Answer to the public consultation from the European Commission on the Liikanen report

Response by Finance Watch

13 November 2012

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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INTRODUCTION

The High-Level Expert Group (HLEG) on reforming the structure of the EU banking structure was given the mission to “consider whether there is a need for structural reforms of the EU banking sector or not, with the objective of establishing a stable and efficient banking system serving the needs of citizens, the economy and the internal market”.

The report of the HLEG provides a thorough, precise and far reaching analysis of the issues and challenges facing the European banking system. It highlights in particular the current moral hazard situation and its negative consequences on economic competition and on society, and insists on the limits of the so-called universal banking model.

Answering the question raised by the European Commission, the HLEG clearly states that there is a need for further structural regulation, a conclusion we fully support.

However, when it comes to the proposal itself we believe it does not go as far as the diagnosis could have suggested.

A detailed position of Finance Watch on the proposal from the HLEG is provided in the third part of the present document. The first part gives evidence to support the case for a regulation of banking structure, whereas the second one provides answers to the arguments against a split of banking activities.

1. WHY A REGULATION ON BANKING STRUCTURE IS NEEDED

“Any institution that has the benefits of a commercial bank — including the government’s safety nets — has to be severely restricted in its ability to take on risk. There are simply too many conflicts of interest and too many problems to allow commingling of the activities of commercial and investment banks.”[1]

A. Moral hazard and its consequences need to be addressed

Large universal banks are often defined as “too big to fail”. This means that a government would not let them fail because of the fear of the impact of such a failure on the economy:

- Vital economic functions are at stake, namely safety of deposits, payment systems, and credit provision;
- The failure of a large universal bank, because it is interconnected with the whole banking system (e.g. through interbank lending and other sources of wholesale funding), could lead to the failure of other banks.

[1] quote from Joseph Stiglitz

The HLEG report clearly identifies moral hazard and its deterrent impact on banking models, on the economy and on taxpayers' money.[2]

The implicit guarantee from the State provides large universal banks with a clear advantage: markets fund them at a rate significantly lower than the rate at which they would be willing to lend to them absent the implicit public backing. Credit Rating Agencies take this implicit backing into account when assessing credit worthiness of banks: as the HLEG report puts it, "the implicit support is, amongst others, evident from the credit ratings of banks, which typically involve a 'stand-alone rating' and a (higher) 'support rating'. Whereas the former assesses the bank's creditworthiness by looking at the net cash flow generation of the business activities as such, the latter takes into account the extent to which the bank implicitly enjoys backing from the state."

A bank benefiting from implicit state backing can take significantly higher risks, at a lower cost: this is what is described as moral hazard.

Moral hazard has a number of consequences:

- *It leads to competitive distortions*: large universal banks, thanks to implicit public backing, benefit from a competitive advantage thanks to the cheaper funding they can access on the financial markets;
- *It distorts the very nature of banking activities*: moral hazard has the effect of distorting the nature of banking activity away from economically useful activities, thereby reducing the propensity of the banking system to serve the needs of the real economy.
- *It encourages excessive risk-taking*: markets permit banks to take risks greater than what they would otherwise be permitted to take thanks to cheaper funding. This leads to excessive risk-taking.
- *Taxpayers money is put at risk:* taxpayers bear the risk of having to bail-out defaulting banks (thereby creating a situation where banks' profits remain private but banks' losses are socialized).

These implications have been experienced throughout the crisis, and led to the sizeable bail-outs that are comprehensively reported in the HLEG report, and which had such terrible consequences on public finances. To avoid the repetition of such a scenario requires putting an **end to moral hazard in the banking sector**.

B. Commercial banking and Investment banking are different by nature

A distinction can be made between two banking activities, which play radically different functions in our economy:

- *Credit:* through lending, banks (credit institutions) are at the centre of a process that is indispensable to economic activity, providing essential credit to the economy and thereby creating money.
- *Investment:* when a bank trades, negotiates or deals in financial (and sometimes physical) assets, it does (or should do) so by using an existing stock of money.

