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Retail and investment banking: the trials of separation

Rabobank

A broad package of measures has recently been implemented to improve the stability of the banking system, including stronger capital reserves and an expansion of regulatory powers. Banks are preparing roadmaps that enable immediate intervention in the event of any problems, while governments and regulators are reviewing and analysing the structure of banks. Would society be better off disposing of specific bank operations or divisions? In this Special Report we analyse the proposals currently being developed. To use the marriage metaphor, will we be witnessing a divorce between retail and investment banks; will they maintain separate residences, sign a prenuptial agreement, or opt for traditional community of property?

Objectives and definitions

The debate on the separation of banking functions has gathered momentum in the Netherlands following the recommendations of the report issued by the De Wit Parliamentary Committee, which states that savings subject to the deposit guarantee scheme (DGS) must not be exposed to risk arising from investment banking activities. This also applies to the continuity of *retail banking operations.*

Retail banking operations are defined as ‘activities without which a modern society would not be able to function’. In the narrow definition, this includes only services provided to private individuals (particularly lending and savings management) and the payment system. In the broader and more common definition, retail banking also covers services provided to small and medium-sized enterprises (SMEs). Investment banking activities are defined as services provided to large businesses and to financial institutions. This includes both loans to large companies and *capital market services* such as managing rights issues, the *hedging of corporate risks* with derivatives contracts like interest rate swaps and currency swaps, and *consultancy services* such as supervising mergers and corporate acquisitions.

Naturally, that is not to say that retail banking is without risk –in fact, the main risks[1] are associated with lending– and that investment banking does not contribute to the real economy.

Proposed measures

Many banks in the Netherlands and other European countries are set up as universal banks that offer a wide range of services to their customers. These banks undertake both retail and investment banking activities within the same entity. Although operations are often split into divisions in order to ensure an efficient division of duties, from a financial and legal perspective there is a single organisation, i.e. ‘community of property’. Several of the new proposals are aimed at separating retail banking activities and investment banking activities by means of ‘ring-fencing’. The most frequently discussed alternatives are outlined below.

Traditional ring-fencing

Traditional ring-fencing involves an almost total separation into retail and investment branches, with each branch maintaining a separate balance sheet and being required to comply separately with capital and liquidity requirements. In this scenario, the relationship between the bank’s retail and investment branches might be compared to a couple in a

[1] In addition to the risk of default (bad-debt risk), banks are also exposed to substantial interest rate risk and liquidity risk due to the fact that loans provided, including mortgages, have longer terms than savings and other sources of bank funding.

relationship choosing to maintain separate residences ('Living Apart Together').

Ring-fencing according to Vickers

The Vickers[2] plan proposed in the United Kingdom is similar to 'cohabitating under a cohabitation contract'. Under this plan, group relationships will remain intact and the investment and retail arms will have the option to continue operating under the same name. The retail branch (within the ring-fence) incorporates the national payment system and services provided to private individuals and SMEs. The investment branch (outside the ring-fence) includes complex financial products and loans provided to financial institutions.

The Vickers plan provides for both a functional and a geographic separation: within the ring-fence, international payments and business loans are permitted for customers based in the European Economic Area (EEA)[3], but transactions performed on behalf of customers residing outside the EEA are only authorised outside the ring-fence. While lending and guarantees provided among divisions of the same group is possible in principle, these types of capital flows from within the ring-fence to divisions outside the ring-fence will be restricted.

Making the banks ring-fence ready

The Netherlands Ministry of Finance prefers to make banks 'ring-fence ready' rather than actually splitting them into retail and investment arms. Under normal circumstances, banks are not actually broken up, but are rather organised such that, in case of problems, they can separate and retain the systemically important divisions while allowing other divisions to be liquidated. In association with the banks concerned, the Dutch Central Bank has been drafting recovery and resolution plans. This means banks will remain a single entity, albeit with a 'prenuptial agreement' and a 'last will and testament' in place.

US alternative: Volcker Rule

The Volcker Rule, a section of the US Dodd-Frank Wall Street Reform and Consumer Protection Act, does not provide for a separation of retail and investment banking, but rather seeks to prohibit or restrict a number of financial activities. Under the Rule, banks are no longer permitted to engage in proprietary trading (i.e. trading for their own account) and can only invest up to 3% of their capital in hedge funds and private equity funds, as these activities are considered too fraught with risk for their customers' deposits to be exposed to. However, banks remain entitled to trade as part of their risk management operations (for example to hedge the interest rate risk of a mortgage portfolio) or as part of customer transactions. The latter might involve underwriting (i.e. assisting in third-party shares issues or bond issues[4]) or market making (market makers continuously post buy-and-sell quotations for securities or derivatives and act as counterparties to buyers and sellers. Minor transactions are combined, while major ones are divided. Securities are only held for a short space of time). Banks are no longer permitted to assume risk through proprietary trading (that is, solely for their own profit). It is somewhat tricky to separate proprietary trading from trading on behalf of customers, and it is the correct demarcation that is currently under discussion. For example, a general prohibition on securities held in inventory would be a serious barrier to market making and, as a result, would reduce liquidity and increase prices for customers.

