European Commission consultation on reforming the structure of the EU banking sector

Response by RBS Group plc

Executive Summary

Introduction

RBS Group plc ('RBS') welcomes the European Commission's consultation on ring-fencing and is grateful for the opportunity to provide our thoughts.

Our key comments on the consultation are reprised in this Executive Summary section below.

We would be happy to elaborate further on any of the points made in this response and look forward to engaging with the Commission, as it further considers its proposals. In the first instance, any questions should be addressed to:

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Key Comments

Our detailed responses to the Commission's questions are set out overleaf. The main points made can be summarised as follows:

- RBS supports the extensive reform agenda and the efforts of regulators across the world to improve the resilience and resolvability of banks, and to ensure that the burden of any future bank failure does not fall on taxpayers. We consider the creation of an effective resolution framework as the most critical element in this reform agenda.
- We are concerned that ex ante structural reform, such as ring-fencing, may not be the correct response to the problems identified by the High Level Expert Group. We believe that such reform would entail significant costs and customer disruption, for questionable benefit.
- We therefore encourage the Commission to assess the effectiveness of the current regulatory reforms before considering the need for additional structural reform.
- Several member states, including the UK, are already pursuing structural reform measures that are adapted to the specific needs of their banking sector. It is critical that banks are not subject to multiple, inconsistent variants of structural reform as this is likely to negatively impact customers, increase systemic risk and operational risk, and distort competition across the single market.

Detailed Comments

1. Can structural reform of the largest and most complex banking groups address and alleviate these problems? Please substantiate your answer.

1.1 RBS is broadly supportive of the extensive reform agenda that has been pursued since 2008, most notably with respect to increasing the resilience and resolvability of banks. We see the creation of an effective resolution framework as key to addressing "too big to fail" and support the Commission's proposals for a Recovery and Resolution Directive. We encourage the EU to concentrate on delivering this critical piece of legislation, in addition to completion of the Banking Union to resolve the crisis at hand. We would urge the Commission to assess the effectiveness of these changes via a quantitative impact study before considering the need for further significant structural change.

1.2 RBS also believes that macro-prudential supervision is an important part of the emerging new regulatory framework. Framed and executed properly, it is a more effective tool for addressing systemic risk than structural measures. More work remains to be done in this space, both at the national and EU level, particularly concerning a more effective role for the European Systemic Risk Board and defining the European Central Bank's macro-prudential role in the wider regulatory framework.

1.3 It is clear through the financial crisis and recent events that banks of all sizes and business models have failed. The Expert Group's report itself gives some examples: Lehman Brothers, a large US investment bank; Northern Rock, a relatively small UK retail bank; and more recently, the Spanish cajas. Whilst it is important to ensure that banks of all types are resilient, resolvable and not excessively risky, it is difficult on the basis of the evidence to suggest that a particular form of bank structure or set of activities are inherently riskier.

1.4 We have consistently argued that ex ante structural reform does not in itself bring sufficient financial stability benefits to justify its significant costs, and indeed may even exacerbate risk. However, we recognise that in some countries, including the UK, policymakers have concluded that the size of their banking sector, relative to the overall economy, justifies some form of ring-fencing to provide additional options for orderly resolution in the event of a bank failing. These conclusions have been reached with reference to the specific structure and size of each country's banking industry, which vary widely across Europe.

1.5 For this reason we do not believe that an ex-ante ring-fence, applied uniformly to EU banks, is the correct response to the problems that the Expert Group considered. Indeed it is possible that such a measure might serve to concentrate risk by undermining the diversity of European banks that have arisen to serve customers' needs. Nor do we support de minimis exclusions or bespoke ex-ante reform applied to individual institutions. It should be borne in mind that any structural reform will result in costs that will inevitably be partly borne by customers. This would be at odds with the Commission's justifiable aim to improve Europe's trend rate of growth; for example, in the upcoming Green Paper on Long-term Financing.

