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ISDA Safe, Efficient Markets

13 November 2012

Mr Mario Nava
Acting Director - Directorate H – Financial Institutions
Head of Unit H1 - Banks and Financial Conglomerates
DG Internal Market and Services
European Commission

By email: MARKT-HLEG@ec.europa.eu

Response submission from AFME and ISDA to the Commission consultation on the recommendations of the High-Level Expert Group on reforming the structure of the EU banking sector

Dear Mr Nava,

AFME[1] and ISDA[2] welcome the opportunity to comment[3] on this important consultation regarding the recommendations of the High-Level Expert Group on reforming the structure of the EU banking sector.

Our members fully support the HLEG in its objectives of seeking to reduce risk in banks and the banking system including through improving the resolvability of banks, promoting competition and maintaining the integrity of the internal market. We also very much welcome the thorough analysis that the Group has

[1] The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

[2] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 840 member institutions from 59 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org. ISDA is listed on the EU Register of Interest Representatives, registration number: 46643241096-93.

[3] Please note that Lloyds Banking Group has submitted a separate response to the Commission which differs in some respects from the views expressed in this document.

undertaken into the causes of the financial crisis and we are in broad agreement with its findings.

In particular we concur with the HLEG that it was poor risk management and funding policies, rather than business models, which lay at the heart of the crisis.

Nevertheless, we are concerned about many of the HLEG's suggestions and their potentially negative impact on the ability of the industry to play its full part in supporting the European economy's return to growth.

We believe that the HLEG's proposals to separate most significant securities trading activities into separately capitalised entities sits oddly with the Group's findings on business models. Our principal concern is that if implemented, these would place at serious risk the ability of the capital markets to assist in meeting European financing needs at a time of net negative bank lending. The proposals would also inevitably reduce the diversification of firms and would likely result in the withdrawal of some firms from certain capital markets activities and thereby increase structural fragility, harming the development of the single market and reducing competition.

We also have considerable reservations over both the proposed designation of specific bail-in instruments and proposed restrictions on who may invest in them. These risk undermining the scope of liabilities it is anticipated bail-in will apply to under the Bank Recovery and Resolution Directive, while at the same time decreasing the marketability of such instruments and dramatically increasing their costs.

The HLEG has also made a number of proposals to improve corporate governance and remuneration. The industry is very supportive of the Group's objective of ensuring that remuneration schemes encourage long-term sustainable performance. Indeed, following CRD III, much progress has already been made by the industry in this direction. In this context we are concerned that the proposals might lead to unintended consequences by introducing fragility into the European banking system through encouraging the growth in fixed remuneration (hence making banks vulnerable in the event of a sharp decline in revenues).

We also note with interest the HLEG's proposals to use bail-in bonds to partially fund remuneration. While in theory these could be seen as helpful in encouraging appropriate behaviour, they would play a minimal role in protecting taxpayers in the event of a bank's failure and could even lead to perverse results as employees of failed institutions would hold a continuing stake in them.

Considerable progress has been made in addressing the various risks identified by the HLEG in its report. There has been significant and ongoing improvement to the resilience of banks and the banking system, the benefits from which have still to be fully realised. Further interventions to impose a particular structure on banks' businesses is unwarranted and would militate against the HLEG's stated key objective of ensuring that the banking sector is capable of financing the real economy and of pursuing its other functions that contribute to the prosperity of European citizens and the economy.

We look forward to a thorough impact analysis being undertaken by the Commission into all of the HLEG's proposals and we remain available to provide any further assistance as may be necessary.

Please find our consultation submission enclosed.

Yours sincerely

Simon Lewis

Chief Executive Officer,
The Association for Financial Markets in Europe

George Handjinicolaou

Deputy Chief Executive Officer & Head of ISDA Europe, Middle East & Africa

Cc: Ms Nadia Calviño
Deputy Director General
DG Internal Market and Services
European Commission

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ISDA Safe, Efficient Markets

Consultation response

Recommendations of the High-Level Expert Group on reforming the structure of the EU banking sector

13 November 2012

Contents

1. Executive Summary

AFME and ISDA welcome the opportunity to comment on this important consultation on the recommendations of the High-Level Expert Group on reforming the structure of the EU banking sector ("HLEG").

We agree with the core objectives that underpin the HLEG's work. In particular we support the goals of reducing risk in banks and the banking system, including improving the resolvability of banks, promoting competition and maintaining the integrity of the internal market. We also commend the HLEG for its background analysis into the causes of the financial crisis and we are in broad agreement with its principal findings. In particular we concur with the HLEG that it was poor risk management and funding policies, rather than business models, which lay at the heart of the crisis.

Given the HLEG's failure to establish a clear link between business structures and incurred losses in the financial crisis, we are very concerned that it has nevertheless sought to impose a one-size-fits-all business model on banks with significant trading activities. We refer in particular to its recommendation of mandatory ex-ante structural separation of these activities into separately capitalised subsidiaries. We firmly believe that such an approach is unnecessary to achieve the HLEG's intended objectives which can be best met through the consistent implementation of the very comprehensive regulatory programme that is already underway, as well as through other changes to banks' business models that are demonstrably taking place in response to market forces. Indeed, in our view it would risk undermining HLEG's stated key objective of ensuring that the banking sector is capable of financing the real economy and of pursuing its other functions that contribute to the prosperity of European citizens and the economy.

No attempt has been made by the HLEG to assess the impact of its structural separation recommendations, particularly with regard to its potential systemic and operational consequences. We therefore strongly urge that the Commission conduct a thorough impact assessment to consider the balance of costs and benefits resulting from this recommendation before contemplating any legislative proposal. We are particularly concerned that any required separation would restrict the ability of ring-fenced trading entities to deliver affordable credit and risk management services to European customers, as well as the provision of efficient financial intermediation services to European bank depositors and users of capital markets. The prospect of a reduction in the financing capacity of capital markets represents a grave risk against a background of significant European borrowing needs and negative net bank lending and is in our view a serious threat to European growth and a matter of considerable concern.

Furthermore, the immediate mandatory separation of trading operations is likely to result in the inefficient allocation of capital and liquidity and may also increase the structural fragility of the European banking sector by reducing the diversification benefits resulting from banks' existing business models. To the extent that the proposals also result in national regulators seeking local pools of capital and liquidity for trading entities, the proposals also risk further harming the development of the single market by inhibiting cross-border flows.

The impact of the mandatory separation proposals on returns will cause banks to re-evaluate the economics of continuing with certain business lines and may encourage some of them to cut back on their capital markets activities. At the same time we believe that mandatory separation will create high barriers to entry for potential new entrants. The overall result could be a concentration of market activity amongst the remaining players, potentially limiting competition in European capital markets activities and frustrating one of the HLEG's key objectives.

The HLEG's report notes that some members of the Group supported an alternative approach to the separation of trading activities – a so called Avenue 1 approach – under which separation would be subject to a supervisory evaluation of the credibility of banks' recovery and resolution plans. We recommend that consideration is given by the Commission to this approach on at least an equal footing with mandatory separation under Avenue 2. In particular, we endorse the arguments for Avenue 1 set out in the final paragraph on page 100 of the HLEG's report and specifically the recognition that the ongoing regulatory reform programme will already subject banks to sufficient structural changes and that Avenue 1 would complement these developments and could be introduced without interfering with the basic principles and objectives of those reforms. Similarly, we support the view that against the backdrop of the ongoing financial crisis and the fragility of the financial system, Avenue 1 offers an evolutionary approach that limits the risk of discontinuities to the provision of financial services which we have referred to above.

However, we disagree with some aspects of Avenue 1, including the proposal to require additional capital buffers based on the amount of deposit funding. We believe that the issue of the correct calibration of capital requirements for trading activities is one that should be left exclusively to the Basel Committee of Banking Supervisors ("BCBS") to determine as part of its ongoing trading book review. We also consider that, as a matter of principle, any increase in capital requirements should be determined in relation to levels of risk rather than volumes of deposits which may rise and fall independently of any changes in the level of risk.

Furthermore, it is important to maintain the principle that resolution planning should not drive firm structure. Rather, firm structure should drive resolution planning, with recourse only being had to contingent separation when the firm fails to discharge the burden of proof that its chosen structure can be safely resolved.

The HLEG has made a number of recommendations in addition to those on structural separation. These include its strong support for the use of designated bail-in instruments within the scope of bank recovery and resolution. We do not support a specific bail-in instrument which, amongst other things, could significantly increase the uncertainty of the creditor hierarchy. Rather we support the approach in the Bank Recovery and Resolution Directive of a wide scope of liabilities to which bail-in will apply. We also do not support restrictions on who may invest in any bail-in instruments, which could decrease the marketability and dramatically increase the cost of such instruments.

We are also against the HLEG's proposals for introducing an additional non-risk weighted capital buffer for trading book assets and/or introducing a floor for risk based requirements. This would risk unnecessary duplication of capital requirements and a return to an incoherent approach to capital for trading book assets. We believe that the calibration of trading book capital requirements should be left to the BCBS' trading book review.

We also question the HLEG's suggestion that the Commission should consider further measures regarding the treatment of real estate lending within the capital requirement framework, and specifically the imposition of strict caps on loan-to-value and loan-to-income ratios. The obligation on lenders to ensure the ability of borrowers to repay their property loans is already captured to some extent in the Commission's CRD IV proposals. Any further intervention should be subject to an appropriate impact analysis which would need to consider variations in the characteristics of property markets in different member states, as well as whether such macro-prudential tools should be applied at a European level or left to national supervisors to address in the light of local market conditions.

The HLEG has also made a number of suggestions to improve corporate governance and remuneration policies. We are supportive of the Group's objectives of ensuring that remuneration schemes are proportionate to long-term sustainable performance and note that

the industry has made significant progress towards achieving this goal. However we believe that HLEG's proposals regarding the imposition of specific ratios between variable and fixed pay and absolute caps on pay risks causing unnecessary confusion by introducing a new conflicting approach when the results of earlier legislation in CRD III are still emerging. They also threaten to introduce fragility to the European banking system by encouraging the growth of fixed remuneration and by introducing perverse incentives for executives.

