European Banking Federation

EBF Liikanen Task Force Report

“Possible reform of the structure of the EU Banking sector”

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1. Executive summary

In this report the European Banking Federation (EBF) assesses the mandate of the European Commission's High Level Expert Group (HLEG) on possible reforms to the structure of the EU banking sector and puts forward the EBF's views on the need for structural reforms.

The EBF supports the aims to ensure financial stability and to protect Europe's taxpayers from having to step in to shore up banks in Europe. The finalisation of the on-going regulatory reform agenda – including measures still in the pipeline – will help to reach the objectives mentioned in the mandate of the HLEG more than fully.

In the report EBF argues that the backdrop to the structural measures that the HLEG is to consider – primarily the recommendations made by the Vickers Commission in the UK and the so-called Volcker rule in the USA – need to be understood in their context and time. Since the consideration of the aforementioned structural measures in the UK and the USA, there has been a large number of regulatory initiatives that will significantly strengthen the resilience of the EU banking sector (CRDIII, CRD IV, capital treatment of trading book, etc.) and more measures are still to come.

Furthermore, the report puts forward that possible structural measures will have a detrimental impact on a range of special features of the pan-European market structure, among others the importance of bank intermediation, the connection between retail and wholesale banking and the variety of business models that in fact contribute to financial stability. Intervention in this framework risks impairing the efficiency of bank intermediation, which can have a negative impact on lending to the real economy, and therefore on EU and Member States' growth.

Also, the EBF argues that there is no evidence that the crisis was driven by the structure of the EU banking sector or the business models in use. Bank failures did not concentrate on certain type of banking structures or models; this needs to be borne in mind in determining what further steps are appropriate at an EU level. The consolidation of the EU banking sector is a logical consequence of the Single Market, which has delivered tangible benefits here as it has elsewhere, particularly in the ability to move capital across Member States' borders and create deeper capital markets. It is important that the Single Rulebook ambition is not undermined, nor should the EU be put at a competitive disadvantage globally.

EBF therefore states that possible structural reforms are likely to be counterproductive by (a) being unnecessary; (b) further negatively impacting growth; and (c) potentially undermining the benefits of the Single Market by restricting cross-border activities. The EU can do more, without negative impacts on the economy, in the areas of both the completion of an EU-wide crisis management framework and in the area of supervision, where the foundation already has been laid by the implementation of a new pan-European supervisory architecture.

Reaching agreement on the EU crisis management framework is clearly of critical importance to strengthening the arrangements for cross-border resolution. While many individual Member States now have measures in place on a domestic basis, there is much to be achieved from this being built on through the adoption of a harmonised regime which could sit at the heart of enhanced European supervisory cooperation. An EU approach would also encourage further progress on the putting in place of reciprocal arrangements on common approaches in third countries.

Macro prudential oversight also has the potential to contribute to the objectives mentioned in the Liikanen Group's mandate while not undermining competitiveness of the EU and without restricting activities that are integral to the Single Market (i.e. movement of capital via wholesale markets).

2. Introduction

In February 2012 Commissioner Barnier established a High Level Expert Group (HLEG) chaired by Erkki Liikanen, Governor of the Bank of Finland and former member of the European Commission, to look into possible reforms to the structure of the EU banking sector. The European Banking Federation (EBF) has followed the work of the HLEG closely.

On this basis it is the understanding of the EBF that all the regulatory and other reforms of the financial sector have the *following objectives*:

i. to increase the stability of the European financial sector by reducing risk (micro and macro); to ensure orderly resolution of financial institutions – incl. systemically important banks (SIBs) – without having to call on taxpayers;
ii. to maintain the integrity of the Internal Market and to ensure the ability of banks to serve the real economy.

EBF understands that a possible solution the HLEG is mandated to assess is whether, in addition to the ongoing regulatory reform and enhanced supervisory measures, structural reform measures will bring added value in terms of reaching the stated objectives. Structural reform measures are understood to consist of, for example, activity restrictions (Volcker) or structural separation of certain activities (Vickers).

It is worthwhile to recall that the main concrete examples of structural reform to date (i.e. the Volcker rule and the Vickers report) find their origin in reflections launched at a time when the full thrust of the comprehensive regulatory reform measures as agreed at a global level had not been completed. With these measures now clearly defined, it is possible to evaluate whether the collection of regulatory reform measures address the aforementioned objectives in a meaningful and sufficient way.

Structure of the report

The report is structured as follows: Chapter 3 describes the EU market structure and the different types of business models in the EU banking sector; in Chapter 4 we assess the ongoing regulatory reform agenda – regulatory measures that are already implemented, in the midst of the legislative process or in the pipeline – in terms of expected impact on the EU banking sector and their ability to reach the objectives identified by the HLEG; in Chapter 5 we analyse the impact on the European banking sector of introducing structural measures akin to Vickers and Volcker and assess the objectives reached by such an approach; finally, in Chapter 6 we compare the ability of structural measures versus the ongoing regulatory reform agenda to attain the objectives and make a final recommendation to the HLEG.

3. EU market structure

3.1. Importance of the retail banking sector in Europe

As often observed, the EU market can be described as a "bank-based" model, where most of the financing to customers and enterprises is supplied through banking intermediaries as opposed to capital markets. According to ECB figures[1], the share of banks in credit intermediation in Europe lies consistently in the area of 70%-75% of debt financing to households and enterprises. For other major economies like for example the US this number is around 20%.

Throughout the turmoil and financial crisis Europe's banks have sought to fulfil the important role of credit intermediator by seeking to maintain lending levels to the economy in keeping with the economic cycle. The ECB's bank lending surveys have consistently demonstrated this commitment notwithstanding anecdotal reports to the contrary. The absence of a pan-European capital market that could offer an alternative source of funding to the bulk of enterprises (SMEs) in the EU makes that structural reform of the banks may disproportionately affect their prevailing credit intermediation role in Europe.

Banks play an important role in the European economic system. They provide essential financial services to households and businesses. Supporting customers through strong, sustainable and focused relationships in a responsible way is at the core of successful banking. Banks play an important role in providing consumers with access to banking services that enable them to live their daily lives: facilitating payments and financial transactions; supporting small and medium sized enterprises through finance and advice; enabling investments in infrastructure and private finance; and helping businesses to take and manage risks so that they can grow as quickly as possible. Banks also intermediate between suppliers and users of capital in the market. All these functions are essential to the proper workings of a modern market economy.

3.2. Benefits of financial integration

European banking has experienced fundamental changes over the last decades. One of the key factors driving these changes has been the policy measures towards greater financial integration in the Single Market, to which credit institutions responded by consolidating activities in order to increase in size and scope. During the past half-decade, the number of banks in the EU has been gradually declining. By the end of 2010, the number of banks in the EU-27 was 6.825, of which 5.404 were banks based in the euro area[2]. The consolidation of the EU banking sector is a logical consequence of the Single Market, which has delivered tangible benefits here as it has elsewhere, particularly in the ability to move capital across Member States' borders.

The merits of the important policy push for financial integration in the European Economic Area arguably consists of:

[1] Se for example http://www.ecb.int/press/key/date/2009/html/sp090713.en.pdf?0f043356b8a328049f1eb73b936b365f

[2] European Banking Federation; Facts & Figures report, 2011.

- offering the ability for banks to diversify the credit risk in their portfolios through increased cross-border activity, resulting in well diversified asset portfolios;
- offering the opportunity for banks to have a more diversified setting for their funding sources, resulting in more stable funding structures;
- A process of transferring knowledge, expertise and governance across the borders by means of cross border branches and subsidiaries.

Furthermore as pointed out by the ECB[3] the push for financial integration in the European Economic area has also been a decisive factor for the decline in financing costs for European households and firms.

It is not clear to what extent structural reform measures would end up carving up the Single Market for financial services along national lines or activity lines for which a cross-border rationale would be valid only partly or not at all.

3.3. Business models in the EU banking sector

The global trend of consolidation however did not bring complete homogeneity in banks' business activities. The European banking sector still incorporates a rich array of banks, with different business models, legal forms and ownership structures. Apart from the larger commercial, retail and investment banks, which focus on a broad mix of banking activities, a large number of specialised institutions with different ownership structures - public banks, cooperatives and saving institutions - co-exist in this highly diversified market. Such a diversified banking landscape is in itself already a strong protection against financial shocks as different banking types react differently to specific events. Having small and large banks, domestic and international banks, specialised and universal banks, all contribute to a diversified, competitive and safe banking sector.

