Structural Banking Reforms

Janet Mitchell

Introduction

The financial crisis which began in 2007-2008 exposed significant weaknesses in the financial system, at both the micro-prudential and macro-prudential levels. One of the unique features of this crisis relative to previous banking crises was the central role played by complex financial products – in this case involving exposures to US subprime real estate mortgage securitizations – whose risks were not well understood. The sale of these products to financial institutions around the world in the years preceding the crisis meant that the boom and subsequent bust of one segment (subprime) of the real-estate market in one country (the US) had a global impact.

The breadth and depth of the crisis, combined with the massive bank bail-outs which governments felt compelled to undertake when faced with the threat to the financial system of the failure of large banks, led to a broad, international agenda of regulatory reforms. These reforms have included increases in minimum regulatory capital requirements for banks, an increase in the quality of capital held by banks, broadening of the risks for which bank capital requirements are imposed, introduction of liquidity regulation for banks, introduction of macro-prudential policies, and development of frameworks to allow resolution of failed banks without the use of taxpayer funds.

While these reforms should significantly improve the resilience of banks and the financial system, several observers have nevertheless argued that an additional step is necessary; namely, imposition of structural banking reforms. The term structural reforms can cover a wide range of measures, running from the complete prohibition of certain activities by banks, to imposition of limits on certain activities, to the separation of particular activities in different legal structures.

Support for structural reforms derives from the argument that allowing banks to combine commercial and investment banking activities can increase bank riskiness, as well as complexity, which can make orderly resolution of a failed bank more difficult. The focus on structural reforms has been motivated by the role of banks’ trading activities in the recent crisis, as the complex financial products that were at the heart of the crisis were often held by banks for trading purposes. In many cases, the large losses resulting from trading in complex securities caused contagion to the entire bank.

Yet, while trading activities are very risky, an important feature of these activities is their heterogeneity. Some trading activities are riskier than others and some are more beneficial to the real economy than others. Activities classified in the category of trading can include: proprietary trading, or trading purely for the bank’s own profit; intermediation services provided to clients where the bank serves as a counterparty for positions, such as derivatives, that a client wishes to sell or buy for hedging purposes; provision of market making services, often in debt markets, where the intermediary’s participation ensures sufficient liquidity for the market to be active; and securities underwriting. Trading activities other than proprietary trading are sometimes broadly referred to as market making activities. Whereas many of these activities are clearly beneficial to the real economy, proprietary trading activities are not. Unfortunately, it can be challenging in practice to distinguish proprietary trading from market making activities. This helps to explain many of the differences across existing structural banking reform proposals.

Structural banking reforms have indeed been proposed by several countries. Leading in this initiative were the US, via the Volcker rule named for the former Chairman of the Federal Reserve who proposed the measure, and the UK,
with the Vickers reforms, proposed by the Independent Commission on Banking chaired by Sir John Vickers. The Volcker rule prohibits banks from engaging in proprietary trading, while the Vickers reform requires separation of most trading activities from deposit-taking banks into a legally separate trading entity, which can remain within the financial group.

Following the Volcker and Vickers proposals, the Belgian government requested that the National Bank of Belgium (NBB) analyse the desirability and feasibility of introducing structural reforms in Belgium. In response to this request, the NBB published an interim report in June 2012, and its final report appeared in July 2013.

The NBB interim report argued that neither the Volcker rule nor the Vickers proposal was well suited for unilateral implementation by a small country in Europe with a significant presence of foreign banks. In particular, an individual country that implements Vickers-type structural reforms cannot require the ring-fencing of foreign branches of EU banks operating in the country. Hence, if EU foreign branches operate on a large enough scale, an unlevel playing field will be created, since the foreign branches will not be restricted in the activities they undertake. Moreover, foreign subsidiaries of EU banks operating in the country could decide to convert to branches in order to circumvent the structural reforms. Rather than advocating either the Vickers or the Volcker proposals, the NBB interim report put forth a series of policy recommendations adapted to the specific features of the Belgian banking system and corresponding to four policy categories covered by the UK Vickers reforms: recovery and resolution plans; capital surcharges on particular institutions; intra-group exposures; and bank activities. One of these recommendations was to impose a capital surcharge on trading activities above a threshold. The NBB final report developed and finalized the recommendations from the interim report, and it added a recommendation to separate banks’ proprietary trading activities above some threshold. Most of the policies proposed in the final report have now been incorporated in the new Belgian banking law, which will take effect in January 2015.

