Finance Watch
Making finance serve society

To the Heads of State and Government of the European Union

Brussels, 19 October 2011

Dear Heads of State and Government:

Finance Watch calls on the Heads of State and Government meeting on 23 October in Brussels urgently to make bank deleveraging the subject of supervision in order to protect the supply of credit to European businesses and households.

Expectations of higher bank capital requirements and a mark-down of sovereign debt may lead to a shortfall in European bank capital reported to be in excess of € 100 billion. Large banks are expected to shrink their way to compliance rather than raise equity at current low prices, raising the prospect of a significant credit contraction at a time of weakening economic growth. The current contraction of the wholesale bank funding market will likely exacerbate this in months ahead.

The temptation for banks is to reduce loans, especially to small and medium sized businesses, instead of other parts of their balance sheets. But the largest European banks hold very substantial trading and derivative assets, very often larger than their entire loan portfolio. The public interest would be best served if, despite the short-term impact on bank profits, deleveraging were concentrated on these financial assets instead of on real economy lending.

Some may say that deleveraging is a private matter for banks. However, we consider that the externalities caused by possible material deleveraging make it a matter of legitimate concern for the European and national bank supervisors. The effects on growth and employment of reducing credit to small and medium sized enterprises (SMEs), who have few alternative sources of funding, are likely to be wholly negative. A reduction in derivative and trading portfolios, some of which contain risks ultimately borne by the public, is by far preferable.

The implicit state backing and funding subsidy enjoyed by banks that are considered to be too-large-to-fail also creates, in our view, a duty on governments to hold those banks accountable for their impact on the wider economy. Economic sense and fairness suggest that healthy employers and exporters, for example, should not suffer a withdrawal of credit simply because banks are required to compensate for risks taken elsewhere in their balance sheets.

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We suggest that supervisors be asked to engage with banks to ascertain the likely impact of their deleveraging on the real economy based on asset type and to disclose their findings publicly, including any concerns they have.

Such disclosure would attract public attention and provide banks with an opportunity to demonstrate their commitment to serving the economy. It may also be a factor taken into consideration for any bank requiring public recapitalisation.

We therefore call on the Heads of State and Government to ensure that national and European bank supervisors have adequate means to supervise the deleveraging process of banks, in order to prevent further restrictions on the supply of credit to the real economy.

Should deleveraging by universal banks end up harming the real economy, that would, in our view, raise again fundamental questions about the very concept of "universal banking" and its relationship with the real economy.

We appreciate that supervised deleveraging is only one step on the path to stability and growth. We therefore take this opportunity also to ask Heads of State and Government to examine structural measures capable of ending the "too big to fail" subsidy and to remind them of our recent call[1] to implement higher bank capital requirements on a permanent basis and to adopt stricter liquidity standards as a matter of urgency.

We are confident that you share our view that modern societies should require the financial industry to take account of the public interest.

Yours sincerely,

Finance Watch

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for the good of society. Its 57 members represent, collectively, close to 100 million European citizens. Members include consumer groups, investor associations, trade unions, housing associations, financial experts, foundations, think tanks and other NGOs.

For further information, please visit http://www.finance-watch.org

[1] Finance Watch supports EC call for higher bank equity, 14 October 2011 http://www.finance-watch.org/wp-content/uploads/2011/10/Press-Release-14-Oct-2011-Finance-Watch-supports-higher-bank-equity3.pdf