STAYING GLOBAL AND NEOLIBERAL OR GOING SOMEWHERE ELSE? BANKING REGULATION AFTER THE CRISIS

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1 After the crisis

1.1 Two conflicting reactions

Immediately prior to the global financial crisis, banking regulation all over the world was converging on Basel 2, the second version of the non-binding rule-set drafted by the Basel Committee on Banking Supervision (BCBS). The 2007 Basel Accord was an inherently neoliberal regulatory platform. The Accord built on two crucial technological complexes—balance sheet mediation and advanced risk methodologies—that resulted in risk sensitive capital requirements and allowed regulators to simultaneously regulate and recede from regulation. The strategy was to set capital standards to cap the leverage banks could employ, while emphatically not affecting banks' businexss decisions. Basel 2 was a minimum intervention regulatory package. It set no structural restrictions, banned no instruments and allowed all business models, as long as their risks were adequately capitalised.

In the crisis, the strategy's technological network collapsed. The risk methodologies proved unreliable. Credit ratings were discredited. VaR disintegrated. Capital adequacy alone was found insufficient to ensure bank stability. And a mad scramble for reforms ensued. Now, six years after, global banking regulation arena has seen a fundamental reshuffle.

Two major developments took place. First, BCBS recast the Accord. The Basel 2,5 and Basel 3 reforms yanked up capital requirements, improved capital quality, enhanced risk coverage and fixed many of the failed risk methodologies. In a simultaneous development, the frail and patchy global regulatory consensus, however, started to disintegrate as a flurry local structural regulatory initiatives was initiated. US enacted the Dodd-Frank Act. UK put together the Banking Reform Act. EU is currently preparing a structural reform package, while e.g. Germany has already implemented its own set of structural reforms. All initiatives share one common feature. Their basic makeup contradicts the Basel-negotiated regulatory approaches. Business model bans are back on the agenda. The US Volcker rule that bans proprietary trading in banks. The UK Banking Reform Act requires that all retail banks are ring-fenced, i.e. separated functionally and in terms of capital from other financial entities and subjected to activity restrictions. The EU proposal envisions a proprietary trading ban and a potential "inverse" ring fence where trading entities are separated from the other actors and subject to some trading bans.

The two set of reform initiatives seem to diverge radically from each other. The fundamentals are different. Despite the crisis-induced revisions, the core Basel regulatory strategy still seems to remain mostly intact. As long as risks—now liquidity risks included—are covered, the Accord imposes no business model constraints. The national structural reform initiatives, instead, push a distinctly different agenda: banking is regulated by explicitly constraining the scope of allowed businesses.

1.2 Objectives and structure

The objective of this paper is to inquire into the relationship between these two regulatory agendas, and ultimately, ask where post crisis banking regulation is made and what it is like. The key question is, is global banking regulation converging towards a new paradigm which

will render the neoliberal Basel approach redundant? If a novel dominant strategy emerging, what is it like?

The article uncovers a complicated milieu of banking regulation. I will argue that the diagnosis stressing the differences between two sets of responses might, in fact, be naive. Chapter 2 and 3 map out the Basel landscape. Chapter 2 discusses Basel before the crisis. I argue that Basel was a neoliberal regulatory platform, but it was influenced by a deep-seated suspicion of the technologies that allowed it to be neoliberal. Second, in Chapter 3 I look into the post-crisis Basel reforms and inquire into the regulatory strategies the new Accord has adopted. A perplexing picture where the neoliberal edifice is cracking up emerges with some hints that the distance between the local and global initiatives might not be as long as commonly imagined. Many Basel 2,5 and Basel 3 risk methodology revisions undo the core Basel 2 regulatory strategy—which in itself was already strained when introduced. The revisions amount to—admittedly modest—structural regulation by stealth. Chapters 4 and 5 discuss the regulatory strategy of structural regulation. In Chapter 4, a brief analysis of the national and regional structural reform programs maps the basic contours of is what essentially a host of underwhelming structural initiatives. Chapter 5 discusses their regulatory strategy. Structural regulation initiatives amount to trading bans of varying intensity. All, however, share a modest ambition. The trading bans are limited in scope and only prohibit the most egregious forms of trading or push the riskiest activities away from institutions with access to government funding support. The strategy resembles a PR campaign. The measures manipulate the periphery but retain the core status quo. In Chapter 5, the paper concludes by a discussion of the interplay of the regimes. I will argue that the Basel neoliberal approach to banking regulation has not disappeared nor is it likely to disappear. Instead, the strategy has always been complicated and tortious and now has, again, morphed. Even if the structural reforms from the first glance seem disruptive, they will not unhinge the Basel regulatory paradigm. The reforms are limited in scope and ambition and focus around retaining the status quo. This entails that, on one hand, banking regulation will largely be business-as-usual, but on the other hand, it seems to converging around and increasingly disorganised and dysfunctional but still characteristically neoliberal regulatory strategy.

2 As hands off as BCBS dared

2.1 The dream of not governing at a distance

Basel 2 {BaselCommitteeonBankingSupervision:2006wf}—the long waited reform package to the Basel Accord—went live on January 1, 2007. The day marked a significant transition in banking regulation. Banks would finally be not governed at a distance. Bank system safety was ensured but banks were left alone. The newly redrafted rules made banking safe by requiring banks to hold sufficient capital reserves that matched the real risks banks ran. The regulations had minimal a impact on bank business decisions, in an optimal world none.

