

Structural reform of the banking sector: CBI submission to the European Commission

July 2013

The CBI welcomes the opportunity to respond to the European Commission's consultation on reforming the structure of the EU banking sector. The CBI's contribution to the structural reform debate focuses on the "business user" view of the banking system, helping to align the stability objectives of financial reform with the need for banks to continue to provide the finance and services businesses need to grow.

This submission makes the following points:

- **The CBI supports the universal banking model**
- **SMEs value access to risk management products within a single banking relationship**
- **Accessing capital markets is important to businesses of all sizes**
- **Structural reform must be viewed in the context of a 'new normal' financing landscape**
- **Other EU reforms are aimed at tackling the issue of 'too-big-too-fail'**
- **Structural reform should recognise and be compatible with work already way in member states**

About the CBI

The Confederation of British Industry (CBI) is the UK's leading business organisation, speaking for some 240,000 businesses that together employ around a third of the private sector workforce. We represent a broad cross section of UK businesses from both the financial services sector and non-financial sectors and in all sizes, from family owned businesses to FTSE 100.

The CBI helps create and sustain the conditions in which businesses can compete and prosper for the benefit of all. We are the premier lobbying organisation for UK business on national and international issues. We work with the UK government, international legislators and policymakers to help businesses compete effectively.

Interest Representative Register ID number: 73725676990-18

The CBI supports the universal banking model

The CBI supports the universal banking model which provides clear benefits for business. CBI would be concerned with any Commission proposals that impact the cost, or availability, of banking services for business.

CBI members use the banking system in three main ways:

- **Lending and providing other forms of finance:** Businesses need finance to invest and expand their operations, thereby delivering economic growth and job creation.
- **Managing risk:** Banks help businesses guard against common business risks such as changes in currency exchange rates, interest rates or commodity prices.
- **Providing payment mechanisms and cash management:** Businesses use banks to manage their capital efficiently, ensuring they have enough cash to operate and that any spare cash is well managed.

While the above refers to the banking system in general, the universal banking model provides tangible benefits for business users. In particular businesses make use of:

- **The integrated services on offer from universal banks. This is especially useful for medium-sized, growing businesses to have a “one stop shop” approach to banking.** When businesses are small, they typically use a narrow range of banking products and have one main banking relationship. As they grow, the range and sophistication of the products they need can increase but in practice it is often more efficient to continue to source these from a single bank relationship with which they have a long standing relationship, who understand the needs of the business and are able to make quick, qualitative judgements on the company’s credit quality. Once businesses reach a certain scale they are usually able to invest the time and resources in developing a wider range of funding sources and relationships with banks and other financial institutions.
- **The ability to reduce financial risk cost-effectively by using a single banking relationship for a range of services.** Although it is common for large companies to use multiple banking relationships, they can reduce their credit risk and funding requirements by netting exposures within single relationships. For example, if a company is using a number of financial instruments to manage interest, foreign exchange and commodity risk, some of which have positive values and some have negative values, the firm can net the exposures to reduce its credit positions. Conversely, this same netting can also take place by the bank and the cost of the bank’s credit valuation adjustment for economic and capital adequacy reasons reduces, reducing the overall cost of the products. This netting can also reduce businesses funding requirements.
- **The ability to reduce operational risk by using a single banking relationship for a range of services.** Large complex international businesses use a wide variety of banking products. If a single bank can provide a range of products for a project or across a supply chain it can reduce its complexity and therefore reduce the business’s operational risk. This simplification can come from having a single relationship, particularly on international projects, from practical arrangements, for example simplified process for monitoring positions and from more flexible negotiating arrangements.

- **The ability to underpin large transactions.** Large businesses often need the balance sheet of a large bank to support them. Examples of this include large infrastructure projects or underwriting debt or equity capital issuance. Banks' balance sheets are constrained by internal concentration risk limits and regulatory large exposures rules. Although exposures can be syndicated, where financing requirements can run into multiple billions, banks that can manage large positions are needed for transactions to remain efficient.

Any structural reform proposals along the 'functional' or 'ownership' separation lines outlined in the consultation document will create additional costs for businesses in all of the above scenarios. The CBI would urge the Commission to only consider options that retain the beneficial aspects of the universal banking model for business.

SMEs value access to risk management products as part of a single banking relationship

Small and medium sized businesses value access to risk management products through a single banking relationship. When appropriately marketed and sold, the ability to manage normal business risk arising from fluctuations in currency, interest rates and commodity prices is important for business. This is particularly true of those firms looking to export to new overseas markets. The CBI would strongly oppose the exclusion of the sale of these types of derivative from a deposit bank and is concerned that structural reform will increase the cost of these services for businesses.

The CBI supports a focus from the relevant regulator, in the UK this is the Financial Conduct Authority, on product governance throughout the product life cycle, rather than on products themselves. This would include focussing on the process of designing new products including the approval process; financial promotions and marketing; the sales process; and customer satisfaction and complaints monitoring.

Access to capital markets is important to businesses of all sizes

Structural reform of banks will increase the costs and complexity for firms accessing capital markets. By separating underwriting activity the CBI would be concerned with a potential breakdown in the continuous relationship of a growing firm with their main provider of banking services.

