European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

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EACB Contribution

to the

Consultation by the High Level Expert Group on reforming the structure of the EU Banking Sector

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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.000 locally operating banks and 63.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 176 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 50 million members and 750.000 employees and have a total average market share of about 20%.

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General Remarks

The cooperative banks subscribe to the Commission's intentions for fostering prudent banking and take a stand against any and all forms of irresponsible, high risk banking.

However, it should be mentioned that there is no such thing as risk-free banking. The risk of default by the debtor is inherent in lending. Matching loans to debtors and deposits from creditors, leads to liquidity risks. Furthermore, a bank is constantly exposed to interest rate risk. All these risks arise directly out of the provision of financial services to customers and the real economy. The management of such risks constitutes the core activity of banking.

Cooperative banks are primarily member customer-driven banks. All their activities are principally geared to serving their members. To be able to create member value, cooperative banks strive for a stable and sustainable profit to facilitate this process in the long run. They have a very broad customer base in Europe of more than 181 million customers, mainly focused on private individuals, SMEs, and communities.

Cooperative banks weathered the financial crisis relatively well. Representing about 20% of the financial services rendered in the European Union, its part in write-offs after the outbreak of the financial crisis is only 7%. This is due to their prudence in dealing with risks and the cooperative ownership and governance model that keep them close to their members and customers.

Diversity in EU banking Sector a prerequisite for stability

The members of the EACB are seriously concerned about the fact that any questions raised by the Liikanen group so far focus on the "EU banking sector" without any differentiation. There are important differences regarding business concepts and company models, which result in important nuances. This diversity and the specificities within the EU banking sectors should be taken into account in order to maintain the integrity of the internal market.

In particular, we would like to stress that co-operative banks, as a general rule, mastered the crisis much better than other banking groups[1]. There would have been no crisis if it were for co-operative banks.

Therefore, a "one-size-fits-all/one-model-for-all" approach cannot be the solution, since the structure of the EU banking sector is diverse and not homogenous. As reflected in a CEPS study[2]:

> *'… there are economic, systemic and welfare benefits derived from a successful cooperative sector in the banking sectors in Europe. A financial system populated by a diversity of ownership and governance structures, and alternative business models, is likely to be more competitive, systemically less risk and conducive to more regional growth than populated by a single model.* [3]

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[1] CEPS (2010), '*Investigating Diversity in the Banking Sector in Europe*. Brussels. p. 117 'relative stability could be attributed to the inherently low profitability in good times and the use of consumer surplus as a buffer in hard times to keep proceeds relatively fixed over time' …' the better loan quality and lower asset risk of cooperative banks is a source of stability'.

[2] CEPS (2010), p. 148-149

[3] CEPS (2010), p. vi

"Reducing institutional risk, defined as the dependence on a single view of banking that may turn out to have serious weaknesses under unexpected conditions such as the current crisis."

"There are powerful systemic benefits derived from diversity of business models and ownership structures in the banking sector, to which cooperative banks contribute alongside other banks'.

'Ultimately a diverse system is a prerequisite for stability and growth'

Europe needs an accountable and solid set of banks, well capitalized and well connected to the regions, to the economic tissue and to the real economy. This is the way to ensure a balanced and diverse banking sector and macroeconomic stability. In this respect co-operative banks have a fundamental role to play.

Questions to Banks

1. To what extent are the current and ongoing regulatory reforms sufficient to ensure a stable and efficient banking system and avoid systemic crises?

Key messages

We are of the opinion that the abundant regulatory reforms under way are to a large extent sufficient to ensure a safe and sound European banking system:

a) The forthcoming enhanced prudential requirements will ensure an increased stability and efficient banking system. Moreover, in order to avoid systemic crises specific measures addressed to SIFIs are on their way.
b) The upcoming proposal for a Directive on Crisis Management will set out statutory procedures and tools for controlled resolution and enhance a preventative mindset.
c) An appropriate legislation for shadow banking can contribute to a stable financial system in the near and the long term as the primary objective of Green paper on Shadowbanking is to limit risk on systemic crisis, to have an open eye for contagion as well as to tackle a 'behaviour of avoidance' from this part of the sector.
d) There is a need for an overall ex-post impact assessment of these current and ongoing regulatory reforms assess to what extent to which they contributed to a more stable and efficient banking sectors before reflecting on the need to launch any new initiatives. Moreover, such an impact assessment will also be required in order to gain an overview of overlaps and 'underlaps' of all these different pieces of legislation and to reach a holistic approach in tackling the challenges in which in particular financial surveillance should be enhanced and implemented around sustainable macroeconomic developments.

The main messages are set out in the next paragraphs in further detail.

a) ***Basel III / CRR / CRD IV***

Following decisions taken at G20 level, an intensive reform of the regulatory framework for banks has been launched. A number of remedial actions have already been taken in the past years. Nevertheless, one of the cornerstones of the regulatory reform is currently implemented in the EU: the new Basel Accord.