Considerable progress has been made in addressing the risks identified by the HLEG in its report. There have been significant and ongoing improvements in the resilience of banks and the banking system, the benefits from which have still to be fully realised. Further intervention to impose a particular structure on banks' businesses is, however, unwarranted, not justified by the HLEG's own analysis and could have significant negative consequences for the financing of Europe and the restoration of economic growth.

We look forward to a thorough analysis being carried out by the Commission to address the significant number of unknowns about the recommendations and their impact. We remain available to input constructively into that process.

2. Introduction

AFME [1] and ISDA[2] welcome the opportunity to comment[3] on this important consultation on the recommendations of the High-Level Expert Group on reforming the structure of the EU banking sector ("HLEG").

This response focuses largely on the aspects of the HLEG's recommendations relating to structural separation. We begin in Section 3 by providing some context for the HLEG's review. In Section 4 we analyse the HLEG's report, particularly with reference to mandatory separation under Avenue 2. In Section 5 we examine the objectives of structural separation. This is followed by a section (Section 6) that considers the potential impacts of mandatory separation. We comment on the alternative to mandatory separation, Avenue 1, in Section 7 and follow that with recommendations (Section 8) and a listing of issues that we think should be covered in an impact assessment (Section 9).

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We also provide views on recommendations in the HLEG report that do not necessarily relate to structural separation. In Section 10 we provide comments on the Bank Recovery and Resolution Directive and bail-in. In Section 11 we comment on the calibration of RWAs. Finally, in Section 12 we cover the issues in the HLEG report relating to corporate governance and remuneration.

3. Context for the HLEG review

In January of this year, Commissioner Barnier established the HLEG, which is chaired by Erkki Liikanen, the Governor of the Bank of Finland, to examine the need for structural reforms of the EU banking sector and to make any relevant proposals.

The group has been requested to "consider in depth whether there is a need for structural reforms of the EU banking sector or not and to make any relevant proposals as appropriate, with the objective of establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy and the internal market". Differentiation of this group's work with other banking reforms included a focus on Volcker's Rule restrictions, Dodd-Frank size limits and Vickers structural separation of activities.

The mandate also outlined the particular objectives the group should pursue when formulating any recommendation. These were:

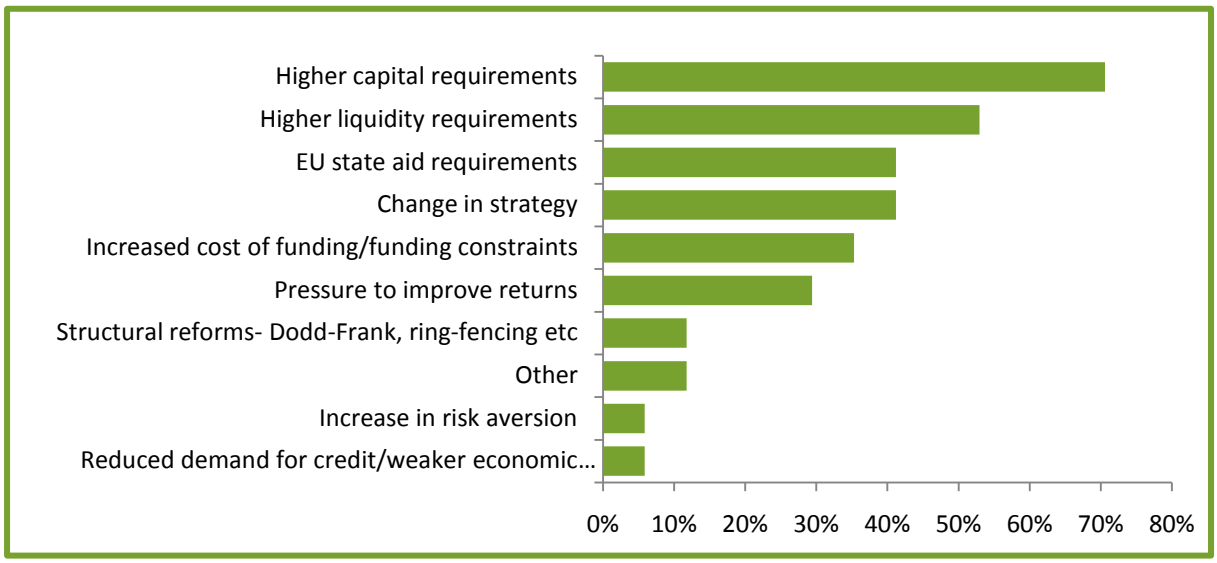
- Reducing the risks of the banking system as a whole;
- Reducing the risks that individual firms pose to the financial system (probability, impact);
- Reducing moral hazard by making market exit a viable option also for largest and most complex institutions and thereby reduce government guarantees;
- Promote competition;
- Maintain the integrity of the internal market.

Whilst we fully support these objectives, we believe that they can be met through the implementation of the very comprehensive regulatory reform programme that is already underway, as well through other changes to banks' business models that are taking place in response to market forces.

This view was reflected in AFME's 1 June response[4] to the HLEG's consultation in which AFME set out objections to any form of structural reform. In particular, AFME noted that structural changes in the industry – driven by regulatory and market factors – are already well underway. This conclusion is shared in Deloitte's recent Bank Survey (2012), which reveals bankers' expectations that reform will be a lengthy process and re-sizing the industry will be achieved through a combination of natural run off, divestment and balance sheet constraint (see Figures I, II and III). Therefore, market driven changes need to be given time to run their course without further intervention in banking structures which is both unnecessary and likely to impair the ability of banks to provide cost effective financing support to their customers and the wider economy.

[4] The response by AFME to the HLEG's consultation can be found at http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=5988.

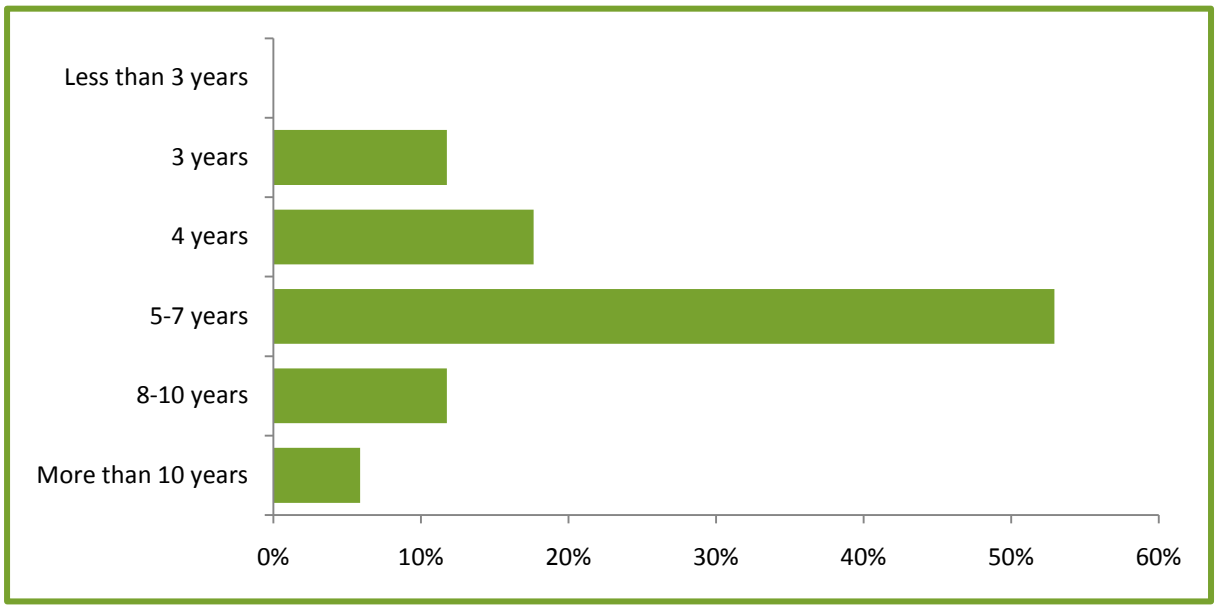
Figure I: Deleveraging drivers



Source: The Deloitte Bank Survey 2012, Deloitte analysis

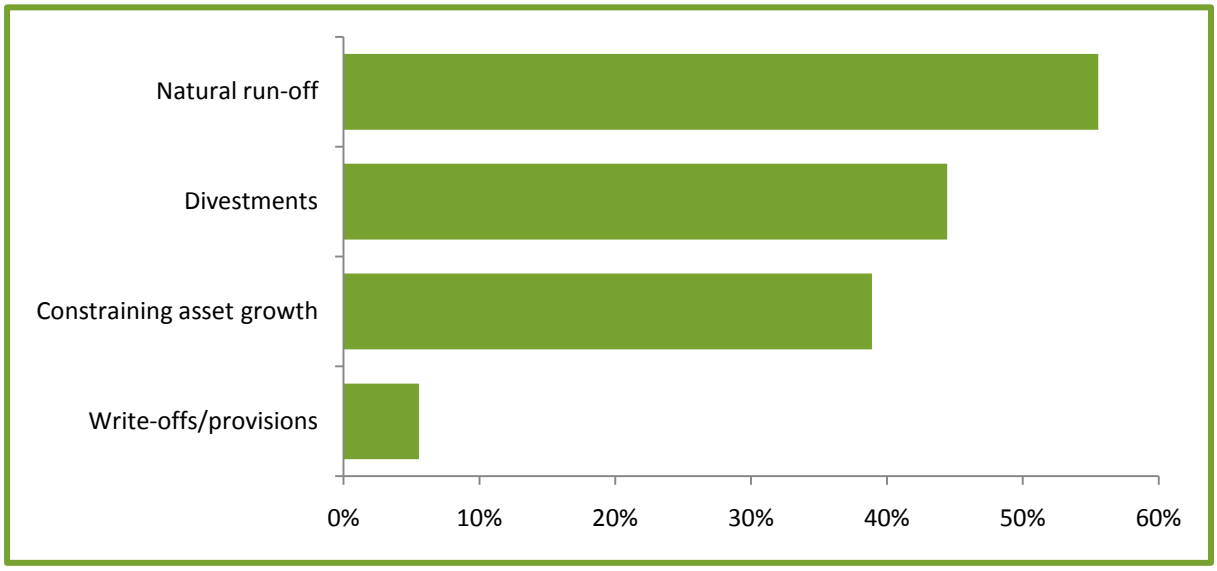
Figure II: Deleveraging timeframe for European banking sector

% of the Deloitte survey respondents who expect the timeframe for European bank deleveraging to be one of the following:



Source: The Deloitte Bank Survey 2012, Deloitte analysis

Figure III: How deleveraging will be achieved



Source: The Deloitte Bank Survey 2012, Deloitte analysis

In its HLEG consultation response, AFME also highlighted the beneficial aspects of diversity in the European banking system in terms of business models and geographical footprints and the risk that this would be undermined by any attempt to introduce one-size-fits-all solutions. AFME further argued that the planned regulatory structural interventions in both the US and the UK offered no precedent for similar action across Europe and in fact suggested the contrary. Finally, AFME noted that any such interventions were likely to have suboptimal outcomes and risk inhibiting further the development of a single market in financial services, exacerbating the threats to the European economy from fragmented, but nationally concentrated markets.

