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EuroFinuse's Response to the Consultation on the recommendations of the High-level Expert Group on reforming the structure of the EU banking sector

Reply of the European Federation of Financial Services Users (EuroFinuse)

13 November 2012

The European Federation of Financial Services Users ("EuroFinuse") *(formerly EuroInvestors the European Federation of Investors) counts more than fifty national and international member and sub-member organizations comprising about four million individual members. EuroFinuse acts as an independent financial expertise center to the direct benefit of the European financial services users (shareholders, other investors, savers, pension fund participants, life insurance policy holders, borrowers, etc.) and other stakeholders of the European financial services who are independent from the financial industry.*

EuroFinuse has experts participating in the Securities & Markets, the Banking and the Pensions Stakeholder Groups of the European Supervisory Authorities, and the EC Financial Services User Group. Its national members also participate in the national financial regulators and supervisors bodies when allowed. For further details please see our website: www.eurofinuse.org.

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Executive summary

EuroFinuse is very concerned about the conclusions of the Liikanen High Level Expert Group, as we represent both shareholders and financial services users' interests, which will be profoundly affected by the expected future reform of the structure of the EU banking sector.

We agree with the general recommendation of the Expert Group **on the necessity of legal separation between risky financial activities from deposit-taking activities within a banking group**. We agree as well that this **separation should be aimed at protecting their socially most vital parts**, which indeed are deposit-taking and those related to the provision of funding to the non-financial sectors of the economy. However, we consider that **further consideration should be made on how this separation should be made**. We doubt that the emphasis should be on separating the most volatile and risky part of the business from the retail part of banks. Instead we should focus on **isolating the retail part of banking institutions** and leave the rest of the activities outside the wall. This would **reduce the incentives** for the financial industry **to lobby for keeping more risky or speculative parts of the business together with retail banking activities** and consequently benefit from cheap funding for those activities that have no direct link with the real economy.

Another important point that the Expert Group has achieved to clarify is the **need for establishing certain parts of banks´ debt as non-eligible for public bailout**, reducing incentives for excessive risk-taking initiatives. This part of the debt should stay of course, within the investment banking part of banks, so the taxpayer does not have to bear the burden of the rescue of the "casino" part of the financial services industry. This is another reason why the **legal separation between investment and retail banking activities should be the keystone of the post-crisis banking industry scenario in Europe**.

Finally, we consider that we should not speak about "ring-fences" but rather of "walls": **the separation of retail and investment banking should not be optional or conducted after the bailout** as some of the proposals of the Expert Group suggest. Otherwise, the danger remains that the badly needed reform of the EU banking sector will be incomplete and lack the necessary steps needed to restore the confidence of investors and users of the financial sector.

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EuroFinuse welcomes this consultation from the European Commission after the publication of the Liikanen Expert Group conclusions.

First of all, we would like to praise the European Commission by having included in the Expert Group a representative of consumers and to the Liikanen Expert Group itself for having auditioned Mr Guillaume Prache, Managing Director of EuroFinuse. Shareholder and financial services users' views should be especially taken into account as their interests would be dramatically affected by a restructuration of the EU banking structure In addition to this; their engagement should be considered as a possible part of the solution to the problems referred to in the Report.

We would like to comment on certain parts of the Liikanen Report that are especially important for us:

> *"the Group has concluded that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within the banking group. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely linked with securities and derivatives markets"*
>
> *Liikanen High Level Expert Group report, iv*

As expressed in our response to the Consultation from the High-Level Expert Group[1], there are at least four critical reasons to have commercial banks getting back to their core business:

- Central bank funding (i.e. public support) must be dedicated solely to commercial banking activities, i.e. the transformation of deposits into loans to the real economy nothing else;

- "Too Big to Fail" banks must obviously get smaller; this will not be achieved by raising capital ratios, but mainly by - again - reserving access to central bank funding to commercial banking activities and preferably by spinning other activities off;

- These other (non-commercial banking) activities also generate very serious conflicts of interests;

[1] http://eurofinuse.org/upload/positions/Liikanen%20Group%20Consultation%20EF%20reply%2030%2005%2020121338453136.pdf, page 2

- Finally, the publicly supported "re-intermediation" of capital markets by banks – i.e. banks now playing a dominant role in capital markets instead of real economy users such as end investors and non-financial issuers has severe negative effects on EU savers and pensioners, on corporate governance and on democracy.

