Finance Watch
Making finance serve society

Finance Watch response to the European Commission's call for evidence on the regulatory framework for financial services

Brussels, 31 January 2016

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, 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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We agree to the publication of this response.

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As a preliminary remark, we would like to highlight the fact that a large part of the regulation decided during the last legislature is not yet transposed into national law. This questions the relevance of doing a stock taking exercise at this stage.

1. Unnecessary regulatory constraints on financing: the Commission launched a consultation in July on the impact of the Capital Requirements Regulation on bank financing of the economy. In addition to the feedback provided to that consultation, please identify undue obstacles to the ability of the wider financial sector to finance the economy, with a particular focus on SME financing, long-term innovation and infrastructure projects and climate finance. Where possible, please provide quantitative estimates to support your assessment.

As stated in our response to the consultation on the impact of the Capital Requirements Regulation on bank financing of the economy,[1] bank prudential regulation has enabled banks to lend more to the economy, by increasing their capital.

Regarding the ability of the wider financial sector to finance the economy, it is important to define clearly what we mean by ability. It is also interesting to note that according to a recent ECB SAFE survey, European SMEs' biggest concern today is "finding customers" whereas "access to finance" is one of their lowest. It is therefore not clear that there is a need to further increase access to finance for SMEs in general in Europe.

If by ability we mean availability of capital, then there is plenty of evidence that there is in fact already too much capital available for investments, hence arguably no need to further increase it.
A 2012 report by the consulting firm Bain & Company[2] found that "*the relationship between the financial economy and the underlying real economy has reached a decisive turning point. The rate of growth of world output of goods and services has seen an extended slowdown over recent decades, while the volume of global financial assets has expanded at a rapid pace. By 2010, global capital had swollen to some $600 trillion, tripling over the past two decades*", and is expected to "*expand by half again, to an estimated $900 trillion by 2020.*" "*Today, total financial assets are nearly 10 times the value of the global output of all goods and services. (..) Our analysis leads us to conclude that for the balance of the decade, markets will generally continue to grapple with an environment of capital superabundance*."

If by ability we mean willingness to invest this capital where it's needed in a stable and sustainable manner, there are indeed a number of obstacles. These obstacles include the ultra-low interest rates from central banks that make lending to businesses and households a less profitable activity.

[1] http://www.finance-watch.org/our-work/publications/1161-consultation-fisma-possible-impact-of-crd-on-bank-financing-of-economy
[2] Bain & Company, A World awash in Money, 2012
Haldane, A. G., The age of asset management?, 2014

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The failure to set up and implement a meaningful bank structure reform in line with the Liikanen report is another obstacle: large universal banks choose to allocate their capital to the most profitable activities and lending to non-financial corporations and households is less profitable than some other activities carried out. A meaningful separation between traditional core bank activities such as lending to households and non-financial corporations and investment banking activities would refocus banks on their core mission of lending and increase the capital allocated to such activities.

The implicit promotion of large universal banks over small banks in prudential regulation is another constraint on financing. Local traditional banks have indeed been shown to be more focused on lending to the real economy.[3]
This promotion takes place via several mechanisms: large banks using their internal models can obtain lower risk weights than small banks using the standardised approach.
By giving the choice between liquid assets and stable funding, liquidity ratios in their current form also implicitly favour short term tradable securities over illiquid assets such as loans.

When talking about financing, we also need to look at **qualitative elements such as the stability of this financing**. What we need is not more funding in general, but more stable funding that doesn't withdraw quickly in times of stress: there is no shortage of funding in good times, the issue is when the funding channels dry up very quickly during crises.
In this respect, the crisis has shown that foreign investors and foreign banks retreat quickly within their borders in times of stress, as they always do, to refocus on their core markets. Local banks on the other hand do not retreat as they have nowhere to do.
As importantly, traditional banks with local branches have long-standing relations with their customers, know the local economic context and competition, and are able to integrate in their credit decision crucial qualitative elements such as knowing personally the management. This makes them more willing to support their clients in difficult times as they are more confident about whether their business is fundamentally sound and will get through this rough patch. On the contrary, an investor in Qatar who does not know the company and the local context will be more likely to cut his funding quickly in times of stress.
The lesson is that we should help to strengthen local traditional banks.
In a context where we are promoting more cross border flows of capital, it is also essential to ensure that measures are put in place to prevent excessive procyclicality in lending to the real economy. Failure to do so would create an additional constraint on the provision of stable financing.

