Reforming the Structure of the EU Banking Sector

High-level Group
Final Report

BEUC Response to the European Commission Consultation

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BEUC welcomes the opportunity to comment on the final report of the High-level Expert Group on Reforming the Structure of the EU Banking Sector.

The financial crisis which has progressively escalated into an economic crisis has had a dramatic impact on European households as users of retail banking services, but also as taxpayers and as workers.

A reduction in competition due to the financial crisis has resulted in a worsening situation for consumers: The level of concentration in major retail banking markets has increased.

The crisis itself highlighted new concerns such as the safety of deposits and the stability of the system which many previously took for granted.

Furthermore, the financial crisis has also exposed the fact that even before the financial crisis many aspects of the banking sector were not working in the best interests of consumers: irresponsible lending, a sales driven culture, major conflicts of interest when distributing investment products leading to mis-selling, unfair bank charges, obstacles to switching due to tying practices and a lack of transparency.

The European Commission published this spring its annual Consumer Markets Scoreboard, according to which "financial services, investments (including pensions and securities), mortgages and real estate services are the markets which are the most likely to be failing consumers across the EU [...] in terms of consumer trust, satisfaction, the ease of comparing offers, problems and complaints, consumer choice, the ease of switching service providers or tariffs, and price differences between countries". It is thus obvious that retail customers do not have a good relationship with banks in general.

BEUC shares the diagnosis made by the High-level Group leading to a call for structural reforms of the EU banking sector

BEUC agrees that a structural reform of the banking sector is necessary at EU level. Consumers have no choice but to rely on the banking system to meet their own financial objectives. Whereas it is not possible or desirable to try and create a risk-free system, there is a need to make sensible and measured reforms ensuring that the primary objectives of consumers can be met; this means that they can operate in a stable banking system where deposits are secure and there are efficient ways to receive and transfer money; they are able to access loans, and interest on borrowing and savings are set at a fair level and are not subject to significant volatility.

Overall BEUC supports the 5 major measures proposed by the Group namely: mandatory separation of proprietary trading activities and other significant trading activities; additional separation of activities conditional on the recovery and resolution plan; possible amendments to the use of bail-in instruments as a resolution tool; a review of capital requirements on trading assets and real estate related loans and strengthening the governance and control of banks.

However, we regret that some issues (e.g. competition) and some additional measures (e.g. on governance, incentive schemes) were treated in a minor way at the end of the report while they are essential to ensure a proper reform of the banking sector in combination with the 5 major measures mentioned above.

BEUC COMMENTS ON SOME PROPOSALS OF THE REPORT

Mandatory separation of proprietary trading activities and other significant trading activities

The proposed ring-fencing requiring legal separation of some particularly risky financial activities from deposit-taking banks within the same banking group is a good compromise. However we think that such an approach (ring-fencing) would not be able to solve the issue of reputational risk: if bankruptcy is triggered in the trading entity, this could create mistrust in the whole banking group putting also the retail bank at risk.

BEUC agrees with the group suggestion to make the separation mandatory if the activities to be separated amount to a significant share of a bank's business (15-25% of the bank's total assets: but why such a large scale?), or if the volume of these activities can be considered significant from the viewpoint of financial stability. However, we are of the opinion that the smallest banks should not be fully excluded from the separation requirement as proposed by the report.

As regards **activities which should be transferred to the legally-separated trading entity**, BEUC thinks that the ring-fence should be much narrower around the retail banking elements of universal banks as it is the only way to achieve security for retail customers. The list proposed by the group has to be considered as a starting point for further analysis. However we regret that proprietary trading is not subject to an outright ban, as this activity is socially useless and dangerous for the whole economy. We also are on the opinion that plain vanilla securitisation for funding purposes and use of derivatives for own asset and liability management should not remain in the 'deposit bank'.

In principle BEUC supports the group proposal as regards **transfer of risks or funds** between the deposit bank and trading entity when operating within the same group, even if we have some doubts on the capacity of some financial supervisors to carry out necessary controls.

