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AK Position Paper

AK Contribution to the Public Consultation

by the European Commission:

Reforming the structure of the EU banking sector

## About us

**The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social-, educational-, economical-, and consumer issues both on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.**

**The AK EUROPA office in Brussels was established in 1991 to bring forward the interests of all its members directly vis-à-vis the European Institutions.**

### **Organisation and Tasks of the Austrian Federal Chamber of Labour**

The Austrian Federal Chamber of Labour is the umbrella organisation of the nine regional Chambers of Labour in Austria, which have together the statutory mandate to represent the interests of their members.

The Chambers of Labour provide their members a broad range of services, including for instance advice on matters of labour law, consumer rights, social insurance and educational matters.

Rudi Kaske  
President

More than three quarters of the 2 million member-consultations carried out each year concern labour-, social insurance- and insolvency law. Furthermore the Austrian Federal Chamber of Labour makes use of its vested right to state its opinion in the legislation process of the European Union and in Austria in order to shape the interests of the employees and consumers towards the legislator.

All Austrian employees are subject to compulsory membership. The member fee is determined by law and is amounting to 0.5% of the members' gross wages or salaries (up to the social security payroll tax cap maximum). 560.000 - amongst others unemployed, persons on maternity (paternity) leave, community and military service - of the 3.2 million members are exempt from subscription payment, but are entitled to all services provided by the Austrian Federal Chambers of Labour.

Werner Muhm  
Director

# Executive Summary

The Austrian Federal Chamber of Labour (BAK) welcomes the Commissions' initiative to reform the structure of the EU banking sector. In our view, it is an important corner stone, without which the other elements of a banking union, the Basel III accord and its implementation by CRD/CRR, the Bank Resolution and Recovery Directive (BRRD), the single supervisory mechanism (SSM) and a reform of deposit guarantee schemes (DGS) cannot be expected to be fully effective.

However, it must be kept in mind, that not only the size, interconnectedness and complexity of single institutions matter, but also the overall size of the financial sector in relation to the economy as a whole can put a country at risk.

# The AK position in detail

## 1. PROBLEM DRIVERS“

*Question 1: Can structural reform of the largest and most complex banking groups address and alleviate these problems? Please substantiate your answer.*

Given the high concentration of EU banking sector structural reforms of the largest and most complex banks and banking groups respectively are indeed essential. But while it is true, that size also matters in the “too big to fail” (TBTF) discussion, it is not only size that matters. As mentioned in Section 1 “PROBLEM DRIVERS“ of this consultation document, size is only one dimension of the problem. Other factors that enhance the default risk at the expense of the taxpayers are complexity and the interconnectedness both within the industry and the group. Any threshold is arbitrary, especially if only size is considered (whether the state, the Eurozone, or the EU is seen as the relevant market), and complexity and interconnectedness are not taken into consideration. Several cases of state intervention in the on-going financial crises were in fact not in favour of the banks or banking groups that would fall under the definition of the largest and most complex banking groups. In fact, according to the last DG Competition overview, since 2009, only in one case -relating to a regional Portuguese bank - envisaged rescue and restructuring aid has been considered not to be compatible with EU-State aid law due the lack of systemic relevance. One also has to keep in mind that not only the size of single entities or groups, but also of

the size of the financial sector as a whole in relation to economy can pose a substantial risk to the economy.

The problem is enhanced by the fact that financial institutions are trying to control their risk by diversification, which is in itself and from the single institutions’ point of view is certainly the right strategy. This strategy has two caveats, if not dysfunctional properties. The first is that we are far from being sure that risks of retail banking and investment banking are negatively correlated. In fact, most evidence seems to point towards a positive correlation between income from interests and income from commissions (as a proxy for retail banking and investment banking respectively). The second one is that risks of different asset classes are becoming closer correlated when all financial institutions are following similar risk diversification strategies, and thereby are increase systemic risk. The logic conclusion would be that we need a higher diversity of institutions / players in financial markets, which means that a more diversified regulatory approach to different sub-sectors of the banking industry would lower systemic risk. The same argument holds whether there are few big players or many little players that act more or less the same and could be called the paradox of diversification.

The text of Section 1 “PROBLEM DRIVERS“ also addresses the problem of cross-subsidising activities other than retail banking through DGS (ultimately guaranteed by the state or the tax payer respectively) by lower financing costs for these activities within a banking

group at the expense of retail banking. Resolving this problem, retail banking should see lower financing costs if it is separated from other activities, which in turn means that this measure should lead to better financing conditions for consumers and small and medium enterprises (SME), the back bone of the European economy.