4. Analysis of the HLEG's report

In broad terms we agree with much of the background analysis and findings set out in the HLEG's report, in particular:

- The report's description of the crisis, which identifies many of the key issues with regard to the development of national banking sectors;
- The finding that no particular business model fared particularly well, or poorly, in the financial crisis and that losses were caused by poor risk management and funding policies rather than driven by particular structures;
- The recognition that financial crises can be caused by smaller institutions, if many banks run into problems at the same time due to correlations and interconnectedness;
- The acknowledgement that promoting diversity in bank business models at system level is beneficial;
- The recognition of significant diversity among the larger universal banks, driven by the differences in their customer bases;
- The acceptance that "one-stop-shopping" is valuable to customers;

- The acknowledgement that derivatives are integral risk management tools for large and small non-financial corporate customers; and
- That the key objective is to ensure a banking sector that is capable of financing the real economy and of pursuing its other functions that contribute to the prosperity of EU citizens and the economy.

Despite a thorough analysis of some aspects of the financial crisis and the benefits of diversity in the banking system, the HLEG recommended the mandatory separation of banks' trading and banking activities without establishing clear justifications between its initial assessment of the issues that it was seeking to address and its proposed structural remedy. We believe that there is insufficient evidence linking bank structures and performance during the financial crisis to support the HLEG's recommendation for the mandatory separation of trading activities. Further, mandatory separation would appear to run counter to the HLEG's recognition of the benefits of universal banking, which we believe would be undermined by such a proposal. We note that the HLEG does not make any attempt to assess the impact of its recommendations, particularly with regard to the capacity of ring-fenced trading entities to fund their activities and the ensuing ramifications on the capacity to provide capital markets risk-based services.

The HLEG's separation proposal also appears to be at odds with the criterion of servicing the needs of citizens and the European economy, which is stated in its objectives. We therefore recommend that this is something that the Commission should take account of when it conducts its full impact assessment into the Group's proposals.

In the following sections, we analyse the rationale of the structural restriction proposal, followed by a critique of the rationale for separation and recommendations.

4.1 Proposals for structural separation of trading activities

The HLEG was established to make proposals as appropriate, with the principal objective of establishing a safe, stable and efficient banking system that serves the needs of citizens, the EU economy and the internal market. As part of its determination of whether further regulatory reforms are warranted, the HLEG developed two potential reform avenues relating to separation of trading and deposit taking activities. These avenues are based on three objectives:

- Further limiting the likelihood of banking failures;
- Improving the resolvability of banking institutions; and
- Reducing the likelihood of having to resort to taxpayers' funds in rescuing banks

The HLEG considered two possible structural reform avenues: Avenue 1 which proposes the introduction of a non-risk weighted capital buffer for trading activities and contingent functional separation of significant trading activities; and Avenue 2 which proposes a similar capital buffer but with immediate functional separation of significant trading activities. The HLEG recommended Avenue 2, although it appears from the report that this was a majority rather than a unanimous view. The next section reviews the second avenue.

4.2 Avenue 2 – Overview

We share and support the HLEG's overarching objectives set out above. However we believe that rather than supporting these objectives, the proposals for mandatory separation of significant trading activities militate against them. Ensuring the supply of affordable credit and

risk management services to European consumers, SMEs and corporations, as well as the provision of efficient financial intermediation services to European bank depositors and users of capital markets is of vital importance. Yet we believe that the structural restrictions proposed are likely to reduce the efficiency with which financial services can be provided, something which the HLEG also acknowledges in its report.

The evidence offered in the HLEG's report does not support the theory that mandatory structural separation increases the stability of the financial sector. In particular we are somewhat perplexed that the HLEG, having acknowledged the absence of a clear link between business structure and incurred losses in the financial crisis, then proceeds to suggest the imposition of a particular structure on banks through the mandatory separation of their trading activities. As was pointed out in AFME's June response[5] to the HLEG's consultation, market related activities which the HLEG now wishes to separate accounted for only a minority of the losses that were incurred during the financial crisis.

Implementing an immediate mandatory separation of banks' trading operations may have unintended consequences. It is likely to increase the structural fragility of the European banking sector by reducing the diversification benefits resulting from banks' existing business models and increasing the likelihood of bank failures, contrary to the stated objective. Mandatory separation risks limiting competition in European capital markets activities and harming further the development of the single market by leading national regulators to seek local, 'trapped' pools of capital and funding, thereby inhibiting cross border flows of liquidity and capital. This inhibition of cross border flows has been a significant contributory factor to the prolongation of the financial crisis in Europe.

4.3 Avenue 2 –HLEG's rationale

In this section we critique each element of the HLEG's rationale for Avenue 2 in turn.

First rationale

The Group begins by arguing that separation of (significant trading) activities is the most direct instrument to tackle banks' complexity and interconnectedness. It also suggests that incentives for risk-taking in the trading arm would be reduced as the latter would not be able to profit from liquidity, funding and solvency support from other parts of the group.

On the general point of support, we observe that the Commission's proposal for a Bank Recovery and Resolution Directive anticipates the possibility that a bank may wish to provide support to a failing part of its operation in order to facilitate its recovery. It is therefore highly unlikely that Avenue 2 could be, or indeed should be, used to prevent such support from being offered provided that this did not compromise the viability of the Group providing that support. Indeed, the non-availability of such support might well run counter to a key task of the HLEG: reducing the risks that firms pose to the financial system.

With regard to the risks that stem from complexity (and other perceived systemic risks), this is already being directly addressed through requirements that globally systemically important banks (G-SIBs) and domestically systemically important banks hold a separate capital buffer against this risk. Some 40% of the weighting within the proposed scorecard determining the level of extra capital required by G-SIBs is allocated to interconnectedness and complexity, with the value of OTC derivatives, level 3 assets, trading book and available for sale values all

[5] The response by AFME to the HLEG's consultation can be found at http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=5988.

contributing to the calculation of complexity. Requiring mandatory separation of trading activities and their separate capitalisation would therefore lead to potential double counting of capital requirements, especially now that the FSB has recently proposed specific equity capital buffers for all G-SIBs.

As noted above, the HLEG also argues that risk-taking would be reduced as a result of separation. Considering the low proportion of bank losses due to proprietary trading during the crisis (4% - Tricumen, 2012), it is arguable whether such a restriction will achieve any incremental benefits in terms of the stability of the financial sector. On the other hand, the vast majority of risk assumed by banks is on behalf of their customers. This may take the form of hedging activities either directly with customers or through laying off customer risk via credit default swaps or through transactions with other banks.

Banks may also assume risk through the provision of secondary market-making activities in debt or equity instruments. These customer activities fulfil a real need and would have to be satisfied either through the separated trading entity or some other entity which may not be as closely regulated. Similarly there is a risk, recognised by the HLEG, that enforcing mandatory separation on trading entities could increase their funding and capital costs. Particularly in the current circumstances where banks face significant funding pressures and downwards ROE pressure, these increased costs are likely to be passed on, at least in part, to banks' customers and therefore could potentially act as a disincentive to prudent behaviour by discouraging hedging activities and reducing banks' liquidity facilitation – thereby resulting in an increase in risk and suppressing economic activity. As discussed below, mandatory separation may damage the economics of certain activities to a point where some banks may be no longer willing to provide them, leading to a reduction in financing capacity, potential market concentration and a reduction in competition, all of which is likely to adversely impact a European economic recovery.

While we fully accept that trading activities should be prudently funded and capitalised, this does not require that they be housed in a separate legal entity. It is important to recognise that trading entities are not to a material extent, or in general, funded by insured deposits as we postulate that this may be one of the HLEG's reasons behind suggesting mandatory separation of these activities. In the majority of European Member States banks have a ratio of customer deposits to customer loans of less than one. Put simply, this means that they have no excess deposits over and above those needed to fund customer lending, so trading activities are much more likely to be funded through the wholesale and secured borrowing markets.

Nor do we believe that the prospect of banks receiving solvency support from other parts of a group is something that can be used to justify the mandatory separation of trading activities. As the HLEG notes, the capital requirements for trading activities are currently being considered as part of the BCBS's fundamental review of the trading book. The review has still to be completed but it is already known that market risk-weighted assets will increase substantially next year. Furthermore, the HLEG acknowledges that there is a risk of overlap between its proposals for an additional capital buffer and those being considered by the BCBS, which is best placed to calibrate accurately the appropriate amount of capital required for trading activities. The important point is that the total amount of capital in a banking group should be sufficient to protect against all categories of risk wherever they are located and regardless of the structure through which activities are undertaken and risks assumed.

Second rationale

The HLEG's second rationale for Avenue 2 is that separation should in principle make recovery and resolution more feasible. We agree that all banks should be resolvable without recourse to taxpayers. At the global level the FSB has recently reported that good overall progress is being

made in reforming national resolution regimes and advancing recovery and resolution planning for G-SIBs. In Europe the issue of resolvability is already being considered in the Commission's proposals for a Bank Recovery and Resolution Directive (RRD). The RRD requires that banks be resolvable under their resolution plans. It also confers powers on authorities to require banks to amend their legal or operational structures should this be necessary to achieve resolvability. We therefore believe that rather than seeking to impose the same structural arrangements on all banks regardless of existing business models, it should be left to the judgment of the management who have intimate knowledge of their banks to determine how best to structure their groups – with the authorities having the capacity to demand structural changes in those cases where banks' managements, having been given the opportunity to do so, have failed to demonstrate the resolvability of their institutions. We would be concerned with any move by policymakers away from a regulatory regime focused on risk. Finally, the ex-ante separation of trading activities could, by artificially separating activities which are carried out alongside each other, lead to a less favourable outcome for creditors by lowering the value of a bank's franchise in the event that it had to subsequently be resolved.