According to the ECB[4] the types of banks mentioned above can be defined either as "diversified" banks – *i.e.* banks that combine different banking activities; like for example investment banking and corporate banking – or as "specialised" banks, i.e. banks that restrict themselves to only a few activities, like for example investment banking[5].

So business models, to a large extent, can be distinguished by the scope of activities and funding strategies they engage in. Most retail-oriented banks, such as commercial, savings and cooperative banks, provide traditional banking services to the general public. Investment-oriented banks focus more on trading activities, relying on a variety of funding sources whilst

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[3] European Central Bank; Financial Integration in Europe, 2012.

[4] European Central Bank; EU Banking Structures, 2010.

[5] In this ECB report investment banks are those where the financial and investment business have accounted for over 50 % of their average income over the last 3 years.

often maintaining a retail network of their own. Other banks provide services to their institutional clients, including large and mid-sized corporations, real estate developers, international trade finance businesses, network institutions and other financial institutions.

Two main categories of activities

There are basically two main categories of activities worth distinguishing:

- "**Retail activities**". The retail banking activities are usually very well understood as they deal with banking products most people use on a day-to-day basis like for example payment services, loans and deposits. Retail banks are more likely to provide loans, and retail activities often use customer deposits as the primary means for funding. Retail activities are clearly customer oriented, maintaining an extensive network of branches and having more employees. Banks with more retail activities need to be present in a broader geographical area, requiring a greater number of branches and a larger staff to engage directly with their retail customers. Retail banks are less likely to engage in trading activities. However, it must be noted that, given the volatility of financial markets, even "specialised" retail banks have to adjust their risk profile, taking positions in the wholesale markets since interest rate risk, credit risk, etc. have to be continuously and dynamically managed. "Specialised" retail banks need the expertise and capacity to enter these markets.

- **"Investment activities**". Investment banking may sound less familiar to the public at large, but investment activities are also useful for the economy and are generally also customer driven.

Some examples of investment banking activities are:

- To help individuals secure the mortgages they need to buy a home, investment banks market and distribute covered bonds. This lowers the price of mortgages for household borrowers.

- To help companies hedge interest rate and foreign exchange risks in relation to their expansion, thus creating financial security and allowing prudent financial budgeting;

- To help finance large infrastructure projects like schools or hospitals by providing syndicated loans or infrastructure funds that invest into public-private partnerships.

- To provide funding to and market making of sovereign and local authorities' bonds in order to lower their cost of funding.

In many markets there is a significant, and growing, demand from small and medium-sized enterprise (SME) customers for investment banking products. The level of demand for these products varies by market, based on a range of factors, such as: the nature of the economy, especially the role of exports; the prevalence of international sources and uses of cash in SME accounts; and the sophistication of the SME customer base, often driven by the sophistication of the latter's own customers. These factors are widely observable in the EU where companies, including SMEs, act increasingly across borders within the EU and beyond.

All banking activity – whether agreeing on an individual's mortgage; lending € 10,000 to a small business; helping a farm or large company hedge commodity price risks; or helping a government price and sell its bonds – *involves risk taking by a bank*. Banks by their very nature, therefore, must carry and manage that risk in order to meet the needs of their customers and the economy. Removing that risk from banks implies either removing it from the economy or placing it outside of the regulated banking sector, i.e. to the shadow banking sector.

3.4 The linkage between wholesale and retail banking in the EU

It is important to stress that banks need access to wholesale financial markets in order to play their important role in balancing the financial accounts of the region in which they are active.

Banks' balance sheets are the natural result of the savings of the population under the form of deposits and loans to households, corporates and the public sector. In open economies, and certainly within a monetary union, supply and demand of funds is not always in equilibrium. Some countries have structural surpluses, others have deficits. For example, Belgium presently has a cumulated surplus of savings, which has to be invested outside the country. On the other hand, the Netherlands have a structural deficit of deposits in comparison to the demand of credit. The Dutch banks are net importers of foreign capital.

Cross border flows of funds are essential for open economies. These flows are one of the major reasons for the creation of the European internal financial market. Banks are the natural intermediaries to bring demand and supply of funds in balance through the importing or exporting of capital. The most straightforward way to do this is to use wholesale financial markets. A restriction on banks fulfilling that role would increase the risk of credit crunches in some Member States, and overheated asset markets in others.

Moreover, banks perform a socially useful maturity transformation by collecting short term deposits and granting long term credits. On the one hand they allow customers to keep deposits that are liquid and safe. On the other hand they provide long term loans, often with fixed interest rates, to companies and individuals. To hedge their risk, banks must transfer this risk to investors using market products.

4. The regulatory reform agenda

4.1. Introduction

The current international approach to ensuring stability, safety and efficiency in the banking sector is based on adjusting regulation to the current system. The principal benefit of this approach is that it is essentially an *incentives-based* solution. It focuses on the identification of negative externalities and the creation of tailored responses, which maintain the overall efficiency of the system and ensure consistency across the financial sector (both banking and non-banking sectors). By contrast, structural reforms attempt to do the reverse. Instead of adapting regulation to emerging risks, it attempts to change the system itself to avoid the emergence of risks. This is fundamentally an interventionist solution based on prohibition rather than creating incentives to avoid certain activities.

This Chapter gives an overview of the most important measures of the regulatory reform agenda initiated by the G20 as a response to the financial crisis in 2008. For each regulatory measure there is a short description of the aim of the measure and of the objectives that it will achieve.

4.2. Prudential reform measures

Banking regulation and supervision in Europe - but also globally - is subject to a process of intense reform. The driver for that reform is the government-driven G20 roadmap. A number of remedial actions have already been taken in the past by the regulators/supervisors and the European banking industry in the aftermath of the crisis.

4.2.1. Capital requirements

As for the *Basel Accord*, new measures include:

- Strengthening the quantity and quality of capital, including an increase of the tranche of the highest quality capital (core equity tier 1) from 2% to 4.5% and the introduction of a capital conservation buffer of 2.5%; in addition, a new countercyclical buffer, meant to prevent excessive credit growth, could add up to 2.5% additional capital;
- A new framework for counterparty credit risk;
- The introduction of a leverage ratio as a backstop measure;
- A reassessment of the capital treatment of banks' trading books ("Basel 2.5").

All of these measures are intended to increase the financial stability from a micro-prudential standpoint. They also contribute to a safer banking sector thus improving the resilience of the industry at large and further protecting the taxpayer from stepping in. However, the implementation of the Basel III framework - CRD IV/CRR in the EU - should be consistent across the EU; an uncoordinated implementation in different Member States could put at risk the objective of the Single Rulebook, create an unlevel playing field and open incentives for regulatory arbitrage.

In addition to the Basel III capital requirements, the G20 has agreed upon the implementation of a capital buffer for global systemically important banks identified according to a set of criteria. These "G-SIBs" have to hold additional capital ranging from 1% to 2.5% of risk weighted assets, with the possibility of being extended to 3.5% (see chapter 4.2.3).

4.2.2. Liquidity standards

The Basel III proposal also includes two new liquidity standards: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

The LCR aims to ensure that a bank maintains an adequate level of unencumbered, high quality assets that can be converted into cash to meet a bank's liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors. At a minimum, the stock of liquid assets should enable the bank to survive until day 30 of the proposed stress scenario, by which time it is assumed that appropriate actions can be taken by management and/or supervisors, and/or the bank can be resolved in an orderly way.

The NSFR aims to promote more medium and long-term funding of the assets and activities of banking organisations. This metric establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a one year horizon.

This standard is designed to act as a minimum enforcement mechanism to complement the LCR and reinforce other supervisory efforts by encouraging structural changes in the liquidity risk profiles of institutions away from short-term funding mismatches and towards more stable, longer-term funding of assets and business activities. The NSFR standard is defined as a ratio of the available amount of stable funding to a required amount of stable funding. This ratio must be greater than 100%.

The main aim of the liquidity standards is to ensure better management of liquidity risk and minimising the likelihood of individual banks experiencing difficulties in funding their liquidity needs as well as avoiding a situation where the banking system comes under severe stress again due to scarce liquidity.

