Changing the Structure of Banking: Volcker, Vickers and Liikanen

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Abstract: This article is about structural banking regulation in the UK, US and EU. Instead of analyzing and evaluating this regulatory reform from a technical point of view, this article focuses on the paradigm shift that is implied by the separation of certain risky market-based banking activities and 'boring', yet socially important retail banking activities. This post-crisis view on banks' societal role emphasizes the service function of banks. Post-crisis notions of 'too much finance' supported by empirical evidence, fuels the shift. Other factors include the idea of an implicit social contract between banks and society and evidence on the distortive qualities of trading activities. This article argues the Volcker rule in the US, the Vickers proposal in the UK, and the EU Liikanen proposal are necessary to strengthen the links between banks and the real economy. This corrects the pre-crisis situation in which an excessively large financial sector profited during good times while society suffered the losses in bad times.

Introduction

The global financial crisis (GFC) of 2007 brought to the attention of regulators, academics, and the general public, questions on the role of the financial industry in society. The most fundamental of all questions perhaps, touches upon which goal finance is pursuing. One insight shared by many, is noted by former Senator Fred Thompson: "the real scandal here may be from not what is illegal, but what is totally permissible ... The system is clearly not designed with the interest of the general public or the investor in mind."[1]

After the GFC, structural separation of banks began to form part of the regulatory agenda. Whereas capital requirements leave the business model of banks intact, structural bank regulation means banks may not carry out certain particularly risky activities. These reforms echo the United States Glass

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[1] *The Fall of Enron: How Could This Have Happened: Hearing Before the Comm. On Governmental Affairs,* 107th Cong. (Jan. 24, 2002), (Statement of Sen. Fred Thompson, Senate Governmental Affairs Comm.), at http://www.senate.gov/-gov-affairs/012402thompson.htm, in: D.L. Rhode and P.D. Paton, 'Lawyers, ethics and enron', (2002) 8 *Stanford Journal of Law, Business & Finance* 1.

Steagall Act of 1933[2] that prohibited the combination of investment banking and commercial banking within one banking group. This act was repealed in 1999 as a part of the deregulation process that is one of the several causes of the GFC.[3]

This post-crisis regulatory reform and the concepts upon which this reform rests, is part of a development that attempts to counteract the (pre-crisis) situation where the financial services industry greatly expanded without regard to the service the industry extended to the real economy.[4] These structural banking reforms contribute to correcting this situation by diverting banks away from engaging in trading activities that did not benefit the real economy; even worse, caused the economy to suffer great losses. I argue the structural banking reforms mark a welcome paradigm shift on the societal role of banks. The separation of certain securities market activities from retail banking activities stems from the post-crisis view that emphasizes the service function of banks.[5]

First, I set out the distinct frameworks of structural bank regulation in the US, UK and EU and explain why the combination of commercial and investment banking is distortive. I give some background of the changed financial services industry and its implications for the desirable structure of banks. Lastly I argue society's expectations justify the intervention in the structure of the business models of banks.

1. Structural regulation of banking: Volcker, Vickers, and Liikanen

What is referred to as the Volcker Rule in the US, ring-fencing in the UK, and the Liikanen proposal in the EU constitutes the restriction imposed on banks to carry out certain business activities considered to be risky. The Volcker rule went into effect in April, 2014, ring-fencing in the UK will come into force in 2019, and the EU rules are subject to negotiations, after being rejected last May by the European Parliament.[6] The reforms differ in their approaches to

[2] Banking Act of 1933

[3] S. Claessens and L. Kodress, 'The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions', *IMF Working Paper* March 2014, accessed at <http://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf>, 6.

[4] T. Lothian, 'Beyond macroprudential regulation: Three ways of thinking about financial crisis, regulation and reform', 3 G*lobal Policy* 2012, 412.

[5] M. Lehmann, 'Volcker Rule Ring-Fencing or Separation of Bank Activities: Comparison of Structural Reform Acts Around the World', *LSE Law, Society and Economy Working Papers* 25/2014, 2, accessed at http://www.lse.ac.uk/collections/law/wps/WPS2014-25_Lehmann.pdf.

