

# **Structural Banking Reform: An FSB perspective and some alternatives**

**Andrew Cornford**

The international reform agenda for financial regulation continues to move forward on several fronts under the auspices of the [Financial Stability Board](#) (FSB), the body responsible for coordinating, and reporting on, progress to the G20. The subjects covered by the agenda include not only rules which target the functioning of financial institutions and markets but also less tangible initiatives designed to enhance trust between regulators in different countries and between the financial sector and the public.

Banks are to be rendered more resilient through rules concerning higher capital requirements, new standards for the liquidity of their balance sheets, and changes in their incentives to engage in proprietary trading, market making and contingent exposures through off-balance-sheet entities such as structured investment vehicles (SIVs) and asset-backed commercial-paper (ABCP) conduits. Rules for shadow banks (intermediaries that undertake financing through maturity transformation but have not been subject to the same regulation as banks) are also being developed. Moreover derivatives markets are now simpler and more transparent, and thus, it is hoped, safer.

The new rules for institutions and markets are to be accompanied by more intensive cooperation between national regulators, international procedures for peer review and assessment of progress regarding implementation the reform agenda and, the FSB hopes, alertness to new financial vulnerabilities as they emerge and are identified.

The initiatives of the FSB are being accompanied by, and often complement, initiatives and measures being taken at national and regional levels. The FSB recently has recently issued a report to the G20 which address the consistency of such initiatives and proposals with its own reform agenda and with major features of the pre-existing regime for cross-border banking and finance. ([FSB, Structural Banking Reforms Cross-border consistencies and global financial stability inclinations, Report to G20 Leaders for the November 2014 Summit, 27 October 2014](#)). Although the report has no pretension of being comprehensive, it serves to bring out various potential inconsistencies as well as some lacunae and weaknesses of the FSB agenda.

The report covers in varying levels of detail structural reforms in United States, the European Union (EU), at a national level some EU member states (United Kingdom, France and Germany), Indonesia, India, Singapore, and Mexico. A major focus of the structural reforms discussed, whose objectives are greater financial stability and a reduction in the potential burden to tax payers of future bail-outs, has been separation and restriction of certain financial activities undertaken by banks and greater clarity as to geographical jurisdiction through subsidiarisation requirements for foreign banks.

For United States the measures singled out by the FSB report are the following:

- The Volcker Rule of the Dodd-Frank Act under which banks are prohibited from engaging in proprietary trading (short-term, speculative risk taking separate from involvement in trading as part of services to clients) and from investing in, sponsoring or having certain other relationships with hedge funds or private equity funds. The core objective of this prohibition is to address risks posed by these activities to institutions benefiting from deposit insurance.

- The Swaps Push-Out Rule of the Dodd-Frank Act which prohibits the granting of federal- government assistance such as access to the discount window of the Federal Reserve and deposit insurance for institutions registered with the Commodities Futures Trading Commission as swap dealers or with the Securities Exchange Commission as security based swap dealers or major participants in the markets for security-based swaps. Exemptions are provided for certain hedging and risk-mitigating activities. Here too the objective is to limit the swaps activity in which an institution eligible for federal government assistance can engage.
- Under Enhanced Prudential Standards for Foreign Banking Organisations (FBOs) such institutions with non-branch assets in United States of USD 50 billion or more will be required to place their subsidiaries in intermediate holding companies subject to capital, capital planning, liquidity, and stress-testing requirements similar to those applicable to United States bank holding companies. This rule is designed not only to address risks to financial stability but also to promote a more level competitive playing field for domestic and foreign banks. There is no requirement that all the banking activities of FBOs be conducted through subsidiaries incorporated in the United States, nor are there limits on the amounts which a FBO can lend to its parent or other non-United-States affiliates.

In justifying the last measure the United States authorities note that the requirement that banks hold capital in different jurisdictions appropriate to the risks incurred in those jurisdictions should contribute to financial stability. Moreover in their view such a measure will facilitate cross-border resolution of FBOs if this becomes necessary, regardless of the approach chosen for this purpose. Under the single-point-of-entry approach to bank resolution the existence of a United States Intermediate Holding Company means that there is a single entity for interfacing with the foreign bank's parent. Under multiple-point-of-entry approach the Intermediate Holding Company can serve as a focal point for separate resolution of the United States operations of an FBO.

