Finance Watch

Making finance serve society

Evidence provided to the High-level Expert Group on structural reform of the E.U. banking sector at 29 March 2012 hearing

Finance Watch would like to thank the High-level Expert Group on structural reform of the E.U. banking sector to be given the opportunity to share its analysis on the fundamental topic of the structure of E.U. banking.

Looking at this issue from the point of view of customers, we will try to answer the three following questions:

1. Is the current banking structure efficient at channeling banking resources to serve the needs of banks' customers?
2. Does the current banking structure create a sufficient level of competition between banks for the benefit of their customers?
3. Does the current banking structure provide the necessary continuity on banking services that are indispensable to customers and to society?

Preliminary remarks: consequences of the "too important to fail" syndrome

The fact that large banks (often referred to as Systemically Important Financial Institutions – SIFIs) are deemed to be "too important to fail" creates moral hazard and has two consequences:

1. Markets permit them to take risks greater than what they would otherwise be permitted to take.
2. Large banks receive a funding subsidy on their wholesale funding linked to the fact that creditors are willing to lend to them at a rate significantly lower than the rate at which they would be willing to lend to them absent the implicit guarantee from the State.

Three methodologies have been used to quantify the funding subsidy derived from "too important to fail": *Kou* (2004) uses Merton's option based theory for valuing corporations, *Baker* and *McArthur* (*Center for Economic and Policy Research*, 2009) compare the cost of funding between U.S. banking institutions with assets above $ 100 billion and assets under $ 100 billion, and *Andy Haldane* (*Bank of England*, 2010 and 2011) along with *new economics foundation* (2011) use a methodology based on the difference between the credit ratings of banks on a standalone basis (no State support) and taking into account State support.

The *Bank for International Settlements* and *the International Monetary Fund* also use the credit rating based approach to quantify banks' funding subsidy, thereby making it a credible methodology. *Haldane* and *new economics foundation* arrive to very similar results using the rating based approach whilst *Kou's* option based methodology leads to much higher estimates of banks' funding subsidy and *Baker* and *McArthur* focus on U.S. banks. With a view of being conservative and of focusing on European banks, only the numbers derived from the credit rating based methodology applied to European banks are presented in the table below.

Table 1:

Estimate of the funding subsidy received by European banks in 2010

Funding subsidy	***Amount in € (2010)***
HSBC	17 228 000 000 €
RBS	15 383 000 000 €
Commerzbank	13 277 000 000 €
Crédit Agricole	12 293 000 000 €
Barclays	11 829 000 000 €
Landesbank Baden-Wurtenberg	9 653 000 000 €
Lloyds	7 646 000 000 €
BNP Paribas	6 221 000 000 €
Société Générale	5 398 000 000 €
DZ Bank	5 377 000 000 €
Deutsche Bank	3 897 000 000 €

Source: new economics foundation, 2011
"Quid Pro Quo, Redressing the privileges of the banking industry"

Note: Andy Haldane, Executive Director Financial Stability Bank of England, estimates that the average funding subsidy for the top five UK banks between 2007 and 2009 was over £ 50 billion annually ("The $ 100 billion question", 2010)

Remarks:

- ✓ The level of the funding subsidy is extremely important (sometimes equivalent or even bigger than the banks' pre-tax profits).
- ✓ There is an obvious relationship between the size of the balance sheet and the importance of the funding subsidy but other parameters like the loan to deposit ratio and the resilience of the bank on a standalone basis also have an influence (for instance, for the loan to deposit ratio: the more deposits, the less wholesale funding, the smaller the funding subsidy). This explains why some of the largest banks receive a comparatively smaller (but still far from negligible) funding subsidy.