[6] < http://www.consilium.europa.eu/en/press/press-releases/2015/06/19-restructuring-risky-banks-council-agrees-negotiating-stances/> accessed 17 August 2015.

separating banking activities. Yet, all the structural banking reforms agree that deposit-taking and financial services to non-financial sectors of the economy, constitute the 'socially most vital parts' of banking services that should be protected from risks incurred by securities markets activities.[7]

1.1 Vickers: ring-fencing in the UK

Objectives to be achieved through ring-fencing in the UK[8] include: improving the resolvability of universal banks, insulating vital banking services from instability in the financial system and from riskier banking activities, curtailing (implicit) government guarantees and protecting banks from running excessive risks.[9] Where the continuous provision of services is critical to the economy, these activities have to be ring-fenced.[10] This is said to be the case regarding those services on which customers (individuals and small and medium-sized organisations) rely for their day-to-day transactions.[11] These are services such as deposits and overdrafts that flow from these deposits.[12] A ring-fenced body should conduct these activities, i.e., a separate entity that is economically and legally independent from the rest of the group to ensure that insolvency of the parts outside the ring-fenced body do not affect the protected activities.[13] Dealing in investments or commodities as principal is an excluded activity, meaning that the ring-fenced body may not carry out these activities.[14] The activity of dealing in investments as principal is the buying, selling or subscribing for, or underwriting securities.[15] These activities may, however, be carried out under specified circumstances for risk-management

[7] 'High Level Expert Group Report on reforming the structure of the EU banking sector, Final Report' 2 October 2012, 100 (hereinafter: Liikanen Report); Independent Commission on Banking, 'Final Report Recommendations' September 2011, 35 (hereinafter: ICB Report); Financial Stability Oversight Council, 'Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds', January 2011, 9 (hereinafter: FSOC Study).
[8] The UK can request for derogation of the EU regulation, in accordance with the derogation-clause of article 21 Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions 2014/0020 (COD) (hereinafter: Structural Regulation) which stipulates that if Member States adopted national legislation that have an equivalent effect as the regulation before 29 January 2014, they can request derogation of the structural requirements.
[9] ICB Report, 35.
[10] Ibid., 36.
[11] Ibid., 37.
[12] Ibid., 37.
[13] Financial Services (Banking Reform)Act 2013 (FS(BR)A), s. 142H.
[14] The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014, S.I. 2014 No. 2080 (EAP Order 2014); Articles 4 and 5(1)(2).
[15] Art. 4, EAP Order 2014, See s. 14(1) Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (RAO).

purposes.[16] Furthermore, exposure of the ring-fenced body to other financial firms is restricted to reduce the dangers of the interconnectedness of financial intermediaries and the contagion caused by a failure of another financial firm.[17]

1.2 The Volcker rule: prohibited proprietary trading

Perhaps the most straightforward objective of the U.S. Volcker rule is 'to limit the transfer of subsidies from the federal support provided to depository institutions to speculative activities'.[18] Furthermore, requiring banks to cease prohibited proprietary trading activities should reduce potential conflicts of interest between the bank and its customers, and reduce risk to banks.[19] Prohibited proprietary trading is defined as: 'engaging as principal for the trading account of a banking entity in any transaction to purchase or sell specified types of financial instruments,'[20] such as securities and derivatives.[21] Trading account is defined as an account the bank uses to enter into a transaction, principally with the intention of profiting from short-term price movements.[22]

The Volcker rule is narrow in scope: banking entities are prohibited from conducting proprietary trading, which prohibition is subject to a broad set of exemptions that apply in restricted circumstances, such as market making and underwriting of securities.[23] This has led to the comment that the universal banking model in fact remains practically untouched.[24] However, the legislator has attempted to make this model safer by banning those activities that are considered to be particularly dangerous and unnecessary for the intermediation