These new rules include: strengthening the quantity and quality of capital, especially by increasing the common equity ratio from 2% to 4.5%, the introduction of a capital conservation buffer of 2.5% and a countercyclical buffer up to 2.5%. In addition, there is a new framework for counterparty credit risk, a rule obliging banks to hold a sufficient amount of high quality assets that can be converted into cash to meet liquidity needs over a 30 days period (LCR), another rule obliging banks to hold a minimum amount of stable funding depending on the character of its assets over a time horizon of one year (NSFR) and a leverage ratio.

In addition to Basel III, the G20 have agreed upon the introduction of a capital buffer for global systemically important banks from 1% to 2.5% of risk weighted assets, which could even be increased to 3.5%. Moreover, specific provisions in several EU legislative proposals (e.g. systemic risk buffer next to capital conservation and countercyclical buffer, stricter capital requirements, balance sheet thresholds and principle of proportionality applications, etc) which are under way are geared particularly to financial institutions of a certain size. Many suggested regulatory measures are thus already 'structurally focused'. Mr. Bernanke[4] put it in a straightforward manner:

> *"It is worth reiterating that most of these enhanced regulatory and supervisory measures focus on the largest, most interconnected financial institutions, and we are working to ensure that community banks are not subjected to rules designed primarily to constrain risks at larger institutions."*

The CRD IV / CRR, which will implement these new rules, will considerably contribute to enhance the stability of banks in the EU and address the systemic risks posed by SIFIs. The effect of its various measures of this legal package will be important and cannot be fully assessed at this moment in time.

b) Crisis Management Proposal

Moreover, the upcoming proposal for a Directive on Crisis Management will set out statutory procedures and tools for controlled resolution and enhance a preventative mindset.

This forthcoming Directive is expected to provide public authorities with far reaching resolution measures to interfere in the organization of banking groups when an institution fails or is likely to fail and use a wide range of mandatory measures in case of resolution, (while in normal time institutions should remain to be prudentially supervised without any interference in their structures).Therefore, the Crisis Management Directive reduces moral hazard as it would contribute to a controlled resolution and market exit even of large complex cross border institutions, reduce reliance on government guarantees and therefore to a stable banking system as a whole.

Furthermore, institutions and authorities will be required to draw up recovery and resolution plans for the event of a material deterioration of their financial situation. We consider that these requirements and recent EBA initiative[5] a will force institutions and supervisors alike to do some ex-ante thinking. They will also require them to take a more preventative approach.

Moreover, while resolvability and resolution planning are certainly highly important aspects, we think that more consideration should be given to reflections on prevention in order to avoid the need for resolution and resolvability. Proper management and supervision remain key.

c) Green Paper on Shadow Banking

We would also like to draw the attention to the Green Paper on shadow banking which highlights that part of the financial sector remains opaque and is insufficiently regulated. The primary objective of this initiative is to limit risk on systemic crisis, to have an open eye for contagion as well as to tackle a 'behaviour of avoidance' from this part of the sector. It is therefore necessary to tackle this globally and in specific targeted way first in order to ensure a more stable system.

In general, we support the initiative taken by the Commission and FSB to examine the possible threats posed by shadow banking activities and entities. These should be

[4] Please see: Speech held by Chairman Ben Bernanke at the 48th Annual Conference on Bank Structure and Competition, in Chicago, Illinois on 10 May 2012 available at: http://www.federalreserve.gov/newsevents/speech/bernanke20120510a.htm

[5] Please see EBA Discussion Paper on a Template for Recovery Plans of 15 May available at: http://www.eba.europa.eu/Publications/Discussion-Papers/Year/2012/EBA-DP-2012-2.aspx

addressed in an appropriate way in order to anticipate and prepare for any potential future developments that may threaten the stability of the European Union's financial system. However, we would like to stress the fact that because shadow banking activities are performed globally, a global approach or at least an approach attuned with other major regulators outside Europe (e.g. the US and in Asia) is pivotal.

Further, we have noted that there are several proposals made that try to tackle shadow banking by further regulating banks as clients of the shadow banking entities. However, the risks entailed in the core activities of shadow banking entities are not tackled. There is for example still a lack of legislation for non-regulated financial firms and hedge funds (shadow banks). As long as the regular banking sector remains strongly regulated and no comparable rules for shadow banks exist, a safe financial system remains an illusion. As a consequence, it can be detected, in this unsatisfactory legislative situation in which the prudential rules for banks will be considerably enhanced, the serious threat that certain banking activities will migrate to the shadow banking sector. Therefore, supervisors should collaborate in order to anticipate, recognize, address and mitigate in a tailored way the particular risk entailed by a specific shadow banking activity.