4.2.3. Regulation of Systemically Important Banks (SIBs)

In light of the lessons learned from the financial crisis, the international community wants to reduce the impact of the collapse of a systemically important market participant and at the same time put a price tag on the economic benefits of systemic importance. The G20 countries commissioned the Financial Stability Board (FSB) to draw up more stringent regulatory measures for systemically important financial institutions (SIFIs), of which the banks were the first group to be addressed (SIBs). The FSB's basic recommendations include the creation of a framework for effective resolution, greater loss absorbency – on a scale going beyond what is required under Basel III – and more intensive supervision, especially of global SIBs (G-SIBs). A possible extension of these recommendations to cover domestic SIBs, insurance companies and other non-banks is still under discussion by the FSB.

SIBs are to be identified using a scoring system based on five indicators: size, interconnectedness, substitutability, global activity and complexity. The score can be supplemented if deemed necessary by a qualitative assessment of the national competent authority. Of the 73 banking groups already investigated, 29 have been categorised as systemically important. Depending on their precise final score, these banks will be required to hold between 1% and 2.5% additional common equity capital. Should their systemic importance increase, a capital surcharge of 3.5% can be imposed. These capital requirements can be tightened further at national level, though it will be possible to hold the additional buffer in the form of contingent capital.

The new requirements are to be phased in between 2016 and end-2018 under the same timetable as that for the other Basel III capital buffers and should be complied with in full by 1 January 2019. The number of investigated banks and the number of banks identified as systemically important are to be reviewed by 2014. In Europe, the requirements will be implemented as part of the CRD IV/CRR.

4.3. Enhanced supervision (micro and macro)

Besides the deficiencies of the existing prudential rules, the financial crisis has highlighted the structural weaknesses of the EU supervisory architecture, which failed to anticipate and to resolve the collapse of several cross-border banking institutions.

As a strong and quick response to the deficiencies pointed out by the de Larosière High Level Group, the EU lawmakers agreed on a major overhaul of the supervisory architecture and decided to create:

- At the micro-prudential level, the European System of Financial Supervisors (the ESFS), transforming the existing Level 3 Committees (CEBS, CEIOPS and CESR) into European Supervisory Authorities (the ESAs);
- At the macro-prudential level, the European Systemic Risk Board (the ESRB) in charge of identifying, examining and reporting on vulnerabilities in the Single Market.

European Supervisory Authorities

The ESAs, and more specifically the EBA in the area of banking supervision, have been operational since 1 January 2011. Even if the national supervisors keep the responsibility of the day-to-day supervision, the ESAs have been given binding powers over national supervisors in seven broad areas:

- Power to intervene directly in emergency situations;
- Power to settle disputes between national supervisors;

- Exclusive supervisory powers over credit rating agencies (ESMA only);
- Power to issue binding technical standards;
- Power to intervene directly against institutions breaching EU law;
- Power to issue guidelines and recommendations;
- Power to coordinate peer reviews between national supervisors.

The ESAs will ensure the consistency and the convergence of supervisory rules and practices, and will boost efforts to create a level playing field in regulation and supervision through full harmonisation and peer reviews. National supervisors will have to demonstrate that they have the resources and take the actions required by their peers, and onsite inspections by international delegations will become more frequent and more inquisitive.

Against this background, the EBA will have a leading role in ensuring the consistent and coherent functioning of the colleges of supervisors, with a view to streamlining their functioning and the exchange of information. It is also worth noting that the CRD IV/CRR further strengthens the powers of national supervisors, which will be allowed to intervene in a more intrusive way and at an early stage, i.e. when they consider that the institution is likely to breach the prudential rules.

The European Systemic Risk Board

The ESRB has been tasked with the objective of identifying and prioritising systemic risks; monitoring the regulatory perimeter to identify risks emerging outside the regulated sector; issuing risk warnings and making recommendations to mitigate those risks; and coordinating the work of the European Supervisory Authorities and engaging with the work of the IMF and World Bank.

The ESRB has identified three principles to underpin the framework in which this work will take place:

- <u>Flexibility</u>: the European authorities and Member States must have the ability to, at their discretion, require additional disclosures or to temporarily tighten a number of Pillar 1 metrics, such as aggregate capital levels, liquidity requirements or leverage limits;
- Scope to <u>act early and effectively</u>: Macro-prudential authorities should act before the build-up of significant imbalances or unsustainable interconnections develop; and
- Efficient <u>coordination</u>: Member States must coordinate their actions and exchange information via the ESRB to mitigate against negative externalities or unintended consequences.

The ESRB principles will support the development of a suite of macro-prudential tools that will enable supervisors firstly to identify risks to European financial stability and second to take action to mitigate those risks. This is a vital enhancement to the European supervisory regime and one which has been replicated internationally and promoted by the G20.

EBF strongly believes that the revamping of the supervisory architecture outlined above will significantly minimise the systemic and fiscal consequences of bank failures, and will reduce moral hazard, bearing in mind that enhanced supervision and prevention should be the key to avoid the use of the resolution tools. There is no doubt that the European Supervisory Authorities will evolve over time towards a more integrated framework, interacting with the European Systemic Risk Board in order to liaise the micro-prudential and the macro-prudential perspectives.

4.4. Crisis Intervention

4.4.1. Deposit Guarantee Schemes

The central purpose of a deposit guarantee scheme (DGS) is to protect the depositors, to ensure their deposits in case of failure. This in turn should prevent a loss in confidence in a bank or the sector and avoid banks-runs. Therefore, in general it can be stated that a DGS contributes to enhancing the financial stability. There are several ways in which the role of DGS in this respect must be viewed: first from micro perspective (depositor and banks) and secondly from a macro perspective.

The increase of the coverage level to €50.000 and subsequently €100.000 enhanced depositor confidence in such a way that they stopped transferring funds from one country to the next (with higher protection levels). This has not prevented all bank runs however. Experience has shown that the most important element in preventing depositors from withdrawing 'en masse' their monies from a bank is *the level of knowledge* which they have of the DGS. Financial literacy of depositors and information sharing of banks on the DGS contribute to the effective functioning of DGS' and therefore the stability of the financial system. Therefore, the European Commission already has put forward proposals in the revision of the EU directive to provide the depositors with better information on the DGS. These proposals are supported by the industry.

From the banking perspective DGS has a very positive impact on the financial stability, be it from a more macro perspective. DGS installs confidence among depositors for the benefit of the system as a whole. The spill-over effect of a single bank failing is reduced by the DGS. In order for a DGS to be able to play its part a very important element is that depositors should at all times have the confidence that the DGS has sufficient funds (collected ex ante or ex post) at its disposal to be able to pay out. Using DGS as a tool for crisis management must never leave the DGS without funds.

It is often stated that from a micro banking perspective, DGS could introduce moral hazard issues, i.e. banks take disproportionate risks in the knowledge that the depositors will be reimbursed. This issue has been minimised by introducing ex ante funding all over Europe and by using risk based premiums in the way contributions are paid. This in turn enhances the financial stability overall.

The way premiums are paid in the current ex ante schemes differs greatly within Europe. Some are based on risk-weights (partially) whilst others are not. Any European model for risk-based contributions will have to carefully balance effectiveness, complexity, clarity and fairness.

4.4.2. Crisis Management

The European Commission has indicated that rules are needed to enable the effective crisis management and re-organisation or well-organised liquidation of a failing cross-border bank. The objective is to ensure that all national supervisory authorities have the tools required to identify problems in the banks at a sufficiently early stage and to intervene in order to either restore a bank or group of companies or prevent further decline. A further objective is to enable banks that operate across borders to fail or be phased out without the interruption of vital bank services or problems spreading to the wider financial system as a whole.

The long-awaited proposal for a crisis management directive establishes preventative, recovery and crisis resolution measures and procedures applicable to banks. This includes the creation of national resolution authorities, more risk-based supervision, recovery and resolution plans, early intervention powers, resolution tools and powers, cross-border resolution procedures, bail-in tools and resolution funding.

- It is proposed that a crisis management regime be put into use if a bank is failing or likely to fail and it is unlikely to be able to meet the supervisory authorities' requirements within a reasonable time. The crisis management authorities should be conferred with a number of crisis resolution powers, including the possibility of selling the firm, using a bridge bank model, separating activities as well as the possibility of writing off or converting debt (bail-in) to re-capitalise.

- It is proposed that requirements concerning a national "resolution fund" be introduced to provide coverage in the event of losses and expenses beyond the capital and the unsecured creditors. All institutions must contribute to the fund. The resolution fund can be part of the deposit guarantees scheme's fund.

According to the principle that "Prevention is better than cure", the EBF is supportive of the creation of a crisis management framework as the one described. An effective crisis management framework in which all banks are required to comply with tight preventative measures and all creditors suffer losses before taxpayers is a superior tool for curbing systemic risk compared to structural reform.