[2] HLEG report, page 23

Commercial banking's major function is to provide credit (and thereby to create money), but it is also about two other functions that are vital to our economy: payments systems and safekeeping of savings. Investment banking on the other hand is about trading, negotiating and dealing assets. These functions are important to our economy: investment banks play the role of market makers and intermediaries in financial markets which makes them (or should make them) important players in the allocation of savings to enterprises and as providers of risk management solutions.

The economic model for each of these activities is fundamentally different too. In a recently released report from the IMF[3], the following descriptions are provided:

- *(Commercial) banking* is relationship-based, not scalable, long-term oriented, with high implicit capital, and low risk thanks to the law of large numbers.
- *Trading (Investment banking)* is transactions-based, scalable, short-term, capital constrained, and with the ability to generate risk from concentrated positions.

Based on these descriptions, one could question the rationale for a commercial bank to engage in trading. The same IMF report gives evidence that the objective is to use 'spare capital' (put otherwise: to "take advantage of the balance sheet of the bank") in order to improve the profitability by means of increased trading activities.

On the asset side, combining both activities encourages the creation of asset bubbles

By having commercial banking and investment "under the same roof" (so-called universal bank concept), the money creation process inherent to commercial banking enables the development of investment banking and has the natural consequence of having **amounts of newly created money feeding investment banking activities. One potential consequence is the creation of asset bubbles, as experienced in the current crisis.**

Behind the idea of separating commercial banking from investment banking activities, it is often said that deposits must be protected from the risks inherent to trading. This is true. But it is only a partial explanation of the reason why there must be a strict separation between deposits and trading activities.

The HLEG observes that "cheap credit and free capital flows contributed to the build-up of imbalances in the euro area and helped fuel the boom-and-bust cycles observed in several Member States."[4] We would even go further: 95-97% of the money created in deposits in the banking system comes from loans and is therefore money created by the private banking system. By allowing trading to take place in an entity taking deposits, regulators allow de facto money creation to feed trading activity, which can, amongst other things, have the consequence of feeding asset bubbles.

The relationship between deposits and trading must therefore be looked at from both angles: deposits must be protected from risky trading activity but, as importantly, trading must be protected from being fed by deposits, which by nature come from credit, as this has **the consequence of inflating trading beyond what makes economic sense for society,** leading to an **over-development of trading and the creation of asset bubbles**.

[3] Banking and Trading, IMF working paper, October 2012
[4] HLEG report, page 32

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On the liability side, combining both activities impacts the quality and volatility of funding

The process described above is further fuelled by an additional funding benefit that investment banks can gain from being combined with commercial banks. As noted previously, commercial banks typically enjoy a relatively stable deposit base, while investment banks are typically funded with potentially more volatile market based funding. As the HLEG report states[5]: "The expansion of trading activities has been fuelled by funding benefits for those activities within integrated banking groups ("intra-group subsidies"). Integrated banking groups benefit from access to intra-group deposit funding that is relatively stable, long in duration, less risk sensitive and explicitly guaranteed. Moreover banks issuing debt to fund investment bank activities pay a blended interest rate, as bank investors take into account the non-investment bank part of the bank (e.g. deposit funding). In both cases, **the risks inherent in the integrated banks' trading activities are not fully priced into their funding costs in normal times**, thereby increasing the incentives for excessive trading risks."

Putting commercial banking and investment banking under the same roof leads to **a distortion of the funding structure in favour of wholesale funding**, thereby **increasing the exposure of the commercial bank to systemic liquidity risk.** Indeed, whereas a pure commercial bank marginally needs wholesale funding, trading activities require much higher amounts of wholesale funding: on average, large European universal banks need €18 of wholesale funding for each €100 in deposits in order to finance their loan book; in comparison, their trading book amounts on average to €77, hence a need for a total of €95 of wholesale funding instead of just €18[6]. The commercial banking activity requires that 15% of funding comes from the wholesale market, whereas combined activities bring this share up to close to 50%, hence an increased dependence on wholesale funding.

These imbalances can rapidly create solvency problems: mark-to-market accounting implies quick changes in asset prices; in times of stress, a tightening in market liquidity can therefore rapidly translate into changes in the banks' equity base, and a fear of solvency problems within a bank can itself quickly lead to a cut of its access to wholesale funding.

The liquidity and solvency of financial institutions are therefore strongly interconnected. It follows that solvency problems cannot be anymore interpreted as being exclusively due to the asset side but also, in universal banks, to the liability side, where the vulnerability of the investment bank funding contaminates the commercial bank.

