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Banks at the Service of the Economy?

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This Policy Brief discusses a few simple measures to improve both the commercial and investment banking landscapes, with or without formal separation. Covering deposits with quality collateral would make them safer and would help create an easier guarantee and resolution mechanism at the larger eurozone level. Strong central counterparties and transparency requirements would improve market mechanisms and market discipline in capital markets and investment banking. Specific governance measures would also help improve the financial sector. Finally, a better control of bank solvency, together with improved capital market transparency and accessibility, should encourage the progressive deleveraging of commercial banks, and enhance the long term funding of the economy by capital markets.

Regulation has evolved over time

Given that actors and activities in the financial sector constitute a "public good," and are prone to excesses, banks and capital markets are regulated. In the United States during 1930s, and much earlier in some other countries, financial activities were segregated to prevent risk contagion, and limit conflicts of interest. Until the 1980s, banks, brokers and other financial intermediaries were numerous, and most had "single functions." After the 1980s, the lessons of the financial scandals and crashes of the 1920s were gradually forgotten; the single function became less mandatory. Some large, even mammoth, "universal banks" appeared in both Europe and (to a lesser extent) in the US.

Today, "universal banks" in Europe often carry out a large number of activities, including commercial banking (deposit-taking and lending), brokerage of securities and investment funds, and investment banking (issues of securities, arbitrage and speculation in capital markets). They are big and have a dominant share of savings and dominate the field of financial intermediation. The largest universal banks often adopt collusive behaviour that in many sectors leads to price manipulation, which leaves little room for competition.

European governments are now providing guarantees for bank liabilities for aggregate amounts that are often larger than the official public debt and even the Gross National Product (GNP). Belgium for instance, guarantees at around €400 billion worth of bank deposits and other debt (more than its

€380billion GNP) with substantial risk. There is no lack of savings in Europe, and certainly not in Belgium, yet businesses in many European countries are complaining that their access to bank financing is difficult at times.

European banks are encouraged to invest a large part of their assets in government bonds, which could crowd out private lending and create what is called a "deadly embrace." Banking crises and public finance crises feed off of one another, creating a downward spiral that can be difficult to stop. Banks would not have to fund governments or large corporations if capital markets in Europe were sufficiently opened.

FINANCE HAS BECOME VERY BIG

The share of financial firms in both the US economy and many European economies has grown from 2-3% of GDP in the 1980s to 8-10% of GDP today, which could either mean that there has been a vast creation of added value and satisfaction or an enormous reduction in cost-efficiency, oligopoly rents, and a kind of "financial tax" levied on the economy. The added value of banking is not obvious, and is a debate on its own. At any rate, we can say that modern financial services come at a very high cost, and are very risky.

Regulating the "mammoth" banks and the complicated financial products and markets that accompanied them is very difficult, to say the least. The boards of directors of large universal banks have long shown that they are often not in control of market activities, and it now appears clear that oftentimes top management is not in control of these activities either. Regulators cannot be expected to control risk more effectively than management or boards of directors. Therefore, simply advocating for more regulation of the same banks and same capital markets might sound redundant.

Any reform of the banking sector in Europe should bring simple but radical changes, and lead to regulatory controls that can be easily implemented. It should chiefly aim to 1) reduce the risk of bank failure and its impact on both the depositors and states that guarantee the deposits, and on the system as a whole; 2) improve the efficiency (by reducing the cost of intermediation and improving the quality of allocation) of capital markets in terms of channelling savings towards the economic agents who need and deserve financing.

SEPARATING POORLY FITTING ACTIVITIES

The principle for simple solutions is well known, and proposed by many politicians, academics, independent observers, and even previous defenders of the "deregulated big universal banks" model, such as former Fed Chairman Alan Greenspan and retired CEOs of some of the largest banks in the world. In essence, the integration of various activities within a universal bank is inefficient and dangerous, which is why big banks should be replaced by separate entities that specialize in some activities and have fewer internal conflicts of interest.

In practice, insurance and banking should be separated. They are different businesses, and do not mix well. Commercial banking should be separated from investment banking, and then rigorously and more simply regulated. Such regulation should include implementing adequate limits to lending policies, risk concentration, and minimal capital buffers. Bank expansion beyond a certain size should be discouraged, and even taxed. For investment banking activities, brokerage and investor advising should be separated more clearly from securities origination and issuer advising, as the two are obviously in conflict.

