



European Financial Services
Round Table



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HOW REGULATION CAN PRESERVE THE CONTRIBUTION OF FINANCIAL FIRMS TO ECONOMIC GROWTH IN EUROPE

AN EFR PERSPECTIVE

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EXECUTIVE SUMMARY

Europe urgently needs to return to economic growth, not only to lessen the pressure of the sovereign debt crises but also to safeguard the long-term welfare of European populations.

What specific policy measures are required is a matter of dispute among economists. Yet all would agree that a well-functioning financial sector is essential to the economic health of Europe and its citizens. Section 2 of this paper describes the basic functions of banks and insurers, and explains their vital role in the real economy in intermediating between lenders and borrowers, absorbing risk and providing payment services.

Financial sector regulation can promote long-term economic growth by reducing systemic risk and increasing investor and consumer confidence. But it can also hinder financial firms from playing their distinctive role in the economy. Over-cautious regulation can restrict the supply of credit to the real economy. And inconsistencies in the rules can create uneven playing fields, encouraging “regulatory arbitrage” whereby capital flows not to its economically best use but to uses (unintentionally) favoured by the rules. In a globalised financial industry, unilaterally onerous regulation in one jurisdiction threatens to drive capital and financial operations to other jurisdictions. The EFR supports Europe’s and the G20’s policy goals, however regulators and policymakers must ensure that European financial firms continue to provide competitive products and services that are vital to citizens and businesses.

The crisis showed the necessity of reforming the regulation of financial firms. But it is important that reforms to regulation help insurance companies and banks to play their vital role in promoting economic growth across Europe. EFR supports a regulatory reform agenda that:

- Makes banks and financial firms *independent* of taxpayer support, including through effective resolution tools, thereby reducing moral hazard and distortions in risk pricing. In this context, EFR supports the move towards a Banking Union with stronger role of the ECB
- Ensures a *coordinated approach and level playing field* across countries and sectors – most importantly, across banking and insurance (allowing for the structural differences in their assets and liabilities)
- Encourages new funding models, new sources of investment and improves the financing of long-term projects. More long-term finance for viable projects, including in infrastructure and low-carbon technology, will boost growth, innovation and jobs in Europe. The securitisation markets also need to be revived and, to this end, The EFR was a co-founder of the Prime Collateralised Securities (PCS) initiative and continues to support this important project

- Explicitly trades-off systemic safety and economic growth. In the short-term, with financial risk-taking naturally subdued by the recession, this should make regulators err on the side of growth, while putting in place a framework for a long-term and stable expansion
- Provides clarity in the reform process as uncertainty stifles the ability of banks and insurers to invest in the real economy. The competitiveness of the European financial services industry also needs to be preserved vis-à-vis other parts of the world

The EFR represents Europe's major banks and insurers. It is committed to providing Europe with the stable but vibrant financial sector required for economic growth and to constructive engagement with policy-makers. The EFR is also a firm believer in a fully integrated internal market and the benefits this produces for the broader European economy, its citizens and businesses.

1. INTRODUCTION

Five years into the financial crisis, economic growth remains low across Europe. In some parts, output is continuing to contract. The severe fiscal stress of some European governments raised the spectre of sovereign defaults or the disintegration of the single European currency, with systemic implications.

Without a return to growth, European governments will find it difficult to solve their current fiscal problems or to honour their unfunded promises to provide pensions and healthcare for their aging populations. Low growth over a prolonged period of time may lead to increasing unemployment, declining incomes, lower asset values and under-funded retirements. The gains made by the euro to the integration process in Europe are under threat as a result of the sovereign debt crisis.

Opinions differ about the best path to economic recovery, amongst economists as well as politicians. Yet all agree that financial firms play a vitally important role in a healthy market economy, and that European financial firms are currently not able to play this role to the full extent.

Why not? What hinders banks and insurers from playing their distinctive roles in the European economy? And what can be done to remedy the situation? These are the topics of this report, especially insofar as the answers concern financial sector regulation.

The cost of the financial crisis shows the need for regulatory reform. This reform should be guided by a vision of the role of the European financial sector in the real economy. It should aim to make the financial sector dynamic, efficient and able to weather an economic or financial crisis without relying on taxpayer support.

Of course, regulation should aim to make financial firms safer. But regulation should not aim at making them risk free. To perform their vital economic functions, banks and insurance companies must take risks. Regulation must strike a balance between keeping the system safe with limits on risk taking and encouraging the financial sector to take economically necessary risks. A risk free financial system would create an economic desert.

We hope this report will contribute to constructive discussions between governments, regulators and the financial sector in their common interest of supporting a vibrant, growing and stable European economy. The Members of the European Financial Services Round Table (EFR) represent many of Europe's major financial institutions. We are ready to play our part in bolstering growth across Europe.

2. HOW FINANCIAL FIRMS PROMOTE ECONOMIC GROWTH

The financial industry has become sophisticated, diverse and global. Many financial transactions take place between financial institutions and the instruments traded can be complex, such as the higher-order derivatives that were heavily traded in the run-up to the crisis. These features have made some commentators call into question the value of financial firms' activities to the real economy and to society as a whole.

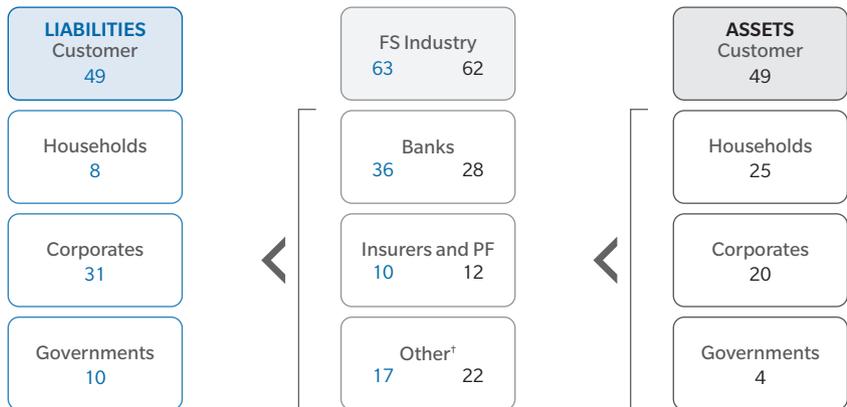
The complexity of financial services reflects the complexity of the real economy. A globalised economy requires global financial services. Floating exchange rates and volatile interest rates create risks that have to be managed, and require more complex financial products. Yet such complexities do not change the core functions performed by financial firms – principally, banks and insurers – which remain vitally important to the health of market economies, and even more so in a complex environment. In this section, we explain how financial firms promote growth by performing their core functions of intermediating between lenders and borrowers, absorbing risk and providing payment services.

