Consultation by the High-level Expert Group on reforming the structure of the EU banking sector

1 June 2012

Finance Watch is registered in the Joint Transparency Register under registration number 37943526882-24

Preliminary remarks:

Why are we asking the question of reforming the structure of the EU banking structure? What is the problem?

The question of reforming the EU banking structure finds its source in the moral hazard situation of the banking system and in its two main consequences: firstly it puts taxpayers at risk as they bear the risk of having to bail-out defaulting banks (thereby creating a situation where banks profits remain private but banks' losses are socialized) and, secondly, it has the effect of distorting the nature of banking activity away from productive lending activity, thereby reducing the propensity of the banking system to serve the needs of the real economy.

Consequences of the "too big to fail" syndrome:

The fact that many banks are deemed to be "too big 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 big 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, further adding to the credibility of this 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 together between 2007 and 2009 was over £ 50 billion annually ("The $ 100 billion question", 2010)

<u>*Remarks:*</u>

- ✓ 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 size 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.

Implication of the funding subsidy derived from "too big to fail" on the structure of banking activity and on their ability to serve the needs of their customers

Data

Data taken from a sample of **32 listed Europeans banks** (source: *AlphaValue*) 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 big 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 about 8.300 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). While the exact proportion of activity that can be called customer facing varies from market to market, we consider that trading activities as a whole should not routinely benefit from a public funding subsidy.

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 big 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.

With those preliminary remarks in mind, we will now respond to the three first questions asked in the consultation launched by the High-level Expert Group on reforming the structure of the EU banking sector.

- ***First question: to what extent are the current and ongoing regulatory reforms sufficient to ensure a stable and efficient banking system and avoid systemic crises?***

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 Basel III (CRD IV / CRR in the EU context)*

As described in *Finance Watch*'s report *"To end all crises?"*, implementing Basel 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 as it looks at banks on a standalone basis and does not address the issue of systemic risk. This is mainly due to the conjunction of two factors: 1) Basel III / CRD IV requires a minimum level of equity capital from banks insufficient to make them truly resilient; 2) Basel III / CRD IV does not address the issue of systemic risk and of the fragility of the banking system coming from the interconnectedness of banks.

Moreover, Basel III / CRD IV does not address in any meaningful way the issue of moral hazard encountered in the banking system.

✓ *Imposing a capital surcharge on Significantly Important Financial Institutions (SIFIs)*

Imposing a capital surcharge on SIFIs comes from a good intention (making too important to fail financial institutions more resilient) but, in Finance Watch's view, has the major negative consequence of increasing moral hazard when this is precisely the problem we are trying to solve.

The reason for this situation is simple: by giving an official list of banks that will under no circumstance be let down, public authorities reinforce moral hazard and distort further competition between the largest banks and their smaller competitors. In that context, the benefit of a 2.5% capital surcharge weighs little as it will not make a significant difference to the 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).

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.

In Finance Watch's view the SIFI concept seems misguided and should be reconsidered by policymakers.

- ✓ *Designing a bank resolution mechanism and a crisis management system, including a "bail-in" regime for banks deemed "too big to fail".*

In general, bank resolution mechanisms and living wills may be a way, in the best of cases, of making future bank defaults somewhat smoother to manage but cannot, in our view, be 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). Obviously the detail will have to be considered in the light of the directive proposal soon to be released by the European Commission but, here again, this should not be awaited as a magical solution.

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 and be subject to better market discipline. This would, in turn, reduce the distortions of competition linked to "too big to fail" 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 impact on the viability of current bank business models if exposed to true market funding costs, 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 near future (this, despite the strong rationale of "bail-in" bonds and despite the fact that this route should be pursued with diligence).

- ***Second question: which structural reforms would improve the safety and efficiency of the banking system in the EU in the near term? In the long term?***

We present hereafter six structural reforms 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 own implementation specificities 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 or at least seriously mitigated.

The first four solutions are considered as near term solutions (in particular the first two) whilst the last two solutions are more long term (which means that even if they might not be finalized in the short term, a credible plan to implement them should be put in place in the short term and rolled out over the necessary period).

We put a particular emphasis on near term solutions n° 1 and n° 2 because of their simplicity and our conviction that, if they were adopted jointly, they could improve very significantly the current structural flaws of the EU banking system.