[16] See art.14(1) to (3) and art. 14(5), EAP Order 2014.
[17] See ICB Report, 50. The prohibitions and exceptions are set out in art. 13 and 14 EAP Order.
[18] FSOC Study, 9.
[19] Ibid., 15.
[20] See 12 U.S.C.A. § 1851(a)(1)(A) and (h)(4) and for the implementing final rule with a section-by-section analysis: *Rules and Regulations*, 'Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds', Final Rule; 79 Federal Register vol. 21 (Jan. 31, 2014), <accessed July 9 at: http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/FR-2014-01-31.pdf>, 5542. (hereinafter: Rules and Regulations).
[21] 12 U.S.C.A. §1851 (h) (4).
[22] 12 U.S.C.A. § 1851(h)(6) and implementing final rule §___3(b)(1)(i), see *Rules and Regulations*, 5542.
[23] 12 U.S.C.A. § 1851(d)(1)(B).
[24] M. Lehmann, 'Volcker Rule Ring-Fencing or Separation of Bank Activities: Comparison of Structural Reform Acts Around the World', *LSE Law, Society and Economy Working Papers* 25/2014, 7, accessed at http://www.lse.ac.uk/collections/law/wps/WPS2014-25_Lehmann.pdf.

function that banks fulfil in the economy.[25] In other words, economically futile 'speculation' is prohibited, but not useful banking services to clients.[26] The US justifies these exemptions of market making and underwriting activities under a welfare argument that the speculation for clients is carved out: '…to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation'.[27] Moreover, contrary to the UK rules which allow for trading activities and deposit-taking activities to be conducted by separate members within the same banking group, under the US rules proprietary trading may not be carried out by any of the entities in the banking group. Furthermore, investments in hedge funds and private equity funds are not permitted, except under certain circumstances.[28] Similar to the UK rules, permitted hedging activities to manage risks should be genuinely designed to reduce risks, and are only permitted under strict circumstances.[29]

1.3 Liikanen: a hybrid of the UK and US approach

The High-Level Expert Group on reforming the structure of the EU banking sector' sets out the objectives of structural banking separation in the European Union as: limiting the incentives and the ability of banks to take excessive risks with insured deposits, preventing the use of safety net guarantees to cover losses incurred in the trading entity of the deposit bank, and hence limiting the liability of the taxpayer and the deposit insurance system.[30] Unlike the detailed rules of the UK and US structural reforms, the EU proposal is very concise; the relevant rules almost fit on a page and a half.[31] Systemically important banks are prohibited from undertaking proprietary trading activities for the sole purpose of making a profit for their own account without any connection to client activity or hedging the entity's risk.[32] Investing in alternative investment funds is also prohibited, as well as holding shares in any other entity that engages in proprietary trading.[33] National regulators have to review trading activities of deposit taking banks with an eye on potential separation.[34] If certain risk levels are exceeded (e.g. the ratio of trading assets

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[25] Ibid, 7.
[26] Ibid, 7.
[27] FSOC Study, 1.
[28] See 12 U.S.C.A. § 1851 (d)(2)(4); See 12 U.S.C.A. § 1851 (a)(1)(B) & exemption in: 12 U.S.C.A. § 1851 (d)(G)
[29] See final rule §___5(b)(2)(ii), *Rules and Regulations*, 5632.-33.
[30] Liikanen Report, 2.
[31] <http://corpgov.law.harvard.edu/2014/03/08/does-volcker-vickers-liikanen/ >, accessed 7 July 2015.
[32] Art. 5(4) and 6(1)(b) Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions 2014/0020 (COD) (hereinafter: Structural Regulation)
[33] Art. 6 (1)(b) Structural Regulation
[34] Art. 8 (1) Structural Regulation

to total assets),[35] the regulator must decide that the specific banking entity may not carry out those risky activities.[36] The trading activities that have been separated may only be carried out by an entity that is legally, economically and operationally independent from the deposit-taking bank. This separate entity may not carry out deposit-taking activities, nor provide payment services connected to these deposits.[37] After separation, the core credit institution (the deposit-taking entity) is permitted to prudently manage capital, liquidity and funding through the use of certain derivatives (the hedging of risk should be demonstrably shown to the regulator).[38] The remuneration policy must not incentivize the use of these activities for profit.[39] Exposures of a core credit institution to financial institutions should be limited.[40]

