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Mr Erkki Liikanen
Chairman of the High-Level Expert Group on reforming the structure of the EU banking sector

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Subject: **The European Commission's Financial Services User Group's position on reforming the structure of the EU banking sector**

Dear Mr Liikanen,

The Financial Services User Group (FSUG) has been set up by the European Commission to represent the interests of European consumers, retail investors or micro-enterprises, as well as individual experts with expertise in financial services from the perspective of the financial services users.

The High-Level Expert Group you chair has an extremely important responsibility, and we wish to communicate to you and the Group the views of the FSUG on bank structures.

We strongly believe that the commercial banking activities (i.e. the intermediated funding of the real economy: businesses – SMEs in particular which are net job creators in the EU – and households) should be separated as much as possible from other activities (such as trading, investment banking, asset management, insurance, etc.) that commercial banks have been diversifying into in the recent decades.

There are at least three critical reasons to ensure commercial banks get back to their core business:

- greater accountability and transparency
- risk allocation and management
- conflicts of interest.

1. Greater accountability and transparency

First, commercial banks enjoy a unique privilege, which is the access to central banks' funding. The purpose of central bank funding is to enable commercial banks to perform their role of funding the real economy: collecting deposits and transforming them into loans. It has never been intended for anything else. Central banking funds – which is public money: belonging to the EU citizens – should not be used by banks to fund any other activities, such as trading, investment banking, asset management or insurance. As a matter of fact, today EU citizens have no clue what the almost free money (1 % interest rate on three-year loans) in the amount of EUR 1 trillion provided by the ECB to EU banks (known as 'LTROs') is used for by the banks. But all the evidence gathered by the FSUG and others shows that it does not seem to be primarily used to develop credit and/or lower the cost of credit to the real economy. This nevertheless equates to tens of billions of euros of public subsidies to European banks that should be used to strengthen economic growth and help jobs creation.

2. Risk allocation and management

Second, allowing commercial banks to develop non-commercial banking activities has led to significantly more financial instability, an increase of systemic risks and the rise of so-called 'too big to fail' institutions. Indeed, for example, allowing banks to massively securitise their mortgage loans portfolios and thus quickly taking them out of their balance sheets in the most recent decades, is the key enabling factor for the 'subprime' bubble: if subprime loans were to stay in the lending banks' balance sheets as it was in the past, banks would have exercised much more scrutiny and would have been much more responsible lenders. The subprime crisis was itself the trigger for the global and devastating financial crisis that is still ongoing.

In the recent decades, many commercial banks have also been adding higher margin businesses to their franchise, leveraging their distribution networks, and relying on their ability to get refinanced by central banks. This is one of the reasons for the rise of 'too big to fail' institutions. It has also resulted in an unfair transfer and allocation of risk to citizens – in other words, rewards were privatised while risk was socialised.

One quite logical solution to the 'too big to fail' and risk/reward allocation issues is to reduce the size of these institutions by spinning their non-commercial banking businesses off. This is quite easy to do: similar for example to the pharmaceutical conglomerates spinning off their upstream chemical businesses in the 1990s. This is much more logical than the current EU authorities' approach which is to bring even more capital into these already too big institutions, or to let banks downsize their credit businesses instead of spinning off non-credit businesses.

3. Conflicts of interest

Thirdly, allowing commercial banks to expand into non-commercial banking activities such as trading, asset management, insurance, etc., has led to very significant conflicts of interests, so-called 'Chinese walls' turning out to be most often Japanese (paper) ones. For example, listed companies often find themselves to have big banks at the same time as their credit provider and as a major shareholder, especially through shares owned by their asset management arm. Another example: quite a few packaged investment products created by asset managers who are affiliates of banks are built upon derivatives contracted with the parent bank's trading department.

Also, this expansion of commercial banks into other businesses has led to the re-intermediation of capital markets (equities and bonds markets), crowding out end-investors (individual ones in particular, pushed by banks toward highly-commissioned 'packaged' investment products instead of securities in the recent decades), and thus severing the link between economic owners of listed companies and their management.