Therefore we think before reflecting upon any structural reforms that an appropriate legislation for shadow banking can contribute to a stable financial system in the near and the long term.

d) <u>Need for Overall Ex-Post Impact Assessment and holistic approach</u>

Finally, we are of the opinion that the ongoing regulatory reforms (CRR/CRD IV, DGS, Crisis Management-Directive, Green Paper Shadow Banking, more transparency for rating agencies) should be first finalised.

Then after a certain period of time following their implementation, the ex-post impacts of these new regulatory standards should be first evaluated to assess the extent to which they have contributed to ensure a stable and efficient banking system and avoid systemic risks before reflecting upon any possible new structural initiatives without empirical evidence underpinning the need for reform.

Moreover, such an impact assessment will also be required in order to gain an overview of overlaps and 'underlaps' of all these different pieces of legislation and to reach a holistic approach in tackling the challenges in which in particular financial surveillance should be enhanced and implemented around sustainable macroeconomic developments.

2. Which structural reforms would improve the safety and efficiency of the banking system in the EU in the near term? In the long term?

Key messages

In answering which structural reforms would be necessary, we would like to refocus on the ultimate goals to be reached by any suggested measures.

The ultimate objective as set out in the mandate of the Liikanen Group is *'to establish a safe, stable and efficient banking system serving the needs, the EU economy and the internal market'*. In this respect, we would like to reiterate that

a) The ongoing and forthcoming regulatory reforms at global and EU level aim to strengthen and reduce the risk within the EU banking sector. It is necessary to provide for a reasonable amount of time to put the new requirements in place first before any new action/initiatives are taken.

b) Diversity of business models and opportunity for choices improves a lower risk profile, enhances competition and maintains the integrity of the internal market. Each of these different business models should be fundamental reference for evaluating risk.

c) The cooperative corporate model features such as its specific incentive structure to put members' interest before profit maximisation, the prevalent mutual trust and long term banking approach, and safety net systems were always and also in the middle of the crisis geared to have and maintain a stable and efficient banking system. These characteristics should not be undermined in any way and could serve as benchmark[6].

The financial crisis has shown the sensitivity of the markets and indicates clearly that in this intertwined global financial market, the end does not justify any short or long term means and measures which are taken hastily without assessing their potential harmful impacts. A profound reflection is therefore necessary to recognise and appreciate the well functioning elements of the EU banking sector, such as the co-operative banking model which are already directed to meet the ultimate objective to have a safe and sound EU banking sector.

Please find our key messages elaborated further below.

a) ***Ongoing and forthcoming requirements will ensure an increased stability***

Reflecting on whether structural reforms are necessary in the first place, we think it should be borne in mind that at the European level there are many regulatory reforms under way (CRR/CRD IV, Crisis Management-Directive, DGS, Shadowbanking and more transparency for rating agencies) which aim to prevent systemic risks and try to make the European banking system more safe. These ongoing regulatory reforms should be first finalised. Then after a certain period of time, after their implementation, the impact of these new regulatory standards should be evaluated before any structural reform requirements are hastily decided. Although the Commission provides in its proposals ex-ante impact assessment for the future effects of its legislation, the actual consequences of certain provisions may only be evaluated ex-post after application of this provision in a certain period of time.

[6] See: De Larosière J., (2011), *Don't punish the banks that performed best, The Financial Times*, March 3rd; Masera R (2012), *Testimony to the Finance Committee of Italy's Parliament*, February 1st

b) Diversity in EU banking Sector is a prerequisite for stability

Secondly, the members of the EACB are seriously concerned about the fact that any questions raised by the Liikanen group so far focus on the “EU banking sector” without any differentiation. There are important differences regarding business concepts and company models, which result in important nuances.

This diversity and the specificities within the EU banking sectors should be taken into account in order to maintain the integrity of the internal market. In fact, these different business models should be fundamental reference for evaluating risk. A particular distinction should be made between “stakeholder value banks” whose primary (and almost exclusive) business focus is maximising shareholder’ profit interests and “stakeholder value banks” in general (and cooperative banks in particular) which have a broader focus on the interests of a wider group of stakeholders (notably customer-members in the case of cooperative banks, the regional economy and the society in the case of savings and public banks)[7].

In this respect, we would like to stress that co-operative banks, as a general rule, mastered the crisis much better than other banking groups[8]. There would have been no crisis if it were for co-operative banks[9].

