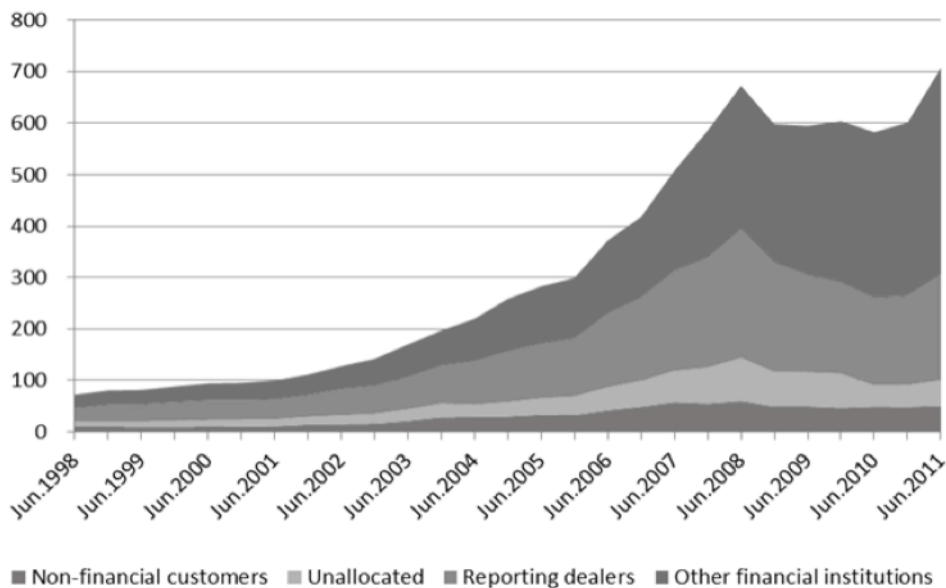


Figure 1: OTC Derivative Trading Counterparts (Source: BIS 2010)

## 2.2. The current criterion of separating proprietary trading but not other trading activities does not reflect the reality of trading activities and is therefore not implementable as such

**Article 3 Paragraph 2 Section 3 BA-D provides for the separation of (non-market making) proprietary trading, as this high-risk activity is not part of the core function of banks.** Yet, Finance Watch questions the differentiation of proprietary trading and trading as customer service / market making as proposed in Article 2 of the Bill as there is ample reason to believe that this form of differentiating activities is not feasible in practice. This is due to the fact that in effect, “market making is proprietary trading that is designed to provide ‘immediacy’ to investors. For example, an investor anxious to sell an asset relies on the market maker’s standing ability to buy the asset for itself, immediately. Likewise, an investor who wishes to buy an asset often calls a market maker who then sells the asset out its inventory.”<sup>14</sup> Market supervisors can therefore not differentiate whether a financial institution is keeping stocks and other financial instruments in its inventory for the purpose of market making, or as result of proprietary trading for its own account.<sup>15</sup> Finance Watch would like to highlight that the exemption of market making activities in the current Bill represents a major difference to the Liikanen Report that does not exempt market making activities. In view of being consistent with the Liikanen Report Finance Watch thus recommends separating market making activities from credit and deposit taking activities of banks.

Pages 59 – 60 of the Bill contain a concrete list of market making, trading and trading-related activities that financial institutions shall be allowed to carry out. These activities include among

<sup>14</sup> Duffee, Darrel: 2012. Market Making Under the Proposed Volcker Rule, [www.federalreserve.gov/SECRS/2012/January/20120118/R-1432/R-1432\\_011712\\_88664\\_334954090642\\_1.pdf](http://www.federalreserve.gov/SECRS/2012/January/20120118/R-1432/R-1432_011712_88664_334954090642_1.pdf)

<sup>15</sup> Hackethal & Krahn 2013.

other things customer service transactions in the process of clearing and settlement, entering into term contracts for the purpose of hedging customer risks, and other customer service transactions for the purpose of risk insurance.

The market making and trading activities listed share fundamental characteristics with the proprietary trading activities that the Bill foresees to separate (“Eigengeschäft”). By nature market making necessarily involves taking a view on how prices are going to move and involves holding an inventory (c.f. above). These are also the two essential elements of proprietary trading (“Eigengeschäft”). All market making (as opposed to broking) involves thus an element of proprietary trading. Making markets involves standing ready to buy and sell, and communicating to market participants the prices at which the market maker is willing to do so. Deciding on those prices requires for market makers to decide how happy, or not, they are to hold the instruments in question on their book and adjusting their bid and ask prices accordingly. Market making does not involve simply adding a margin to a (hypothetical) mid-price, it involves adjusting the price to buy and your price to sell to “win” or “miss” client trades and to adjust inventory accordingly, all the while bearing in mind reputation.