Under the Banking Reform Act of December 2013 banking groups headquartered in the United Kingdom are required to "ring-fence" banking services whose temporary interruption would have a significant, unfavourable impact on the domestic economy, in particular on households and SMEs. Within its group the ring-fenced bank would be a separate legal entity meeting capital and liquidity requirements on a standalone basis and subject to special, higher capital requirements. Certain financial services such as the taking of retail deposits and the provision of overdrafts to individuals and SMEs would be provided only by ring-fenced entities. The exposure of ring-fenced institutions to other financial institutions is restricted as is their participation in securities and derivatives business.

The objectives of this reform are not only greater resilience for ring-fenced banks but also facilitation of their resolution in the event of failure. The reform is complemented by a Supervisory Statement of September 2014 increasing the rigour of the conditions as to supervision in their home countries which will be required in the authorisation and supervision of foreign bank branches from outside the European Economic Area.

A proposal of the European Commission for banks which is expected to be adopted in 2015 includes a ban on proprietary trading and a potential separation of certain trading activities from deposit taking. The separation would require that the deposit-taking and other entities be distinct in their legal, economic, governance, and operations.

The proposal would apply to banks identified as being of globally systemic importance or exceeding certain thresholds in total assets or in trading activities as a proportion of total assets. Interestingly in view of the sovereign debt crisis in the Euro area, trading in EU sovereign debt instruments would be excluded from the scope of the ban on proprietary trading activities and of structural separation. As with the reforms in United States and

United Kingdom one objective of the proposal is the facilitation of the resolution of large and complex banks which fail through the placing of risky activities in separate legal entities.

France, Germany and Belgium have introduced reforms at the national level which target trading activities that exceed a threshold figure as well as certain relations with hedge funds as a proportion of a deposit-taking institution's balance sheet. In such cases the institution must either discontinue the activities or transfer them to an independent trading entity. Market making for securities, so long as it does not threaten the solvency of the institution, is permitted so that the model of universal banking is not threatened. Here too the objectives of the reform include the protection of deposits and the preservation of financial stability more generally.

In Switzerland an act of 2011 specifically directed at the problem of Too Big To Fail (TBTF) banks lays down rules for risk management and the capital structure of Domestic Systemically Important Banks (D-SIBs), which increase in strictness with bank size. An organisational structure is prescribed which assures that systemically important functions will continue in the event of insolvency.

Structural measures are being introduced in China which bear on the separation of banking and securities market activity: Restrictions are in place on lending by banks for securities-market activities and only "authorised pilot banks" are permitted to set up non-bank financial affiliates.

The FSB report also draws attention to various structural reforms elsewhere, some clearly related to the international reform agenda and others with primarily domestic policy objectives but in each case clearly bearing on the consistency of the reforms with the rules and standards of the existing international financial regime:

- In Indonesia foreign bank branches are required to hold a certain proportion of their assets in domestic assets which meet certain requirements. The objectives here are to enhance Indonesia's role as a host supervisor for foreign banks as well to promote banking stability.
- In both India and Singapore, under to measures soon to be in place, foreign banks will have to be incorporated as subsidiaries. The objectives of this subsidiarisation include enhancing the host authorities' oversight and their capacity to manage resolution of banks in the event of insolvency. The countries cite as precedents regimes elsewhere such as in Australia.
- In Mexico, where subsidiarisation is the rule for foreign banks, limits have been introduced for related-party transactions. The power to set higher capital requirements and limits on transfers to a parent company is granted to supervisors in the context of resolution or liquidation if adequate arrangements for cooperation with foreign resolution or liquidation authorities are not in place.

While there is a consensus within the FSB that the measures agreed as part of the international agenda of regulatory reform will contribute to financial stability and thus to curtailment of future support to systemically important institutions, there is also realisation that not all potential problems due to cross-border banking have been addressed and that some of the reforms may increase the costs of such banking.