> *‘… there are economic, systemic and welfare benefits derived from a successful cooperative sector in the banking sectors in Europe. A financial system populated by a diversity of ownership and governance structures, and alternative business models, is likely to be more competitive, systemically less risk and conducive to more regional growth than populated by a single model.* [10]

Therefore, a “one-size-fits-all/one-model-for-all” approach cannot be the solution, since the structure of the EU banking sector is diverse and not homogenous. As reflected in a CEPS study[11]:

> *“Reducing institutional risk, defined as the dependence on a single view of banking that may turn out to have serious weaknesses under unexpected conditions such as the current crisis.”*
>
> *“There are powerful systemic benefits derived from diversity of business models and ownership structures in the banking sector, to which cooperative banks contribute alongside other banks’.*
>
> *‘Ultimately a diverse system is a prerequisite for stability and growth’*

[7] CEPS (2010), p. 7-8
[8] CEPS (2010), p. 117 ‘relative stability could be attributed to the inherently low profitability in good times and the use of consumer surplus as a buffer in hard times to keep proceeds relatively fixed over time’ …’ the better loan quality and lower asset risk of cooperative banks is a source of stability’.
[9] De Larosière J., (2011), *Don’t punish the banks that performed best, The Financial Times*, March 3rd; Masera R (2012), *Testimony to the Finance Committee of Italy’s Parliament*, February 1st .
[10] CEPS (2010), p. vi
[11] CEPS (2010), p. 148-149

c) ***Focus on positive elements: prudent co-operative banking model***

Thirdly, we are of the opinion that a complete overhaul of the banking industry in the sense of structural reform will not necessarily improve safety or efficiency in long run and especially not in the short run for consumers, the financial markets nor the economy as a whole.

We suggest that Liikanen group reflects on what the positive elements in the banking sector were during the financial crisis that maintained the motor running. As mentioned before, co-operative banks, as a general rule, mastered the crisis much better than other banking groups[12]. The specific characteristics of co-operative banks as set out below should therefore be cherished as a beacon of stability in rough times and could serve as basis to tackle moral hazard and the general wrong incentive structure prevalent in banking system.

The cooperative banks have a very specific ownership, governance and capital structure which are a great attribute to the European banking landscape and very well if not even best suited for the envisaged aim to avoid systemic risk and return to 'basic banking'. Although different types of cooperative banking groups exists in the various EU member states, there are certain key unifying features specific to cooperative banks which made them weather the difficult financial circumstances since autumn 2008 relatively well due to the following specific features:

a) *Co-operative Incentive System: promotion of members' economic interest*

The specific incentive structure of cooperative banks is one of the major reasons why co-operative banks went through the crisis better than others. More attention should be given to this aspect. This rationale could be taken as long term objective for changing 'structurally' the general behaviour and mindset in the financial sector. Moreover, given this incentive system co-operative banks already meet the objective 'of establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy and the internal market' as set out in the mandate of the Liikanen group.

Co-operatives do not aim at maximizing profit, but rather on promoting the economic interest of their members[13]. As Oliver Wyman[14] pointed out:

> "*financial rewards are not the primary reason for customers, …., to be owners via membership – the provision of good value products and services is assumed to take precedence over profits as a motivating factor".*

Due to the principle of open membership, in most cases everybody can become a member of a co-operative bank, typically by buying a member share or certificate.

However, the amount of capital that a single member can hold, is typically fairly limited, as is the number of voting rights (the one man – one vote principle prevails).

[12] CEPS (2010), p. 117 'relative stability could be attributed to the inherently low profitability in good times and the use of consumer surplus as a buffer in hard times to keep proceeds relatively fixed over time' …' the better loan quality and lower asset risk of cooperative banks is a source of stability'.

[13] CEPS (2010), p.8 'stakeholder value banks (including cooperatives) need to generate profit in order to survive and expand, but that profit is not the sole or even primary bottom line objective'

[14] Oliver Wyman (2008), p. 18

- *Distribution of Profit on an Equitable Basis*

Moreover, any dividends paid (if at all) will only represent a minor part of the annual profit. The biggest part will be allocated to the bank's reserves, to which, in most cases members have no access. Typically, the value of a co-operative share can never be higher than the face value. Oliver Wyman[15] therefore concluded:

> *"… the demands on capital are less acute. Members of co-operative banks typically take a longer term, risk-adverse view than shareholder-owned banks, with a correspondingly lower expected return."*

Due to this mechanism, co-operative banks accumulate capital by design. In fact, co-operative banks are reliant upon internal capital for strategic investments, whilst the commercial banks have greater access to raise additional funds, for example through the issuance of stock.

Therefore, the co-operative banking model stands for an incentive structure that does not favour any risky business strategies[16]. There are no shareholders that can create intensive pressure for a high return on equity, since high returns would not result in advantages for the members. Management rather has to ensure that it creates member-value, by providing good services and (in some cases) paying reasonable dividends while ensuring the stability of the banks by a sufficient level of profitability and the allocation of sufficient funds to the banks' reserves.

