World Future Council

VOICE OF FUTURE GENERATIONS

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World Future Council response to the public consultation of the European Commission on the structure of the EU banking sector

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1. Can structural reform of the largest and most complex banking groups address and alleviate these problems?

The structural reform of banks cannot cope efficiently with severe problems such as high leverage in the financial system and excessive risk taking. There is neither evidence nor plausibility that the reduction of intra-group subsidies through separating deposits from trading activities will lead to shrinkage of the financial sector. Banks refinance themselves primarily, if not solely, through lending activities within the financial sector. Therefore procyclical and opaque credit intermediation chains, including the re-pledging of securities and overly complex financial innovations, make appropriate risk premiums impossible.

De Larosière has already pointed out[1]:

"Separating or ring-fencing retail or market activities does not improve their risk management nor does it eliminate excessive risk taking – even in traditional retail activities – or the possible involvement of banks in the formation of asset bubbles. It does not address investment banking or market risks either, which may still require a bailout if they turn to be systemic."

[1] De Larosière, Jacques (26/9/2012); Seductive simplicity of ring-fencing, in: Financial Times.

Instead, key to addressing these problems are **debt brakes for the financial sector**, a preventive testing of financial innovations **(finance TÜV**[2]**)** and a **scalable financial transaction tax** to slow down systemically risky volatility.

1.1 Debt brakes for the financial sector

To address high leverage and leverage driven asset bubbles by debt brakes is much more logical and targeted than separating or ring-fencing banking activities. Excessive leverage within the financial sector plays a primary role in creating asset price bubbles as well as in making financial institutions too big and too connected to fail. It is nearly impossible to close highly levered financial institutions without systemic consequences. Moreover, and most crucially, leverage can be more important to asset prices than interest rates.

Therefore, debt brakes for the financial sector have to be installed. Firstly, central banks and regulators should focus on the value of that which serves as collateral: in the case of overvalued assets, they should curb the permitted value of these assets as collateral. Regulating leverage based on loan-to-value ratios (asset-based leverage) rather than solely according to debt-equity ratios of banks (investor leverage) will include the whole financial sector. A central bank should, for instance, say[3]: "You cannot loan at two percent down on houses." Secondly, the re-pledging of securities in long credit intermediation chains has to be limited. Thirdly, leverage from mergers and acquisitions (M&A) should be constrained. Pavan Sukhdev proposes that the capital structure of M&A transactions which exceed a given transaction amount – such as US$10 billion – ought to be reviewed by central banks[4].

1.2 Finance TÜV

Financial instruments need to be tested and put to the precautionary principle no less than other aspects of society like drugs. The de Larosière-Report warned about the over-complexity and systemic importance of financial instruments in early 2009[5]:

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[2] German abbreviation for road-safety tests.

[3] Geanakoplos, John (2011); What's missing from macroeconomics: endogenous leverage and default, Cowles Foundation paper, no. 1332, p 224.
http://cowles.econ.yale.edu/~gean/art/p1332.pdf

[4] Sukhdev, Pavan (2012); Corporation 2020, US, p 157f.

[5] De Larosière-Report, 25/2/2009, p 13.
http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

"The complexity of a number of financial instruments [...] also explain why problems in the relatively small US sub-prime market brought the global financial system to the verge of a full-scale dislocation."

Financial institutions would need to prove that the financial instrument benefits the real economy and is the most welfare-enhancing option. They must prove that the risk-reward-profile is positive.

Our economies do not need millions of different financial instruments. The same purpose can often be fulfilled by a variety of financial instruments, which can be more or less useful or harmful to the real economy and to society. A good alternative to collateralised debt obligations is simple covered bonds backed by real assets[6]. Securitisation can be useful up to a point; savings banks, for example, use it to diversify regional risks. However, re-securitisation is not needed by the real economy and should be prohibited.

As a key preventive and efficient measure at the base of financial regulation, financial prior testing would facilitate and simplify new regulations. The risk of institutions "too complex to be supervised", "too complex to be managed" and "too connected to fail" would be reduced.[7]

1.3 Scalable financial transaction tax

The purpose of the financial transaction tax, apart from raising revenues, is to avoid excessive trading and systemically risky volatility. Thus the tax rate should be scalable. This would enable the tax to efficiently contribute to preventing price bubbles. A scalable tax rate has already been suggested by economist Paul Bernd Spahn in 2002 in his report

[6] Judge, Kathryn (March 2012); Fragmentation nodes: a study in financial innovation, complexity, and systemic risk, Stanford Law Review, vol. 64, p 716f.

[7] See also

a) Reiners, Suleika (5/4/2013); Introduce precautionary principle for financial products, or they will fail us, on: EurActiv.
http://www.euractiv.com/euro-finance/introduce-precautionary-principl-analysis-518903

b) World Future Council (13/11/2012); What we need is a preventive testing of financial innovations (finance TÜV), Answer to the public consultation of the European Commission on the Liikanen-Report.
http://www.worldfuturecouncil.org/fileadmin/user_upload/Future_Finance/Liikanen_final.pdf

commissioned by the German Federal Ministry for Economic Cooperation and Development[8].