The trick was done by the interaction of two ingenious assemblages of regulatory technologies. The first assemblage allowed Basel 2—as its 1988 predecessor (Basle Committee on Banking Supervision, 1988)—to work on banks through their balance sheets. The rules established firm bounds on the bank leverage by setting a maximum total asset value ceiling for a given capital level. Balance sheet constraints are a unique regulatory device. The constraints do not force banks to take or not to take any particular actions or acquire, hold or divest spe-

cific assets. The rules simply establish a space banks may do as the wish, if they keep within the bounds established by the assets to capital ratio. In terms coined by governmentality studies, BCBS was governing at a distance. It had developed a way "to link calculations at one place with action at another, not through the direct imposition of a form of conduct by force, but through a delicate affiliation of a loose assemblage of agents and agencies into a functioning network"(Miller and Rose, 1990, pp. 9–10) and could conduct the conduct of banks (Rose, 1999, pp. 214–215). In its Basel 1 form, the assemblage, however, had dark side. Unsophisticated balance-sheet mediated regulation often has the unintended consequence of in fact governing and affecting bank conduct. Almost every imaginable implementation turns into a giant incentive scheme, bringing about perverse misgovenance and encouraging misguided asset selection decisions. This happened in Basel 1 (Jones, 1999; Working group led by Patricia Jackson, 1999).

Basel 2 fixed the shortcoming. It introduced the new gold standard of banking regulator: VaR based risk sensitive advanced capital adequacy methodologies. The methodologies—Internal Models Approach (IMA) for market risk, Internal Ratings Based Approach (IRBA) for credit risk and Internal Models Method (IMM) for counterparty credit risk— eliminated the misguided incentives. IMA—introduced in the 1996 Market Risk Amendment(Basle Committee on Banking Supervision, 1996a)—allowed banks to use VaR models to determine the scope losses they were likely to suffer in a one percent 10 day adverse market event with the resulting VaR figure constituting the basis for market risk capital charges. In Basel 2 reforms, the approach was extended to banking books and counterparty credit risk. The new IRBA methodology set the capital charges to match the probable credit losses at the 99.9 percent confidence level in a one year risk horizon (BCBS, 2005) while IMM specified a Monte Carlo simulation (but not VaR) based methodology for counterparty risk.

A set features of the VaR based technologies made the transition possible. First, the VaR methodologies reflected the tools banks used internally to frame asset selection decisions. When capital requirements were set with VaR methodologies, regulatory incentives aligned with internal ones. The confluence of decision frames worked to eliminate the inevitable incentive effects regulations had. Second, the methodologies reproduced the "real" risks inherent in bank assets. The VaR figures were scientifically firmly grounded, theoretically robust estimates of the actual risks banks ran (e.g. Jorion, 2002). No more guesswork, or seat-of-the-pants estimates (Goodhart, 2011, p. 253). This "reality" of risks eradicated the remaining incentive effects. Even if the internal and regulatory risks diverge, the misalignment is irrelevant. Real risk estimates push banks to the directions they should go anyway, even without regulation. The space of bounded of freedom was turned into a space unbounded freedom for rational, risk-conscious banks.

2.2 Living with bad models

The picture I have sketched above is, of course, an exaggeration. VaR did revolutionise capital regulation, but its implementation was an arduous, messy process fraught with dangers. The technologies were precarious, fragile and unreliable, little like the impregnable science the rules portray them. The fragility is reflected in the rules. E.g. IMA was littered with both practical and theoretical problems far into the 2000s. The 1996 and early 2000s computer resources were still inadequate to run the most sophisticated models. Implementation was

hugely expensive. Even the best models struggled to make sense e.g. idiosyncratic price variations, non-linear products, jump processes. BCBS was not ignorant of the problems. The Committee knew that the IMA VaR measures could very well misstate risks and understate their scope.

As a response, the regulatory body introduced a complicated system of safety layers and checks. The adjustments began with the introduction of the brutal multiplication factor of three. Any VaR number produced by the models was to be multiplied by a factor of three to arrive at the capital requirement (MRA B.4(i)). In addition, the Committee introduced a backtesting procedure. Backtesting encourages banks to build conservative VaR models by penalising exceptions, days on which the actual losses exceed the VaR model predictions (MRA B.4(k) Basle Committee on Banking Supervision, 1996b). The specific market risk regime is another safety device. BCBS was well aware that most 1996 VaR models would fail to account for e.g. idiosyncratic price shocks and sudden changes in correlation and volatility environments. To mitigate the vulnerability, the Committee first established a floor for modelled specific market risk capital charges (MRA B.4(and in 1997 migrated to the "4xVaR" regime (Basle Committee on Banking Supervision, 1997). The Committee, essentially, admitted that most contemporary VaR models were still incapable of capturing "event and default risks", albeit they might be able to explain other specific market risk related effects such "explain historical price variation", "capture concentrations" and "be robust to an adverse environment". Until the banks could "demonstrate that the methodologies it uses adequately capture event and default risk", they had to contend with an "additional prudential surcharge". The specific market risk VaR estimates would be multiplied by four instead of the normal multiplication factor of three.