In October 2012 a high-level expert group appointed by the European Commission to examine the question of structural banking reforms for Europe, and headed by Governor Liikanen of the Bank of Finland, published its report. The Liikanen group took account of specific characteristics of the European banking system when formulating its recommendations, which included separation from deposit-taking banks of a subset of trading activities above some threshold, where the set of activities to be separated was narrower than those to be separated from deposit-taking banks in the UK Vickers proposal. France and Germany followed with their own structural reform proposals, which require separation of an even narrower set of activities (primarily, proprietary trading) than those proposed by the Liikanen group. Most recently, the European Commission has published a proposal for a European regulation on structural reforms. This proposed regulation draws on aspects of the Liikanen recommendations and of the Volcker rule.

This article examines the existing structural reform proposals, discussing differences in their features and analysing their implications. It also considers the potential costs and unintended consequences of the various proposals. Finally, it motivates the need for a broad approach to structural reform policies and outlines the structural reform measures put forth in Belgium.

The remainder of the article is organised as follows. Section 1 analyses the key differences among existing structural reform proposals. Section 2 considers the different proposals in light of commonly cited objectives for structural reforms and of potential costs. Section 3 discusses the structural reform measures in Belgium relating to trading activities. Section 4 concludes.

1. Key features of bank structural reform proposals

As noted above, the starting point for proposals of structural reform is the argument that combining commercial banking and certain types of investment banking activities can increase risk and make bank resolvability more difficult. While there is no unanimous agreement as to whether universal banks are safer or riskier than “pure” commercial banks, it is fairly well acknowledged that combining income from investment banking and commercial banking can increase income volatility.\(^1\)

It is also worth noting that the idea of separating investment and commercial banking activities is not new. Structural banking reforms were introduced in the 1930s in both the US and in Belgium. In the US, the Glass-Steagall Act, which took effect in 1932, prohibited commercial banks from undertaking any investment banking activities. Belgian structural banking reforms were implemented in 1934-1935 and forbade banks from holding shares in nonfinancial firms. In both the US and Belgium, however, the motivation for the structural reforms was

\(^1\) See, for example, Stiroh (2004, 2006), who shows for US banks that noninterest income is more volatile than interest income, and the correlation between the two types of income has increased over time, thereby suggesting declining diversification benefits. A high share of trading income is not associated with higher bank profitability, but it does appear to increase bank risk.
to avoid conflicts of interest faced by commercial banks that also performed investment banking activities. In both countries the reforms were weakened over time and eventually removed: the Belgian structural reform legislation was fully abolished in 1993, while the US Glass-Steagall Act was repealed in 1999. (1)

Structural reform proposals often require that certain securities market activities be removed from deposit-taking banks and thus undertaken by “trading” entities that do not accept retail deposits. In fact, most of the key differences between structural reform proposals can be characterized along two dimensions: (1) which activities must be removed from deposit-taking banks; and (2) whether the “trading entities” that undertake the activities separated from the deposit-taking banks can be located in the same group as the banks. These two dimensions capture the main distinctions between the current proposals. As a point of comparison, note that the US Glass-Steagall Act separated all investment banking activities from commercial banks and prohibited the investment banking activities from being undertaken within the banking group.

The table in the Appendix characterizes the current structural reform proposals along the two dimensions. As this table demonstrates, each of the current proposals is less extreme than Glass-Steagall along at least one of the two dimensions.

As can be seen from the table, the US Volcker rule proposes the narrowest separation of activities. Namely, it requires separation of only proprietary trading activities and ownership of hedge funds and private equity. On the other hand, it does not allow the separated activities to be performed within the banking group. At the other end of the spectrum is the UK Vickers proposal, which separates most securities related activities from deposit-taking (“ring-fenced”) banks. All dealing in investments as principal, and all commodity trading must be separated from ring-fenced banks, with the exception of transactions that are linked to the bank’s hedging needs or to liquidity management. Similarly, ring-fenced banks are not allowed to undertake derivatives transactions except those needed for hedging or liquidity management, and except for limited amounts of simple derivatives for offering hedging services to clients. In contrast to the US Volcker rule, the Vickers proposal allows the separated activities to be performed by another entity within the group.

The Liikanen structural reform recommendations and the draft EU regulation lie in between the Volcker rule and the Vickers reforms. The Liikanen proposal, and likely the EU regulation, separate a broader set of activities than Volcker but a narrower set than Vickers. The Liikanen proposal separates proprietary trading and market making activities above some threshold. It also allows the separated activities to be performed within the group. The draft EU regulation foresees separation of some subset (to be determined) of trading activities above some threshold. It also forbids banks from engaging in “open” proprietary trading; i.e., trading by units or individuals specifically designated for proprietary trading. The recent French and German proposals resemble Volcker in terms of the activities to be separated, and they resemble Liikanen and Vickers in allowing the separated activities to be undertaken within the group.

