Opinion of the European Economic and Social Committee on 'What changes for Europe's banking sector with the new financial rules?' (own-initiative opinion)

(2012/C 299/02)

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On 14 July 2011 the European Economic and Social Committee, acting under Rule 29(2) of its Rules of Procedure, decided to draw up an own-initiative opinion on

What changes for Europe's banking sector with the new financial rules?

The Consultative Commission on Industrial Change, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 11 June 2012.

At its 482nd plenary session, held on 11 and 12 July 2012 (meeting of 12 July), the European Economic and Social Committee adopted the following opinion by 135 votes to 2 with 5 abstentions.

1. Conclusions and recommendations

1.1 The primary role of the banking sector, which accounts on average for 5 % of EU GDP, should be to finance the real economy – with a particular focus on innovative companies and the growth of SMEs, the driving force of the EU economy – and to safeguard depositors' savings.

1.2 The Committee welcomes the efforts being made by the European Commission and the Member States to bolster the banking sector and to prevent further financial crises by lowering risk levels and mitigating their effects.

1.3 The Committee maintains that lessons need to be learned from recent economic and financial crises and a fresh approach adopted to ensure more effective supervision by national, European and international authorities and increased accountability of financial institutions.

1.4 The Committee supports the measures aimed at strengthening banks' capital structure and their ability to finance the economy while cautioning banking executives against the temptation to seek very short-term profit and to engage in speculative activities that destabilise the markets.

The responsibilities of banking executives and of oversight bodies at national and EU levels and within the banks themselves need to be clearly and better defined, so as to promote ethical behaviour on the basis of transparent rules.

1.5 The Committee draws attention to the difficulties that arise from the accumulation of regulatory measures, and to the challenges that have to be faced by the 8 000 European banks in order to finance the economy in a difficult economic environment in Europe, which has been hit by a debt crisis whose scale and consequences have not yet been brought under control.

1.6 Europe's banks are facing increased competition from third-country banks, which are not subject in their country of origin to the same legislative and regulatory constraints as banks in Europe.

1.7 The measures aimed at strengthening banks' capital structure include requirements for increased, better quality capital, enhanced risk coverage, the introduction of a leverage ratio and a new approach to liquidity. These measures are likely to impact on bank balance sheets, and may bring about a substantial decline in profitability.

1.8 Consequently, banks are tending to downsize, in order to become more robust, to shift their focus to the most profitable activities, and to reduce their range of financial services in order to have greater control over their risk exposure.

Some are advocating the need to return to their core business: receiving customers' deposits, protecting savers and financing the real economy.

1.9 The EESC believes that a gradual return to the separation of commercial banking activities from those of corporate and investment banking is desirable. The current global crisis shows that a globalised financial system based on unfettered liberalisation entails a risk of derailment linked to the misuse of this freedom by the markets:

— the excessive size of the multinational financial groups makes their governance, supervision by oversight bodies and evaluation by rating agencies very difficult to the point of lacking much credibility;

— financial instruments have become uncontrollable. While not objecting to financial innovation in principle, it is not acceptable that a financial product can circulate freely on the international market in a less-than-transparent manner while no one knows the nature of the risk involved or where ultimate responsibility lies;

1.10 The new capital requirements, particularly the obligation to build up a capital ratio of 9 % of the highest quality capital – by 30 June 2012 in the case of the 60 systemic banks, and between 2015 and the end of 2018 for the rest – could have adverse consequences for local or cooperative banks, which are more SME- and micro-enterprise friendly. Capital requirements should not discriminate against any particular group of banks.

1.11 If banks face difficulties in raising capital, it will be harder for SMEs to obtain the finance they need. A credit crunch and a rise in bank charges must be averted. The Committee thus urges the Commission, the European Banking Authority (EBA) and the national supervisory authorities to ensure that the capital buffers of small banks are adapted to their economic model.

1.12 Prudential requirements are already leading to tighter, more costly credit for small businesses, including start-ups, innovative companies and the more risky ventures. Europe will not be able to achieve the goals of the Europe 2020 strategy, the Digital Agenda, Cloud-active Europe, the Energy roadmap 2050 or the Small Business Act if the share of funding for SMEs falls following implementation of the new prudential measures.