1.6 We are concerned that proponents of ring-fencing may a) underestimate the economic benefits of scale inherent in many segments of banking activity (particularly with increased regulation) and b) where those benefits are recognised, may attribute too great a proportion of them to the effect of an implicit government subsidy for banks viewed as too big or too important to fail. A miscalculation on this point may result in significant negative economic impacts for consumers, in addition to the disruption that such large-scale restructuring of banking activities is likely to entail.[1]1

[1] Relevant academic studies include: Wheelock & Wilson: "Do large banks have lower costs? New estimates of returns to scale for US banks", Journal of Money, Credit and Banking 2012. Feng & Serilitis: "Efficiency, technical change and returns to scale

2. Do you consider that an EU proposal in the field of structural reform is needed? What are the possible advantages or drawbacks associated with such reforms? Please substantiate your answer.

2.1 We recognise that a number of Member States have adopted structural reform measures, including the recommendations of the Independent Commission on Banking in the UK. These policy responses have been strongest in countries where the banking industry is particularly large in relation to the overall economy.

2.2 Moreover, national banking structures diverge across Member States, contributing to the diversity of the European banking sector. It is appropriate, if there are to be structural reform measures, that these are taken on the level best suited to assess the particular risks of a system (i.e. the principle of subsidiarity). These risks are primarily borne by national governments, echoing Sir Mervyn King's judgement, that "banks are global in life, national in death".

2.3 Notwithstanding this, we recognise that bank failures have negative externalities for other Member States, which the Commission should consider. The proper way to solve this problem – and to ensure that the burden of bank failure does not fall on taxpayers – is to establish an effective and workable Recovery and Resolution regime. Going beyond this, the EU is rightly pursuing a Banking Union, comprising at least those countries in the European Monetary Union. These measures are substantial and require a great deal of political will. RBS is concerned that diverting attention to ring-fencing diverts attention away from those measures that are fundamental to resolving the problems of financial stability.

2.4 Regarding "too big to fail", we strongly support the development of an effective resolution regime, so that failing banks may be restructured in an orderly fashion without any recourse to taxpayer capital support. Central to this is to ensure that as wide a pool of creditors as possible is eligible for bail-in. Current proposals for a Resolution Fund to bear losses, for example, perpetuate moral hazard by shifting the cost of failure away from a bank's shareholders and creditors to its competitors. The latter, unfortunately, cannot instil market discipline in the same way a bank's creditors can do. Ring-fencing serves to complicate the bail-in debate, potentially leading to unintended consequences by placing restrictions on where eligible bail-in liabilities can be held in a banking group. It also has an impact on the strength of the legal entities issuing the bail in liabilities.

2.5 On balance, we believe the risks likely to derive from ring-fencing – primarily the concentration of risks in uniform business models and the negative consequences for economic growth – outweigh the potential benefits. We have an additional concern that ring-fencing may increase moral hazard and entrench any implicit subsidy, by leading customers to believe that retail banks are in fact guaranteed. We rather encourage the EU to concentrate on fully and successfully delivering the large amount of regulatory reform that better addresses the problems European banks face.

3. Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator.

3.1 We believe there are material concerns with each of the proposed definitions as follows:-

3.2 Definition 1: assets Held for Trading and Available for Sale:

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in large US banks", Journal of Banking and Finance 2009. Hughes & Mester: "Who said large banks don't experience scale economies? Evidence from a risk-return-driven cost function", Working Papers, Federal Reserve Bank of Philadelphia 2011.

Definition 2: assets Held for Trading only

3.2.1. These definitions have the benefit of being based on generally accepted accounting principles, and are therefore widely accepted and understood across the industry. However, they are not risk-based measures and have features that make them unsuitable as indicators of systemically risky activity.

3.2.2. Assets classified as "Held for Trading" result from a wide variety of activities, ranging from supporting clients' risk management by short-term foreign exchange hedging through to trading actively on the institution's own account. Separating out the less risky, client-related elements of these activities behind a ring-fence is likely to be a material inconvenience to clients.

3.2.3. Further, since the "Held for Trading" classification reflects the institution's approach to managing the asset, rather than any definitive characteristics of the asset itself, the same asset may be held under different classifications (Held for Trading vs. Available for Sale vs. Loans & Receivables) at different institutions, even where it has been acquired in objectively similar ways.

