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Register of Interest Representatives No. 62379064909-15

Contribution to "Consultation by the High-level Expert Group on Reforming the structure of the EU banking sector"

To what extent are the current and ongoing regulatory reforms sufficient to ensure a stable and efficient banking system and avoid systemic crises?

We understand the Expert Group's pursuit to structural reforms in order to avoid systemic crises in the future. We as German Savings Bank strongly support prudent regulation because Savings Banks are obviously interested in resilient financial markets. However, we would like to point out that systemic crises can emerge from many settings and cannot be avoided in all circumstances.

We are of the opinion that in spite of numerous activities that have been developed in banking supervision in the last three years, little improvement has been achieved when it comes to the stability of financial markets.

Obviously the new standards that ensure high quality of common equity as well as prudent liquidity requirements (Basel III) contribute to bank's stability to a certain extent. These rules, although designed to fit large internationally active banks, have to be implemented by every institution in Europe, regardless of it's size. In fact it seems that the new rules are already penalising small institutions unduly in comparison with large banks.

From a risk-based point of view it is necessary to focus on the real sources of risk that threaten the stability of financial markets. In this regard - as mentioned before - little has been achieved.

We still hold the "too big to fail"-problem for a pending issue. Given the fact that some banks in UK or France have a total balance sheet of their home countries' GDP clearly indicates where the risks for the financial markets are allocated. In this context we think that a surcharge of 2,5 % common equity is hardly enough to compensate this risk.

In addition to that it is obvious that banks have been facing a regulatory avalanche since 2009 whereas the regulation of the shadow banking sector is only at the outset. In order to ensure the stability of financial markets we think it is about time to establish some stricter regulation in order to avoid disincentives and evasive action.

Which structural reforms would improve the safety and efficiency of the banking system in the EU in the near term? In the long term?

In the past and especially before the beginning of the financial crisis increased levels of cross-border banking consolidation are being considered in the context of achieving better integration in Europe's retail banking markets. It was argued that banking consolidation can contribute to increasing the long-term efficiency as well as strengthening the profitability and competitiveness of the banking sector. Ireland has been picked as a good example for this development. We would like to recall that Ireland was among the first member states that faced severe fiscal consequences due to governmental injections into the banking sector.

As one key component of the European Union's attempt to create a single market for financial services the European Commission started with the Financial Services Action Plan (FSAP). Beginning in 2005, the European Commission as part of the FSAP launched various legislative initiatives to harmonize the retail business, so the retail banking and SME financing. From the perspective of the former internal market Commissioner Charlie McCreevy the EU has long held the view that Europe's banking sector is too fragmented and more cross-border mergers are vital to consolidate the financial services sector. So he made himself strong for a consolidation - that means for the creation of large European banks as global player in the global market.

This was however just one side of the story. At that time the European Parliament (EP) had been pursuing a completely different approach and took empirical evidence into account that suggests that banking consolidation can have negative impacts on the stakeholders of banking markets, namely the customers, shareholders and employees of credit institutions. From the European Parliament's point of view risksharing and the efficient allocation of risks in the financial markets are achievable through diversification. The majority of the Members of the European Parliament (MEP) advocated the diversity in the European banking market as an advantage in the interests of the European citizens and especially the financial market stability.

In its resolution 'on further consolidation in the financial services industry' **(Muscat Report, July 2006)** the EP drew the importance of a diversified banking market. There the EP acknowledged that "EC legislation should not favour any single type of business model or corporate structure or any single type of product over another". The EP "believes that the diversity of financial institutions, which better reflects the variety of financing needs of corporate entities, SMEs and consumers, should be preserved and that, therefore, EC legislation should not fa-

vour any single type of business model or corporate structure or any single type of product over another;"[1]

Similarly to it, the EP also provided in its initiative report 'on Competition: Sector inquiry on retail banking' **(Pittella Report, May 2008)** detailed recommendations regarding a pluralistic and diversified banking sector in Europe. The report advocates that "diversity of legal models and business objectives of the financial entities in the retail banking sector (banks, savings banks, cooperatives, etc) is a fundamental asset to the EU's economy which enriches the sector, corresponds to the pluralist structure of the market and helps to increase competition in the internal market".[2] Further on the report "stresses that pluralistic banking markets and diversity of providers are preconditions for competition throughout the EU banking market provided that there is no distortion of competition and a level playing field is guaranteed for all market participants on the principle, 'same business, same risks, same rules'".[3]

In the same year the EP agreed the report 'on the Green Paper on retail financial services in the single market' **(Karas Report, May 2008)**. The key message of this report is that a real "competition itself requires a large number of market participants. Limiting the market to a few large providers would undermine that aim. For the same reason the diversity of legal forms (limited company, cooperative, savings bank and mutual association) should be encouraged." [4]

From the beginning of the process the **German Savings Banks (DSGV)** supported these views of the EP and argued that a concentrated European strategy on cross-border consolidation would induce negative side-effects on the stability of the financial system. Already in 2004 the German Savings Banks together with all European savings banks made aware in an open letter to the former Commissioner McCreevy and the Council Presidency that cross-border consolidation leads to closer linkages between financial markets, institutions and systems. This means that the potential cross-border contagion of financial crisis will increase.[5]

Especially today such concerns should be at the heart of any strategy to improve the integration of Europe's banking market. The DSGV is strongly in favour of achieving more integration if it leads to increased levels of competition in the sector, and in expressing the ideals of a competitive European banking industry. The experiences of the ongoing financial crisis show, that to gain and assure stability there is a need for workable and plural market forces. From our perspective a political aim with utmost importance must still be to shape the banking markets by securing a workable competition.