2. What is 'wrong' with commercial banks conducting trading activities?

In a study on the interaction between long-term relationship banking activities and short-term trading activities Boot and Ratnovski show how relationship banking may suffer as a consequence of funding over-allocation to trading activities by banks.[41] Even though trading activities are not malignant per se, trading by banks is distortive because of the undermining effect on relationship banking. Trading became important for banks because of the low profitability of relationship banking activities. The development of information technology weakened the traditional central role of banks in the financial system as information providers.[42] Commercial and investment banks became vulnerable to falling asset prices during the GFC because of the over allocation of resources to trading.[43] In the case of the European universal bank UBS, the bank suffered dramatic losses in 2008.[44] The commercial banks Washington Mutual and Wachovia in the U.S. fell victims to the same fate.[45] To illustrate the shift that took place from traditional banking activities to

[35] Art. 9(1)(2) Structural Regulation
[36] Art. 9(1) and (3) Structural Regulation
[37] Art. 13(1) and art. 20(a)(b) Structural Regulation.
[38] Art. 11(1) Structural Regulation
[39] Art. 11(2)(b) Structural Regulation
[40] Art. 15 (1) Structural Regulation
[41] A.W.A. Boot & L. Ratnovski, 'Banking and Trading', Amsterdam Centre For Law and Economics, 26, accessed at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2142161.
[42] By weakening banks' grip on borrowers, see ibid., 26. See on the role of bank in solving informational problems: F. Allen, E. Carletti and X. Gu in: ed. A.N. Berger et al., *The Oxford handbook of banking* 2nd. edn. (OUP, 2015), 31.
[43] Financial Services Authority, 'The Turner Review, A Regulatory Response to the Global Financial Crisis' 2009, 28.
[44] A.W.A. Boot & L. Ratnovski, 'Banking and Trading', IMF Working Paper October 2012, 4, accessed at http://www.imf.org/external/pubs/ft/wp/2012/wp12238.pdf.
[45] Ibid., 4.

trading activities, note the ratio of trading assets to loans on US banks' balance sheets, rising from 30 per cent in the beginning of the 1990s to 60 per cent in 2013.[46] A similar shift occurred in Europe, with banks focusing more on trading while at the same time moving their focus away from customer-based relationships ,[47] in other words, those activities the structural banking reforms refer to as the 'socially most important activities'.[48]

Securities market activities are capable of complementing classic bank services, and separating these activities in one view would be problematic, as the promotion of bank lending ‘needs’ these complementary activities.[49] Trading restrictions must leave space for those market activities, such as taking positions for hedging purposes, an activity inherent in relationship lending.[50] The proposals, though each to a different extent, leave space for non-traditional banking activities as long as these activities complement the retail functions of the banks. For example, U.S. regulations aim to exclude only those activities considered 'unnecessary and economically futile speculation', but not useful banking services to clients.[51] Yet, the U.S. Volcker rule arguably leaves too much space for exemptions, which undermine the very aim of the structural bank reform.[52]

2.1 Privatization of profits and socialization of losses

Another problem with combining trading activities and retail banking arises from traditional relationship banking that generates deposits guaranteed by the state.[53] The Liikanen report notes this pre-crisis situation where universal banks benefited from access to stable deposit funding, guaranteed by the state, whilst investors in debt issued by banks to fund trading activities took this safer funding into account in pricing the debt.[54] The funding costs of these

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[46] A.W.A. Boot & L. Ratnovski, 'Banking and Trading', Amsterdam Centre For Law and Economics, 4.
[47] Liikanen Report, 89.
[48] See para. 1.1
[49] A. Persaud, A., Reinventing financial regulation: a blueprint for overcoming systemic risk, (Apress 2015), 52.
[50] A.W.A. Boot & L. Ratnovski, 'Banking and Trading', *IMF Working Paper* October 2012, 36.
[51] M. Lehmann, ‘Volcker Rule Ring-Fencing or Separation of Bank Activities: Comparison of Structural Reform Acts Around the World’, *LSE Law, Society and Economy Working Papers* 25/2014, 7.
[52] Ibid., 7. Mainly about the Volcker rule it has been argued that the prohibition might be too narrow, see also: A.W.A. Boot & L. Ratnovski, 'Banking and Trading', *IMF Working Paper* October 2012, 35.
[53] Liikanen Report, 90 and FSA, 'The Turner Review, a regulatory response to the global banking crisis', March 2009, 95.
[54] Liikanen Report, 90.