The Committee calls on the Commission to very closely monitor trends in bank lending and bank charges to businesses and individuals.

1.13 The measures aimed at increasing the effectiveness of market supervision by national, European and international authorities will have far-reaching consequences for the organisation of banks and internal oversight. This will place greater responsibility on management, with the requirement to assess the return on equity more carefully and improve risk management. The banks will have to draw up their sales forecasts and product and banking portfolio development strategies with due regard for their return and an assessment of ability to absorb capital. This will lead to restructuring with a view to increasing the importance of IT, audit, and risk management departments and their staffing levels, at the expense of other, more traditional areas.

1.14 Banks in the EU employ over 3 million people, the vast majority in retail banking. Since early 2011, more than 150 000 jobs have been cut and many branches have closed. Various forecasts estimate that a further 100 000 jobs will be lost in 2012. The Committee calls on the Commission to help improve sectoral social dialogue and to develop consultation with the social partners on the initiatives affecting the development of the profession.

1.15 When the new rules are implemented, the Committee would like to see account being taken of the different situations of the Member States, and particularly the new EU Member States, whose credit markets have not achieved their full potential and whose banks are mostly owned by the major European and global banking groups. To improve their balance sheets and meet the new requirements, these groups may be tempted to transfer funds from their subsidiaries and curtail their investments, greatly reducing the financing of the economies of these countries. The Committee points out here the commitment made under the Vienna initiative to avoid an outflow of funds. It is necessary to protect certain particular models such as the cooperative banks in Germany and Poland. This sector comprises over 300 banks in Poland alone and to achieve the radical reform that the new rules entail will require a transition period.

1.16 To support the harmonisation process, the remit of the European Banking Authority needs to be bolstered. The Committee points out that the free movement of capital is ensured at EU level, while the security of deposits and bank solvency fall under the remit of the national authorities. The credit market differs from one Member State to the next. In countries where credit is underdeveloped, catching up too quickly in terms of debt levels can create a speculative bubble. If the prudential rules are implemented uniformly across the EU, national authorities will be unable to intervene in time. However, it is worth considering the suggestion of several European leaders to create an EU banking union to establish EU-level supervision for systemic banks and a guarantee for deposits in case of bankruptcy.

1.17 At global level, European banks are in danger of becoming less competitive in relation to their competitors. For banks raising additional own funds, most of the available capital is in sovereign wealth funds and Asian and Middle Eastern banks. There is a real danger that the ownership of the EU banking system will move out of the control of EU Member States. For this reason, the Committee calls on the European authorities to step up their efforts to ensure that the same prudential rules will apply worldwide, with the aim of achieving a genuinely global set of rules.

1.18 The new IT technologies: e-banking, home banking, secure virtual transactions (electronic signatures) and cloud computing are revolutionising traditional banking services. The banks will have the difficult task of financing the real economy while having to cope not only with higher funding costs following the introduction of new technologies, but also lower profitability. The Committee feels that all banking stakeholders should be supported through this far-reaching change.

2. **Introduction**

2.1 The financial crisis and its impact on the economy have led governments and financial authorities to look at the root causes of the collapse of a financial system thought to be established, well regulated and properly supervised.

2.2 The initial financial and monetary measures were taken in some haste (substantial cut in base rates, liquidity, state aid); longer-term measures have been aimed at bolstering the structure of the markets and preventing future systemic crises: hence their regulatory, supervisory or fiscal nature. While the supranational organisations – the IMF, the G20, the BIS, the Commission – have adopted an open attitude to cooperation, there have been differences of opinion.

2.3 Since the 2008 crisis, more than 50 legislative measures have been adopted by the EU. 99 % of the reforms will have been passed by the end of 2011, to come into effect in 2013, with the exception of the core tier one capital ratio, which becomes effective for the 60 banks deemed systemic on 30 June 2012. For the other banks, this measure is to come into effect between 2015 and 2018.

2.4 The third Basel Accord, published in November 2010, requires banks to hold more higher-quality capital in order to withstand future crises, and in particular to hold:

— 4,5 % of common equity and 6 % of tier one capital of risk-weighted assets;

— a mandatory capital conservation buffer of 2,5 %; and

— a discretionary countercyclical buffer, allowing national regulators to require up to another 2,5 % of capital during periods of high credit growth.