C. Banking Union and Recovery & Resolution Framework need resolvable banks to be efficient

If implemented without a fundamental change in EU banking structure, Banking Union will only reinforce the moral hazard situation of the EU banking system and its worst negative consequences (i.e. putting taxpayers at risk and reinforcing the trend of very large banks to serve less and less the real economy – witness the fact that only 28% of EU banks' balance sheets are

[5] See HLEG report, p.90
[6] This illustrative example is based on data from the HLEG report, page 127, on the top 30 banks (total assets, share of net loans to customers, share of assets held for trading).

dedicated to lending). Capital and liquidity pooling mechanisms[7] included in the Banking Union and RRF proposals have the effect of moving moral hazard from the national to the European level.

Implementing an **efficient resolution mechanism** is a key to developing a properly functioning Banking Union in the EU. As evidenced by the US experience which has in place an efficient bank resolution mechanism, resolving small to medium size banks is an achievable objective. However, it is highly doubtful that very large complex banks can be resolved easily.

With the Banking Act of 1933 (also known as Glass-Steagall act), the United States had built a framework for their banking system, based on three pillars:

1. The creation of a federal deposit insurance (FDIC)
2. The creation of a single federal supervisor (the same FDIC), assorted with the necessary powers to deal with the management of banks' failures
3. The separation of investment banks and deposit banks

This framework evolved through the years. The major change[8] came in 1999 when the drop of the mandatory separation of investment banks and deposit banks led to the development of giant financial institutions.

Until the failure of Washington Mutual in 2008, the FDIC successfully dealt with failures of US banks: smaller and less complex, US banks were resolvable.

Washington Mutual was the biggest failure the FDIC had to deal with in its 75 years history, and for the first time, FDIC was unable to resolve a bank without costing tax-payers money.

Washington Mutual had a balance sheet of about USD 300 Bn, which is only about 10% of the largest European banking group, and had a much simpler structure than most European universal banks. It is therefore difficult to believe that the EU, with a bank resolution mechanism that encounters some intrinsic difficulties that the US does not have (including lack of fiscal backstop and the fact that, contrary to the US situation, there will not be any possibility for a "European Treasury" to lend money to the resolution authority) will be able to resolve the largest and most complex EU banks, when the long-experienced and successful US authorities could not in a much smaller and simpler case.

An approximate estimation can give a rough idea of how a European resolution fund would appear in comparison to the large European banks. These estimates are illustrative.

[7] Capital pooling refers to rules that will apply to European banking groups and their subsidiaries under the Single supervision mechanism included in the Banking Union project. Liquidity pooling mechanism refers to the project making it mandatory for national deposit guarantee funds and national resolution funds to lend to other funds of EU member states upon demand.

[8] Another major change had occurred in 1991 with the introduction of the FDIC improvement Act that imposed the prompt corrective action (PCA) policy and the least cost resolution principle. Such device proved to be efficient as long as separation was in place. PCA has a triple merit: being partly automatic, it avoids the pressure of bank lobbies; being progressive, it addresses the deterioration in banks' balance sheets early enough to avoid involving the taxpayer most of the time; using simple tools, it is transparent and shielded from the bad faith of the supervisees.

* Based on EU impact assessment for DGS, covered deposits represent on average 1/3 of total deposits in the EU[9];
* Total deposits of EU banks amounted to €15 Tn end 2011, covered deposits might therefore be around € 5 Tn;
* If a resolution fund achieved to reach 1% of covered deposits in a 10 year-period of time, this fund should amount to ~€ 50 Bn in 10 years;
* This amount is to be compared with the average balance sheet of EU large banks (30 top banks) which is more than € 800 Bn, i.e. 16 times more, today. The multiple for EU top 15 banks (average balance sheet of €1.300 Bn) is of 26;

At the time of Washington Mutual's failure, the FDIC fund amounted to USD 45 Bn. Washington Mutual was just 7 times bigger, with about USD 300 Bn in assets. In addition to the fund, the FDIC has the possibility to borrow from the US Treasury. This would not be made possible at European level, given our institutions and the absence of an EU Treasury.