Some may consider this not to be a very exciting business model. However, as recent experience has shown, it certainly contributes to establish a safe, stable and efficient banking system that serves the needs of the members and customers, the economy and the internal market. We therefore, think that these specific incentive structures have to be taken into consideration in a due assessment of the need for structural reforms.

b) *Cooperative's prevalent mutual trust and long term banking approach*

Given the abovementioned main statutory aim of cooperative banks to explicitly promote economic interest of its members rather than maximizing profit, cooperative banks have automatically a longer term perspective to business. Cooperative banks have as such a comparative advantage in establishing long lasting fiduciary trust relations with customers which require them to constantly and continuously directly provide vital financial services, the so-called 'originate to hold' model.

Historically, the cooperative corporate form was created on the fundaments of principle of mutual trust/mutual 'self-help'[17], in particular in the non-predictive sectors such as agriculture, which translated into long term engagements. Today, this is reflected in their success to enter into longer term contractual relationships such as mortgages[18] and life insurance. Also during the crisis, their relationship –orientated business model proved to be the best to grant credit at times of increased borrowers' asymmetries of information. The advantage of such relationship is emphasized in a CEPS study[19] which states that:

> *"The special value of mutuality rests on its capacity to establish and sustain relationship and longer term contract structures. Cooperatives have a comparative advantage in establishing trust"*

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[15] Oliver Wyman (2008), p. 35

[16] CEPS (2010), p. ii in case where the cooperative banks demutualised and stepped away or beyond these traditional cooperative values of arm's length lending problems arised.

[17] CEPS (2010), p. 27

[18] E.g. in many countries, the cooperative banks have a great market share in the provision of residential mortgages such as the Rabobank in the Netherlands

[19] CEPS (2010), p. 7

This mutual trust exerts itself in the belief on the one hand from a cooperative bank's perspective that a client will meet its obligations given that there is an arm's length relationship and members are often customers; and on the other hand from the client's perspective there is the trust provided by the cooperative incentive structure that there is a prioritisation of members' needs. In this way, this principle of mutual self help inherently fosters the idea that cooperative banks will continue to perform their financial services directly to clients and shall not require external interventions to continue their services.

c) *Inverse Pyramid Structure of Co-operative Banking Groups improves control*

The general structure of banks is based on a classic pyramid structure, in which a holding or a bank controls several subsidiaries, whose activities may differ significantly. However, the co-operative banking system in Europe can rather be characterized by an "inverse pyramid structure" in which regional/local banks own the central bank. In such a way there is also a balanced approach as local banks have control over the retail and (if applicable) wholesale activities of the central bank.

Cooperative banks have been created gradually, as networks of local and regional credit cooperatives. The specific feature of cooperative banks that created the member ownership structure is that they are developed "from bottom-up", on the basis of the two or three layer system, implying a local and/or regional and central level.

As a general rule, political power emanates from the base. The groups' governance implies that local needs are taken into consideration in any business policies designed at central level. Typically, central institutions are owned, directly or indirectly, by local banks which have oversight and control over its retail activities.

d) *Safety net of co-operative alliance enhances security*

Due to the inverse pyramid structure, cooperative banks have established internal liability structures i.e. a network with an integrated structure with extensive vertical and/or horizontal cooperation. These internalised mutual self help systems means that cooperative banks in 'good and bad' times support one another.

The alliances exist in a kind of network cooperation institutions, of which the nature, degree of integration and the role of these institutions vary per co-operative banking group. The abovementioned mutual trust approach is not only externalised towards its clients but also internalised within the cooperative structures as an internal control system. These alliances may take a role of an internal central bank function, intermediating liquidity within the network[20], institutional protection schemes to secure the certainty of repayment for creditors and depositors and as such enhance the banks' funding opportunities, intra group interbank market, intra group liquidity systems for the management of excess liquidity.

These internal cooperation structures are an internal safety net which makes the cooperative banks more effective in coping with capital, liquidity or insolvency problems without external intervention or aid.

[20] CEPS (2010), p. 18-19

3. What are your views on the structural reform proposals to date (e.g. US Volcker Rule, UK ICB proposal)? What would be the implications of these proposals on your institution and the financial system as a whole?

Key messages

Cooperative banks fully share the ambition and are very willing in helping to shape a safe financial system. Many of them already took the decision to refrain from certain high risk activities[21].

- We do not think that there is a general concept on how a banking group should be structured. This very much depends on the business model, the size, the risk profile and the incentive structures of the institutions in question.

a) In the debate brought forward by the ***UK ICB Proposal*** on the separation or ringfencing of retail and corporate/investment banking activities, we call on regulators to take a very cautious and balanced view on the matter.