There is a question about the interaction of the activities of the ring-fenced bank and other financial services entities such as insurance companies. As it stands, there could be restrictions on ring-fenced banks who have tied relationships with insurance companies to offer their products. This could restrict the availability of products to consumers, without significantly affecting the risk profile of the bank. However, it could also protect consumers from being presented with a limited range of products in the belief that this was an independent recommendation.

Possible amendments to the use of bail-in instruments as a resolution tool

BEUC supports the proposal of the group as regards the use of designated bail-in instruments and the need to clarify the position of bail-in instruments within the hierarchy of debt commitments in a bank's balance sheet so that investors know the eventual treatment in case of resolution.

We also support the proposal that the bail-in instruments should not be held within the banking sector in order to not worsen the situation in case of systemic crisis and to limit interconnectedness within the banking system. We agree that this would be better accomplished by restricting holding of such instruments to non-bank institutional investors (e.g. investment funds and life insurance companies). It has to be made crystal clear that retail investors should also be excluded of such measure.

A review of capital requirements on trading assets and real estate related loans

The group suggests that the Commission should consider measures regarding the treatment of real estate-related lending within the capital requirements framework and recommends as a direct measure that **loan-to-value (LTV) and/or loan-to-income (LTI) caps are included in the macro-prudential toolbox**.

BEUC is of the opinion that in the estate-related lending area the goals of ensuring financial stability and responsible lending should complement each other and not be treated as different issues as both objectives are fully interconnected. If regulators do start to utilise LTI and LTV for macro-prudential purposes, there needs to be a proper impact assessment undertaken in order to be in line with consumer interests.

We regret that the Directive on credit agreements relating to residential property about to be finally adopted does not provide use of these ratios for creditworthiness assessment while they are already used by lenders in some Member States.

Lenders should take into account all information which is relevant for creditworthiness assessment. In order to do this, lenders should favour direct contact with borrowers by asking relevant questions and ask necessary documents in order to assess their professional and financial situation and their financial objectives. Loan-to-income and debt-to-income ratios are of primary importance in that respect and should be universally used by lenders and intermediaries. Loan-to-value (LTV) ratios should never substitute loan-to-income (LTI) ratios or a thorough assessment of a borrower's repayment capacity. Indeed, a low LTV ratio does not mean the borrower will be able to repay the loan. Therefore, loan-to-income and loan-to-debt ratios are more important, while LTV ratios may serve as a complementary tool[1]. Acceptable levels of these ratios would be better defined at national level in accordance with national specificities and economic indicators; however principles should be decided at EU level[2].

In case of use of LTV ratios, ensuring accurate property valuation is of crucial importance from both borrower's creditworthiness and market stability perspective. Valuation must be performed by professionally competent and independent appraisers. In the past, some surveyors and valuation experts often provided the exact value of the collateral needed for loan approval rather than the actual value of the property.

[1] In some countries like in France, home loans are linked to repayment capacity of borrowers and not to the value of the assets financed.

[2] See BEUC Response to the Financial Stability Board consultation on Principles for Sound Residential Mortgage – Nov 2011

Additionally, prospective market developments, such as a potential increase in real estate prices, should not be taken into account by lenders/intermediaries when assessing the borrower's creditworthiness and making lending decisions. The recent crisis and housing market bubbles showed the harmful effects of such manipulations. For example, in Spain reliance on future housing price increases, together with property overvaluation, lax underwriting standards, low interest rates, generous tax breaks for mortgage interest payments and capital repayments gave rise to the market bubble. As a result, numerous consumers whose homes were sold in foreclosure still owed their lenders money after repossession.