Stricter competition rules should also be enforced both in banking and in capital markets

in order to reduce the present concentration of power.

But let us be realistic. If European governments have not yet been willing or able to act together to achieve these goals (in spite of the magnitude of the 2008-2013 crisis), they are unlikely to act effectively soon. The US government and regulators are now taking serious measures to reform their banks and capital markets, and the UK is starting to reform its banking sector by isolating commercial banking from market risk taking. On the European continent, however, there is not much movement. Any attempts at reforming the system are blocked by the banking lobby, which has been successful at convincing French and German governments that any measure that limits the speculative zeal of mammoth European banks is an Anglo Saxon plot to harm the Deutsche Bank or BNP Paribas and benefit Goldman Sachs and the bedevilled "hedge funds."

SOME TRANSITORY AND OTHER REFORMS ARE NEEDED IN ANY CASE

The measures proposed henceforth are alternative measures to be applied in case the reforms listed above cannot be decided upon quickly. However, most of these alternative measures would be useful in any type of banking architecture. Some of the rationale for these proposals—such as the lack of evidence of economies of scale in commercial banking (above a modest level), or the uncommon advantages size is giving to a few investment banks and universal banks that can abuse markets and get away with it—have been analyzed and documented in academic studies, producing diverse diagnoses and recommendations.

Protect deposits better

Many universal banks are directly or indirectly using cheap, state guaranteed client deposits to engage in risky market and financial activities, and to leverage their balance sheets. They often give seniority and other privileges to their counterparts in those activities. This puts depositors in a de facto junior (or subordinate) position, and puts taxpayers at great risk. The credit flow, which many of these banks do not consider a priority, has been reduced in many countries, while the cost of credit has increased.

A simple reform measure could bring a lot of good. Banks collecting deposits should be requested to protect depositors with full collateral cover, as is used in case of covered bonds. This collateral should consist of diversified loans for the economy at large (i.e. loans to individuals, corporations, public sector, etc.), and should be progressively expanded until 100 percent of deposits are covered. This should not discourage lending to the economy. In fact, the state guarantee that is currently and generously given to any bank should in the future be reserved for banks that can give acceptable loans to the economy as collateral. These "covered deposits" would be rather easy to define and no more difficult to manage than "covered bonds," which have recently multiplied in Europe.

Commercial banks that do not give privilege to creditors, have sufficient equity, and have a reasonable lending policy that is monitored by the regulator could be exempt from the obligation to collateralise their deposits. All other banks, however, should adequately cover their deposits, for example those that give more than 10% of their assets in collateral. This would simply mean providing their depositors with a *pari passu* (meaning "equivalent standing") clause comparing all creditors, something banks themselves request when they lend to their own clients, especially those whose equity buffers are considered too low.

A way towards a pan-European guarantee mechanism, or even a Banking Union

A deposit guarantee and resolution mechanism could be based on specialised agencies called National Deposit Insurance Companies (NDIC), under the (optional) umbrella of a European Deposit Insurance Company (EUDIC) that intervenes if and only if the NDIC have correctly applied the rules (e.g. have adequately checked the quality and diversity of the assets in the collateral). The cost of insuring deposits should be defined in relation to the risk profile of each bank and each collateral portfolio. It should be paid by banks to the NDIC, which would pay the EUDIC a premium for the reinsurance it provides.

This would probably be a very good way to facilitate a banking union at European level. The logic of a banking union is to have a common supervisor (the European Central Bank), a common resolution mechanism, and a common deposit guarantee scheme. Achieving it in that order would be very difficult, because Member States –the ultimate risk takers in the system – are not sufficiently informed about the associated risks. Starting with deposits and the protection of deposits would probably be more promising.

Large universal banks can be expected to resist such a scheme. In most European countries, the compensation the state receives guaranteeing deposits is much lower than the market price for such a guarantee would be. Moreover, this current scheme does not discriminate in terms of risk; the more risky banks pay the same as the less risky ones. This guarantee on banks' liabilities thus amounts to a subsidy; the weaker the liability, the bigger the subsidy. It is not surprising, therefore, that some banks are weakening the status of their depositors by using their best assets as collateral for other forms of financing (such as covered bonds and repurchase agreements) and market transactions, since this weakening is not reflected in the price they pay to guarantee those deposits, and thus the government subsidy gets higher.