Possible shifts to non-bank finance must not serve as an excuse for weak bank regulation but rather be integrated within an overall approach. This is exactly the purpose of debt brakes for the financial sector, a finance TÜV and a scalable financial transaction tax.

2. *Do you consider that an EU proposal in the field of structural reform is needed? What are the possible advantages or drawbacks associated with such reforms?*

In an interconnected world overall approaches are desirable as regards simplification and effectiveness for regulators, supervision and companies. To best achieve its regulatory effect, any rules should apply to all banks and financial institutions in Europe, regardless of where they are based.

Therefore, any European agreement should at the same time allow a country to undertake further reforms in order to avoid any drawbacks of sticking with too low standards due to the need for a minimum consensus decision. Single countries and companies, for example social-environmental banks, can develop useful role models of best policies and best practices.

3. *Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator.*

In addition to the first definition, which includes all assets held for trading and available for sale, three factors are crucial:

- leverage without having an equivalent value in the real economy, particularly based on loan-to-value ratios (asset-based leverage, see 1)
- complexity of financial innovations, be it within or outside bank balance sheets

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[8] Spahn, Paul Bernd (January 2002); On the feasibility of a tax on foreign exchange transactions, Bonn. http://www.wiwi.uni-frankfurt.de/professoren/spahn/tobintax/

- trading frequency.

4. *Which of the approaches outlines above is the most appropriate? Are there any alternative approaches?*

Ex ante measures are preferable in order to optimise and harmonise regulation and supervision and to avoid regulatory and supervisory delay. This applies not only to a separation of banking activities but also to leverage limits, the approval of financial innovations and the criteria for the scaling of a financial transaction tax.

5. *What are the costs and benefits of separating market-making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?*

Separating banking activities can simplify the resolution of single banks when a crisis occurs. Yet it is not suitable for avoiding further deep financial crises (see 1)[9]. Therefore, debt brakes for the financial sector, a finance TÜV and a scalable financial transaction tax are necessary.

The original Glass Steagall Act of 1933 in the US banned market making and underwriting without causing any harm to the economy. The argument that the separation of services might increase prices is questionable. Studies have shown evidence that house banks have used their dominant position to enforce inflated prices[10]. Some real-economy companies have now become big players in financial trading themselves; their arguments do not represent the needs of the real economy.

[9] See also Fricke, Thomas (2013); Wie viel Bank braucht der Mensch? Raus aus der verrückten Finanzwelt, Frankfurt/ Main, pp. 178-183.

[10] Häring, Norbert (2010); Markt und Macht. Was Sie schon immer über die Wirtschaft wissen wollten, aber bisher nicht erfahren konnten, Stuttgart, pp. 27-29.

6. Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?

There is no economic need for deposit banks to offer risk management services to their clients. If, for example, insurance services are required, banks can provide these services on an agency basis.

7. As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?

The legal separation of an economically intertwined bank will increase the costs of a bank resolution.

8. What are the relevant economic links and associated risks between intra-group entities?

Economic links between intra-group entities are negligible in terms of systemic risks. What matters much more is the interconnectedness of banks within the overall financial sector, especially through credit intermediation chains, and within the real economy.

9. As regards full ownership separation, what are the associated costs and benefits?

Full ownership separation, such as under the Glass Steagall Act 1933, is the easiest option in the case of a bank resolution. At the same time, benefits are limited because an investment bank can also be systemically important due to its deep intertwining with the financial sector and the real economy. Taxpayers' money might become involved in a bail-out nonetheless. The systemic risk in the financial sector cannot be expected to shrink through the dropping of intra-group subsidies, which do not play any substantial role (see 1).

The costs of full ownership separation affect financial institutions, for example, through limited possibilities for M&A. However, the Glass Steagall Act did not cause any economic problems; it was only abolished due to lobbying pressure from the financial sector. Regarding employment, full ownership separation could lead to more jobs as administration might be needed twice.

10. Does the above matrix capture a sufficiently broad range of structural reform options?

In view of the limited impact of ring-fencing or separating banking activities as such, the matrix captures a broad range including full ownership separation. Concretions and sub-categories are imaginable, for example on how to design ownership including public and private stakeholders.

11. Which option best addresses the problems identified?

Full ownership separation such as in the Glass Steagall Act of 1933 is the clearest approach. Other options make the fence unnecessarily permeable and hence lead to diffused bank structures, which are to the detriment of effective regulation and supervision. Banking reform can only flank and should not neglect effective measures such as debt brakes for the financial sector, a finance TÜV and a scalable financial transaction tax (see 1).

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About the World Future Council

The World Future Council (WFC), founded in 2007, is a charitable foundation, with a staff of around 20, working with 50 eminent members from around the world who have already successfully promoted change. We endeavour to bring the interests of future generations to the centre of policy making. In close collaboration with civil society groups, members of parliament, governments, business and international organisations, we research future just policies and legislation. We then advise political decision-makers, offering them tried and tested courses of action and support them in the concrete implementation of new policies.

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