We agree with the economic advisor to the BIS who said: "The system should be able to manage the failure of any single institution. […] The right to succeed must be accompanied by the opportunity to fail."[10] We need to put in place a framework that allows banks to fail and resolvable banks are a key part of such a framework.

A **Banking Union and a Bank Recovery and Resolution mechanism** therefore need an adequate banking structure to be put in place beforehand.

The HLEG report itself acknowledges the need for strong governance and institutional frameworks in order to make a Banking Union work, stating that, in the absence of such frameworks, financial stability risks are created :"While there were clear excesses, it does not follow that there is a necessarily a trade-off between financial stability and integration. Rather, what it does show is that there were shortcomings in the institutional frameworks to support the Single Market - that is, financial integration was not matched by adequate regulatory and supervisory institutions and the required economic governance frameworks."

Finance Watch's view is that banks need to be simpler in structure, smaller and less entangled if we want them to be "resolvable". In other words, a Banking Union, a Bank Recovery and Resolution mechanism and a reform of banking structures need to be implemented in parallel. The sole implementation of a Banking Union without a simultaneous reform of banking structure would not only risk missing the stated objective of breaking the vicious circle between banks and sovereigns but could increase the negative consequences of the moral hazard situation currently prevailing in the banking sector.

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[9] Impact assessement from the European Commission on Deposit Guarantee Schemes, 2010, p.103 http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm

[10] "The future of financial intermediation and regulation", Stephen Cecchetti, Economic Adviser at the Bank for International Settlements (BIS) and Head of its Monetary and Economic Department, 30 October 2012

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2. WHY THE ARGUMENTS AGAINST A SEPARATION OF ACTIVITIES DO NOT OUTDO THE BENEFITS

A. About the universal banking model

Economies of scale and economies of scope in banking do not exist beyond a size of around € 100 Bn. This statement was previously evidenced in Finance Watch's response to the Liikanen consultation in June 2012.[11]

The comparison that is being made in the HLEG report between profitability ratios of small, medium and large EU banks provides further evidence, showing that larger banks do not perform better than smaller banks, be it in terms of RoA, RoE or 5-year market returns.[12]

Another observation made by the HLEG report is that the smaller the banks, the higher price to book ratios tend to be. This observation is interestingly confirmed by a recent analysis[13] which makes the comparison between the evolution of US and UK banks' price to book a few years before and after 1929 and 2007. In both cases, price to book reached a low in the years after the crash, with a market price below book value after two years, and remaining below book value after five years. For investors, this implies that breaking those banks into parts would bring more value than selling them at market price. It therefore starts to become attractive for investors to call for a separation of those banks, and in fact numerous senior bankers have called for a separation[14].

The one stop shop concept put forward by proponents of the universal bank concept does not hold: the theory goes that clients would want the same bank to be able to deliver on the entire range of commercial banking and investment banking products. This is not true.

- Clients have no problem going to two different banks to purchase two different services, something that they do anyway today when they organise competition between the banks serving them.

- In fact, when a corporation is looking for a given service (e.g. a loan) and then for another service (e.g. a currency swap to support trade operations), the people involved will very often be different, possibly on the corporation's side and almost certainly on the bank's side where the corporation will typically deal with two different departments of the bank. Large banking groups are struggling to create synergies between business lines and to further develop cross-selling, and this is partly because clients lack a single point of contact for a broad range of services. In these cases splitting activities will not be an issue for bank clients.

[11] See Finance Watch's answer to the Liikanen consultation, June 2012, http://www.finance-watch.org/2012/06/finance-watch-response-to-liikanen-consultation/
[12] HLEG report, page 128 Charts, A3.1, A3.2 and A3.4,
[13] "The dog and the Frisbee", chart 20, page 36, Andrew G. Haldane, 2012
[14] See Finance Watch's list of senior bankers calling for a separation of banking activities: http://www.finance-watch.org/2012/07/who-are-the-senior-bankers-calling-for-separation/

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- Banks themselves provide third-party services (e.g. in the wealth management industry, clients are able to buy funds and other investment products from a number of financial institutions thanks to so-called “open-architecture” models).