2.1. FINANCIAL INTERMEDIATION

Capital formation requires resources to be diverted away from current consumption: that is, to be saved. If entrepreneurs had to rely upon their own savings, many opportunities to invest in new businesses, to build new plants and machinery and improve productivity would be lost. Hence the economic importance of credit, which transfers saved funds to people with a current use for them.¹ Financial firms contribute to economic growth by intermediating these transfers. Exhibit 1 illustrates how the financial industry is channelling the cash surpluses of the different types of economic households to lenders. Private households are net funding providers, while corporates and governments are net borrowers.

¹ "Credit" is here used in its broadest sense, to include any transfer of funds in return for some kind of claim. A loan is the obvious case but providing funds in return for equity also counts. In return for their funds, an equity investor receives a claim on (a share of) the profits and net assets of the firm. Banks and, more often, insurers, pension and other investment funds often provide businesses not only with debt capital but also with equity capital

EXHIBIT 1: FINANCIAL INTERMEDIATION IN EUROPE (EUR TRILLION, 2010)



† "Other" is primarily asset managers. The assets and liabilities of financial intermediaries are not equal because inter-financial firm assets and liabilities have been excluded.

Source: Bank of England, European Central Bank, Orbis

In the following paragraphs, the different mechanisms through which this intermediation has a positive effect on the economy are briefly discussed.

POOLING OF FUNDS AND REDUCING SEARCH COSTS

By aggregating savers’ funds, financial firms eliminate the need for an individual or business that wants to borrow a certain amount of money for a certain period to find someone else who wants to lend precisely the same amount for the same period.² Financial intermediaries thereby reduce the search cost for borrowers and lenders. Financial firms typically transfer the funds of many small savers to fewer larger borrowers. This aggregation or pooling of funds also allows borrowers to access the large quantities of capital required for major projects, including Public Private Partnerships.

TRANSFORMATION OF RISKS

While financial institutions are intermediaries between lenders and borrowers, they also transform the risk profile of the financial flows. In general, lenders prefer low risk or even risk free investments. However, financial institutions are expected to use these funds to finance investments, which carry some degree of economic risk. In this way, financial institutions balance the differences in the risk preferences of lenders and borrowers.

2 Because commercial banks can lend money that is deposited with them on demand – that is, because they need only hold “fractional reserves” – they can expand the supply of money beyond the base money created by central banks. Jack deposits EUR 100 at Bank A. Bank A lends EUR 90 of this to Jill. Jill deposits this money with Bank B. Now Jack has EUR 100 to spend and Jill has EUR 90 to spend. The money supply has increased from EUR 100 to EUR 190. This can be repeated up to the limit imposed by the required reserve fraction. So, for example, if the required reserve were 5%, bank lending could increase the base money supply by 20 times

In general, lenders also prefer shorter-term instruments while borrowers seek long-term loans. For example, a private household will typically prefer short-term savings accounts for investing their cash surpluses, while simultaneously asking their bank for a long-term mortgage loan to buy a house. This shortage of long term funding, which is essential to finance productive investments is, to some extent, remedied by the maturity transformation performed by of financial intermediaries (especially banks), as illustrated by Exhibit 2.

PUBLIC-PRIVATE PARTNERSHIPS

The idea of public-private partnerships (PPP) originated in the 1980s when governments in the developed countries struggled to encourage private investments in infrastructure, education and health. PPP are seen as a way of guaranteeing:

- Quality service, since delivery and operational risks are transferred to specialised private companies that are better at project management and execution than governmental agencies
- Proper governance, since the public exerts a level of control over the project
- Lower public expenditure, because the funding comes from the involvement of private investors, often with return guarantees from the government

The advantages of PPPs have been confirmed by recent studies conducted by the National Audit Office (NAO) in the UK, which stated timely delivery and customer focus to be the primary benefits.

The large size of banks and insurers and the free flow of capital between regions are essential in funding PPP projects, which often runs into the hundreds of millions of euros. Between 1990 and 2009, 1,300 PPP projects were undertaken in Europe, with a capital value greater than EUR 250 billion. Banks provide lower costs of funding for such projects, as they are better informed about the borrowers than other investors. Banks also join syndicates in order to diversify and manage the associated risks. Insurers provide risk solutions for public sector entities and development agencies.

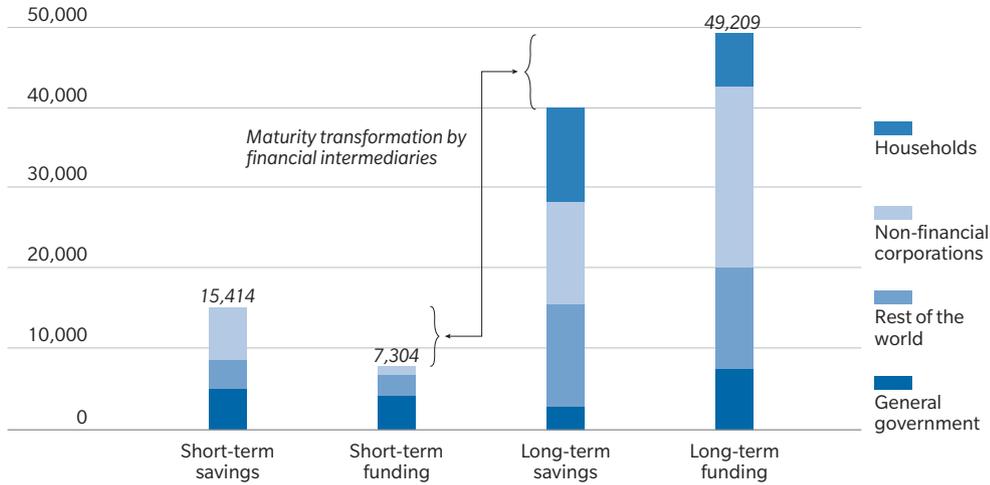
SOME EXAMPLES IN EUROPE

In June 2011, French banks finalized the financing for the **Sud Europe Atlantique high-speed rail line concession**. This project costing a total of EUR 7.8 billion encompasses the financing, design, construction, operation and maintenance of a 302 km-long stretch of high-speed rail line between two big European cities as part of a 50-year concession. Réseau Ferré de France, which manages the French rail network, has entrusted special purpose entity LISEA with the project. Altogether, this represents one of the largest public-private partnership agreements in Europe, further establishing European banks as major players in the European infrastructure financing market.