trading activities thus were mispriced which increased incentives for taking excessive trading risks.[55] This mispricing came down to an implicit subsidy from the public sector to banks.[56] Dr Marcel Rohner, CEO of UBS Group, acknowledged the subsidy in a testimony for the UK Parliamentary Banking Standards Committee on January 10, 2013.[57] Moreover, besides benefitting from retail deposit insurance, large banks that combine trading activities with retail banking activities often benefit from their 'too big to fail' (TBTF) status.[58] TBTF banks have access to lender of last resort funding (i.e. being bailed-out by the state to prevent a failure that potentially has systemic consequences).[59] The UBS Shareholder Report[60] for example admits the expansion of its fixed-income business was funded on the back of retail and commercial bank funds lent at an inadequate transfer price to investors.[61] These developments neutralized market discipline, and ultimately resulted in a privatization of profits and a socialisation of losses.[62]

3. Banking at society's service: an answer to banks' identity crisis

Banks are closely linked to the real economy. Healthy, well-managed banks are crucial for the realization of society’s financial needs. An impaired ability to provide credit to the real economy is detrimental for companies and households. The economic downturn a decrease in credit extension would create undermines the strength of the banking system (a ‘self-reinforcing feedback loop’).[63] The influence of financial development on a bank’s role in the economy, which in turn influenced the modern bank’s business model, ultimately resulted in an identity crisis in banking.[64] This identity crisis refers particularly to a focus away from business lines that account for traditional core banking business, such as long-term commitments to customers by providing funding through credit lines, towards trading activities.[65]

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[55] Ibid., 90.
[56] Ibid., 91.
[57] J. Zinkin, *Rebuilding trust in banks: the role of leadership and governance* (Wiley, 2013), 208.
[58] Financial Services Authority, 'The Turner Review, a regulatory response to the global banking crisis', March 2009, 95.
[59] Ibid., 95.
[60] UBS, 'Shareholder Report on UBS's Write-Downs', 18 April 2008
[61] FSA, 'The Turner Review, a regulatory response to the global banking crisis', March 2009, 95.
[62] J. Zinkin, *Rebuilding trust in banks: the role of leadership and governance* (Wiley, 2013), 208.
[63] Liikanen Report, 88.
[64] A.W.A. Boot & L. Ratnovski, 'Banking and Trading', Amsterdam Centre For Law and Economics, 26.
[65] Ibid., 26.

The structural banking reforms provide an answer to this 'identity crisis' encountered by banks. As we have seen, the notion that recurs in studies in the UK, US and EU is the protection of *socially* important banking functions. The protection of core banking functions through restricting riskier activities not essential for the 'key economic role of intermediation',[66] has led to comments both from the industry and academics that these reforms turn banks into public utilities. Jon Pain of KPMG said the reforms returned UK banking to a "more simple 1940-50s style of retail banking where it was perceived as more of a basic utility with low returns on equity for shareholders."[67] Alastair Hudson[68] stated that ring-fencing echoes a growing view among policymakers and regulators about banking as a basic utility, "given that it is essential to the operation of the economy in the modern world, and therefore that continuity of supply is necessary for social and economic life."[69] As we will see, this development is an answer to society's justified post-crisis expectation on the role of banks.