Addressing systemic risk by using central counterparties instead of systemic banks

Derivative transactions include a large part of interest rate activities and commodities, and many of them involve forward (i.e. future) transactions, that are accompanied by long settlement risks.

Bilateral (known as Over The Counter, or "OTC") derivative transactions are concentrated within the dominant banks in each market. In those bilateral transactions, banks are counterparties to each other, and dominant banks have very large volumes of counterparty contracts, making them "systemic." The fact that Lehman Brothers was such a dominant player in OTC derivatives was a major reason its bankruptcy created "systemic" problems.

The largest of these systemic banks are referred as SIFIs: Systemically Important Financial Institutions. They are often considered to be "too big to fail." For this reason, these institutions have received tacit public bail-out guarantees and the cheap funding that such guarantees provide, which further enhances their capacity to dominate and manipulate financial markets. It is thus not surprising that these dominant banks want to keep the system the way it is, even though it does not serve the interests of other market participants or taxpayers, who unwillingly underwrite it.

There is another way to organize financial transactions like derivatives, namely by facilitating centralization through mandated centralized exchanges. If this occurs, settlement can be done centrally as well. Central Counterparties (CCPs) for derivative transactions greatly reduce the systemic risk of possible bank failure, but any CCP itself should

be capitalized at a high level. Some legislative steps are being taken in the US, and to a lesser degree in Europe, to force banks to clear all derivative transactions above a certain level through CCPs. These CCPs must be very solid and thus highly capitalized, which is an argument large banks use against centralization. Yet an easy way to do this would be to use the proceeds of a (modest) Financial Transaction Contribution (FTC) on any derivative transactions. This would help create a capital buffer within the CCPs. After a while, the capitalization of the CCP would be large enough to truly strengthen the system. Above a certain level of capital buffer within the CCP, the FTC could be reduced or eliminated.

Some may argue that this constitutes a kind of Financial Transaction Tax, but even so it is perfectly logical, as the proceeds would be used to make sure a financial activity pays for risks it generates.

This centralization would bring more security and transparency to prices and market practices. It is not favoured by the largest market participants, who seem to benefit from the present lack of transparency. Some large industrial companies are also pleading against such centralization, which might seem surprising since non-bank users of derivative markets often pay for the lack of transparency. But it also appears that in some large commodity markets, large industrial companies have developed trading practices that might also manipulate the system.

Force banks to report on securities lending and profitability, and put limits to it

At the very least, securities lending should be made more transparent and less risky. Moreover, end-investors should explicitly approve of any lending of securities they own directly or indirectly, and receive the compensation for it. The lending and relending of securities should be more controlled, more transparent, and prohibited when need be; it might also be safer if these transactions went through CCPs.

Make non-dramatic bank failures possible

Governments in Europe have sought to avoid large bank failures until now, which has led to growing subsidies, moral hazards, and other problems. The amount of guarantees given to banks is rising, along with the risk for taxpayers. As long as banks are not allowed to fail, the sector could become more and more dysfunctional. The two reasons given to bail out banks in Europe are as follows: 1) to protect depositors, and 2) to avoid systemic risk to market counterparties, or "a new Lehman". The counterparty risk should be greatly reduced by the standard application of CCPs in all securities and derivative transactions.

With the generalization of covered deposits and CCPs, a bank in difficulty could be reorganised, bailed-in by its creditors, or left to fail. Its covered deposits and collateral could be carved out in an orderly way, under the control of the Deposit Insurance Company, and at little to no cost and risk to taxpayers.

Remuneration policy

Remunerations in banking are far higher than in any other sector, and their variable part ("bonuses") is often used to encourage recipients to seek profit at all cost. In finance, many traders and sales people are in a position to make easy money on taking risks, manipulating markets to cheat on clients, and even cheating the banks themselves. Consequently, all of the above happens. A typical observer would lament the behaviour of dishonest traders and pity the victims on Monday, but if the issue of remuneration is brought up on Tuesday, they swallow the story that high "performance related" bonuses are needed to keep "rare talent" in the bank, even

though this "performance" is measured through rough profit reporting that does not discriminate against fraud or excessive risk taking. When fraud and excessive risk taking occur, observers seem to consider it as inevitable.