The European Investment Bank (EIB) and large European universal banks have partnered over the years to provide loans to support investment by local authorities and small and medium-sized enterprises (SMEs). In partnership with European banks, the EIB has provided loans to local authorities and social housing agencies to support urban renewal projects across Europe. With regard to the private sector, the EIB has opened a financing facility for SMEs that aims to allow independent businesses with less than 250 employees in the agricultural, industrial or services sector to take out loans with universal banks, on favourable EIB terms, to support the tangible or intangible investment they need to expand.

EXHIBIT 2: MATURITY TRANSFORMATION ACHIEVED BY FINANCIAL INTERMEDIARIES IN THE EURO AREA

EUR BN
OUTSTANDING AMOUNTS AS OF 30.09.2011



Source: European Central Bank, BNP Paribas

THE ADVANTAGE OF DIVERSIFICATION

Financial intermediaries reduce risk by lending to a large and diverse pool of borrowers. A saver thereby reduces his risk by lending to a financial intermediary rather than directly to an end borrower. In addition, the scale of financial firms' lending or investing allows them to invest in credit assessment skills that individual savers cannot acquire. By thus reducing the risk of lending, financial intermediaries increase the supply of loanable funds and reduce their cost to borrowers, such as businesses and households.

RISK INTERMEDIATION BY BANKS AND INSURERS

Banks and insurers play different roles in financial intermediation. **Banks** typically take short-term deposits and make longer-term loans. This creates a so-called maturity mismatch or transformation, whereby a bank's liabilities are of shorter duration and more liquid than its assets. If a bank's creditors (depositors) start to withdraw their funds at an unexpectedly high rate – if a "run" occurs – the bank will be unable to liquidate its assets fast enough and will default on its obligations to its creditors.

By contrast, the liabilities of **Insurers** – such as commitments to making annuity payments or to cover damage under a property and casualty (P&C) policy – are typically long-term and less liquid than its assets. Insurers invest the streams of premiums they receive from their policyholders in liquid tradable assets such as government bonds and high-grade corporate debt and equity. This means that insurers do not face the risks of a massive run on their liabilities. This difference explains why banks have access to the central bank in case of liquidity needs, while insurance companies do not.

ALLOWING CONSUMPTION SMOOTHING

The saving and borrowing products provided by financial firms allow people to smooth consumption over the course of their lives, during which their incomes can vary greatly. Europeans typically consume more than they earn while young adults, then consume less than they earn while middle-aged and then, when older, again consume more than they earn. Government spending on education and pensions plays a role in this consumption smoothing. But so do financial firms, with banks typically providing the debt that allows people to consume more than they earn while young and life insurers providing the savings vehicles that ultimately provide retirement incomes.

“Rainy day” savings, short-term consumer debt and property and casualty insurance (P&C) also allow households to maintain consumption in the face of misfortunes, such as becoming unemployed or being the victim of a crime or accident (see also 2.2).

CAPITAL AND RISK PRICE SIGNALS – ALLOCATING CAPITAL IN THE ECONOMY

Financial firms are central participants in the capital markets. The allocation of capital to potential other uses depends on the prices of the financial products that financial firms create and trade, including their deposits and loans. Provided these prices accurately signal the supply of and demand for capital, and those who decide on its allocation are profit-seekers, capital will be allocated to its most valuable uses. Similarly, the efficient allocation of risk in the economy depends on the price signals provided by the risk products created and traded by financial firms. These price signals are transmitted to the economy by the financial institutions directly (banks through pricing of deposits and credit, insurance through pricing of premiums) but also by financial markets instruments such as options and futures.

THE ROLE OF COMMODITIES FUTURES IN THE REAL COMPANY

Buyers and sellers of commodities have imperfect information on which to base their decisions. Consider, for example, a farmer trying to decide how much of his land to allocate to which kinds of produce. He knows the price of onions, potatoes, etc. today: that is, he knows their spot price. But that is not the relevant price for his decision. His allocation of land to production must be based on a forecast of the price of these commodities in the future, when he will be bringing his harvest to market. Alas, such forecasting is inherently unreliable, since the future price depends on information unavailable to the farmer.

This is where futures markets are helpful. The prices they provide for future delivery of commodities improve on the estimates that the farmer could practically make himself. And, by trading futures contracts, he can hedge his position, effectively assuring a spot price for the date he will bring his harvest to market. In the absence of futures markets, spot prices would be more volatile because producers would have less information on which to adapt their supply to expected changes in demand and production costs. Most empirical studies have confirmed that futures markets do indeed have this positive effect. The commodities price volatility of recent years, which some commentators have blamed on the trade in commodities derivatives, is more likely to be a result of real changes in underlying supply and demand.

Risk-based prices delivered through financial institutions and instruments provide a powerful incentive for households and businesses to avoid excessively risky behaviour. High interest rates induce businesses to de-leverage and decrease risky activities, while high property insurance rates reduce excessive building in unsafe places, such as coastal areas prone to hurricanes. These price signals – though inevitably imperfect – promote the efficient allocation of resources, stabilize economic activity and protect households from unnecessary risk.

Of course, this assumes that market prices are not distorted. In fact, however, prices that depend on risk often are. Seeking to protect citizens from various risks, governments end up subsidizing risky behaviour. For example, living on coastal property is subsidized by tax-funded recovery programmes after storms and floods. This “moral hazard” may result in an inefficient over-allocation of resources to coastal property.

Such risk subsidization also applies to financial firms, mainly through implicit government guarantees of wholesale creditors. These reduce the market “risk premium” faced by financial firms and may encourage them to take excessive risks. Moreover, they create implicit government liabilities at a time when fiscal budgets are strained to breaking point. The new regulatory framework should take into account the unintended and often counterproductive indirect effects of certain such well-intended interventions.

Market prices may also be distorted by excessive collective optimism (irrational exuberance), which creates bubbles or by panic, which leads to crashes. While it remains extremely difficult to identify such market exaggerations, the new approach of macro-prudential supervision should encourage dangerous developments to be identified and addressed before it is too late.