3.1 Implications of the extreme growth of finance

> "…instead of being a servant, finance has become the economy's master..."[70]

In light of the extreme growth of the finance industry reforms are inevitable. Previous to the crisis, the entire financial system had grown excessively relative to the real economy.[71] Assets available for investment on a global scale doubled between 2001 and 2006.[72] For instance, financial intermediation in the UK rose from around 50 per cent of gross value added (GVA) in 1945 to almost 350 per cent by 2009.[73] On a European level, total assets held by MFIs (Monetary Financial Institutions, including money market funds) accounted for 350 per cent of GDP in the European Union.[74] This growth was accompanied by an increase in total system leverage (total debts relative to

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[66] ICB Final Report, 46.

[67] G.A. Walker, 'Structural regulation and financial reform: the Independent Commission on Banking', *Law and Financial Markets Review 12* 2011 5 (6), 423.

[68] Professor in Finance Law at the University of Southampton

[69] A. Hudson, 'Banking regulation and the ring-fence', *Compliance Officer Bulletin* 2013, 8.

[70] Wolf (2009) noted that the U.S. financial sector grew six times faster than nominal GDP prior to the 2008 global financial crisis, arguing that "…instead of being a servant, finance has become the economy's master..." in: A.W.A. Boot & L. Ratnovski, 'Banking and Trading', *IMF Working Paper* October 2012, 9.

[71] Financial Services Authority, 'The Turner Review, a regulatory response to the global banking crisis', March 2009, 16.

[72] C.W. Murdock, 'The Big Banks: Background, Deregulation, Financial Innovation, and 'Too Big To Fail'', *Denver University Law Review* 2012 90, 524.

[73] ICB Final Report, 127.

[74] Liikanen Report, 11.

assets), which aggravated the vulnerability of the financial system.[75] Activities internal to the banking system grew much faster than end services to the real economy.[76] Claims within the financial system exploded (between banks, investment banks and hedge funds).[77] Not only did this expansion result in great interconnectedness between financial institutions, the growth of the relative size of the financial sector and the loosening of the connection between the financial industry and the real economy also magnified the impact of the crisis on the real economy.[78]

The Liikanen report also emphasizes the importance of the connection between banks and the real economy. The report states that, based on recent studies, the emerging consensus is a smaller financial sector could be more desirable to support productivity growth.[79] Along similar lines, the IMF notes how studies using data from post 1990 show there can be a case of 'too much finance'.[80] Based on empirical research, the IMF highlights that during early and intermediate stages of financial development, economic growth is still stimulated while volatility increases. In the third 'stage' where many advanced economies are situated, financial development leads to lower growth and increased volatility.[81] In this third stage financial depth no longer contributes to increasing the efficiency of investment.[82]

The fundamental function of credit intermediation is to channel resources into the most productive activities.[83] The explosion of claims between financial institutions shows the intra-movement of funds, without generating new wealth for society.[84] 'Too much finance' can generate too much fragility

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[75] Financial Services Authority, 'The Turner Review, a regulatory response to the global banking crisis', March 2009, 19.
[76] Ibid., 16.
[77] Ibid.,18.
[78] Ibid.,18.
[79] Liikanen Report, 29-30. These studies focus on the negative effects of enlargement of financial systems on real growth of the economy. The research establishes that smaller financial sectors (and banking sectors) could be more desirable to enhance productivity growth. See: S.G. Cecchetti & E. Kharroubi, 'Reassessing the impact of finance on growth', *Bis Working Papers* No 381 July 2012, especially pp. 11-12; J. Arcand et al., 'Too Much Finance?', *IMF Working Paper* June 2012.
[80] IMF Staff Discussion Note, 'Rethinking Financial Deepening: Stability and Growth in Emerging Markets' May 2015, 7, accessed at https://www.imf.org/external/pubs/ft/sdn/2015/sdn1508.pdf.
[81] Ibid., 24.
[82] Ibid., 8.
[83] Ibid., 7.
[84] J.G. Taft, *A Force for Good: how enlightened finance can restore faith in capitalism* (Palgrave Macmillan, 2015), 27. In Lothian's words this is a case of 'financial hypertrophy' (the expansion of the financial sector measured by the proportion of talent, as well as resources and profits that it absorbs without regard to the service extended to the real economy) as opposed to financial deepening which is the multiplication of links between