Basel III introduces a minimum 3 % leverage ratio and two mandatory liquidity ratios: the short-term liquidity ratio, which requires banks to hold sufficient high-quality liquid assets to cover their liquidity requirements over 30 days; and the long-term liquidity ratio amounting to a minimum amount of stable funding above their liquidity requirements over one year.

2.4.1 The European Commission put forward its proposals on transposing Basel III into CRD IV in July 2011. This is aimed at strengthening the European banking sector while encouraging the banks to continue to finance the growth of the economy. However, the Commission has not taken any practical initiatives to encourage lending.

2.5 The proposals' objectives are to encourage banks to hold more capital in order to resist shocks and to set up a new framework enabling supervisors to monitor banks and take action when they spot risks.

2.6 CRD IV covers areas of the current Capital Requirements Directive, but it needs to be transposed in a way suitable to each country.

2.7 Despite the delays and flaws in the rules adopted, real progress has been made towards a new set of rules. However, the following questions remain:

— Are the new rules going to cover the full spectrum of financial practices at global level?

— Once market regulation is in place, will it be possible to have confidence in effective supervision?

— And will the new rules influence and change the situation for the 8 000-plus banks in Europe's banking sector (structures, consolidation, distribution methods, staffing), and their behaviour with regard to the financing of the economy: credit for businesses, authorities, individuals?

3. **Adverse financial and economic conditions**

3.1 Europe's banks are currently having to cope with sudden regulatory and economic changes that are giving rise to concerns as regards their ability to fulfil their role of financing the economy at a time of economic downturn triggered by the debt crisis, which is particularly affecting the euro area.

3.2 Upon implementation of the Basel Committee measures (Basel III), banks are required to build up their capital, to comply with very high, long-term NSFR liquidity ratios and to create prudential capital.

3.3 Stress testing of the banks, carried out in two phases, has failed to assuage doubts over the impact of a default by one or more members of the euro area.

3.4 A lack of confidence has taken hold in the international financial community sparking liquidity problems on the interbank market. This has led banks to shift their focus to the safest investments.

3.5 Against this backdrop, the ECB has intervened twice and offered a total of EUR 1 000 billion in three-year loans to the banking sector at a rate of 1 %. This facility has been vital to restoring confidence on the interbank market and keeping credit flowing in the economy. However, a substantial tranche of these funds has been redeposited with the ECB, and another portion used to buy public debt. The Committee thinks that the ECB should devise a means of tracking the use of these funds.

3.6 The need to recapitalise the banks, estimated by the European Banking Authority to require in excess of EUR 100 billion, is becoming increasingly urgent.

3.7 Lending to businesses, particularly SMEs and authorities, and to individuals, is becoming subject to increasing stringency. The associated risks are being carefully scrutinised by the banks, which is pushing up the costs of this financing. At the same time, the alternative of financing businesses through the financial markets is even more difficult. This situation, coupled with austerity policies, has fuelled predictions of little or no growth, apart from a very few exceptions, in the year 2012 across the entire European Union.

4. **Supervision and regulation of the banking sector**

4.1 In this regard, it is important to think back to the subprime crisis. Warning signs that a subprime crisis was about to erupt should have been heeded by the supervisory authorities. No one doubted the return on an investment that delivered a profit to the bankers and their clients. Although the FDIC warned against these products, no action was taken by the Federal Reserve during the period 2002-2006.

4.2 The collapse of Lehman Brothers bank could have been avoided if the oversight bodies had noticed its severe liquidity problems in time. The danger posed by mortgages offered at 100 % of the value of the property and sold on in bundles by financial intermediaries was beyond the control of anyone. To prevent future crises, measures should be introduced bestowing personal liability on the directors of financial institutions for lack of proper supervision.

4.3 While it is true that the crisis erupted as a result of overly complex "toxic" products, it is also true that oversight bodies could have prohibited their creation, or circulation, on the basis of the existing rules.

The new rules will not be able to provide a cast-iron guarantee against a fresh crisis occurring if supervisory authorities are not given sufficient resources to fulfil their role and if internal oversight remains ineffective.

4.4 Given financial deregulation, governments should deliver on their international cooperation commitments so as to prevent uneven regulation across different areas.

