Why we need to reform banking structure in parallel with building a banking union

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About Finance Watch

Finance Watch is an independent, non-profit public interest association dedicated to **making finance work for society**. Its members represent, collectively, many millions of European citizens and include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

Finance Watch is funded by grants, donations and membership fees. It does not accept any funding from the financial industry or political parties. For 2012, Finance Watch has also received funding from the European Union to implement its work programme (there is no implied endorsement by the EU of Finance Watch's work, which is the sole responsibility of Finance Watch).

Finance Watch was registered on 28 April 2011 as an Association Internationale Sans But Lucratif (non–profit international association) under Belgian law.

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Outline

Why the EU needs to reform banking structure in parallel with building a banking union

After the summit held on 29 June 2012, the Heads of State or Government of the Euro Area affirmed as the main objective of the banking union the necessity "to break the vicious circle between banks and sovereigns". This resulted in the single supervision mechanism proposed by the Commission on 12 September after the bank recovery and resolution mechanism that had been proposed on 6 June. Finally, on 2 October the High-level Expert Group on reforming the structure of the EU banking sector chaired by Erkki Liikanen published its report.

This presentation will develop the view that the three reforms need to be implemented in parallel as the sole implementation of a banking union without a simultaneous reform of banking structure would have the consequence of not only missing the stated objective of breaking the vicious circle between banks and sovereigns but possibly of also increasing the negative consequences of the moral hazard situation currently prevailing in the banking sector.

Content

WEAKNESS OF THE EU BANKING STRUCTURE REVEALED

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The financial crisis highlighted major structural failures of the EU banking system :

- **Implicit and explicit public subsidy** benefiting to - mostly large universal - banks (moral hazard)
- … with the **implied competition distortion**

Bail-out of large **banks was made at taxpayers' cost**

Banks failing to serve the real economy sufficiently

Quotes from the Liikanen report

*"Systemically important EU banks benefit from **an implicit guarantee of their debt**, raising **concerns about the level-playing field,** distortions of competition, **risk-taking incentives** and **costs to tax-payers**"*

*"Total **state aid used to support the EU banking sector** since the start of the crisis amount to … **13% of EU GDP** … up to end 2010"*

*"In march 2012**, loans** to non-financial corporations and households **only make up 28% of the aggregate balance sheet** of EU MFIs."*

THE NEED TO PUT AN END TO THE SELF-FEEDING DOOM-LOOP BETWEEN STATES AND BANKS

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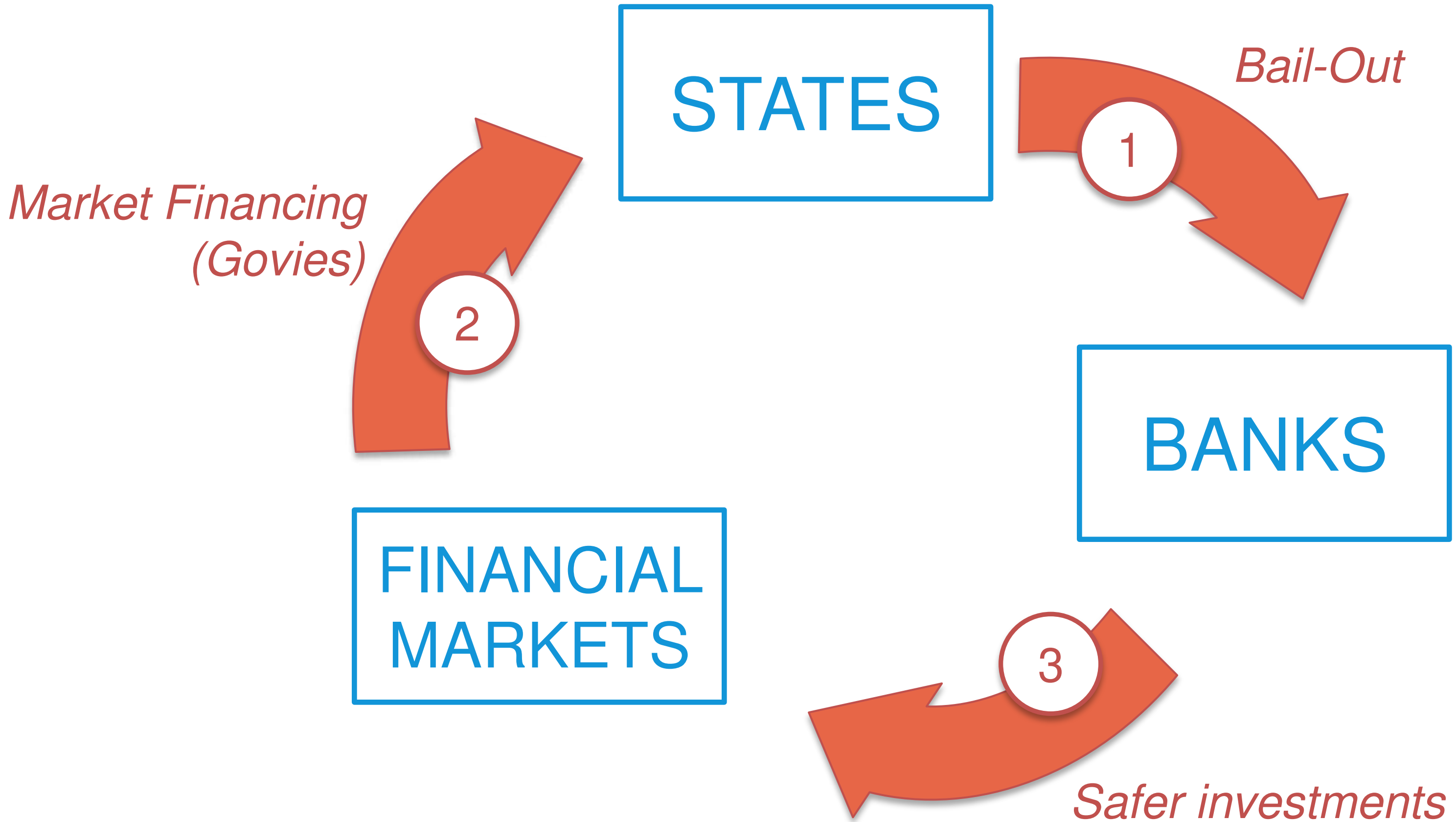