The same wary and cautious approach to VaR implementation is dominant in both the 2004 IRBA and 2005 IMM. During IRBA consultations, the industry strongly argued for full authority to be granted to banks to model credit risks. The Committee, however, emphatically declined. It did not believe in banks' risk measurement capabilities (Young, 2012). The end-result is a perplexing credit risk engine that simultaneously is a Merton-Vasicek Asymptotic Single Risk Factor credit risk model, forces banks to build giant, strictly regulated PD generation machineries and makes up an abashed risk weight scheme totally dominated by regulator's discretionary, seat-of-the-pants judgments. In effect, banks gained the licence to model default probabilities, but, once the exposure PD was estimated, the rest followed automatically. IMM is tainted by similar fears. It, at first, allows for full scale Monte Carlo simulation of future counterparty exposures but, in second step, imposes a conservative aggregation methodology to turn the simulated future exposure paths into a single number capital charge.

2.3 Hubris with trepidation

In sum, Basel 2 deployed a seemingly straight-forward contrived regulatory strategy. At its core lies a VaR based technological assemblage designed to not govern banks at distance, to simultaneously make the banks safe and leave them alone. In the documents, the assemblage is portrayed as rock solid, firmly embedded in best scientific practice and capable of producing the truth on risks. Simultaneously, there are, however, signs of fear and caution. The impeccable veridiction machinery is backstopped by safety layers, conservative calibrations and half-hearted implementation. The thrust of BCBS's efforts is clear. The Committee did not

want to govern the banks. It thought it had the technology not to govern them but feared its instruments. It went as hands-off-as-it-dared (cf. Major, 2012) not to govern.

3 A strategy in pieces

3.1 Fixes

The as hands-off-as-we-dare strategy of not governing banks at a distance broke down in the global financial crisis. The reason is simple. The real risk technologies on which the strategy was built had disintegrated. IMA was ruined, IMM struck by CVAs. The securitisation framework was decimated (Atik, 2011; Financial Services Authority, 2010 chapter 5; Moosa, 2010). The BCBS response came in two waves. It was pioneered by the Basel 2.5 package (BCBS, 2009a; 2009b; 2009c) published in September 2009. Basel 2.5 was followed by Basel 3 (BCBS, 2010a; 2010b)a year later.

The two packages constitute simultaneously both a modest incremental update and a sweeping overall recalibration of the Accord. The latter package, Basel 3, delivers most of the reform's impact. The package, first, carried out a brutal recalibration of the minimum capital requirements. Banks were, quite simply, required to hold significantly more and better quality capital. Simultaneously, the charge structures were revamped to dampen procyclical effects and provide a rudimentary macroprudential tool set. In addition, risk coverage was boosted. The Accord now targets liquidity risk for the first time.

From the regulatory strategy point of view, these reforms are relatively uninteresting. The recalibration effort, essentially, retained the not governing at a distance strategy. It simply increased capital costs across the board. The new LCR and NSFR ratios target a new risk, but with their inflexible design essentially retrace the Basel 1 strategy. Of course both reforms will affect bank business models. Increased capital charges may force banks to divest some (trading) businesses. The liquidity ratios will affect funding models and force banks rethink the way they conduct their business. The leverage is probably a unique contraption: the blunt anathema of the basic Basel regulatory technology, designed and put in place to explicitly mitigate the risks of risk-based regulation. Nevertheless, the most significant regulatory strategy changes, however, came about when BCBS tried to "enhance risk coverage" and fix "risk sensitivity".

3.2 Fake risks

Remember that the Basel 2 VaR regime was effectively decimated by the financial crisis. The fears had come true. The once impeccable risk technologies had failed. Trading books were worst hit. Banks had suffered devastating unanticipated losses on credit instruments—in particular securitisation products—and derivatives for which Basel 2 had required to hold no or very little capital reserves (BCBS, 2012; Financial Services Authority, 2010).

BCBS reacted correspondingly. The Basel 2.5 forcibly targeted the market risk and securitisation framework shortcomings. BCBS narrative was the IMA was to be mended and the broken risk methodologies were to be fixed. Risk coverage was to be enhanced and risk sensitivity improved. Here, three measures stand out. The Committee introduced the stressed VaR measure and the incremental risk charge to enhance risk coverage and risk sensitivity in trading books. In addition, most securitisations were banished from specific market risk models,

save for correlation trading portfolios. Basel 3 contained a number of similar initiatives, most notably the counterpart credit risk framework adjustments and the new CVA charge.

On first glance, the measures seem to perpetuate BCBS's core strategic approach. The risk technologies are repaired to allow banks to be governed with real risks without govern gin them. The methodology details, however, tell a different story. sVaR, IRC and CVA are all quick and dirty fixes, low in theoretical orthodoxy but rich in impact (BCBS, 2009d). E.g. the stressed VaR in Basel 2.5 § 718(lxxvi)(i) shares little with theoretically robust market risk estimation. The charge forces banks to model expected losses under two scenarios. The first scenario is the "normal" Basel 2 ten day future, the second a future in which "an appropriate stress scenario" plays out (Chen, 2014, pp. 197–198). The two resultant VaR figures are simply added up to arrive at the IMA capital requirement (Basel 2.5 § 718(lxxvi)(i)). Consequently, sVaR fails to work as its Basel 2 predecessors did. It does not put in a place an industry best practice risk estimate capital requirement, nor is it a usable internal control device (International Swaps and Derivatives Association et al., 2009, pp. 8–10). The same patters repeats in the IRC and CVA. IRC is a composite risk measure that layers a IRB equivalent capital requirement on the new normal IMA regime. The resultant risk gauge, again, reproduces a risk that does not exist and is highly problematic as a internal control device. CVA, in turn, mangles the credit valuation adjustment risk badly as the charges focuses only solely on the counterparty credit risk and misses the market risk vectors of CVA. Again, regulatory and internal incentives dealing (Global Financial Markets Association et al., 2010; Rebonato et al., 2010).