With respect to structural reform proposals that permit the separated activities to be performed by a “trading” entity within the group, the question then arises as to the requirements for ensuring a sufficient degree of separation between the deposit-taking bank and the trading entity. The third column of the table in the Appendix provides an indication of the requirements of the different proposals in this regard. It can be observed that all of the reform proposals that allow the separated activities to be performed within the group apply restrictions on the exposures between the deposit-taking bank and the trading entity. For all proposals, intra-group exposures must be conducted on a third-party basis and are subject to standard third-party large exposure limits. (2) The draft EU regulation also allows for an additional restriction: authorities may set stricter limits on aggregate large exposures of deposit-taking banks to all financial institutions.

All of the proposals allowing the separated activities to be conducted within the group also foresee legal and economic separation of the trading entity from the deposit bank. None of the proposals allows the bank to own the trading entity, and all proposals foresee application of prudential requirements on a solo basis.

Interestingly, while the other proposals specify that the trading entity must be legally economically separate, the Vickers reforms require the ring-fenced, deposit-taking bank to be legally, economically, and operationally autonomous from the other entities in the group. This seems to be more than a semantic distinction. As the main objectives of the Vickers reforms are to make retail banks safer and to protect taxpayers from bearing the costs of bank failure, the Vickers reform package also involves imposing an extra capital buffer on the retail, ring-fenced banks, while applying the Basel 3 capital requirements to the legally separate trading entities. In the words of

(1) For more detail see Appendix 1 of the NBB Interim report: Structural banking reforms in Belgium.
(2) These restrictions amount to imposing limits on intra-group exposures that resemble the limits imposed on between deposit-taking banks’ exposures to investment banks when the Glass-Steagall rule was in effect.
the Vickers report, such an arrangement makes UK retail banking safer than the international standard while at the same time sustaining the UK’s position as a pre-eminent international financial centre. Such a distinction is much less important in a country like Belgium, whose financial system is composed mostly of retail banks and which does not have a large investment banking segment.

2. Objectives and potential costs of structural reforms

What are the potential advantages and disadvantages of each of the structural reform proposals? The advantages can be evaluated in terms of the intended objectives of structural reforms. We can cite at least five objectives for structural reforms, which are emphasized to greater or lesser degrees across the different countries that have put forth proposals:

Objectives of structural reforms

(1) Eliminate the deposit guarantee subsidy for investment banking activities
(2) Improve bank resolvability by reducing complexity
(3) Reduce contagion from risky activities to retail banking
(4) Reduce bank risk taking
(5) Reduce potential risk to taxpayers of bank failure

Potential social costs or unintended consequences of structural reforms include the following:

Costs and unintended consequences of structural reforms

(1) Reduction of diversification benefits
(2) Reduction of financial services to firms/SMEs
(3) Incomplete separation of activities because the deposit-taking bank is able to surreptitiously continue undertaking prohibited activities

Several general observations can be made in relation to the costs and benefits of different structural reform proposals. First, the broader is the set of trading activities removed from deposit-taking banks, the greater is the potential for reduction in complexity and improvement in the resolvability of deposit-taking banks. The Vickers reform separates the broadest set of trading activities, allowing retail banks to retain only a limited amount trading activities for the purpose of hedging and risk management. In contrast, the Volcker rule separates only proprietary trading activities, leaving market-making activities on deposit banks’ balance sheets. As is discussed below, market-making transactions often have similar risk characteristics as proprietary trading activities; therefore, removing only proprietary trading from deposit banks may not significantly reduce complexity.

Similar arguments can be made with respect to contagion from risky trading activities to traditional banking. One would expect that the Vickers reform and the Liikanen proposal would be more effective in this regard than the Volcker rule, since the Volcker rule leaves market making activities on banks’ balance sheets. (1)

Another issue, however, is that contagion and resolvability are also a function of the interconnectedness between financial institutions. Hence, for proposals such as Vickers and Liikanen that separate a broader set of activities but that allow the separated activities to be undertaken by another entity within the group, the nature and complexity of intra-group exposures and the degree of operational independence of the deposit-taking bank will be crucial for determining the extent to which resolvability is improved and contagion is reduced. In the absence of strict intra-group exposure limits and true operational autonomy of the trading entity and the deposit-taking bank, these objectives may not be achieved.