The excesses observed in some Member States in real-estate lending cannot be disconnected to the issue of access to housing. In a number of countries, the only means of access to housing is to become owner; rental housing is almost nonexistent and being a tenant is generally misperceived. This means that first-time buyers do not have time to build up savings before taking a loan. This explains that loans may exceed 100% of the value of the property as purchasers have also to pay various fees and taxes associated with buying real estate. The absence of overall housing policy has led to a strong demand for housing only financed by mortgage credit, which has sometimes led to housing bubbles and unaffordable housing costs for first-time buyers.

We regret that no measure has been proposed in the Report to solve the **issue of foreign currency loans**. In some Central and Eastern European mortgage markets like Poland, Austria, Hungary, Latvia or Croatia foreign currency loans dominate the market. In Hungary, for example, around 1 million consumers have mortgages and consumer credits in Swiss francs. This type of loan exists even in Western Europe, e.g. in France a collective complaint of around 4.000 victims has recently been filed with the court.[3] These loans were initially perceived as low risk due to sound real estate market conditions and stable exchange rates. But the situation has quickly deteriorated since the beginning of the global financial and Eurozone crisis as well as increased volatility in foreign exchange markets. As a result, consumers' monthly repayments have drastically increased (sometimes even doubled) heavily affecting their loan affordability. These types of products are not adapted to retail borrowers' needs as the vast majority of consumers do not properly understand foreign exchange risks and do not have any coverage against this risk, unlike institutional borrowers. This is why some national authorities have already taken certain measures to protect borrowers. The Austrian Financial Market Authority for instance recommends financial institutions to stop lending in foreign currencies to private consumers, except "*high net worth individuals in excellent credit standing*".[4]

In October 2011, the European Systemic Risk Board (ESRB) published a set of recommendations on lending in currencies other than the legal tender of the relevant country ("foreign currency lending") addressed to the Member States of the EU, their national supervisory authorities and the European Banking

[3] „Des clients intoxiqués aux prêts suisses": http://www.liberation.fr/societe/01012393342-des-clients-intoxiques-aux-prets-suisses
[4] Extension of the FMA Minimum Standards for Granting and Managing Foreign Currency Loans and Loans with Repayment Vehicles, Extension of 22 March 2010: http://www.fma.gv.at/typo3conf/ext/dam_download/secure.php?u=0&file=2511&t=1327138685&hash=adf6f16f9ac7d4d4ecb368debcf6c19d

Authority[5]. These recommendations reflect financial stability concerns arising from foreign currency lending to the non-financial private sector: "*This phenomenon is currently present in EU countries to different degrees and has led in some cases to a build-up of substantial mismatches between the currencies in which the non-financial private sector receives its income and those in which it pays back loans, thus making it more vulnerable to unfavourable movements in the exchange rate. High levels of foreign currency lending may have systemic consequences for the countries concerned as well as potential for cross-border contagion.*

The recommendations cover borrowers without a natural or financial hedge and address the risks identified by the ESRB. For credit and market risk, the recommendations are intended to limit the probability and consequences of such risks materialising by increasing the resilience of the financial system and ensuring the creditworthiness of new borrowers. It is also recommended that borrowers be given the appropriate information to make well-informed decisions. Moreover, credit institutions should properly incorporate foreign currency lending risks into their internal risk management systems, which in turn is expected to contribute to improved risk pricing.

Regarding excessive credit growth induced by foreign currency lending and the possibility of the emergence of asset price misalignments, national authorities are recommended to further tighten their rules on foreign currency lending. (…)."

While firms that engage in international trade may cover themselves against currency risk, no instrument exists for borrowers while they are engaged in credit agreements of long duration. Informing consumers about the risks of foreign currency loans is not a sufficient measure to protect them as provided by the Directive on credit agreements relating to residential property.

BEUC is of the opinion that such loans should be banned both for ensuring financial stability and better protect consumers.

Strengthening the governance and control of banks

We agree with the Group when saying that governance and control are more important for banks than for non-banks given their systemic importance; this is the reason why it is necessary to increase existing corporate governance reforms by specific measures to strengthen boards and management; promote the risk management function; rein in compensation for bank management and staff; improve risk disclosure, and strengthen sanctioning powers.