3.2.4. Assets included in the "Held for Trading" category include gross figures for derivative assets i.e. prior to netting arrangements. "Real" derivative exposures are more accurately measured based on net exposure (i.e. after netting).

3.2.5. This may lead to significant concerns if this definition is used to determine if a bank crosses any threshold for mandatory separation, given that a ratio based on this gross derivatives figure would exaggerate the weighting of derivatives relative to their actual financial significance. For example, per RBS's 2012 report and accounts gross derivative exposures were £442bn (34% of total group assets). However, the net derivative exposure was £34bn, i.e. 3% of total group assets.

3.2.6. In addition, assets held within the bank's liquidity portfolio might be categorised as "held to maturity" but are traded in order to ensure that banks remain active participants in those markets so that they can use these buffers to meet liquidity needs. This is a regulatory requirement.

3.2.7. Furthermore the Commission should be mindful that these definitions are set by accounting standard makers, and monitored by auditors rather than regulators. Accounting standards change over time and the objectives for accounting standard setters are not necessarily aligned with financial regulators. Moreover, accounting standards are not consistent globally and this may result in different regulatory classification across firms.

3.2.8. We would encourage the Commission to leverage the research of the Basel Committee (May 2012 Fundamental Review of Trading Book Capital Requirements) into the issues that arise when creating divisions between banking book and trading book. In particular we would highlight the risk of separating hedges from underlying positions, and the material implications that would arise when breaking up netting sets.

3.3 **Definition 3: gross volume of trading activity**

3.3.1. In contrast to earlier definitions, trading volume should in principle be a P&L-based metric that focuses on turnover, rather than a balance-sheet measure. The proposed definition fails to capture trading velocity, with the result that it is not an effective measure of trading volume. It appears rather to measure balance sheet allocated to trading assets.

3.3.2. Any measure based purely on the scale of trading activity (either in absolute terms or as a percentage of turnover) is likely to identify primarily market-makers. Proprietary trading activity could involve taking significant medium-term risk positions that would not per se create a high volume of trading activity.

3.3.3. It is conceivable, therefore, that under this definition some institutions could run small - but high risk - proprietary trading desks, without breaching the absolute or relative triggers that may be defined.

3.3.4. It is not clear therefore that this definition would provide effective segregation in that it would still be possible to use client deposits to fund high risk proprietary trading positions.

3.4 **Definition 4: net volume of trading activity**

3.4.1 As with the gross volume measure, this approach does not capture trading velocity and therefore fails to reflect a realistic measure of trading volume.

3.4.2 The metric proposed appears only to measure "net" exposure in terms of balance sheet quantum. This would not capture, for example, a proprietary trading position by mismatch of currency, maturity, counterparty or other risk element. It would appear therefore to be open to considerable arbitrage opportunities.

3.4.3 This measure also appears to assume that trading assets are hedged by trading liabilities. In many instances, however, a long inventory position may be hedged through use of derivatives, for example.

3.4.4 An imbalanced risk trading position may perhaps be measured more accurately by a net Market Risk metric rather than by any metric focused on trading volume per se. Such a measure would however also highlight market makers who hold high levels of (unhedged) inventory. This could equate to a high volume of client-related activity rather than specific proprietary trading activity, albeit we acknowledge that this distinction is open to different interpretations. A metric based on market risk is also likely to be volatile, given it would be susceptible to changes in inventory levels, client trading activity and market movements.

3.4.5 There is also the potential for arbitrage between jurisdictions, given that the Market Risk will be calculated using internal models approved by national regulators who may adopt different risk model parameters and may apply varying levels of scrutiny to their models approvals process.

4. Which of the approaches outlined above is the most appropriate? Are there any alternative approaches? Please substantiate your answer.

4.1. It is clear through the financial crisis and recent events that banks of all sizes and business models have failed. Whilst it is important to ensure that banks of all types are resilient, resolvable and not excessively risky, it is difficult on the basis of the evidence to suggest that a particular form of bank structure is inherently riskier.

4.2. We do not therefore consider that any of these responses is necessarily most appropriate or would lead to ex ante reform that would be inherently better or worse than other models outlined above.