A final consideration relating to contagion is that for proposals that allow the separated activities to stay within the group, even in the absence of significant intra-group exposures between the deposit bank and the trading entity, contagion may occur between entities of the same group through reputation channels. Structural reforms that do not allow the separated activities to be performed within the group are not vulnerable to this form of contagion. (2)

A related observation is that proposals that prohibit the separated activities from being undertaken within the group will be more likely to succeed in eliminating the implicit deposit guarantee subsidy for securities market activities, as deposit funding cannot be used even indirectly through intra-group transfers to finance the trading activities. However, these proposals may also be more likely to reduce diversification benefits and to negatively impact SMEs, since SMEs may find it more difficult than larger firms to access the services of independent investment banks. This latter concern exists to some extent even when the trading activities are still allowed to be performed by a separate entity within the group, and it explains the

---

(1) The scope of the trading activities to be separated through the current EU draft regulation is not yet known.

(2) In a July 2013 editorial, the Financial Times expressed another worry about separation: that it cannot fully prevent the investment banking culture from contaminating the retail bank. This editorial recommended a return to the Glass-Steagall form of separation of investment and retail banking.
Liikanen commission’s recommendation to separate trading activities only above a certain threshold value. The idea is to set the threshold high enough so that deposit-taking banks can continue to undertake a level of trading activity that is necessary for providing financial services to SMEs.

Each of the structural reform proposals involves major implementation challenges, although the particular challenges differ across the proposals. For the Volcker rule (and the French and German proposals), the main challenge will be to accurately distinguish between proprietary trading and market making activities. These two types of activities often generate similar risk profiles, and the distinction between the two comes down to the intention of the trader. For example, the provision of market making services often requires the market maker to assume the role of counterparty, which requires the market maker to hold the position as “inventory” on its balance sheet until the transaction is completed. Hence, proprietary trading and market-making activities may have quite similar characteristics; namely that the banking entity acts as principal in trading the underlying position, the bank holds the position for a short period of time, and the bank may earn profit or losses from price variation in the position over the time in which it is held.

Accurately distinguishing between activities such as market making and proprietary trading requires authorities to develop a specialized reporting and monitoring framework, incorporating a range of qualitative and quantitative restrictions and limits. Formulating simple rules that sufficiently delineate these activities without creating significant loopholes poses a challenge in practice. Indeed, the Liikanen group cited the practical difficulty of distinguishing between proprietary trading and marketing making activities as the principle motivation for its recommendation to separate from banks both market making and proprietary trading activities (without trying to distinguish between them) when trading activities exceed some threshold.

Interestingly, and as noted above, the EU draft regulation, which appears to reflect much of the spirit of the Liikanen report, does prohibit a form of proprietary trading that can be considered as “open” proprietary trading; in other words, proprietary trading that is costless to identify, since it represents trading activities that the bank has openly designated as proprietary trading. Adding such a ban to the “Liikanen-like” activity separation that is also foreseen in the draft EU regulation does not generate the implementation difficulties discussed above with respect to a separation requirement involving only proprietary trading.

For Vickers, Liikanen, and the EU regulation, all of which allow the separated activities to be performed within the group, a major implementation challenge will be to ensure that the deposit-taking bank is sufficiently independent from the trading entity, so that contagion from risky trading activities to deposit-taking banks is indeed reduced and bank resolvability enhanced. For example, the bank will need to be able to continue in operation even if the trading entity becomes insolvent. It is also unclear how significant a role reputation may play in practice and, consequently, whether failure of the trading entity would nevertheless lead to failure of the bank, in the absence of intervention by authorities.

Finally, a challenge faced by all of the structural reform proposals will be to ensure that deposit-taking banks do not undertake “hidden” proprietary trading activities, or proprietary trading under the guise of hedging or risk management operations. Preventing “hidden” proprietary trading will require a system of supervisory monitoring that detects transactions that deviate from the Treasury function. Interestingly, the $6.2 bn trading loss reported by JPMorgan in 2012 occurred in its Chief Investment Office, a unit that was designated to perform Treasury functions for the institution.

3. Structural reforms in Belgium

As in other countries, banks in Belgium have reduced their trading activities, including proprietary trading, since the crisis. As an illustration of this development, Chart 1 shows the evolution of “trading” income as a proportion of total income for the four largest Belgian banks from 2007-2013. “Trading” income in this figure contains all components of bank income that derive from investment banking or trading activities; i.e., that are not directly linked to traditional commercial banking activities. (1) The curve in the figure represents the average share of trading income of the four largest banks, and the bars illustrate the range in these values across the four banks. As shown in the graph, the average share of trading income in total operating income for the largest four Belgian banks declined from over 40% in 2007 to around 20% in more recent years. (2)

While it is apparent from Chart 1 that banks’ have reduced their trading activities since the crisis, it is also clear from the figure that, at least for some banks, trading activities were quite significant, and probably excessive, in the

(1) Note, however, that trading income excludes income from hedging, since hedging can undertaken for commercial banking or trading activities.