NEAR TERM SOLUTIONS (by order of ease of implementation):

I. **Near term solution n° 1: require regulators to estimate and publish the amount of public funding subsidy for each bank; require banks in receipt of such a subsidy to provide details to regulators of the asset side of their balance sheets.**

- *Objective:* ensure that subsidies are recognized so their existence can play a role in future policy making, and enable public authorities to assess the use to which this subsidy is put from a public interest perspective.
- *Means:* require regulators to devise and apply a method of estimating the funding subsidy deriving from too-big-to-fail status, which would then be published. Require banks to provide full access to the asset side of their balance sheet to regulators, which regulators can then aggregate and analyse.
- *Rationale:* if public funding subsidies for too-large-to-fail banks are to be a fact of life for the immediate future then it is reasonable to

ask that the public be given some information about the impact of this subsidy on bank activity. Publication of the size of this subsidy would make it easier for future policy decisions and regulations to take the subsidy into account. Asset disclosure to regulators, rather than directly to the market, would allow useful analysis while addressing confidentially issues relating to bank customer data.

II. <u>Near term solution n° 2:</u> in exchange for the support of society to banks, for the funding subsidy they derive from it and for the privilege of creating money they have been granted by society, require from banks with a balance sheet size above EUR 200bn that at least 50% of their balance sheet be dedicated to lending to non financial entities and at least 33% to lending to GDP contributing activities

- *<u>Objective:</u>* until the issue of "too big to fail" and of the funding subsidy that banks derive from it has been resolved, ensure that bank activity contributes to the economy and to society instead of the present paradoxical situation where the greater the funding subsidy extracted by a bank from society the further away its activities develop from economically and socially useful purposes.
- *<u>Means:</u>* Require from banks with a balance sheet total above EUR 200bn that at least 50% of their balance sheet be dedicated to lending to non financial entities and at least 33% to lending to GDP contributing activities
- *<u>Rationale:</u>* the paradox of the situation emerging from the current EU banking structure is that, as described in this document, the bigger the bank, the bigger the funding subsidy extracted by banks from society and the bigger the funding subsidy (rent) received by a bank the more remote that bank's activities develop from socially and economically useful activities. This situation must also be put in perspective with the privilege granted by society to banks to create money (the famous "loans make deposits" principle with the implication that more than 95% of the money created in western societies is created by commercial banks). If the "too big to fail" syndrome is not going to be resolved in the near term, the least that society should require from banks would be to devote a significant proportion of their activity to activities that contribute to society and to the economy. Namely, this should take the form of a minimum 50% of their balance sheet dedicated to lending to non financial entities (i.e. excluding lending to other financial institutions, shadow banking entities and all forms of hedge funds) and 33% to GDP

contributing activities (a non exclusive list of such lending to GDP contributing activities could be: working capital facilities, lending to enterprises regardless of the size of the enterprises, trade finance, project finance, etc…). These percentages are indicative and could be subject to a calibration process as necessary. In this logic, real estate lending would be considered as lending to non financial entities but not as lending to GDP contributing activities as the latter cannot, by nature, be related to asset purchases. This measure would have the very important consequence of limiting the distortion of banking activity deriving from “too big to fail”.

III. Near term solution n° 3: put an end to the tax advantage of banks' debt funding over banks' equity funding

- *Objective:* incentivize banks to raise equity funding rather than debt funding.
- *Means:* address the issue of the bank debt tax subsidy deriving from the tax deductibility of debt interest / stop the tax preference for debt.
- *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 bank 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 big 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.

IV. <u>Near term solution n° 4:</u> implement a regime and develop a market for "bail-in" bonds issued by banks

- *<u>Objective:</u>* make banks pay the true cost of funding of their activity and protect tax payers from possible bail-outs.
- *<u>Means:</u>* 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.
- *<u>Rationale:</u>* 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 big to fail" subsidy).

LONG TERM SOLUTIONS:

I. <u>Long term solution n° 1:</u> limit the size of banks

- *<u>Objective:</u>* limit the size of banks in order to make a default possible.
- *<u>Means:</u>* put a cap (probably in a range between € 100 billion and € 200 billion) on the size of assets that a bank can hold.
- *<u>Rationale:</u>* 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 17 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%) nor their employees (headcount reductions), a situation which creates a strong case for questioning whether "big is really beautiful" when it comes to banking. A complementary measure would be to conduct a review of barriers to entry facing new banks wishing to set up in the EU, with a view to encouraging a better bio-diversity of banks of all sizes within the economy.