In the Bank Resolution and Recovery Directive (BRRD) proposal one of the preventive measures is the separability of different activities within a banking group. Without this measure, we see little chance of the BRRD becoming an effective framework. Additionally, from our point of view the problem of moral hazard would persist, should investment banking activities not be separated sufficiently from retail banking due to a reliance on implicit guarantees.

We therefore think that structural reform of the largest and most complex banking groups alone does not address and alleviate these problems sufficiently. We rather think that (1) given the evidence that also smaller, highly interconnected and complex banks had to be rescued (2) given the lack of evidence of negative correlation between retail and investment banking and (3) given the paradox of diversification (4) given the cross-subsidising of other activities than retail banking within a group that takes deposits and (5) given the need of an effective BRRD, structural reforms have to encompass more than just the largest and most complex groups.

## 2. SUBSIDIARITY

*Question 2: Do you consider that an EU proposal in the field of structural reform is needed? What are the possible ad-*

*vantages or drawbacks associated with such reforms? Please substantiate your answer.*

Geographical regulatory arbitrage not only has brought about distortions in the allocation function and increased instability of the financial system, but also has led to a race to the bottom in the regulatory and supervisory process. Additionally, we are confronted with a re-fragmentation of the internal market on the financial markets in the aftermath of the financial crisis. Therefore, an EU proposal is certainly the best approach to structural reforms of the EU Banking industry.

Having said that, the proposal should be ambitious enough in order to tackle the problems weighing heavily on the European economies' and sovereign financing conditions following the financial crises, but at the same time consider historically grown structures of the European economies to find the right position in the matrix sketched out in Table 1 of the consultation document.

### 3.2.1. Scope of banks potentially subject to separation (De minimis exemptions)

*Question 3: Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator.*

The lack of publicly available figures for banks' specific business lines by itself poses a problem. If such information is not publicly available, rather little can be said about the risk that ultimately is guaranteed by taxpayers. Additionally, any definition of what activity other than

retail banking is considered to be a risk for deposit taking bank backed by DGS is based on assumptions that are formed by the experience of the last crisis. Therefore, the best way to separate the risk of retail banking from other activities is to isolate retail banking from all other banking activities, albeit within a banking group.

So in our view, the best way would be in the direction of the path proposed by the banking reform commission in the UK, which does not rely on assumptions and arbitrary thresholds, which risk and which quantity of the activity could pose a risk to retail banking. In other words, a rather narrow definition of retail and a very wide of investment banking would be the most appropriate definition, and the separation requirement should not be restricted to the biggest banks.

Turning to the argument that there is a high number of smaller, legally independent credit institutions, one has to consider that the vast majority of these credit institutions are organised in a sector of decentralised local and regional institutions, which would put them into the position of being able to offer services other than typical retail banking services from within the sector to their clients without being the legal counterpart. This in turn would mean that the central institutions of a sector should be reduced to core competences, namely services other than retail banking, and the decentralised local and regional institutions of such a sector should be restricted to retail banking.

In addition, BAK is proposing that not only the function / service itself should be considered in these definitions, but also the place of situs. Activities and exposures in jurisdictions that do not apply regulatory standards comparab-

le to those of the Capital Requirements Directive/Regulation Bank Resolution and Recovery Directive should only be allowed to banks not taking deposits.

### 3.2.2. Supervisory discretion for separation

*Question 4: Which of the approaches outlines above is the most appropriate? Are there any alternative approaches? Please substantiate your answer.*

In our view, structural reforms cannot be carried out on a case-by-case approach. This would lead to high legal uncertainty, potential pressure on supervisors and potential supervisory arbitrage. So, more or less the same arguments that are true when it comes to the question of whether an EU proposal would be the appropriate and most effective approach (see answer to question 2) also hold for clear cut ex-ante separation provisions/legislation without discretion of the supervisor.

### 3.2.3. Activities to be separated

*Question 5: What are the costs and benefits of separating market-making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?*

For markets and segments of markets with low liquidity market makers certainly play an important rule. However, also the similar nature of market making to other trading activities in combination with the risk of the exposure in illiquid markets for smaller credit institutions should not be underestimated, even though these exposures are most of the time of short term nature. Nevertheless, as argued in the answer to question 3, for smaller banks organised

in a sector decentralised local and regional institutions, we would see the function of market making at the central institute of the sector.