- The US experience between 1933 and 1999 (the period during which commercial banks and investment banks were separated in the US) demonstrates, if needed be, that clients, including very large corporate clients, have no problem going to a commercial bank to purchase a service (e.g. a loan) and going to an investment bank to purchase another service.

Finally, a separation will have the benefits of showing the real **economic value and risks** of each activity.

B. Will it be the end of European investment banking?

Separating commercial banks from investment banks implies no judgment on the relative value of the two different businesses but is just a reflection of the fact that they are of a different nature, have different economic consequences and entail different types of risk.

The separation of commercial banking and investment banking activities will not prevent the latter from operating, witness the development of a very dynamic investment banking sector in the US until 1999. If anything, the US experience of separation shows that there is no reason why separating trading activities from lending activities should have any impact on the trading capacities of investment banks (if we judge from the US experience, quite the opposite is actually true with the biggest investment banks in the world having developed under strict separation from commercial banking activities).

In any case, investment banking and the possibility to buy and sell securities remains; there is, therefore, no reason why those activities would be hampered by a separation.

C. Will the cost of banking services for corporates and sovereigns rise inevitably?

No, the cost of banking services for corporates and sovereigns will not rise inevitably. The objective of a regulation on banking structure is to build a resilient banking system, in the long run. In as much as this reduces the risks to banks this could decrease bank funding costs. Indeed, the cost of funding of a bank is a direct function of the risks taken on the asset side. As importantly, an increase in bank diversity could increase competition amongst banks, both of which effects would tend to reduce rather than increase the cost of banking services. Moreover in as much as universal banks fund at a blended rate, separation may reduce the cost to (ring-fenced) commercial banking customers.

Additionally, as put in the HLEG report, if there were to be a cost, “to the extent that part of the funding cost increase is due to the removal of an implicit subsidy, this may not present a social cost”.

D. Will it endanger European economy's competitiveness?

In a working paper released recently, the Bank for International Settlements has analysed how finance impacts the growth of the economy.[15] It comes to the conclusion that above a certain size, too big a financial system has a deterrent impact on growth and on the economy. Their conclusion is twofold: "First, financial sector size has an inverted U-shaped effect on productivity growth. That is, there comes a point where further enlargement of the financial system can reduce real growth. Second, financial sector growth is found to be a drag on productivity growth. Our interpretation is that because the financial sector competes with the rest of the economy for scarce resources, financial booms are not, in general, growth-enhancing. This evidence, together with recent experience during the financial crisis, leads us to conclude that there is a pressing need to reassess the relationship of finance and real growth in modern economic systems. More finance is definitely not always better." If we follow BIS reasoning, then if the separation of trading activities from other banking activities were to lead to a reduction in size of the banking sector in the EU, this would constitute a positive factor for European economic development.

We would add to this that, as reported by the HLEG, the total size of banks almost doubled in the 2000s[16], whereas on average 28% of the balance sheet of banks is today dedicated to loans (to households and companies, to the exclusion of financial institutions).

E. Will it put an end to the European banking sector's diversity?

How diversified is the European banking system today?

Briefly put, the diversity of the European banking system is greatly reduced by the domination of a small number of very large and complex banks which operate the same business models. As has been seen, these banks would be extremely difficult to resolve in crisis and attract unfair advantages relative to the more diverse range of smaller institutions.

The European banking landscape, composed of more than 8000 financial institutions, is largely dominated by a very limited number of banks[17]:

- The **top 15 European banks** represent close to **€ 20 Trillion in assets**. This is **more than 43%** of total assets of the European banking sector.
- Among these 15 banks, 14 are G-SIBs (Globally Systemically Important Bank)
- All of these banks are deposit banks. They also conduct investment banking and trading activities and can therefore be identified as universal banks.
- The total balance sheet of the top 15 European banks is about 1.5 times the EU27 Gross Domestic Product (GDP)[18].
- Each of these banks has more than € 600 Bn - and on average €1.300 Bn - in assets.

[15] BIS Working Paper, Stephen G Cecchetti and Enisse Kharroubi, "Reassessing the impact of finance on growth", July 2012
[16] See HLEG report, p. 12
[17] Source : HLEG report
[18] Eurostat, EU27 GDP 2011 : € 12.6 Trillons

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Given their importance and size, and given the public subsidy they implicitly benefit from thanks to their large deposit base, the largest European banks represent a risk for the diversity of the European banking system: implicit public backing gives them access to cheaper funding than smaller or more specialized players[19], therefore distorting competition. A clear advantage is given to the large-scale universal banking model.