Third rationale

The HLEG's third rationale for Avenue 2 is that it would make it easier for management and boards to understand and manage their operations and for outsiders to monitor and supervise them, leading to enhanced effectiveness of market discipline and financial supervision. We contest these assertions. The ability of management and the market to understand certain activities should be independent of the legal structure through which those activities are undertaken. Regulators should presume (in the absence of evidence to the contrary) that management decisions are in principle the most effective means of running a business and that banks' managements organise the activities of their institutions in a manner which makes the most sense to them.

The artificial separation of activities into separate legal entities could therefore have the opposite effect to that suggested by the HLEG, by preventing management and external parties from seeing the overall picture in terms of strategy, risk and return from businesses which inter-relate with each other and which have historically been considered alongside one another. In short, it could confuse rather than clarify. Banks' operating structures are not static and periodic re-organisations already take place and are doing so at an accelerated pace in response to regulatory developments.

It is also noteworthy that considerable public and private information is already disclosed by banks with regard to their trading operations and were owners or supervisors to consider this to be inadequate, either for their own purposes or for market transparency reasons, then both can (and do) ask for more. There is no reason why the provision of information on activities needs to be governed by the legal structure through which those activities are undertaken.

Furthermore, with regard to market discipline, while it is acknowledged that the willingness of counterparties to transact on the same terms with a separated trading entity might be different from a trading business that was part of an overall Group; this is a function of a perceived level of support on offer to the trading activities from the Group and not the result of the legal form through which these activities are carried out. Market discipline could equally apply without any separation.

Fourth rationale

The HLEG has also argued that separation would enable further control of the activities of each functional entity and could amongst other things be used to prohibit certain risky activities,

especially in deposit banks which enjoy explicit government guarantees. Structural separation is not, however, necessary in order for supervisors to impose additional controls on risky activities as these powers of direction already exist, for example under Pillar 2 arrangements. Linking the capacity of supervisors to control risky activities to the legal entity through which activities are undertaken is, in our view, misconceived. Moreover, given that the whole thrust of the Bank Recovery and Resolution Directive is to remove the moral hazard of implicit government guarantee, it is inappropriate to use this historic phenomenon as a justification for separation.

Fifth rationale

The HLEG also suggests that separating commercial banking and trading could reduce the mixing of the two different management cultures. Given that even under the HLEG's proposals both the trading and deposit taking entity would share common ownership under a holding company structure, it is likely that the senior management with overall responsibility for both operations would sit on the same Board. Even if there were to be structural separation into separate legal entities the management of both could share the same premises and even work physically alongside each other.

Perhaps more significantly, the implicit presumption behind the HLEG's argument that the mixing of the two cultures is somehow bad and to be avoided is also open to challenge. There could be benefits of mixing cultures, with a deposit bank benefitting from a market-risks culture that would be stronger in a trading operation. The financial crisis has shown, and the HLEG has itself recognised, that inappropriate risk taking was a root cause of banks' problems. This was not, however, something that was specific to one type of activity as opposed to another or indeed to one type of structure over another. Moreover, many of the initiatives now in train are aimed at moderating what was perceived to be the more risky culture in trading businesses and it would not be fair to assume that the culture in such businesses will necessarily be more aggressive or risky in future than that in other banking activities.

Sixth rationale

The HLEG concludes that functional separation as proposed under Avenue 2 can take place within a universal banking model and suggests that the impact on potential efficiencies resulting from diverse service provision would be more limited. We disagree with this argument; forced separation of activities into separately capitalised entities under a common holding company could still give rise to considerable diseconomies. In its analysis of the HLEG's report Oliver Wyman (2012) identifies three broad areas of impact: funding and capital, operational and commercial. It suggests that funding and capital costs for a standalone trading entity will be materially higher than before separation due to lower leverage required to maintain an acceptable rating and higher cost of funds and capital. The precise impact will depend amongst other things on the required level of capitalisation for the trading entity, how this varies from the capital allocation that would in any event have been required under BCBS proposals, the ability of the trading entity to raise funds from its parent and on what terms, and the proportion of its funding from secured external sources.

There are also likely to be material separation costs and an increased cost base to contend with, a reduced ability to leverage shared infrastructure and the cost of new IT front and back office and risk systems. There may also be material costs resulting from the need to novate legal agreements, which in itself could be a time consuming and complex operation. Separation would inevitably result in restrictions to services provided to clients and the potential loss of clients to other entities that are not similarly impacted, with negative consequences for profitability.

5. HLEG's structural separation objectives

As well as questioning the rationale that is used to support the HLEG's recommendation for the immediate functional separation of significant trading activities we further question the extent to which such proposals meets its own objectives.

Following its rationale for Avenue 2, the HLEG proposes five key objectives, related to financial stability, in support of mandatory structural separation. These are to:

- Limit a banking group's incentives and ability to take excessive risks with insured deposits;
- Prevent the coverage of losses incurred in the trading entity by the funds of the deposit bank, and hence limit the liability of taxpayer and the deposit insurance system;
- Avoid the excessive allocation of lending from the deposit bank to other financial activities, to the detriment of the non-financial sectors of the economy;
- Reduce the interconnectedness between banks and the shadow banking system, which has been a source of contagion in a system-wide banking crisis; and
- Level the playing field in investment banking activities between banking groups and stand-alone investment banks, as it would improve the risk sensitivity of the funding cost of trading operations by limiting the market expectations of public protection of such activities.

We agree with the HLEG's objective of removing the implicit subsidy of taxpayer-funded bail-outs. However, we believe that there are other means to achieve this through a combination of existing and planned regulation, as we describe throughout this paper. Furthermore, we believe that the objectives are ill-conceived and that some of them contradict the wider analysis in the final report and conflict with the main objectives of the HLEG.

First, we agree with the HLEG's analysis in its report, which does not support the view that excessive risk taking occurred mainly in investment bank entities. Rather most risks with insured deposits were taken in deposit banks. We also agree with the HLEG's conclusion (p. 32 of the report) that "simple labels such as 'retail bank' or 'investment bank' do not adequately describe the business model of a bank and its performance and riskiness". As already explained above, the notion that insured deposits are somehow directly funding trading activities is a false one as in most EU Member States banks do not have any excess deposits over and above those needed to fund their customer lending activities. Therefore insured deposits are much less likely to be deployed or put at risk in funding trading activities. This first objective is therefore unlikely to be satisfied by mandatory separation of trading activities. Seeking to impose an unnecessary one-size-fits-all approach to separating trading activities is unlikely to increase systemic stability nor safeguard insured deposits.

Regarding the second objective it is not entirely clear what is meant by "the funds of the deposit bank". As explained immediately above any funds on-lent by the deposit bank to support trading activities would almost certainly be drawn from the wholesale market rather than sourced from insured deposits. If the concern is a broader one of providing liquidity and capital support from the deposit bank to the trading activities, then the key issue is ensuring that there is adequate capital and liquidity within a group to support all risks regardless of the legal structures within

which they are carried. This is part of the risk control processes which are the responsibility of management and should be overseen by supervisors who could impose additional capital and other requirements in the event of need. Furthermore the risk of losses falling on taxpayers is already being addressed by the requirement to put in place effective recovery and resolution arrangements where good progress is being made by the largest banks. As a result we believe that the second objective can be better addressed through arrangements other than enforced separation, the costs of which are likely to heavily outweigh any benefits.

The third objective of preventing excessive lending from the deposit bank to other financial activities to the detriment of the non-financial sector of the economy appears to presume, but produces no evidence, that this is an issue. It also appears to imply that trading activities do not benefit the non-financial sectors of the economy. Yet the vast majority of trading activity is ultimately undertaken on behalf of the non-financial concerns; helping them to raise capital, providing liquidity in their equity or debt, hedging their commercial risks and so on. Enforced structural separation of trading activities is therefore likely to have the exact opposite effect to that intended by reducing capital and liquidity allocated to these activities, making them more expensive or even uneconomic for banks, and damaging their ability to perform these vital roles on behalf of their customers. Beyond this it would risk reducing the diversity of business models and thereby increasing systemic fragility.

With regard to the fourth objective of reducing interconnectedness between the bank and shadow banking sectors, we note that work to address the risks associated with such connectivity is already underway. The BCBS will launch a consultation shortly on the interconnectedness between banks and the shadow banking system. This is also a key focus area on the European regulatory agenda, which in our view limits the need to address the same issue via structural separation. In addition it is also worth noting that the current regulatory work on centralising derivatives trades to clearing houses and margin requirements on non cleared OTC trades, will both reduce the interconnectedness and counterparty risks that were prevalent during the financial crisis.

One of the consequences of forcing the mandatory separation of trading activities is that some of these activities may no longer be viable for certain banks. Some of these activities may be taken on by other banks or perhaps by non-bank entities. In the case of the latter this would potentially increase the proportion of capital markets business conducted outside the mainstream banking sector. Were this to be the case it could conceivably reduce the level of direct activity between banks and non banks. Overall systemic risk would not of course be altered but some risks may become less visible, harder to measure and regulate. If this were to occur it could result in precisely the negative consequences that the HLEG is seeking to avoid with this objective.

The HLEG's final objective appears to be directed at trying to achieve a level playing field for all trading activities. Our presumption is that its objective is to increase competition by enforcing a structure on universal banks to make sure that they compete for funds and capital as well as other resources required by their trading businesses on the same basis as standalone investment banks. Leaving aside the lack of clarity around important issues such as parent guarantees and intra group funding, this is a challenging ambition given the many factors that determine competitive positioning. The HLEG has not produced any evidence to suggest that the current market structure leads to uncompetitive markets or behaviours or indeed that its attempt to engineer structural change would result in a better outcome.

6. Impact of mandatory separation

In this section we set out the potential impacts that we believe may follow from any decision to implement mandatory separation.