   - the ICB report provides for a far-reaching demerger of institutions, which has *major implications especially for the co-operative business model* with its specific inverse pyramid and intragroup liquidity system. This is seen in comparison to the universal banking model which has no disproportionate activities in one particular area outside of retail banking and can be considered to withstand adverse internal and external circumstances best.
   - In the view of the cooperative banks, it is not the demarcation of business products and geographical spread of the activities that limits the probability of bankruptcy, but mainly the prudence of its management reflected in the risk profile of the bank and the solidity of the institution reflected in capital and liquidity buffers. Adequate regulation, in particular Basel III/ CRD IV, and banking resolution measures will have to safeguard this.
   - Structural separation or ringfencing of banking activities is likely to have very profound negative consequences for the European economy, in terms of the financing of the real economy, growth, employment and consumer choice and specifically for the cooperative model

b) The ***Volcker Rule*** could be a proper solution to directly address the most volatile business areas of EU banking sector which are not connected with core client business. However, this will require detailed guidance to define properly the border between allowed and not allowed activities/deals. In this respect there should be enough leeway to take into account the specific business concept of a bank, its balance sheet total and the composition of its balance sheet. The end result would be a less risky banking environment

Our main remarks are specified in the following paragraphs.

a) UK ICB proposal- Vickers' Report

It is necessary to point out that what at first glance may seem a simple intervention (splitting off specific corporate and investment banking activities) in the Vickers' report may all too soon lead to insurmountable problems when put in practice. Furthermore, they fear that even if such a separation can be carried out, it will not bring about the envisaged stability, and the economies in Europe will suffer from a lack of finance.

[21] CEPS (2010), p. 116 'Groeneveld and de Vries (2009) also note that the empirical evidence suggests that the largest losses in cooperative banks tend to occur when they stray beyond the traditional scope of their business

More specifically, the proposed ring fencing requirement in the Vickers Report will have serious negative implications for the co-operative model in comparison to a joint stock model and would even require cooperative banks to cease their activities.

i. *Harmful to Inverse Pyramid Structure of Co-operative Banking Groups*

First, the ICB proposal is conflicting with the structure of co-operative groups in Europe.

The ICB report is considering a structural separation of activities that is based on the presumption of a classic pyramid structure, in which a holding or a bank controls several subsidiaries, whose activities may differ significantly. We understand that ringfenced entities must:

i. not have any exposures to a non-ringfenced bank or a non-bank financial organisation outside its corporate group (item 3.39 ICB Report) and

ii. apply regular legal lending limit restrictions to exposures within its corporate group (and vice-versa; item 3.87 of the ICB report).

In a cooperative structure a group of smaller banking entities owns a bigger banking entity which means that local banks, hold shares in regional credit institutions. This inversed pyramid structure provides for a balanced approach as local banks have control over the retail and wholesale activities of the central bank.

However, if the ringfencing principle is applied at EU level, shareholdings of e.g. ringfenced local entities into the central cooperative or other entities conducting businesses which are not allowed for the ringfenced entity are forbidden.

Additionally, the 'inverse' pyramid structure' of cooperative banks does not make it possible or allow for separating 'mandated retail' activities from prohibited activities in strict insulated entities, as the smaller entities will always have holdings in the bigger common banking entity that is engaged in prohibited activities.

As a consequence the approach of the Vickers Report would be more harmful to cooperative banks and even break up or dismantle their entire governance structure in comparison to a bank with commercial joint stock model.

ii. *Threat to Co-operative internal 'economies of scale' system*

Secondly, an important number of co-operative local/regional banks has created, over the time, common companies and institutions within the group where services are bundled at the central level of the group. These service companies which are owned by local banks are for efficiency purposes and not for profit orientation – as that would go against the co-operative statutory aim to serve members' needs. Nevertheless, these well established sub-pyramids would be no longer allowed if ringfencing is required.

Typically, co-operative networks dispose of insurance companies, asset management companies and apex banks, but also of common academies, publishing houses, etc. Local banks hold participations in these service institutions directly or indirectly. The very restrictive approach of the Vickers report would, to a large extent, exclude any such participation. These companies or institutions would only be allowed to offer a very reduced range of services and require the ring fenced entities, e.g. small and medium sized local co-operative banks to provide these services on a stand alone basis. This would nullify the purpose of economies of scale.

iii. *Negative effect on co-operative intra-group liquidity systems*

Moreover if recommendations of the Vickers' report would be followed, co-operative local banks which keep their surplus liquidity with the regional banks and central institutions would need to cease such activities. While, during the crisis this liquidity pool has been of great advantage.

Due to the inverse pyramid structure, cooperative banks have established internal liability structures i.e. a network with an integrated structure with extensive vertical and/or horizontal cooperation. The alliances are a cooperation intermediating liquidity within the network[22], a so-called intragroup liquidity systems for the management of excess and shortage liquidity.

These alliances are an internal safety net which makes the cooperative banks are more effective in coping with capital, liquidity or insolvency problems without external intervention or aid.

