Finance Watch
Making finance serve society

Introductory speech by Christophe Nijdam, Secretary General of Finance Watch,

at the Finance Watch conference

"Between a rock and a hard place – the future of traditional banking"

Wednesday 1 June 2016, Royal Library of Belgium, Brussels

Ladies and gentlemen,

Welcome to Finance Watch's summer conference about the future of traditional banking.

I am very happy to see again the diverse mix of delegates that makes our conferences special: EU policymakers, civil society representatives, financial sector representatives, academics and press. Welcome to you all, I look forward to your comments and interventions during the Q&A sessions for the two panels of this afternoon.

Before introducing our first keynote speaker, I would like to say a few words about our topic today.

Traditional banking in Europe is under pressure from two sides:

- on one side, there are new post-crisis rules to tackle "too big to fail" banking institutions ("2B2F");
- on the other side, there are new market entrants using financial technology to disrupt long-established banking practices.

These are the rock and the hard place of the conference title.

We have chosen to focus this event on traditional banking because of its central importance to the economy.

Let me explain what I mean by this term. Don't worry, I am not going to tell you that every bank should be like "Bailey Brothers' Building and Loan" from the film "It's a wonderful life". While I like that bank and the film very much, the traditional banks we have in mind are not fictional. They can be found all over Europe in a variety of corporate forms but with three common features:

1. they are focused on their **local** areas and use local knowledge and relationships to lend in their local economy;
2. they have **stable** funding sources, with plenty of stable deposit funding and lower leverage than 2B2F banks;
3. they are **small** enough to fail without pulling down other financial firms, and small enough not to exert an unreasonable influence over politicians.

Local, stable and small. So why are they under threat?

Let's start with the rock

This is really a story about competition.

Between 1990 and 2001 in industrialised countries, there were 10,000 mergers and acquisitions in the financial sector (Federal Reserve (2002). That is a lot of small banks disappearing, and the sector has become even more concentrated since the crisis. The rules of market capitalism and competition do not apply to the banking giants that now dominate the economy.

Perhaps that is why trust in the banking sector remains lower than in any other sector (Edelman Trust Barometer 2016), while pay remains unacceptably high: according to a recent survey, the average (not the highest) annual earnings of London-based managing directors at the largest European investment banks was around EUR 1m (Business Insider, May 2016, based on data from Emolument database).

The Bank of England believes the lack of diversity in banking, both intellectual and financial, contributed significantly to the depth and severity of the global financial crisis. As chief economist Andy Haldane explained, a lack of diversity within the financial eco-system, with many institutions holding similar portfolios, created a financial monoculture vulnerable to shocks. Haldane said that in 2008: "*this old lesson from evolutionary biology and systems theory was learned painfully and abruptly*" (Haldane (2016)).

There is a good case for saying that this oligarchic market structure is bad for growth even in good times.

Research shows that small local banks and coops lend proportionately more to small and medium sized enterprises (SMEs) – the engines of jobs and growth - than large domestic or foreign banks.

And SMEs in countries with good systems of small local banks are more successful than SMEs in countries without such a banking system (Bank of Finland (2014), UNEP (2015), Finance Watch (2015). Just look in that respect at the German Mittelstand with the local Sparkassen and Volksbanken. Or in the US with community banks.

Traditional banking – local, stable and small – has therefore something of real value to offer the EU's growth agenda; something that 2B2F banks with their remote, automated credit scoring, volatile wholesale funding and trading biases cannot do so well.

To be clear, Finance Watch does not want to replace one monoculture with another but to ensure system diversity, where the different strengths and focusses of different banking institutions can meet the different needs of society. For this to happen, large incumbents will have to be stripped of unfair advantages distorting competition, so that other business models can compete. This will not happen on its own.

In our view, the EU has to refocus on this problem urgently.

The rise of nationalism and populism in too many EU countries, as well as the UK's Brexit referendum later this month, are fuelled by economic insecurity as people's fears and anger are channelled skilfully, but wrongly, against foreigners. A financial crisis will almost certainly make this worse.[1]

So we are on a worrying track – another financial crisis, or simply more years of low growth, will have political consequences: it is already happening.