4.5 The following principles should underpin the new set of rules:

a) while the banking profession is open, checks on individuals and on the source of capital should be much more stringent and effective;

b) professionals responsible for financial transactions should be subject to authorisation, regulation and oversight; it is imperative that non-banks and shadow banking be eradicated;

c) new financial products should be subject to authorisation and supervision by national and European banking authorities.

4.6 The work of supervisory authorities should be subject to a periodic assessment by an independent body of experts who are no longer working in the financial sector. This assessment should, *inter alia*, focus on the impact of their decisions on the management of banks.

5. **What changes for Europe's banking sector?**

5.1 Banks are currently under great pressure as they must redefine their business model following the new rules. The combination of the rules and the difficult economic and financial climate has had the following effects:

— all financial institutions have a strengthened capital structure; most are already in compliance with the tier one ratio; banks will tend to reduce the size of their balance sheet to become more robust (footnote: KPMG study, December 2011, *Evolving Banking Regulations, A long journey ahead – the outlook for 2012*);

— the Basel III rules and the requirement to meet the liquidity ratio over more than one month (NSFR) and the one-month liquidity coverage ratio (LCR) are increasing banks' capital requirements and the need to maintain excess liquidity, in some cases four times higher than banks' minimum liquidity needs. These measures will adversely effect financial results and lead to reduced balance sheets;

— a difficulty in developing loan books in periods of economic growth, on account of the countercyclical capital buffer. Despite a higher demand for credit, the banks will have to deal with higher capital adequacy ratios. Loan portfolios should maintain this buffer, at the request of the supervisory authorities. The liquidity buffer set by national supervisory bodies may even be as high as 2,5 % of capital requirements.

5.2 All of this means:

5.2.1 a substantially diminishing average return (ROE) for the banking sector of between 10 % and up to 30 % in extreme cases; this limits the interest of investors in the banking sector and erodes the capitalisation of European banks;

5.2.2 a reduction in the financing of businesses and authorities and more costly credit, particularly for SMEs, which are often considered to be higher-risk ventures presenting insufficient guarantees or co-financing;

5.2.3 a possible reduction in long-term loans, resulting from the introduction in 2018 of the long-term liquidity NSFR ratio and the leverage ratio. This could have a negative influence on the financing of infrastructure investments;

5.2.4 a requirement to better assess the return on equity and improve risk management. The banks must draw up their sales forecasts and product and banking portfolio development strategies from the point of view of return and in terms of an assessment of ability to absorb capital;

5.2.5 banks may face very high costs in terms of auditing and reporting in order to comply with the new rules and meet the requirements of national and international supervisory bodies. This will have an impact on the organisation of banks, and mean structural changes.

5.2.6 There will be a tightening of credit in privileged risk-weighted sectors. Moreover, the introduction of a leverage ratio may in the long term restrict the financing of states, local and regional authorities and other sectors that once enjoyed privileged risk weightings;

5.2.7 one possible consequence of more costly credit is the transfer of some activities to institutions that are not subject to these rules. This works to the advantage of non-banks – lending to individuals at very high rates, often in cash – whose activities are subject to less stringent supervision than applies to the banks.

5.3 The new rules do not distinguish between the major banks and small institutions. They may be unsuited to certain countries, such as the new Member States of Central and Eastern Europe, which have high growth rates.

— In these countries, the new rules are likely to curtail investment. Banks in these countries are often owned by multinational groups and domestic shareholders hold a minority stake. Parent banks may repatriate a substantial part of the capital of their subsidiaries to meet the rules at global level. Substantially diminished, these subsidiaries will curtail their contribution to financing the local economy. The Committee points out that the free movement of capital is ensured at EU level, while the security of deposits and bank solvency fall under the remit of the national authorities.

5.4 The credit market differs from one Member State to the next. In countries where credit is underdeveloped, catching up too quickly in terms of debt levels can create a speculative bubble. If the prudential rules are applied at EU level, national authorities will be unable to intervene quickly enough. To support the harmonisation process, the remit of the European Banking Authority needs to be bolstered.

5.5 Certain particular models such as the cooperative banks, which operate independently and healthily, need to be catered for. To achieve the reform that the new rules entail will require a transition period. Cooperative banks are crucial to local development. They act in the interests of their members, who are also their depositors and borrowers: SMEs, farmers, municipalities and many other local players.