Similarly, hedging necessarily involves transforming rather than eliminating risks. Simply put, the only way to eliminate a risk is to sell the source of that risk. A hedge, by definition, is something other than selling the underlying source of risk. Therefore hedging always involves taking a proprietary view e.g. on counterparty risk, on the movements in an index vs. the price moves of a component, on movements in prices of similar instruments with different maturities and so on.

Managing derivatives positions implies by definition opening risk positions on multiple parameters (market level, interest rates, volatility, correlation, etc...) and in the reality of a trading operation there is very little, if any, economic difference between “pure proprietary trading” and the management of client facing derivatives positions that require banks’ traders to take a view on the evolution of those market parameters.

Given the wide scope of the activities to be allowed under the new rule and their structural similarities to the activities that are to be ring-fenced, **the Bill will not achieve its objective of protecting banking activities that are vital for society (deposit taking, credit and payment services) from high risk trading activities carried out by banks.** Instead, most financial institutions will de facto be able to carry on not only their general (by nature) risky client facing trading activities but also their proprietary trading as before thanks to the high threshold of trading activities triggering the separation of proprietary trading.

### **2.3. Due to its impracticability, the current proposal should be replaced by simpler rules that are straightforward to apply in practice**

The fundamental similarity between all trading activities and their difference from commercial banking activities is one reason why Finance Watch is convinced that, in the absence of full separation, a strong ring fence that would keep all trading activities including market making and client-facing ones separated from vital banking activities is essential.

The difficulty of distinguishing between trading activities provides a strong argument for simplicity, with regard to proprietary trading as well as with regard to the principles and rules of separation. . . Aside from the possibility of losses, a complex definition of permitted trading activities, either inside the ring-fenced entity or elsewhere in the group, will be subject to attempts at regulatory arbitrage and to degradation over time. Simple rules, on the other hand, would simplify the choices of investors in commercial and investment banks with their respective risk profiles.

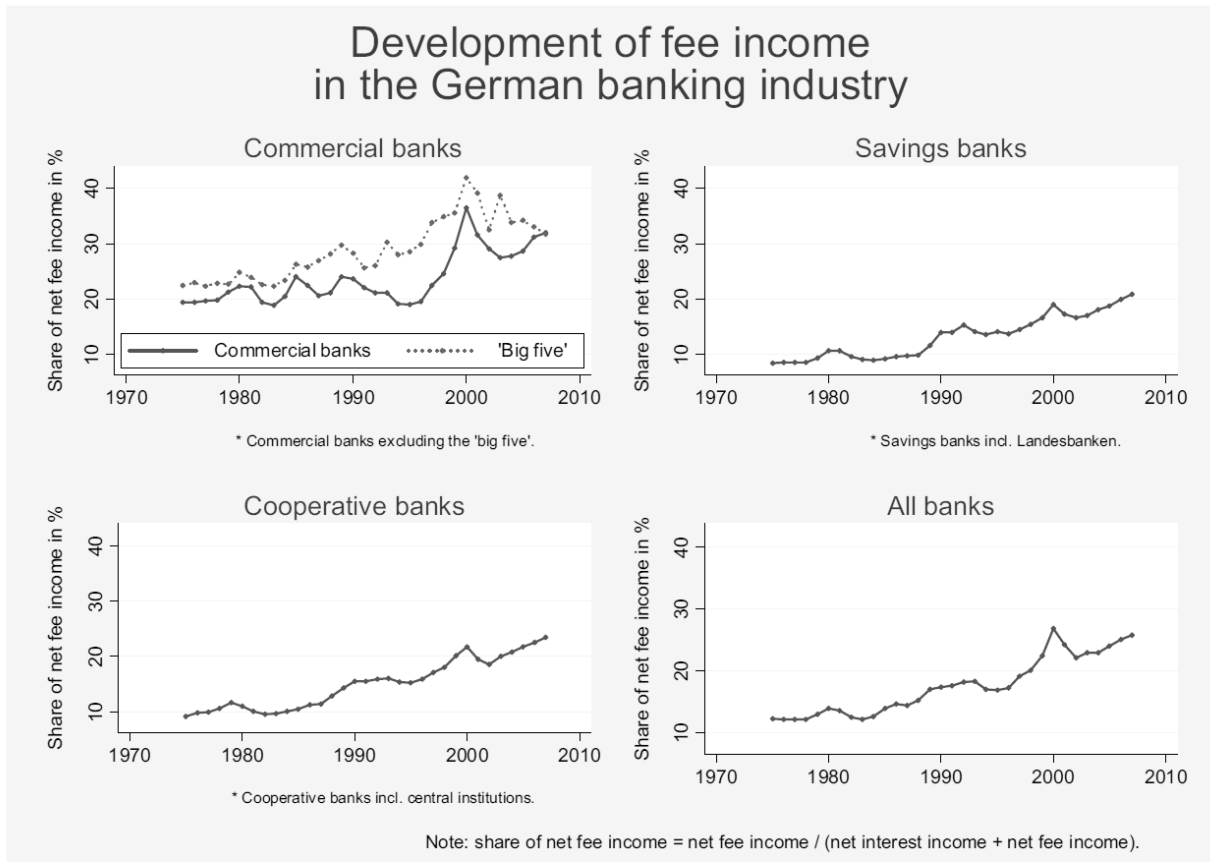
Simple rules that group trading activities in an investment bank, separated from commercial banking activities, would aid regulatory control, including addressing public interest concerns across a range of investment banking activities. For example market making involves activities that might not be fully in the public interest. **Moreover, separation must simply be seen as the natural consequence of the fact that trading activities are of a different nature from credit activities. Therefore even useful market making activities have no reason for being carried out “under the same roof” as credit activities and being subsidized by public support.** The “real” economy might need investment banking (to raise large scale finance) but, funding subsidies aside, one can reasonably ask how much investment banking needs the “real” economy. The majority of investment bank trading appears to be directed elsewhere. Less than 10% of OTC derivative notional outstanding faces non-financial firms. World trade is less than 5% of foreign exchange activity.<sup>16</sup> Also, less than 10% of Eurozone non-share securities are issued by non-financial firms.<sup>17</sup> In short, the vast majority of financial market activity is not concerned with directly financing the “real” economy. Nevertheless it is banks, and only banks, that organize the issuance of these securities and make markets in them. It is not simply proprietary trading that should be insulated from public support, but also finance-to-finance securities and derivatives trading that should be forced to stand apart from (implicit) public support.