[3] "*While business lending is a statistically significant source of bank profits, its quantitative importance varies dramatically across bank size. For large banks, business lending contributes to the rate of return on equity very little. (..) One possible policy implication of our findings is that capital injections into the larger banks per se are unlikely to lead to an expansion of credit to business.*" Ekpu, Paloni 2015 Financialisation, business lending and profitability in the UK

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Lastly, the recent **push within the Capital Markets Union to shift retail savings from bank deposits to capital markets, may also have adverse consequences**: **a reduction of bank deposits would reduce the core funding source of smaller traditional banks, reducing their ability to lend**. As large banks are likely to compensate by increasing their reliance on wholesale funding, a very procyclical unstable form of funding, **such a shift could also lead to more fragile bank funding structures**, in contradiction with the lessons from the crisis.

3. Investors and consumer protection; Investor and consumer protection: please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on investor and consumer protection and confidence.

The crisis of 2008 showed that consumer and investor protection was inadequate. The regulations introduced aimed at correcting detrimental practices such as mis-selling and general misconduct, conflict of interests, inaccurate/wrong advice and ambiguity of the contract terms.

We agree with the description of the situation and the statement presented in the Communication "A reformed financial sector" (COM 2014/279). We share the view that the most effective consumer protection comes from preventing the occurrence of excesses such as those experienced in the run-up to the last crisis.

At this point it is difficult to say whether consumers and investors are better protected than before the crisis. We acknowledge that a lot of new rules have been introduced but it takes time to assess properly if they function correctly. Especially in the case of MiFID II and PRIIPs, we think that it is too early to comment as the rules have not yet been implemented and the work has moved to level 2.

We also want to highlight the fact that most consumer protection measures have been focused so far on transparency / disclosure and on advice at the point of sale. Despite compelling evidence of consumer detriment, nothing has been done to address consumer detriment stemming from flawed product design. In this respect measures such as the comprehension alert in the PRIIPs regulation should see their scope expanded and their use made mandatory to address issues such as the offering of excessively complex products or products that embed features that exploit behavioural biases.[4]

We also expect that the Commission's plans on Capital Markets Union and any follow ups on its green paper on retail financial services will require additional consideration of how to protect consumers and investors.

[4] See http://www.finance-watch.org/presse/communiques-de-presse/88-topics/consumer-issues/627-discussion-paper-prips-regulation-proposal

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In the case of CMU, appropriate consideration should be given to Investor Compensation schemes (legislation currently withheld under REFIT) if we want to encourage more retail investors to engage in capital markets.

In relation to the green paper on retail financial services, ensuring adequate consumer protection will require a new approach to regulation, especially on the aspect of digitalization. The challenge will be to regulate the highly complex interplay of industry business models, products, practices, players and technology in a fast-developing environment.

4. Proportionality / preserving diversity in the EU financial sector: are EU rules adequately suited to the diversity of financial institutions in the EU? Are these rules adapted to the emergence of new business models and the participation of non-financial actors in the market place? Is further adaptation needed and justified from a risk perspective? If so, which, and how?

EU bank prudential rules are not adequately suited to the diversity of financial institutions in the EU. They are **excessively complex and favour large universal banks** over other business models.
As discussed earlier, liquidity ratios need to be redesigned to incentivise stable funding over liquid assets, and the inbuilt advantage of the IRB approach over the standardised approach needs to be removed.
More fundamentally, **bank prudential regulation needs to be based on simple and more robust metrics such as a binding leverage cap**. Such a metric has been shown to be a much better predictor of bank distance to default.[5] It is also simpler and less susceptible to arbitrage.

13. Gaps: while the recently adopted financial legislation has addressed the most pressing issues identified following the financial crisis, it is also important to consider whether they are any significant regulatory gaps. Please indicate to what extent the existing rules have met their objectives and identify any remaining gaps that should be addressed.

Post crisis bank prudential regulation kept the excessive complexity of earlier regulations, making it less robust and more vulnerable to regulatory arbitrage. There is a clear recognition of the excessive complexity of bank prudential regulation (see BIS 2013: The regulatory framework: balancing risk sensitivity, simplicity and comparability - discussion paper http://www.bis.org/publ/bcbs258.htm) and its lack of predictive power in relation to bank failure (www.oecd.org/finance/Bank-Business-Models-Basel-2013.pdf).

[5] OECD, Blundell-Wignall, A. and Roulet, C., Business models of banks, leverage and the distance-to-default, OECD Journal Financial market Trends, No 103, January 2013

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We need to revisit the framework in light of the lessons learned, including implementing a leverage cap and giving it a prominent role, making risk weights more consistent between financial institutions and investigating the complementary measures indispensable to make bail-in work.

While much regulation has been put in place after the crisis, most of it is micro-prudential, aimed at making individual financial institutions more robust. **Much remains to be done in macro-prudential regulation to make the financial system as a whole more robust and stable.** This is indeed very different: making the system more robust requires, for example, ensuring that financial institutions do not run into trouble at the same time. If one medium-sized bank runs into trouble, this is not a threat to the financial system, as other banks can buy the troubled bank and ensure a continuity of services. If however most banks experience troubles simultaneously as happened during the crisis, governments may need to intervene to bail them out with taxpayers' money. As long as this is not addressed, we have not reduced the risk of future crises, which is a pre-requisite for sustainable growth.