5.6 The major banks will seek investment that is low-risk and more profitable; in addition, there are fears of higher taxation and losses on the sovereign debt of certain liabilities.

5.7 The consolidation process will probably accelerate. Savings banks and cooperative banks can rely on sources of funding that are "autonomous", but the banks that go to the markets to refinance will be forced to merge, with negative consequences for SMEs and consumers. Some banks have been acquired and sold on after their local or regional network has been dismantled. There has been a high incidence of domestic bank concentration in the cooperative and mutual sectors as well as in savings banks.

5.8 A lower level of bank profitability, due, *inter alia*, to higher funding costs, and the extremely restrictive principles governing liquidity management may lead to higher bank charges and interest rates for term deposits as well as for clients' private accounts.

5.9 In the context of the new rules, banks are speeding up their restructuring and use of new technologies (online banking, virtual counters, use of smartphones).

— The combination of the use of new technologies and the diversification of products sold is accelerating the reconfiguration of branch networks and the move to non-cash-handling counters. Bank branches are now increasingly limited to advising customers and selling financial products. At the same time, these new means of making transfers and payments require highly secure systems to withstand the cyber attacks that pose a threat to online- and smartphone-banking.

5.10 The changes in distribution channels will ultimately lead to a shrinkage of branch networks and a reduction in employment. The implementation of the CRD IV Directive will lead to additional IT and risk-management jobs being created in the banks at the expense of the other bank activities. High-quality social dialogue needs to be developed at all levels on the issues of jobs and training in order to properly manage the ongoing change.

6. **Future developments**

6.1 The European Parliament has given its approval in principle to a tax on financial transactions, which the Commission is considering introducing; however, there is no consensus among Member States, and the US authorities are not keen on the idea. The low rate envisaged should not constitute an unbearable burden for banks or a competitive handicap at global level. As highlighted in two opinions previously adopted by the EESC [1], the purpose of this tax is both to provide new tax revenues, in particular to fund development assistance, and to change the behaviour of the banks to shift the focus towards medium- to long-term funding of the economy, as opposed to very short-term speculative trading.

(1) EESC opinion of 29.03.2012 on the *proposal for a Council Directive on a common system of financial transaction tax and amending Directive 2008/7/EC* – (OJ C 181, 21.6.2012, p. 55) and EESC opinion of 15.7.2010 on *financial transaction tax (own-initiative opinion)* (OJ C 44, 11.2.2011, p. 81)

6.2 The issue of separating retail banking from corporate and investment banking is currently under consideration in a study instigated by Commissioner Barnier, thus calling into question the universal bank model. The debate is centred on a total separation, a ring-fencing of investment banking activities or prohibiting banks from engaging in proprietary investment. Some experts are against this idea, stressing that universal banks ensure the depth and liquidity of markets and are better at financing the economy.

6.3 The development landscape of the financial world and the banking sector has altered over the last thirty years: the opening-up of the markets led to the globalisation of finance; this in turn contributed to the development and proliferation of tax and regulatory havens. Increased competition at global level fostered the emergence of new financial institutions, and new products and services.

6.4 The major banking groups have displayed the weaknesses and limitations of a level of growth that precludes good governance. They will tend to downsize so as to become more robust with less marked, more predictable profit fluctuations, and no extravagant bonuses. They will concentrate their activities on their core business, i.e. receiving deposits and providing credit, while limiting their provision of other services, curbing their international expansion and focusing their activities on higher-growth markets, which will restrict their profitability.

6.5 The new rules will see the awarding of bonuses and executive remuneration practices subject to greater accountability and more stringent controls.

6.6 Banking supervision extended to all types of financial business would allow oversight of non-banks (such as shadow banking).

6.7 Binding rules on access to the banking profession need to be introduced to enable staff to be selected with the requisite skills to reassure clients and investors.

6.8 When state aid and international aid in response to the financial crises dries up, the sector as a whole is likely to evolve in line with economic conditions and the development of new technologies, but especially following the strategies specific to each well-managed company. The banks will have the difficult task of retaining their credibility as lenders to the real economy while having to cope with higher financing costs and lower profitability.

Brussels, 12 July 2012.

The President
of the European Economic and Social Committee
Staffan NILSSON