through the loosening of links with the real economy, making finance the master rather than the servant it should be.[85] Structural banking regulation attempts to strengthen the connection between banking services and the real economy by protecting those services critical for the real economy from excessively risky securities markets activities. These trading activities are less important for the real economy[86] because they do not stimulate productivity-enhancement.[87] The most obvious types of such trading activities are speculative trading, with speculation defined as the movement of "money from one pocket to another"; i.e. finance serving itself.[88] Besides strengthening banks' service function by limiting excessive risk-taking with a view on profits, structural banking regulation aims to ensure retail banking activities are protected from the risks that flow from the riskier business lines of the bank, and by correcting the inequity of banks 'placing bets' with state-guaranteed deposits.[89] Summarizing, structural banking regulations impose discipline on banks to protect their "institutionalized service to the real economy" (financial deepening as opposed to financial hypertrophy).[90]

3.2 Finding a balance

The structural bank reforms reduce diversification of banking activities. Product and services diversification by banks used to be associated with efficiency gains.[91] However, diversification of banking business models coupled with excessive risk taking, resulted in artificially high market liquidity.[92] In any case, evidence on the added value of banks with diversified business lines is generally weak and academic research mainly associates

finance and the real economy, channeling long term savings to long term productive investment; T. Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 412.

[85] T. Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 414.

[86] L. Gambacorta & A. Van Rixtel, 'Structural bank regulation initiatives: approaches and implications' *BIS Working Paper* No 412 April 2013, 1, accessed at: http://www.bis.org/publ/work412.pdf.

[87] T. Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 416-17.

[88] J.G. Taft, *A Force for Good: how enlightened finance can restore faith in capitalism* (Palgrave Macmillan, 2015), 27; T. Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 418.

[89] T. Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 417.

[90] T. Lothian, Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform, Global Policy 3 issue 4, 2012, 415.

[91] L. Gambacorta & A. Van Rixtel, 'Structural bank regulation initiatives: approaches and implications' *BIS Working Paper* No 412 April 2013, 8, accessed at: http://www.bis.org/publ/work412.pdf.

[92] Ibid., 11.

product diversification by commercial banks with heightened risk levels and detrimental effects on the bank sector.[93] Research established the main advantage of large size is the implied subsidy that comes with the TBTF status of banks that combine trading and retail banking activities.[94] As discussed, the separation of securities market activities and commercial banking aims to eliminate this implied subsidy.[95]

One of the criticisms[96] of the trading restrictions in the US that recently took effect, is market liquidity may decrease as a consequence of the reduced dealer inventories held by banks.[97] This could make it harder for companies to raise funds on the corporate bond markets, since reduced liquidity usually results in investors demanding higher prices.[98] At the same time recent studies show that liquidity has its limits in terms of beneficial effect on the real economy,[99] and these limits have been reached in advanced economies such as the US and the European Union. As the financial crisis demonstrated, banks, by nature prone to systemic risk, are not made to take on trading losses resulting for instance from a collapse of corporate bond markets.[100]

The structural banking reforms are not bullet-proof in every sense. This relatively heavy-handed regulation imposes large costs on banks by requiring them to reorganize and potentially puts them at an international competitive disadvantage.[101] Yet, the same argument can be brought up against this reasoning, as against the potential negative effect on market liquidity that these reforms would have: it is a reasonable price to pay for safer banks that provide financial services to companies.[102]

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[93] F. Fiordelisi & D. Marquez-Ibanez, 'Is Bank Default Risk Systematic?', *Journal of Banking and Finance* 2011.

[94] L. Gambacorta & A. Van Rixtel, 'Structural bank regulation initiatives: approaches and implications' *BIS Working Paper* No 412 April 2013, 9, accessed at: http://www.bis.org/publ/work412.pdf.

[95] In the U.S., by July of this year, Goldman Sachs and JPMorgan Chase had closed down proprietary trading operations and wound down several investment funds, 'Volcker rule, much ado about trading', *The Economist,* 25 July 2015.

[96] Other common arguments against structural bank regulation is that it pushes more activities into the shadow banking sector and that it is excessively costly for banks to restructure their operations.