Equity markets are an increasingly important source of growth capital for small and medium-sized businesses, offering these firms access to the public markets and both retail and institutional investors. In addition to growth capital, public equity markets also offer small and medium-sized businesses increased visibility amongst key stakeholders. Structural reform would add another barrier, by creating two separate entities for a business to deal with, with the risk of further disjointing access to different types of finance at different stages of the business growth cycle.

The CBI is also concerned about the impact of structural reform on market making. Market making plays a crucial role for businesses by ensuring the smooth running of secondary markets. Of particular concern is the potential negative effect on the corporate bond market. Due to the difficulty in distinguishing between market-making and proprietary trading, we see a potential for damaging effects on liquidity in the corporate bond market as a result of structural reform. Reduced liquidity in the corporate bond market is

particularly worrying given the amount of corporate debt which is required to be refinanced in the coming years.

Structural reform must be viewed in the context of a ‘new normal’ financing landscape

Structural reform of the banking sector will increase the costs of financing for business at a time of already dramatic change in the European financing landscape. The CBI urges the Commission to consider structural reform in this context.

As highlighted in the CBI’s response to the Commission’s green paper on long-term financing, access to finance for businesses remains a major challenge for many economies throughout Europe. We feel this should be a major priority for the Commission. Growth must lie at the core of financial policy-making if a fully-fledged recovery is to take hold.

The CBI’s analysis of the ‘new normal’ in business finance can be found in our report *Financing for Growth*. We found that banks account for nearly three-quarters of all credit intermediation in the UK, compared to just 25% in the United States, where alternative sources of finance are more widely available (see figure 1 below).



(Figure 1: Share of total assets by jurisdiction in percentages, Financial Stability Board, Shadow Banking Strengthening Oversight and Regulation, October 2001).

While the CBI is working with policy makers to help ease this transition, by promoting alternative sources of finance, the importance of bank finance to business in the near term is clear. We would urge the Commission to strongly consider the impact of any structural reform proposals on the availability of finance for growing firms.

Other EU reforms are aimed at tackling the issue of ‘too-big-too-fail’

The CBI supports efforts to increase the safety and stability of the financial system. There are, however, a number of dossiers already under consideration which we feel go a long way to addressing the issues outlined in the consultation document.

The CBI believes that financial reforms should focus on three key areas to increase financial stability whilst enabling banks to perform their primary economic role of supporting growth:

- **Better regulation and more rigorous supervision.** High quality supervision that detects potential risks early, deals with them effectively before they have an impact, and meets the challenge of complex international financial markets is essential. *In the UK this is being addressed through the creation of the Financial Policy Committee and the Prudential Regulatory Authority. At the EU level the Single Supervisory Mechanism will provide much needed oversight of the macro-prudential landscape.*
- **Better quality capital and liquidity, with counter-cyclical buffers.** Improved capital and liquidity measures that improve the banking sector's ability to absorb shocks arising from financial and economic stress, including the ability to draw on the capital conservation buffers during periods of stress, are essential. *The implementation of CRD IV will lead to a safer, sounder banking system with a more prudent capital allocation.*
- **Recovery and resolution plans, with robust cross-border agreements.** Suitable recovery and resolution plans prolong the ability of a firm to continue in operation through a period of crisis or stress, and ensures the orderly resolution of a firm in the event it fails, whilst avoiding impacts on financial stability and maintaining the provision of critically important functions to the economy without exposing taxpayers to loss. *The successful completion of the Recovery and Resolution Directive, alongside the other pillars of banking union is designed to address the 'too-big-too-fail' issue outlined in the consultation document.*

The CBI broadly supports EU moves to increase the stability of the financial system. In the context of other EU reforms however the CBI is not convinced that bank structural reform passes a cost-benefit test in terms of additional stability benefits against the additional costs it will impose. Ex post assessments of individual banks is a more pragmatic approach than ex ante structural reform, for example in the UK the Financial Conduct Authority has 'resolvability' as one of its key criteria for assessing banks.

Structural reform should recognise and be compatible with work already underway in member states

The CBI supports the introduction of a ring-fence of retail banking activities in the UK and we are working with the UK government to ensure businesses can continue to access the financial services they need to grow. While the CBI supports UK structural reform we have been clear that there are high associated costs which will have a negative impact on non-financial businesses.

The UK Government's own impact assessment¹ of implementing the ring-fence puts the direct costs to banks at between £2 billion - £5 billion per year, added to transitional costs of between £1.5 billion - £2.5 billion. It puts the indirect, present value GDP cost at between £7 billion - £20 billion per year and a long-run reduction in the GDP level of between 0.04% - 0.1%. The CBI would be concerned if further costs were borne from a structural reform proposal at the EU level.

The CBI suggests that any Commission proposals take into account initiatives already underway at member state level. This includes awareness of the different approaches taken by the German, French and UK

¹ <http://www.parliament.uk/documents/impact-assessments/IA13-005.pdf>

governments. Any proposals would need enough flexibility for member states to avoid duplication of structural reform initiatives already underway.

This flexibility might be provided by adopting the first option, *ex post separation subject to constrained discretion by the supervisor*, in section 3.2.2 of the consultation document.