2.2. RISK ABSORPTION – A DRIVER FOR ECONOMIC ACTIVITY

Financial firms, principally insurers and reinsurers, take on some of the risks of individuals and businesses in return for premiums. These transactions benefit both parties because, by pooling the risks of many policyholders, the insurer experiences less loss volatility than the individual policyholders would if not insured. Because the insurer can hold the risk at a lower cost than the insured individual or business, the premium can cost the insured party less than it would cost to hold the risk.

Even without risk pooling, risks can often be transferred at a price that benefits both parties. The party assuming the risk may have a greater risk appetite (perhaps on account of having a longer time-horizon) or be better able to manage the risk or have a “natural hedge” (as, for example, an airline does with regard to a falling oil price). In recent decades, innovation in tradable risk instruments – such as commodity, debt, equity and even weather derivatives – has dramatically expanded the range of parties who can directly engage in risk transfer, including farmers, investment funds and non-financial firms. While these instruments can be traded on exchanges, such as the London International Financial Futures and Options Exchange

(LIFFE), they are often traded “over the counter” (OTC), with financial firms frequently acting as a counterparty in the transaction.

Without the ability to insure or otherwise convert risks into costs, people would often be unwilling to undertake the productive activities that give rise to those risks. The famous example is the role of marine insurance in opening up European trade with the New World. An individual merchant faced the prospect of losing his ship and its cargo at sea. Over the long run, earnings from the trade could cover this expense. But if a ship were lost early in the life of the business, the merchant would be wiped out. By insuring this risk, initially through a system of mutual guarantees, merchants could invest in a ship without the fear of being quickly put out of business by bad luck.

Today, insurance remains a pre-requisite for much economic activity. For example, most international trade takes place with insurance cover and the payment guarantees that are part of the banks’ trade finance service. And banks will typically not lend to uninsured construction activities.

Nor does insurance encourage enterprise only “before the event”. After natural disasters, crimes or accidents, insurance payments help householders and businesses to recover losses and replace or repair productive assets. Insurance thus helps to sustain consumption and production after misfortune.

THE NEW ZEALAND EARTHQUAKE OF 2011

When a 6.3 magnitude earthquake struck the city of Christchurch in the South Island of New Zealand on 22 February 2011, more than 100 people lost their lives and many buildings were destroyed. This damage and loss of life occurred despite the wide range of prevention measures the country had in place.

In addition to its prevention measures, New Zealand has the highest levels of earthquake insurance in the world. Residential properties are insured by the government-run Earthquake Commission scheme (EQC) up to NZ\$ 100,000 (EUR 60,000) per building and NZ\$ 20,000 for contents; households can buy private insurance above the NZ\$ 120,000 cover provided by the Earthquake Commission; and commercial and industrial risks are insured by local and global insurance companies, including the major European reinsurance companies that provide coverage all over the world.

Losses from the February 2011 earthquake totalled around EUR 10 billion. About 80% of these losses were covered by the insurance sector. Local insurers cannot usually carry such a loss burden alone. In this case, about 70% of the claims were passed onto the global reinsurance community, again a significant amount by European reinsurers.

Consider another natural disaster that illustrates the important role played by reinsurance. In 2005 Hurricane Katrina swept across the Gulf of Mexico. It destroyed thousands of houses and cost the lives of more than 1,800 people. This presented the insurance industry with a bill for over USD 70 billion, then the highest ever for a single event. Had it not been for reinsurance, many insurers would have suffered detrimental losses. Overall in 2005, a year with many catastrophes, 12% of insurers received payments from reinsurers. This represented more than 100% of their equity capital.

2.3. PAYMENTS – FACILITATING TRADE

Trade increases economic efficiency, whether domestic or international. It encourages production to occur where it has a comparative advantage, thereby minimising average costs and increasing consumer surplus. And it promotes the division of labour, or specialisation, which increases labour productivity. The greater the scope of trade, the greater these economic benefits.

Trade, in turn, depends on a reliable method of making payments. The massive growth of domestic and international trade over recent decades could not have occurred without the reliable payments systems supplied by financial firms. And, of course, intra-Eurozone trade has been promoted by the euro, which eliminates the transaction and exchange rate volatility costs of trade between parties with different currencies.

Advances in payments technology over recent years have greatly increased convenience for consumers, who can now make payments without the risk of carrying large sums of cash and without wasting time queuing in bank branches to get it.

In developed economies, the use of electronic payments, in particular payment cards, has continued to replace cash and several initiatives have been launched around mobile payments. In Europe, the EU and banks have worked together to create the Single Euro Payments Area (SEPA). In emerging markets, payments technology based on mobiles is allowing people to engage in commerce that was impossible for them only a few years ago due to the lack of banking and IT infrastructure. Electronic payments and new payment solutions continue to support the strong growth of e-commerce in Europe (around 20% per annum).

THE SINGLE EURO PAYMENTS AREA (SEPA)

The Single Euro Payments Area (SEPA) became operational in 2008 to improve the efficiency for cross-border payments and to transform the various national markets for euro payments into a single market. As of March 2012, SEPA covers 32 countries: the 27 EU member states, Iceland, Liechtenstein, Norway, Switzerland and Monaco.

The initiative, a partnership between EU lawmakers and European banks, allows consumers to make cashless euro payments to anyone else in the SEPA area with a single bank account and single set of payment instruments. By developing common financial instruments, standards, procedures and infrastructure SEPA enables economies of scale and thereby reduce the cost to European consumers and companies and make the economy more competitive as a whole.

3. POST-CRISIS REGULATORY REFORM

A number of institutions collapsed during the crisis despite the fact that they complied with the prevailing regulations aimed at ensuring their solvency. Of course, solvency regulations do not aim for a zero probability of default. But they aim for a low probability of default and for stability of the system as a whole. This crisis provides strong indications that there were important shortcomings in the regulatory design. No one disputes the need for regulatory reform. EFR supports Europe's and G20's policy goals of increasing financial stability and restoring confidence in the financial sector. The new European supervisory system, complemented by the recent announcements on banking union, represents real progress to promote financial stability and foster the integration of the Single Market. One key element is establishing an efficient and effective interface between macro and micro prudential oversight.

Any redesign of the regulatory framework is complex and needs to be handled with care. It is relatively easy to identify shortcomings in the framework, and to imagine what can be done to strengthen it further. But it is more difficult to find out how the new rules will change the behaviour of operators and of the system as a whole. Great care needs to be taken to avoid "unintended consequences". Poorly designed or calibrated regulations can hinder financial firms in performing important economic functions to such an extent that they can do more harm than good.

