What are banks for? "A return to fundamentals", published in *Les Echos* on 12 January 2015

Guilty! Weren't the banks accused of being responsible for the financial crisis triggered in 2007? A necessary vent for the economic difficulties, they continue to face legitimate criticism. And yet, without banks, there is no economy.

I believe that it is now time for a number of important ideas to take centre stage.

Commercial banks play a fundamental role: they take in savings and make loans, acting as intermediaries between those with financing capacity and those requiring financing. In developing countries, a significant proportion of national savings never enters any rational and efficient allocation system. The majority of the population do not have a bank account and invest in assets or hoard their cash. This system is inefficient as savings are not invested to produce growth, namely in support of individual and corporate projects. The financial markets are de facto exclusively the reserve of a few, large companies, due to the costly and regular requirement to produce information to attract investors for bond issues.

Thanks to their in-depth understanding of clients, households, professionals, SMEs and even large companies, the banks are better able to assess the borrower's profile, and therefore to make appropriate allowances for the credit risk. By their very nature, they are able to minimise the information imbalance that exists between the lender and borrower. They therefore enable numerous economic stakeholders to finance their projects.

Furthermore, by investing in banking products, savers take a risk with the bank and not with the multitude of borrowers to whom the bank lends. Through its role as intermediary, the bank also plays a crucial economic and social role.

The second function of the commercial bank is to take on the so-called transformation risk associated with interest rates and liquidity. Such risks emanate from the fact that both households and companies most often favour short-term and readily available investments, while borrowers most often require long-term financing of a sufficient duration so as to make the investment profitable or to generate a savings capacity to repay a property loan.

The commercial bank therefore acts in the interests of the economy by centralising risk which it assumes in place of other economic stakeholders, thereby promoting growth. For their part, the financial markets bring sufficiently large and well-informed borrowers and lenders into direct contact, leaving them to manage all such risks.

There is a clear understanding of the importance of defining the most appropriate regulations to enable the banks to fulfil their role while guaranteeing maximum security for their depositor clients and, more broadly, the financial system as a whole.

The most recent crisis confirmed the intrinsic instability of finance. And the inescapable necessity of effective bank regulation. But it has to be given in the right doses. Any overreaction which excessively restricts the risks taken by the banks would give rise to another - and equally worrying - danger, namely that of strangling the economy by curbing the availability of finance. Only in very limited circumstances can the markets take the place of the banks. Excessive restrictions may also push the banks into transferring risk to companies and the general public by directly or indirectly selling them their securitised loans or, for example, by primarily only granting variable-rate property loans. This could also encourage a form of parallel, "shadow" banking system which is virtually unregulated.

By over-reducing bank risk due to the otherwise perfectly legitimate desire of obtaining "Phoenix banks" rising out of their own ashes (bail-in) and not needing to be saved by the state (bail-out), could lead to the trading risk taken by the commercial banks being transferred to other players in the economy, ultimately the taxpayers.

So correct regulation can only be arrived at through precise analysis of the situation in question. The indispensable and irreducible role of the banks in the economy must therefore be correctly understood to avoid an outcome contrary to the desired objective.

Olivier Klein
CEO of *BRED*
Economics and Finance Professor at the HEC