The scale of funding provided to European issuers through the facilitation of investment banks and potentially effected by mandatory separation is significant. In 2011 European governments issued €1.1tn of debt. Supranationals issued €185bn of debt and corporate debt issued (including bank debt) was €790bn. Covered bonds and securitisations placed with investors topped €397bn and €88bn respectively (Dealogic, AFME). In terms of equities, €123bn of European IPOs and secondary offerings were underwritten. These issuers including sovereigns typically expect, as a condition of being able to underwrite or bid for securities at auction, that the dealer bank provides some type of ongoing secondary liquidity in their new issue.

6.1 Implications for the viability of market making businesses

We are concerned that restrictions placed on the ring-fenced trading activity in terms of reduced funding flexibility, reduced counterparty capacity, increased capital usage and increased operational complexity may discourage participants from entering and staying in this important liquidity-providing business. Separating banks' trading from non-trading activities is, we believe, likely to have significant negative consequences by way of increased costs for corporate customers and investors, who are the clients of the trading businesses.

In order to fully understand the potential funding issues for segregated trading businesses, AFME canvassed the opinions of experts in assessing counterparty creditworthiness and investors. The key questions they asked about the HLEG's recommendations are set out below:

- Will the ring-fenced entity (RFE) have access to central bank liquidity?
- Can the RFE achieve a sufficiently high credit standing whether through a rating or otherwise, to be able to borrow from third parties on an economically viable basis?
- Will the business mix of the RFE be sufficiently diverse to convince external funders that the business model is sustainable on its own?
- Is there a risk that ring-fencing trading activities will lead to greater rating differentials between different legal entities in the same group and potentially damage the Group rating due to diminished diversification benefits and the risk of trapped resources at subsidiary level?
- Might structural separation reduce the willingness of counterparties to deal with the trading entity and/or its parent group or demand more collateral for doing so?
- Will the parent group be able to provide unlimited financial support, even if parent guarantees are not contractually permitted?
- Will non-RFE affiliates of the same group be able to provide funding on any basis, and if so, on what commercial terms?
- Will the RFE be subject to large exposure limits with affiliates and if so, will the remaining entity be sufficiently strong from a credit standpoint to attract mainly third-party counterparties?
- How much would secondary market spreads increase for corporate and investors, if banks are no longer able to cross-subsidise fees earned in markets business to services in non-RFE businesses such as lending?

- Will the amount of additional capital required, given the restrictions of business, result in a projected ROE which is so low as not to be commercially viable?
- Will the RFE have sufficient collateral to meet various funding, swap and clearing obligations?; and
- Whether there is a risk that the costs of providing certain services in the EU will be such that they will be provided from other jurisdictions?

The experts and investors were of the view that if the answers to the above questions indicate that the projected ROE of a particular stand-alone RFE is not viable, those trading businesses are likely to shrink or be abandoned in favour of those capital markets businesses which are not ring-fenced. Remaining trading businesses are likely to be sized to a niche level, which is unlikely to be able to service the needs of government issuers, large, mid-size and SME corporate, as well as banks that need wholesale funding. Moreover, if existing firms shrink or exit their trading businesses the viability of remaining capital markets businesses may be threatened, since the flow of new issue mandates from governments, corporates and others is highly dependent on firms' ability to provide post-issuance secondary market making activity to ensure liquidity in their shares or bonds. Where some banks withdraw from certain activities some of these activities may migrate to other less or non-regulated providers who are not governed by the same set of controls, leading to potential regulatory arbitrage and increased risks resulting from less supervisory oversight.

Some market making activities may, however, remain viable as the mandatory separation of trading activities could lead to a concentration of market making activities in Europe in fewer larger institutions. Such institutions are likely to be either those that are able to fund themselves on a standalone basis or are able to be supported by their parent companies. This concentration would, however, do little to address overall financing capacity as, other things being equal, while there may be some market share gains, funding costs would still increase overall due to some firms being unable to rely on group support. Capital employed is also unlikely to increase especially if, as seems likely, the HLEG's requirements reduce returns through higher funding and other costs forcing firms to reallocate resources to more profitable opportunities. The net result is therefore likely to be a reduction in overall funding capacity.

In summary, the HLEG's recommendation to mandatorily separate banks' trading activities is likely to lead to major changes to the structure of European capital markets. In effect it could establish substantial barriers to entry, force the withdrawal of smaller and mid-sized providers and restrict the ability of Europe's universal banks to develop their business models. There could potentially be some leakage to less well regulated non-bank players while the remaining market would become more concentrated which is likely to create competitive distortions and be unhelpful for systemic stability and the Single Market.

6.2 Implications for the EU economy of the mandatory separation

We believe that the HLEG's proposal for the mandatory separation of trading activities would negatively impact on the ability to finance the European economy and lead to inefficiencies in the allocation of capital and liquidity. By reducing bank diversity and increasing market concentration the proposals could heighten fragility and reduce competition in the European banking sector.

The prospect of a reduction in the financing capacity of capital markets comes against a background of significant borrowing needs. According to the estimates of Standard and Poor's (S&P) Europe has new financing needs of $US1.9-$2.3tr by the end of 2016, equivalent to around 75% of EU GDP. S&P also estimate that Europe has a projected annual funding gap of $US210-260bn. With bank lending in Europe having collapsed over the last five years from

€685bn to a net repayment of €33bn in September 2012 according to the ECB, partly as a result of regulatory pressures forcing the industry in aggregate to shrink balance sheets, this financing gap will have to be met very largely from the capital markets. This would seem to be highly challenging given that the required amount of new issuance is more than double the annual historical issuance volume of circa $US100bn. Taken together with the negative impact on primary and secondary market trading activity resulting from the mandatory separation of trading activities, the HLEG's proposals may lead to a reduction in European economic growth.

7. Avenue 1 analysis: An alternative to mandatory separation

Considering the HLEG's acknowledged problems with (Avenue 2) mandatory separation and the concerns we have highlighted, we believe it is worth investigating the HLEG's other avenue. It is noted in the HLEG's report that members of the group supported 'Avenue 1', or in other words, conditional structural restrictions, subject to supervisory review.

The restrictions would be based on two key elements:

- Non-risk weighted capital requirement for trading activities on top of the risk weighted Basel requirements
- Separation of trading activities subject to a supervisory evaluation of the credibility of the recovery and resolution plans

We are in favour of a regulatory framework that encourages competition and diversity and believe that intervention from authorities to require structural changes should be limited to cases where there are clear and obvious concerns to be addressed. Furthermore, this avenue, while protecting the financial system from particularly risky business models, allows for a natural evolution of the European banking sector to take place and complements other regulatory reforms that will address the same systemic issues as the HLEG's structural reform, such as the RRD, BCBS Fundamental Review of the Trading Book, G-SIB/D-SIB buffers, Shadow Banking and CCP and OTC Margin work streams. These regulatory agendas all combined will significantly reduce the risks in the trading books and the systemic risk in the financial sector as a whole, thus limiting the benefits from ex ante mandatory restrictions. This avenue also avoids having to establish a trigger point when the evolution of a bank takes it either above or below the mandatory separation level.

However, we disagree with the proposal to require additional capital buffers based on the amount of deposit funding. The HLEG has recognised the possibility of regulatory overlap in setting additional capital levels with the ongoing trading book review being undertaken by the BCBS and as a result suggests taking account of this work in calibrating the size of the additional capital buffer. The rationale offered by the Group for the imposition of an additional volume based capital requirement is that it would address the problems of excessive risk taking incentives and high leverage in trading activities and the risks of systemic risk due to excessive interconnectedness between banks. We believe that the BCBS is best placed to determine the appropriate amount of capital required for trading activity. This together with the additional capital buffers imposed on G-SIBs, an element of which specifically addresses complexity issues, and the possibility of applying additional Pillar 2 requirements should be sufficient to address the concerns expressed by the HLEG.

Even were this not to be the case we fundamentally disagree with linking any additional capital which may be required as the business expands to an increase in deposits. Increasing capital should be linked with increasing risk and not deposit growth, which has no relationship to risk.

Risks can rise or fall at the same time as the volume of deposits falls and rises depending on the nature of the business being written. For example, a bank making markets in G7 Government debt may well be assuming a lower level of risk than one trading in a lower volume of high yield debt.

It is unclear whether the HLEG is concerned about the increased risk to insured deposits within a group with a growing trading entity operating alongside a banking business. Yet even if this is the case it is very unlikely for reasons already given that the trading entity will be funded by insured deposits. Growth in the trading entity will therefore have no impact on the risk faced by insured depositors, while any overall increase in risk will automatically be reflected in capital requirements without the need for an additional volume based measure.

With regard to the second element of the Avenue 1 proposals; the contingent functional separation of trading activities, we believe that firm structure is best determined by boards and management and that resolution plans should be designed to ensure a firm is resolvable given that structure. The Bank Recovery and Resolution Directive (RRD) includes the power for resolution authorities, in conjunction with competent authorities, to reduce or remove any substantive impediments to resolvability. We believe that the measures taken under those powers should be reasonable, directly correlated to the impediment and take into account the desirability of maintaining the franchise value of the institution. This last point should minimise the impact on an institution's ongoing operations, which is especially relevant where there are alternative ways of addressing any impediment. Institutions should have rights of appeal and review, including judicial review, for decisions made by authorities. Such a right of appeal will encourage authorities to engage in an informed bilateral discussion prior to imposing any measures to address resolvability. This approach to resolution planning will ensure that depositors are appropriately protected and that an institution can be resolved without recourse to a bail-out or causing systemic instability.

The assessment by authorities of resolution plans should focus on resolvability, rather than necessarily jumping to the question of whether separation is required. In the particular circumstances of the legal and operating structure of an institution and its resolution it should not be necessary to segregate retail and trading activities. Rather, in developing RRPs institutions and authorities should consider the particular circumstances of each institution and ensure that the plans are appropriately tailored to ensure resolvability, considering both cost and complexity on a bank-by-bank basis. A tailored, iterative approach will take into account the subtleties of each jurisdiction and organisation to ensure the solution is appropriate for the circumstances. We recommend that this tailored, iterative approach be embraced and implemented.

8. Recommendations

This section contains recommendations based on our analysis of the two avenues.