[97] 'Volcker rule, much ado about trading', *The Economist*, 25 July 2015

[98] Ibid.

[99] S.G. Cecchetti & E. Kharroubi, 'Reassessing the impact of finance on growth', BIS Working Papers no. 381 July 2012, accessed at: <http://www.bis.org/publ/work381.pdf>.

[100] 'Liquidity in markets: frozen', *The Economist*, 18 April 2015

[101] 'Safeguarding European Banks, the European Union proposes a radical overhaul of its banks', *Financial Time*s, 1 February 2014.

[102] 'Liquidity in markets: frozen', *The Economist*, 18 April 2015

4. The way forward

The relation between finance and society may be seen as constituting an implicit social contract between the former and the latter.[103] The post GFC contract between finance and society holds finance more accountable for its impact on the real economy. Finance has a higher, and at the same time simple purpose: to serve the real economy.[104] Interestingly, the OECD notes that a system of renewed incentives, rules and regulations should be designed governing 'the system of promises upon which the financial sector is built'.[105] This concept of a 'system of promises' is an interesting one, especially from an ethical perspective. It touches upon the idea of a social contract between society and financial intermediaries and on conceptions of stewardship that come down to the duty of the promisor to carry out activities that advance the self-interest of the promisee.[106]

This promise would on a formal level consist of respecting and fulfilling the self-interest of the promisee,[107] just as in a private sphere contractual arrangements are governed by commercial law where fiduciary duties are common.[108] In this context 'promisee' refers to society at large, especially those actors who do not participate on a level playing field with big financial intermediaries, e.g. SMEs and households. This promise is to provide the financial means that SMEs and consumers need to finance their business, so that goods are produced and jobs are created. For households it means they should be able to safely store their deposits.[109] An important term in this implied contract is those activities from which society does not benefit should be restricted as much as possible.[110] There is no place for speculative trading

[103] J.G. Taft, *A Force for Good: how enlightened finance can restore faith in capitalism* (Palgrave Macmillan, 2015), 22.
[104] Ibid. xiv.
[105] G. Wehinger, 'Banking in a challenging environment: business models, ethics and approaches towards risk' 2 2012 *OECD Journal: Financial Market Trends*, 2.
[106] J.G. Taft, *A Force for Good: how enlightened finance can restore faith in capitalism* (Palgrave Macmillan, 2015), 22-23.
[107] Ibid., 22.
[108] Ibid., 23.
[109] J.G. Taft, *A Force for Good: how enlightened finance can restore faith in capitalism* (Palgrave Macmillan, 2015), 24.
[110] Ibid., 35. See also Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 416-17 on the prohibition of trading activities that lack in a relation to the enhancement of productivity.

activities in this contract between financial intermediaries and society at large, and only limited space for securities markets activities in general. This corresponds with the expectation of society that finance plays a useful role akin to public utilities.[111]

Concluding Remarks

This paper focuses on the broader implications of regulatory reform, which consists of protecting certain 'socially important' banking activities. These reforms represent society's demand for a more equitable industry that enjoys legitimacy because of its service function. The structural banking regulations in the US, EU and UK specify a regulatory framework that puts in place the preconditions to ensure at least one part of the finance industry – the banking sector – honors its promise to provide services society needs, instead of focusing on lucrative but non-economically productive activities. The technicalities of the regulation are important and time will reveal the robustness of the rules. If successful, structural banking reform constitutes one of the (regulatory) steps that alter the banking landscape. The finance industry changes from a sector that profits handsomely during the good times by engaging in socially useless activities,[112] and is then bailed out by governments in bad times, [113] to one whose prime purpose is to serve the economy.

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[111] J.G. Taft, *A Force for Good: how enlightened finance can restore faith in capitalism* (Palgrave Macmillan, 2015), XIV.

[112] T. Lothian, 'Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform', *Global Policy* 3 issue 4, 2012, 411.

[113] Ed. A.N. Berger et al., *The Oxford handbook of banking* 2nd. edn. (OUP, 2015), 35.