Possible amendments to the use of bail-in instruments as a resolution tool

"The power to write down claims of unsecured creditors or convert debt claims to equity in a bank resolution process is crucial to ensure investor involvement in covering the cost of recapitalisation and/or compensation of depositors. It also reduces the implicit subsidy inherent in debt financing. This additionally improves the incentives of creditors to monitor the bank"

Liikanen High Level Expert Group report, viii

In view of the establishment of such a regime, investors should count with appropriate pre-contractual information disclosure regimes and selling prices for debt instruments that could be eventually transformed into bank equity.

We should make sure as well that market actors and especially retail investors, are properly informed of the differences between the debt instruments from the investment part of banks and the retail banking side (if a ring-fencing solution is to be implemented at EU level).

Strengthening the governance and control of banks

"Governance and control is more important for banks than for non-banks, given the former's systemic importance ability quickly to expand and collapse; higher leverage; dispersed ownership; a predominantly institutional investor base with no strategic/long-term involvement; and, the presence of (underpriced) safety nets"

Liikanen High Level Expert Group, x

We definitely agree that the benefits of shareholder involvement are potentially bigger in the case of financial institutions. Consequently, corporate governance standards for financial institutions should be inclusive with investors and clients' views.

As for the issue of the dispersion of banks' ownership, we would like to refer to the specific evidence provided by the data of ownership of US corporate equities from our response to the consultation from the Liikanen Expert Group[2] on the dramatic change in firms' ownership in the last 40 years.

> **Governance and control mechanisms**:
>
> *"Attention should be paid to the governance and control mechanisms of all banks. More attention needs to be given to the ability of management and boards to run and monitor large and complex banks"*
>
> *Liikanen High Level Expert Group, x*

Requiring specific expertise of banks' board members (for instance, knowledge on accounting and finance for Audit Committee members) could be a positive step to this extent. Promoting the inclusion of independent members in firms' management boards is another measure that should be considered.

> ***Ownership and corporate governance***
>
> *"The problem of monitoring banks is amplified by the fact that share ownership tends to be very dispersed, as is evident also by the number of institutional investors. Even the largest shareholders in most cases only hold a small share of the equity of the bank. (…)*
> *The ability and incentive of shareholders to monitor is therefore limited. Moreover, the opacity of many banks and the complexity of their activities further reduce the ability of shareholders to exert control over the banks in which they invest.*
> *There has recently been a surge in shareholder activism in relation to bank remuneration, with shareholders blocking proposed remuneration packages. But shareholder engagement is still very limited, for example when it comes to strategic managerial decisions (…)*
> *This lack of external monitoring gives rise to an agency problem, which allows bank managers to pursue strategies that may deliver private benefits that are not necessarily in the interest of the owners or other investors of the bank."*
>
> *Liikanen High Level Expert Group, section 3.4.4 , page 50*

[2] http://eurofinuse.org/upload/positions/Liikanen%20Group%20Consultation%20EF%20reply%2030%2005%20 20121338453136.pdf, page 6

It is very important that the High Level Expert Group has addressed the issue of the "shareholder spring" in its Report. We agree that opacity is the bigger hindrance to shareholder engagement and thus transparency is a prerequisite for shareholder engagement. For a concrete explanation to the current limitations of shareholder engagement, we would like to refer to EuroFinuse´s recent research study *"Barriers to Shareholder Engagement- A Report on Cross-Border Voting"*[3].

We would like to point out however, that the potential of shareholder engagement should not be underestimated. Non-shareholder friendly corporate governance practices are a reason why shareholder engagement so far is low. We believe as well that the potential role of organizations that legitimately represent the interests of shareholders should be considered. This role however, cannot be properly exercised partly because of the limited resources they count with.

Reducing contagion and complexity
(…)
"Upcoming Securities Law Proposal – clarifying securities ownership chains (forthcoming)
The European Commission is currently preparing a legislative proposal on the legal certainty of securities holding and transactions. The proposal is expected to address the legal framework of holding and disposition of securities held in securities accounts, the legal framework governing the exercise of investors' rights flowing from securities through a "chain" of intermediaries, in particular in cross-border situations, and the submission of any activity of safekeeping and administration of securities under an appropriate supervisory regime. The proposal is expected to facilitate the resolution of financial institutions active across borders by clarifying "who owns what" in complex securities transactions chains"