4.3. We would consider that pure proprietary trading activity (by which we mean using capital for one's own account to generate trading profits (and risk taking losses) disconnected from customer activity) involves risk that is inappropriate for a bank funded by client deposits.

4.4. However, we recognise that when considered through an analytical (objective) lens, the trading risk that is created in banks as a result of "pure" proprietary trading is potentially hard to distinguish from that which is connected to actual or anticipated customer activities (including market making), meeting customer portfolio needs and portfolio hedging. Both forms of activity can result in the build up of significant volumes of inventory. Some of this inventory may be present on banks' balance sheets for extended periods of time.

4.5. This poses a significant challenge when considering how law and regulation might be used to restrict proprietary activity as there is no bright line that can be drawn to differentiate between the two types of activities.

4.6. We would suggest that a risk-based metric is better suited to measuring the scale of riskiness in a business's trading activity. A measure based on the scale of market risk RWA as a percentage of total RWA, or market risk capital vs total capital, would be more appropriate. However, such metrics would also potentially fail to separate active market makers from proprietary traders for the reasons outlined above, and may not be appropriate for all ring-fence constructs under consideration.

5. What are the costs and benefits of separating market-making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?

5.1 The activity of market-making is to continuously quote prices to any market participant. Except for specialist standalone investment banks, the underlying rationale for undertaking this activity is primarily to support the client franchise: trading promotes market knowledge, price discovery and insight into investor appetite. This in turn enables the bank to better advise customers on debt issuance strategies across different markets and to price client trades appropriately. Any segregation of market making activity from customer risk management activity will therefore potentially distance the client from the market and may result in pricing dissynergies.

5.2 Underwriting of debt issuance (bonds, loans) is an integral part of the client franchise for many corporate banks considered to be investment banks. We believe that clients benefit greatly from a banking relationship that can advise on / provide a range of funding sources including underwriting issuance in the debt / bond markets. It would be greatly beneficial for clients to retain this capability within the client's main relationship bank (which we believe should continue to be the deposit bank), albeit the UK has chosen not to pursue this model.

5.3 There is a symbiotic relationship between primary trading (eg., supporting client issuance in debt capital markets) and secondary trading (eg., market-making in debt instruments in issue). A bank that is active in the secondary markets has the investor base and insight into investor appetite / market pricing to support clients preparing to issue in the primary markets. It is therefore in the interest of clients that banks are able to maintain close and effective communication / working relationships between primary and secondary franchises.

5.4 We believe there is a much weaker case for retaining equity underwriting capability within the deposit entity. This is a niche product provided to a larger corporate / FI clients and could in principle be segregated from deposit taking, albeit care is required to establish a clear dividing line from debt instruments given the range of hybrid instruments.

6. Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?

6.1 We strongly consider that it is in the best interests of our customers – in particular those with relatively "vanilla" banking requirements - that where feasible they should be able to source all required banking services from one provider as this offers operational efficiency. Customers should be free to choose multiple service providers, but not forced by legislation to do so.

6.2 Risk management products are closely connected to other basic banking services that should be within the basic product offering of any deposit bank. For example, fx risk management products (swaps, forwards) complement money transmission and trade

finance products, and interest rate risk management products are closely aligned to lending products. If a customer is obliged to source these products from separate providers, then there are clear dissynergies and additional costs to the client in providing further collateral and having to negotiate with a separate product provider, not only at the outset but at any time that facilities may need to be amended / restructured.

6.3 It is not clear that additional safeguards are needed to effectively oversee the sale of risk management products. Existing controls already provide regulators with significant influence to ensure that risk management products are managed appropriately within deposit banks. For example, conduct risk rules ensure that appropriate risk management products are sold to clients, and prudential controls enable regulators to oversee the scale of market risk exposure (or balance of market risk vs credit risk) within any institution.

7. As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?

8. What are the relevant economic links and associated risks between intra-group entities?

8.1. At present there is considerable diversity of structure within the EU banking sector. Bank operating models have developed (organically and inorganically) according to the needs of their client / product set and their geographic diversity. As a result, the precise nature of intra-group relationships varies enormously. This diversity of banking models adds additional resilience to the sector by ensuring that institutions are exposed to a variety of risk factors and to different scales. There is a danger that imposing a tighter control on group structures will remove this diversity and serve to increase systemic risk, rather than reduce it.

