EuroFinuse EuroInvestors

# Consultation by the High-Level Expert Group's on reforming the structure of the EU banking sector

## Response of the European Federation of Financial Services Users (EuroFinuse)

**30th May 2012**

***The European Federation of Financial Services Users ("EuroFinuse")*** *(formerly European Federation of Investors, in short EuroInvestors) counts more than fifty national and international member and sub-member organizations. In turn those count 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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EuroFinuse' response is largely based on its hearing by the High Level Group on 24 May 2012. EuroFinuse welcomes this consultation on a critically important issue for the European financial services users, but also to all EU citizens and for the European economy and society.

## Executive Summary


**The European Federation of Financial Services Users firmly believes that the commercial banking activities (i.e. the intermediated funding of the real economy: businesses[1] and households) should be separated as much as possible from all other activities (such as securities, currencies and derivatives trading, investment banking, asset management, insurance, etc.) that commercial banks have been diversifying into in the recent decades.**

Why?

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
- 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 (end investors and non-financial issuers) has severe negative effects on EU savers and pensioners and on corporate governance and on democracy.

Solutions

Besides ensuring central bank funding only helps the transformation of deposits into loans to the real economy, other – less crucial – measures should be considered in order to ensure establishing a safe, stable and efficient banking system serving the needs of citizens and of the E.U. economy, with a particular emphasis on the reduction of systemic risk and moral hazard and the promotion of competition.


[1] SMEs in particular, which are the only net job creators in the EU, and which have less access to direct funding on capital markets (equity and bonds).


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1. **Commercial banking enjoys a unique privilege: the access to central banks' funding. This privilege must have a counterparty**

Commercial banking is a very specific and unique business as it is at the core of money creation (and destruction). In all countries, money creation is considered a public matter, and this is the reason why central banking is a public activity. Money creation happens when deposits collected are transformed into loans to the real economy. Indeed, collecting deposits and lending to the real economy[2] are the two activities that make commercial banking unique.

Commercial banks enjoy a unique privilege, which is the access to central banks funding. Central Bank funding purpose is to enable commercial banks to perform their role of funding the real economy: collecting deposits and transforming them into loans. It has never been intended for anything else. Central banking funds – which are public money and therefore belonging to the EU citizens – should not be used by banks to fund any other activities such as trading securities, currencies[3] and derivatives, investment banking, asset management or insurance.

There is no economic and no moral rationale for public agencies such as Central Banks to fund and subsidize those other activities, which were performed decades ago by non-bank enterprises (and still are) without any public privilege granted to them.

As a matter of fact, today, EU citizens have no clue what the almost "free money" (1% interest rate on three year loans) in the amount of one trillion euros recently provided by the ECB to EU banks (known as "LTROs") is used for by the banks. But all the evidence gathered by EuroFinuse and others (like the European Commission's FSUG[4]) shows that it does not seem to be primarily used to develop credit and/or lower the cost of credit to the real economy. Indeed, it shows the opposite: the volume of bank credit to the real economy is still much lower than in 2007 (pre-crisis), especially for SMEs, and the cost of credit (spread) is currently increasing rather than decreasing for SMEs and households.

This nevertheless equates to tens of billions of euros of public subsidies to European banks[5] that should be used to strengthen economic growth and help jobs creation.

[2] Collecting deposits and lending money to the real economy are the two fundamental and distinctive activities of commercial banking. Payment services are important, but are not specific to banks, and are not a financing activity but an information technology ones, and – as such – do not require any specific financial regulations. Indeed, non-banks have started to compete in this business, like PayPal for example.

[3] The world currency transactions amount to about USD one quadrillion per year (source: Allen & Overy, The Euro and currency unions, 2011), very largely disconnected from the real economy needs whatever way one measures it (GDPs, total exports, etc.).

[4] FSUG: Financial Services User Group, see for example the minutes of its April 2012 meeting (not published).

[5] The only constraint for EU banks to get LTRO funding is to provide collateral in the form of Euro Sovereign bonds; therefore deliberately inciting banks to hold on to or to invest further into these securities (end result very similar to the US Fed's "Quantitative Easing" by the way). Assuming the average three year return on this asset class is 2 %, the subsidy to

The European Authorities should demand disclosure from European banks on the precise and quantified use of these massive subsidies. We suspect that a very significant part is used to invest into Euro Sovereign bonds as this is the only collateral required for the LTROs. This would confirm the Public Policy induced crowding of the real economy out of capital markets and the further reintermediation of these capital markets (see below).