Liikanen High Level Expert Group report, section 4.2.3 , page 74

We definitely agree on the necessity of further clarification regarding the identification of the legal owners of firms´ shares. To this end, we welcome the preparation of the legislative proposal from the Commission that would clarify at least the holding of the securities transacted. In this same line, the FSUG (Financial Services Users Group) has commissioned a Study to clarify the ownership structure of EU listed companies.[4] A better view of the property scheme of EU banks´ shares in Europe could help to design at a later phase, corporate governance standards that promote a longer holding time of those shares, especially by direct investors such as retail and institutional investors. A longer holding of

[3] http://eurofinuse.org/upload/UserFiles/file/FINAL_Barriers%20to%20Shareholder%20Engagement.pdf
[4] http://ec.europa.eu/dgs/internal_market/calls/index_en.htm

securities contributes to the financing of the EU economy and increases the incentives of active surveillance of firms 'managers performance, thereby potentially contributing to the aforementioned corporate governance-related problems of EU banks.

In addition, the direct holding of shares by investors is key for guaranteeing a longer holding period of the shares. If held indirectly (e.g. through investment funds, structured products) they lose control of the ownership period of securities. The incentive for a fund manager to hold shares for a long time is thus limited. We should mention as well that in a post-Liikanen framework (with a division between investment and retail banking) the direct holding of shares could be especially beneficial for retail banking, as this part of the business would be more closely linked to the real part of the economy. A direct holding of shares of the part of the bank devoted at investment banking could also contribute to the reduction of excessive risk assumption that such activities usually present.

Corporate Governance and remuneration

(…)

"In order to ensure that staff and management incentives are aligned with a bank's long-term interest and do not encourage excessive risk taking, new rules introduced in 2010 (CRD III) require banks to implement remuneration policies which do not encourage excessive risk-taking. In particular the rules require a substantial part of variable remuneration to be paid in shares or share-like instruments and demand deferring a substantial portion of the variable remuneration over a longer time"

Liikanen High Level Expert Group report, section 4.2.5 , page 78

Such policies should be complemented by promoting "say on pay" compliant corporate governance schemes e.g. disclosure and vote of managers´ remuneration policies in General Assemblies by shareholders. This is a market-based solution to managers´ remuneration agency problem with a big potential: it is shareholders who have the bigger interest to protect the value of the firm. It should be especially strengthened in the banking industry, as this is the sector where managers´ remuneration practices became more abusive towards shareholders (excessive bonuses and "*golden parachutes*") and which ended up with authorities having to intervene directly in banks 'remuneration policies.

Corporate Governance and remuneration
(…)

"Shareholder control is limited as shares are often dispersed and held by short-term investors; other investors have fewer monitoring incentives, because even with bail-in proposals implemented only some of them face a risk of loss).
Weak governance and shareholder control has often plagued credit institutions with strong political connections. Moreover, the scope for control will reach its limits if the size or complexity of a bank itself makes it impossible for the management and external investors to effectively control risks. However, improvements in corporate governance will not be effective in addressing collective underestimation of risks which are characteristic of systemic crises."

Liikanen High Level Expert Group report, section 4.2.5 , page 79

We absolutely agree with the diagnosis on the limited control of banks by short-term investors. However, the reason why other investors exercise as well a limited surveillance of banks is not, in our opinion, because they do not face a risk of loss. We can see that even before the financial crisis, when nobody knew about future banks´ bail-out and that some of the investors would be protected against these eventual losses, shareholders´ involvement was equally low.

Indeed, the size and complexity of a bank may challenge the supervisory capacity of investors but such difficulties are limited to specific areas such as risk management. As said before, the potential contribution of shareholder involvement in firms in general (and banks in particular) is huge and further legislative measures should be considered.

Deposit Insurance Schemes

*"The effectiveness of DGS in preventing bank runs depends on the trust their financial capacity and their ability to ensure that depositors have continuous access to their deposits and are not affected by a bank failure (whether through compensation pay-out or through other means, such as facilitating the transfer of the deposit accounts to another entity). Payout delays should not prevent depositors from accessing their funds immediately***"**

Liikanen High Level Expert Group report, section 5.3, page 83

We also agree on the necessity of immediate access by depositories to their funds in case of bank failure, especially in this context of extremely low confidence of investors in financial institutions. If this is not tackled EU citizens´ savings could be diverted from the financing of the real economy to other non-productive investments such as real estate and investment in tangible goods.