Not only those large universal banks dominate the market and distort competition, but they are identified as of systemic importance at a global scale. This raises the question of the potential impact of a failure of such banks on financial and economic stability in Europe given the probable inability of a European recovery and resolution framework to deal with such a huge failure. Our banking system cannot be considered as sustainable if just one bank can endanger the whole system, and regulation is here to protect citizens in the case of extreme circumstances. We must therefore make sure that the framework we are building makes such a protection possible.

The HLEG report quotes a number of researches that have been conducted on the diversity of the banking system[20]. Those researches lead to the conclusion that **there is a decline in diversity due to the convergence of business models of large financial institutions**[21]. In particularly, it is evidenced that large financial institutions have become similar to each other, replicating similar risk exposures (especially through similar trading strategies)[22], which amplifies the impact of shocks.

What we can learn from the US experience about the benefits of separated activities

The Glass-Steagall Act (§ 16, 20, 21, 32 of the Banking Act of 1933) limited the ability of commercial banks, which take deposits from the public, from engaging in certain kinds of financial trades and transactions undertaken by investment banks. In essence, this statute provided greater security to banking deposits in commercial banks. Additionally, investment banks were only able to leverage their own funds, limiting the systemic risks of citizens.

By forcing the legal separation of investment and commercial banks, the law prevented commercial banks from engaging in investment banking activities that could endanger deposits, selling underwritten securities onto bank customers and making loans to companies in which the bank had invested. Under the Act, securities firms actually enjoyed some benefits as they had a large part of their competition banned: as a result, between 1933 and 1999, the US witnessed a strong development of securities markets. The separation between commercial and investment banking deprived investment banks from an access to cheap funds (in the form of deposits) forcing them to limit their size and the size of their bets**. These limitations increased the number of market participants, making markets more liquid.**

What we can learn from past crisis about the benefits of separated activities

Separating banks that accept deposits from those that underwrite and trade securities can minimize moral hazard and facilitate regulatory oversight. Banking regulators were charged with ensuring the stability of commercial banks by minimizing risk and monitoring the soundness of their lending standards.

[19] E.g. small/medium-sized investment banks do not benefit from as cheap a funding as larger players with a strong deposit base. Their profitability is therefore impacted by the price of their funding. See first part of the present report.
[20] HLEG report, Box 3.1, page 34
[21] See also Finance Watch's report "To end all crisis", p. 25, about asset uniformity.
[22] Charles A.E. Goodhart, Wolf Wagner, "Regulators should encourage more diversity in the financial system", 12 April 2012

The separation between investment and commercial banking helps make the financial system more resilient. After the 1987 stock market crash, the economy was relatively unaffected because commercial banks were little impacted by decreasing equity prices. During the 1990-91 banking crisis, securities markets helped decrease the credit crunch because they were unaffected by the banking crisis. By contrast, in 2008 the banking crisis and the stock market crisis infected each other, pulling down the entire economy.

3. FINANCE WATCH POSITION ON THE HLEG's PROPOSALS

The analysis provided by the HLEG is thorough, precise and far reaching. In particular:

- It analyses precisely the current moral hazard situation and its negative consequences on society;
- It highlights the fact that EU's largest banks are too large and too complex for the good of society;
- It shows that economies of scale and scope in banking are missing beyond a size between 5% and 10% of the current size of EU's largest banks;
- It also analyses very lucidly the existence and the consequences of the funding subsidy extracted by the largest banks from society.

Given this analysis, the HLEG proposals can be qualified as minimal. In particular, it can be argued that its proposal to separate trading activities above a threshold of 15% - 25 % whilst preserving the universal banking model is not fully coherent with its preliminary analysis and suffers from the weaknesses described underneath.

In the face of those weaknesses, the HLEG proposals have the merit of showing a direction that makes sense and that starts addressing the most fundamental issues of the EU banking sector.

Given what is at stake and given the analysis made by the HLEG on the reform of banking structure, any reform less ambitious than the one proposed by the HLEG would be economically meaningless and would not start addressing the most fundamental problems of the European banking system. The following provides the more detailed position of Finance Watch on the set of proposals made by the HLEG.