Concerns have also been expressed in some quarters – but not for obvious reasons in countries now pursuing a policy of subsidiarisation – that the structural banking reforms in some countries will have the effect of trapping liquidity and capital in domestic silos and impeding intra-group transactions, thus complicating the management of globally active banks. Inter alia, such reforms are viewed by these quarters as complicating international

initiatives on cooperation regarding the resolution of cross-border banks. The counterargument is that subsidiarisation or other measures designed to increase the independence of domestic banking entities provide *ex ante* clarity concerning the relation between such institutions and their parents. This will help to avoid the imposition of ad hoc, uncoordinated ring-fencing requirements during times of stress.

Supporters of subsidiarisation also draw attention to the improved alignment of business lines with legal structures. Liquidity and capital will be held where different risks are located within the banking group. This should contribute to the simplicity and transparency of the bank's operations as well as to the effectiveness of micro- and macro-prudential regulation and supervision. These advantages of subsidiarisation should be set against any costs of the resulting fragmentation of cross-border banking and diminution of the interest of cross-border banks in maintaining a presence in the foreign markets in question.

The arguments of the opponents of structural reforms also include the reduction of liquidity in the financial markets of countries which undertake them. Here the counterargument of supporters of structural reforms such as the ring-fencing of retail deposit taking and subsidiarisation points to the lack of empirical evidence for such reductions in liquidity, and to the possibility of designing the reforms in a way which would anyway minimise such reductions. The opponents of structural reforms also point to the dangers of regulatory arbitrage and to the leakage of banking activities to shadow banking systems. However, although regulatory arbitrage and leakage of activities to the shadow banking sector are real problems, they are not necessarily made more difficult by less cross-border banking and are anyway being addressed as part of the reform agenda.

Opponents of the structural reforms also cite potentially adverse effects for competition in countries' banking markets resulting from less cross-border banking. Although such effects are possible, its importance will eventually have to be assessed in the context of many other coincident changes to countries' regimes for banking.

Indeed, the attitude of the FSB towards the concerns expressed about the reform agenda is sceptical: "These concerns have been expressed in fairly high-level terms, and the impacts are generally acknowledged to be hypothetical since in most cases final rules have not gone into effect. Moreover authorities generally feel that it is difficult to disentangle that element of market participants' responses – and the consequent effect on market functioning – that might be due to structural reforms (whether in place or in prospect) from changes that are taking place in response to other reforms underway (such as higher capital and liquidity requirements or implementation of D-SIB regulatory regimes) or from broader market and economic developments".

The FSB does acknowledge that structural banking reforms will have an impact on plans for the resolution of cross-border banks in the event of insolvency. The Basel Committee on Banking Supervision will be keeping this subject under review and reporting to the FSB by the end of 2015.

Moreover the OECD intends to take stock of the consistency of the treatment of cross-border branches and subsidiaries with its Codes of Liberalisation of Capital Movements and of Current Invisible Operations. This brief mention of the OECD Codes in the FSB report is of interest because little attention has been paid, at least publicly, in official circles so far to the issue of the consistency of the post-crisis reform agenda and the regime for cross-border finance in place at the time of the outbreak of the crisis.

Questions can be reasonably raised as to the extent to which the FSB report approaches issues from a sufficiently global perspective. Moreover its coverage of structural reforms arguably fails to go far enough in its coverage of issues related to banks' size and complexity and avoids the closely related subjects of governance and remuneration.

In a message of September 2014 to G20 Finance Ministers and Central Bank Governors the FSB implicitly acknowledged concerns among emerging-market and other developing countries that the work of the FSB has been excessively focussed on the problems of advanced economies. As part of its attempt to remedy this the FSB “will make proposals to the Brisbane summit of the G20] on the structure of its representation and the inclusiveness of its working procedures, and will increase the availability of information about its operations. Following a survey of FSB members, proposals are being developed that will:

- respond to the increasing integration of emerging markets in the global economy;
- ensure that the FSB’s work is informed by the best expertise in national jurisdictions, and
- maintain the FSB’s effectiveness as a decision-making body “(FSB To G20 Finance Ministers and Central Bank Governors, “Financial Reforms- Completing the job and looking ahead”, 15 September 2014).