Evaluating the current regulatory reform agenda

"Lack of focus on consumer protection in financial regulation and supervision: the financial crisis at least partly originated in irresponsible lending practices. However, the current EU-wide regulatory and supervisory framework and proposals may not sufficiently address these aspects. Several EU initiatives focus on improving transparency of financial instruments (MiFID, PRIPS, UCITS). However, they present two types of shortcomings: first, transparency alone may not be sufficient effectively to protect retail consumers (e.g. in view of complex financial products, selling techniques) and there may be a need to consider different avenues (e.g. engage into more intensive product regulation and/or regulation of marketing practices in the banking sector); and, second, there are supervisory gaps (e.g. consumer protection authorities not being competent in the financial area, and financial supervisors focusing on prudential control) leading to inconsistent implementation"

Liikanen High Level Expert Group report, section 5.3, page 91

We would like to praise the High Level Expert Group for having successfully identified the lack of consideration of consumer protection in financial regulation and supervision. Irresponsible lending is only one of the many issues where this lack of consideration is patent. Inadequate pre-contractual disclosure regimes and selling practices of retail investment products had a capital role in the spread of the financial crisis throughout the economy.

As stated by the High Level Expert Group, transparency alone is not sufficient to effectively protect consumers. The most remarkable example are inducements in the financial sector: they prevent advisers to provide trustworthy investment recommendations to investors. Full disclosure of inducements will not be enough unless the investment advisor is required to act according to high professional standards and always in the best interest of the client.

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Determining the nature of further reforms

(…)

"In particular, two illustrative structural reform avenues were developed and discussed:

- The introduction of a non-risk weighted capital buffer for trading activities and contingent functional separation of significant trading activities; and

- A similar capital buffer but with immediate functional separation of significant trading activities.

Both avenues may lead to functional separation (i.e. segregation of trading activity in excess of a threshold to a separately capitalised and funded stand-alone subsidiary). However, whereas in the first avenue such separation is contingent upon a supervisory evaluation concluding that a bank would not be able to wind down its trading risk positions in a crisis situation in a manner that safeguards its financial health and/or overall financial stability in the second avenue functional separation would be immediate and independent of any discretionary supervisory evaluation"

Liikanen High Level Expert Group report, section 5.4, page 94

We believe that only the second of the two proposed structural reforms could be appropriate: the separation of retail banking and investment banking parts of the business should be total and mandatory. Otherwise, the risks of regulatory arbitrage would be big so the internal organization of financial institutions in the future would be aimed at circumventing the regulation and diverge from the banks´ optimal business organization in this new framework aimed at preserving the stability of the financial industry.

In addition to this, we do not believe that raising capital ratios is an appropriate solution for making the financial system more stable. To this end, we would like to refer to the following three reasons we provide in our response to the consultation from the Liikanen Expert Group:

- First, it is likely to make banks even bigger in terms of relative size to the real economy businesses, which is contrary to the need to get the "TITF" smaller.

- Second, increasing capital ratios will very often imply raising equity on capital markets, thus further crowding the real economy out of equity funding access. This crowding out effect on equity markets by the banking sector seems to have been lately overlooked by

Regulators. For example, banks weigh close to 15 % of the STOXX Europe 50 equity index[5], way more as compared to recent decades (and above 18 % if you add insurance companies, which include such “bank-insurance” companies such as ING) in a time when bank stock prices are depressed. This can only get worse with the Basel III / CRD IV approach.

-Third, this approach is unlikely to prevent big banks from becoming insolvent. For example, Dexia had been publicly ranked 12th best bank out of 92 European banks by the ECB in July 2011 in terms of capital ratios[6]. Two months later, the Belgian and French taxpayers had to commit to provide tens of billions of euros to rescue it, and non-insider shareholders lost billions as well.

We believe the keystone for a new banking industry structure should be to ensure central banking funds are used only for commercial banking activities.

Structural separation conditional on the recovery and resolution plan

“All banks with significant trading activity would be subject to a supervisory evaluation of the credibility of their recovery and resolution plans in terms of their ability to wind down their trading risk positions in a crisis situation. Banks would present to their supervisors, as part of the overall recovery and resolution plan (RRP) foreseen under the proposal for a Directive on Bank Resolution and Recovery, how they could wind down their trading risk positions in a crisis situation in a manner that does not jeopardize their financial health and/or significantly contribute to systemic risk. Banks should be able to demonstrate that they are in a position to segregate retail banking activities from trading activities and wind down the latter separately, without affecting the conduct of the retail business and creating the need to inject taxpayers’ funds”

Liikanen High Level Expert Group report, section 5.4.1.2, page 96

We do not agree with the proposed methodology. We believe that it will be extremely difficult and arbitrary to proof that retail banking activities can be separated from investment banking activities. The separation should be made in any case, and of course previously to a bail-out situation otherwise the risks of contagion to the retail part of the bank are high.