I. Is the universal banking structure efficient at channeling banking resources to serve the needs of banks' customers?

Data

Data taken from a sample of **32 listed Europeans banks** (source: *AlphaValue* – as per spreadsheet provided) shows that at the end of 2010 the aggregate breakdown between trading assets (excluding derivatives), derivative products and loans on the balance sheets of banks was the following:

Total assets	Derivatives	Trading portfolio	Loans	Miscellaneous
22 697 521 620 494 €	3 500 257 000 000 €	6 981 752 000 000 €	9 538 961 000 000 €	2 676 551 620 494 €
100%	15%	31%	42%	12%

The same data taken for the **10 largest listed European banks** (with balance sheet totals ranging between € 929 billion and € 2.166 billion) gave the following breakdown:

Total assets	Derivatives	Trading portfolio	Loans	Miscellaneous
15 770 228 636 385 €	2 855 987 965 184 €	5 739 006 922 268 €	5 599 268 812 904 €	1 575 964 936 029 €
100%	18%	36%	36%	10%

The same data taken for the **10 smallest listed European banks** (with balance sheet totals ranging between € 83 billion and € 232 billion) gave the following breakdown:

Total assets	Derivatives	Trading portfolio	Loans	Miscellaneous
1 274 980 375 240 €	58 648 765 360 €	110 899 095 240 €	960 254 729 920 €	145 177 784 720 €
100%	5%	9%	75%	11%

Interpretation

Financial theory teaches us that there exists a relationship between risk and reward. In a "too important to fail" environment, extreme events (extreme risks) are underwritten by society at large (taxpayers) but the rewards generated by those extreme risks are kept by banks. This, as we know, is called moral hazard. This situation explains why large banks are considerably more involved in trading and derivatives activities than small banks: the larger the bank, the bigger the funding subsidy (which effectively comes down to extracting a rent from society to increase

artificially the profitability of trading and derivatives activity) and the bigger the value of the underwriting of trading risk by society (moral hazard). In a world of asymmetric risk profiles and of subsidized funding, developing highly risky trading and derivatives activities enables banks' to capture the extreme positive outcomes of those activities (hence the well documented outrageous remunerations of traders) without suffering from the extreme negative outcomes (moral hazard).

This phenomenon explains the data shown page 3: the more a bank grows in size and adopts the so-called universal banking model the more it has a tendency to move its activity toward trading and derivatives at the expense of its loan book (the loan book of the 10 smallest listed banks of our sample represents 75% of their total balance sheet whilst the loan book of the 10 largest listed banks of our sample represents only 36% of the total balance sheet).

The trend shown in the statistics presented here for listed banks only would most likely be even more pronounced if data from all European banks could be analyzed. Europe has more than 8.000 banks when the data analyzed here is only for 32 listed banks (this also means that the so-called 10 "smallest banks" of our sample still belong to the top 0.5% largest European banks).

If lending is taken as a good approximation of the ability of banks to service customers as opposed to serving themselves (proprietary trading book), data shows clearly that very large size banks and the universal banking model do not go in the direction of serving customers. Even if we take into account the fact that a fraction of trading books (whose size varies from one bank to the other) corresponds to customer facing transactions, it can safely be asserted that a very significant part of derivatives and trading transactions are done for the banks' own account (for instance, about 4% of foreign exchange transactions in the world – US $ 4 trillion per day, including derivatives – correspond to international transactions of goods and services and hedging of customers' currency risk, leaving the rest – 96% - as purely proprietary trading flows).

II. Does the current banking structure create a sufficient level of competition between banks for the benefit of their customers?

Today's banking environment and banking market structure create an uneven playing field for banks of different sizes.

This phenomenon is explained by "too important to fail" and the funding subsidy captured by large banks: put simply, the larger the bank, the bigger the benefit derived from moral hazard and the greater the distortion of competition vis à vis smaller competitors.

On the issue of distortion of competition between large banks and small banks, *IMF* Staff discussion note *"The Too-Important-to-Fail Conundrum"* published on May 29, 2011 contains some particularly important remarks (extract from pages 5 and 6):