This can happen in two main ways. Regulation can be over-cautious, making institutions and the financial system safe but at an excessive cost in terms of suppressed financial activity and reduced economic growth, effectively penalising the same taxpaying individuals that it is intended to protect. And regulation can cause capital to be misallocated. This reduces long-term growth, or even fuels bubbles that create systemic risks. The EFR fears that the current regulatory agenda, despite containing valuable elements, may err in both these ways.

Before discussing the problems of risk regulation, however, it is useful to understand the concepts of systemic risks and moral hazard, which make regulating the financial sector so challenging.

3.1. SYSTEMIC RISK AND MORAL HAZARD

The banking sector is highly interconnected. The interbank market and the organisation of payments systems create direct links and contagion channels for problems. Furthermore, banks are often exposed to the same risks. For example, a collapse of the housing market in a certain region will lead to problems for all banks active in that region. Even when such connections do not exist, a problem in one bank can lead to a loss of confidence in the whole banking system. The failure of one bank can thus have a domino effect, causing a series of failures of other banks. Even without material exposures to a failed counterpart, a bank may suffer a “run” on its short-term liabilities as spooked creditors withdraw their funds.³

To reduce this risk, governments have established lenders of last resort (central banks) to provide commercial banks with liquidity should they be subject to a run. They have instituted deposit guarantees or mandatory (and subsidised) deposit insurance, which reduce the chance of runs by making depositors unconcerned about the solvency of their bank. And, when banks do become insolvent, governments typically recapitalise them, thus saving their creditors from any loss and preventing “contagion”.

The popular expression “too big to fail” suggests that such recapitalisations or bailouts are reserved for the largest banks. There is some truth in this in the US, where many small banks have been allowed to fail. In the recent crisis, however, European governments bailed out even small financial firms, such as Northern Rock in the UK and the cajas in Spain. These bailouts transferred bank losses to the public sector and ultimately taxpayers, rather than letting them flow through to bondholders (equity holders typically incurred losses and in some cases were wiped out).

While these measures are aimed at reducing systemic risk (which was apparently achieved for several decades), they also contribute to it by increasing moral hazard. The implicit promise to bailout banks’ wholesale creditors reduces the risk premium financial firms pay for their debt. This acts as a subsidy for banks’ risk-taking and thereby encourages them to take inefficiently high quantities of risk. During the pre-crisis boom, many banks were leveraged over 35 to 1 yet paid no material risk premium on their debt. In short, guarantees to bank creditors undermine the market price mechanism that would otherwise discipline risk taking by banks.

Several post-crisis regulatory reforms aim at addressing this problem. They are intended to allow for the rapid and orderly resolution of insolvent financial institutions, minimising disruption to the financial sector and real economy, and avoiding any call on taxpayers’ funds. In June 2012, the European Commission announced an ambitious set of measures aimed at avoiding future bank bailouts.

3 Insurers will be affected by bank failures but the sector is not subject to the same risk of runs. This is because their liabilities are not callable in the way that bank deposits are. An insured event must first occur and then the claims process may take place over several years: for example, when it involves a prolonged medical treatment or the reconstruction of a commercial building. The stable funding of reserves and the longer pay-out process limit the risk of “domino effects” in the industry and also allow for an orderly wind-up in the unlikely event of insolvency

If successful, these reforms will not only save taxpayers the cost of bailing out failed institutions. More importantly, they will reduce the moral hazard created by creditors' expectations that they will be bailed out should the bank fail. By making banks' cost of debt vary with their risk, these reforms will improve the market discipline on bank risk taking, providing bank managers with an additional economic, not just a regulatory, incentive to manage risk properly.

However, given the current economic climate and funding difficulties facing European banks, and the on-going implementation of new solvency rules in banking and insurance, these anti-bailout measures must be implemented cautiously and their cross-sectoral impact carefully assessed. Bail-in bonds, for example, are untested on a large scale. A sudden regime shift may be destabilizing for the sector and detrimental to economic growth.

3.2. RISK REGULATION AND CAPITAL ALLOCATION

Following the crisis, the capital and liquidity rules imposed on banks are being tightened. The risk weights applied to various lines of business, such as derivatives trading, are being increased. And banks will be required to increase the amount of shareholders' equity they hold against any given level of "risk weighted assets": up from 2.5% under Basel 2 to 9% under the new rules of the European Banking Authority (EBA).

Additionally, banks will need to reduce maturity mismatching, funding illiquid assets with illiquid liabilities.⁴ Basel 3's Net Stable Funding rules require banks to massively increase the portion of their liabilities that are stable or – more likely, given the scarcity of stable funding – to reduce their illiquid assets, such as loans to small and medium businesses (see Exhibit 3).

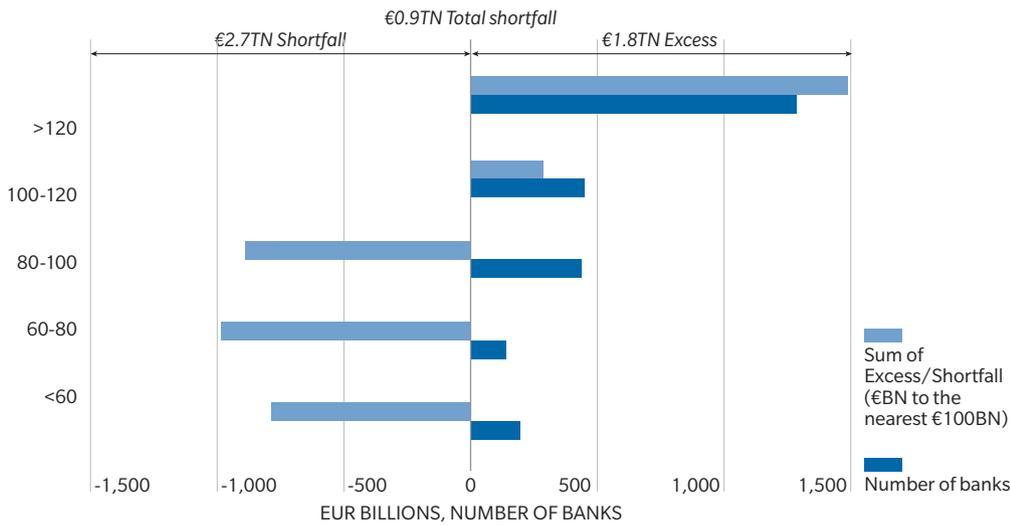
Similarly, Solvency 2 is expected to require European insurers to hold more capital against certain assets: most notably, against long-term corporate debt.⁵ This will limit the scope for insurers and potentially pension funds, if the rules are applied to them, to invest in longer-term growth enhancing projects such as infrastructure and low-carbon technologies, while also limiting insurers' appetite for bank debt.

