EUROPEAN COMMISSION
Directorate General Internal Market and Services

SUMMARY OF THE REPLIES TO THE CONSULTATION OF THE INTERNAL MARKET AND SERVICES DIRECTORATE GENERAL

ON

THE RECOMMENDATIONS OF THE HIGH-LEVEL EXPERT GROUP ON REFORMING THE STRUCTURE OF THE EU BANKING SECTOR

December 2012

Commission européenne/Europese Commissie, 1049 Bruxelles/Brussel, BELGIQUE/BELGIË - Tel. +32 22991111

The High-level Expert Group on reforming the structure of the EU banking sector ('the Group'), chaired by Erkki Liikanen, Governor of the Bank of Finland, presented its report to the European Commission on 2 October. The report contains both structural and non-structural reform recommendations aimed at complementing the current regulatory reform agenda:

- As regards *structure*, the Group recommends a mandatory separation of proprietary trading and other high-risk trading activities into a separate legal entity within the banking group (recommendation 1). This separation would only be mandatory if the activities to be separated amount to a significant share of a bank’s business. Accordingly, the majority of banks would remain unaffected, to the extent that they would have credible and effective recovery and resolution plans in place. Furthermore, the Group considers that separation of additional activities may be necessary conditional on the recovery and resolution plans (recommendation 2). That judgement would be left to supervisors.

- The *non-structural* recommendations relate to the use of bail-in as a resolution tool (recommendation 3); a review of capital requirements on trading assets and real estate related loans (recommendation 4); and measures aimed at strengthening the governance and control of banks (recommendation 5).

The European Commission held a stakeholder consultation on the Group's recommendations between 2 October and 13 November 2012. The consultation was organised via the Commission's normal consultation framework.

In total, the Commission services received 89 responses by end-November 2013. Responses received after this date are read by the Commission, but are not taken into account in this summary. The largest category of respondents were individual banks and banking associations (38 responses), followed by other financial institutions or their representatives (13), representatives of corporate customers (11), retail customers or their representatives (9), public authorities (13) and others (5 - including think tanks, etc.). In terms of nationality of those responding, the consultation received responses from various EU-wide or international organisations as well as from 20 different EEA Member States, with the largest number of country responses from the UK (16 responses), Germany (11) and France (9).

This note summarises the replies received, structured to cover each of the five main areas of recommendations made by the Group. The proposal for the mandatory separation of bank trading activities was subject to most comment and controversy, especially from responding banks, and hence is summarised in more detail.

1. MANDATORY SEPARATION OF PROPRIETARY TRADING ACTIVITIES AND OTHER SIGNIFICANT TRADING ACTIVITIES (RECOMMENDATION 1)

In general, banks welcomed the Group's analysis, but argued that a compelling case for mandatory separation of trading activities has not been made. They felt that the proposal was not backed by the required evidence, and that there was a need for a thorough impact assessment.

The current reform agenda is seen by responding banks as sufficient to tackle the identified problems in the banking sector, including in particular the measures taken or proposed in CRR/CRDIV, the bank recovery and resolution directive (BRR), Banking

Union, EMIR, etc. Also, structural separation recommendations are criticised along a number of dimensions, namely that:

- Costs are high: Structural separation is inconsistent with universal banking. The result will be higher funding costs for banks, loss of economies of scale and scope, etc. These costs will ultimately be borne by the users of banking services, for example in the form of higher costs of credit and reduced market liquidity, and will therefore harm the real economy.
- Claimed benefits may not materialise: Bank structure is not seen as a main driver of the financial crisis. Also, structural separation may not actually help in delinking retail and investment banking activities, because these would still be conducted within the same group. Structural reform may indeed make matters worse, by creating incentives for regulatory arbitrage and shifting activities to the shadow banking sector.
- Competitiveness of the EU banking sector is harmed: Structural reform is argued to harm competitiveness of the EU banking sector, also depending on the geographic scope of the separation requirement (e.g. would incoming non-EU banks be subject to the same requirement?). Only the very large trading houses would be able to continue to attract sufficient funding for trading activities; other trading operations would not be viable on a stand-alone basis, thus leading to increased concentration in the market.
- Consistency with other structural reform initiatives is not ensured: Banks are concerned about inconsistency between structural reforms at EU level and what has already been proposed in the USA and the UK.
- There is a lack of clarity and detail: The Group's proposals are seen to lack clarity and detail regarding implementation, in particular with respect to i) the measurement of the thresholds of what constitutes 'significant' trading activities that would mandate separation, ii) the activities to be separated, and iii) the relationship between the separated trading entity, the deposit bank and the holding company. Several banks also argued that the proposed thresholds are flawed and appear to be chosen arbitrarily, based on data that is prone to measurement error and unrelated to risks.