It must be noticed that in Germany the switch in business models from interest generating operations (i.e. credit and lending) to fee generating operations (trading) large has been very much a large Commercial banks phenomenon since the mid-1990s. It is noticeable that Savings and Cooperative banks are much less dependent on trading than Commercial banks. Figure 2 shows the differences in the importance of trading for various types of banks in Germany and how Commercial banks have been relying more and more on fees and spreads from trading activities since the mid-1990s. The pattern is repeated at the European level as figure 2a below shows.

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<sup>16</sup> Cf. footnote No. 11; World Trade Organization (WTO): 2013. Statistics Database. <http://stat.wto.org>; Bank for International Settlements: 2010. Triennial Central Bank Survey, Foreign exchange and derivatives market activity in 2010, Statistical Release, [www.bis.org](http://www.bis.org) (own calculations).

<sup>17</sup> European Central Bank. 2013: Securities Issues. <http://www.ecb.int/stats/money/securities/debt/html/index.en.html> .



Source: Deutsche Bundesbank, Monthly Report.

Figure 2: Development of Fee Income in the German Banking Industry (Source: Busch, R., Kick, T.: 2009. Income diversification in the German banking industry. in: Deutsche Bundesbank Discussion paper Series 2, Banking and Financial Studies, 2009-09).

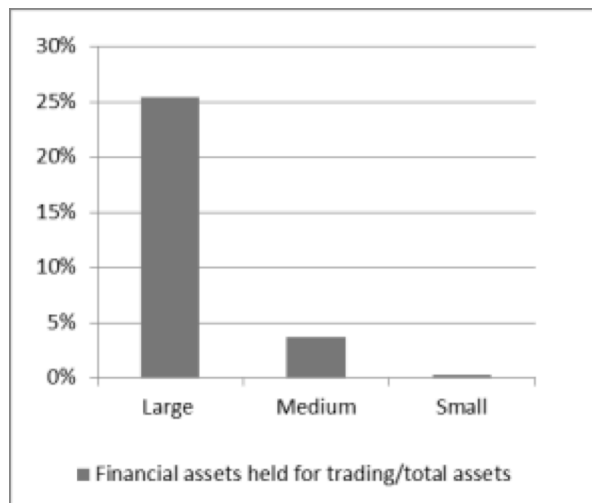


Figure 2a: Importance of trading activity for EU banks as of 2011 (Source: Liikanen et al. 2013).

