PROXINVEST’S answer to the consultation of the Directorate General Internal Market and Services of the European Commission on “Reforming the structure of the EU banking sector”.

As independent proxy advisory and corporate governance research company, also Managing Member of the only European multi-countries proxy service company ECGS Ltd., Proxinvest is pleased to comment on the consultation of the Directorate General Internal Market and Services of the European Commission on “Reforming the structure of the EU banking sector”.

This consultation follows the excellent analysis of the Liikanen High-Level Expert Group (HLEG) on the topic. The great merit of the thorough and up-to-date Liikanen review of the European banking system was that not only the systemic risk issue of EU banking groups was analyzed, including their balance sheet expansion, high leverage, lack of market discipline, lack of bank resolvability, excessive risk-taking, trading and market-based activities, but also the general economic impact on competition resulting from their implicit bail-out expectations as well as the impact on the financial system of the multiple conflicts of interests of their multiple business activities was taken into consideration.

Proxinvest considers that the issue is approached properly by the current consultation when it underlines both the risks and the benefits of cross-subsidization resulting from the all-trading and all investing capacity of big banks.

The definition of the public interest in this debate cannot be limited to the satisfaction of the bankers themselves nor of some of their clients, generally presented by the banks themselves as big industrial or financial groups actually using the different activities of these universal banks. For Proxinvest, the public interest scope of the E.C. must be extended to the general impact on small or individual clients of the banks as well as on the financial and non-financial service industries witnessing the entry of banks in their field of activities. Major universal banks in Europe are not only leaders in broad financial services such as brokerage, arbitrage, asset management and insurance, they have become strong and sometimes dominating leaders in non-financial service industries such as real estate, car rental and computer services and they aggressively enter the home services, telephone and computer services industries.

Proxinvest would also add up here two biases generated by the weight of these largest and most complex banking groups on the general economic development: a bias favoring the service of big clients at the cost of individual and small enterprises, a bias favoring the short term income for the bank at the cost of longer term projects.

This leads us to answer to the first question of the consultation: YES, structural reform of the largest and most complex banking groups address and alleviate the problems stressed by the High-level Expert Group. Not only it can, but it is the only way and also the most efficient way to fairly address and alleviate these problems. Banks in Europe have fully lost the entrepreneurial spirit of self-starting enterprises and have accustomed themselves to act as regulated institutions entertaining strong ties with the Financial
authorities and national professional associations to defend their corporative interests. Most of the above mentioned problems have been generated following structural regulatory changes occurred in the national banking rules, for example in France in 1965 and finalized at the European level with the MIFID Directive of 2004, Proxinvest thereunder strongly recommends to reconsider, in the name of fair competition and efficient economic funding the current free mix of financial and non-financial activities within the same State protected financial group.

To the second question of the consultation about the perimeter of this reform Proxinvest also answers YES, an EU proposal in the field of structural reform is needed, and further national State would be even well inspired not to wait for such excellent international initiative.

Proxinvest certainly supports that a EU-wide approach to regulation would (i) avoid the costs for banking groups of diverging national bank structural reform proposals; (ii) avoid potential inconsistencies of national reforms; and, (iii) safeguard the EU internal market in financial services.

Proxinvest supports further that it is within the mission of the European Community original project to foster fair competition while it observes that the national banking associations and authorities have in the last years developed a more protectionist approach, suggesting that they certainly have concern for their liquidity and their solvability and profitability but no consideration for the a fair level playing field for domestic of foreign competing services providers.

On the question 3 on the appropriate definition of systemically risky trading activities Proxinvest’s answer is framed by a larger approach of the banking reform than the present consultation which addresses only the issue of systemic risk and final bank solvency. Our approach of the banking system, in line with the Liikanen report findings, is also strongly concerned by the negative impact of the current universal banking model over fair competition in the banking and general service industries.

We consider that the barrier to entry created by the banking regulation and the open access in any non-banking service area to banks implicitly protected by the tax payers have had in the last thirty years a negative impact over 1/ the general quality of banking services, 2/ the overall capital allocation to the economy and 3/ the service industries invaded by State protected banks.

We consider also and we have demonstrated\(^1\) that the internal competition and conflicts of interests of the different divisions of these multi-business universal banks have created an internal short-perm preference bias, which encouraged uncontrolled asset trading and risk taking.