As evidenced above, we believe that the HLEG's main structural proposal is flawed. It may have material unintended consequences that contradict the EU treaty rules of promoting diversity and is detrimental to the Single Market. Further to our analysis of the impacts of the proposed restrictions on capital markets and the inefficiencies that trapping capital and liquidity into smaller pockets will have, we believe that the proposal also fails to reduce systemic risks in the European banking sector. Despite some concerns about Avenue 1 we believe that consideration should be given to whether its broad thrust would be less damaging to the real economy than Avenue 2. We have highlighted the key issues in the two avenues in the table in Appendix Two.

As outlined in Section 7 above there are aspects of Avenue 1 with which we do not agree.

Based on analysis of both of the avenues in the report, we recommend consideration is given by the Commission to the Avenue 1 approach (without the additional capital buffers for deposit funding, due to the reasons described in the section on analysis of Avenue 1) on at least an equal footing with Avenue 2. Splitting up universal banks into separately capitalised entities, operating at arm's-length and without cross-group guarantees necessarily involves eliminating natural hedges, increasing risk and volatility. Consequently, a small issue in one of the entities (in the deposit bank or trading entity) may be magnified by the restrictions on funding and capital allocation that trap excess resources which cannot be transferred to cut exposures or mitigate losses. Banks' constrained ability to tackle issues at the source may lead to full blown reputational damage across the group that can have far reaching consequences.

Restricting funding flows and banks' ability to utilise their relationships across the lines of business is likely to increase pro-cyclicality in the system. We also note that although the analysis in the HLEG report does not support the view that market-making and proprietary trading are especially risky activities, the HLEG's recommendations depend on an unsupported assumption that certain activities carry higher risk than others. On the contrary, we believe that banks that provide a range of through the cycle relationship-based services are ideally placed to provide a full range of products and services to European exporters and therefore make a vital contribution to the economic recovery.

Although we do not support the mandatory separation of trading activities we accept that the Commission may still want to identify banks with significant trading operations in Europe. In this respect it will be imperative to ensure that any calibration exercise requires national supervisors to apply a consistent and transparent methodology. This should take account not only of the size of trading assets and the volume of trading business but also the nature of that business and its relative volatility. It should be risk adjusted, acknowledge collateralisation and net rather than gross exposures and be calibrated against the size of a bank's capital base and not just its gross balance sheet or gross revenues.

9. Considerations for the Commission's impact assessment

In this section we provide views on the scope of an impact assessment of the recommendations, as well as pivotal questions that the Commission might like to consider.

It is clear that any structural reform would require a consideration of the complex trade-offs involved. In this respect it will be imperative that the Commission conducts a thorough impact analysis to identify the balance of costs and benefits before any legislative proposal. Given the existing very extensive regulatory reform programme, the burden of proof that further interventions would, despite their negative economic consequences, be justifiable on the grounds of increased safety and stability of the banking system is particularly high.

In this section we list the potential systemic and operational impacts of the proposed structural separation that we believe it would be helpful to examine as part of the impact assessment. We also provide a short example in Appendix One of the consequences in a market-making context to demonstrate the type of consequences that the impact assessment would have to consider.

9.1 Systemic considerations

We propose that the impact assessment should include careful analysis of the incremental reductions in, for example, system-wide probability of default (PD) and loss given default (LGD). These need to be carefully weighed against any long-term reductions in the efficiency of the financial markets, any additional risks created in the system or decreases in competition as the result of structural regulation. The economic externalities of such restrictions that could inhibit economic growth in the EU should also be considered.

In addition to the systemic impact assessment described above, there are other key considerations that should be taken into account in designing the impact assessment. These include:

- The effect of structural changes on the competitive landscape in the European capital markets, including whether they would introduce barriers to entry or create a market characterised only by a large institution oligopoly and niche players;
- The effect on the Single Market;
- Whether the proposals harm European banks' ability to provide services and whether those services will be provided by firms from other jurisdictions and in other markets;
- In light of the recent problems with the deposit bank sector (e.g. Cajas), whether the proposal makes the deposit banks safer;
- The potentially negative impact of the proposals on the availability and pricing of funding necessary to support capital market growth. Review of key areas that could be undermined if structural and funding flexibilities are reduced;
- Whether separation of trading businesses will reduce the number of suitably rated counterparties, and if so whether there will be a material reduction in market liquidity;
- The geographical scope of the structural restriction:
    - If applied globally, whether there could be problems with single presence rules as well as extra-territoriality rules,
    - If applied on a national level, the affect of liquidity and capital being trapped in even smaller pockets;
- The potential systemic implications of arms-length inter-entity transactions and the large exposure regime, including:
    - Potential costs in terms of funding efficiency, end-user pricing and impact on savings returns and investment,
    - Any reduction in trading entities' ability to support European issuances and to provide private equity,
    - Any impact on the wider European economy,
    - Any systemic risk implications as a consequence of the banking systems' increased reliance on wholesale funding due to limited flexibility in allocating funding and capital across the group.

9.2 Operational considerations

There are also a number of operational issues that might be considered as they could have a material impact on the costs of the regime, listed below:

- The interaction with existing or proposed national level structural restrictions (for example, the Vickers recommendations in the UK), including whether the proposals are compatible and whether they would result in a double ring-fence;
- The viability of existing trading entities, including the magnitude of the shift from the current operating models. Whether we will observe a move to large trading entities covering most activities and small deposit banks for guaranteed deposits and retail payments systems or vice versa, depending on the bank specific business model;
- Whether holders of existing bank debt would be affected, including whether bonds would need to be partially novated to the new trading entity and whether this would be feasible. Alternatively, if the existing bonds aren't novated, whether it is feasible for the 'old' entity to retire/repurchase/call outstanding bonds and reissue new ones;
- The effect on the hedging of bank default risk in the CDS market, as existing contracts do not capture the correct legal entity exposures;
- Whether existing contracts between a bank's trading businesses would need to be moved to a different legal entity, and if so, whether this legally feasible and whether it give rise to tax problems for corporates and investors;
- Whether the need to transfer master agreements and other contracts between or to trading entities could disrupt the markets;
- Implications for clearing and settlement;
- The gross costs of separation, for example in terms of the duplication of back office, risk functions and systems;
- The effect on the provision of client services where the customer relationship (for non-bank customers at least) remains with the parent and is back-to-backed with the trading entity. Such an arrangement would probably result in a double-counting of counterparty-risk RWAs as the internal transaction could not be netted in the absence of a consolidated capital account;
- Whether it would be the trading entity or deposit bank that would face CCPs and hold CVA, margin and contract with the CCP.

The territorial scope of the recommendations is unclear and could also have significant implications for the overall impact. The extent to which proposals would apply to affected banks globally, or just their European operations needs to be clarified. There is also an absence of any explanation around how the branches and subsidiaries of third country institutions would be treated. The impact assessment could consider the various permutations for issues around territoriality.

The interaction with the scope of the DGS Directive is also a potentially important factor. The DGS Directive could widen the scope of insured deposits and change the shape and scope of the ring-fence. Such a change could impact much of the analysis and conclusions for the HLEG's report.

10. Recovery and resolution

10.1 Additional separation of activities conditional on the RRP

We strongly support the Bank Recovery and Resolution Directive (RRD) as a crucial step in addressing too-big-to-fail and eliminating moral hazard. We agree with the HLEG's emphasis on the need for institutions to draw up and maintain effective and realistic Recovery and Resolution Plans (RRPs) and we also believe that there is a need for resolution authorities, in consultation with banks, to develop a top-down resolution strategy to complement the bottom-up resolution analysis contained in RRPs.

However, we believe that the assessment by authorities of resolution plans should focus on resolvability, rather than focusing on separation as suggested by the HLEG. In the particular circumstances of the legal and operating structure of an institution and its resolution, it should not be necessary to segregate retail and trading activities. Rather, in developing RRPs institutions and authorities should consider the particular circumstances of each institution and ensure that the plans are appropriately tailored to ensure resolvability, considering both cost and complexity on a bank-by-bank basis. A tailored, iterative approach will take into account the subtleties of each jurisdiction and organisation to ensure the solution is appropriate for the circumstances. We recommend that this tailored, iterative approach be embraced and implemented.

We welcome the HLEG's support of the role of the EBA in the RRD, ensuring that RRPs and the integral resolvability assessments are applied uniformly across member States. However, we also note that the EBA would not have legal jurisdiction over third countries so there is still work to be done to address home-host country cooperation on resolution proceedings.

10.2 Possible amendments to the use of bail-in instruments as a resolution tool

AFME has been a consistent and early supporter of bail-in as a resolution tool. However, we do not agree with the suggestion of the HLEG that bail-in should be applied only to a specific class of instruments, which is effectively a new capital requirement, and we believe that all of the arguments given by the HLEG in favour of its proposal can also be used to support a broad application of bail-in to senior liabilities.

We believe that bail-in should apply to existing debt and cover a wide class of unsecured liabilities to ensure greater loss absorbency and improve investor incentives. The specific class of bail-in instruments proposed by the HLEG implies that senior creditors of a bank outside of the specific bail-in instruments are remote from suffering losses on their investments and is perhaps akin to continuing an implicit guarantee on non bail-in bank debt. Such investors may not be appropriately incentivised to assess and price their investments with a resulting decrease in market discipline. Furthermore, the more limited application of bail-in to a smaller class of instruments will in total provide less loss absorbency. If indeed it is accepted that senior debt outside of the bail-in instruments is still subject to losses in resolution then it must also be accepted that all senior creditors of a bank are subject to losses. Thus, the HLEG proposals would merely result in the creation of a new tranche in the creditor hierarchy. AFME believes that institutions themselves are best placed to determine any further stratification of creditor hierarchy beyond existing regulatory requirements.

The HLEG notes that its proposed narrow application of bail-in raises issues of phasing-in and also of limited market-demand for the bail-in instruments of smaller institutions. We note that these issues do not arise with a broad statutory basis for bail-in.