4.4.3. Recovery & Resolution Plans

As mentioned the recovery and resolution plans (RRPs) are an essential part of an all-encompassing crisis management framework (i.e., covering preventative, coordination, recovery and resolution measures) and a strong emphasis should be given to preventative and early intervention tools, the proper exercise and deployment of which are likely to have a less detrimental impact than the deployment of resolution tools. However, a reasonable balance must be struck between effective, robust supervision and supervisory approaches which are overly intrusive into the normal, day-to-day running of a healthy business.

Recovery and resolution plans are vital components of the solution to addressing risk associated with SIFIs, in the following way:

- A recovery plan sets out how a bank would respond to a severe stress including a capital recovery plan and a liquidity recovery plan. Plans will need to demonstrate the extent to which recovery could be supported by management actions to reduce the risk to which the business is exposed. The plan should also cover how the firm would cope with the failure of its largest counterparties – a 'contagion control plan'. Recovery plans are clearly the domain of the bank itself, but should be subject to robust challenge by its college of supervisors.

- A resolution plan aims at putting the authorities in a position to be able to use any of the options open to them under the bank resolution and insolvency arrangements. The authorities want to be assured that firms are able to provide in potentially very short timescales data needed to assess the resolution options and to execute the chosen strategy.

4.4.4. Bail-in

In addition to recovery and resolution plans the bail-in (or debt write-down) tool can be potentially useful to combat the too-big-to-fail syndrome and therefore reduce moral hazard. As a result, the price at which banks will be able to access funding will increase and incentives for over-leveraging will be significantly reduced. At the same time, the bail-in could potentially help to smoothen the process of resolution by creating an additional buffer that could be deployed to cover losses without the need for public support or a systemically disruptive bankruptcy process.

The timing and the implementation of any bail-in mechanism, however, must be carefully thought through to avoid imposing an excessive funding cost that could impair the provision of credit to the real economy and result in an excessive deleveraging, particularly at this time of financial and economic fragility. Any attempt to rapidly introduce a bail-in process, where the investor community fails fully to understand and appreciate the features of such a new debt instrument could jeopardise the economic recovery. Nonetheless other parts of the framework such as the various preventative measures and empowerment of resolution authorities with resolution tools (e.g. bridge bank, asset separation) could be implemented at an earlier stage without causing market disruption and could potentially significantly enhance the framework in the short term.

Key parts of the discussion on bail-in include the scope of the liabilities eligible for bail-in. A narrow definition of bail-in-able debt could lead to incentives for arbitrage. An alternative - and preferred option by the EBF - would be a wider scope, in which the majority of liabilities could be affected by bail-in. This could also reduce the possibilities of arbitrage and therefore the need for a minimum quantity of bail-in-able debt, thus preserving the concept of a pure debt instrument and mitigating the potential impact on funding structures and costs.

4.5. Capital markets reform

Capital markets have been affected by a number of recent EU legislative initiatives that are meant to re-design the regulatory framework to enhance the stability of the financial system and that of individual firms. Among others the following legislative initiatives are worth noting.

4.5.1. The EU reform of OTC derivatives (EMIR)

Since the beginning of the crisis the absence of common rules on over-the-counter (OTC) derivative contracts was considered to be one of the major blind spots in financial regulation. Considering limited transparency over the growing volume and size of transactions on OTC derivatives, this became an area of potential threat to financial stability.

Following recommendations from the G20[6] the European Commission adopted the European Market Infrastructure Regulation (EMIR)[7]. The objectives of the reform are:

- Firstly, to increase the transparency of a sector, that had so far largely been opaque. Transparency is meant to enhance the efficiency of the market, but also to increase the capacity of supervisors to monitor the exposures by individual firms and the risk in the system, and the ability of counterparties to assess counterparty risk therefore enhancing the stability of individual financial institutions and of the systems as a whole. EMIR aims to increase transparency by mandating that all "financial counterparties" (which includes banks, investment firms, credit institutions, insurers, registered UCITS funds, pension funds and alternative investment fund managers) report to a "trade repository" the details of any OTC derivative contract entered into and any modification or termination of the contract;
- Secondly, to mitigate the risk in OTC derivatives transactions, and particularly counterparty risk, by imposing clearing obligations on relevant class of OTC derivatives and imposing risk mitigation techniques for OTC derivative contracts not cleared by a central counterparty (CCP);
- Thirdly, to adopt a sound regulatory and supervisory framework for the activities of the CCP, including authorisation, organisational and prudential requirements;
- Fourthly, to introduce a regime to enhance the access to information on OTC derivatives transactions by introducing a legal framework for the regulation and supervision of trade repositories. This includes authorisation and registration requirements, access to and participation in trade repositories, disclosure of trade information and reporting standards. Trade repositories will publish aggregate OTC trade positions by classes of derivative contract.

[6] http://www.pittsburghsummit.gov/mediacenter/129639.htm.

[7] The Regulation was finally adopted 29 March 2012 and will be published shortly.

Overall this initiative - together with the ones adopted by other non-EU jurisdictions (and particularly in the US under the Title VII of the Dodd-Frank Act) – is expected to strengthen significantly the stability of individual financial firms and the overall financial system.

4.5.2. Short selling and CDSs

Since the first measures adopted by some national authorities in Europe after the Lehman collapse in September 2008 and the subsequent restrictions on short selling which had been approved in an uncoordinated manner by the majority of national competent Authorities across the EU, the need emerged for a common and harmonised regulatory framework on short selling. The EU Regulation on short selling[8] addresses this fragmented approach by introducing common EU transparency requirements and harmonising the powers that supervisors may use in exceptional situations where there is a serious threat to financial stability. It also introduces rules on the availability of financial instruments before entering into any (uncovered) short sale. In particular, the Regulation introduces measures aimed at:

a) Increasing transparency on short positions held by investors in certain EU securities. The lack of information regarding short selling prevents regulators from being able to detect at an early stage the development of short positions which may cause risks to financial stability or market integrity;
b) Ensuring Member States have clear powers to intervene in exceptional situations to counter the risk of negative price spirals and reduce systemic risks and risks to financial stability and market confidence arising from short selling and credit default swaps. In exceptional situations that threaten financial stability or market confidence in a Member State or the EU, the regulation provides that competent authorities (coordinated by ESMA) have temporary powers to require greater transparency or to impose restrictions on short selling and credit default swap transactions or to limit individuals from entering into derivative transactions;
c) Ensuring co-ordination between Member States and the European Securities Markets Authority (ESMA) in exceptional situations; and
d) Reducing settlement risks and other risks associated with uncovered or naked short selling. To tackle the increased risks posed by uncovered short sales, the Regulation requires that anyone entering into a short sale must at the time of the sale have borrowed the instruments, entered into an agreement to borrow them or made other arrangements to ensure they can be borrowed in time to settle the deal.

4.5.3. Revision of Markets in Financial Instruments Directive (MiFID) and Market Abuse Directive (MAD)

Some of the responses to the financial crisis relate to the functioning of secondary markets of financial instruments (MiFID and MAD) and to the distribution of investment products to clients.

[8] Regulation no 236/2012 published in the Official Journal of the European Union on 24 March 2012

The original objectives of MiFID were to improve the resilience of EU financial markets through free competition and high levels of market transparency and investor protection. These objectives have been achieved to a large extent. However, the effects of MiFID also gave rise to the emergence of other factors that are currently addressed in the MiFID revision which, in particular, seeks to address the following problems:

a) Increasing the transparency of market segments that remained so far opaque. This is the case for so called dark pools and other trading systems for shares that exploited the exemptions foreseen in MiFID; this is also the case for financial instruments other than shares, that are meant to be subject to new transparency requirements;
b) New phenomena emerged recently, mainly due to technological innovations and developments, such as high frequency trading and algorithm trading. These phenomena contributed in some specific situations to negative price spirals (such as the flash crash in the US market) posing threats to the stability of the system. The revision of MiFID and MAD address this innovations and the challenge that they create to the efficiency and integrity of financial markets;
c) The competitive dynamics initiated by MiFID also facilitated the growth of new trading platforms not covered by the regulatory framework, such as crossing networks. These are organised platforms which are currently not regulated but are playing an increasingly important role. The revision of MiFID is meant to address this concern by introducing a new regulated category of trading platforms (Organized Trading Facilities, OTFs), extending the same transparency rules;
d) To align with EMIR the MiFID revision will move all trading of derivatives which are eligible for clearing and which are sufficiently liquid to either regulated markets, Multilateral Trading Facilities, or to the new organised trading facilities (OTFs);

The importance of market integrity has also been highlighted during the financial crisis. In this context, the G20 agreed to strengthen financial supervision and regulation and to build a framework of internationally agreed high standards. The revision of the Market Abuse Directive is the opportunity to update the framework in Europe with regard to the following main issues:

- extending the regulation to new markets, platforms and over-the-counter (OTC) trading in financial instruments;
- Extending the regulation to commodities and commodity derivatives and emission allowances;
- Reviewing the capacity of regulators to effectively enforce market abuse regime.