Accordingly, we have never considered the trading activity of banks as a risk “per se”, but merely the internal inefficiencies of multi-business financial groups to have resulted in defaulting credit allocation and risk management within universal banks and some big multi-business financial institutions.

This important framing point being set, the objective of the separation of some banking activities from the traditional loan and deposits is not for us to isolate only systemically risky trading activities.

Our answer to the specific question on Scope of banks potentially subject to separation would therefore be to recommend including all banks carrying substantial activities in addition classical retail and

corporate lending and deposit taking. At the same time we consider the appropriate perimeter of systemically risky trading activities should be the narrowest proposed, “focused on net volumes, which is likely to only capture those institutions that have a higher share of unbalanced risk trading”.

On the points 3.2.2. on the Supervisory discretion for separation, and 3.2.3. Activities to be separated, we would clearly favor the Ex ante separation with immediately applicable separation rule. However, because we consider the problem to be much larger than concentrated in the trading activity of banks, we recommend an alternative approach for the splitting of the classical State or tax-payers protected deposit and lending activity from all other financial or non-financial services activities of banks.

We therefore recommend to go back to the classical prohibition of the holding of certain assets for registered i.e. implicitly protected banks. Until the eighties of the previous century, banks where prohibited in many countries to hold shares and real goods such as real estate for their own, except assets used for their banking operations. They were, with a late allowance concerning the covering of part of their equity position against inflation, under the strict prohibition to own risky equity investments in the asset side of their balance sheet. They were, however, freely trading foreign exchange for their customers and their own accounts and their “interest rates transformation” generally was, at the time, their most important own account risk taking activity. In view of the many derivative instruments developed since thirty years, we consider the credit, interest rates and currency derivative such as swaps and the CDS to be legitimate assets for these pure-play banks.

Proxinvest would, however, recommend going back to the same rule thereby forcing the banks to justify the benefit of the public protection they enjoy. Two items would remain for discussion, the definition of a loan asset versus and equity asset and the allowance for inflation protection. Needless to say the practice of long term lending having happily developed since the seventies, the definition of a loan asset would have to be restricted to a reasonable duration of the risk, not exceeding thirty years, we would recommend not to exceed 25 years. As concerns the allowance for inflation protection we do not see the merit of such allowance, the business of pure banks being to lend money the inflation protection of their equity funds should be provided by their legitimate business only.

Our answer on the question 5 clearly favors the “Broad” trading entity and “narrow” deposit bank concept: in our opinion all wholesale and investment banking activities should be separated. However, because we recommend a separation of activities based on the type of assets held in the balance sheet and not based on the frequency or type of use of these assets, our separation does not at all exclude for banks the trading activity on fixed income assets, interest rates and currencies. Therefore, our recommendation keeps for the deposit bank their full ability to directly provide corporate and retail clients with certain risk management services, but not all of them. Under our scenario, the deposit bank would be able to provide forex, credit default and interest rate coverage services. They would however never be able to provide to their clients, directly or indirectly damage insurance, oil price coverage, equity swaps or real estate options. All these products would be left to specialized non State protected entities, such as investment bankers, brokerage houses, insurance companies, real estate developers.

Everyone will see many substantial benefits from such a separation of activities for the real efficiency of real full time banks, the quality of bank services and also for the healthier loan and capital allocation in the economy, the fair competition in the financial and non-financial services business.

On the final question of the Strength of separation, we would fully support as the only appropriate separation, the only serious separation the strict ownership separation where the ownership of assets supporting different activities would be fully separated.

Accordingly, the real banking services and the other multiple non-banking services would have to be provided by different firms with different owners that have no affiliations. This is the approach followed
by the Volcker Rule and was also the approach followed by the 1933 Glass-Steagall Act.

We fully support this realistic Volcker approach because; it is the only one that clearly isolates the non-banking activities from the implicit support of the States. Proxinvest can provide multiple example cases were, thanks to accounting, functional, economic, legal or governance separations, within the same banking group the conflicting files are kept isolated for a while but finally solved by the decision of a CEO accessing all the conflicting information and finally deciding for the short term profit because this is simply the only practical and logical solution to manage complex conflicted decision within a multi business banking firm.

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