### 3. Financial Trading Institution (Finanzhandelsinstitut)

#### 3.1. The design of the financial trading institution defined in Article 25f BA-D contains ambiguities that need to be overcome

Article 25f BA-D defines the Financial Trading Institution in which separated activities (as defined in Article 3 Paragraph 2 Section 3 BA-D) will be located. According to this definition, the Financial Trading Institution has to operate as an economically and legally independent entity; that entity may, however, carry out its business within a bank group that includes the credit institution the business of which is to be protected by the Bill. The Financial Trading Institution has to be licensed under the BA and may do business with group entities only at arm's length. Special information rights and duties of the responsible supervisory board of the Financial Trading Entity, or the respective parent apply.

Finance Watch welcomes the general approach applied by Article 25f BA-D of setting up Financial Trading Institutions as financially independent entities, which are subject to specific supervisory rules and requirements. We expect that from these requirements it will follow that **separated trading activities will only be pursued if they are economically sustainable on a stand-alone basis**. I.e. Financial Trading Institutions will not be benefiting from implicit state guarantees; they will gain in size only if the business model is deemed sustainable by shareholders and investors. In addition to prohibiting the deposit-taking bank to transfer capital to the Financial Trading Institution, Finance Watch further suggests that the latter can increase its capital only with the approval of the supervision authority so as to ensure market stability and prudent behavior.

Further on, Article 25f BA-D is imprecise as to the question of the relationship that shall prevail between the credit institution and the ring-fenced Financial Trading Institution. It is also imprecise as to the question of the consequences that follow from the supervisory rules defined in Art 25f 5 BA-D with regard to the supervisory independence of the Financial Trading Institution.

Given these gaps and ambiguities, as well as in light of the above-described proposal of alternative measures for protecting essential banking services via separating banking activities, Finance Watch would recommend to follow the approach developed in the introductory general remarks of this statement, in particular following the non-operating holding company structure recommended by the OECD.<sup>18</sup>

**Moreover, Article 25f BA-D should be clear on separating governance bodies:** in order to ensure an appropriate management of both activities, and to avoid a situation where the interests of the investment bank would be mingled with those of the deposit-taking bank, each entity should have separate executive teams, with no overlap between the two.

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<sup>18</sup> Blundell-Wignall, Adrian, Wehinger, Gert, Slovik, Patrick: 2010. The Elephant in the Room. The need to deal with what banks do. OECD Journal: Financial Market Trends; 2010, Vol. 2009 Issue 2, pp.11

## ANNEX: GENERAL REMARKS ON BANKING STRUCTURES

With a view of contributing to the debate on banking structure and beyond the specific case of the German banking Bill, Finance Watch would like in the following section to share its vision of a possible separation of banking activities.

In Finance Watch's views banking reform has **two main dimensions**:

1. The first dimension deals with **the possibility of separating banking activities** between deposit and credit functions on the one hand and financial markets functions on the other hand. Obviously, there are many ways of realising this and this statement is a contribution to developing a vision of how to do it.
2. The second dimension deals with **how to deal with defaulting or near to defaulting credit institutions** so that their failure does not trigger a systemic crisis or the necessity for the taxpayer to bail them out.

Banking reform taken in its first dimension (possibility of separating bank activities) is above all **aimed at the large universal banks**, which are much exposed to financial markets and highly interconnected – hence able to disrupt the whole financial system when facing significant losses.

To illustrate this point, the balance sheet structure of three of the largest European banks can be compared:

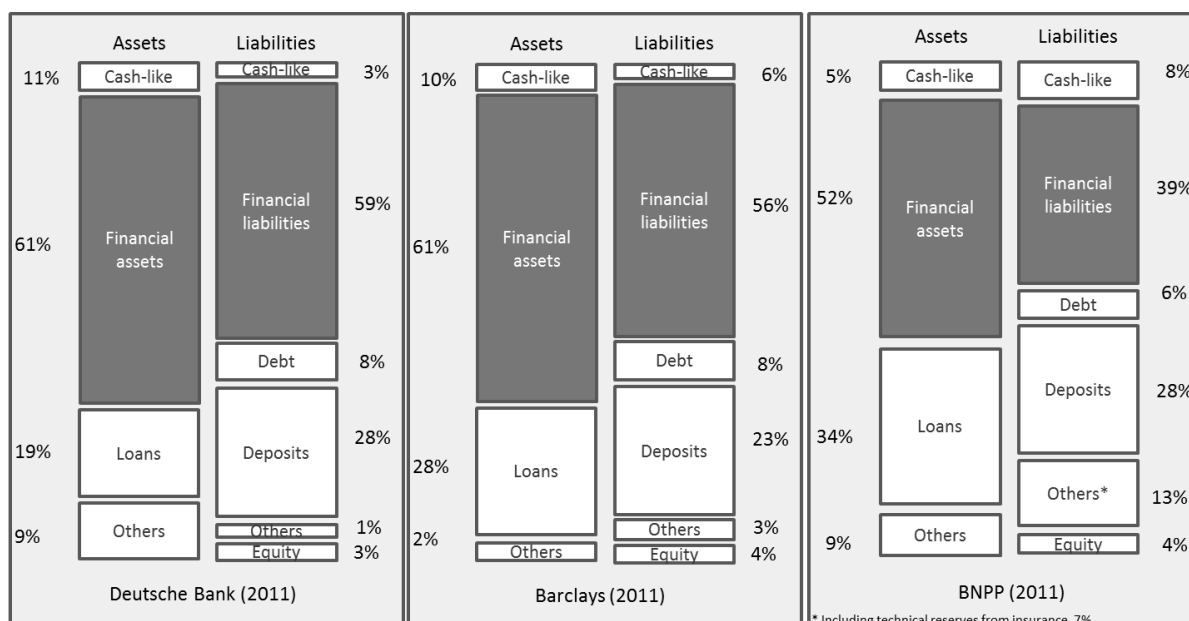


Figure 3: Balance sheet structure of the three largest European Banks (Source: Annual Reports for the business year 2011 of the respective banks)

This comparison shows that:

- There are **no national business models** when it comes to the mega banks;
- Large universal banks are **market-based** (be it on the asset or on the liability side). Their trading activities dominate their balance sheet – hence the fact that managerial concerns prevail with regard to separation proposals;
- As reported in the report of the High Level Expert Group headed by Governor Erkki Liikanen (HLEG), “diversification at the bank level can make banks more similar to each other and the system as a whole less diversified and vulnerable to shocks.”<sup>19</sup> This is particularly true for the trading activities of large banks, which are therefore **tightly interconnected**;
- Moreover, these market activities are to a large extent not related to the real economy. This is evidenced by the fact that (1) large banks literally make financial markets (market making) (2) financial products facing the real economy represent less than 10% of the total amount of financial products that are currently being traded:
  - Less than 10% of debt securities issued relate to non-financial companies<sup>20</sup>
  - Less than 10% of OTC derivatives<sup>21</sup> (see Figure 1 above) are traded with a non-financial counterpart, leaving the rest - more than 90% - as trading instrument for and by the financial sector
  - World trade is less than 5% of foreign exchange activity.<sup>22</sup>

For reasons we commented extensively in our reply to the HLEG report consultation,<sup>23</sup> Finance Watch believes that a separation of vital banking activities vs. trading activities is needed, with in the first place the objective to **tackle too-big-to-fail and too-interconnected-to-fail**.

However, **we also understand that among European banks, a local/regional universal banking model needs to be preserved**. This refers to small banks with local/regional reach that provide local businesses with a full range of products, including hedging of the risks they take in the context of their commercial activities. The point is that to a large extent, this model is not much exposed to market risks, because of its funding structure on the liability side and of the very nature of its activities on the asset side. The graphs on the following page illustrate the comparative balance sheet structures of **German banks**, depending on their business model. **We see that savings banks and cooperative banks clearly have a different business model, and that while they are “universal banks”, able to serve their corporate clients fully, they are marginally exposed to financial markets compared to their large international competitors** (referred to as commercial banks in the graphs below).

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<sup>19</sup> Liikanen et al. 2013.

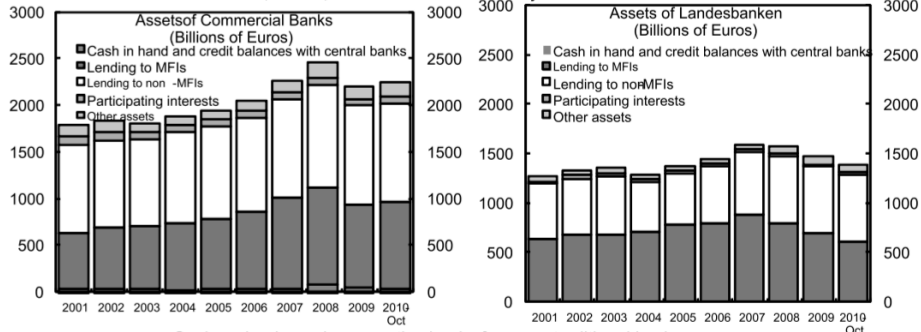
<sup>20</sup> cf. footnote No. 17.

<sup>21</sup> BIS 2010; cf. footnote No.11.