The promotion of shadow banking within the Capital Markets Union makes it more urgent to address the gaps.

One of the gaps is the **absence of a countercyclical backstop for shadow banking.** Due to the procyclicality of our financial system, financial stability requires some entities to be able to lever up and provide liquidity in a countercyclical manner, being willing to buy when everybody wants to sell in order to avoid downward price spirals.

As the Federal Reserve Bank of Dallas puts it "*in order for some participants to deleverage, or liquidate their positions, offsetting parties must be willing to assume those positions on an order of magnitude matching the demand for liquidity. (..) The private sector as a whole cannot delever unless the Fed or some other public sector entity is willing to lever up its balance sheet to put a floor under otherwise declining asset values and net worth*".[6]

This is precisely why public safety nets were introduced for banks in 1933, as it was acknowledged that credit transformation is an inherently unstable and risky activity requiring public backstops, namely deposit guarantee schemes and access to central bank liquidity, to be made stable.

Shadow credit intermediation however does not have a direct and explicit access to these safety nets, and the crisis evidenced the failure of private backstops such as monoline insurance companies.

For non-bank lending to be stable we need to either expand the scope of public safety nets to shadow banking, **which would increase the risk of moral hazard** and which arguably would require steps to level the regulatory playing field with banks. **Alternatively we need to shrink the size of the shadow banking sector to a size where private backstops can be effective**.

[6] Federal Reserve Bank of Dallas 2012

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Yet the Capital Markets Union proposes to increase the size of shadow banking without any proposal to address this point. **Failure to address this point could lead to a more unstable financial system**.

As **non-bank credit intermediation is a more collateral-intensive activity**, it can lead as well to **additional interconnectedness and procyclicality of leverage**, both key factors of systemic risk that need to be addressed.
In this respect we strongly welcome the work done by the Financial Stability Board with respect to **minimum haircuts for securities financing transactions**. We also welcome their work reviewing financial stability issues linked to **re-hypothecation and the re-use of collateral**[7], and we look forward to reading their findings in early 2016.
Most importantly, **we strongly hope that the FSB's recommendations will be quickly translated into law and implemented in the EU**.

Lastly, the **absence of a meaningful bank structure reform in line with the Liikanen and Barnier proposals** is another regulatory gap as moral hazard has yet to be comprehensively addressed.

14. Risk: EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.

The promotion of shadow banking / non-bank lending within the Capital Markets Union and the related revival of securitisation **aim at shifting risk outside of banks**. In this respect it could be argued that **risk shifting towards less regulated financial entities is not an unintended consequence but rather an explicit objective**.

This shift is problematic as there is **no regulatory level playing field** and **we have yet to transform shadow banking into resilient market-based finance**, whereas arguably this should precede the promotion of shadow banking.

We understand that the political shift from "we need to regulate shadow banking" to "we need to promote shadow banking" is linked to a **renewed focus on short-term growth and competitiveness at all costs**. This shift seems to have translated into a **fallacious trade-off between financial stability and growth**, in which regulation that improves stability is presumed to be bad for growth. In our view, financial stability is not a growth impediment but a pre-requisite for sustainable growth in the wider economy.

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[7] FSB, Transforming shadow banking into resilient market-based finance - an overview of progress, November 2015

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15. Procyclicality: EU rules have been put in place to make the financial system less procyclical and more stable through the business and credit cycle. Please indicate whether some rules have unintentionally increased the procyclicality of the financial system and how.

The promotion of a more collateral-intensive non-bank system of credit intermediation is likely, other things being equal, to increase the procyclicality of the financial system.

The additional procyclicality comes from several factors, including **market driven lending decisions and pre-selection bias** in securitisation, **fluctuations of haircuts in securities financing transactions, fluctuating pools of eligible collateral and velocity of collateral**.[8]

Lastly, **the forthcoming leverage cap for banks should also in our view include a countercyclical element** to make it consistent with the countercyclical buffer in regulatory capital and avoid potentially creating asset fire sales when banks' leverage hits the cap.[9] We recommended a flexible ratio fixed at 5% / 20x leverage in normal times and at 3% / 33.3x leverage in downturns[10] to provide the countercyclical flexibility necessary to adapt the banking landscape to economic cycles.

[8] For more details see Finance Watch, A missed opportunity to revive "boring" finance?, 2014
[9] See Finance Watch, To end all crises? p20, February 2012
[10] With no netting of derivatives and full inclusion of off balance-sheet items

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