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

II. Long term solution n° 2: separate commercial banks from investment banks

- *Objective:* separate banks between services indispensable to customers and to society and other services.
- *Means:* 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 proprietary trading, 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. Activities falling in a "gray zone" between those two categories could be put, at the option of banks, in one category of banks or the other.
- *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 (banking resources are less and less allocated to useful economic purposes) and destructive for society (cost of bail-outs). Given the fact that banks create money in the course of their lending activity, 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, in our view, a clear economic and social nonsense.

- ***Third question: what are your views on the structural reform proposals to date (e.g. U.S. Volcker Rule, U.K. ICB proposal)?***

Both the Volcker rule and the U.K. ICB report start from the analysis that the structure of the banking system puts taxpayers at risk in case of a bank default ("too big to fail") and that society should be protected from such negative consequences.

We share this analysis. It is however in our view incomplete if taken alone, as the issue of the funding subsidy extracted by banks from society (see above) is at least as important as the necessity to protect taxpayers given the consequence it has of pushing banking activities toward less socially and economically useful activities such as proprietary trading and derivatives dealing.

The U.K. ICB's proposal does address the issue of the funding subsidy derived by banks from society but, in our view, would only partially resolve this issue if applied as such to EU banks.

More specifically:

- U.S. Volcker rule

The proposed U.S. Volcker rule has the immense merit of trying to eliminate the underwriting by U.S. taxpayers of proprietary trading risk taken by deposit taking banking institutions.

However, the Volcker rule has, in our view, two limitations that would make it only a very partial solution to the "too big to fail" syndrome if applied as such to EU banks:

1. The fact that client facing trading operations would still be allowed for deposit taking banking institutions under the Volcker rule does not eliminate many of the trading risks taken by banking institutions and does not resolve the issue of the funding subsidy linked to "too big to fail" (for instance, AIG Financial Products's enormous positions in credit linked derivatives that led to the bankruptcy of its parent company in 2008 were all customer facing and would therefore most probably have been allowed if they had been put in place by a deposit taking banking institution subject to a Volcker rule type regulation).
2. The many exemptions that have been lobbied into the current version of the Volcker rule proposal seem to blur the lines between proprietary trading and client facing operations and, more generally, between

activities allowed or prohibited under the rule. This in turn, makes it a complex instrument and raises questions about its effectiveness if it were to be applied in the EU context. The current debate in the aftermath of the recent several billion dollar loss incurred by JP Morgan Chase CIO trading operation about whether such an operation would have been possible or not under the Volcker rule and the lack of clear answer from experts on this question is, if anything, not reassuring in that respect.

- U.K. ICB's proposal:

In Finance Watch's view, the U.K. Independent Commission on Banking's proposal goes into an interesting direction in its objective to protect the U.K. taxpayer from the negative consequence of banks' defaults and in its attempt to reduce significantly the funding subsidy extracted from society.

Having said that, Finance Watch is of the view that two problems would remain if a "Vickers type" solution were to be applied to all EU banks, thereby making it only a very partial structural solution.

The problems if an ICB type solution were applied to the entire EU system would be that:

1. As the insulation, by Sir John Vicker's own admission, would not be perfect between the ring-fenced entity and the non ring-fenced entity of banks, the funding subsidy derived from "too big to fail" would at least partially remain;
2. More importantly, the line of demarcation drawn between so-called "ring-fenced" banking activities and activities "outside of the ring-fence" does not seem to us as being the proper one if it were to be applied to the EU banking system. In Finance Watch's view, the separation should be made between banking services that are strictly indispensable at all times to customers and to society and those that are not, as opposed to between retail and wholesale banking activities as proposed by the ICB.

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:

- Deposit taking
- Payment services
- 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 activities 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 therefore the only ones for which it is legitimate to commit taxpayers' money to provide a guarantee: Finance Watch believes that society and taxpayers cannot underwrite all economically useful activities.

Importantly, Finance Watch believes that the line of separation between banking activities 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). The reason for this is that lending to GDP producing activities is a good proxy for activities that contribute to the economy and to growth whilst lending for asset purchases is about (newly created) money chasing (old) money, which, as repeatedly seen in economic History, has so often the effect of creating asset bubbles.

By allowing real estate lending inside the ring-fence, the ICB proposal allows, in our view, the funding subsidy to benefit real estate assets purchases and therefore has the natural effect of feeding real estate price bubbles. This, in turn, has the effect of putting tax payers at risk as witnessed by the recent UK, Irish and Spanish situations, to name but a few. In Finance Watch's view, this should not be encouraged at EU level.

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society.

Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large section of European citizens.

Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, and that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society.

For further information, see www.finance-watch.org

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