- Despite the added risks they pose to financial stability, compared with systemically less important institutions, [SIFIs'] implicit or explicit government backing gives them a funding advantage and, therefore, a competitive advantage. […] The largest banks have been able to borrow funds at lower rates than smaller banks and that this advantage widened after the crisis.
- Given their size and importance to their domestic economies, these institutions may enjoy strong political ties and hence may be in a position to influence regulatory policies to their advantage.
- According to the Federal Deposit Insurance Corporation (FDIC), large U.S. banks with more than $100 billion in assets are now borrowing at preferential rates compared with the rest of the industry, especially since the crisis. While differences in financial strength and credit quality may play a role, existence of explicit credit rating criteria for official support suggest that TITF status is also a factor behind the funding cost gap. BIS (2010) reports, for instance, that official support in 2009 for the 50 largest banks translated on average into a three-notch upgrade of their rating, up from a two-notch upgrade in 2006. More recently, the removal in new German legislation of the protection over banks' Tier 2 bonds resulted in a downgrading of several German banks' subordinated Tier 2 debt, on the prospect that the legislation will increase the risk of losses among debt holders in the event of a failure.

The current regulatory trend towards imposing to SIFIs an additional capital charge of 2.5% seems, in that context, misguided as it will only contribute to reinforcing the "too important to fail" syndrome whilst adding very little benefit in terms of resilience of the banking system in case of a major crisis (the additional 2.5% of risk weighted assets – i.e. on average about 1% of total assets– will be of little relevance in a major financial crisis given the magnitude of the sums involved and the interconnectedness of the global banking system). By giving an official list

of banks that will under no circumstance be let down by public authorities, the so-called SIFI capital surcharge will reinforce moral hazard and distort further competition between the largest banks and their smaller competitors.

This issue of distortion of competition is very important in Europe as 17 out of the 29 SIFIs identified by the *Financial Stability Board* are European: this situation makes for a European banking market suffering from particularly important distortions of competitions between large and small banks, a situation that can only be detrimental not only to small banks but also, and perhaps more importantly, to banks' customers.

III. Does the current banking structure provide the necessary continuity on banking services that are indispensable to customers and to society?

Let us start by defining the banking services that are truly indispensable to customers and to society.

Finance Watch's view is that three categories only of banking services are indispensable at all times for society to function ("must have") when all other services are either useful but not indispensable ("nice to have") or, for some of them, economically and socially useless.

Banking services indispensable at all time to society:

a) Deposit taking
b) Payment services
c) Lending to activities contributing to GDP (i.e. lending to corporations and enterprises of all sizes – small, medium and large - from working capital requirements to long term funding)

For the avoidance of doubt, "indispensable banking services" are defined here as banking services without which society and the general economy would stop functioning immediately.

This does not mean that other banking services are not useful (many of them are) but only that the three categories of banking services given above are strictly indispensable at all times for society and the economy to operate. For instance, real estate lending or hedging of currency risk for exporting corporations (to name only two in a long list) fulfill a real economic purpose but the economy would not stop immediately if those activities were interrupted momentarily, thereby giving time for market forces to get organized to provide new solutions in case of a crisis.

In our view, the three categories of activities described here as

indispensable (deposit taking, payment services and lending to GDP producing activities) are the only ones for which it is legitimate to commit taxpayers' money to provide a guarantee. We will come back to this point.

It must be noted that this list is different from the list established by U.K's Independent Commission on Banking (ICB) report as the ICB defines indispensable lending activities as lending to SMEs and retail customers, thereby introducing a distinction on the basis of the size and legal nature of the borrower, when we propose a distinction founded on the purpose of lending.

We believe that the line of separation should not be between lending to small customers (individuals and SMEs) on the one hand and to large customers (large corporations) on the other hand but between lending to GDP producing activities and lending to non GDP producing activities (asset purchases). We also see no reason to make a distinction between lending to small and medium size enterprises and lending to large enterprises.

The safety net provided by society to banks must be limited to indispensable banking services as its extension to other services has the double negative consequence of putting taxpayers' money at risk and of distorting competition. Under the current organization of the E.U. banking system, the continuity of indispensable banking services is only achieved at the price of putting taxpayers' money at risk for non vital banking activities and of an enormous distortion of competition.

IV. Possible solutions

The mission of the High-level group is to make recommendations on reforms of E.U. banking structures that could contribute to the objective of 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.

