Andreas Dombret: Cutting the Gordian Knot or splitting hairs – the debate about breaking up the banks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ILF (Institute for Law and Finance) Conference "Too Big to Fail III: Structural Reform Proposals – Should We Break Up the Banks?", Frankfurt am Main, 21 January 2014.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at today's conference. It is a pleasure and an honour to be here.

The story goes that at some point in history the kingdom of Phrygia was without a king. The priests therefore consulted an oracle to determine who should fill the vacant position. The oracle decreed that the next man to enter the city in an ox cart should become the new king. That man was Gordias, a peasant.

Gordias became the king of Phrygia and, out of gratitude, his son dedicated the ox cart to the gods. The gods in turn tied the cart to a pole with a complicated knot – the famous Gordian Knot. This knot was so complex that for centuries no one was able to untie it. Hence, the cart was still tied to its pole when Alexander the Great entered the scene in 400 BC.

Meanwhile, it had been prophesied that whoever untied the knot would become king of Asia. Alexander, full of ambition, took on the challenge. Unable to find the loose end of the knot, he drew his sword and sliced the knot in two, thereby undoing it. Since then, the Gordian Knot has become a symbol for solving seemingly insoluble problems by thinking outside the box and then taking bold action.

The insoluble problem in our case is how to secure financial stability. And after six years of crisis, more and more people are, understandably, looking for a Gordian solution. To some, the solution would be to break up the banks – with one bold stroke of the sword, as it were. Broadly speaking, the dividing line would run between those parts of a bank engaged in commercial banking and those parts engaged in investment banking.

In my speech today, I will address the question of whether this is a sensible approach. As I speak first at this conference, my objective is to give an overview of the issue, discuss the pros and cons of the proposal and try to draw a tentative conclusion. Let us begin by looking at the arguments put forward by the proponents of breaking up the banks.

2. Breaking up the banks – the objectives

The underlying notion is, of course, that there are two different worlds. There is the world of commercial banking, which is populated by conservative and "prudent" bankers who support the real economy and provide a haven for savings. And then there is the world of investment banking populated by the Gordon Gekkos of this world, who pose a constant risk to financial stability and to taxpayers' money.

The combination of these two worlds in a universal bank is seen as a source of systemic risk. It is therefore being proposed that they be separated: instead of universal banks there would just be pure commercial and pure investment banks. But why is the combination of commercial and investment banking perceived as a source of systemic risk? And what specifically are the objectives of those who want to separate them?

The general objective when breaking up the banks is to shield those parts that are deemed vital for the real economy from those parts which have little or no connection to the real economy – to shield commercial banking from investment banking. The underlying assumption is that investment banking is risky and thus more prone to losses and failure.

If the investment banking branch of a universal bank were to fail, it would drag the commercial banking branch down with it. Both parts would go down together, disrupting the real economy. It is therefore argued that separating the two parts would block this channel of contagion, shield the real economy and protect savers and taxpayers alike.

But there is more to the argument. Two aspects are usually emphasised. The first aspect is the existence of deposit insurance schemes. These schemes render deposits risk-free – at least up to a certain amount. Consequently, depositors demand lower risk premiums. This holds even if the bank in question is engaged in risky investment banking activities. Universal banks can therefore draw on a subsidised source of funds to finance their investment banking activities. It is argued that separating commercial and investment banking would abolish this subsidy, align incentives for investment banks and force them to reduce the size of their business.

The second aspect is the existence of implicit government guarantees for certain banks. If a large and interconnected universal bank fails, the whole financial system might be disrupted, as might the real economy. The taxpayer might therefore be forced to step in and save the bank to prevent an even worse outcome. Banks that enjoy such a status are termed "too big to fail" or "too interconnected to fail". Just like deposit insurance, such an implicit government guarantee subsidises investment banking activities.

Proponents of breaking up the banks argue that pure investment banks with no connection to the real economy would be treated differently. They would be excluded from deposit insurance schemes and also from implicit government guarantees. Consequently, if things went wrong, they would not be rescued by the government at the taxpayers' expense – moral hazard would be reduced. Moreover, banks would become less complex and thereby easier to resolve.

These are – in a nutshell – the central arguments brought forward by the proponents of breaking up the banks. They claim that breaking up the banks would block channels of contagion, would remove subsidies for risky investment banking, would lower the risk of systemic crises, would make banks easier to resolve and would eventually save taxpayers' money.

3. Breaking up the banks – would it work?

Now, could one stroke of the sword really take us all the way to financial stability? To answer this question, we have to take a step back. To me, financial stability cannot be achieved as long as banks are too big, too interconnected or too complex to fail. Finding a solution to this problem would eliminate implicit government guarantees, would align incentives and would increase financial stability.

What we need at a very basic conceptual level are two lines of defence. First, we have to make banks safer to reduce the likelihood of failure. Second, if a bank fails, it must be able to do so without disrupting the entire financial system. Erecting these two lines of defence is the basic challenge we are facing. And at the same time, it should be the benchmark for evaluating the benefits of breaking up the banks.

The first question is therefore: would breaking up the banks make them safer? It is true that commercial banking would benefit if it had some degree of insulation from the perils of investment banking. But is commercial banking in itself really safer than investment banking? Looking back, we have to admit that pure commercial banks were at the centre of the recent crisis: Washington Mutual, Countrywide, Hypo Real Estate and the Spanish savings banks, to name just a few. The question of stability ultimately depends on the sustainability of the business model. And a commercial bank that is highly leveraged and has an unsustainable business model can be as risky as any investment bank. In addition, breaking up the banks would reduce their potential to diversify. This, in turn, could increase their exposure to individual shocks – they might even become less safe.

