The EU Single Market

Consultation by the High-level Expert Group on Reforming the Structure of the EU Banking Sector

Submission by Thomas Lines, a retail customer

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I. Background information

1. My name is Thomas Joseph Lines and I am an independent consultant in international trade and development, living in the south of England. I have previously worked as a financial correspondent, reporting among other things from Paris on the French banking sector and international debt reschedulings. I have also undertaken research on bank regulations and other aspects of banks' governance, both for an M.Phil. degree dissertation and later when I was a lecturer at Edinburgh University.

2. I represent no organisation and am making this submission as a retail bank customer.

3. At present I have a current account, a house mortgage account and a small savings bond with a leading building society (mutual savings bank); a savings account with a specialised commercial savings bank, of Dutch ownership; and a credit card with a cooperative bank.

4. This submission draws in part on a paper I wrote in 2011,[1] and before that an M.Phil. dissertation I submitted at the Institute of Development Studies, University of Sussex in 1987.

II. Differences between banks

Question: 'What are retail customers' recent experiences in terms of access to credit and savings and investment? Do they identify differences according to bank type (specialised bank, universal bank, etc.)?'

5. None of the three institutions that I use suffered serious adverse effects from the banking crisis. This is quite unlike Britain's major commercial banks. I put it down to three factors:

[1] Lines, T. (2011), 'The Dog That Didn't Bark: When banking crises did not occur and what we can learn from that', Weymouth, U.K.: Green House. Available at www.greenhousethinktank.org and www.tomlines.org.uk.

i. The forms of ownership, at least in the cases of the building society and the cooperative bank, which make them more responsive to the needs of depositors and account-holders and less eager to pursue profits[2] for their own sake. At the building society I am after all one of the owners, with a vote at annual general meetings; indeed, not a customer at all but a member of the Society.

ii. Tighter rules affecting building societies than commercial banks, in particular restrictions on access to money-market and interbank funding and consequently greater reliance on deposits.

iii. Different policies than those pursued by the biggest commercial banks, in particular a reluctance to use non-deposit funding at the two banks and the limited use by all three institutions of derivatives and securitisation (which I think is also restricted by regulation in the case of the building society).

III. Main concerns

Question: 'What are the main concerns of retail customers in their relationship with their bank?'

6. I cannot speak for any customer other than myself, although the question refers to 'retail customers' in the plural. As a retail customer I use banks and building societies for the following services, in order of their importance to me:

i. To safeguard my money, some of which I need for current use and some I set aside as savings.

ii. For the safe, rapid and reliable transfer of money on my behalf through the banking system (including the use of my credit card), both within my own country and outside it, since I travel frequently and work for clients in other countries.

iii. To enable me to buy a house with a long-term mortgage loan (of which 15 years of the 25-year term have now elapsed).

iv. To maintain the value of my money, so that it at least keeps up with the general rate of inflation (not successfully achieved in the U.K. since 2009, I should note).

7. I have scarcely ever used banks or building societies for any other purpose, except to get local currency when I am abroad.

8. I also consider that these are the main functions of banks in general, in roughly the same order of importance to the general economy. More precisely, I would describe the main functions of banks as follows.

9. **The primary function of banks** is to safeguard their clients' money and facilitate their transactions. The network through which banks communicate might be

[2] Strictly speaking, mutual societies do not make profits but surpluses, since they are not distributed but all go into reserves.

described as the plumbing of the market economy. As a closed system it is a natural monopoly, and it provides an essential public service. It is not by accident that many countries, including members of the European Union, have placed banks in the public sector at various times. This public function of banks must always be borne in mind when considering banking policy.

10. It is a **secondary function of banks** to lend money. As a way of making profits, it helps to pay for the primary function to be carried out.

11. **The most important bank loans** are those which directly facilitate production and transactions in the wider economy. They are most often of short term, and include for example lending for working capital and trade finance.

12. **The next level of lending** – still important, but not as essential to the wider economy - is longer-term loans for business investment, government or personal clients' requirements (such as mortgage loans, personal loans and credit card borrowing).

13. **The least essential functions** of banks are non-lending services supplied to companies, such as the underwriting of bond issues and advice on company mergers and acquisitions, as well as all kinds of financial derivatives and securitisations. In my opinion some of these functions are not needed at all, and others (particularly fee-based advisory functions) do not need to be carried out by banks and could be taken away from them without wider loss. The market economy operated satisfactorily without any financial derivatives or securitised loans until less than 40 years ago, and it is hard to see that these should be considered essential in any bank or quasi-bank.

14. As a retail client, I do not want any loan to me to be sold on to another party. I would regard that as a breach of trust by my lender, especially if it was done without my knowledge or permission. In Europe the selling and securitisation of loans are a recent innovation, mistakenly introduced in emulation of U.S. practice. A lender which has to hold its loans until maturity is likely to be more careful in assessing credit quality before lending.

15. Banks should be restricted to banking activities alone. They enjoy great privileges and should not be allowed to go beyond their sphere. As an example, in the commodity markets banks should not be allowed to trade on any exchange or hold shares in any company that trades in physical commodities or commodity futures, even if they lend to that company. Nor should they hold shares in any company that performs any other function in that sector, such as coal mines, port facilities, warehouses that serve a metal exchange or international shipping. Global investment banks have recently bought equity in all of those fields. It is an abuse of their position.

IV. Structural reforms and conclusions

Question: 'What are the views of retail customers with respect to structural reform of banking in general and in particular with respect to the structural reform proposals to date (e.g. US Volcker Rule, UK ICB proposal)? What structural reforms would be desirable from their point of view?'