The proposal of the HLEG could significantly increase the uncertainty of the creditor hierarchy. We note that bail-in is only one of the resolution tools proposed in the RRD. Equally and just as validly, a resolution plan may rest on the creation of a bridge institution, for example, or the resolution authority may decide in the circumstances of a resolution that a bail-in is not appropriate. The HLEG's proposals suggest only a specific class of bail-in instrument. It is unclear how such instruments would be treated under other resolution tools. It would be incongruous to suggest a significant departure of hierarchy between different resolution approaches and the increased levels of investor uncertainty that this implies. If indeed the HLEG intends that the bail-in instrument would be subordinated to other senior debt under all resolution tools, it may be simpler to refer to the bail-in instrument as a new type of Tier 3 capital. To be clear, AFME does not support such a suggestion but believes that this may be the implication of the HLEG's proposals.

AFME strongly supports the objective of the HLEG that calls for clarity so that investors are able to anticipate the eventual treatment of their instruments in the case of resolution. However, we believe this would be better achieved, and achieved for all resolution tools, by requiring that resolution authorities publish a detailed statement setting out their general approach to applying resolution tools to institutions and groups within their jurisdictions. Such a statement would include a description of the authority's approach to the bail-in tool and the circumstances in which it would be used and the process that would be followed in resolution. Furthermore, the EBA could create guidelines to provide greater clarity on when it would be necessary and appropriate to include derivatives in a bail-in. Finally, the RRD could be modified in many instances to ensure that the creditor hierarchy is appropriately protected. These measures will greatly increase the level of clarity for investors without having to resort to a specific class of bail-in instrument.

10.3 Holding within the banking sector

AFME does not support a restriction on holding bail-in instruments in the banking sector. Banks are already subject to regulation in relation to large exposures to ensure that they are not overly exposed to any particular counterparty. Supervisors also monitor such exposures under Pillar Two. AFME believes that these protections are sufficient to limit the interconnectedness within the banking system without unduly restricting business decisions. In fact, such a restriction would be ineffective in breaking the link between banks in any event because banks are linked in other ways (e.g. through CDS contracts) and participate in the same markets. It should be noted that the FSB-mandated data templates for G-SIBs will require detailed information about institution-to-institution exposures. This information will enable authorities to make informed decisions about the knock-on impacts of any decision to apply bail-in amongst the most global and interconnected firms.

Furthermore, requiring a concentration of a bail-in instruments in investment funds and insurance companies could (a) decrease the marketability and dramatically increase the cost of such instruments and, more importantly from a financial stability perspective, (b) hardwire a concentration of a certain type of risk in a particular part of the financial system that could increase systemic fragility and perhaps lead to solvency issues in the insurance sector rather than dispersing losses more widely across the financial system.

11. Calibration of risk weighted assets

The HLEG makes some recommendations relating to risk weighted assets for the trading book and for real estate assets, on which we provide comments, in turn, below.

11.1 Trading book

The HLEG report makes several references to financial models and non risk-based capital requirements. We are supportive of the use of modelling and we believe that firms should be incentivised to develop and continually improve models to measure and assess risk.

The Trading Book Group ("TBG") of the BCBS published its Fundamental Review of the Trading Book in May 2012. This is a very serious attempt, which is supported by industry, to simplify and harmonise the current patchwork of rules which have been imposed up to and including the Basel 2.5 proposals. We believe that it would be illogical and counterproductive to recommend a further layer of regulation prior to the consultation process of the Fundamental Review being complete. Indeed, this would duplicate steps already being taken by the TBG. Although the HLEG report expresses support for the Fundamental Review, this is undermined by the proposal for a non-risk based capital requirement and a further layering of rules.

Furthermore, the HLEG report makes proposals to better capture tail risk present in large or complex portfolios. This is, however, addressed by the Fundamental Review proposal, which is supported by the industry, to move from Value at Risk ("VaR") to Expected Shortfall as the primary measure of market risk. Expected Shortfall is a measure which, unlike VaR which only looks at one tail point, takes information from all outliers beyond the specified confidence level. Leverage and Operational Risk are also addressed in the Basel 3 and Pillar 2 proposals respectively.

In summary, whilst we are broadly supportive of many of these proposals, we firmly believe that they should be addressed in the context of the Fundamental Review which will integrate changes into a coherent framework rather than impose a further layer. The latter approach has created the issues and inconsistencies which the Fundamental Review is seeking to correct.

11.2 Real estate

In its report the HLEG makes a connection between excessive real estate lending and the banking crisis and thereby proposes consideration of additional capital requirements for real estate lending and more stringent conditions on caps for loan-to-value and loan-to-income. If not applied globally such changes could lead to a distortion of competition, with institutions from different jurisdictions subject to different regulatory approaches. We recommend that the proposals are considered as part of the impact assessment to determine whether such an approach is appropriate on the basis of risk and taking account of any impact on competition. Consideration should also be given as to whether such macro-prudential tools should be applied at a European level or left to national supervisors to address in the light of local market conditions. The impact assessment should also consider the consequences for the economy of such changes, considering the relevance of the real estate sector for the many countries that were not affected by excessive lending. In assessing the impact it should be noted that similar provisions are already included in the Commission's proposals for CRD IV in Article 120(2)(b):

"Institutions shall consider an exposure or any part of an exposure as secured only if the risk of the borrower does not depend upon the performance of the underlying property or project, but on the underlying capacity of the borrower to repay the debt from other sources, and as a

consequence, the repayment of the facility does not materially depend on any cash flow generated by the underlying property serving as collateral. For those other sources, institutions shall determine maximum loan-to-income ratio as part of their lending policy and obtain suitable evidence of the relevant income when granting the loan."

12. Improvements to corporate governance including remuneration

As to the HLEG recommendations on 'incentive schemes', we certainly support the HLEG's objective of ensuring that remuneration schemes "are proportionate to long-term sustainable performance".

We highlight the fact that significant industry progress has already been made, as shown by recent studies on remuneration practices conducted both by public and private bodies (e.g. the recent FSB report "2011 Thematic Review on Compensation - Peer Review Report"; the EBA's "Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices"; the study on 'Performance and remuneration in investment banking' that AFME commissioned from the performance and reward consultants McLagan).

From a methodological perspective we believe that an in-depth consideration of the possible unintended consequences and the economic impact of the proposals on remuneration is required. In this respect, we welcome the fact that the HLEG calls for an assessment of the impact of the measures that it considers in its report. We suggest that this assessment be carried out in the context of the action plan on corporate governance and company law currently in train and, with regards to the prudential aspects, in a review of the implementation and effectiveness of CRD III.

At the same time, we stress the fact that the proposals considered in the HLEG Report – namely the ratio of fixed to variable remuneration or absolute levels of variable remuneration - contradict the important prudential approach agreed globally at G20 and FSB levels, and implemented in Europe by CRD III, by which variable remuneration is the lever to align remuneration incentives and risk management. Variable remuneration is now closely linked to the performance of the firm, is deferred over an extended period of time, and is subject to malus and claw-back. We believe that it will be counterproductive to introduce a new conflicting approach when the results of earlier legislation are still emerging. Overall, we believe that while effective alignment of remuneration incentives and risk management is a key objective, the rights of shareholders in determining key questions on pay and commercial strategy need to be preserved. Enhanced shareholder engagement has always been a key objective for EU policy-makers and important results are clearly being achieved in this area. We note that the proposals considered in the HLEG report could, however, inhibit stronger shareholder engagement.

12.1 Fixed to variable ratio

A legislated ratio of fixed to variable remuneration runs a real risk of re-introducing fragility into the European banking system. Such a requirement is likely to result in increased fixed remuneration, and subsequently EU banks may have difficulty competing for talent in a global industry. A bank with higher fixed costs is much more likely to suffer precarious losses when revenues drop. Increasing fixed remuneration and decreasing flexible remuneration reduces flexibility on paying for performance, and, paradoxically, reduces one of the interventions available in a stress situation. It further creates an unlevel playing field.

Additionally, a set fixed to variable ratio will reduce a firms' ability to apply risk adjustment measures, thus less compensation can be paid from risk-adjusted bonus pools and less pay is delivered in shares and/or subject to malus and claw-back. Also, with less flexibility for remunerating staff, firms may have to resort to reducing numbers of staff during cyclical downturns (increasing unemployment rates) only to have to hire new staff during cyclical upturns. This method of operating is likely to be disruptive of the overall operations of the firm and may not be in the best interest of shareholders.

12.2 Caps on variable pay

Linked to the above, we would not endorse hard caps on variable pay. Firms (in consultation with shareholders) must retain some element of flexibility when implementing their pay policy.

Also, we do not believe that there should necessarily be a trade-off between dividend pay-out ratios and bonus payments. Unlike remuneration, dividends are an after-tax distribution rather than a pre-tax charge. Situations will arise where there would be a positive (or negative) correlation between these elements, but this will vary from firm to firm and should not be mandated. Regulators already closely focus on ensuring that firms maintain adequate capital levels. This includes the ability to constrain remuneration and dividends if the capital conservation buffer is breached on the downside; therefore the payment of variable remuneration should not limit a firm's ability to maintain and strengthen its capital position. Dividend pay-outs are considered as part of this monitoring exercise by regulators.

Many firms undertake extensive consultation with institutional shareholders across a range of remuneration issues. Ratios of fixed to variable pay and limits on overall pay should continue to be a matter for firms and their owners to decide upon and determine what is most appropriate for their business at different points in the economic cycle.

12.3 Bail-in bonds

As bail-in bonds are directly linked to capital there is an argument that they are an inappropriate remuneration vehicle where individuals are not in a position to influence, determine or be involved in the usage of capital in their day to day activities.

In the event of resolution, employees as holders of the bail-in bonds would rank higher than shareholders, which may be an unintended consequence. In the event of a bank failure, equity would be written off and bail-in bonds may be converted to equity. This might result in the perverse outcome that executives of failed banks would be left with equity in the bank and therefore some residual value, whilst equity holders would have nothing. We think the incentives of executives are better aligned where their bonuses are paid in stock, although there are a range of other measures also required to align incentives.

Equally, it is not clear how such bonds could be structured and that they would necessarily align the incentives of the employee and the bank. Alternatively, bail-in bonds used for remuneration could either attract a market-level coupon, which will be high to reflect the risk of loss, or be of a special class with a lower or no coupon, in which case they will form an insignificant part of the capital base and be required to be redeemed by the issuing bank rather than sold into the market when the time comes to monetise the award. This appears to be self-defeating in terms of the capital and incentive objectives noted.