**2. "Too Big To Fail" banks must get smaller - not even bigger - by separating non-commercial banking activities**

Allowing commercial banks to develop non-commercial banking activities in the last decades has led to significantly more financial instability, an increase of systemic risks and the rise of so-called "too big to fail" institutions. Indeed, for example allowing banks to massively securitize their mortgage loans portfolios and thus quickly taking them out of their balance sheets in the most recent decades was the key enabling factor for the "subprime" bubble: if subprime loans were to stay in the lending banks' balance sheets as it was in the past, banks would have exercised much more scrutiny and would have been much more responsible lenders. The subprime crisis was itself the trigger for the global and devastating financial crisis that is still on-going.

In the recent decades, many commercial banks have also been adding higher margin businesses to their franchise, leveraging their distribution networks, and relying on their ability to get refinanced by central banks. This is one of the reasons for the rise of "too big to fail" institutions. One quite logical solution to the "too big to fail" issue is to reduce the size of these institutions by spinning their non-commercial banking businesses off. This is quite easy to do: similar for example to the pharmaceutical conglomerates spinning off their chemical businesses in the nineties. This is much more logical than the current EU Authorities approach which is in effect bringing even more capital into these already too big institutions, or letting banks downsize their credit businesses further[6] instead of spinning off non-credit businesses.

It is also probably preferable to the softer "ring-fencing" approach very recently taken by the UK Government, following the proposals of the Independent Commission on Banking led by John Vickers, as it still much better guarantees the establishment of a Chinese wall around

banks imbedded into the ECB's LTRO program so far can then be estimated at € 30 billion (100 basis points spread over 3 years).

[6] For example, French bank Société Générale is currently closing down its property lending business outside of France, as part of its plan to meet Basel III capital ratios requirements. This is an easy way to deleverage its balance sheet while holding on to non-commercial banking but higher margin activities. But property is a very important real economy business, providing a lot of direct and indirect jobs, contrary to securities and derivatives trading.

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commercial banking, and the prevention of widespread conflicts of interests (see below para.3).

The ten biggest listed European banks have only 36 % of their assets invested into loans. This means a spin-off or closing down of non real economy lending activities could reduce the size of these "TITF" (too important to fail) institutions by up to almost two thirds.

### 3. The development of non-commercial banking activities inside banking institutions has generated severe conflicts of interests

Allowing commercial banks to expand into non-commercial banking activities such as trading, asset management, insurance, etc. has led to very significant conflicts of interests, so-called "Chinese walls" turning out to be most often Japanese (paper) ones.

For example, listed companies often find themselves to have big banks at the same time as their credit provider and as a major shareholder, especially through shares owned by their asset management arm. Another example: quite a few packaged investment products created by asset managers who are affiliates of banks are built upon derivatives contracted with the parent bank's trading department. Another example is asset management companies manufacturing synthetic ETFs and swapping all subscriptions' proceeds with the parent bank[7].

European banks own many of the major European asset management companies and – at the same time – are their main distributors. The same applies to a lesser extent to bank-owned insurance companies. This - not client interest - best explains for example the recent shift in saving flows in France from life insurance products to bank term deposits.

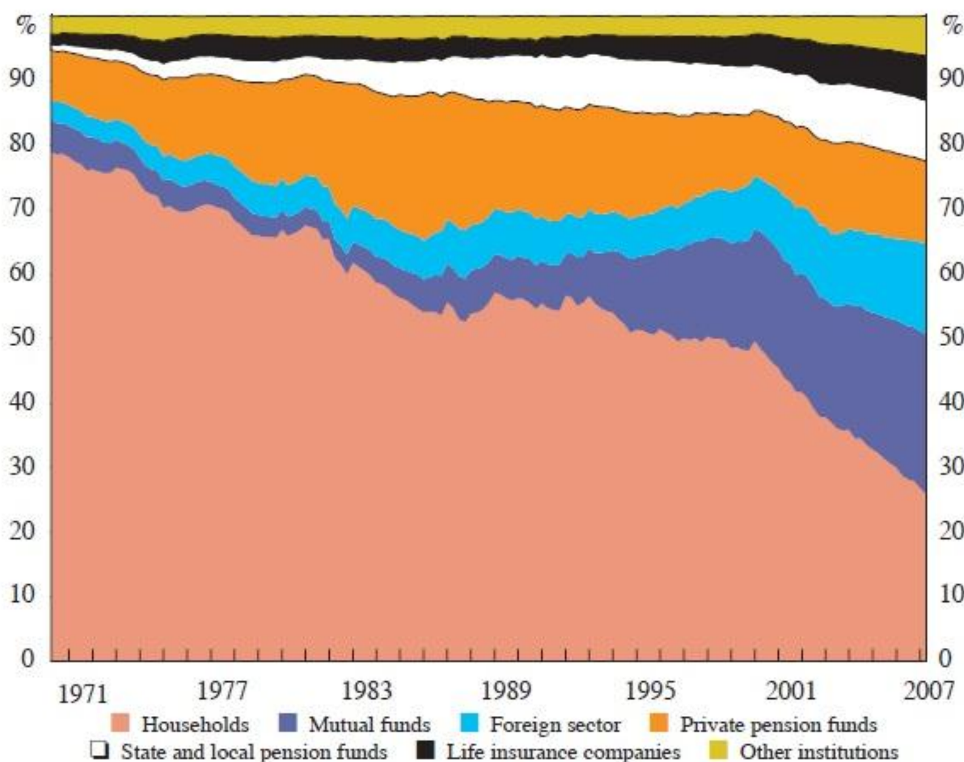
### 4. The severe drawbacks of the "re-intermediation" of capital markets by banking institutions