It is regrettable that these very good suggestions have not been very detailed in the report.

Governance and control mechanisms

We agree that attention should be paid to the governance and control mechanisms of all financial institutions with systemic and customer-facing

[5]http://www.esrb.europa.eu/pub/pdf/recommendations/ESRB_2011_1.en.pdf?d68a58264eec2fa32866b86a5bfa6ec7

responsibilities, whatever their size and more attention needs to be given to the ability of management and boards to run and monitor large and complex banks.

Proposing to apply fit-and proper tests when evaluating the suitability of management and board candidates is a good suggestion.

The key role of the board of directors is to direct/supervise the affairs of the bank. Board members are fiduciaries, required to act in the best interest of the company. To ensure an open discussion within the board about the bank development, potential risks and current operations, we consider it necessary that there is a sufficient independent element in relation to the executives, especially to the CEO, to avoid potential conflicts of interest and to prevent concentration of management powers in the hands of one person. As the chairperson has a crucial role within the board, we believe that the chairperson should not carry executive responsibilities. It is important to ensure the functions and duties of the chairperson of the board of directors are separated from those of the CEO who will be responsible for executive/operational decisions and day-to-day management. Such a division will allow the chairperson and non-executive directors to oversee aspects about governance, overall policy and strategic direction and represent the needs of the shareholders and other stakeholders (being the guardian of shareholders' interest), will improve accountability and will provide checks and balances in the board.

Non-executive members of boards of companies therefore should have a wide experience, appropriate qualifications, personal qualities, independence and come from diverse backgrounds that fit the needs of the bank in question. To enable boards to recruit new directors from the widest possible pool of potential candidates, BEUC believes that recruitment policies should be:

a) precise about the profile of directors and

b) transparent to shareholders of the bank and its customers. Banks should be required in their annual reports to list the name of the chairperson and non executive members with appropriate details of their backgrounds, especially current and recent external (board and management) positions, gender, age, and date of joining the company and board.

We consider that non-binding measures are insufficient, which is highlighted by the fact that a number of Member States do not follow the recommendations on remuneration and directors' pay adopted by the Commission in 2009.

Incentive schemes

We fully share the views of the group when saying that one essential step to rebuild trust between the public and bankers is to reform banks' remuneration schemes, so that they are proportionate to long-term sustainable performance. We agree that a regulatory approach to remuneration should be considered that could stipulate more absolute levels to overall compensation (e.g. that the overall amount paid out in bonuses cannot exceed paid-out dividends). Board and shareholder approvals of remuneration schemes should be appropriately framed by a regulatory approach. We also fully agree that a share of variable remuneration should be in the form of bail-in bonds. There should also be the option for banks to claw back bonuses that have been paid out in the past where these have led to poor outcomes or failures in risk management.

Reforming the remuneration structure is not only for the top management. It is necessary to question the whole chain of remuneration in the financial sector including the remuneration of so-called advisors in direct contact with consumers whose remuneration and performance evaluation is based on the quantity and types of financial products sold to retail customers. There is significant research showing the misalignment of consumers' and advisers' interests when sales forces are remunerated on a commission basis. Such remuneration practices lead to major mis-selling.

Improving transparency of remuneration is critical to ensure independent roles of non-executive directors. In terms of executive directors it is important to disclose the nature of the remuneration schemes and policies so that stakeholders can assess if directors remuneration fits with the level of the performance of the firm. In this context it is important that the remuneration is disclosed individually and that the remuneration committee/the board design appropriate policies and schemes which should be approved by shareholders.

Where bonuses are paid as part of a remuneration package, it has been proven that there is a real danger that directors and management concentrates on the generation of high levels of short-term profits to enlarge their bonuses sometimes to the detriment of the longer term viability of the company, its employees and consumer customers.

