New York, November 20, 2012

The European Commission
Markt division
Brussels, Belgium
By internet mail

Comment letter on the Liikanen Report of the High Level Experts on European Banking

Dear Sirs,

I am allowing myself to send you some comments on the Liikanen Report, as a European Banking practitioner, commentator and author, as well as a teacher of *European Banking and Finance* At Columbia University School of law.

My contribution to the analysis of the report of High Level Experts will be essentially focused on items 5.4 to 5.6. This does not disregard the remarkable work done by the Group. In fact, the analysis of the situation should be treated as a special study that would in itself be extremely helpful to those who try to understand the current situation of the European Banking System.

I had a hard time understanding whether the report was trying to put in place a reform to structure a more solid banking or to accompany the *current* European resolution system with extra measures once a bank is in difficulty. This ambiguity explains some of my comments.
It is partly due to the fact that the a-priori of the Group that *No particular banking model fared particularly well, or particularly poorly, in the financial crisis.* Such a statement is not substantiated and, to a certain extent, closes the fundamental debate before it starts. One just needs to look at the demise of the UK banking system that suffered the worst banking crisis of all. Between Northern Rock, the nationalization of several banks, the Libor crisis, we have there a vivid example of the best regulated (nothing beats the Banking Act if it had been applied) and a mismanaged banking system. It is a way to avoid the question of the merits of the European universal banking system.

1. **Preventive measures**

1.1 **The trading buffer must be justified and risk weighted: the level playing field question**

The proposal to require banks to have an additional equity buffer is not justified by quantitative or qualitative arguments. It is important that a level playing field exists between banks across the world when it comes to the equity allocated to agency businesses.

Are we talking about market making? This is already covered under Basle III. It might not be advisable to put European banks in a regulatory disadvantage in a regular market making activity.

Are we talking about proprietary trading? That would be an admission that European banks will be more vulnerable than their counterparts since they would have more latitude in proprietary trading.

In any case the buffer should be risk adjusted. Trading in bonds, equities, derivative products or sovereign debt do not carry the same amount of risk. Rather than a general buffer, I would apply it to the trading activities using the Basel III criteria in order to put European Banks at par with their global counterparts.

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1 5.5 p. 99
1.2 The European Universal Banking System

Predictably, no attempt has been made to question the universal banking model that prevails in the Eurozone. The approach allowed the Group to avoid looking at the specific risks of the European universal banking system. This sacred cow defended by the global European Banks is only indirectly addressed by some separation of the trading activities and the deposit taking institutions. I am definitely not trying to suggest that we come back to the Glass Steagall Act, which was implemented in other times, but those who decided to abolish it and the banks that forced this abolition never answered the haunting question: had the Glass Steagall Act been in place, what would the financial crisis of 2008 have been?

As a preventive measure, the weakness of the structure of the US investment banks and their outrageous leverage following a new US regulation (40 times for Merrill Lynch and Lehman Brothers) would not have been possible. Deposit Banks would not have massively securitized their assets to distribute them and concentrate on fee earning activities.

1.3 Proprietary trading

The proposal of the High Group of Experts is to separate proprietary trading when banks have 15-25% of their assets in trading activities. This approach is conceptually incorrect.

Proprietary trading is the trading of the equity capital of the bank. By definition it cannot be separated. Furthermore, the importance of proprietary trading as a share of the own funds of the bank that will allow assessing the risks associated to that activity.

\[ \text{2 5.4.2.1 p.98} \]
\[ \text{3 5.5.1 p.101} \]
The idea to “separate” proprietary trading makes no sense: proprietary trading involves the whole equity of the bank. The only way to “separate” proprietary trading is to actually split the bank which the High Group of Experts does not advocate, and rightly so. In its final rulemaking, this proposal has to be conceptually revisited. A European version of the Volcker rule has to be defined.

1.4 The Volcker Rule

In the United States, the Dodd Frank Act\(^4\) has established the nature of the instruments and to limit some activities in proportion of the equity. One of those rules affect equity investments in hedge funds and private equity: their aggregate value cannot represent more than 3% of the equity of the Tier 1 capital of the bank.\(^5\)

When it comes to proprietary trading, the principle should be unequivocal. Shareholders are investing in banks own funds whose mission is clearly to be allocated to protect the bank against specific banking risks.

The Group seems to be hesitant to tackle the issue despite the benefits of the Volcker Rule. It might reflect the intense lobbying that banks on both side of the Atlantic Ocean have developed to convince their authorities that it was the wrong measure.

The Volcker Rule does not prohibit banks from developing and managing trading activities provided that they are adequately capitalized and concentrate on agency business. But there is no justification for the

\(^4\) This is a summary of the Dodd Frank Act produced by the US Senate. [http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf](http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf)

\(^5\) A US law firm summary of the proprietary trading limitations, June 2010 [http://www.pillsburylaw.com/siteFiles/Publications/CorpSec_Alert_Volcker%20Rule_07-21-10_secure.pdf](http://www.pillsburylaw.com/siteFiles/Publications/CorpSec_Alert_Volcker%20Rule_07-21-10_secure.pdf)
transformation of the bank’s equity into a hedge fund through the trading of speculative instruments for the bank’s own account.

