Is it pointless to separate banking activities?

Jean-Luc Gaffard and Jean-Paul Pollin

It is at the European level that the last chance for a structural reform of the banking system can be found, that is to say, a separation between investment banking and retail banking. If we are to believe the banking industry and certain academic circles, such a separation is at best useless and at worst harmful. Separating risky activities from non-risky activities, or non-speculative activities from speculative activities, would, it is held, prove illusory. All banking activity is risky, if not speculative. After all, the subprime crisis in the United States, the crisis of the savings banks in Spain, and the crisis of Northern Rock in the United Kingdom were all the result of reckless risk-taking in the granting of property loans to households. Furthermore, universal banks have to some extent helped to save overly specialized institutions. In these conditions, a minimalist law on separation such as the French law or a more binding law such as proposed in the Vickers report in the UK or like the one envisaged by the Liikanen Group would be of little use in terms of achieving stability. It would be better, then, to trust to prudential regulation, which should indeed be strengthened. This is particularly true since commercial banks should be able to develop market activities to meet the needs of their customers.

First of all, the existence of economies of scope that would justify bringing together commercial banking and investment banking have never been proven. Moreover, the "business models" of the two are very different, to the point that joining them may involve a risk of weakening the commercial bank's capacity to do its job. Furthermore, the argument set out above ignores in particular the systemic dimension of the

financial and banking crisis. When the savings banks went bankrupt in the United States in the early 1990s, the consequences were circumscribed because the financial system was relatively closed. With the subprime crisis, the real problem came from contagion that was directly related to the close connectivity that had arisen within the financial system.

This is not a matter of simply recognizing that any banking activity entails risk, but rather of taking into account the impact of the contagion that market activity is primarily responsible for. It is especially transactions in derivatives that give rise to the interconnections between financial intermediaries. These are multiple, poorly identified connections created by market activities, which have had devastating consequences on the traditional lending activity of banks because of reckless risk-taking and losses in market transactions (and not just in "proprietary trading" operations).

Naturally, in the face of systemic risk, prudential regulation does need to be strengthened. But however important it may be to regulate functions, this is undoubtedly less important than regulating the financial institutions themselves. Revenues from commercial banking are de facto relatively regular, apart from periods of severe crises, while those from an investment bank are much more volatile. An investment bank needs a commercial bank to withstand market fluctuations (and enjoy any available government guarantee), but the reverse is not true. The problem comes down to whether it is appropriate to take the risk of destabilizing the heart of the banking system in order to strengthen the pursuit of activities whose social utility is not always clear, and which should find their own means of survival.

Wisdom would thus have it that the financial system should be compartmentalized so as to limit any contagion. Regulations should specify the types of assets in which each category of

institutions could invest as well as the type of commitments that they can make. This is what stands out from the legislative and regulatory arsenal developed in the United States and Europe following the Great Depression, an arsenal that was largely dismantled in France in 1984 and the United States in 1999 when the Glass-Steagall Act was terminated. This is what should be put on the agenda again by returning to an effective separation between commercial banks and investment banks. Not only would this separation create a certain seal between the various compartments of the financial system, but it would also help to avoid the dilemma associated with institutions that are "too big to fail". The aim is to protect the commercial bank from market risk. It is also to put an end to the implicit subsidies that universal banks have from the State, which are no longer really justified by separation and which can endanger the public purse. All these measures should be conducive to growth.

For more on this subject, please read *OFCE Note* no. 39 of 19 November 2013 [in French] by Jean-Paul Pollin and Jean-Luc Gaffard, "Pourquoi faut-il séparer les activités bancaires?" [Why banking activities need to be separated].