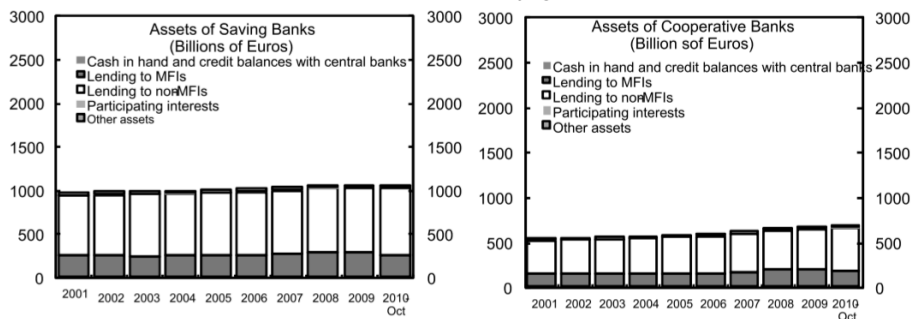
<sup>22</sup> WTO 2013; cf. footnote No.14.

<sup>23</sup> Finance Watch. 2012: Answer to the Public Consultation from the European Commission on the Liikanen Report. Response by Finance Watch, [http://www.finance-watch.org/iframe/Publications/Responses/121113\\_Answer\\_to\\_EC\\_Consult\\_Liikanen.pdf](http://www.finance-watch.org/iframe/Publications/Responses/121113_Answer_to_EC_Consult_Liikanen.pdf)

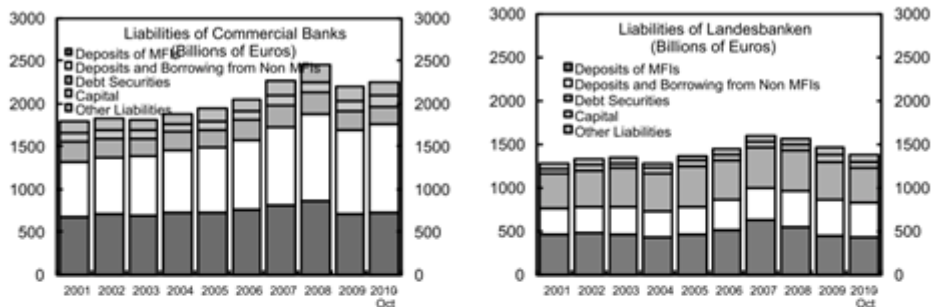
*Commercial banks and Landesbanken largely expanded their balance sheets during boom periods. These, in turn, increased the vulnerability once the crisis hit.*



*Savings banks and cooperative banks focus on traditional business, but are rather structurally rigid.*



*Some large banking groups and Landesbanken increased their wholesale and international business activities, but these have been refocused since the crisis.*



*Savings banks and cooperative banks are domestically-oriented, mainly taking stable deposits.*

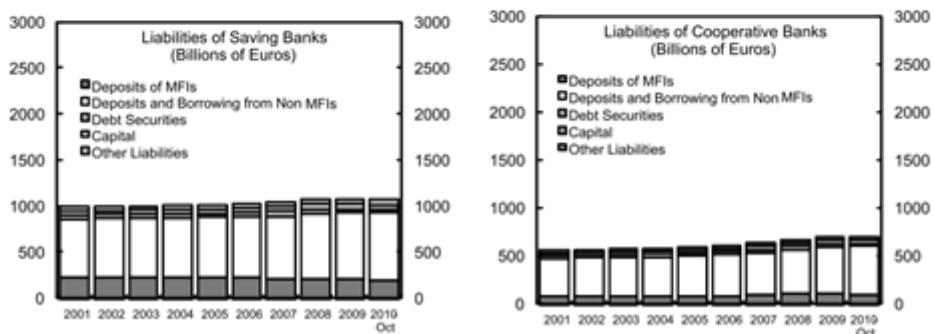


Figure 4: Balance sheet structure of German Banks  
(Source: IMF: 2011. Germany. Technical Note on Banking Sector Structure, IMF Country Report No. 11/370, www.imf.org)



Finance Watch believes that the following modus operandi gives a coherent and realistic approach to reforming banking structures in that it goes a long way towards solving the most fundamental problems linked to the universal nature of very large banks whilst preserving the possibility for the vast majority of small to medium size banks to keep on operating as they are today.