8.2. Any enforced restructuring to a standardised model would need to reflect the diversity of needs that these different banking models require. The costs of such restructurings are likely to be significant, covering a broad range of areas including client contracts, collateral, operating model, operating systems, staff contracts, suppliers, and funding. The scale of disruption and duplication will vary significantly dependent upon the degree of enforced separation and ability to maintain some functionality within a “shared services” operating company.

8.3. In considering the imposition of this scale of operational disruption on the EU banking industry, the Commission will no doubt be mindful of the considerable operational risk inherent in this degree of restructuring, over and above the existing regulatory reform agenda. It will also be mindful of the potential disruption to funding markets caused by the uncertainty arising from the need to migrate capital and debt issuance to a different legal entity structure.

8.4. While some countries have legal mechanisms to enable the transfer of banking activities between legal entities (e.g. the provisions of the UK’s Financial Services and Markets Act Part VII) these mechanisms may not be effective internationally. The difficulty of large scale restructuring should not, therefore, be underestimated.

9. As regards full ownership separation, what are the associated costs and benefits?

9.1 The merits of enforced separation of ownership between deposit and trading entities will depend on the scale of activities to be separated. For a narrow trading entity comprising only (narrowly-defined) proprietary trading, this raises fewer concerns. The scale of cost duplication / value destruction would be modest, and the client impact small. However, as

highlighted in paras 4.4-4.5, there are significant challenges in effectively defining proprietary trading which may challenge the feasibility of this approach.

9.2 However, we see little advantage in enforcing such separation measures for a broader ring-fence. This is likely to represent significant disruption to the customer base, both through increased complexity in accessing products from the trading bank and through the duplication in processes that this will require throughout the product life cycle. Processes affected will include due diligence and money laundering controls, credit assessment, settlement, account administration, etc.

9.3 For customers with limited product needs from the trading bank, the cost of this additional workload may act as a significant barrier to accessing investment banking services. For example, customers considering extending their funding sources to the debt capital markets may currently do so through the organic evolution of their banking relationships. Under a scenario where all investment banking activity is obliged to sit under separate ownership, such a separation would require the customer to establish dialogue with different institutions. This would represent a substantial deterrent to diversification of funding away from "traditional" bank funding.

10. Does the above matrix capture a sufficiently broad range of structural reform options?

10.1 Whilst the matrix covers a range of options, there is one option envisaged within the paper that this does not capture, namely that of maintaining the status quo.

10.2 This may be an appropriate response should one consider that other aspects of the reform agenda (notably Recovery and Resolution Planning) represent a robust response to the issues of "Too Big to Fail" and that ex ante structural reform is not the most appropriate response.

10.3 In addition, the range of options includes no reference to geographical scope. Further variants of these models – for example limiting scope of activities in the EU – may be worthy of further consideration.

11. Which option best addresses the problems identified? Please substantiate your answer.

11.1 RBS has maintained a consistent view that ex-ante structural reform does not solve the problems of bank failure and may even exacerbate systemic risk. Unnecessary costs associated with structural change will be partly borne by customers, impacting on economic growth. Instead, a targeted, firm-specific approach through the recovery and resolution regime is a better policy response.

11.2 However, in a UK context, we recognise that policy makers and wider opinion have not been persuaded by these arguments, and we stand ready to implement ring-fencing as legislative requirements begin to be more clearly defined, through the legislative process.

11.3 If ex-ante structural measures are pursued at an EU level, we believe it is critical that banks are not subject to multiple, inconsistent variants of structural reform – this would further negatively impact customers, as well as potentially increase systemic risk and distort competition in the single market. While the Expert Group's proposals are intended to be compatible with those of the UK's Independent Commission on Banking, further work will be required to deliver this objective. For example, the differing geographical scope means that there are entities which are excluded from both types of ring-fence, such as a non-EEA retail deposit-taker. If there must be structural reform it is essential that Member States implement only one type of ring-fence.

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