16. As we have seen, there is a spectrum of banking activities and a clear order of precedence between them. Global, EU and national regulations should reflect and reinforce this, encouraging banks to prioritise functions that are higher up the list. More precisely than above, I would suggest this order of priority as a guideline:

i. Safeguarding clients' money and maintaining its value (both current accounts and savings).

ii. Maintenance of an efficient payment system and the safe, rapid and reliable transfer of money through it on behalf of clients.

iii. Loans which directly facilitate production and transactions in the non-financial economy (such as working capital and trade finance).

iv. Loans for business investment and to government.

v. Loans for personal clients, including residential mortgages.

vi. Other business services, such as the underwriting of bond issues and advice on mergers and acquisitions. There is a case for taking much of the consultancy type of work out of banks' hands altogether.

vii. Financial derivatives in general, including securitised loans.

17. While banks are necessarily connected through the payments system, a large part of the recent trouble arose from their interconnections at the levels of funding and derivatives. In most countries outside the United States these connections did not exist in the past. The interconnectedness of banks was already discussed by banking experts in the 1980s, in tones that sometimes came close to alarm. In 1987 the Bank for International Settlements warned that the interbank market's 'potential for transmitting destabilising influences across the world should not be underestimated'.[3] This is precisely what happened 20 years later, in much the same way as was foreseen at that time.

18. Long experience demonstrates that competition between banks is not necessary for their good functioning and can be damaging. I have studied the system in the U.K. in the 1950s and 1960s, a unique period in which there were no major bank failures anywhere in the world: it was emphatically *not* highly competitive. The small number of 'clearing banks' operated a cartel to fix interest rates on deposits, loans and overdrafts. (In the late 1960s they paid interest on deposit accounts at a uniform rate 2 per cent below the Bank of England's Bank Rate.) The building societies operated a separate cartel in mortgage lending.[4] In Canada now there are six dominant banks, which operate in close liaison with the authorities in a system which has remained unusually stable throughout the crisis. It is noteworthy that the first

[3] 'BIS sees slower interbank lending', *Financial Times*, July 29th, 1987. This is discussed further in Lines (2011), cited above (and also in my M.Phil. dissertation of 1987, available on request).
[4] Lines (2011), p. 4.

casualty of the recent crisis was that of Northern Rock in September 2007, which arose because, for competitive reasons, the bank had offered excessively high deposit rates and low loan rates, and was excessively dependent on external (wholesale) funding.

19. I therefore draw the following conclusions as to the desirable future structure of banking in the European Union:

i. **Banks should be legally restricted to strictly banking activities**, namely the taking of sight and time deposits, carrying out transactions on behalf of clients, lending money at interest, and a limited number of the corporate services traditionally carried out by investment and merchant banks.

ii. In general, **proprietary trading by banks and the ownership by banks of shares** in non-bank companies **should be prohibited**. The only possible exception could be permission to take minority shareholdings in companies that a bank *lends* to, according to the German tradition, in the interest of strengthening relationships between a bank and its clients.

iii. **Ownership structures matter**. My recommendation is to promote mutual and state ownership (locally, regionally or nationally) as preferable to profit-seeking commercial ownership. However, all banks which undertake activities in the low-priority and more risky areas (vi) and (vii) in para. 16 above should be owned as partnerships, with executive partners bearing full financial responsibility, along the lines of London's merchant banks and New York's investment banks until less than a generation ago.

iv. **Directors** of banks and building societies under mutual, corporate or state ownership **should be legally placed under a fiduciary duty to their depositors**, which would precede their responsibility to any external shareholders.

v. **No bank may be owned by any entity** (domestic or foreign) **which has any interests outside banking**.

vi. In banking, **oligopolistic structures appear to be safer**. The banking system is closed and monopolistic because of the universal payments system, and therefore competition can only operate at its margins. Competition brings with it the aim of maximising profits, which encourages risk, but a bank's first duty should be to minimise financial risks faced by its clients. There is enough risk already in the mismatch of maturities on a bank's balance sheet. Bank managements recognised this in the past but they have been allowed to forget it. In this area of the economy, competition should therefore not be seen as necessarily desirable.

vii. **Ensure that 'utility' banking becomes once again the dominant part of the sector**, rather than investment or wholesale banking. In the U.K. the Vickers Commission calculated that between 64 and 82 per cent of British bank assets would remain outside the retail banks which it proposed to 'ring-fence' for safety.[5] This would leave socially useful utility banking in the minority and therefore the less influential of the two branches. An important goal of regulation should be to sharply cut back the size and scope of the non-utility

[5] Independent Commission on Banking (2011), 'Interim Report: Consultation on reform options', p. 53, Fig. 3.5. Downloaded at http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf, September 2011.

sector. Much of this should come from strict limits on what is permitted in that field.

viii. **Use regulations to limit and discourage activity in riskier areas** of banking, including the outright prohibition of many derivatives. All derivative instruments – those that already exist as well as any that are invented in future – should require approval by a licensing authority. The proposer would have to satisfy the authority that the instrument serves a useful purpose and does not risk any grave economic harm, along similar lines to those that apply to medicines.

ix. **Sharply reduce interbank lending and funding from the money markets**: to this end, regulate loan-to-deposit ratios within strict limits, to be gradually reduced until loan assets may not exceed 100 per cent of a bank's deposits, without risk weighting. The aim is eventually to make every bank in the EU self-reliant, using its own deposit base – as they were in the past. That way a banking problem will be limited to the bank where it arises and not transmitted to others. That is the only way of ensuring true resilience.

x. Banks should be expected to **undertake credit assessment (due diligence) for themselves** rather than relying on external bodies, in particular credit rating agencies.

xi. **Relations between authorised banks** on one hand **and the world of 'shadow banking'** on the other need to be carefully reviewed and strictly regulated.