3.3 A garbled strategy

For the Basel regulatory strategy, this transition is significant. In contrast to Basel 2, BCBS has now put the emphasis on capital charge impact and jettisoned the technological core of Basel 2. SVaR, CVA and IRC may make banks safer but the measures leave them no more alone. The Committee does no more go as-hands-off-as-it-dares. It seems to have a hidden structural regulatory agenda. Discourage trading. Make it shrink by appealing to the real risks that have to be sufficiently capitalised. The only problem in this account is that after sVaR, CVA and IRC the risk methodologies are no longer real in the—admittedly limited—sense they were under Basel 2. Consequently, the Basel Accord turns into a self-proclaimed neoliberal regime with interventionist tendencies, in a curious passive-aggressive manner. The Committee imposes fake risks on banks to sufficiently capitalise unreal risks. It is discouraging trading, all the while insisting it is simply enhancing risk sensitivity.

In this context, the Fundamental Review of the Trading Book (BCBS, 2012) is an extremely interesting project. The review envisions a total overhaul of IMA and SMM. In particular, the 99 percent 10 day VaR capital charges will be replaced by a 97,5 percent variable risk horizon Expected Shortfall (ES) capital measure. The regime will also be further modularised to allow for piecemeal approval and approval revocations. The most important piece of the puzzle is the move to the 97,5 percent ES risk measure. The measure situated in a paradoxical game. On one hand, BCBS has lost its faith in the risk technologies, but, on the other, introduces a new one to govern trading books. The case for ES is, of course, strong. It is, without any doubt, a superior risk measure when compared to VaR. The measure is more robust to tail events. It is no longer a measure of minimum loss in a bad case scenario, but a composite of all possible losses beyond the confidence level. In addition, it should make conscious

tail risk loading strategies hard to implement. However, the measure is marred by the same basic problem as VaR is. The risk metric is as reliable or unreliable as the assumptions—or the future generation machinery—it contains. If VaR was prone to blow up, ES is similarly compromised. At the same time, the piece-meal approach to model approval BCBS envisions, takes the Committee further away from the idea of letting real risks govern banks.

4 What happens outside Basel

4.1 A two-pronged attack

The global BCBS and Financial Stability Board (Financial Stability Board, 2013; Helleiner, 2010) led response constitutes only a part of the regulatory reform initiatives triggered by the financial crisis. BCBS and FSB have provided the baseline for regulatory response. All major international financial hubs have committed to implementing the Basel reforms, but also initiated reforms that go further than the baseline.The most important subset of these initiatives engage in what is known as structural regulation. Structural regulation is a befitting term to highlight the contrast between the global and local regulatory agendas. In a marked difference to Basel reforms, market and bank organisational structures have served as the primary targets in these reforms.

In the following, I will briefly map the local structural regulatory initiatives. I will discuss four projects, i.e. those undertaken in the US, UK, Germany and EU. The first three have already matured into legislation, while the EU plans are still on the drawing board. My focus will be on the initiatives' effect on banks' trading activities, the aspect most relevant when discussing the relationship between Basel and local reforms. Thus, I will not discuss e.g. their recovery or bail-in tool related aspects, which are also partly global projects (Financial Stability Board, 2012).

After a brief discussion of each individual initiative, I will sketch out some of the basic tenets in the regulatory strategy the structural regulation initiatives make up. Of course, here no singular strategy will emerge. The different initiatives are situated in highly divergent surroundings with varying banking market structures and political situations. However, one common theme seems to be underpinning all regulatory initiatives. All structural regulation projects walk a fine line between banning trading and keeping it alive, retaining status quo and doing something to market structures. Their ambitions are limited.

4.2 US

The structural reform initiatives were pioneered by the US Congress in the Dodd-Frank Act. The Act contains in its Section 619 the Volcker rule (Banking Holding Company Act Section 13 (12. U.S.C 1841), named after the former US Federal Reserve Chairman Paul Volcker who proposed the regime. In the Act, the Volcker rule is concise. It was, however, sketched out in further detail in a prolonged Agency rule-making process which turned the relatively parsimonious four-page legislative text into 300 some pages of the final Rule (Department of the Treasury et al., 2014).

The Volcker rule introduces a ban on "proprietary trading". The idea behind the rule is relatively simple—and draconian. No "banking entity" may "engage in proprietary trading; or acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge

fund or a private equity fund". Proprietary trading is defined as "as engaging as principal for the trading account of the banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, a security, derivative, contract of sale of a commodity for future delivery, or other financial instrument that the Agencies include by rule" (Section 13(h)(4)).