A number of measures are already being considered to improve the resilience of banks and diminish the likelihood or the impact of banking crises. These measures are mainly:

- ✓ The implementation of Basle III (CRD IV / CRR in the E.U. context)
- ✓ Imposing a capital surcharge on SIFIs
- ✓ Designing a bank resolution mechanism and a crisis management system, including a "bail-in" regime for banks deemed "too important to fail".

As described in *Finance Watch*'s report *"To end all crises?*", implementing Basle III in the E.U will be a useful step towards a somewhat less fragile banking system but will not be sufficient on its own to stop future banking crises, not to speak about reducing moral hazard.

As already stated in this document, imposing a capital surcharge on SIFIs will actually increase moral hazard and should therefore be re-considered by policy makers.

In general, bank resolution mechanisms and living wills may be a way, in the best of cases, of making future banks defaults somewhat smoother to manage but cannot be in our view the "silver bullet" able to transform the default of a banking giant into a painless exercise that would avoid the disruption of indispensable banking services to customers. Large banks are very complex, highly interconnected institutions with a relatively limited number of business lines but a far larger number of legal entities in many different countries: these ingredients seem to make the possibility of a smooth unwinding and continuation of essential services of a failed institution sound like a dream, absent an international authority in charge of managing the resolution process (such an authority having little perspective of existing in the foreseeable future, if at all).

However, one bank resolution scheme idea makes particular sense: it is the idea of having banks issue so-called "bail-in" bonds, i.e. bonds issued by banks that could be written off or converted into equity upon the injunction of a supervisor before a bank becomes insolvent. This solution would have the merit of not only protecting tax payers but also, given the risk that would be borne by bail-in bondholders, to make banks pay for the true cost of funding of their activity. This would, in turn, put an end to the distortions of competition described in this paper and act as an incentive for banks, and in particular large banks, to refocus on their role as lenders to the economy in a balanced manner as opposed to taking huge speculative risks. Having said that, given the many difficulties of implementing a "bail-in" bond regime (mainly due to the many legal issues and the difficulty of defining bail-in triggers, not to speak about the significant additional cost of funding for banks and about the question of the very existence of a market for "bail-in" bonds), too much hope should not be founded on the possibility of seeing such a regime implemented in the foreseeable future (this, despite the strong rationale of "bail-in" bonds and despite the fact that this route should be pursued with diligence).

We present hereafter four possible technical solutions that address the issue of moral hazard in the banking sector and its negative consequences. A combination of these various solutions should probably be considered by policy-makers. Each of these solutions has its specific implementation difficulties but policy makers should not be deterred by implementation difficulties given the impasse where the banking world and society will arrive if the issue of moral hazard is not resolved.

a) Possible solution n°1:

i. *Objective:* incentivize banks to raise equity funding rather than debt funding.
ii. *Mean:* address the issue of the bank debt tax subsidy deriving from the tax deductibility of debt interest / stop the tax deductibility of debt interest for banks.
iii. *Rationale:* allowing tax deductibility of bank debt interest is a way for society to subsidize debt financing of banks when society needs effectively banks to raise more equity financing in order to reduce the likelihood of banks defaults. Moreover, by acting as an incentive for banks to raise more debt, the current banks' debt tax subsidy reinforces the negative effects of the funding subsidy linked to "too important to fail": if banks were funded with more equity and less debt, the distortion of competition between large and small banks linked to the funding subsidy would be mechanically reduced as the funding subsidy would apply to a smaller amount of debt. This is crucial and can be addressed easily.

b) Possible solution n°2:

i. *Objective:* limit the size of banks in order to make a default possible.
ii. *Mean:* put a cap (probably in a range between € 100 billion and € 200 billion) on the size of assets that a bank can hold.
iii. *Rationale:* two issues must be looked at in a discussion about the possibility of capping banks' sizes: 1) moral hazard and 2) the ability of banks to serve the needs of their customers and compete effectively. As far as moral hazard is concerned, capping banks' sizes is one of the most effective solutions: the smaller the bank the smaller the moral hazard. As far as banks' ability to serve customers and to compete is concerned, many research papers suggest that the optimal size of banks could be around $ 100 billion, some papers even suggesting that diseconomies of scale and scope might appear above that level (see *References* page 13 for a review of literature on this topic). It could also be expected that having more banks of a smaller individual size would be favorable to employment in the