However, not all banks argued a strong case against structural separation. Also, several banks made a number of constructive proposals, for example regarding the designation of activities to be separated and the measurement of the proposed thresholds.

Banks and other respondents called for an impact assessment to further evaluate the rationale, objective and viability of the recommendation. The respondents themselves generally did not provide a quantification of expected impacts.

As regards non-bank respondents, business federations or other representatives of corporate customers generally expressed strong reservations about mandatory separation and a move away from universal banking in Europe. This is feared to increase costs and reduce access to bank finance for corporate customers. These concerns were coupled with calls for policy measures to reduce the barriers to entry in the banking market and fostering non-bank finance channels.

Among the public authorities, including central banks and national finance ministries, there were diverging views on the need for structural reform. While some were not convinced about the additional benefits of such reforms, others expressed strong support for insulating deposit-taking banks from other (trading) activities. However, even those

in support of structural reform called for greater clarity on the nature of the proposed separation and an impact assessment.

Support for structural separation was generally provided by other financial institutions, at least from their perspective as institutional investors in banks. Institutional investors pointed to the tensions between the cultures of investment banks and retail/commercial banks and the wider risks if investment banking activity is being funded with retail deposits. They also feel that separation could facilitate market monitoring, risk management and bank resolution. However, the responding investors had some doubts about the proposed activities to be separated as well as the measurement of the thresholds for mandatory separation.

Strong support for mandatory separation was also provided by consumer representatives and a number of think tanks or NGOs. The view of some was that the Group's proposals did not go far enough, e.g. that deposit banks should be prohibited altogether from engaging in proprietary trading.

2. ADDITIONAL SEPARATION OF ACTIVITIES CONDITIONAL ON THE RECOVERY AND RESOLUTION PLAN (RECOMMENDATION 2)

Respondents were generally in support of strengthened recovery and resolution plans (RRPs) and improved bank resolution. Several respondents noted that the Group's recommendations for additional separation conditional on a bank's RRP risked overlapping the provisions in the proposed BRR, which already envisages a number of measures, including structural change that the resolution authority may impose on banks where necessary and appropriate to facilitate resolution.

Banks argued that, with an effective recovery and resolution regime in place, there is no need for the mandatory separation proposed in the Group's first recommendation. Rather, the choice of corporate structure should be a matter left to be determined through the RRP process, as the relevant authorities are best placed to make the judgement on a case-by-case basis about whether or not a change in corporate structure enhances resolvability.

Some banks however considered any structural separation based on supervisory assessment as too intrusive and creating legal certainty. It was also considered important that uniformity in the RRP assessment is applied across Member States, and that the EBA should play an important role in this.

Other respondents took a more sceptical stance, saying that conditional separation based on the RRP would be arbitrary and that supervisors lack the capacity to adequately evaluate RRPs, especially given the complexity of the large EU banks. Mandatory separation of trading activities would simplify banks and make the recovery and resolution framework more effective and credible.

3. AMENDMENTS TO THE USE OF BAIL-IN INSTRUMENTS AS A RESOLUTION TOOL (RECOMMENDATION 3)

Not all respondents commented on the bail-in proposals contained in the Group's report. Some provided various comments on bail-in, but without commenting directly on the specific Group proposal that there should be a more targeted bail-in approach involving clearly designated bail-in instruments rather than bail-in of almost all unsecured

liabilities. As regards comments on the specific Group proposals, there was no consensus among the respondents.