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[1] cf. EP resolution on further consolidation in the financial services industry (2006/2081(INI)) P6_TA(2006)0294, Committee on Economic and Monetary Affairs, Rapporteur: Joseph Muscat 4 July 2006, para 9, p. 3.
[2] cf. EP report (2008) on Competition: Sector inquiry on retail banking (2007/2201(INI)), Committee on Economic and Monetary Affairs, Rapporteur: Gianni Pittella, 5 May 2008 (A6-0185/2008), Recital H, p. 4.
[3] ibid. para. 24, p. 8.
[4] cf. EP report (2008) on the Green Paper on retail financial services in the single market (2007/2287(INI)), Committee on Economic and Monetary Affairs, Rapporteur: Othmar Karas, 15 May 2008 (A6-0187/2008), p. 13.
[5] cf. Open Letter to Commissioner McCreevy and the Council Presidency (Dutch and Luxembourg), 7 December 2004.

In addition to that we think that the business model of regionally active Savings Banks has shown as well it's resilience to adverse developments as it's profitability. Same is true for regionally operating cooperative banks. Due to their retail oriented business model and their local market expertise they performed well in the crises. Any structural reforms that would lead to the breaking up of smaller institutions is the wrong way. Forcing these institutions into mergers leads to bigger banks that consequently exacerbate the "too big to fail" issue.

What are your views on the structural reform proposals to date (e.g. US Volcker Rule, UK ICB proposal)? What would be the implications of these proposals on your institution and the financial system as a whole?

Right at the start we are of the opinion that there are no hard and fast rules. Structural reforms can not be implemented by a copy and paste method across the globe. They have to fit the shape of the economic zone.

Volcker rule or Glass-Steagall Act for example follow the old US doctrine of a separate banking system. This might be adequate for the US where universal banking is not common due to historical reasons. The US banking market consists of several large investment banks focussing on investment banking and numerous small regionally active banks like the community banks and other business models. The Volcker rules does therefore not undermine the fundamental structure of the US financial market.

Unlike in the US, universal banks are quite popular in continental Europe. Provided that initial condition, implementation of the Volcker rule in Europe would lead to fundamental structural changes and destruction of business models. What is more, a separation banking system in our opinion does not remove sources of instability as can be proved by Lehman Brothers that was at the core of the financial crisis although having been a pure investment bank. In addition to that we think that tearing apart universal banks will have a negative impact on services provided to customers. One-stop service would no longer be possible which is not for the good of the customer. Especially the larger among the SMEs need this kind of service to support their further growth.

Regarding the Vickers Commission's proposal we comprehend the idea behind ring fencing. We have the impression that the Vickers Commission aim at meeting doubts about the capability of the British deposit guarantee scheme which has proved not to be sufficient in case of Northern Rock. Therefore it might make sense to ring fence the retail activities in order to avoid bank runs and to address moral hazard.

This proposal might fit a British banking system which is shaped by a few large universal banks that are engaged in retail business as well as in the investment banking. However, we think it is preferable to strengthen a deposit protection schemes' credibility and validity instead of

ring fencing retail business. In addition to that, ring fencing in combination with higher capital requirements provides for a considerable disincentive, namely to reduce retail business and to increase activities in the investment banking.

Summing all up it can be noted that structural reforms can only work effectively and sufficiently if they fit the environment. As financial markets differ considerably there will not be a blueprint for an European structure.

What are the main challenges of your financial institution as regards resolvability? Are you implementing structural changes to your institution in the framework of your recovery and resolution planning?

We made good experiences with a institutional protection scheme instead of deposit guarantee schemes. The "Joint Liability Scheme" ensures that Savings Banks will continue to operate and that they will discharge all their obligations. This "institutional protection" is achieved by funds provided by the Savings Banks Finance Group itself, and also by extensive monitoring mechanisms. With the Joint Liability Scheme, the Savings Banks Finance Group goes far beyond what is required by law because the scheme protects customer deposits in full. The Joint Liability Scheme ensures that Savings Banks will continue to operate, i.e. that they will discharge all their obligations and that bank accounts will be maintained. Since the establishment of the Joint Liability Scheme in 1973, creditors of Savings Banks, *Landesbanken* or central building societies – whether customers or investors – have never had to waive outstanding claims. This is a major source of our customers' solid confidence in German Savings Banks. What is more that our experience shows that institutional protection is by far less costly than resolution of a bank a satisfying creditors. Which leads to the conclusion that institutional protection scheme is a proven and successful form of an early intervention mechanism.