MAD and MiFID are essential legislative actions to foster and keep at the highest international standards the competitiveness, efficiency and integrity of EU financial markets. Their parallel revision is an important step to ensure that recent developments are addressed and that regulatory and supervisory convergence at EU level is enhanced for the achievement of the Single Rulebook objective.

4.5.4. Investor protection

The harmonisation of conduct of business rules has been generally considered in the European context as necessary for both removing the obstacles to the effective cross-border provision of investment services and ensuring an adequate level of investor protection. As a result, the MiFID Level 1 and Level 2 Directives' conduct of business rules introduced, *inter alia,* requirements for suitability and appropriateness assessments depending on the type of investment services provided. The appropriateness assessment aims, among the rest, to prevent complex products being sold on an execution-only basis. As part of the Lamfalussy framework, further work has been carried out in 2009 by CESR in relation to the identification of complex products, the provision of advice and inducements.

Following the establishment of ESMA, the authority has started the preparation of guidelines with the aim of further enhancing clarity and fostering convergence in the implementation of certain aspects of the MiFID suitability requirements and with this, contributes effectively to enhancing consumer protection, which is one of the ESMA's objectives.

In the recent MiFID/MiFIR proposals, the European Commission acknowledged that MiFID had improved the protection of both retail and professional investors. Modifications in a number of areas could further enhance investor protection and therefore additional proposals in relation to advice, inducements, suitability assessment, cross-selling practices and handling of clients' funds or instruments, have been put forward.

As noted above, the development of a common European approach for eliminating the differences between the conduct of business regimes at national level has been identified as a priority for ensuring level playing field for investment firms and foster public confidence. Conduct of business rules are subject to a robust regulatory framework, involving national and European authorities. Where necessary, actions have been taken to tackle the identified deficiencies. This is expected to contribute effectively to enhancing consumer protection and to the establishing of a sound, effective and consistent level of regulation and supervision. Competent authorities themselves have also a role in enhancing investor protection, for instance, local supervisors can assume a more active role by encouraging investor education.

4.5.5. Credit rating agency reform

Credit rating agency reform is not directly aimed at reforming financial institutions, but the overall aim of credit agency reform is to make the financial system more transparent and accountable thereby contributing to financial stability. Furthermore, credit ratings affect financial institutions indirectly in a number of ways – as issuers of securities; as professional investors; and when calculating risk weighted assets to comply with capital requirements.

In the EU a first set of rules on credit rating agencies - CRA 1[9] - is already in place. It introduces, among other issues, a registration requirement which submits rating agencies to public supervision; requirements to ensure rating agencies' and individual analysts' independence; and disclosure requirements on rating agencies' methodologies, assumptions and on historical performance.

A second set of rules is currently being debated among EU legislators, aimed at further reinforcing the regulatory framework of CRAs by increasing the independence between issuer and CRA, enhancing supervision and transparency of CRAs, and reducing the overreliance on CRAs. One of the main features here is the proposal of mandatory rotation where CRAs can rate issuers for a maximum of three years, but only rate up to a maximum of 10 consecutive debt instruments.

4.6. Remuneration, sanctions and governance

4.6.1. Remuneration Policies

Whilst recognising that remuneration policies were not the direct trigger of the financial crisis, they have been regarded by international and European stakeholders as one of the underlying contributing factors when based on short-term profits and fuelling a risk appetite that was disproportionate to the loss-absorption capacity of institutions,.

In response to a call by the G20, the FSB elaborated in 2009 Principles and Standards for sound compensation practices. The FSB peer review of 2011 concluded that good progress was made towards their implementation. The Principles introduced rules regarding the remuneration of certain categories of staff, notably (i) avoid multi-year guaranteed bonuses; (ii) defer significant portion of variable compensation, have it subject to appropriate malus or clawback arrangements and vested in the form of stock or stock-like instruments; (iii) make transparent, through disclosure requirements, the firms' compensation policies and structures; (iv) limit variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base (v) grant supervisors the responsibility to review, and under circumstances modify, the firms' compensation policies and structure; (vi) consider guaranteed bonuses as not being consistent with the sound risk management.

The regulatory reform successfully addressed in the EU, through the introduction of binding EU legislation, the identified shortcomings pertaining to the structure of remuneration policies and inappropriate corporate governance systems. It reinforced the role of the supervisors and empowered them to assess the remuneration schemes in the broader context of sound risk management. The results of recently conducted assessments show that good progress has already

[9] Regulation N° 1060/2009/EC was adopted in September 2009 and entered into force in all Member States 7 December 2010. By year-end of 2010, CRA I was amended to allow the new European Securities and Markets Authority (ESMA) to supervise rating agencies – hence CRA II.

been made in the key aspects. Since the envisaged measures help avoiding excessive risk-taking by individual credit institutions, they ultimately prevent also the accumulation of excessive risk in the financial system. The adoption of a binding legislation prevents also regulatory arbitrage in the Single Market. The implementation date for the new rules was January 2011. Areas in which further improvement is needed have been already identified and the progress is on-going. Further assessment is planned by EBA in the form of a benchmark exercise based on remuneration data collected.

The CRD IV/CRR proposal confirmed the existing CRD III rules on the structure of remuneration and, in addition, proposed a new set of corporate governance arrangements.

4.6.2. Sanctions

In February 2009, the de Larosière Report recommended that sanctioning regimes should be urgently strengthened and harmonised since weak and heterogeneous regimes can potentially induce regulatory arbitrage in the Single Market. The December 2007 ECOFIN Council invited the European Commission to study the differences in supervisory powers. As a result, a cross-sectoral stocktaking exercise of Member States' sanctioning regimes was conducted.

In the 2010 Communication on sanctions in the financial services, the European Commission noted that divergent and weak sanctioning regimes could lead to a situation in which sanctions are not optimal in terms of effectiveness, proportionality, and dissuasiveness and this, in turn, risks undermining consumer protection and market integrity, may create distortions of competition and weakens the confidence in the financial sector. In order to tackle these risks, the European Commission suggested the introduction of minimum common standards at European level.

The CRD IV/CRR proposal contains new provisions on sanctions. Whilst not tackling criminal sanctions, the proposal sets out the minimum set of administrative sanctions and measures that should be available to competent authorities in the case of a breach of key provisions of CRD IV/CRR. By means of minimum harmonisation, it sets out the types of administrative sanctions which should be given to the competent authorities in case of specific infringements. It also specifies the maximum level of administrative fine and the criteria which, among the others, should be taken into account by the competent authorities when determining the type of administrative sanctions/level of fine.

By increasing the effectiveness and dissuasiveness of national sanctioning regimes, the ongoing reform aims to ensure better compliance with EU banking rules. The reinforcement and approximation of the legal framework concerning sanctions is expected to contribute to the consistent and effective application of EU rules in all Member States, and permit coherent steps to be agreed within colleges of supervisors for cross-border banks. The better enforcement will help improving the stability and the functioning of the financial system. Therefore, overall, the impact should be positive even though some of the proposed provisions have raised (legal) concerns.

4.6.3. Corporate Governance

Strengthening corporate governance arrangements has been identified as a priority by the European Commission. International bodies (OECD, FSB and the BCBS) have also reviewed their existing practices and guidelines, notably the BCBS adopted in October 2010 principles for enhancing corporate governance. The 2010 European Commission Green Paper on corporate governance in financial institutions and remuneration policies stated that although the general consensus is that the existing principles of corporate governance, namely the OECD principles, the recommendations of the Basel Committee, and Community legislation, already cover the problems that emerged during the crisis, the broad scope of the rules and their non-binding nature decreases their effectiveness. Options identified in the Green Paper have already been introduced in the CRD IV/CRR Proposal, notably in relation to the strengthening of the risk management related functions. In September 2011, the EBA adopted Guidelines on Internal Governance by taking into account also recent developments, such as the BCBS principles. The great majority of Member States reported that they comply or intend to comply with the Guidelines.