[5] See Stoxx Europe 50 fact sheet: http://www.stoxx.com/download/indices/factsheets/sx5p_fs.pdf
[6] See for example Euroshareholders press release on the Dexia 2011 collapse.

In addition to this, the proposed mechanism would need a very heavy supervisory regime. So far, both the EBA and national supervisors lack such a capacity. Consequently, supervision would probably not be exerted optimally. Full and mandatory separation between retail and investment banking would probably be more cost-efficient and provide higher certainty and guarantees to market participants.

Avenue 2: Immediate functional separation of significant trading activities

"An alternative approach to avenue 1 is to require the functional and capital separation of significant trading activities at the outset without the need for a prior supervisory evaluation. Under this avenue, banks with significant trading activity in excess of a certain threshold (as per Avenue 1) would have to separate that activity from other retail and commercial banking activities.

If a threshold is set at a value greater than zero, this approach could be used to exempt banks which have limited trading activities as part of their business model of a universal bank, in order to support other banking activities and offer customers a full range of banking services.

Banks in excess of the threshold would have to transfer the activity to a separate legal entity. A choice would be needed as to whether the bank should transfer only the activity in excess of the threshold or all the investment bank activity"

Liikanen High Level Expert Group report, section 5.4.2, page 98

We believe that if opting for the ring-fencing solution, it would be much easier and direct to ring-fence the part of the bank that would need public money injection (e.g. the retail banking part) as suggested by Britain´s independent commission on banking. In addition,the "risky bits" of banks should be appropriately identified for an effective supervision by authorities.

As explained in our response to the Liikanen Expert Group consultation, separation between investment and commercial banking is – contrary to what some interested parties would claim – quite easy to achieve. For example, the recent unexpected and enormous loss in the "hedging" department of JP Morgan further demonstrates that proprietary trading must be reduced to a minimum for any bank claiming access to central bank money, and that the "hedging" scope allowed for commercial banks must be strictly limited to actual commercial banking risks in the banks' balance sheets.

Incentive schemes

"One essential step to rebuild trust between the public and bankers is to reform banks' remuneration schemes, so that they are proportionate to long-term sustainable performance. Building on existing CRD III requirement that 50% of variable remuneration must be in the form of the banks' shares or other instruments and subject to appropriate retention policies, a share of variable remuneration should be in the form of bail-in bonds. Moreover, the impact of further restrictions (for example to 50%) on the level of variable income to fixed income ought to be assessed. Furthermore, a regulatory approach to remuneration should be considered that could stipulate more absolute levels to overall compensation (e.g. that the overall amount paid out in bonuses cannot exceed paid-out dividends). Board and shareholder approvals of remuneration schemes should be appropriately framed by a regulatory approach"

Liikanen High Level Expert Group report, section 5.5, page 106

A regulatory approach into defining necessary levels of variable versus fixed income remuneration seems very appropriate. Remuneration should at least partly consider banks' long-term performance in order to disincentive excessive risk assumption by managers. In any case, any regulatory reform in this sense should consider shareholders' views and be highly inclusive with them.

Competition

"To improve effective consumer choice and enhance consumer protection, it is necessary to improve transparency, address product tying and ensure responsible marketing practices. Self-regulatory measures have proven to be insufficient in this regard"

Liikanen High Level Expert Group report, section 5.7, page 108

This is another important conclusion to remark on: abusive marketing practices such as tying have a direct effect on the contagion of the problems of financial markets throughout the whole economic system.

Finally, we would like to highlight some of our proposed measures to the Liikanen expert group in our response to their consultation to further reduce systemic risk and therefore save taxpayers’ and non-insider investors’ money:

- Central banks’ lending to institutions which only have 75 % or above of their balance sheet made up of loans to the real economy;

- Banks keeping at least 50 % of counterparty risk when securitizing their loans;

- Strengthening the Deposit Guarantee Schemes to ensure they are all pre-funded by the banking industry;

- Banks increasing their transparency on the use of public funds: central banking funds, and rescue funds;

- Limiting interbank funding (and funding to other non-commercial banking financial institutions like investment banks and hedge funds) as a percentage of total balance sheets; and

- Controlling the effects of greed on mortgage credit, national supervisors should limit the amount of mortgage loans as a percentage of the collateral fair value and limit the interest charge as a percentage of borrowers’ income, and review or audit the enforcement of those limits every year.