By significantly increasing the capital and liquidity buffers of financial firms, these reforms ought to make insolvencies less likely and less costly to debt-holders and taxpayers (in the case of bank bailouts) when they do occur. However, they also impose costs on businesses and households.

4 This paragraph summarises in simple terms what are in fact very complicated rules concerning banks' capital and liquidity levels. Readers seeking further detail should consult the Bank of International Settlements (BIS) webpage for the Basel Committee on Banking Supervision: www.bis.org/bcbs

5 Note that Solvency 2 is not a response to the financial crisis but has been in development since 2001, though its capital requirements were increased post-crisis

EXHIBIT 3: NET STABLE FUNDING SHORTFALL OF EUROPEAN BANKS (AS OF JUNE 2011)



Source: Oliver Wyman Report on European Bank Funding (2011)

Extra capital and liquidity requirements increase banks’ and insurers’ funding costs. To maintain profits at a rate that makes them viable in the long run, at least some of these costs will need to be passed onto banks’ and insurers’ customers, in the form of higher borrowing costs and higher insurance premiums.

Higher borrowing costs entails less borrowing, less investment and hence less economic output.⁶ A recent study by the Bank of England estimated that doubling bank capital minima would reduce annual GDP by 0.3%. The OECD has estimated that implementing Basel 3 will reduce annual GDP by between 0.015% and 0.15%. The International Institute of Finance estimated that increased capital requirements would cost millions of jobs in Europe over the next five years.

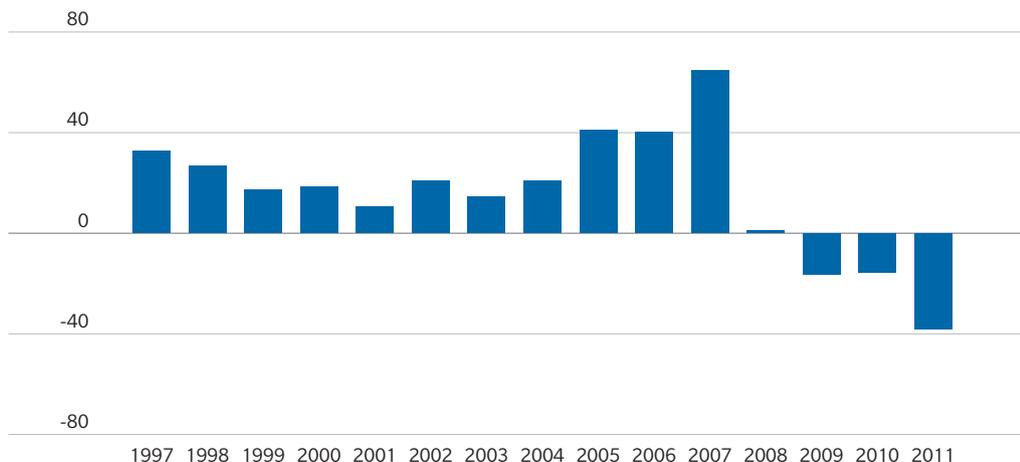
Higher insurance premiums may also reduce employment. One analysis found that for every 1% increase in the average price of insurance – stemming, for example, from a tax increase – 50,000 jobs was lost.⁷

6 Another adverse effect of increased regulatory capital charges may be reduced risk management by non-financial firms. The Credit Valuation Adjustment (CVA) capital charge to be applied to derivatives is expected to more than double the costs of using them for non-financial firms

7 Cragg, Michael, J. David Cummins, and Bin Zhou, The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis, The Brattle Group, July 8, 2010. Though for the US market, the results would be broadly true for any advanced economy

EXHIBIT 4: NET STABLE LENDING TO EURO-ZONE CORPORATES

EURO BILLIONS 1997-2011



Source: Swiss Re reports, Economic Research & Consulting

As the range of these figures show, the size of the effect is difficult to estimate. Nevertheless, there is certainly a trade-off involved when setting capital and liquidity minima. If set too high, the cost in lost economic output will exceed the benefits in reduced systemic risk. The prevailing hypothesis is that by roughly doubling banks' capital requirements, and by making the changes entailed by Solvency 2, the benefits of stability will exceed the costs of reduced investment. But, given the uncertainty around the effects on both stability and investment, this can be little more than a guess.⁸

Pre-crisis, many financial firms, especially banks in the UK and US, delivered returns on equity in the region of 20%. This was well above the long run trend of 10% to 12%. It may have been a sign of the bubble economics occurring at the time. However, the profitability of financial firms can also be too low for the good of the economy. If financial firm's returns are driven below the cost of capital by poor management or onerous regulation, capital will flee the system and prevent financial firms from playing their economic roles.

The unavoidable trade-off between safety and dynamism is well known. But reduced investment is not the only cost of badly designed capital and liquidity regulations. Another is the tendency of capital rules to cause a systematic misallocation of capital and pro-cyclical behaviour.

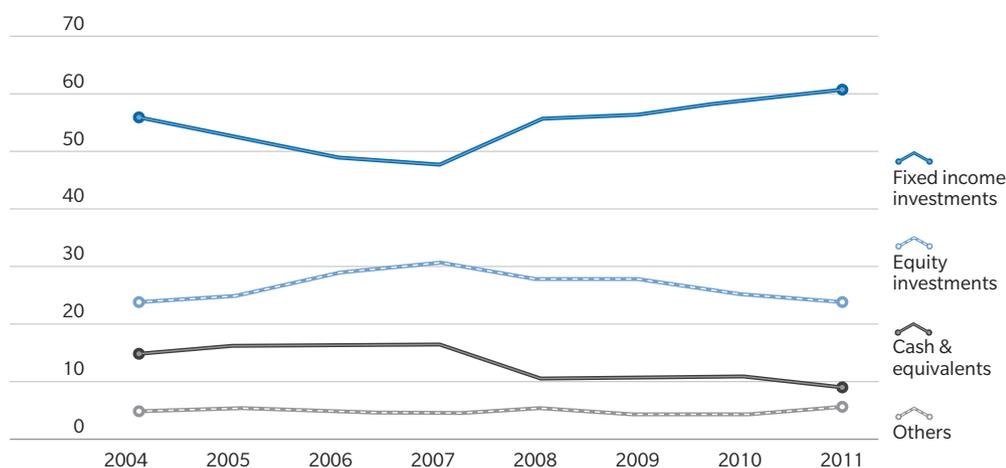
⁸ Besides the direct costs of increased capital and liquidity requirements, these changes have an indirect cost in the form of regulatory uncertainty. An environment of continued change to regulations, and of increased regulator discretion, inclines the executives of financial firms to "play it safe". Rather than invest in ventures that may run afoul of changes to regulations, they direct their capital to safe but relatively unproductive uses, such as buying government bonds or depositing funds with central banks