- a. **If there is a proper investment bank entity in the banking group**, and provided that the two entities (investment bank and deposit-taking bank) are properly separated, then **all the trading activities should occur in the investment banking entity** of the group. The rationale behind is to avoid unnecessary costs and to build on existing, economically viable entities. The cost of such a transfer of activities would remain low (at most one-off reorganisation costs).
- b. **In the case where there is no separate investment banking entity**, acknowledging that it might be possible for a deposit-taking bank to conduct limited trading activities to the benefit of its non-financial clients, **some trading activities might be allowed in the deposit-taking bank**. The following **threefold rule** would apply:
  - These trading activities must be limited to **simple financial instruments** undertaken with / on behalf of **non-financial firms**
  - The **amount of trading activities within the deposit-taking bank should be capped as a % of total balance sheet**. Based on the data provided in the HLEG report,<sup>24</sup> we would suggest **a 5% threshold** given the fact that on average medium sized-banks' trading activities are below that level and small banks are far below (less than 1% on average). However the amount of the threshold should be precisely assessed in the impact assessment and could be slightly adjusted.
  - Should the bank wish **to increase the share of its trading activities above the threshold**, then any increase shall be **backed by additional equity**. For example, if trading activities increase to 6% of total balance sheet, then an additional amount of equity equivalent to 1% of total balance sheet would be required.

This approach of the “*de minimis*” principle has a number of advantages, among which the following:

- The 5% threshold **allows medium and small-sized commercial banks to provide plain vanilla hedging / trading services to their non-financial business clients**. These banks will therefore not be challenged in their current business model;
- The additional equity “covers” the additional trading activities and related risks that go beyond the imposed threshold. Any loss that is incurred above the threshold is therefore unlikely to threaten the solvency of the bank; moreover, **the management of the bank remains fully responsible in front of its shareholders** for the risks taken in the context of its trading activities;

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<sup>24</sup> Liikanen et al., 2013, p.35 Chart 3.3.4.

- **Large banking groups with significant trading activities** will be able to pursue those activities in a separate entity (existing or to be created), which shall not represent more than a **minor reorganisation cost**. In any case, there is no reason why such a reorganisation would have a social impact;
- **Trading activities will only be pursued in a separate entity if they are economically sustainable on a stand-alone basis**, i.e. without benefiting from the implicit guarantee from the state; they will gain in size only if the business model is deemed sustainable by shareholders and investors.

***In summary:***

- If there is an investment bank entity in the banking group, and provided that the two entities (investment bank and deposit-taking bank) are properly ring-fenced (see Figure 5 below) then all the trading activities should incur in the investment banking entity of the group.
- In the case where there is no separate investment banking entity, some trading activities might be allowed in the deposit-taking bank provided that (1) these activities are limited to simple financial instruments and (2) their size is strictly capped in comparison to total assets or, if in excess, covered by additional equity (see previous page).

For the first category, where the trading activities are ring-fenced within an investment banking entity, strict governance rules must be applied to make the separation efficient. We refer here to a large extent to the NOHC model as proposed by the OECD:<sup>25</sup>

- **Separate legal entities operating under a non-operating holding company :**

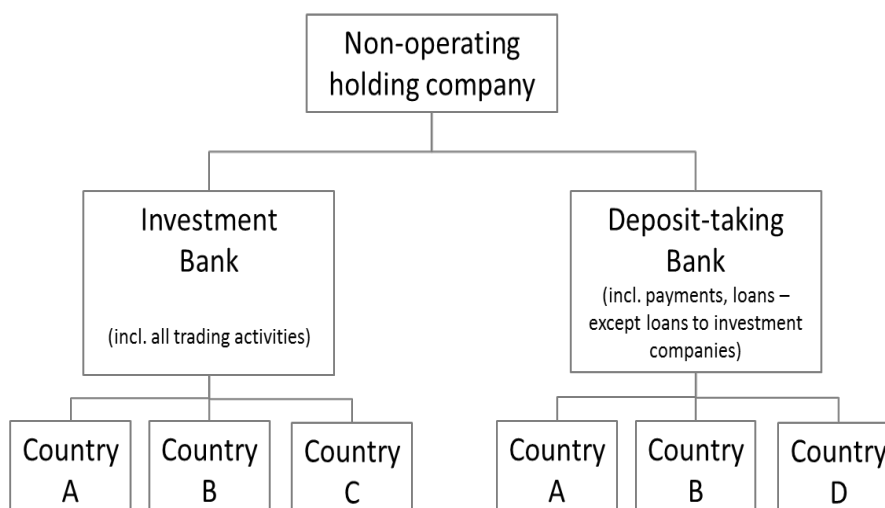


Figure 5: A Model of Banking Separation (own Figure).

<sup>25</sup> Blundell-Wignall, et al. 2010. pp.11.