Despite the apparent blanket ban, the rule allows banking entities to engage in a number of "permitted activities". The permitted activities are exemptions to the overall ban: if not explicitly permitted in the rule they would fall under the ban. The first exemption covers financial instrument issued by US governmental bodies and agencies. Banking entities may purchase, sell, acquire or dispose of e.g. US government, GSE and state and municipal bonds (Section 13(d)(1)(A)). The second exemption allows banking entities to engage in underwriting and market-making activities, but only "to the extent that any such activities […] are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties" (Section 13(d)(1)(B)). The third exemption permits "risk-mitigating hedging activities" (Section 13(d)(1)(C)). However, the rule limits permitted hedging to that which "reduce[s] the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings". This entails that portfolio hedging is no more acceptable. In addition, the rule allows e.g. the purchase of securities on behalf of clients and proprietary trading that occurs solely outside of United States.

The exemptions are relatively wide in scope. In fact, Volcker rule imposes lenient restrictions. The rule entails that most forms of proprietary trading may continue in banks, albeit the scope of the activity is, at least somewhat, restricted.

4.3 UK

The basic framework of the UK approach to structural reforms was formulated by the Vickers Commission (Independent Commission on Banking, 2011a; 2011b). The Vickers Commission report advocated for a strict separation of the deposit-taking banks (known as ring-fenced entities) from other financial institutions and placing severe restrictions on the businesses deposit-taking banks could conduct and assets they could hold. Apart from these measures, the Commission mostly argued for business as usual. No business model restrictions would be placed on the non-ring-fenced entities. The regulatory framework would remain largely unchanged, save for the additional loss-absorbency requirements which exceed Basel 3 standards the Commission envisaged would be imposed on most financial institutions (Independent Commission on Banking, 2011b).

The final Financial Services (Banking Reform) Act 2013 implements the brunt of the Vickers Commission proposal. The Act sets up a ring fence around banks' retail operations or "core activities and services". If a bank wishes to take deposits from or provide payment or overdraft services to individuals and SMEs—excluding eligible non-core depositors—, the bank faces severe restrictions on the assets it may hold and businesses it may pursue. The Act simply provides a blanket ban on most trading activities. A ring-fenced bank may not "deal in investments as principal". What dealing in investments as principal was left to be decided by Treasury secondary rule-making. A Treasury Excluded Activities and Prohibitions Order (*The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014, SI 2014/2080*, 2104) was issued in July 2014. The order bans ring-fenced entities from engaging in all "buying, selling, subscribing for or underwriting securities or contractually based in-

vestments". In addition to the proprietary trading ban, the UK Act also bans ring-fenced banks from incurring exposures of any kind to financial institutions, save when providing certain payment services.

The Order, however, grants for limited exceptions to the wholesale trading ban. Some limited hedging is allowed even if it would entail principal investments. The allowed hedges may, however, only be undertaken if the sole or main purpose of the transaction is to limit the ring-fenced body's exposure to changes in interest rates, exchange rates or commodity prices, retail price or of residential or commercial property prices indices, share price indices or default risk. The other significant exception allows banks to conclude simple, easily valuable exchange traded derivatives contracts with the entity's account holders.

The UK approach to structural regulation is strict. Ring-fenced entities are not allowed to do any trading, just engage in plain vanilla financing intermediation. The stringency of the ring-fence is, however, off-set by the reverse side of the ring fence. Non-ring-fenced banks—or rather the corporate groups to which the ring-fenced entities belong to—enjoy unrestricted freedom to do whatever Basel 3 allows. They may still engage in market-making and underwriting, do proprietary trading and deal in derivatives. The only requirements is that the deposit-taking institutions stand apart from the rest of the group to allow for uninterrupted provision of the core services even in times of crisis. The independence requirement translates into a list of demands on group structure and inter-group relations. All dealings with the rest of the group must be on "arm's length terms". Further, the ring-fenced body must be able to "take decisions independently of other members of its group" and not be dependent on the resources which are provided by a member of its group and which would cease to be available to the ring-fenced body in the event of the insolvency of the other member". It also has to be able to function, i.e. "carry on core activities" even if the group became insolvent (Financial Services (Banking Reform) Act 2013 142H).

4.4 Germany

The German banking reform act—Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen of 7 August 2013—is a hybrid of the UK and US initiatives. The Act imposes a limited trading ban on banks as the US Volcker rule does while simultaneously requiring trading operations to be separated from deposit-taking institutions akin to the UK ring-fencing initiative.

The German initiatives' trading ban is a watered down version of both the UK ring-fencing scheme and the Volcker rule. First, the ban does not affect all institutions. Instead the German reform only bans a relatively small subset of large German banks from engaging in dealing on its own account (Eigengeschäfte) or lending to alternative investment managers. The threshold conditions of the ban are high. To fall under the ban, a bank—a credit institution, a financial holding company or conglomerate with a credit institution—has to hold least 100 billion euros or 90 billion euros and 20 percent of its total balance sheet assets held for trading or available for sale under IAS 9. In practice, the ban affects HOW many institutions. To further restrict the scope of the ban, the Bundestag explicitly excluded market-making, client transaction hedging and interest rate, currency, liquidity and credit risk management transactions from the scope of ban (Article 2), essentially retracing the broad idea of Volcker rule exemptions.

In a similar vein to UK ring-fencing, the trading prohibition not total. The prescribed activities can continue within the financial groups. They only have to be moved and confined to special financial trading institutions (Finanzhandelsinstuten). These trading entities are separate, ring-fenced organisations but may be still kept within the bank groups. However, to guarantee that the entities do not jeopardise the existence and operations of the rest of the banking group, the entities are required to stand legally and organisationally independent. The independence entails that the group may not provide any funding support to it, but the group must supervise the entity's risks and transactions.