As for underwriting activities, banks are usually exposed to risks stemming from guarantees, which require a considerable size of the bank anyway. Also in the case of underwriting, BAK would therefore see a case for separating the risk of this investment banking activity from deposit taking / retail banks.

*Question 6: Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?*

As elaborated in the above question, BAK very much favours a narrow definition of retail / deposit taking banks and a wide definition of investment banking. However, we do see the need and demand of e.g. export orientated SME for hedging some of their risk such as interest rate risk and / or foreign exchange. As for retail banks organised in a sector of decentralized, regional and local institutions, these services could be offered via the central institute. For other retail banks, these services and instruments could be offered to SME, provided these risk management tools are designed in a way which does not give rise to increased exposure to market risk, and that the services are sufficiently simple and that they do not threaten resolvability. In any case, a deposit taking / retail bank should only be allowed to offer such instruments and services to SME, and particularly not to other financial institutions. In all other cases, a deposit taking / retail bank

should only be allowed to act as an agent of a third party and not as a legal counterparty. Doing so, it has to serve the interest of the client.

### 3.2.4. Strength of separation

*Question 7: As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?*

As stated in the text of the consultative document, with mere accounting separation it cannot be expected that the goals of the reforms of the structure of the EU banking sector could be met, since it would only be a formal reporting requirement.

#### **Functional separation with economic and governance links restricted to current rules:**

The application of CRD/CRR in terms of capital, liquidity, leverage and large exposures to entities within the group is in our view a minimum requirement, should the goals of reforming the structure of the EU banking sector be met. For banking groups, it is a common practice to set up subsidiaries to e.g. "optimize" their structure for different taxation regime and / or regulatory arbitrage. Therefore, as long as there is full consolidation and e.g. no requirement of separate funding and no requirement for sub-consolidation, the costs for banking groups would not change much compared to the current situation. There would in turn be hardly any benefit with respect to risk for financial stability, since the main problem drivers would still be in place.

**Functional separation with tighter restrictions on economic and governance links:**

The costs of funding in a scenario with separate funding and sub-consolidation requirements with regard to CRD/CRR in terms of capital, liquidity, leverage and large exposures should be expected to decrease for retail and commercial banking (RCB) of deposit taking banks. The costs of funding of wholesale and investment banking (WIB) are expected to increase reflecting the higher risk and the lack of guarantee by DGS.

To avoid that a part of the group puts other parts, especially those with functions essential to an economy (deposit taking and lending to households and SME, payment infrastructure) at risk, restrictions should be in place concerning large exposure risks and intra group guarantees from the deposit taking entity to the trading entity. To avoid deliberate mispricing of risk, which would be another form of transferring risk between separate entities within group, intra-group prices should follow the principle of third party, commercial term.

One of the problems in the run-up to the crisis was flaws in the corporate governance structure of financial institutions. In order to avoid conflicts of interests, in order to ensure more independence of the different entities and in order to avoid obstacles to resolvability, the cross use of board directors within the group should be limited.

Overall, for a banking group as a whole, the degree of change in the group will depend on the respective size of the different parts, with benefits to be expected for RCB. This in turn should lead to less risky and less costly RCB services and instruments for households and SME.

Last, but not least, functional separation with economic and governance links restricted to current rules would not suffice to remove impediments to resolvability which is a corner stone of BRRD.

There should be further studies about how IT and other infrastructure of banking groups could be on one hand jointly used to avoid an increase of fixed costs and be easily separated in a scenario in which restructuring or resolution is inevitable.

*Question 8: What are the relevant economic links and associated risks between intra-group entities?*

The most fundamental economic link is certainly the question of funding of the group and its entities respectively. As elaborated in the text of the consultation document and the answers to the above questions, the relevant factors are the guarantee of deposits by DGS reducing funding costs and the implicit guarantee of banks too big, too interconnected, of too complex to fail. These cross-subsidies and flawed incentives (moral hazard) lead to mispricing of risk and excessive risk exposure within a banking group in which RCB is not separated adequately from WIB.

Guarantees and the pricing of risk in financial instruments within banking groups can be used to reduce capital requirements, leading to too high levels of leverage as compared to levels that the legislator / regulator would see as sustainable. Therefore, there should be limits on intra-group guarantees and transactions should only be allowed on third party commercial terms.

The joint use of infrastructure (IT, payment systems) reduces fixed costs. However, the risk associated with this



structure is, how these systems are to be separated in case of restructuring or resolution.