QUESTIONS ABOUT THE EUROPEAN UNIVERSAL BANKING MODEL

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Quotes from the Liikanen report

Too large a banking sector?

Bank assets / GDP, 2010

	Total bank sector	Top 10 banks
EU	349%	122%
US	78%	44%
Japan	174%	91%

Efficiency of the universal banking model?

*"The available estimates tend to suggest that **[maximum efficiency scale of banking] are relatively low** compared to the current size of the largest EU banks"*

*"**There is less evidence that other forms of functional diversification** [other than combining deposit-taking and lending activities] **create value**"*

EU banks growing too fast?

Total assets of MFIs in EU vs GDP (source Eurostat), 2001-2011, in €Tn

	MFIs assets	GDP EU 27
2001	25	9.6
2007	38	12.3
2011	46	12.6
	x1.8	x1.3

What value for society?

*"Fast growth and uncontrolled expansion is **difficult to square with business model sustainability**."*

*"**Excessive complexity and conflicts of interest may result** as banks expand their activity range"*

CONTENT

WHAT ARE THE CONTEMPLATED ANSWERS?

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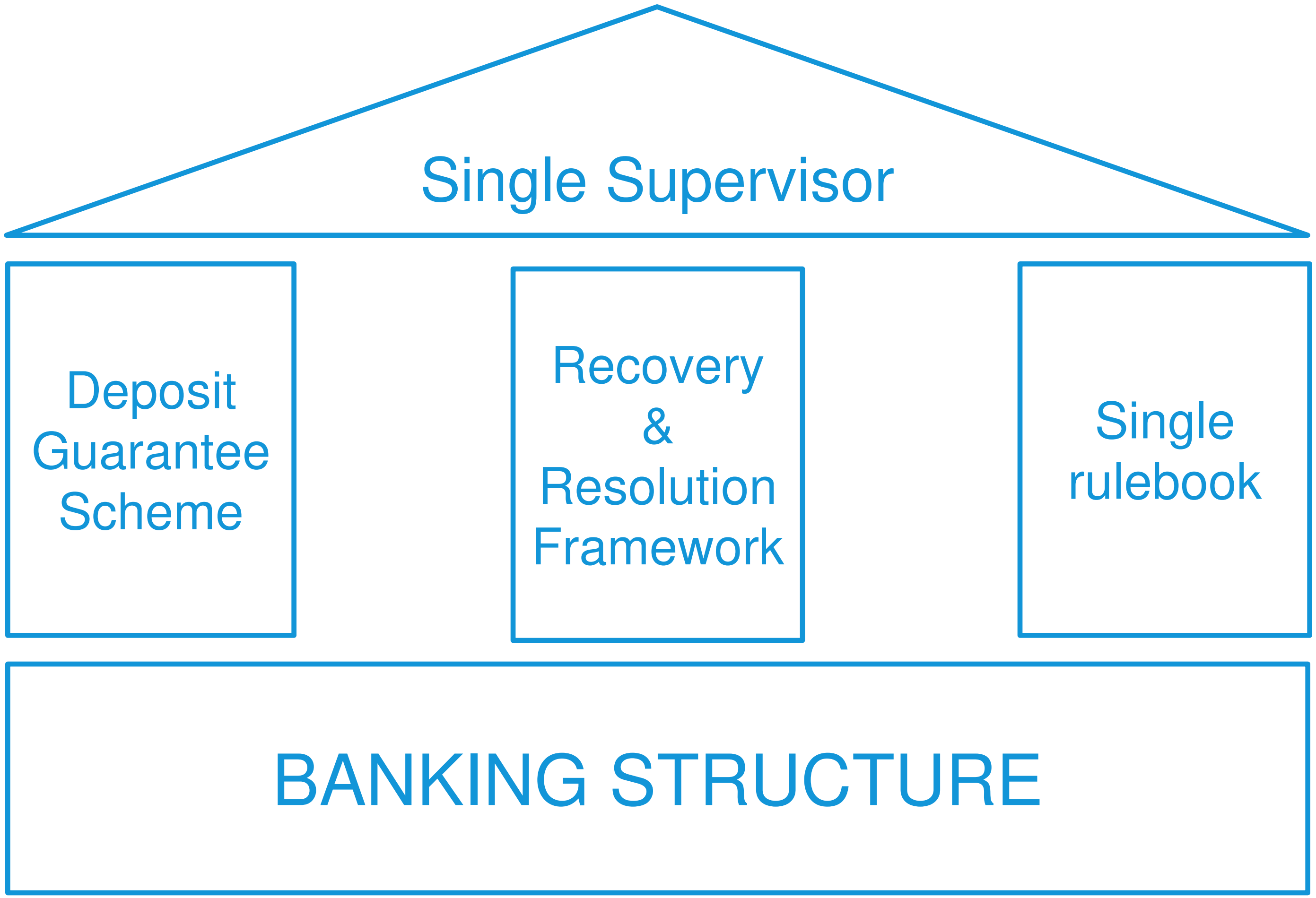
To address these major economical and societal issues, the European Commission has been and is still working on **a set of proposals**, namely:

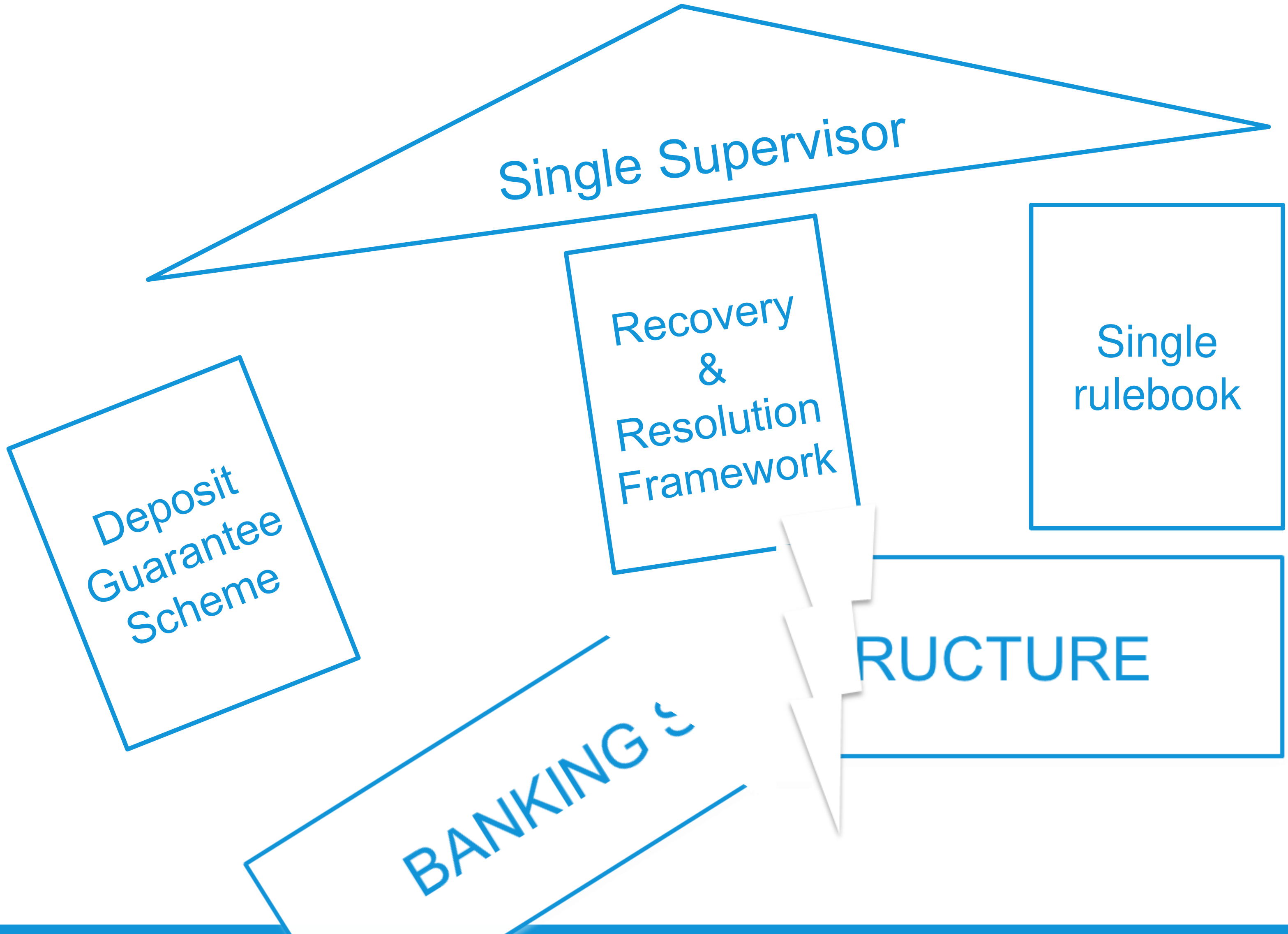
- Consultative work on **the structure of the European banking industry**, initiated by the Liikanen report and the related consultation, and that will hopefully lead to a legislative proposal ;
- Legislative proposal for **a recovery and resolution framework** ;
- Proposal for a **banking union**, including **a single supervisory mechanism** at European level supported by **a single rule book**, combined with **a deposit protection system**.