With the implementation of the strengthened risk management rules as part of the new corporate governance framework for banks, it is expected that institutions will become more resilient against adverse market conditions which will, in turn, contribute to the stability of the financial sector. Therefore, the overall the impact is expected to be positive. Corporate governance arrangements are of great importance for banks, in particular the risk management part. Good corporate governance should also provide incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders. However, it is important to differentiate between provisions which are specific to financial institutions and other provisions which should remain part of general corporate governance rules.

4.7. Conclusion on the regulatory reform agenda

Chapter 4 clearly illustrates that the regulatory reform agenda is both very ambitious, comprehensive and fully addresses the objectives mentioned in Chapter 2: to increase the stability of the European financial sector by reducing risk (micro and macro); to ensure orderly resolution of financial institutions – also for Systemically Important Banks – without having to call on taxpayers; to maintain the integrity of the Single Market and ensure the ability of banks to serve the real economy.

In some cases – in terms of practical applicability – it is even the case that the attainment of one of the desired objectives risks to happen at the expense of another objective. This is for example the case with capital requirements where the political pressure and sometimes diverging demands from national, regional and international regulators risk hampering the objective of banks serving the real economy (to the extent desired in times of economic downturn).

Furthermore it must be stressed that there is still a considerable lack of understanding among regulators, politicians and stakeholders of the overall impact and practical functioning of the regulatory reform agenda: many of the proposals – some of them with considerable effect on the European financial sector, as for example MIFID/MIFIR and CRD IV/CRR – are still in the process of final adoption. And further proposals are expected and/or have just been released– for example on SIFIs, revision of the trading book and crisis management – that are crucial to the attainment of a more stable (cross-border) financial sector as well. Hence, for many of the regulatory reform measures their implications for the financial stability are not yet very clear or well-defined.

Therefore, it's the view of EBF that there's a need to implement the upcoming regulations first, before pressing ahead with discussions on possible additional structural reforms. A premature decision on structural reforms is likely to complicate and distract from the implementation of ongoing regulatory reforms and will also make it more difficult to evaluate their impact. Furthermore, the EBF firmly believes that the finalisation of the regulatory reform agenda will reach the stated objectives more than fully without the necessity of any additional structural measures.

For illustrative purposes *Annex 1* presents a table that sums up the different regulatory measures described in this chapter, the objectives they aim at as well as their expected impact.

5. Structural reform measures

5.1. Introduction

This chapter gives an assessment of the structural reform measures in the UK and the USA and the possible impact of such measures on the European banking sector.

5.2. The Vickers report and the Volcker rule

In its mandate the Liikanen High-Level Expert group (HLEG) was asked to assess the value of structural reform and pay particular attention to ongoing structural reforms, i.e. the Volcker rule in the USA – a part of the Dodd-Frank Act – and the Vickers report in the UK. These two rules are national answers that have been introduced as an attempt to address systemic risk associated with Systemic Important Banks (SIBs) and enhance resolvability of such institutions. The proposal from the Independent Commission on Banking (ICB) chaired by Sir John Vicker, prescribes structural separation via a ring fence for retail banks - so-called retail ring fencing - and higher loss absorbance for the ring fenced retail banks. The Volcker rule restricts the proprietary trading and investment activities of deposit-taking institutions, including their participation in hedge funds and private equity business. However, unlike the Glass-Steagall act[10], this approach allows retail and commercial banking to be combined with investment banking activities that do not entail proprietary trading. A pending practical question for the Volcker rule is how to tell the difference between a proprietary trade and a risk-reducing hedging or market-making one - an issue the Dodd-Frank Act leaves to regulators. The Volcker rule and the Vickers report are described in detail in **annex 2**.

The recommendations made by the Vickers Commission in the UK and the so-called Volcker rule in the USA need to be understood in their context and time. That is, as national responses developed at the early stages after the financial crisis in 2008. After the introduction of these structural measures in the UK and the US a large number of regulatory initiatives have been introduced at international level through G20 that will significantly strengthen the resilience of the EU banking sector - and more measures are still to come. The current examples of structural reform in the UK and US have not been able to take the breadth of the international regulatory reform process into consideration. Nor have the two structural reform proposals been able to take into consideration the considerable re-structuring of the EU banking sector that has already been spurred by the ongoing regulatory reform agenda - and where the European Commission anticipates further re-structuring going forward[11]. Among other things the new liquidity and capital requirements as well as the expected bank resolution measures will pressure banks to raise cost-effectiveness, improve their capital levels and at times lead to further divestment away from non-core assets. Any proposal should as a minimum take the adherence of the European

[10] The Glass-Steagal act, implemented in 1933, prescribed full separation of commercial banking from investment banking. The Glass-Steagal act was repealed in 1999 by the The Gramm–Leach–Bliley Act.

[11] European Commission; European financial stability and integration report 2011; April 2012.

Banking sector to the G20 reform and the re-structuring of the EU banking sector into consideration - this is not the case of the Vickers proposal and the Volcker rule.

The idea inherent in both the Vickers report and the Volcker rule seems to be that structure and certain business models were at the core of the financial crisis. However, there is no evidence that the financial crisis was driven by the structure of the EU banking sector or the business models in use. Bank failures did not concentrate on certain types of banking structures or models. On the contrary, the financial crisis has been indiscriminate in terms of the size and nature of institutions that have been impacted. In the UK there have clearly been consequences for firms the size of RBS and HBOS, through to Northern Rock and Bradford & Bingley, and then through to Dunfermline and the other building societies obliged to seek mergers through their weakened financial position. In the US, while Lehman Brothers and Bear Sterns suffered on the investment banking side, Washington Mutual constituted a $307bn failure, 450 smaller institutions have failed since the beginning of 2008 and many more are believed to remain on the FDIC 'on watch' list. It should also be added that US retail banks, German Landesbanken and Spanish *Cajas* (saving banks) are the three areas of banking seen by the IMF as giving rise to on-going concern of a systemic nature – i.e. narrow, smaller scale banks. This needs to be borne in mind when determining what further steps are appropriate at the EU level.

It must be kept in mind that all banking activity involves risk taking by a bank. Banks by their very nature, therefore, must carry and manage that risk in order to meet the needs of their customers and the economy. Removing that risk from banks implies either removing it from the economy or placing it outside of the regulated banking sector, i.e. to the shadow banking sector.

5.3 No link between structural reform and financial stability

A main argument of both the Vickers Report and the Volcker Rule is that structural reform will enhance stability and protect taxpayers against future bailouts. However, there is no convincing evidence that structural reform has a direct influence on systemic risk and would make restructuring or resolution easier in the event of a crisis.

The taxpayer could only be exempted if investment banking activities were devoid of systemic risk. Only then could a bank become insolvent without affecting the wider financial system. But this is not the case. The fact is that structural reform will not be able to totally eliminate interconnectedness, and thus channels of contagion, in the banking sector.

Systemic risk is largely independent of a bank's business model or the structure of the banking sector. This view is backed up by a recent ECB study[12], which finds that a bank's business model cannot protect it from getting into financial difficulties. On the contrary, the study demonstrates that all business models contain parameters with the potential to make banking more or less risky. The solution is therefore not to prescribe certain business models.

[12] http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1394.pdf

5.4. Impact of structural reforms on the EU banking sector

One of the main implications, common to both the Vickers report and the Volcker rule, is that these proposals will intervene in the structure of a banking model that has been developed across Europe: that of diversified banks (i.e. banks that combine different banking activities; for example investment banking and corporate banking[13]).

However, as described in chapter 5.2 the financial crisis did not demonstrate the weakness of diversified banks and it would therefore be wrong to consider the concept of diversified banks as one of the main causes of the crisis, which has to be tackled with "structural" measures.

On the contrary, a balanced diversification of sources of revenues and of funding represents a clear asset to preserve the stability of financial institutions, having the capacity to absorb external shocks in a much more resilient way than a specialized entity could do. Any intervention that would severely impact on the organization and functioning of diversified banks needs to be assessed against the potential impact on the stability of these banks.

The ECB's report on EU Banking Structures[14] provides empirical evidence that diversified banks have been less affected by the financial crisis than specialised banks and argues that diversified banks have a greater resilience based on clear synergies between private banking, retail and corporate banking and investment banking. Diversified full-service banks are diversified by geography, product lines and customers and this helps to diversify risk and reduce concentrations. Overall, this is beneficial to financial stability.

