Note on Banking Reform by Professor John Vickers for the Finance Committee of the Deutscher Bundestag

1. The crisis has shown, among other things, that fundamental reform of large and complex banks is necessary in the public interest. Reform needs two inter-related elements:
    - much greater loss-absorbency by banks in terms of greater capital, sufficient bail-inable debt, etc, and
    - structural reform, on which this note concentrates.

2. The UK reforms and the Liikanen recommendations for structural reform of large and complex banks both involve separation, within universal banks, of retail/deposit banking from trading/investment banking. In UK terminology this is 'ring-fencing'. It has several advantages, including:
    - an important degree of *insulation* of basic banking, upon which households and small businesses are so dependent, from risks in global investment banking
    - making more credible the *resolvability* of these institutions if and when the next crisis occurs
    - helping, together with greater loss-absorbency, to diminish *taxpayer exposure* to banking risks, which Eurozone banking union makes all the more important
    - providing a sound long-run framework for bank lending to the *real economy.*

3. Quite apart from the Volcker rule, the US already has ring-fencing. Although the Glass-Steagall prohibition of affiliation between deposit banking and investment banking was repealed in 1999, US law regulates how deposit banks within bank holding companies may and may not deal with the investment banking affiliates that they are now permitted to have. The Dodd-Frank Act is tightening these provisions. Thus the UK structural reforms and the Liikanen proposals are in this respect convergent with the US.

4. It would have been a wholly inadequate solution to the UK's banking policy problems to apply a form of the Volcker rule *instead of* ring-fencing. (A reflection of this is that the main UK-based banks have testified to the Parliamentary Commission on Banking Standards that they do not engage in proprietary trading of the type that the rule is intended to cover.) Moreover, US experience is showing the difficulty of distinguishing in practical ways between proprietary trading that is customer-oriented and that which is not. Likewise Liikanen did not seek to draw a line through trading but – in my view rightly – proposed more far-reaching structural reform.[1]

[1] I am puzzled however that Liikanen proposes to allow securities underwriting in deposit banking. It logically belongs with trading in my view.

5. In principle one could *add* a form of Volcker rule to ring-fencing, as the US has done, but the UK's Parliamentary Commission has not recommended this. Rather, they have urged the regulator to monitor and if necessary 'bear down' on such proprietary trading in other ways.

6. I am no expert on the German banking system, but for the reasons indicated above, I would question whether the Draft Bill by itself would be an adequate structural policy approach. It is a step on the road to Liikanen but I would encourage policy-makers in Germany, and elsewhere in the EU, to take the whole journey to Liikanen. Prospective Eurozone banking union adds to the need for well-structured, as well as well-capitalised, banking.

7. Finally I wish to stress that Liikanen and the UK reforms, unlike the Glass-Steagall era in the US, are fully consistent with universal banking. They provide for *structured* rather than unstructured universal banking. If adopted, this will help create a sounder long-run framework for bank lending to the real economy in Europe, while curtailing taxpayer liability – not least German taxpayer liability – for Europe's banking risks.

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