4. DEALING WITH ARGUMENTS AGAINST SEPARATION

Opponents make a number of arguments against separation. These include claims that:

- The activities of retail banking would be less profitable, so the cost to retail customers would be higher.
- Banks would be restricted in their ability to offer their customers access to additional capital market products and services.
- A separated structure does not correspond to the continental model of universal banking.
- The difficulty of deciding what should be ring-fenced and what should not be.

However, these counter arguments are easily dealt with. We take each counter argument in turn.

Profitability and retail costs

On the point about profitability, there is no reason to assume that a ring fence or even a full split should lead to higher costs for retail customers. It depends entirely on how effective policymakers are at regulating banks and ensuring competition from the consumer perspective.

Moreover, retail banks (and investment banks) simply need to get used to living on lower returns on equity – especially in this new economic paradigm. Lower, more realistic returns on equity would allow more benefits to be passed onto consumers. It should be a priority for policymakers to ensure that banks adjust to lower returns on equity.

Furthermore, it is not possible to assert that splitting banks would naturally lead to lower returns for retail banks anyway. For example, if you look at the special Retail Banking supplement in the Economist (19-25 May 2012), on page 4 of the supplement includes a reference to analysis by McKinseys. This study argues that basic retail banking has been the most reliable generator of consistent profits and high returns on equity. When McKinsey ranked the world's biggest banks by return on equity, this correlates closely with the proportion of revenue made from retail banking, not from the investment banking operations.

The implication is that in fact the investment banking operations actually 'hold back' the efficiency of the retail operations. If they were separated, the retail operations on a stand-alone basis would have the opportunity to improve efficiency and, critically, structure their operations to deliver sustainable, reasonable returns on equity – not dangerous, volatile returns. Therefore, if policymakers regulate these retail banks properly and ensure effective competition, this would ensure these efficiencies were passed on the retail financial user.

Moreover, simple retail banks would be easier to regulate from a prudential perspective. Therefore, there would a comparative regulatory 'dividend' to pass onto retail consumers, so leading to lower charges.

Offering customers more financial market activities

Regarding offering customers more activities, if this means that banks would not be able to offer complex products to retail financial users (for example derivative based products), then this is not necessarily a bad outcome. Ordinary financial users do not need any more complex products. Many of the innovations developed in the investment banking operations have not been socially useful. Moreover, the retail operations have been under pressure to 'distribute' complex financial innovations which benefit the investment banking operations but not the retail financial user.

Moreover, if the retail banking operation did need to call on investment banking operations for genuine reasons then they could still do this by buying services in the open market using their financial muscle to demand competitive terms from a range of investment banking providers. This opens up the investment supply chain and promotes much more transparent financial markets and therefore better regulation.

Continental universal banking model

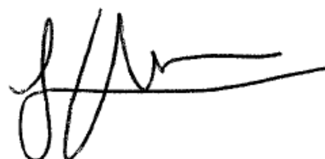
Whether or not a ring-fenced or split banking model corresponds to the universal banking model, is an irrelevant point. The priority of policymaker should be to ensure they create a banking system that meets the needs of financial users and real economy, not the needs of producers with legacy business models. Some of the biggest recent banking failures or public rescues in Europe – Fortis and ING – are 'universal' banks.

Difficulty of deciding the separation

Again, this is an irrelevant point. The important point here is that, in order to regulate properly (for example to understand the risks involved in different banking operations), policymakers and regulators have to identify the different types of activities and services operated within a universal bank. Therefore, the activities and services that would need to be allocated to a retail bank and investment bank are already known. So, it is just a question of political will, not difficulty in identifying the relevant activities.

We hope these comments are helpful, and would welcome the opportunity to submit the FSUG views to your Group to provide more detailed analysis and further explain why the separation of non-commercial banking activities is so crucial for the sake of the European economy and of the European civil society.

Yours sincerely,



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