This arises from near certainty that the mandated measures of risk (against which capital must be held) will be inaccurate in various respects. Inconsistencies between different risk regimes – for example, between Basel 3 and Solvency 2 – suggest that at least some of the mandated measures are incorrect. If they are, then firms complying with them and seeking to maximise return on equity will be inclined to misallocate capital. And because all firms face the same rules, they will misallocate capital in the same ways. By favouring certain asset classes, such as real estate or government bonds, regulatory capital regimes may create asset bubbles. They can also cause capital to flee certain asset classes. Changes to the capital requirements in Europe are expected to contribute to the continued reduction of insurers’ holdings of corporate equity.

Similarly, if not properly coordinated across boundaries, regulation can create incentives for “regulatory arbitrage” between jurisdictions or sectors and, hence, for the misallocation of capital. Under current and proposed regulation, the same transactions, assets or liabilities can receive different regulatory treatment depending on the country where they occur and on whether they are made by a bank, insurer or other entity. Where European regulation is more onerous than regulation in other jurisdictions, such as Hong Kong or the US, the result could be significant outflows of capital.

The levels of capital and liquidity held before the crisis were inadequate, particularly for banks. If measures taken to protect taxpayers by making financial firms easily resolvable prove successful, bondholders will demand higher “capital buffers” at financial firms to compensate for default risk, regardless of any capital regulation. For this mechanism to work, banks will need to be allowed to fail, with bondholders suffering losses. Next, politicians must

EXHIBIT 5: EUROPEAN INSURERS’ ASSETS BY TYPE (2000-2009)



Note: Calculated based on investment portfolio of major European insurers (AXA, Allianz, Generali, Aviva, Zurich and AEGON). All the data based on EUR. Data converted to EUR using end of period FZ rates if original reporting is in non-EUR currency.

Source: Swiss Re reports, Economic Research and Consulting.

credibly declare their determination to avoid bailing out failed banks in the future. With strong resolution legislation in place, the regulatory requirements can be lightened, which will be a benefit for businesses, consumers and the economic growth.

3.3. STRUCTURAL ELEMENTS AND REGULATION

The success or failure of a regulatory regime does not depend on the quality of the rules alone. It also depends on the environment in which financial firms have to act. Even the best rules cannot protect financial institutions when the environment is unstable and unbalanced. Three issues, much discussed these days, must be settled to deliver an effective regulatory framework for the financial sector: stability supervision, the EU banking union and the debate about structural measures concerning banks.

Stability supervision aims at stabilising the financial system and reducing the risk of a systemic crisis. At the global level (FSB), at EU level (ESRB) and in each European member state, threats to financial stability should be detected and timely recommendations and interventions should protect society against bubbles and crashes. While safeguarding financial stability remains an ambitious goal, the efforts to achieve it are welcomed because any improvement in financial stability would automatically stabilise financial institutions. Much work is still needed to define at the European and international level how stability supervision will be organised, how threatening developments will be detected, which tools will be made available to tackle the problems, and what should be the role of the financial institutions at each level of the supervisory process.

The EU banking union aims at creating an integrated banking market within the Eurozone, including supervision, crisis management and eventually a deposit guarantee scheme. The crisis has demonstrated that a fragmented supervisory framework makes crisis management extremely difficult in an integrated financial market. And in normal economic times a banking union would make the supervision of banks, active in several member states, more effective and efficient. However, achieving this ambitious goal will be difficult, given the complexity of harmonising the supervisory frameworks in the member states. The response to this challenge must reflect a balanced and coherent approach of risk and economic growth, as presented in this paper.

Structural measures concerning banks are widely discussed within the EU, and some member states are planning to impose further structural regulations on banks, for example by “ring fencing” retail banking activities. The aim of such regulation is easy to understand: protect the taxpayer by protecting the deposits of the population against dangerous financial

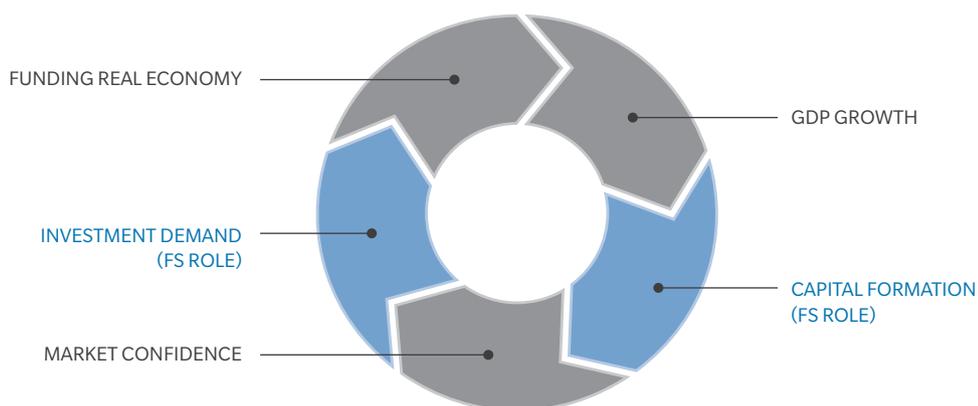
market activities of banks. However, the reality is more complicated. As suggested by studies of the ECB, diversified banks, which combine retail and wholesale financial activities, seem to have been more resilient during the crisis than pure retail or pure investment banks. Furthermore, European SMEs and corporates require financial services that mix retail and financial market activities. A diversified bank with a balanced mix of retail and financial market activities and an integrated risk management framework seems to be a sustainable business model. Artificially separating banking activities is unlikely to create a dynamic financial sector, responding to the financial needs of the real economy.⁹

4. A FRAMEWORK FOR LONG-TERM GROWTH

4.1. VIRTUOUS CIRCLE

There is a virtuous circle for economic growth, in which growth creates the means and incentive to invest, which in turn creates higher growth. This circle turns on the back of the financial firms. As described in Section 2, they help to form the capital for investment and then to allocate it to more valuable uses.