The German approach, thus, builds on "reverse ring-fencing". The core banking operations are insulated from risky trading activities not by requiring the banking operations be standalone organisations—as in the UK ring-fencing— but by pushing the trading operations to separate entities with minimal ties to the rest of the group. The philosophy differs from the UK approach. The useful "third-party service" trading operations may benefit from the funding support from guaranteed deposits. Instead of making sure that the banking entities survive as in the UK approach, the idea is to ensure that the trading entities survive and—or rather—die on their own.

4.5 EU

The EU structural reforms are still in the making. The process started with the Liikanen report (High-level Expert Group on reforming the structure of the EU banking sector, 2012). The Liikanen report advocated the separation of proprietary trading and other hight risk trading from deposit-taking banks. The scope of proposed bans went further than in the German law. The report suggested that all "proprietary trading and [most] assets or derivative positions incurred in the process of market-making" should be migrated to trading entities. Banks' derivatives activities would be severely restricted and confined to "own asset and liability management purposes, as well as sales and purchases of assets to manage the assets in the liquidity portfolio" and "provision of hedging services to non-banking clients". The report also would have allowed the banks to engage in underwriting.

The final proposal by Commissar Michel Barnier was published a year later. The proposal is a watered down version of the Liikanen report. The Commission proposal shied away from enacting an EU wide ban on proprietary trading. Instead, a "mandatory" ban only extends to a small selection, maybe thirty in number, of EU systemically important banks.

The ban is not comprehensive. Like the German initiative it allows for a significant amount of trading to continue within banking groups and for unlimited trading in groups ring-fenced trading arms. In addition, the proposal defines proprietary trading very narrowly. According to Commission, proprietary trading is buying and selling and taking positions in financial instruments or commodities "for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity" or client transactions hedging. The scope is further restricted by providing that such trading has to be conducted by "desks, units, divisions or individual traders specifically dedicated to such position taking and profit making". The proposed scope is liberal. It would allow EU banks to engage in far more trading than their US counterparts.

The trading entity ring-fence requirements are almost identical to the German initiative. The trading arms of banking groups have to independent from their parents, hold their own capital and be cut off from funding support from the rest of the group.

The relatively lax trading restrictions are buttressed by rules that allow for "potential separation of certain trading activities". With the rules, the regulation would grant national supervisors the discretion to impose trading restrictions which go further than the "mandatory" trading restrictions. The rules establish a yearly cycle of assessment of the riskiness of bank trading operations. If the assessment indicates that the relevant tests are met and the bank's trading operations constitute a threat to the financial stability of the institution or to the Union financial system as a whole, the supervisor may require the institution not "to carry out the trading activities", unless the institution demonstrate that "the reasons leading to the conclusions are not justified".

5 The regulatory strategy of structural regulation

5.1 Not banning trading

What to make of the structural reforms briefly discussed above? Of course, the target of all the initiatives is trading. All projects seek to curb bank risk-taking when it is unrelated to traditional financial intermediation, in form another. The first issue to note is that the post-financial crisis trading bans are limited in scope all over the world. None of the four discussed structural regulation initiatives bans all trading in banks. Most will not even significantly affect the permissibility of trading per se. The dynamics of how this is achieved are, however, twofold.

The US initiative primarily manipulates the scope of banking group permitted activities. Many trading business models are prohibited altogether. The ban is, however, not comprehensive. The Volcker rule allows for many trading activities to continue. The European reform programs, in turn, focus on less prohibitions. The emphasis is on ensuring that the activities are conducted in safe locations within the financial groups. The manipulation of what banks—in the large sense of the word—may do, is less of a concern but, however, takes place. The European structural regulation initiatives, thus, work on two planes: they manipulate both the substance and structure of banking.

The take is paradoxical. As far as substantive restrictions are concerned, the UK ring-fencing initiative constitutes the extreme option. Trading is banned altogether. The ring-fenced entities may only engage in plain vanilla financial intermediation only. The stringency of the ring-fencing initiative is, however, constrained by its extreme short reach. In fact, no activity is actually impermissible to banks, as long as they are not ring-fenced entities. Banking groups are free to trade in the non-ring-fenced parts of their corporate groups to their hearts' content.

US Volcker rule also resides at the strict end of the substantive restrictions spectrum. The rule goes the relatively far by banning all proprietary trading in banking groups. Simultaneously, the US approach, however, contains significant exemptions that allow banks to still run sizeable securities inventories and derivatives books. In fact, most analysts seem to suggest that the overwhelming majority of banks' trading operations will conceptually fit into the scope Volcker rule exemptions. Some accounts even suggest that relatively little will change as mar-

ket-making and underwriting already constituted the overwhelming share of all bank trading operations and brought in most of trading-related profits and the prohibited actions were not a significant revenue source. E.g. the US Government Accountability Office reported in 2011 that in six major US banks, making nearly 90 percent of all trading related profits, to-be-banned proprietary trading contributed an insignificant portion of firm's overall profits. The reported detailed "standalone proprietary-trading desks" produced about $5 billion in revenue in 2009, after losses in 2007 and 2008 and paled in comparison to other revenue sources and bank operations (US Government Accountability Office, 2011). The Impact Assessment report accompanying the EU structural reform proposal points to a similar direction for EU banks (Commission Staff, 2014 Annex 10). Impact studies, thus, suggest that the US proprietary trading ban may, in end, be relatively inconsequential. Of course, the impact of the Volcker rule is not entirely contained to changes brought about the proprietary trading ban. The operational constraints exemption requirements impose on banks may also have market structure consequences, both to banks and markets. Banks and some commentators have argued that market impact may be catastrophic in some quarters. As banks have scaled down their market-making activities in anticipation of the rule, liquidity has dried up in some debt instruments (Chon et al., 2014; Dizard, 2014).