(2) It is important to note that the distinction between “trading” and “non-trading” income implied in Chart 1 does not correspond to the distinction between net interest income and noninterest income that is often used in the academic and policy literature. Because of the level of detail available in supervisory reporting data, we are able to go beyond the broad distinction between interest and non-interest income and identify elements of bank income that are associated with commercial banking activities versus other activities.
build-up to the crisis. A key motivation underlying the structural reforms put in place in Belgium is to prevent banks from returning to the levels of trading observed prior to the crisis.

As has been noted above, the intended objectives of structural banking reforms are multiple, and challenging to achieve. Each of the existing structural reform proposals gives rise to specific implementation difficulties, thereby creating some uncertainty as to the ultimate effectiveness. This suggests the need for a broad policy approach, containing “multiple lines of defence”.

3.1 Capital surcharge on trading activities

The NBB interim report on structural banking reforms in Belgium recommended a capital surcharge on trading activities exceeding some threshold. This recommendation was further developed in the NBB final report, and its objective is to deter banks from engaging in an undesirable level of trading activity, or from returning to levels such as those observed prior to the recent financial crisis. Two indicators will be used for the determination of the surcharge: a non-risked-based indicator, which is in line with the spirit of the Liikanen recommendations, and a risk-based indicator, based on market risk capital requirements. Box 1 describes each of these indicators.

If a capital surcharge on trading is triggered by the non-risked based indicator, the amount of the surcharge will equal the volume of trading activity that exceeds the threshold value of the indicator. If the capital surcharge is triggered by the risk-based indicator, the surcharge will equal three times the amount by which the capital requirements for market risk exceed the threshold value of the indicator. If both surcharge indicators are triggered, the amount of the surcharge will equal the maximum of the surcharges implied by each of the two indicators.

Box 1 – Indicators and threshold values for determining the capital surcharge on trading

Non-risk-based indicator

The non-risk based indicator of trading activities uses as a starting point the activities classified by banks in the IFRS accounting category of Held for trading (HFT). Non-derivative assets in the HFT category, together with short positions in HFT liabilities, can safely be assumed to be linked with banks’ trading activities. We define the measure “Pure trading assets” (PTA), as follows:

Belgium has adopted such a broad approach, combining elements of the Liikanen recommendations with aspects of the Volcker rule. First, a capital surcharge will be applied to banks’ trading activities above some threshold, in order to discourage banks from undertaking excessive amounts of trading. Second, banks are forbidden from engaging in proprietary trading. In addition, trading activities that cannot be clearly allocated into the categories of “allowed” trading activities and which exceed a threshold must be separated into a legally distinct trading entity. We discuss each of these measures below.
\[ PTA = HFT \text{ Assets} - HFT \text{ Derivatives assets} + HFT \text{ Liabilities short positions} \]

While some of the derivatives in the HFT category are linked to banks’ trading activity, some of these derivatives are associated with banks’ hedging activities but must be classified in the accounting category of HFT because they do not satisfy the criteria for classification in the category of derivatives for hedge accounting. Given that the above PTA measure includes no derivatives, it represents an underestimate of trading activities. We therefore include a proportion of HFT derivatives in our final indicator of trading activities.

We first define “HFT Derivatives” as follows:

\[ HFT \text{ Derivatives} = \frac{(HFT \text{ Derivatives assets} + HFT \text{ Derivatives liabilities})}{2} \]

By taking the average market value of the HFT derivatives on the assets and liabilities sides of balance sheet, we avoid any distortions due to changes in market price movements causing a shift of large quantities of HFT derivatives from the asset to the liabilities side of the balance sheet or vice versa.

We can now define the final measure of trading activities:

“Trading activities” = (PTA + 80 \% of HFT Derivatives)

The threshold condition for the non-risk based indicator is given by:

\[ \text{Indicator: } \frac{\text{“Trading activities”}}{\text{Total Assets}} > 15 \% \text{ of Total Assets.} \]

This condition implies that if Trading activities exceed 15 \% of total assets, the bank will be subject to a capital surcharge, which will equal the amount by which the trading activities exceed the 15 \% threshold.