A. About the separation of activities under a same roof

Too many risks remain if the separated activities are kept within the same financial group

- *Risks of funding leakages*

  If the trading entity and the insured-deposit entity remain under the same roof (same ownership, same board), then risks of leakages remain. As stated in the HLEG report (p.viii), "The significant risks of the separated or stand-alone trading entities warrant a robust capital rules to control the risk posed to the parent group and financial system as a whole." In other words, unless much stronger requirements are made of the trading entity, the holding company – and therefore the financial group as a whole – will be at risk. We see a high risk that under stressed circumstances, the owners of a financial group will use funding resources available in the group (e.g. from the deposit bank) if it is the way to avoid a failure of the trading entity and therefore of the entire group.

- *Reputational damages*

  Without a strict separation (with different trademarks and shareholdings), the insured-deposit entity could suffer from reputational damages coming from the trading entity; any major loss or other issue that could question the solidity of a given financial group, even if it is related to the trading entity, could lead to a bank run, and therefore put at risk the deposit taking entity.

The proposed threshold for a split is too high

The proposal to separate trading activities above a threshold of 15% - 25 % (even if combined with a €100 Bn threshold) whilst preserving the universal banking model is not fully coherent with the HLEG preliminary analysis. Both the range and the threshold are very high and seem to leave the vast majority of EU banks outside of the scope of the proposed reform. On average, large banks (30 top banks as identified in the HLEG report) have 25% of their assets held for trading. The impact, in our view, would be too limited.

We propose a 5% threshold, with the objective to significantly impact the structure of the European banking system, having in mind the objective to tackle moral hazard, the consequences of keeping, under a same roof, activities of a radically different nature and the necessity of building a workable resolution and recovery framework.

With regard to the HLEG's recommendation not to apply the mandatory split to "the smallest banks", we do not see any obvious rationale behind this. In addition, there could be some legal implications to such a distinction. If anything, such an approach would require a clear definition of which banks should be understood as "the smallest banks".

The list of activities that must be put in the trading entity can be extended

We generally agree with the proposed list of activities that must be separated into the trading entity. In particular, we strongly support a separation of lending to financial institutions (including hedge funds and prime brokerage for hedge funds).

The separation of trading activities as proposed by the HLEG, between market making and proprietary trading on the one hand (secondary market in the trading entity), and of securities underwriting on the other hand (primary market in the deposit-taking entity) is, by contrast, not the right one. Indeed, primary market teams need to work with secondary market teams to price, distribute and trade primary market operations. This has the implication that separating primary and secondary market operations is not functional. We would therefore recommend that both primary market and secondary market activities be gathered in the trading entity.

B. About an enhanced role of the resolution authority

Finance Watch is supportive of the HLEG in its proposal to strengthen the RRF proposal. However, we believe that only an appropriate banking structure will allow a proper functioning of the framework, in the long term.

- An efficient recovery and resolution framework and a powerful resolution authority are key components of a banking supervision framework. However, its success is highly dependent on the resolvability of the banks that are being supervised, as evidenced by the US experience[23].
- The concentration of the European banking industry raises concern in this respect. We therefore believe that a resolution and recovery framework, together with a single supervision, will only be effective and efficient if banks become simpler and smaller.

C. About the recommendation related to bail-in bonds

The bail-in-able bonds regime is the central articulation of the recovery and resolution framework currently being discussed at European level. We believe its success is highly dependent on banking structure.

We welcome the fact that this mechanism will make bank creditors bear the cost of potential losses as well as profit from the benefit of potential gains. However its effectiveness and success will depend on a number of factors, including if a bail-in-able bonds market actually exists, and if so, whether it is of a sufficient size: bail-in-able bonds must not only see their existence recognized from a legal stand point but, must also be issued by banks (and therefore bought by investors) in sufficient quantity to make them a meaningful tool.

We therefore believe that bail-in-able bonds can be an essential part of the solution to put an end to moral hazard and to the doom-loop between banks and sovereigns, however, we would above all warn against the danger of implementing a “paper solution” that never leads to sufficient real world issuance of the relevant bail-in-able bonds and recommend also (1) that banks be made less risky, and (2) that sufficient capital is required in order to absorb losses, as suggested in our previous recommendations related to capital requirements[24].