The odd dynamic of simultaneously banning and allowing characterises the initiatives in Continental Europe. In substantive terms, the initiative reside at the liberal end of the spectrum. They establish restricted bans on trading operations, and always on a subset of banking entities. All banks are not covered as in the US. In a sense, the initiative mimick the UK approach, but consistently water down. The separation is partial. Only the "heaviest" forms of proprietary trading will have to take place in separate trading entities. The non-trading parts of the banking groups still have the possibility to engage in trading, while the deposit-taking institutions may engage in light trading.

Here, we can draw the first conclusion. Despite the structural reform agenda, we will not see a reinstatement of Glass-Steagal style restrictions anywhere in the world. No regulator seems willing to discard with trading altogether. Consequently, trading is not becoming an irrelevant business. To the contrary, the initiatives simmer down to attempts at containing the damage trading while allowing those trading operations deemed integral to the support market functioning. The outcome, in fact, testifies to success of the Basel regulatory efforts. The Accord facilitated the construction of financial markets where bank trading operations are integral to the functioning of the markets that imagining a banking sector that would not provide these infrastructure services is nearly impossible. And very little can be done to disentangle the banks from the financial markets.

5.2 Doing as little as possible

The regulatory strategy of structural reforms is, thus, not to rout out trading. Rather, the primary political motive of most structural reforms seem to be the public anger at bankers' perceived greed and unethical behaviour (Davidson, 2010). Political decision-makers had to do something to look like they were reacting to what happened during the crisis. And trading happened to become the chief culprit and target for reforms together with OTC derivatives (Merkley and Levin, 2011).

Of course, focusing on both was—to a large extent—justified given the loss experiences. Both activities had imposed huge losses on banks and had feeble connections to the easily legitimate traditional financial intermediation businesses—which had not blown up. The critics had an easy task arguing that banks' scope of business should be limited to traditional core banking functions, i.e. taking deposits from the surplus sector and extending the funds as credits to the deficit sector. Trading, i.e. taking risks for private gains—with public support—was something that was easy to castigate as serving no legitimate purpose.

The loss experiences provide incontrovertible evidence that trading operations were prone to impose large losses. The few publicly available detailed post-crisis loss attribution exercises disclose a landscape dominated by the collapse of the securitisation markets. The overwhelming majority of trading losses were related to securitisations. In the BCBS Trading Book Group exercise mortgage trading, ABS trading, portfolio credit derivatives and securitisation warehouse losses seem to account for well over a half of all trading related losses with "proprietary trading"—whatever that means—accounting for a tiny fraction (BCBS, 2012, pp. 57–58). The UK more granular exercise unearthed a similar picture (Financial Services Authority, 2010 chapter 5). The collapse of securitisation markets was the devastating event. This, of course, slightly changes the picture. If the crisis was chiefly caused by the collapse of securitisation businesses, the destabilising potential of proprietary trading diminishes. Of course, one could argue that the securitisation arena was the venue par excellence for proprietary trading and, thus, warranted strict bans to make sure that a similar cataclysm never happen again. When assessing the strength of the argument, one has to bear in mind that the BCBS had already acted to address the shortcomings of Basel securitisation rules with a number of relatively tough measures.

Curtailing greed and satisfying the demands of a putatively angry public give rise to messy regulatory strategy. Anger must be balanced with the cooler appraisal of the consequences of manipulation. Here, reason takes the shape of retaining what is "useful" and legitimate in banks' business, a service to the public. The problem is that the "public service" functions banks perform are not confined to traditional lending-based financial intermediation, the easy case only criticised by the most vehement critics of our (Chamley et al., 2012). The trading operations may have been risky and appeared morally questionable, but, as it soon turned out, they were not, in fact, useless. Trading by banks was an inseparable part of the financial infrastructure and supported the every-day life on the markets. Without support from banks' trading operations, the markets would look very different, misfire and impose welfare losses. Some of the financial fabric keeping modern economies going would be lost. In some quarters, markets would cease to exist altogether. To further complicate things, the inevitable effects drastic reforms would have on short-term economic growth would hit vulnerable economies, already struggling to recuperate from the crisis. It would be incredibly hard to ween the economy off the drug the operations provided it (e.g. Wolf, 2010). As a consequence, the structural initiatives, consequently ended up walking a tight rope between making the financial system safer, keeping the economy rolling and satisfying the—possibly irrational—calls for retribution against traders.