This indicator implicitly assumes that 80 \% of HFT derivatives are linked to banks’ trading activities, or equivalently, that 20 \% of its HFT derivatives are linked to hedging of its banking book exposures. If a bank can adequately demonstrate that some percentage \( X < 80 \% \) of its derivatives is associated with trading (or equivalently, that \( (1-X) > 20 \% \) of its derivatives are used for the hedging of its banking book exposures, or for market making in EU government debt), then the proportion \( X \) will be substituted for 80 \% in the condition for Indicator 1.

**Risk-based indicator**

This indicator will be based upon the level of capital requirements for market risk as a proportion of total capital requirements. Whereas capital requirements for market risk apply to positions in a bank’s trading book and, therefore, serve as a good risk-based indicator for trading exposures, market risk capital requirements must also be calculated for all foreign exchange risk, even if this risk is incurred as a result of a bank hedging exposures in its banking book. Given that in practice a significant proportion of foreign exchange positions represent hedging of banking book exposures, we subtract from our risk-based indicator the portion of the market risk capital requirements due to foreign exchange positions. The measure of market risk capital requirements used for Indicator 2 is thus given by:

“Adjusted capital requirements for market risk” = Total capital requirements for market risk – Market risk capital requirements for foreign exchange risk.

The condition for triggering a capital surcharge according to the risk-based indicator is given by:

\[ \text{Indicator 2: } \frac{\text{“Adjusted capital requirements for market risk”}}{\text{Total capital requirements}} > 10 \% \]
The capital surcharge triggered by Indicator 2 will equal three times the amount by which capital requirements for market risk exceed the threshold. One of the concerns that may arise with this indicator is that some banks use internal models for the calculation of their market risk capital requirements while others use the Basel standardized approach. The differences in models and approaches can lead to differences in market risk capital requirements for similar exposures and thus reduce the degree of comparability across banks. Ideally, one should use an identical approach, such as the Basel standardized approach, for all banks. Along these lines, one of the ongoing developments in the Basel regulatory framework relating to the trading book is to begin collecting from all banks the data that would be necessary to compute market risk capital requirements using the standardized approach.

The table below reports the average values of Indicator 1 and Indicator 2 over time for the four largest Belgian banks. As can be seen from this table, in 2008 the average value of both indicators would have exceeded the thresholds, although there was considerable variation in the individual values across banks. This table also shows that the values of both indicators have declined over time, reflecting the decline in the banks’ trading activities following the crisis.

VALUES OF INDICATORS FOR THE FOUR LARGEST BANKS
(in %)

<table>
<thead>
<tr>
<th>Indicator 1:</th>
<th>End-2013</th>
<th>End-2012</th>
<th>End-2010</th>
<th>Q1 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>[(HFT assets) – (HFT derivatives assets) + Short positions + 80% × (HFT derivatives)] as % of total assets</td>
<td>8.4</td>
<td>12.3</td>
<td>15.3</td>
<td>21.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Indicator 2:</th>
<th>End-2013</th>
<th>End-2012</th>
<th>End-2010</th>
<th>Q1 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital requirements for market risk as % of total capital requirements</td>
<td>3.0</td>
<td>5.2</td>
<td>8.8(1)</td>
<td>13.9(1)</td>
</tr>
</tbody>
</table>

Source: NBB.
(1) Estimated to reflect Basel 2.5 rules for capital requirements for market risk.

The amount of the capital surcharge is intended to dissuade banks from actually exceeding the threshold values of the indicators. As such, it is expected that the banks’ trading activities will remain below these thresholds. Hence, the capital surcharge will have a similar effect as the activity separation requirement recommended by the Liikanen group and incorporated in the draft European regulation on structural reforms. Interestingly, the idea of a capital surcharge appealed to some of the members of the Liikanen group, and there appears to have been a difference of views among the members regarding the most appropriate policy instrument. Rather than the mandatory activity separation ultimately recommended in the group’s report, some members argued for the imposition of a non-risk-weighted capital surcharge for trading activities, combined with supervisory discretion regarding activity separation on the basis of the bank’s recovery and resolution plan. Along these lines, Belgian authorities indeed consider the capital surcharge to be a good substitute for an activity separation requirement.

3.2 Proprietary trading

In addition to the recommendation of a capital surcharge on trading activities above a threshold, the NBB final report on structural reforms contained a recommendation to separate proprietary trading activities whose value exceeds some (low) threshold of the banks’ own funds. This recommendation, together with the capital surcharge, has been further developed and included in the Belgian banking law. Like the Volcker rule, the Belgian banking law forbids banks from undertaking proprietary trading activities. The Belgian law also forbids banks from...
engaging in certain trading activities judged to be particularly risky, such as securitisations containing tranches of other securitisations, and the granting of unsecured loans to hedge funds. Trading activities allowed by the Belgian law include hedging and liquidity management, transactions undertaken at the request of clients and the associated hedging of those transactions, and market making. Although these categories of activities are indeed permitted, the level of activities in each category must conform to quantitative risk limits for that category and to aggregate limits relating to total market risk capital requirements. The implementation framework also contains important qualitative requirements linked to governance, risk management, and compliance.