BEUC supports approaches to profit sharing such as is found in the Swedish Handelsbanken (www.handelsbanken.se) banking group whereby certain amounts above average profits are shared with management and staff through the foundation mechanism 'Oktogonen' and must be retained by the recipient and cannot be accessed or utilised until the person retires from the bank. We believe that there is merit in this method – it ensures a long-term perspective can be taken by directors and employees both their own advantage and that of the bank and its shareholders.

Sanctioning

It is more than obvious that in order to ensure effective enforcement, supervisors must have effective sanctioning powers to enforce risk management responsibilities, including sanctions against the executives concerned, such as lifetime professional ban, claw-back on deferred compensation, and where appropriate, imprisonment .

Inadequate supervision, combined with overreliance on bank management, boards and market discipline, has played a key role in the current crisis.

If some Member States have already begun to seriously reform their financial supervision system, this is not yet the case everywhere. Having sanctioning powers would not be sufficient if supervisors are not better equipped in terms of strong inquiry powers, including use of mystery shopping, and additional resources.

Competition and consumer protection

It is unfortunate that this question has been little developed in the report and that the group has just called for further analysis. This question covers various aspects:

- The banking concentration level is leading to lack of competition in a number of EU Member States is. Allowing mergers to take place which substantially increase the market shares of the largest banks results in less competition for consumers. Furthermore, setting aside the competitive framework through special treatment of banks during the financial crises has significantly distorted market structure. Bank customers have nothing to gain from a limited number of banks, quite the contrary.
- A lack of new market participants, exacerbated by ineffective market competition and difficult funding conditions.
- Lack of transparency (bank fees, hidden commissions) and some commercial practices like most practices of tying financial services prevent consumers to shop around and benefit from better deals.
- At cross-border level, bank business practices prevent consumers to take out financial services in a country where they are not resident. Concretely, the single market does not exit for consumers. The report points out that the integration of the financial sector at the European level would be receding, but we often forget to consider this question of the integration from the demand side.

According to the World Bank[6], competition in the banking sector promotes efficiency and financial inclusion, without necessarily undermining financial stability.

Even if the recent crisis is perceived as an episode where competition exacerbated private risk taking and helped destabilize the system, the correct public policy is not to restrict competition. What is needed is a regulatory framework that ensures that private incentives are aligned with public interest. The state can play a role in enhancing banking competition by designing policies that guarantee market contestability through healthy entry of well-capitalized institutions and timely exit of insolvent ones and by creating a market-friendly informational and institutional framework. Governments should be mindful of the consequences of their intervention during crises and limit negative consequences on bank competition and risk taking.

When analysing whether the banking system is meeting the needs of consumers it is also important to consider whether the conditions for **competition to be effective** exist within the market. We want to see a market where 'effective competition' works to reward prudently run banks which deliver good value products and great customer service and to punish banks which do not. We also draw a key distinction between consumer choice and 'effective competition'. Whilst within a particular market consumers may have the 'choice' of thousands of different products, competition will only work for consumers if they can properly compare, evaluate and choose between the different products on offer and switch to providers which deliver good value products and service. Ultimately, effective competition also requires imprudently run banks and those which do not operate in the interests of consumers to be allowed to fail.

[6] http://siteresources.worldbank.org/EXTGLOBALFINREPORT/Resources/8816096-1346865433023/8827078-1346865457422/GDF_2013_Report.pdf

The features of a market where effective competition operates would include:

- Competition on the merits – firms genuinely compete on the basis of the quality and value of their products or services rather than exploiting consumers' behavioural biases such as inertia and their difficulty in understanding complex products and service;
- Consumers are engaged and able to compare the quality or performance of different financial products and firms;
- Consumers have access to the products they need;
- Prices and the quality and characteristics of products are transparent and easily comparable;
- Products do not include hidden charges or unfair contract terms;
- There are low barriers to market entry and exit (while preserving essential services for consumers);
- There are low barriers to switching (both real and perceived); and
- Consumers are able to pursue effective and speedy redress where necessary.

End