Recent cases have demonstrated that the predilection of banks is to speculate in the field of derivatives and stock market indexes. The JP Morgan Corporate Investment Office lost $6 billion on “macro hedging” using a loophole of the Dodd Frank Act imposed by the US Congress under the intense lobbying of banks led by ... JP Morgan. There is no justification for a bank to speculate on the possible trend of a stock market.

2. Governance of the banks

The report of the Group tackles the issue of Governance in a generic way. Governance and controls are more important for banks than for non-banks. 6 Unfortunately, the report blends together management, board of directors and controls. This does not allow a specific analysis of the strength and weaknesses of each, and no specific measures are proposed.

I would like to single out here the question of the Boards of Directors 7. It is mentioned in the summary of proposals without further elaboration 8. They have become a combination of submission to the management, limited competence and insufficient courage of Directors. From the election of Board Members, the system is structured to provide a cooptation of Members amongst a restricted number of

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6 5.5.5 p. 105
7 Georges Ugeux, La Trahison de la Finance: douze réformes pour rétablir la confiance, Paris, Editions Odile Jacob, Septembre 2010. 255 pp. particularly the chapter 3 on Renforcer les Conseils d’Administration.
The English version of the book is available at http://www.lulu.com/shop/search.ep?keyWords=ugeux&categoryId=100501
8 p. iii
people. This has been clearly identified in the Higgs Report⁹ on the role and effectiveness of independent directors that became part of the UG corporate governance code published in 2012.

The following questions have to not been addressed:

- How do the directors defend their performance when shareholders of banks, from Fortis to Societe Generale, whom they are supposed to represent, lost 80% of the value of their shares since 2007? It is also the level of losses of the European Bank indexes, including the Euro STOXX banking index that lost 75% over the past five years.

- How do bank regulators approve the appointment of bank directors? How can the system match expertise and independence?

- At the time of the Kerviel crisis at Societe Generale, only one independent director had a banking background.

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⁹ Review of the role and effectiveness of Independent Directors
The United States have started taking measures to ensure that a minimum of the Board understands financial services, and the audit committee should include financially literate members. I remember that when this was discussed, the lawyers were very upset that they were not considered qualified. On the other side, all CEOs are deemed to be financially literate.

It is imperative that the Commission looks more closely at the Governance of banking boards. Am I allowed to mention that most directors of banks are the same as before the crisis?

I would recommend that the Commission considers this part of banking regulation and sets up rules, supervision and auditing of governance rules in order to avoid the consequences for the stability of the European Banking System.

3. The resolution mechanisms

While there are considerable discussions about the resolution mechanisms, it is difficult to find a directing line of thought. The report jumps from regulation of banking to resolution of banking crisis without providing a directive suggestion.

The endorsement of the Bank Recovery and Resolution Directive and the Recovery and Resolution Plans seem to be simply endorsed by the High-level Expert Group. It is interesting to note wider separation...to ensure resolvability and operational continuity. This might only be triggered by some circumstances that threaten the bank as a whole. I would like to stress here

10 http://www.sec.gov/rules/final/33-8220.htm

11 5.5 p.100
12 Summary of the Proposal, p. iii
that prior to resolution measures, preventive measures have to be put in place. Too much accent is put on the resolution, not enough prevents the crisis.

One should also not underestimate the difficulty for the Commission to decide that a bank requires some corrective measure when its situation is precarious: the authorities might be accused of accelerating the difficulties and ultimately be considered as liable for such demise.

4. A structural reform is indispensable.  

Many of the observations of the Liikanen report should draw the attention of policy makers:

- Europe is overbanked: while the total assets of the US banks represent less 78% of their country GDP, the same ratio in Europe reaches 350%. The UK is at 575% and France at 420%. This percentage was 250% ten years ago. The assets grew from 30 to 45 trillion euros. What did the regulators do? Did equity grow at the same pace or was it increased leverage?

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13 Georges Ugeux. *Can Europe produce a coherent and effective financial regulation*, in Columbia Journal of European Law, September 2012

14 Summary pp 11-12
It is obvious that the universal banking system has had a pure growth strategy which was ensuring that capital markets did not reduce their 70% market share of financial assets, while, in the United States, the ratio is at 40%.

Most of the largest European banks have a total equity/total assets ration below 4%. The growth of assets in European bank balance sheets resulted in an insufficient capitalization of the European banking system compared to its US counterparts.

Europe is structurally overexposed to the risks of its banking system. Unless measures are taken to ensure that the share of bank financing be substantially reduced, the reforms of the Liikanen report will only scratch the surface of the necessary structural and institutional reforms of the European Banking System.

**Recommendation**

In view of the above, it is essential to take measures that strictly increase the financial health of European financial institutions, reduce the share of the banking system and question the performance of the universal banking system that seems to have been very effective in monopolizing finance in its balance sheets.

15 Chart 3.4.13p.47
The question of **too big to fail** should be addressed, not only at the level of the banks themselves, but at the macro-economic level. Could banks actually collapse Europe?

Europe is playing with fire and, by letting the current structure in place, is also putting its European Central Bank in difficulty: to *support bank lending*\(^{16}\), the ECB is now letting its balance sheet explode.

This is the real challenge of the European banking system.

Let me finish with a quote of Goethe that was mentioned by the previous European Central Bank President, Jean-Claude Trichet, in his farewell speech:

*“Knowing is not enough; we must apply. Willing is not enough; we must do.”*\(^{17}\)

Sincerely,

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