What has this to do with traditional banks?

A key priority for policymakers must be to reduce the size and influence of 2B2F banks that are poorly configured to serve the real economy, while at the same time promoting banks whose business models are primarily geared to local enterprise lending; in other words banks that are local, stable, and small.

At Finance Watch, we know as well as anyone that this is not an easy task.

Big banks have good lobbyists, the best that money can buy, and they have plenty of money to do so.

They have resisted structural reform and are now opposing leverage caps. The bail-in regime is some progress but cannot end 2B2F banking as long as bank structures are unreformed. For us, this view was confirmed last week when the Commission published Level 2 rules on bail-in that omitted a crucial 8% burden sharing requirement (L'Agefi, 24/05/2016), indicating that policymakers are unable to commit to enforcing bail-in in a full blown crisis. We will hear more about this important topic in this afternoon's keynote speeches from Sir Paul Tucker and Avinash Persaud, and the panel afterwards.

Policymakers are taking us further in the wrong direction with some elements of the Capital Markets Union. Of course, we support those measures in the CMU Action Plan that encourage equity funding and connecting investors in one country with businesses in another.

But we do not endorse plans to give banks extraordinary capital relief for securitisation. As we have argued in some detail, together with a growing body of economists, moves in this direction may boost the profitability of 2B2F banks but will do little for smaller banks and the real economy, other than exposing it to financial stability risks and a possible surge in real estate lending.

If we are looking for ways to promote local, stable and small banks – the ones that specialise in financing productive enterprises that employ people in long-term jobs - and if we want to reduce the

[1] Researchers at Chicago Booth university found in 2013 from a sample of 60 countries that financial crises radicalize electorates. They concluded: "After a banking, currency, or debt crisis, the share of centrists or moderates in a country went down, while the share of left- or right-wing radicals went up in most cases."

unfair advantages of 2B2F banks whose business models are built around different objectives, we must go further than the regulation we have had so far.

Removing the current built-in unfair advantages for large banks over small ones in prudential regulation and structural reform of megabanks are the obvious places to start.

So much for the rock, what about the hard place?

The threats and opportunities from financial technology companies, called fintechs, are only starting to be known.

Among the threats, fintechs are now competing with nearly every function carried out by traditional banks, including saving, lending, foreign exchange, and above all, payments. According to a recent survey, adoption rates of fintech products could double within a year. The surveyors, EY, warned that “the risk of disruption is real” (EY FinTech Adoption Index, Dec 2015).

The EU is helping this along, especially in payments services with the Payment Services Directive (PSD2), and yet the EU is not a fintech leader.

For example, only one EU country appears in the World Economic Forum’s top ten countries for mobile banking. Sweden was ninth on the list, three places behind… Zimbabwe (WEF (2015)). There are enormous business opportunities here, and the sector could and should evolve quickly.

We know that regulators are watching.

The UK’s so-called regulatory sandbox, where innovators have been able to test products in a ‘safe environment’ without the normal regulatory constraints for two months, will close next week after hundreds of applications. The Bank of England governor will give a major speech about fintech in the next days (Business Insider), and other countries are similarly active. The EU is making progress on crowdfunding and peer to peer lending. But with most P2Ps untested in a downturn, and warnings and problems around P2P securitisations piling up in the US (Moody’s, Bloomberg), regulators should not miss the opportunity to shape these markets positively while they can.

The key question here is whether fintech will help the financial sector to serve citizens better or worse than it does now.

For traditional banks, and retail customers, the question is whether fintech will see a flourishing of opportunity and customer service, or be quickly captured by the big boys, in a winner-takes-all result that we have seen before in other sectors, such as in Big Pharmas acquiring nimble Biotech start-ups.

To point us in the right direction, towards a more innovative financial system where firms compete fairly to serve their customers and obey the normal rules of capitalism, it is now my great pleasure to welcome our first keynote speaker of the day, who I understand has some important points to make about regulating systemically important banks.

A senior central banker who has seen the financial system at its best and worst, a leading international expert on financial regulation and the chair of the Systemic Risk Council, among other prestigious roles, ladies and gentlemen please join me in welcoming **Sir Paul Tucker.**

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