This being said, diversified banks have certain characteristics in terms of risk, which have to be reflected in regulation, supervision and internal risk management.

However, a possible way to keep risks under control for diversified banks is strong supervision, systematically based on scenario analysis and stress tests, coordinated by EBA, and based on the input of the ESRB. Such an approach allows the diversified banks to benefit as much as possible from optimal diversification, which is also good for financial stability, while eliminating the risk of extreme strategies. Hence the aim of the supervision should be to pursue a "balanced" diversified bank, which benefits to a maximum degree from diversification between market segments.

Closely monitoring the strategies and structures of diversified banks, with peer comparisons could also help supervisors in better monitoring the business mix of diversified banks. Again, EBA should play a major monitoring role in this process.

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[13]Definition used in the ECB's report on EU Banking Structures published in September 2010.

[14] Ibid.

Many of the arguments mentioned above, whilst being formulated in the context of the potential impact on the business model of diversified banks, most common in the EU, are nonetheless also valid to more specialized business models.

For example, even “pure” retail banks have to adjust their risk profiles, taking positions in the wholesale markets since interest rate risk, credit risk, etc. have to be continuously and dynamically managed. Limiting the possibility of banks to manage actively their risk profile using transactions on wholesale markets would increase their risks considerably.

Also it should be kept in mind that separation of structures would lead to a profound reorganization of banks generating high organizational and administrative costs and reduction of economies of scale (and scope) and efficiency.

5.5. Impact of structural reforms on the financial sector as a whole

Structural reform measures risk having a detrimental impact on the European financial sector by increasing the overall risk of the sector instead of decreasing it.

Ring-fencing the retail activities – and mandating the artificial separation of retail vs. investment banking – would have important disruptions on the way many banks currently work in the EU creating problems for their stability. This is mainly, but not exclusively, due to existing imbalances between surplus/deficit capacities of retail sectors within the same country and the concrete need to combine the retail activities to the capital markets activity. This occurs either because the banks’ funding needs exceed the availability of savings in the specific country (as described in chapter 3 this is the case, for instance, of the Netherlands) or, on the contrary, because the retail banks have surplus savings exceeding the retail borrowing needs within the country (this is the case, for instance, of Belgium). In both cases confining retail activities within one single entity would seriously endanger the stability of banks that, on the contrary, need to access the capital markets either to enhance their funding needs or to post their surplus.

Furthermore structural measures would affect the current heterogeneity of the European banking sector negatively. A diversified banking landscape is in itself already a strong protection against financial shocks as different banking types react differently to specific events. Having small and large banks, domestic and international banks, specialised and diversified banks contribute to a diversified, competitive and safe banking sector.

In addition structural measures would make banks unable to serve adequately the growing demand for integrated services, especially from the European small and medium-sized enterprise (SME) segment. EU companies, including SMEs, act increasingly cross border within the EU and globally. They require international financial services for which access to wholesale markets is essential: trade finance, import, export, financing of foreign investments, forex services, and international loans, are just some of the many products they need for their development. Specifically SMEs ask for integrated services, as they have not the size or expertise to buy directly on the international wholesale markets. A bank, which wants to offer these clients an appropriate portfolio of services and products, needs to be active on the wholesale and the retail markets, and has to play its traditional role of "transformer" between wholesale and retail markets.

Therefore, it is the view of EBF that given the nature of the banking sector in the EU, the lessons that can be drawn from the financial crisis and the structure of economies of the EU countries, the disadvantages deriving from a potential adoption of UK- or US-style structural reforms for the EU would be much larger than the eventual benefits that they would generate.

6. Conclusion and EBF recommendations

The EBF supports the aim of reaching the objectives mentioned in Chapter 2, e.g.

i. to increase the stability of the European financial sector by reducing risk (micro and macro); to ensure orderly resolution of financial institutions – incl. Systemically Important Banks (SIBs) – without having to call on taxpayers;
ii. to maintain the integrity of the Internal Market and to ensure the ability of banks to serve the real economy.

and understands the need for an overall assessment of the impact of the ongoing regulatory reform measures.

However, the EBF remains unconvinced that structural reform measures should be considered as a part of this exercise due to the fact that structural reform measures simply do not seem to reach the mentioned objectives. On the contrary, such structural measures could actually turn out to be counter-productive, leading to fragmentation of the European financial market and creating incentives for circumvention thereby increasing risks embodied in the financial activity outside the banking sector.

A core element of the G20 financial reform agenda is to reduce the moral hazard related to implicit government guarantees by making orderly resolution of financial institutions a real possibility thereby avoiding the need for future calls on taxpayers. Structural reform does not provide an answer to this question as the failure of a bank is not usually dependent on the structure of the banking system or the business model of the bank. Indeed, the diversity of business models enhances financial stability. In turn, a comprehensive crisis resolution framework does provide an answer to the moral hazard question and full implementation of globally agreed reforms is essential.

Structural measures as the ones contained in the Volcker rule or proposed in the Vickers report, per se, do not solve the problem of exposures by banks to risky assets. Risk cannot be eliminated – but it can be reduced. However, there's no real evidence that splitting up banking activities through structural reform measures is likely to reduce risk and thereby to reach another of the main objectives mentioned above. Instead, reforms which reduce heterogeneity in banking structures will impact financial stability negatively. In terms of risk reduction the prudential toolbox as well as stronger supervision shows much greater capacity for results as this approach adapts regulation to emerging risk instead of trying to avoid the emergence of risk using structural reform measures. In other words an incentive based approach is preferred to an interventionist approach.

Structural reform measures can also be very detrimental to the European market structure which is defined by a high level of bank intermediation; a strong connection between retail and wholesale; national differences in structural surpluses and deficits that necessitate all banks' unencumbered access to wholesale markets; and a wide variety of business models that adds financial stability and structural resilience to the European banking sector. Introducing structural reform measures will not only increase the overall level of risk of the European banking sector but also harm the ability of banks to serve the real economy and in particular the growing client need for integrated services among the European SME segment. This will in turn have impact on EU and Member States' growth.

Finally, it is important to recall that both the Vickers report and the Volcker Rule were designed at the early stages of the development and adoption of the G20 regulatory reform agenda. Therefore these proposals have been unable to fully take into account the ongoing development of the full G20 regulatory reform agenda. And furthermore, the Vickers report and the Volcker Rule do not consider the considerable restructuring of the European banking sector that has already been brought about by the ongoing regulatory reform agenda.

EBF recommendations

In conclusion, EBF finds that structural reform measures are not needed to reach the objectives mentioned above. On the contrary, in the worst case they could turn out to be costly, ineffective and ultimately reducing the financial stability of individual banks and of the banking system as a whole.

The EBF finds that with the ambitious regulatory reform agenda already on the table, but far from being completed, it is fully possible to reach the stated objectives without resorting to highly invasive structural reform measures.

In EBF's view, it is time to make a halt, implement the current and upcoming regulations and assess the overall quantitative impact of these reform packages before pressing ahead with discussions on possible structural reforms.

European Banking Federation

Annex 1: Overview table of regulatory reform measures

Comment: a **+** indicates that the regulatory measure reaches the objective and the text states how/the expected impact of the measure.

Objectives / regulatory measures	Financial stability (micro)	Financial stability (macro)	Orderly resolution/reduction of moral hazard (avoid call on taxpayers)	Consumer & investor protection	Maintain integrity of Internal Market
Capital requirements	+ (enhanced loss absorbency significantly reduces micro-risk)	+ (financial sector better to absorb shocks from financial + economic stress thereby reducing spill-over to real economy)	+ (better capitalised banks prevent taxpayer to step in)		
Liquidity	+ (better liquidity risk management/ liquidity buffers increase resilience of banks in situations of stress)	+ (reduce probability of liquidity shortage/liquidity stress situation in the financial system)	+ (more resilient banking sector prevent taxpayer stepping in)		
SIB regulation	+ (G-SIB buffer, more loss absorbency)	+ (enhanced supervision + decrease contribution to systemic risk)	+ (resolvability assessment + RRPs for G-SIBS, better prevention, strengthen early intervention, decrease likelihood of bank failures)		