EXHIBIT 6: VIRTUOUS CIRCLE OF ECONOMIC GROWTH



9 “Ring fencing” retail banking from large corporate and investment banking has become a popular idea among politicians and financial commentators seeking to enhance systemic safety. Yet it is worth noting that several financial crises have been caused by excessive mortgage lending which fuels a house-price boom and subsequent busts. Ring-fenced retail banks would be no less vulnerable to such crises than universal banks: that is, banks that combine retail and corporate or investment banking. In fact, in the case of such a retail property crisis, universal banks are likely to be less likely to fail than retail banks, since a smaller portion of their total assets would be exposed to property prices

The circle is not powered by the financial sector alone. It requires sufficient saving and investment demand to support the financial sector. These depend on macro-economic and structural factors that financial firms cannot directly control.

In the current economic environment of Europe, the circle is turning in reverse. Low growth and low interest rates punish savers, deterring capital formation. At the same time, a lack of market confidence and regulatory conditions make it difficult to allocate capital to asset classes other than government debt. This limits the ability of the real economy to grow.

Crude government economic stimulus could end up creating “bridges to nowhere” and hindering the adjustment process required to return Europe to economic health. Instead, Europe needs urgently to make structural economic reforms that renew business and consumer confidence and create investment demand. Such a reform agenda goes well beyond the financial sector and its regulation. But it includes them.

4.2. RECOMMENDED DIRECTION FOR FINANCIAL SECTOR REGULATION

For the growth circle described above to start turning in the right direction again, the financial sector must be able to play its role. To do so effectively, it must be, as far as possible, a business like any other. In other words it must be:

- **Independent** of taxpayers, so that no moral hazard is created by the expectation of government bailouts. This will allow market prices to direct the efficient allocation of funds and risks
- **Competitive** and, hence, efficient, innovative and customer-centric
- Sufficiently **profitable** to attract the capital required to fund investment in the real economy something threatened by artificial reductions of return, caused for example by punitive taxes or regulatory capital requirements that are not based on real risks

Policies that restrict the financial sector may currently be popular but they risk harming the economy. Financial sector regulation should not aim for retribution or for safety at any cost, since neither of these goals benefits the people of Europe. Rather, it should aim to ensure that financial firms face an undistorted trade-off between risk and return: one in which financial risk-taking is neither subsidized nor taxed disproportionately, thereby giving economically optimal decisions the best chance of being made.

What does this entail for the proper priorities of regulatory reform agenda? Five things are needed.

First, regulators should continue their efforts of making financial firms independent of taxpayers with recovery and resolution plans and harmonised resolution tools. With these in place, intervention that distorts the price of risk second-guesses management, or hampers the workings of a normal market should be neither necessary nor desirable.

Second, regulators should seek a coordinated approach and a level playing field from the rules that apply across countries and sectors most importantly, across banking and insurance (allowing for the structural differences in their assets and liabilities). This will minimise the incentives for regulatory arbitrage and, combined with taxpayer independence, help to prevent the emerging balkanisation of the European financial markets. Success depends as much on supervision as on regulation. Different levels of stringency in the enforcement of common rules can create de-facto differences in regulatory regimes.

For these reasons EFR supports the move towards a Banking Union with the strong involvement of the ECB in order to restore confidence in the EU banking sector and enhance trust in the euro. Supervision should, in principle, cover all banks in Europe.

Third, the policy framework must support new funding models and new sources of investment. Encouraging the provision of more long-term finance via the capital markets – for example, for infrastructure projects or low-carbon technology – is an obvious way to promote sustainable growth, innovation and jobs. EU project bonds are a welcome initiative. Their low-risk and long duration match the needs of institutional investors, provided that EU solvency rules can be made sufficiently flexible. The rules governing credit rating agencies should be designed so that they do not limit investment through the capital markets. And the securitization market needs to be revived. We support the Prime Collateralised Securities (PCS) initiative, which aims to enhance liquidity in the secondary market for asset-backed securities by addressing investors' concerns over quality, transparency and simplicity.

Fourth, the trade-off between safety and growth must be an explicit consideration of regulatory initiatives. In the short-term, with financial risk-taking naturally stifled by the recession, this should make regulators err on the side of growth, while putting in place a framework for a long-term and stable expansion. Despite a stated intention to remove the pro-cyclical elements of financial regulation, most current reform initiatives do precisely the opposite. They increase the cost of investment just when it is at a cyclically low level. Over the long run, regulatory arrangements should make supervisors feel the trade-off between safety and growth so that they make decisions that encourage a sound but vibrant financial sector. If financial supervisors are accountable solely for safety, they will be inclined to make inefficiently cautious trade-offs.

Fifth, while EFR agrees with the objectives of reforms to the financial sector, the reform process must solidify in a clear manner. Uncertainty about the regulatory and supervisory frameworks that currently applies to banks and insurers stifles their investment in the real economy. Any reforms should also ensure that the competitiveness of the European Financial services industry is maintained vis-a-vis other parts of the world.

If the regulatory reform agenda follows this path, governments, supervisors, customers and taxpayers can be assured that risk and reward are properly balanced as they should be, and that the financial sector will support renewed and sustainable growth across Europe. The Members of the EFR are ready to play our role in achieving this objective.



European Financial Services
Round Table

EFR'S VISION AND ITS MEMBERS

OCTOBER 2012

EFR'S VISION

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe.

EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

Increased fragmentation as a result of the post-crisis regulatory response underlines the need to safeguard the Single Market and to protect the level-playing field. The EFR therefore strongly encourages national governments and the EU institutions to continue their efforts to create a truly single market for wholesale and retail financial services, which will play an essential role in providing long-term financing for the economy in Europe. Furthermore strong market discipline is essential to ensure fairness and alignment of interests of the financial sector and the real economy towards serving the citizens of Europe and the world.

The integration of financial markets does not stop at the EU's borders – markets are increasingly global. EFR Members therefore encourage both national and European leaders to establish internationally consistent and coherent financial regulation and supervision and to support and promote free and open markets throughout the world.

EFR Members' companies combined represent¹

- Around 944 million customers
- More than 2 million employees
- €33.48 trillion total assets
- €10.26 trillion assets under management

¹ Please note that double counting of customers may occur

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