Banking groups do not only enjoy economies of scale, but also economies of scope. This means that the same banking group can offer different services through the same channel. The risk that RCB incurs risks stemming from instruments and services of WIB can be eliminated, if the RCB acts as an agent and not as a counterpart of these services and instruments.

Liquidity management within the group can help to optimize liquidity of the group. However, it bears the risk of spill over between RCB and WIB units. Therefore, there should be a clear requirement of sub-consolidated liquidity management for each part and transactions should be carried out on third party, commercial terms to avoid deliberate mispricing of risk and cross-subsidies from the deposit taking entity to the trading entity.

Cross use of directors of the board is a typical form of an economic link in case of subsidiarization (whether subsidiaries are set up to “optimize” the structure of the group for tax purposes and / or regulatory arbitrage or whether they are set up to fulfil regulatory requirements of functional separation). The risk hereby lies in the conflict of interest and the lack of economic independence to avoid implicit intra-group guarantees and the mispricing risk in case of intra-group transactions. Moreover, flaws in corporate governance were one of the factors driving the build-up of the crisis. Therefore there should be limits on the cross-use of directors within the group, and independent risk committees should be set up for the RCB and the WIB entity.

*Question 9: As regards full ownership separation, what are the associated costs and benefits?*

While ownership separation would be the optimal solution when only spill overs and / or resolvability are considered, the costs of ownership separation seem rather high and a full application of ownership separation would hardly be feasible and put the diversity of European banking at risk. It could lead to disruption of services, given the grown structure of European banking, where in many countries small (RCB) banks are organized in sectors, where the central institute can take over the functions of WIB.

Having said that, the costs of ownership separation on the one hand and the costs of a non-effective reform of the structure of the EU banking sector on the other hand can both be best avoided if a functional separation with tight restrictions on economic and governance links is implemented.

However, as stated in the introduction, it must be kept in mind, that not only the size, interconnectedness and complexity of single institutions matter, but also the overall size of the financial sector in relation to the economy as a whole can put a country at risk.

### 3.3. Options to be considered

*Question 10: Does the above matrix capture a sufficiently broad range of structural reform options?*

Yes.

*Question 11: Which option best addresses the problems identified? Please substantiate your answer.*

As for the definitions of respective parts of banking group – retail and commercial banking (RCB) being one part and wholesale and investment banking (WIB) being the other, the definition should not be based on assumptions about the source of possible spill overs from WIB to RCB based on the experience of the recent crisis. The less assumptions necessary, the better and sounder the solution would be. Therefore, a rather narrow definition of RCB and a rather wide definition of WIB would certainly be the option for more financial stability. Furthermore, as discussed above, we see little or no evidence for a negative correlation between RCB and WIB, indicating that lower funding costs for WIB within a group are to be associated with cross subsidies from RCB. In addition we are concerned about increased correlation coefficients between asset classes that in our view derive from the paradox of diversification. The more agents try to diversify their assets in a risk optimizing strategy, the more the asset classes become correlated. So in BAKs' view the diversification argument for a universal banking group is not a strong one, while having different entities with different risk strategies (those of RCB and WIB will typically differ) should be expected to increase overall financial market stability.

Since thresholds are rather arbitrary and evidence has shown that also banks that would not exceed the threshold suggested by the HLEG had to be saved, the reform of the structure of the EU banking system should not be restricted to the largest banks, but rather be generally applied. Small banks that are operating within a decentralized sector could move their WIB activities to the central institute, which in turn should be restricted to WIB.

As for the functional separation, BAK sees a strong case for the 2nd column – functional separation 2 (functional separation with tighter restrictions on economic and governance links). Intra-group economic links are too close to achieve the goals of the reform of the EU banking structure if these links are not stricter and tighter. This is true for funding, as well as for certain CRD/CRR requirements as e.g. large exposure risks, pricing of transactions within a group and corporate governance (see answers to questions 7 and 8).

While ownership separation would be the optimal solution when only spill overs and / or resolvability are considered, with the given, diverse structure of banking groups and the given customer relationships, a full ownership separation approach would incur the risk of services to depositors, small investors and SME being interrupted and lead to considerable restructuring and funding problems.

So to summarize, on BAKs' view, option H with a functional separation and stricter requirements, and a narrow definition of retail and commercial banking and a broad definition of wholesale and investment banking would best address the problems identified.

Should you have any further questions  
please do not hesitate to contact

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