In the end, the quantum of capital that would be involved in remunerating employees in bail-in bonds would be very low relative to the capital base and it would be unlikely that these instruments would be significantly loss-absorbing and will not be sufficient to avoid resolution in itself. Additionally, the payment of variable remuneration in bail-in bonds will most likely be

an administratively complex task and there may also be a knock-on effect to the firm's accounting and capital structures.

12.4 Rights of shareholders

Although we are fully supportive of the rights of shareholders, we believe that proposals involving enhanced shareholder engagement in remuneration should be carefully reviewed and determined, considering in particular how to deal with third country shareholders. Also, it is not always the case that shareholders currently have the expertise required or the appetite to deal with the technical aspects of setting or opining on remuneration packages. Overall, however, as mentioned above, shareholder rights should include the ability to determine key questions on pay and commercial strategy in a flexible and appropriate manner.

13. Conclusion

Considerable progress has been made in addressing the risks identified by the HLEG in its report. There has been significant and ongoing improvement to the resilience of banks and the banking system, the benefits from which have still to be fully realised. The same is true of the market infrastructures through which banks conduct their business. Regulation is undoubtedly causing banks to re-evaluate their business models and to allocate their capital to where it can deliver the best risk adjusted returns.

The HLEG stated that "a key objective is therefore to ensure a banking sector that is capable of financing the real economy and of pursuing its other functions that contribute to the prosperity of EU citizens and the economy." It also notes that this objective cannot be achieved without restoring and further enhancing the resilience of banks and confidence in the banking sector as a whole and that the sector must become sustainable and not rely on any extraordinary taxpayer support. We are in full agreement with these views and believe that the industry and regulators are well on the way towards achieving these aims. Further intervention to impose a particular structure on banks' businesses is, however, unwarranted, not justified by the HLEG's own analysis and could have seriously negative consequences for the financing of Europe and the restoration of economic growth.

We look forward to a thorough analysis being carried out by the Commission to address the significant number of unknowns about the recommendations and their impact. We remain available to input constructively into that process.

14. References

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Appendix one – Example of consequences in a market-making context

This appendix provides an example to demonstrate some of the systemic and operational factors (set out above in Section 9) associated with the HLEG's proposals and which should be considered.

Depending on the exact form in which the HLEG proposals were adopted, one practical consequence of ring-fencing market-making activities could be that customers have to transfer ('novate') open derivative contracts – and the counterparty credit relationships inherent in them – to a ring-fenced entity. In other words, customer X stops facing financial-group entity Y, and instead faces ring-fenced financial-group entity Z for all open contracts, as well as any new ones.

Even if facing the ring-fenced entity was not a regulatory requirement, it could in any case be prudent from the perspective of the financial-services firm, to centralise all portfolio risk management in such an entity[6].

Transfers of this nature would be a major logistical exercise, potentially entailing each and every customer of each affected firm giving formal consent to the change. This would, therefore, not just be a question of massive scale, involving as it would thousands of customers across the firms in question. It would, for each of those customers, entail an intensive negotiation process. For reasons of legal certainty (and to afford the customer the opportunity to protect itself from any credit-related consequences of the change in counterparty), any such transfer is not legally binding without the formal, written consent of the customer in question. Moreover, even if that consent was available in principle, the process might not be a simple mechanical one. To the extent that there were indeed changes in creditworthiness implied in the change of group entity, customers would have a strong motivation to negotiate credit protection, which can itself take a variety of forms.

As noted elsewhere in this response, it is not clear from the HLEG's proposals to what extent it may – as an alternative to novation – be possible for customers to continue to face a non-ring-fenced-entity. In any case, even if that proved possible, the practical outcome for the market-making firm would be that they would wish to transfer the market risk arising from customer-facing transactions into the centralised book referred to above. This would clearly then raise the issue of large-exposure limits (which apply to intra-group exposures just as they do to external ones). Even if the transactions did not come up against large-exposure limits, such an arrangement would probably result in a doubling-up of counterparty-risk RWAs. This is because, in the absence of a consolidated capital account, the internal transaction could not be netted against the customer-facing transaction.

An alternative to intra-group transactions would, in theory, be for the customer-facing entity to hedge its market exposure by transacting with competitors. This, however, would not only disadvantage the firm with the customer relationship (by providing business for competitors), but would also increase interbank exposures in the process. Note that such contracts would not necessarily lend themselves to central clearing, since customer transactions are most likely to be tailored (in order to meet the idiosyncratic risk-management needs of those customers). It is also noteworthy here that, for intra-group transactions under EMIR, there is a deliberate exemption from clearing and collateral (subject to certain conditions). In other words, the valid role of intra-group exemptions, in the larger picture of offering risk-management services to the real economy, is recognised in that piece of legislation.

[6] This allows for maximum offsets of market risk, with benefits for the individual firm and, by extension, the system as a whole.

Appendix two – Comparison of the key aspects of the two avenues

Topic:	Avenue 1	Avenue 2	Industry Views
Resolution plans:	**HLEG:** Banks would present how they could wind down their trading risk positions in a crisis situation without jeopardising their financial health and/or significantly contributing to systemic risk. Banks should be able to demonstrate that they can segregate retail banking activities from trading activities and wind down the latter separately, without affecting the retail business and injection of taxpayers' funds. If the plans are not satisfactory, the resolution authority is able to enforce separation of trading entities.	**HLEG:** In addition to the mandatory separation, further separation maybe required, according to the supervisory assessment as per Avenue 1.	Both avenues can lead to the same outcome for irresolvable, systemic banks. Mandatory separation punishes bank business models that are not deemed contributors to systemic risk and reduces structural diversity without lowering systemic risk, marking a move away from the regulation of risk. Firm structure is best determined by firms' boards and management. Resolution plans should be designed to ensure that a firm is resolvable given that structure. The assessment by authorities of resolution plans should focus on resolvability rather than separation.
Costs and structural choices:	**HLEG:** This avenue avoids the immediate costs of separating banks' various activities, when not warranted, from the public interest perspective and offers flexibility to their structural choices. Those EU universal banks that acted with prudence have weathered the financial crisis well. This avenue incentivises banks to carry out stability-enhancing changes themselves, but also leaves the supervisors with the final say.	**HLEG:** The requirement for the different parts of the banking group to be self-funded and separately capitalised would reduce diversification benefits, increase bank funding or other costs and as a result increase the cost of financial services. Implementing this separation is also likely to include decisions on where to draw the line between the different parts of an integrated universal banking group, which is not straightforward. Relative to complete separation, functional separation within the universal banking model would preserve some economies of scale and scope in operating costs and revenues. However, functional separation may not substantially improve transparency of intra-group transfers, because defining market prices for the purposes of arm's length pricing remains difficult and subject to judgment.	We assume material costs due to separation of risk management and operational staff under Avenue 2as well as other structural and frictional costs. Splitting up universal banks necessarily involves eliminating natural hedges, increasing risk and volatility. Transfer of contracts and master agreements is likely to create uncertainty in the market.

Topic:	Avenue 1	Avenue 2	Industry Views
Systemic risk and Single Market:	**HLEG:** This avenue avoids the problems of defining ex ante the scope of activity to be separated or prohibited. It supports a harmonised approach in the Single Market, provided that the EBA issues clear standards for the approval of the RRPs; and provided that supervisors, including the new single supervisor, are empowered to implement the standards in a consistent manner. Reduction of market uncertainty and prompt EU-wide implementation would be supported by setting a common timetable.	**HLEG:** The central objectives of the separation are to make banking groups, especially deposit-taking entities providing financial services to the non-financial sectors of the economy, safer and less connected to trading activities; and, to limit the implicit or explicit stake the taxpayer has in the trading parts of banking groups. Separation of market-making and proprietary trading activities into separate legal entities is the most direct way of tackling banks' complexity and interconnectedness. As the separation would make banking groups simpler and more transparent, it would also facilitate market discipline and supervision and, ultimately, recovery and resolution.	Avenue 2 reduces diversity by limiting firms' ability to evolve their business models, introducing a significant structural barriers for firms to engage in larger scale capital markets activity. It is also likely to increase market concentration and reduce competition. Avenue 2 is an unjustified ex ante intervention that impedes the natural evolution of the European banking sector already taking place. Avenue 2 increases systemic risk, reducing diversification and undermining the Single Market by trapping liquidity and capital.
Trading capital:	**HLEG:** This avenue specifically addresses problems of excessive risk-taking incentives and high leverage in trading activities by introducing an additional volume-based capital requirement. It also addresses the risks in complex business models combining retail and investment banking activities and systemic risk due to excessive interconnectedness between banks.	**HLEG:** This immediate functional and capital separation (i.e. not subject to supervisory discretion) would be complemented by the same additional non-risk weighted capital buffer for trading activities outlined in the first avenue of reform, apart from the part increasing in proportion to the level of deposit funding.	We believe that the underlying issues are being addressed by the BCBS trading book review, CRD IV capital buffers and other regulatory frameworks. We also disagree that the trading entities in most banks are funded by the guaranteed deposits, as evidenced by the loans-to-deposits ratios.
Regulatory burden:	**HLEG:** The avenue is designed to complement existing regulatory developments based on the Basel rules and the EU supervisory and bank resolution proposals. Thus, it could be implemented as a part of the overall regulatory reform programme without interfering with the basic principles and objectives of those reforms.	**HLEG:** The Group has concluded that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking and other banking activities within a banking group. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely linked with securities and derivatives markets.	Substantial increase in regulatory burden under Avenue 2. There is uncertainty over the territorial scope of the mandatory separation proposals. Creation of another level of sub-groups will have material legal and regulatory consequences. Heavy-handed solution considering that there is no evidence that structures were a problem during the financial crisis.
Mandatory separation of activities:	-	**HLEG:** Separation of activities is the most direct instrument to tackle banks' complexity and interconnectedness. Incentives for risk-taking in the trading arm would be reduced, as the latter would not be able to profit from liquidity, funding and solvency support from other parts of the group.	This is provided for by the recovery and resolution directive and the ongoing shadow banking work, without the negative consequences associated with mandatory separation. Existing second tier Capital markets players close to the threshold may deleverage and exit the business, further concentrating the capital markets in Europe. Potential creation of an oligopoly of large trading entities and several niche market players, possibly reducing competition.