Also, this expansion of commercial banks into other businesses has led to the re-intermediation of capital markets (equities and bonds markets), crowding out end investors. Individual ones in particular, pushed by banks toward highly commissioned "packaged" investment products and away from securities in the recent decades, as the graph below shows[8]:

[7] See the ESMA Securities & Markets Stakeholder Group Advice on ETFs and other UCITS issues, November 2011.

[8] US case. Comparable data currently unavailable for the EU, but the trends are most probably even more accentuated. FSUG (see note 4) has asked the Commission for a research project to get these critically important data for EU financial policy making, as one can properly manage only what one can measure.

**Figure 11: Ownership of US Corporate Equities**
As a per cent of total holdings at market value



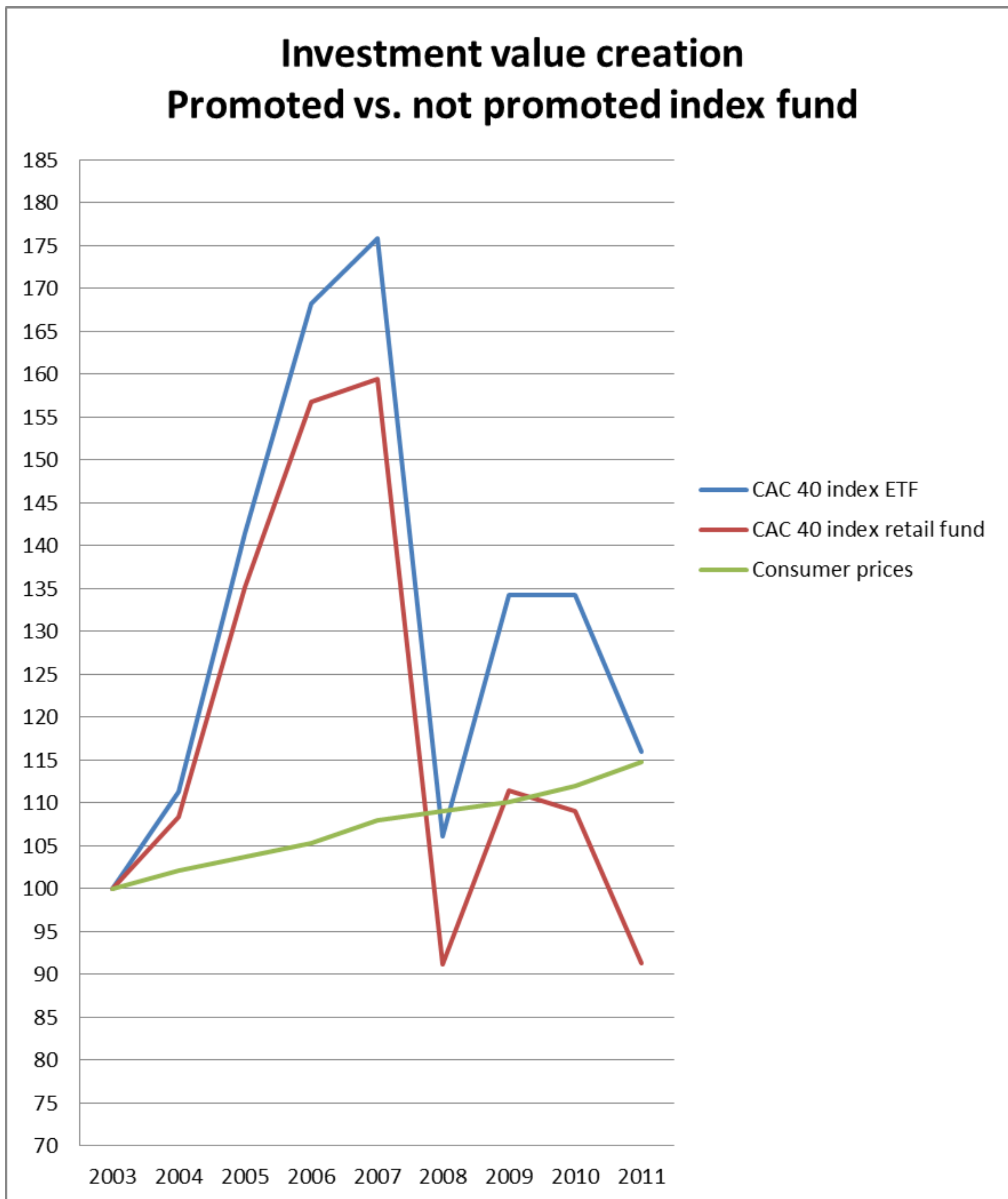

Source: Board of Governors of the Federal Reserve System

What we designate as the reintermediation of capital markets by banks has two severe drawbacks:

- It is severing the link between economic owners of listed companies and their management, transferring voting rights (i.e. power) to institutions that do not have their interests aligned with economic owners (end investors, pension savers, etc.). Indeed, many major European asset management companies belong to banks or insurance companies, and the dominant “PRIPs”[9] distributors are banks and insurers. Their main interest is in the commissions received, and the average turnover rate of long equity funds in Europe (excluding index ones) is around 100%, i.e. they “own” shares” for less than a year on average. This is more than an economic issue, it is political: the European economy is more and more owned legally by institutions who do not behave as real, responsible and long term owners, creating the “ownerless” corporations.

[9] PRIPs: EC acronym for “packaged Retail Investment Products”

- It is partly responsible for a severe conflict of interest of distributors of savings and investment products (mostly banks again), which have been promoting highly commissioned products instead of capital market ones in the last decades. The result can be devastating as this simple and real case shows how the real value (net of inflation, i.e. monetary illusion) of pension savings is being destroyed by commissions[10]:




[10] In that case (CAC 40 is the French big cap equity index) 25% savings value destruction in only eight years entirely due to the bank intermediary's commissions. Source: EuroFinuse research published in Eurofinuse response to the European Commission's Green Paper on Pensions, 2010.

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It is even worse in most big banks which sell only "in-house" savings products to their customers[11]. The separation of non-commercial banking activities – especially securities trading and asset management - would certainly help building a real "Chinese wall" between those activities and better protect savers, especially pension savers, by at least forcing "universal" banks to an arm's length relationship with asset management firms.