The problem described here is not limited to trading rooms. In distribution activities, for example, sales people, even at local branches, are routinely motivated to sell the financial products that are best for the bank, rather than those that are best for the clients. This practice has continued despite serious evidence of misseling, and after the introduction of the MIFID (Market for Investment in Financial Instrument Directive) which includes rules that state that banks have to practice "best execution" in favour of clients and avoid conflicts of interest.

We do not have a miracle solution with regards to this problem, but making boards of directors more transparent and more responsible as is hereunder suggested would be a start.

Increase the responsibilities of members of banks' boards of directors

The governance of banks could be improved, along with the roles and competences of board members.

Remunerations within banks are problematic, as they can induce irresponsible behaviour that negatively impacts clients, markets, and even banks themselves. Boards of directors should certify at least once a year that, to the best of their knowledge, the remuneration policy and practices of the bank are coherent with laws and regulations, with a decent behaviour in general, and are coherent with the values the bank is claiming.

The board should state that they have examined each product sold to retail clients and are convinced they are *bona fide* and a decent value for the client. If this looks cumbersome, it is probably the best way to limit the proliferation of toxic financial innovation, while allowing useful financial activities. This is also a way to improve the effectiveness of boards.

Impose a leverage ratio and a real analysis of credit risk

The definition of the minimum equity imposed on banks in function of their "Risk Weighted Assets" has been perverted. It allows banks to work with very low levels of equity, as long as they can show that they lend to borrowers with high "ratings" or "control" risk with historical statistics and models. Yet these models are misleading and have perverse consequences to the evaluation of credit risk.

Misleading for market risk

Value-at-Risk and other models with simple indicators are easy to understand, but easy to manipulate and prone to "historical bias," which makes them unreliable in terms of defining the necessary amount of equity on market activities. This was obvious in 2007-2008, when suddenly only very few large banks had enough equity to withstand the crisis without state support or regulatory leniency, or both.

Universal banks sometimes argue that they are no "casino players," and that their market risk is very small compared to their credit risk. However, this is often because market risk is both poorly measured and underestimated.

Perverse for lending

This risk weighted asset approach also negatively influences how credit risk is evaluated. It encourages banks that concentrate on maximizing their return-on-equity (which is the vast majority of them) to focus their lending on loans that fit into their models, thus enabling them to minimize equity needs. Models are increasingly used to judge credit risk, and often produce very negative effects, both on lending

activities and actual credit risk control. This might be a significant explanation for the financing problems many companies in Europe are complaining about. Credit officers and credit committees with real experience are, and could become again, much more effective and flexible than models.

The risk weighted asset method also encourages banks to buy exaggerated amounts of government bonds, because they are often considered to be zero risk. This illusion amplifies banking and public financial crises, creating a downward spiral that is also called a "deadly embrace," as one feeds off the other.

Imposing a leverage ratio (a minimum of equity as a proportion of the balance sheet) , and returning to a control of lending policies that favours common sense and credit analysis experience could therefore bring a lot of good. It would stop encouraging banks to purchase large amounts of government bonds and top quality corporate bonds. Yet, we do not need banks to finance these borrowers, as they should be able to easily finance themselves through capital markets.

Financial intermediation through capital markets and other non-bank channels must be increased

If banks are less able and willing to buy government bonds or top quality corporate bonds that would no longer be characterised by "low equity requirements" because of leverage ratio requirements, that should be an incentive for banks to reduce their balance sheet, and thus their equity requirements under a leverage ratio model. It should not create a financing problem for sovereign or top corporate borrowers, since it is the role of capital markets to finance such borrowers through bond issues. Yet In Europe the "Universal" banking model has not favoured the development of open capital markets until now, which might thus be another good reason to envisage a separation of investment banking and capital market activities from commercial banking.