banking sector. The fact is that over the past five years, very large banking institutions (with total assets above € 1,000 billion) have been serving neither society (enormous social, fiscal and economic cost of the banking crisis; distortion of competition due to moral hazard; low proportion of assets dedicated to financing the real economy) nor their shareholders (share prices down between 50% and 70%), a situation which creates a strong case for questioning whether “big is really beautiful” when it comes to banking.

iv. Note: depending on the threshold chosen, this measure would concern about 0.5% of all E.U. banking institutions only (but obviously a much greater proportion of E.U. banking assets).

c) Possible solution n°3:

i. *Objective:* separate banks between services indispensable to customers and to society and other services.
ii. *Mean:* create banks that have the exclusive purpose of taking deposits, managing payment services and lending to GDP producing activities on the one hand and banks that provide all other banking services (including capital markets activities and lending for asset purchases) on the other hand. Ensure that taxpayers funded safety net is provided exclusively to banks providing indispensable services (deposits, payment services, lending to GDP) and look closely at the possibility of regulating specifically lending (i.e. money creation) made to finance asset purchases (“money chasing money” at the root of all financial bubbles) by the second category of banks that would now be outside of the safety net.
iii. *Rationale:* as described above, a distinction must be made between banking services strictly indispensable to society and the economy (society stops functioning immediately without them) and other services (however useful they may be). Strictly indispensable banking services are the only ones for which it is justified to provide a safety net funded by taxpayers and any safety net provided to other services creates moral hazard situations that are detrimental for the economy (competition distortion) and destructive for society (cost of bail-outs). Given the fact that banks create money in the course of their lending activity, a particular attention must

be paid to making a clear distinction between lending to GDP producing activities (indispensable regardless of the size of the borrower) and lending for asset purchases purposes (not indispensable at all times, including real estate lending which, as recent UK, Irish or Spanish History – to name but a few - has shown, can be a major source of asset bubbles and bank crashes). Given the enormous cost that society always ends up paying when asset bubbles burst, providing a safety net funded by taxpayers to asset lending is a clear economic and social absurdity.

d) Possible solution n°4:

i. *Objective:* make banks pay the true cost of funding of their activity and protect tax payers from possible bail-outs.
ii. *Mean:* create a "bail-in" regime for bonds issued by banks that could be written off or converted into equity upon the injunction of a supervisor before a bank becomes insolvent.
iii. *Rationale:* such a regime would see investors bring "bail-in" debt funding to banks at a cost reflecting the risk they would be taking. This would mechanically make bondholders replace tax payers as the ultimate risk takers in case of banks' insolvency and would come at a price (interest rate) reflecting the risks taken by "bail-in" bondholders, as opposed to the current situation where banks' risks are underwritten without compensation by society and tax payers ("too important to fail" subsidy).

V. Conclusion

Obviously the topic of addressing moral hazard in banking whether by separating banks, capping their size or implementing a bail-in regime (or a combination of these various measures) is and will be controversial. This is to be expected given the fact that it involves forcing existing powerful institutions to restructure themselves.

Ecosystems teach us that sustainability (defined as a combination of efficiency and resilience) is linked to diversity and that concentration means fragility. Interestingly, British historian Arnold Toynbee has documented twenty-one civilisation collapses due to only two causes: too much wealth

concentration, and an elite unwilling until too late to shift priorities in response to changing circumstances.

Moral hazard in banking has huge negative consequences in terms of economic efficiency and cost to society. In Finance Watch's view, this must be addressed without complacency despite resistances, rear guard battles and the unavoidable technical debates that will be arising on how to do it.

This is why we welcome the work done by the High-level Expert Group on structural reform of the E.U. banking sector who has today the unique opportunity of making proposals to shift the priorities of a banking sector clearly facing changing circumstances.

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(edited on "bail-in" arguments and minor details on 11 May 2012)

END

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