We believe that **each of these proposals is a crucial piece in the overall framework**, with banking structure as the foundation.

BANKING STRUCTURE IS THE FOUNDATION



WHAT IF THE FOUNDATION IS NOT ROBUST?



ABOUT THE PROPOSAL FOR A BANKING UNION

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A series of technical issues need to be addressed :

Institutional framework

- Relations between EBA and the Single Supervisor?
- Inability to supervise insurance and securities
- Accountability and transparency?
- Separation of monetary policy and supervision?

Financing of the supervision and resolution process

- Is there a market for bail-in-able bonds?
- Fiscal backstop (no EU taxpayer)?
- What assets for a European resolution fund?
- National / EU level?

Supervision and enforcement

- 27/17 (rights of countries in the EZ and out-EZ)?

➡ **Crucial issues to be addressed**

➡ **A necessary but not sufficient condition** to tackle fundamental structural issues

ABOUT THE PROPOSAL FOR A BANKING UNION

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Beyond technical issues :

- Banking union is **an important step** towards building a resilient EU banking sector.

But

- Banking union proposal as such **does not address moral hazard:** it moves it up at the European level and, taken on its own, increases moral hazard…
- …unless crisis management and bank resolution proposal is implemented and **bail-inable bonds are issued in sufficient quantity**….
- … and **an adequate banking structure** is put in place beforehand. This adequate banking structure needs to address the following issues:
    - "Too big to fail" banks (implications on tax payers' money and distortion of activity and competition)
    - Creation of asset bubbles
    - Many banks above optimal size and seem "beyond resolvability" as evidenced by FDIC experience
    - Political acceptability of cross-border bank bail-outs

LESSONS FROM THE U.S. EXPERIENCE

The U.S. "Glass Steagall Act", 1933 Banking Act

(1) Creation of the single supervision (FDIC), assorted with the necessary powers to deal with supervision and management of banks' failures

(2) Separation of investment banks and deposit banks

- The banking structure was changed in 1999 with the drop of the mandatory separation of investment banks and deposit banks.
- It led to the development of giant financial institutions (the first one being Citi Group, resulting from the merger of Citi Corp. and Travelers Group in 1998).
- FDIC has proved to be an effective bank resolution authority for small and medium size banks but could not manage the resolution of Washington Mutual in 2008 (~USD 300 Bn total assets) without losing money.

CONTENT

HOW TO MAKE A BANKING UNION WORK?

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3 Appropriate governance & accountability of the Single Supervisor

2 Put in place resolution mechanisms which **allow banks to fail** without putting tax payers' money at risk

1 Reform **banking structure** with a view of reducing drastically moral hazard and the **threat it represents to resolution and supervision mechanisms**

Thank you

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