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Objectives / regulatory measures	Financial stability (micro)	Financial stability (macro)	Orderly resolution/reduction of moral hazard (avoid call on taxpayers)	Consumer & investor protection	Maintain integrity of Internal Market
Enhanced supervision	+ (ESAs + strengthened cross-border supervisory cooperation + broadened pillar II mandate for national regulators)	+ (ESRB – identifying + addressing systemic risk)	+ (enhanced supervisory cooperation on cross-border banks + EBA coordinate, participate and ensure consistency in resolution)	+ (ESAs tasked with promoting transparency, simplicity and fairness for customers)	+ (ESAs to ensure regulatory level playing field)
DGS	+ (minimize probability of bank-runs, better DGS information)	+ (depositor confidence in system, reduce bankruptcy spill-over)	+ (contributes to orderly resolution in case of bank failure)	+ (enhanced depositor protection)	
Crisis management	+ (sufficient tools for national supervisors to identify + handle problems in a bank)	+ (no interruption of vital (cross-border) bank services, avoid rubbing off effect on wider financial system)	+ (enhanced prevention measures, early intervention, crisis management tools, bail- in and resolution funding all address the moral hazard problem)	+ (access to essential financial functions is ensured, covered depositors protected)	
OTC derivates reform (EMIR)	+ (increase transparency, mitigate risk, better supervision of CCP's + better OTC information)	+ (increase transparency, mitigate risk, better supervision of CCP's + better OTC information)			

Objectives / regulatory measures	Financial stability (micro)	Financial stability (macro)	Orderly resolution/reduction of moral hazard (avoid call on taxpayers)	Consumer & investor protection	Maintain integrity of Internal Market
Short selling and CDS	+ (Increase transparency by disclosure requirements, reduction of settlement risk etc.)	+ (emergency powers for national regulators +ESMA as coordinator)			
MIFID (/MAD)	+ (increase transparency of market segments, addressing HFT)	+ (increase transparency of market segments, Extension of regulation to non-regulated trading platforms + extension of supervisory scope)		+ (enhance consumer protection by establishing a sound, effective and consistent level of regulation and supervision and foster public confidence)	+ (guarantee competitiveness, efficiency + integrity of EU financial markets. Ex. provision on equal access +fees) + (ensure level playing field)
Credit rating agency reform	+ (enhanced supervision, disclosure requirements, reduction of overreliance on ratings)	+ (enhanced supervision, disclosure requirements, reduction of overreliance on ratings)			
Remuneration	+ (avoid excessive risk-taking by	+ (prevent also the accumulation of			+ (prevents also regulatory arbitrage

Objectives / regulatory measures	Financial stability (micro)	Financial stability (macro)	Orderly resolution/reduction of moral hazard (avoid call on taxpayers)	Consumer & investor protection	Maintain integrity of Internal Market
	individual credit institutions) + (reinforces the role of the supervisors and empowers them to assess the remuneration schemes in the broader context of sound risk management)	excessive risk in the financial system)			in the Single Market)
Sanctions	+ (expected to contribute to the consistent application and effective enforcement of the rules)	+ (expected to improve the stability and the functioning of the financial system)		+ (tackle risks which could undermine consumer protection)	+ (tackle risks which could undermine market integrity)
Corporate governance	+ (it is expected that institutions will become more resilient against adverse market conditions)	+ (the fact that institutions are more resilient will contribute to the stability of the financial sector)			

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Annex 2: Description of Vickers and Volckers

Vickers Report

The UK Vickers report included proposals on ring-fencing, additional loss absorbency and competition and the Commission described its three key objectives for financial stability overall as being to:

- Make banks better able to absorb losses;
- Make it easier and less costly to sort out banks that still get into trouble; and
- Curb incentives for excessive-risk taking.

The Vickers Commission additionally set out the following objectives for the ring-fence:

- Make it easier to sort out both ring-fenced banks and non ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support;
- Insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and
- Curtail government guarantees, reducing the risk to public finances and making it less likely that banks will run excessive risks in the first place.

Objectives: the overall objectives of the Vickers report ("the Report") are:

- creating a more stable and competitive basis for UK banking for the long term;
- Improving resolvability of banks;
- Insulating vital banking services via ring-fencing of retail operations from investment banking activities;
- Curtailing government's guarantees;
- Making banks safer by increasing banks' loss-absorbing capacity and simplifying structures as step towards reduction of systemic risk.

Background: report of the Independent Commission on Banking (ICB) published on 12 September 2011.

Timeline: ICB established in June 2010; final report endorsed by HM Treasury on 19 December 2011; implementation in stages and completed by 2019 consistent with the deadline for implementation of the Basel III reforms agreed by G20 leaders; the British Government will publish a White Paper in spring 2012 setting out further detail on how the recommendations will be implemented. Primary and secondary legislation related to the ring fence will be completed by the end of this Parliament in May 2015 and banks will be expected to be compliant as soon as practically possible thereafter.

Implementation: identification of activities that need to be ring-fenced. Four categories:

- *Services that must be offered within the ring-fence*: retail deposits and provision of over-drafts to individuals and SMEs;
- *Activities that are permitted within the ring-fence*: consumers and SMEs loans, mortgages, credit cards, lending, including leasing and factoring, wealth management services, other ancillary services;
- *Activities that are excluded from the ring-fence* and that are prohibited: services provided outside the EEA transactions with non-ring-fenced financial firms that are not affiliates of the ring-fenced bank (with the exception of regulator approved payments services transactions); services that would result in either a trading book asset or in the requirement to hold capital against market and counterparty credit risks; and services relating to secondary market activity such as the purchase of loans or securities. These prohibitions preclude ring-fenced banks from engaging in securities under-writing, market making, mergers and acquisition advisory services, loans and ABS warehousing, and sponsoring securitization deals.
- *Activities necessary to support permitted services may also be performed*: it is reasonable to expect ring-fenced banks to engage in derivatives contracts with non-ring fenced banks which would entail assumption of market and counterparty credit risks. Ring-fenced banks must also undertake investment in assets that are liquid by virtue of either an active secondary market or by them being eligible for repurchase by the central bank. However, the proposals exclude contracting with counterparties outside of the ring-fenced banks' own financial group that are offering prohibited services. It would appear, therefore, that risks must be managed, possibly in a synthetic fashion, by combining intra-group contracting with the sale and purchase of marketable securities and their derivatives.
- Ring-fenced banks shall establish separate legal entities within the same group (legal and operational independence "functional approach" rather than just legal). Consequences: independent management and board structures; prudential requirements applicable on a solo basis; restrictions are imposed on intra-group transactions

Geographical scope: The ring-fencing requirements will apply to any company or other body incorporated in the UK which undertakes a banking business with permission from the UK regulator. This will include any UK bank or building society, including UK subsidiaries of wider banking groups headquartered in the UK or elsewhere. The requirements will not apply directly to foreign subsidiaries of UK ring-fenced banks, but limitations may be imposed on the activities that subsidiaries of a ring-fenced entity may undertake. The UK branches of banking groups from outside the UK will generally be unaffected by ring-fencing provisions, although the UK Government would expect the prudential supervisor of branches of banking groups based outside the European Economic Area (EEA) to give careful consideration to whether it is appropriate to permit significant amounts of mandated services to be undertaken in a branch rather than through a UK subsidiary. UK branches of EEA banks would remain unaffected.

"Volcker Rule" (section 619 of Dodd-Frank Act)

Objective: strengthening financial stability financial system and reducing risk for firms eligible for government support with separation of some investment banking activities from commercial banks, by prohibiting commercial banks from engaging in proprietary trading and investing or sponsoring in hedge funds or private equity funds. The purpose of the latter prohibition is to avoid circumvention of proprietary trading prohibition and to eliminate incentives for banks to "bail-out" funds that they sponsor, advise or where they have a significant investment.

Legal basis: Section 619 of the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act of 2010). Following the public consultation, implementing measures are still under discussion with the relevant US Authorities.

Timeline: adoption July 2010; effective: 21 July 2012 (or later depending on the effective adoption of implementing measures by relevant US Authorities); compliance from eligible institutions by July 2014. Until then covered banking entities must conform their activities to the requirements of the Volcker Rule (the "Conformance Period"). The US Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission have published proposed regulations implementing the Volcker Rule, but these regulations have yet to be finalized. On Thursday, April 19, 2012, the Federal Reserve Board issued a policy statement clarifying the manner in which the Volcker Rule prohibitions would apply and would be enforced during the statutory two-year Conformance Period. The policy statement indicates that during the Conformance Period covered banking entities will be expected to engage in good-faith efforts appropriate for their activities and investments, that will result in the conformance of all of their activities and investments to the requirements of the Volcker Rule by no later than the end of the Conformance Period.

Exemptions: market-making activities; underwriting; trading on [US] sovereign bonds; hedge transactions; transactions as agent.

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