Those in favour of the targeted approach to bail-in pointed at a number of advantages: that it ensures higher legal certainty; that it reduces the loss of competitiveness by European banks *vis-à-vis* their non-European competitors; that it minimises the cost of funding for banks (as most liabilities would be excluded); that it limits contagion due to bail-in; that it avoids problems linked to bailing-in derivatives, and that facilitates the actual application of bail-in.

Respondents opposing the targeted approach advocated the application of bail-in to a broad set of unsecured liabilities, pointing at the problems of phasing in specific bail-inable bonds; the ineffectiveness of such bonds in the event of a significant failure; the limited market demand for these bonds, especially if issued by smaller banks; and the greater impact on bank funding costs.

The majority of respondents (mainly banks and other financial institutions) presented negative views on the proposal that bail-in instruments cannot be held by other banks, arguing that this would unduly limit the investor base and raise bank funding costs while at the same time be ineffective at limiting interconnectedness in the financial system.

4. Review of capital requirements on trading assets and real estate related loans (Recommendation 4)

Most respondents (mainly banks) opposed the Group's proposal to revise capital charges for the trading book, by setting an extra capital buffer or introducing a minimum floor to risk-based requirements. Instead, they argue that CRDIII and CRR/CRDIV have reduced (or will further reduce) the risks stemming from the trading book, and that any remaining issues should be dealt with as part of the Basel Committee's on-going fundamental review of the trading book.

As regards the Group's proposed measures regarding real estate lending, while there seems to be broad agreement on the risks associated with real estate markets, most respondents were critical regarding the recommendations to enhance the prudential approach (and increase capital requirements or include a ceiling on risk weightings provided by internal models) for real estate exposures. They pointed out that the CRR/CRDIV proposals already offered national flexibility, allowing supervisors to adjust risk weights upwards if necessary. It was also argued that any recalibration of real estate exposures should be accompanied by a wider recalibration process including all asset classes.

Many respondents recognised that the proposed loan-to-value (LTV) or loan-to-income (LTI) ratios were in principle useful macro-prudential tools to curb risks stemming from real estate markets (with LTI ratios seen as superior by some). However, many respondents argued that the evidence on the effectiveness of any such ratios was not clear. Among the responding financial institutions, there was little support for mandatory caps, unlike several consumer representatives, which expressed their support. Also, European real estate markets were considered by some as too diverse to apply any uniform LTV or LTI ratios at EU level. A proper impact assessment would need to be undertaken in order to examine all consequences, including potential adverse side-effects on consumers.

5. STRENGTHENING THE GOVERNANCE AND CONTROL OF BANKS (RECOMMENDATION 5)

There were many respondents who did not comment on the Group's corporate governance recommendations at all, and if they commented, they (in particular banks) often focused mainly on the recommendations related to incentive schemes / remuneration.

Respondents recognised the importance of good governance in banks. They pointed out that significant progress has been made in banks' corporate governance practices in recent years, and that further improvements are under way (e.g. introduced in CRR/CRD IV). In addition, there are calls for proportionality in corporate governance measures.

Respondents generally acknowledged the need for diversity of skills and experience of Board members, but there was less support for introducing the proposed "fit & proper" tests. Similarly, there was general support for a strong risk management, but views were more diverging when it comes to the proposed parallel risk reporting by Risk and Control Management to the Chief Executive Officer and the Risk and Audit Committee.

As regards incentive schemes, the use of a maximum ratio between variable and fixed pay was viewed negatively, at least among the responding banks. Views were split on the use of bail-in bonds as part of remuneration. There was practically no support for fixing the remuneration to dividends, but more support for enhanced shareholders' say on pay.

While there was support for risk disclosure at least in principle, questions were raised on the usefulness of additional disclosure, the administrative burden this would cause, and the fact that this was already covered in CRR/CRDIV.

Respondents did not feel that there was a strong need for strengthening measures on sanctions, with the exception of two (non-bank) respondents.