Contrary to some assertions heard this separation would more likely increase competition in commercial banking and improve value for services. Today the spreads of credit to households and businesses are a record high and are not competitive. The much increased focus on the core business and increased transparency will force commercial banks to become more competitive and efficient to the benefit of real economy customers. This may imply a return of banking personnel remuneration packages to the average one, but is that really an issue for the whole economy and society?

## 5. Solutions

- Increasing capital ratios is not the core solution for three reasons:
    - 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 also 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 too much overlooked by Regulators lately. For example, banks weigh close to 15 % of the STOXX Europe 50 equity index[12] , way up from decades ago (and above 18 % if you add insurance companies, which include such "bank-insurance" companies such as ING). And this is 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[13]. 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.

[11] There are cases where the 100% affiliate asset management company pays 90 % of its commissions back to the parent bank.
[12] See Stoxx Europe 50 fact sheet: http://www.stoxx.com/download/indices/factsheets/sx5p_fs.pdf
[13] See for example Eurosharehoiders press release on the Dexia 2011 collapse.

- <u>The core solution: ensure central banking funds are used only for commercial banking activities is</u>.
  The most adequate way to ensure that is by "ring-fencing" commercial banking activities from all other activities of the same banking group. In turn, the most adequate way to do that is to spin-off these other activities, which is – contrary to what some interested parties would claim – quite easy to do. For example, the recent unexpected and huge 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 to commercial banks must be very strictly limited to actual commercial banking risks in the banks' balance sheets.

- <u>Other measures</u> should be considered as well to further reduce systemic risk and therefore save taxpayers' and non-insider investors' money:
  such as:
  - central banks lending only to institutions that 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 being much more transparent 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 of course, to control 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.

We again welcome the opportunity to provide our analyses to the High Level Group to be able to explain why the separation of non-commercial banking activities is so crucial for the sake of the European economy and of the European civil society.

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