The application of ringfencing principle, would result in severe restrictions and instability of the liquidity flows within the cooperative banking groups. As a result, members of the cooperative group might be forced to place surplus liquidity outside the group which would, inherently, increase the risk exposure of the co-operative sector.

The strategic and managerial necessity of such intra liquidity system specific to cooperative banks model would be taken away.

iv. *Threat to local cooperative banks as universal banks for retail customers*

In the fourth place, the Vickers report suggests a concept that is trying to split up classic European banking activities into various separated and ring-fenced legal entities.

The ICB report is based on a number of basic assumptions which include that:

- corporate and investment banking is not vital for the economy and can therefore vanish without severe consequences;
- investment banks activities are intrinsically more risky than retail banks activities; and
- by legally separating ring-fenced from non-ring-fenced activities, the ring-fenced activities can be effectively isolated from disruptions in the non-ring-fenced area.

In this respect, the ICB report may constitute a solution for the British banking landscape that, with its relatively large corporate and investment banking activities, is very different from the continental European one. Firstly, the risks arising out of investment banking are relatively smaller in continental Europe and such a separation would bring about less of a stability windfall. Secondly, if the banks are forced to discontinue their corporate and investment banking activities and to bring them under independent entities, the latter will in many instances be too small to survive independently. A further disruption of the level playing field will not be beneficial to the continental economies. Finally, there is no evidence at all in the EU that such a diversified approach to retail banking has created problems throughout the crisis. To the contrary, it may even create more stability by generating different sources of income while less ability to diversify the asset side may make banks more prone to risk.

Such separation will even have greater repercussions for European co-operative groups, which consider themselves to be absolutely "retail". Most of them are strongly focused on the retail business, by applying an "all-finance" concept for and requested by their local customers, which includes services particularly in insurance and asset management.

[22] CEPS (2010), p. 18-19

The strength of local co-operative banks lies specifically in the fact that they provide these all encompassing services. They provide retail services (deposits and loans) and also (even smaller co-operative banks) to a lesser extent ancillary services to customers such as derivatives, interest rate swaps, foreign currency swaps, real estate financing, leasing etc. These latter services are primarily used by retail customers to hedge their own lending and foreign currency receivables. The local retail bank is in close contact with its customers and thus in the best position to advise on the credit and interest rate fluctuations as they are well aware of the economic situation of the customer. The local co-operative banks should be able to continue provide these banking services. The diversification of their activities and income streams is a means to reduce their risks. Also in banking regulation avoiding concentration risk is very common

Most of the cooperative banks are funding their activities through a centralised treasury function being very reliant on the issuance of short and long term (bonds) securities, based on a group rating. The funding capacity of a ring-fenced part of the institution will be reduced. Moreover, the ring-fenced parts would be required to invest possible surplus liquidity outside the co-operative group and would, therefore, increase the risk exposure for the co-operative group. In contrast thereto, non-ring-fenced subsidiaries will very often not be able to fund themselves on a stand-alone basis or only at conditions that prohibit doing their own finance business. Consequently, those banking subsidiaries, for instance in the area of leasing, corporate banking, real estate finance, will have to reduce their credit volumes substantially with direct adverse implications for the real economy. Vickers would thus entail the dismantling of many well functioning cooperative banks with adverse consequences for their customers.

Moreover, a local co-operative bank that provides these services in one entity is more cost efficient and transparent for customers. It would be more cumbersome and inefficient for customers to be involved with a pure retail bank for their deposits and loans and a commercial/investment bank for derivatives. It could lead to higher transaction cost as well as reduced safety to access such services due to lack of security by being directly exposed to a commercial/investment bank (if such client was able to get access to a commercial/investment bank at all!).

In any way, drawing a clear demarcation line between pure retail banking, (wholesale/)commercial/investment banking is not straightforward as there are interlinkages which are economical undividable and do not originate due to the structure of the bank itself.

Additionally, the 'inverse' pyramid structure' of cooperative banks does not make it possible or allow for separating 'mandated retail' activities from prohibited activities in strict insulated entities, as the smaller entities will always have holdings in the bigger common banking entity that is engaged in prohibited activities.

Therefore, requiring local cooperative banks to repel certain ancillary activities may create loss of all activities as the two requires separate entities are to small to survive, ultimately lead in the to short run to a loss of customers and in the long run a seizure of activities of small local banks.

v. <u>Services outside the EEA</u>

In a fifth place, according to the Vickers Report banks could pursue all permitted services only within the EEA. This provision could cause serious harm to cross-border banks which are also active in non EU Countries. These banks would have to sell all of its entities outside the European Economic Area even if they only engage in permitted, ringfenced activities. Moreover, large parts of the traditional client-focussed continental European universal banking would be largely impossible since the Vickers approach would *de facto* prevent banks to provide business with non-European Economic Area-entities or trade and export financings requested by its clients.