Taken together, the quantitative and qualitative requirements are designed to ensure that the trading activities performed by banks actually correspond to the allowed categories. It is nevertheless likely that questions will arise with respect to certain activities, which may not unambiguously correspond to the allowed categories while also not being clearly identifiable as proprietary trading. If the capital requirements associated with such “questionable” activities exceed 0.25% of own funds, authorities may require separation of these activities into a legally separate trading unit.

3.3 Combined structural reform measures

The combination of the capital surcharge on banks’ trading activities, which resembles the Liikanen recommendations, with a ban on proprietary trading and an accompanying supervisory framework for identifying “hidden” proprietary trading, similar to that for the US Volcker rule, is innovative. Belgium will be the first country to combine structural reform measures in this way. Belgian authorities view the two policies as complementary, thereby helping to achieve the multiple objectives of structural reforms. On the one hand, given that trading activities in general are particularly risky, the surcharge should dissuade banks from engaging in excessive amounts of trading. On the other hand, proprietary trading or activities that might be suspected of being proprietary trading, should not be allowed to account for a significant proportion of banks’ trading activities.

In addition, as each of the existing structural reform proposals entails implementation difficulties, combining policies can be seen as offering multiple lines of defence in the face of the obstacles. For example, whereas a policy of separation or a capital surcharge on trading activities exceeding a threshold cannot prevent banks from undertaking proprietary trading in amounts below the threshold value, the ban on proprietary trading and the associated implementation framework can help to ensure that this does not occur. Conversely, the difficulty of distinguishing proprietary trading from other trading activities such as market making implies that a ban of proprietary trading alone may not succeed in preventing banks from engaging in excessive, risky trading. Adding a dissuasive capital surcharge can help to ensure that excessive trading does not occur.

Conclusion

This article examines different countries’ recent proposals for structural reforms of the banking sector and outlines the structural measures that have been put in place in Belgium. Structural reform proposals are distinguished along key two dimensions: which activities must be separated from deposit-taking banks, and whether the separated activities are allowed to be performed by another entity within the group. The article then takes account of these features in analysing the reform proposals in terms of the intended objectives of structural reforms, the potential costs of such reforms and the implementation challenges.

The various structural reform proposals differ in the degree to which they may be expected to satisfy particular objectives or give rise to certain costs. At the same time, each of the proposals can be expected to face significant implementation difficulties, although the specific obstacles differ across the proposals. These implementation challenges, together with the multiple objectives cited for structural bank reforms, suggest that it may be desirable to implement an array of policies, in order to minimize the risk that the objectives of structural reforms are not achieved. Belgium has indeed put in place a broad set of policies, which draw on features of structural reform proposals in several countries.

In addition to the recommendations relating to trading activities, the NBB final report on structural banking reforms contained recommendations relating to recovery and resolution, depositor protection, and fiscal advantages of savings instruments. Most of these recommendations have already been implemented or are incorporated into the new Belgian banking law. The resulting policy mix should help to guarantee the success of structural banking reforms and, consequently, a strengthening of financial stability in Belgium.
References


### FEATURES OF STRUCTURAL REFORM PROPOSALS

<table>
<thead>
<tr>
<th>Activities that must be separated from deposit/retail banks to trading entities</th>
<th>Can separated activities/trading entities be in same group as deposit bank?</th>
<th>If trading entity can remain in group, what limits exist between retail bank and trading entity?</th>
<th>Other measures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US Volcker rule</strong></td>
<td>Proprietary trading; ownership of hedge funds, private equity</td>
<td>No</td>
<td>–</td>
</tr>
<tr>
<td></td>
<td>Trading in US government debt excluded from proprietary trading ban</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>UK Vickers</strong></td>
<td>All dealing in investments as principal and trading of commodities; all derivatives contracts except for liquidity management and hedging; Retail banks not allowed to have exposures to non-ring-fenced financial institutions except for hedging, provision of trade finance, or payments services Retail banks can provide limited amounts of simple derivatives for risk management needs of customers Retail bank can provide services to other ring-fenced banks Separation of activities for banks above a threshold size</td>
<td>Yes</td>
<td>Third-party large exposure limits on intra-group exposures Ring-fenced bank must be legally and operationally independent of other entities in group Ring-fenced bank cannot own a subsidiary that performs activities that are prohibited for ring-fenced banks Capital and liquidity requirements imposed on a solo basis</td>
</tr>
<tr>
<td><strong>Liikanen</strong></td>
<td>Proprietary trading and market making activities; exposures to hedge funds, SIVs, private equity Separation occurs only for level of activities above some threshold Supervisors can require broader activity separation, if necessary for recovery and resolution plans</td>
<td>Yes</td>
<td>Exposures by deposit bank to trading entity must be on market terms and subject to interbank large exposure limits Trading entity cannot own or be owned by a bank Transfers of risks or funds from retail to trading bank limited to those which maintain capital adequacy of retail bank Capital and liquidity regulations applied on a solo basis</td>
</tr>
</tbody>
</table>
FEATURES OF STRUCTURAL REFORM PROPOSALS (continued 1)

