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Article

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Prof. Dr. Dorothea Schäfer, Research
Director Financial Markets at DIW Berlin

SEVEN QUESTIONS TO DOROTHEA SCHÄFER

»Separated Banking System Not Enough«

1. Professor Schäfer, Europe is preparing for draft legislation that will see the introduction of a separated banking system. What problems will this create? *First, it is hoped that this system will make it easier to wind up large banks. Second, the aim is to protect the deposits of ordinary citizens from the risks caused by investment banking and trading.*
2. Do you believe that separated banks will really fulfil this hope? *At the moment, the legislation is only proposing that proprietary trading, i.e., the business that banks conduct on their own behalf, will be split off. However, the first problem is that, even after proprietary trading is detached, the banking institutions remain very large. The second problem is market making which involves transactions where, for example, stocks are bought on behalf of a client and resold at a later date. The German government wants market making to be exempt from the banking separation legislation and for only proprietary trading to be split off. Consequently, every bank would be able to claim that its proprietary trading transaction are actually to be classified as market making.*
3. So this means that the banks would simply be able to reclassify their business in order to evade the separation? *Yes, the way in which the German government has structured the draft law clearly allows banks to declare market making as proprietary trading which means it no longer needs to be separated.*
4. Does this whole initiative still even make any sense? *Well, that is the question. Although the law on banking separation would actually exist, ultimately, no bank would be subject to this legislation because all the trading activities that are supposed to be separated off would no longer be classified as such. Even if the very large banks with balance sheet totals of approximately 2,000 billion euros were simply split down the middle, we would still have two large banks with balance sheets of 1,000 billion. A separated banking system just isn't sufficient to guarantee the resolvability of banking institutions. In my opinion, we need to separate banks not just into two but rather three distinct units. The result would be banking institutions with balance sheet totals that might actually be resolvable.*
5. So restricting the size of banks is one objective. The other is to safeguard the deposits of ordinary citizens. Will separating the banks achieve this? *This will only become clear once it has been implemented since these banks can't really be separated from one another but rather have to remain within a holding structure. The management of the overall bank, of course, has no interest in unbundling to such an extent that there is no connection between the individual banking institutions. Thus, the full responsibility for the unbundling would be borne by the banking supervisory body which, in my opinion, does not have the human resources to properly implement such a process.*
6. Presently, the taxpayer takes on the risks of the systemically important banks. Will separating the universal banks really solve this problem? *If the universal banks are divided up into financial units that can be feasibly resolved, the problem of tax payer liability would no longer exist. Of course, the tax payer will always remain liable for deposits under deposit-guarantee schemes. But this overall responsibility for the entire liabilities side of the bank's balance sheet would be eliminated by the separation.*
7. What is your personal assessment of the draft legislation on banking separation? *The draft law is well meaning but the ultimate impact is likely to be marginal.*

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