The second question is: would breaking up the banks limit the size of investment banks by removing funding subsidies? Well, it certainly would remove at least those subsidies related to deposit insurance. But there are two things we should bear in mind. First, if deprived of deposits as a source of funding, an increasing number of pure investment banks would have to revert to less stable sources of funding – they would become less safe. Second, what about that part of the subsidy that is due to implicit government guarantees? This point relates to our second line of defence – to the question of whether a bank can fail without disrupting the whole system.

And frankly, I am not fully convinced that breaking up the banks would block the relevant channels of contagion. True, it would block channels of contagion within banks. But wouldn't they just be replaced by channels of contagion between banks? I think that even after breaking up the banks, the financial system would be characterised by a large degree of interconnectedness. And again, we could take a look into history. Lehman Brothers was a pure investment bank, yet when it failed in 2008 it brought the financial system to the brink of collapse – because it was so interconnected.

Against this backdrop, the question is: what would happen if another pure investment bank were to fail? Would the government really just stand on the side-lines and watch the potential fallout? Or would it be compelled to step in, as it has done before, to save the failing bank – regardless of whether it is attached to a commercial bank or not?

And what about the problem of shadow banking? I see the danger that breaking up the banks might provide incentives to export more and more risky activities to the realm of non-bank banking. However, the risks could easily be re-imported to the regular banking system. In the end, we would have gained nothing. This is why our efforts to control the shadow banking system have to continue.

Regarding the proposal to break up the banks, a lot of questions on the effects and side-effects remain unanswered. And this takes me directly to the last issue I wish to raise. We all know that the worst enemy of good ideas is the need to implement them. In the present case, this refers to the challenge of designing an actual system of separated banking functions. In the theoretical debate, an imaginary line is drawn between investment banking and commercial banking. But where exactly would that line be drawn in reality?

If commercial banking is supposed to support the real economy, it should comprise more than just lending money. Take the example of Germany, which has a bank-based system of corporate finance. German companies procure a wide range of services from their banks. The boundaries between customer business, hedging transactions, market making and traditional proprietary trading are consequently fluid. Finding the right dividing line in the grey area between those activities would be difficult and prone to lobbyism.

The fact that current legislation and legislative proposals are so different in content and scope partly reflects these problems. In the US, the Volcker Rule seeks to prohibit proprietary trading by banks and places severe restrictions on certain forms of investment. In the UK, the Vickers proposal seeks to ring-fence deposit-taking and the provision of credit facilities in legal, organisational and operational terms. In Europe, the Liikanen Commission suggests yet another model which would maintain the universal bank within a holding structure but ring-fence deposit-taking units.

4. Breaking up the banks – the alternatives

Based on the arguments I have laid out, it seems unclear to me whether breaking up the banks would take us all the way to financial stability. It could make banks somewhat easier to resolve – that much is clear. But there are three crucial points on which I have doubts and which should be discussed in more detail:

- I doubt that breaking up the banks would make them safe enough;
- I doubt that breaking up the banks would ensure that they can fail without disrupting the system;
- and I doubt that the proposal of breaking up the banks could be implemented in a suitable manner.

I also doubt whether it is the responsibility of the state to determine what business model works best. In my view, we do not need the same business model all over the world. A lot of countries, including Germany, fared very well with universal banks. Personally, I therefore do not see a reason to abandon the concept of universal banks. And as a matter of fact, legislative proposals such as the Liikanen-proposal also do not seek to abolish universal banks as a general concept.

Why not let the market determine which business models work and which don't? And please do not misunderstand me: the state certainly has to set boundaries to guide this selection process and to protect the financial system, the real economy, depositors and the taxpayer.

In my view, other things are at least equally important if we want to secure financial stability. To make banks safer, we have to increase capital requirements. Banks need more capital and they need better capital. This is exactly what the new Basel rules prescribe. To enable banks to fail without disrupting the financial system, we need resolution mechanisms. At the international level, the Financial Stability Board has published relevant principles. At the European level, a Single Resolution Mechanism is under construction. This mechanism will be a central pillar of the banking union and should be established as soon as possible.

In my view, these measures are more important and bring us closer to financial stability than just breaking up the banks. And I would like to bring up a final point: we must be aware that we cannot solve all our problems through regulation. In addition to regulatory reform, there also has to be a change of culture within the world of banking. And here, investment banks might, on balance, have to change more than commercial banks. Just take the example of compensation schemes. Compensation schemes that reward excessive risk-taking need to be replaced with more sustainable solutions. Relevant regulation exists but to be really effective these rules must become part of the culture.

5. Conclusion

Ladies and gentlemen, I began my speech with an account of how Alexander the Great solved the seemingly insoluble problem of the Gordian Knot. Instead of attempting to untie it as everyone else had done, he just split the knot with his sword.

This is certainly the most famous version of the story, but it is not the only one. There are alternative accounts of how Alexander untied the cart from its pole. According to Aristobulus, Alexander unfastened the cart by removing the pin which secured the yoke to the pole of the cart, then pulled out the yoke itself.

This exemplifies that there is never only one solution to a given problem. And the more complex a problem is, the less likely that it can be solved with a single stroke of the sword. To the contrary, it could make things even worse. Just recall the story of how Heracles cut off the head of the Hydra, just to have two grow back.

To ensure financial stability, we have to apply a wide range of measures. We have to adjust capital requirements, we have to implement liquidity requirements, we have to make banks resolvable to name just a few.

Breaking up the banks might shield commercial banking and thereby the real economy to a certain degree. But it cannot, on its own, ensure financial stability. And when it comes to implementing a system of segregated banking functions, attempts to cut the Gordian Knot might mutate into a tedious exercise of splitting hairs.

Thank you very much.