<table>
<thead>
<tr>
<th>Activities that must be separated from deposit/retail banks to trading entities</th>
<th>Can separated activities/trading entities be in same group as deposit bank?</th>
<th>If trading entity can remain in group, what limits exist between retail bank and trading entity?</th>
<th>Other measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU draft regulation</td>
<td>“Open” proprietary trading; i.e., activities of units or individuals specifically designated as proprietary traders</td>
<td>No for “open” proprietary trading</td>
<td>Trading entity must be legally, economically, and operationally separate from bank</td>
</tr>
<tr>
<td></td>
<td>Certain (to be determined) trading activities exceeding thresholds of particular metrics</td>
<td>Yes for other separated activities</td>
<td>Bank has to be able to carry on its activities in event of insolvency of trading entity</td>
</tr>
<tr>
<td></td>
<td>Trading in EU government debt excluded from separation requirements and proprietary trading ban</td>
<td></td>
<td>Capital and liquidity requirements applied on a solo basis</td>
</tr>
<tr>
<td></td>
<td>Regulation applies to banks above a threshold size</td>
<td></td>
<td>Bank cannot own the trading entity</td>
</tr>
<tr>
<td>Belgium</td>
<td>Proprietary trading; unsecured loans to hedge funds; other highly risky activities</td>
<td>No for proprietary trading, unsecured loans to hedge funds, and highly risky activities</td>
<td>Transactions between the bank and trading entity must be on third-party terms</td>
</tr>
<tr>
<td></td>
<td>Trading activities in a “gray zone”; i.e., that are not clearly proprietary trading but that are “questionable”, above a threshold</td>
<td>Yes, for “gray zone” activities</td>
<td>An additional large exposure limit applies to the deposit-taking banks’ total exposures to financial institutions outside the group</td>
</tr>
<tr>
<td></td>
<td>Application of dissuasive capital surcharge on non-proprietary trading activities above a threshold instead of a separation requirement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>Proprietary trading; unsecured transactions with leveraged funds</td>
<td>No for high frequency trading and trading in agricultural commodities</td>
<td>Trading entity must be legally and operationally independent</td>
</tr>
<tr>
<td></td>
<td>High frequency trading; trading in agricultural commodities</td>
<td>Yes for other activities</td>
<td>Capital and liquidity requirements applied on a solo basis</td>
</tr>
<tr>
<td></td>
<td>Regulation applies to banks with trading above a threshold</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Belgium: Proprietary trading; unsecured loans to hedge funds; other highly risky activities
Trading activities in a “gray zone”; i.e., that are not clearly proprietary trading but that are “questionable”, above a threshold
Application of dissuasive capital surcharge on non-proprietary trading activities above a threshold instead of a separation requirement

France: Proprietary trading; unsecured transactions with leveraged funds
High frequency trading; trading in agricultural commodities
Regulation applies to banks with trading above a threshold
### Features of Structural Reform Proposals (continued 2)

<table>
<thead>
<tr>
<th>Activities that must be separated from deposit/retail banks to trading entities</th>
<th>Can separated activities/trading entities be in same group as deposit bank?</th>
<th>If trading entity can remain in group, what limits exist between retail bank and trading entity?</th>
<th>Other measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>Proprietary trading</td>
<td>Yes</td>
<td>Trading entity must be legally and economically independent</td>
</tr>
<tr>
<td></td>
<td>Activities judged risky by the supervisor</td>
<td></td>
<td>Trading entity must be able to refinance itself independently without guarantees from the parent company</td>
</tr>
<tr>
<td></td>
<td>Regulation applies to banks above a threshold size</td>
<td></td>
<td>Intra-group transactions with trading entity must be conducted on a third-party basis</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Capital and requirements applied on a solo basis</td>
</tr>
</tbody>
</table>