In conclusion,

- Cooperative banks fully share the ambition of policy-makers to shape a stable financial system. However, we do not think that there is a general concept on how a banking group should be structured. This very much depends on the business model, the size, the risk profile and the incentive structures of the institutions in question. On the debate on the separation or ringfencing of retail and corporate/investment banking activities, we call on regulators to take a very cautious and balanced view on the matter.
- The ICB report provides for a far-reaching demerger of institutions, which has major implications especially for the co-operative business model with its specific inverse pyramid, intra group liquidity system.
- The universal banking model, with no disproportionate activities in one particular area outside of retail banking, can be considered to withstand adverse internal and external circumstances best.
- In the view of the cooperative banks it is not the demarcation of business products and geographical spread of the activities that limits the probability of bankruptcy, but mainly the prudence of its management reflected in the risk profile of the bank and the solidity of the institution reflected in capital and liquidity buffers. Adequate regulation, in particular Basel III/ CRD IV, and banking resolution measures will have to safeguard this. Banks and supervisors are currently in the process of restructuring in order to meet the new requirements. This restructuring process is complex and requires time to bear its fruits in a sustainable way. It should not be jeopardised by hastily reforms which may lead banks to completely review their business models and lose the benefits of diversification. Above all, cooperative banks focus on servicing their customers and not engage in products and activities with the only purpose to make a profit.
- Separation or ringfencing of banking activities is likely to have very profound negative consequences for the European economy, in terms of the financing of the real economy, growth, employment and consumer choice and specifically for the cooperative model.

b) Volcker Rule

We believe that the right solution for reducing systemic risks would be to directly address the most volatile business areas of banks which are not connected with core client business. The focus should rather be on considerations how to better control and reduce systemic risk of certain investment activities than considering a restructuring/ splitting up the banks as the real problem lies with the speculation in investment banks and not the retail business.

However, the implications of a possible regulation such as the so-called Volcker rule (a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act) on the cooperative banks is more difficult to predict because the concept as discussed in the US is very complex and foresees numerous not yet specified exceptions. The cornerstones of the Volcker rule are as follows:

- Commercial banks are prohibited to conduct ‘trading a covered financial position in a trading account’. There are a number of exceptions (which are unclear and must still be defined) – however, many cooperative banks (like many other banks in Europe) conduct some sort of trading activities part of which might have to be ceased under a regulation of the nature of the Volcker rule.

- The Volcker Rule prohibits a banking entity from sponsoring or retaining as principal an ownership interest in a covered fund (whereby covered funds include issuers defined as “investment companies” under the Investment Company Act of 1940 (some exemptions) and commodity pools. As it looks, this would hamper the cooperative bank activities with respect to its asset management companies or, at least, to make investments (e.g. as seed money) therein.

In conclusion, it could be a proper solution to directly address the most volatile business areas of banks which are not connected with core client business. However, this will require detailed guidance to define properly the border between allowed and not allowed activities/deals. In this respect there should be enough leeway to take into account the specific business concept of a bank, its balance sheet total and the composition of its balance sheet. The end result would be a less risky banking environment in which attention is be paid to “avoidance behaviour” outside the regulated banking sector.

What are the main challenges of your financial institution as regards resolvability? Are you implementing structural changes to your institution in the framework of your recovery and resolution planning?

Key messages

- We are closely following the ongoing discussions and (intended) initiatives on Crisis Resolution. We are of the opinion that the upcoming proposal for a Directive on Crisis Management will set out statutory procedures and tools for controlled resolution and enhance a preventative mindset; and
- at present, no structural changes are made to cooperatives banks' models and we consider this unnecessary in the future.

The forthcoming Crisis Resolution Directive is expected to provide public authorities with far reaching resolution measures to interfere in the organization of banking groups when an institution fails or is likely to fail and use a wide range of mandatory measures in case of resolution, (while in normal time institutions should remain to be prudentially supervised without any interference in their structures).Therefore, the Crisis Management Directive reduces moral hazard as it would contribute to a controlled resolution and market exit even of large complex cross border institutions, reduce reliance on government guarantees and therefore to a stable banking system as a whole.

Furthermore, institutions and authorities will be required to draw up recovery and resolution plans for the event of a material deterioration of their financial situation. We consider that these requirements and recent EBA initiative[23] will force institutions and supervisors alike to do some ex-ante thinking. They will also require them to take a more preventative approach which is a further step to ensure a save and stable banking sector as it shall provides reflected upon effective measures in case of failure.

Moreover, while resolvability and resolution planning are certainly highly important aspects, we think that more consideration should be given to reflections on prevention in order to avoid the need for resolution and resolvability. Proper management and supervision remain key.

Nevertheless, considering that there is still significant uncertainty about the outcome of these ongoing works it is hard to predict future developments or indicate what main challenges would be.

[23] EBA Discussion Paper on a Template for Recovery Plans