- **Separate governance bodies:** in order to ensure an appropriate management of both activities, and to avoid a situation where the interests of the investment bank would be mingled with those of the deposit-taking bank, each entity must have separate executive teams, with no overlap between the two. In particular, there should be no investment banker in the deposit-taking bank's executive team.
- **Strict limits on equity transfers :**
  - a. the deposit-taking bank cannot transfer capital to the investment bank;
  - b. the NOHC can increase the capital of the investment bank only after requiring the approval of the supervision authority.
- **Separate debt issuance:** the investment bank must fund itself independently from the deposit-taking bank. To do so, it will issue its own debt on the market, separately from the rest of the group. Moreover the non-operational holding company cannot be "double-gearred" i.e. cannot raise debt; in this way the debt financing costs of the investment bank and deposit taking bank subsidiaries are separated and reflect the risks on their balance sheets.

**About the stakeholders and their respective interests in bank separation:**

Looking at the issue of bank separation from the different stakeholders' perspective, the interest they have to oppose a banking reform is far from obvious:

- **Individuals as Taxpayers**

Tax payers have a clear interest to reduce the cost of bank bail outs given their impact on public finances and indebtedness.

- **Individuals as Consumers**

Consumers need more competition on the high-street in order to benefit from the best price. This requires less dominance from the large banking groups (the top 15 banking groups in Europe – out of 8000 – represent 43% of total European banks' assets).

- **SMEs**

SMEs have very limited use of investment banks, which serve mostly financial companies and large corporates. If they face small and medium sized banks, SMEs can still have a one-stop shop thanks to the fact that banks can still be allowed to trade simple financial instruments with non-financial counterparties following the rules described above.

- **Large corporates**

Large corporates already face multiple entry points, use multiple banks and shop around. A separation of banking activities should not make a difference to them.

- **Individuals as bank-employees**

Staff from branch networks and from the back-offices together represent a major share of total staff at universal banks: commercial banking is indeed relationship-based and much more work-intensive.

When commercial and investment banking are combined in a same banking group, a brutal loss in the trading part can brutally put pressure on the whole organisation, leading to job cuts and increased profitability pressure throughout the group, branches and back-offices included. This is currently being experienced at a lot of banking groups.

Commercial, relationship-based banking is much more resilient and less subject to volatile results than investment banking. As a central banker puts it, whereas “in investment banking and trading activities profits are generated by actively seeking risk-taking opportunities by opening risky position (...) in traditional retail banking, profits are mainly earned from interest rate margin income from long term customer relationships in a more stable manner. (...) Also the time horizon differs markedly. In the trading activity the results settled and assessed every single day. In retail banking profits are generated over several years’ time period.”<sup>26</sup>

A separation would therefore benefit the commercial bank (hence the vast majority of banks’ employees) in the long run as it would not act anymore as a buffer to absorb the shocks that can occur in the investment bank and would be submitted to its own profitability constraints.

- **Small / Medium sized banks**

Small and Medium sized banks (as opposed to large banks) shall not be touched by the proposed separation, with a sensible “*de minimis*” rule. Moreover, they will face fairer competition with separation and an end to too big to fail guarantees, thanks to the removal of the implicit subsidy that large universal banks benefit from.

- **Large bank shareholders / investors**

Separation will improve the transparency of banks’ activities. Quoting P. Hakkarainen again, “it will reduce the uncertainty about the quality of banks as an investment opportunity thus facilitating pricing of the separated parts. This, on the other hand, would improve the access to market funding among above average quality banks.”<sup>27</sup>

- **Regulators and supervisors**

Regulators and supervisors will benefit from increased transparency and simplicity: separate entities will be subject to separate reporting and governance, and constrained in terms of activities they can conduct. Financial groups will become more easily resolvable.

We would oppose the argument stating that with separation, the cost of banking services to the real economy would increase:

- Lending (to households, companies and governments) might even get cheaper: lending to the real economy is likely to be considered less risky and therefore be less costly than trading activities. In addition lending to the real economy is likely to be from an entity benefiting from a government guarantee of deposits. Lastly increased clarity and transparency on the operation of banks is likely to lower, not increase, funding costs.
- For some essential activities like making markets in Government bonds, funding of inventory is not dependent on the funding rate of the bank, funding is achieved via collateralised borrowing against the inventory of bonds held (using repo agreements). There is therefore no relationship between the cost of state funding and the structure of banks.

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<sup>26</sup> Hakkarainen, Pentti: 2013. Debate on “Re-evaluating the universal banking model: Can the Volcker, Vickers or Liikanen rules make banks safer?”, [www.bis.org/review/r130305h.pdf](http://www.bis.org/review/r130305h.pdf)

<sup>27</sup> Ibid.