D. About the recommendations related to the review of capital requirements on trading assets and real estate related loans

The HLEG acknowledges the weaknesses in the capital requirements imposed on banks, especially those engaged in trading activities.

In line with our previous recommendations related to CRD IV[25], we would go for stricter recommendations, combining an increase in total capital requirements, an absolute leverage

[23] See point 1.C. for further detail.
[24] See Finance Watch position paper on CRD IV “To end all crises”, April 2012
[25] Among others; for further details, see Finance Watch position paper on CRD IV, “To end all crisis”, April 2012

ratio, the removal of any zero-risk weight, and the introduction of a residual risk weight requirement for transferred exposures.

E. About the measures to strengthen corporate governance

Finance Watch is supportive of the HLEG proposal to strengthen the governance and control of banks. We however believe that such a control will be made even more efficient with an appropriate regulation of banking structure.

We must make sure that the banks themselves are resolvable (cf size, complexity), and question whether there is a market for bail-in bonds.

About remuneration (incl. the use of bail-inable bonds to pay bonuses)

"In 1980, an investment banker was paid roughly the same as a similarly-skilled professional in any other industry. By 2007, they were earning nearly four times as much."[26]

"Those salary differences were particularly pronounced at the top of the pyramid. In 1989, the CEOs of the largest US banks earned 100 times the median US household income. That is quite a gap. Yet by 2007, that multiple had risen to 500. A similar gap emerged for UK and European bank CEOs."[27]

Responsible risk taking needs appropriate rewards. A new international approach to pay and bonus structures (including bail-in-able bonds) should be agreed.

About governance

The HLEG suggests that board and executives be properly chosen in order to make sure they have the ability to run and monitor large and complex banks.

We support such a proposal, and add that a decrease in complexity and size will be of even greater help. Indeed, large institutions are more likely to have conflicts and be more difficult to manage effectively. The need for accountability of the management means that the boards of directors must understand and be held responsible for the risks they undertake.

About risk management

The current crisis showed that managing risk only within individual banks is not enough. There is a need for risk to be examined on a system wide basis taking into account various aspects of firms' behaviour e.g. behaviour that may lead to market bubbles. Banks need to determine their exposures to other markets and apply a more holistic approach to risk by ensuring that appropriate risk management functions and internal control mechanisms are in place.

Following BIS recommendations[28], "banks should have an effective internal control system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board". Finance Watch is supportive of these

[26] Philippon and Reshef, "Wages and Human Capital in the U.S. Financial Industry: 1909-2006", December 2008
[27] Andrew Haldane, speech, October 29th 2012
[28] Principles for enhancing corporate governance, BIS October 2010 http://www.bis.org/publ/bcbs176.pdf

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recommendations, as mentioned in past publications[29], and therefore supportive of the conclusion from the HLEG group in this regard.

However, we also believe that a simplification of banking structure will support the development of a more efficient risk management within banks.

4. CONCLUSION

This year's discussions between high-level experts from universities, the financial industry, NGOs and the media focussed on how to restore trust and responsibility in the financial system. It is also a major objective of the European Commission, as stated in a number of publications.

Finance Watch believes that those crucial issues will not be resolved by the set of regulations currently on the table (among which CRD IV, Recovery & Resolution framework, and Banking Union), unless they go hand in hand with a thorough reform of banking structure. This will be the only effective way to make banks resolvable and therefore "to break the vicious circle between banks and sovereigns". This is a core objective of the EU's current bank reforms and is essential to building a sustainable banking system.

Finance Watch believes that any reform less ambitious than the one proposed by the HLEG would be economically meaningless, making little or no impact on the current structure of the European Banking system. Additionally, among other consequences, implementing a Banking Union as currently proposed would, without reform of banking structure, actually increase the worst evils of the current EU banking system. In a context where the size of the EU banking system represents 350%[30] of EU GDP, this is not a minor consideration.

[29] See Finance Watch position in the report "To end all crises?" p.23, about CRD IV, recommendation to elevate the status and authority of risk managers

[30] Data 2010, HLEG report, p.12

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