The European economy would probably benefit very much from capital markets that take a bigger part in the financing of the economy. In Europe, most of that activity is today in the hands of universal banks

Long term lending is not the easiest activity for banks, since their own funding is very short term. In many countries, however, long term bank lending has existed for a long time, and has even increased in prevalence during the last decades, pushing aside more specialized long term lenders, and increasing their liquidity and interest rate risk.

Because banks took too much liquidity risk, regulators intend to impose stricter limits on the mismatching of maturities, which is already benefitting capital markets; a growing number of large and medium size companies are now tapping bond markets, rather than getting their long term funding from banks. This should grow in the future and will if retail investors are no longer discouraged from investing in such securities by tax and distribution limits. To facilitate the non-bank long term funding of a wider array of borrowers, a number of measures should be envisaged:

- Creating dedicated investment funds that would invest in bonds issued by smaller companies, as we have seen in the US
- Facilitating the return of securitization of loans, a very useful technique that can help banks refinance the credits they provide to their clients. With the necessary precautions, it can be a good answer to the problem.

Separating the funding from the credit risk can also be envisaged:

- Long term credit banks characterized by a light structure that could provide the funding could be resurrected, while commercial banks

and other financial institutions, like credit unions, provide a credit guarantee
- The long term funding could be done by insurance companies, pension funds, and investment funds, while the credit risk could be assumed by commercial banks, credit unions, and the like.

Force transparency on investment banking activities

Until the 1990s, investment banks had successfully developed capital market activities and financial products, and were good at managing their risks and controlling their activities. Since then, however, investment banking activities have grown in volume, and the massive "intrusion" of commercial banks in their activities and ownership has changed significantly. The fact that many market activities were so easily funded using easy money, and that many of the largest investment banks or universal banks became too big to fail, probably induced a race to increase size and profit at all cost, with the dire consequence that we have experienced since 2007.

Various measures should be taken to efficiently reform capital markets, but forcing banks that engage in capital markets to pay the normal price for their financing—without receiving any subsidies from depositor's money or any form of government guarantee— would be a huge step in the right direction.

Stricter limits on the financial activities of commercial banks should also limit the leveraging capacity of hedge funds. These hedge funds are quite good at managing financial risk, and should not be held responsible for the problems of capital markets, but there is no reason that they would get access to subsidised funding, directly or indirectly.

Imposing transparency on capital market activities through the centralisation of all transactions and their central clearing would also go a long way towards improving the market discipline, and the capacity of clients and regulators to identify market abuses.

Separating investment banking from broking would also be very beneficial for the markets and for clients. It has been attempted in the US after the many scandals that created the "internet bubble" in the early 2000s, but the banking lobby was able to resist the separation projects. At least a rule preventing the conflicts of interest of professional investors and asset managers, and making them more responsible for remuneration transparency would be a first step. To alleviate the concern of clients and regulators, banks promised to improve internal separation –i.e. "Chinese Walls"– but most of it remained quite formal and ineffective. Large investment banks are indeed using the "synergies" brought by this cohabitation in a variety of ways and to a various ends, including to gain the "loyalty" of large investors, who like a privileged access to primary market transactions and useful information.

CONCLUSION

A system for protecting deposits that could precede a euro-wide guarantee and resolution mechanism, in combination with a more stock market-like infrastructure to trade and clear derivatives (which has proven remarkably resilient during crisis), would go a long way in reducing systemic risk and governments' need to bail out failing banks. This would allow for fewer regulatory constraints, and would rely to a larger extent on market discipline.

The adoption of minimum leverage ratios for banks would also simplify regulation. Done progressively and together with the right incentives for capital market development (and in consideration of investors' interest in long term securities investment), it should encourage commercial banks to deleverage by reducing

their holdings of government and market-eligible corporate bonds. These bonds would then be easily absorbed by more dynamic capital markets and end-investors, in both the institutional and retail sectors, who would have greater trust in the transparency and reliability of these markets.

Some existing or new institutions might also be used to facilitate the comprehensive development of a long term funding mechanism for the economy, either directly or in addition to securitization. The lessons from the securitization debacle of 2007 and 2008 should be used to drastically improve market practices, but the securitization process itself should not be condemned. Securitization could be a significant part of the solution to the long term funding problem, as it helps lenders manage both their liquidity and interest rate risks.

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