In spite of its reference in its discussion of structural reforms to developments in China, Indonesia, India, Singapore, Mexico and Saudi Arabia the FSB’s report cannot pretend to anything approaching global coverage. The detailed discussion is limited to United States, United Kingdom and the EU. Moreover the principal focus of this discussion is organisational structures and diversification, and capital and liquidity management. The discussion bears the imprint principally of the policy and regulatory response to the financial crisis, which originated in selected advanced economies. Subjects of interest to developing economies under the heading of structural banking reform are omitted. These subjects include the relation of the management of the capital account to banking risks and the relation of the reform agenda of the FSB to the rules of the WTO General Agreement on Trade in Services (GATS) (which has a country coverage that goes beyond that of the OECD Codes, and whose rules bear on corporate form and thus on subsidiarisation).

The coverage in the FSB report of issues of structural reform relevant to – and under discussion in –advanced economies is also far from comprehensive. The relation between organisational reform and the issues of the complexity of banking institutions and resolution in the event of insolvency are frequently mentioned in the paper as major objectives of recent organisational reforms in major advanced economies. Nevertheless the focus is on complexity rather than bank size and the concentration of the banking sector as such, which are major issues under the heading TBTF. Moreover both bank size and bank complexity are related to the incentive system of the financial sector and to the observation of appropriate professional standards by banks’ employees.

Such subjects are part of discussion of banking reform in advanced economies. Particularly interesting in this context, though not atypical of the ongoing discussion of reform – are recent remarks in a speech of William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York ([“Enhancing financial stability by improving culture in the financial services industry”](#), remarks at the Workshop on Reforming Culture and Behaviour in the Financial Services Industry, New York City, 20 October 2014).

The speech begins with an acknowledgement of the continuing pattern of bad behaviour in the financial sector since the outbreak of the financial crisis (behaviour which persisted despite the government intervention to stabilize the financial system) and the pervasive lack of trust in Wall Street among the public. In this context Dudley draws attention to various features of the banking sector. The size, complexity and global scale of large financial firm may mean that they have become “too big to manage”. The shift in the prevailing business model away from traditional commercial and investment banking to trading has led to viewing clients as counterparties (the other side of a trade) rather than partners in a long-

term business relationship. Pay incentives linked to short-term profits combined with a flexible and fluid job market have lessened firm loyalty.

Dudley's approach to reform contains the obligatory reference to the role of a financial firm's senior leadership in setting its cultural and ethical tone and at all levels to a comprehensive agenda which takes in recruitment, career development, performance reviews, pay and promotion as well as infrastructure and internal reporting systems that contribute to objectives under these headings.

More radical is Dudley's reference to the direction which compensation systems may need to take, absent an improvement in prevalent culture in the financial sector. As with other proposals under this heading (including those being promoted by the FSB) Dudley's approach would strengthen the link between pay, on the one hand, and risk taking and unethical behaviour on the other. Dudley endorses the deferral of a substantial part of compensation for a longer period than is typically envisaged in current proposed international standards. This component would not begin to vest until after five years, and this period would follow by vesting over an additional five years. This in Dudley's view would achieve a better correspondence between the time when excessive risks or unethical behaviour was undertaken and that when they could be fully identified.

The second major element of Dudley's approach concerns the form that deferred compensation should take. The Dodd-Frank Act requires sufficient long-term unsecured debt for recapitalising a bank. Dudley would like to see a significant contribution to such debt on the part of the firm's senior managers and important risk takers. This, Dudley believes, would incentivise these two groups "to focus on maximizing the long-term 'enterprise' value of the firm, not just the short-term share price". The arrangement would also avoid dependence for improving behaviour on market discipline exercised by shareholders, a desirable shift in Dudley's view since "financial firms are not transparent enterprises, and it would be difficult even for a diligent shareholder to be able to know when these bad behaviours are taking place, much less to be able to take actions to prevent them". Dudley classifies such deferred debt compensation as "a performance bond".

An arrangement under which senior managers and important risk takers could forfeit their "performance bonds" could be seen as a step in the direction of re-establishing the incentive systems of partnerships where partners are exposed personally to their firms' losses. While such a step would be contentious, Dudley's proposed alternative, if there is no improvement in standards of behaviour in the financial sector, is also tough: "if those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry,...the inevitable conclusion will be reached that your firms are too big and complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified".

Dudley' speech is an interesting departure. However, some critics of the reform process so far might view "performance bonds" and downsizing of TBTF banks as being more naturally complements than alternatives.

**Geneva, November 2014**