In this context, the structural regulatory strategy becomes understandable. Trading is restricted at some quarters and to a degree, but not entirely suppressed. The undesirable—be they deemed such because of risks inherent in them or simply because they are impossible to legit-

imise—activities are either migrated to safer locations outside the core of the banking system or defined narrowly to allow the most important operations to continue. The move outside banks allows regulators to deflect concerns that remaining trading might still constitute a risk to financial stability—and of course argue rightly that risks to financial stability will diminish and long-term economic growth will benefit. The risks are outside the subsidised deposit-taking banks and insulated from the general public of "normal people". The institutional collapses which may still happen due to trading blow-ups, do not threaten the system. Further, taxpayers will be off the hook as the governments have no more an interest in bailing out the now non-essential trading institutions which, in addition, are set up to fail safely and have ample bail-in capital. The neoliberal attitude to financial services takes care of the rest. If traders risk their own capital, there is no reason to restrict risk taking.

6 Global banking regulation after the crisis?

Do the structural reforms unhinge the balance of power in global banking regulation? Despite the seemingly radical differences in the orientations of the structural reform and BCBS regulatory strategy, the answer seems to be no. There are two reasons for this.

First, the scope of the reforms are relatively restricted. Trading is not banned, leaving ample room for trading to continue in banks. Business model neutrality is retained. Only some fringe activities face outright bans.The second reason is their level of ambition. None of the structural reforms amount to a fundamental rethink of the regulatory paradigm. The reforms are superimposed on existing Basel regulatory structures. They do not attempt replace Basel, just complement it by manipulating its reach and the peripheries of the Accord. The core regulations affecting bank behaviour within the scope of allowed business still emanate from Basel. As consequence, the structural reforms do not destabilise the hegemonic position that the Basel regulatory approach enjoys. Banks will still be governed primarily with the technological apparatuses the Basel technocrats dream up.

What is noteworthy is the what the structural initiatives lack. No regulator has dared to attempt imagining a banking system in which capital adequacy would not be one of the primary regulatory tools or where a significantly new set of risk-based capital would be used to govern banks. Even the "narrow banks" enacted by the UK ring-fencing rules will still be governed by the Basel capital adequacy rules, presumably also the IRBA regime. Of course, the more trading is restricted, the lesser impact will the Basel trading rules have. However, the analysis points to a conclusion that the advanced model-based trading book and CCR capital regimes will be far from redundant. Even if the most complex naked proprietary trades will be banned, the continuing mandate to continue with derivatives dealing may still expose banks to significant non-linear market risk. These developments constitute a double-edged sword. The derivatives "market-making" books are a potential threat to financial stability. They could very well still blow up and result in massive losses, especially if counterparty risks realise. Simultaneously, the decreasing complexity of bank trading books might make the revamped Basel market risk framework a more effective tool in governing bank balance sheets, of course at the cost of reduced capital optimisation.

The structural regulation initiatives may, in fact, work to further embed the Basel framework into the regulatory structures. E.g. the Volcker rule final agencies' rule operational requirements further embed the Basel VaR based core technologies into bank control and reporting

flows. The rule— somewhat surprisingly given the Basel trading book Fundamental Review plans— requires banks to monitor activities by e.g. reporting daily VaR risk figures and setting VaR based limits for the trading units (71 CFR 21 p. 6037–6045).

One further point seems worth making, again on the blind spots of the reforms. IRBA has seen very little changes since 2008. The regime has, essentially, survived unscathed, with the exception Basel 3 financial institution correlation factor adjustment recalibration. The Committee has also produced a working paper which lamented the variations in credit risk assessment in IRBA banks. Still, nothing has happened in Basel. Even the securitisation framework will allow continued IRBA use (BCBS and Supervision, 2013). It is important to note that the structural reforms do not address banking book at all.

A muddled picture of the composite post-crisis regulatory strategy emerges. BCBS seems to be still scrambling to respond to the crisis. Basel 2,5, Basel 3 and the post-Basel 3 reforms have significantly boosted global banking system stability, but still shy away from fundamental reconstruction of the regulatory strategy. The reforms seem to suffer from the utter devastation the global financial crisis visited upon the neoliberal Basel 2 regime. The ship is in pieces, but at the sea. The Committee has been engaging in highly pragmatic piece-meal adjustments which lack the theoretical and regulatory strategy cohesion which characterised Basel 2. For good reason. The project was an abortive failure. And it is very probably that a similar theoretically consistent replacement will not emerge (BCBS, 2013; Blundell-Wignall et al., 2014, p. 15). The technologies do not exist. The local initiatives reflect a similar lack of direction. They engage in peripheral manipulations, torn between retaining the status quo and doing something to quell public calls for actions, and making the systems more stable.

Reforms have been reactive. Proactive regulation has evaded the global and local regulators. What has emerged is a piece-meal regulatory strategy that fixes highly localised deficiencies with—at times—passive-aggressive instruments with badly hidden tacit agendas, engages in limited market structure manipulation, but lacks an overall vision of what the financial markets should be like apart from the vision that they should be somewhat similar to those we have now. And as long as that vision is lacking, regulatory strategy is sure to remain a muddled, tortious creature. As David Murphy, the former Head of Risk at ISDA, once wrote on Deus ex Macchiato: "The first question a regulator should ask is 'what kind of banking system do we want?' That is, what types of institutions do we want, taking what risks, and playing what role in the real economy? Once you have answered these questions, you can design a regulatory framework that tends to create the kind of financial system you want, and to discourage ones you don't want" (Murphy, 2012).

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