Impact on banks and their customers

Efficiency and continuity of services

If ring-fencing is implemented in the Netherlands, the retail banks separated under this system will be large enough to enter the

[2] Besides ring-fencing, the Vickers plan also provides for recovery and resolution plans and for an increase in banks' loss-absorbing capacity.

[3] The European Union, Iceland, Norway and Liechtenstein

[4] See www.investopedia.com for definitions of underwriting and market making.

capital market independently. However, diversification and synergy benefits, along with economies of scale, will be partially eliminated. Capital requirements for retail banks may need to be stricter than for universal banks, since several research studies show (Netherlands Ministry of Finance, 2011) that non-diversified banks are more vulnerable. If the ring-fencing system is to be introduced in accordance with the Vickers recommendations, companies will *not* be able to turn to retail banks for standard services such as interest rate swaps and currency swaps in order to hedge currency risks and interest rate risks[5]. These services are procured not only by large corporate clients but are also vital to pension funds, insurers and SMEs with international operations, such as those operating in the flower industry.

In the Netherlands, the separate investment branches will be very small and will need to raise all their funds in the international capital market. However, they will be too small to compete in this market, potentially resulting in mergers and acquisitions. Dutch investment banks will then become likely candidates for acquisition by foreign players, as a result of which Dutch businesses, insurers and pension funds will become completely dependent on foreign investment banks. Recent research (De Haas & Van Horen, 2011) shows that foreign banks are more prone to tightening their credit flows in a weak economy than are domestic banks, which means that Dutch businesses will become more vulnerable if they come to depend on foreign banks for these services.

Effectiveness

The impact on efficiency and services aside, the key question is whether private savings are more secure if held at retail banks than at universal banks, and whether the banking system as a whole will become more stable if some form of ring-fencing is implemented.

It should be noted that several banks that collapsed during the financial crisis were retail banks, including Northern Rock, DSB and Icesave. Furthermore, it remains to be seen whether, in practice, the 'fence' between retail and investment banking is sufficiently fire-resistant. The separate divisions will remain largely interconnected due to mutual transactions and a shared reputation.

If problems arise at an investment bank, this will directly affect confidence in other banking divisions that form part of the same group and even banks outside the organisation. Recall that it was the collapse of investment bank Lehman Brothers that triggered the financial crisis. While it may seem appealing to place specific banking functions within a seemingly secure ring-fence, the more activities are placed outside the ring-fence, the more transactions are created with investment banks and non-banking players outside the ring-fence, which are not subject to the same degree of supervision.

Alternative measures

If the *primary purpose* is to protect savings under the deposit guarantee scheme (DGS), the most effective approach is to give precedence to DGS savings over other bank debt holders. This means that these depositors are given priority over other creditors in the event of a bankruptcy.

It should be noted that there are costs associated with this measure: since, in this case, the other creditors are exposed to greater risk, bank funding may become more expensive – which will result in higher fees for customers – and ratings agencies may decide to downgrade banks. The arguments of various policy proposals also contain a *wider objective*, which can be formulated as follows:

1) improve the stability of the banking system,

2) focus on the social function of banks, providing services to the real economy,

[5] Under the Vickers proposal, retail banks may only use these instruments as part of their risk management operations and not on behalf of customers.

3) ensure that taxpayers do not have to foot the bill for (impending) collapses of banks. This wider objective may be better achieved through different types of measures, some of which have already been implemented, as listed below.

1) Stability

The liquidity requirements and stricter capital requirements set out in the Basel III accord[6] improve stability. Where necessary, the remuneration system and internal risk management process of banks must be changed in order to discourage, rather than reward, excessive risk exposure. The Basel-III/CRD-IV framework provides national regulators with the scope to impose additional buffers on top of the international agreements. However, a 'race to the top' is to be avoided: beyond the optimal level, the social cost of additional buffers exceeds the benefits (Goodhart, 2012).

2) Serviceability

Since the social function of banks should be prioritised, it would be useful to restrict proprietary trading, in the spirit of the Volcker Rule. In the Dutch context, this appears to be mainly a pre-emptive measure designed to prevent excessive proprietary trading in the future. It will need to be examined further whether an absolute prohibition is the most effective and efficient measure, or whether, for example, a maximum percentage might be more useful[7].

3) Costs of impending collapse

A preferential credit position for DGS savings ensures that these savings will remain unaffected. Hybrid forms of finance, such as contingent convertible bonds[8], ensure that bank debt holders contribute to the costs of a potential rescue operation. As noted, there are consequences associated with the cost of funding. In order to ensure that the regulator can intervene effectively and at an early stage, an appropriate set of instruments is essential. The new Intervention Act and recovery and resolution plans aim to meet this need. Needless to say, it is vital to coordinate these types of measures at the international level.

Conclusion

It is definitely worthwhile to explore whether the policy measures proposed in the UK and US could be relevant to the Dutch situation. In so doing, however, we must not lose sight of the main objective, which is to facilitate a stable financial sector that supports the real economy. However, the separation of banks into retail and investment branches is not the most effective method and could even end up backfiring. Specifically, it could destabilise the banks and result in more expensive, lower-quality services to customers.

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[6] See Rabobank Special Report '*Basel III: tough but realistic*'
[7] For example, related to total revenues
[8] Bonds that can be converted into shares