EBA European Banking Authority

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Opinion of the European Banking Authority on the recommendations of the High-level Expert Group on reforming the structure of the EU banking sector

Introduction and legal basis

1. The High-level Group on reforming the structure of the EU banking sector was set up by the European Commission in February 2012 with a mandate to determine whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection, and if that is the case, to make recommendations as appropriate.

2. On 2 October 2012, the Group published its final report ("the Report") which recommends actions in the five following areas:

    a. Mandatory separation of proprietary trading and other high-risk trading activities when these activities are material within a group

    b. Possible additional separation of activities conditional on the recovery and resolution plan

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

    d. Review of the capital requirements on trading assets and real estate related loans

    e. Strengthening banks' governance and controls

3. The EBA competence to deliver an opinion is based on Article 34(1) of Regulation No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC1. In accordance with Article 14(5) of the Rules of procedure of the EBA, the Board of Supervisors has adopted this opinion.

General comments

4. The EBA welcomes the contribution of the Report to the discussion on possible initiatives to strengthen the regulatory framework of the EU. The introduction of structural measures to complement the existing and forthcoming regulatory reform is being considered in several Members States. The EBA emphasises the need to ensure consistency across the Single Market in order to foster level playing field and to avoid regulatory arbitrage. Otherwise, there is a risk that the development of structural measures at the national level ends up supporting a ring fencing of national establishments and contributes to a segmentation of the Single Market. The EBA stands ready to contribute to the design of an EU framework and to monitor possible flexibility left to national authorities.

5. The EBA emphasises the need to strike an appropriate balance in the trade off between preserving the core features of the traditional European model of universal banking and strengthening the resilience of the financial sector by segregating riskier capital market business into a separate legal entity. The proposals put forward by the High Level Group are mindful of balancing these two objectives by preserving the benefits of universal banking thanks to a separate legal entities approach within a single banking group rather than by adopting a complete separation of activities. However, only a thorough impact assessment could provide an evaluation of the potential benefits of such measures on the European banking sector and on the real economy and to compare them with their costs. In conducting this impact assessment, the EBA suggests that particular attention should be devoted to the impact of the increase in the cost of capital and funding for trading firms to assess whether this would be commensurate to the objectives of the reform and would not create unintended adverse consequences. The possible consequences on the structure of the market for investment banking services in the EU should also be assessed.

6. The EBA would also like to stress the need to maintain full consistency between the legislation on bank recovery and resolution and any additional structural measures. As the draft Directive on Bank Recovery and Resolution already provides strong incentives to modify business models away from complex firm structures, which would not allow for a smooth management of a crisis, the assessment of additional structural measures should focus on the incremental net benefit of a legal obligation to segregate trading activities. Within this framework, it will be appropriate to consider that in the absence of a legal segregation, as proposed by the High Level Group, it might be extremely difficult for a supervisory authority to exercise its discretionary judgment and impose a break up of a universal bank, especially if other competent authorities are not responding with similarly harsh measures in comparable cases. Some common, EU-wide legal constraints could be helpful in supporting the supervisory work on bank resolvability. This consideration, however, also points to the need to maintain an appropriate sequencing and coordination of the different legislative measures.

7. Implementation of any structural measures, such as a legal separation of risky financial activities from deposit-taking within a group, would need to be reasonably enforceable by competent authorities. Clear and fair criteria must be established in order to determine situations where this separation is mandatory, bearing in mind that the purpose of this breakdown is to protect the

socially most vital parts of the banking group and to limit the taxpayers' stake in the trading parts of the group.

8. Any structural measure should not be viewed as a substitute for adequate supervision. The crisis showed that any form of banking business carries a high potential for systemic risk. This is true for liquidity and maturity transformation in traditional banking as well as for complex derivatives transactions conducted on banks' accounts in the trading book. All types of activities generating systemic concerns should be subject to intensive supervision. The fact that certain business is done on wholesale markets, between parties who should be able to properly assess the risks stemming from the transactions, and does not entail an immediate impact on retail business and payment activities is not a sufficient reason to reduce supervisory coverage. During the past 20 years, major operational losses faced by individual institutions occurred from activities considered non-risky, where risk management was inadequate.

9. These measures should be accompanied by review clauses and macro-prudential monitoring. Since structural measures are easily eroded via financial innovations, they should be accompanied by arrangements for swift review, while macro-prudential authorities should be requested to closely monitor the migration of risks to non regulated financial intermediaries and the overall effect on the build up of risks in the financial system as a whole. One should avoid that such structural breakdown unintentionally feeds the development of the shadow banking system.

10. Beyond such structural measures, the Report also "*strongly supports the use of designated bail-in instruments within the scope of the BRR Directive, as it improves the loss-absorbency of the* bank". It calls for a clear definition of the position of bail-in instruments in the hierarchy of commitments, which would facilitate the pricing and trading of such instruments and the resulting market discipline and monitoring.

11. The EBA also considers that there is a need to further develop the bail-in framework in the BRR Directive in order to improve its predictability. As already expressed in the 3 March 2011 Opinion on "Technical Details of a Possible EU Framework for Bank Recovery and Resolution", the EBA would rather support a two tier regime where bail-in requirements would be applied explicitly first to a certain category of debt instruments (targeted approach) and, if this proved insufficient, only in a second stage and within a proper administrative procedure for resolution to the remaining classes of debtors (comprehensive approach). Bail-in needs to be carefully designed in order to ensure legal and operational certainty and prevent the risk that its implementation impair the pricing mechanism of banks' liabilities and cause unintended consequences, triggering destabilising effects on other financial institutions and the financial stability as a whole. In the absence of a targeted approach, there is a risk that a wide *ex ante* scope of bail-in instruments turns out to be limited once the resolution occurs.

12. As noted in the abovementioned EBA Opinion, requiring credit institutions to issue and hold a minimum percentage of their liabilities as "bail-inable" debt instruments, besides ensuring a minimum loss-absorbing capacity, has also the advantage to create large market volumes, which in turn will provide market participants with an incentive to standardise contracts, and rating agencies to focus properly on rating such debt instruments.

13. The EBA believes that clear requirements for a minimum amount of loss-absorbing liabilities, calibrated according to a thorough impact assessment and combined with a comprehensive statutory approach to bail-in would ensure strict adherence to creditors' hierarchy and would be appropriately targeted, while preserving the essential features of a comprehensive statutory approach.

Specific comments

14. On the mandatory separation of proprietary trading activities and other significant trading activities' proposal of the Report, significant work on the calibration of the trigger for mandatory separation will need to be carried out before any translation into the EU regulatory framework. The Report adopts a two-stage approach based firstly on trading book and available for sale-related quantitative indicators to set a preliminary view on which banks can be subject to separation and secondly, a supervisors' assessment based on more complex criteria which would eventually determine the need for separation. The EBA stands ready to contribute to possible Commission's work on the calibration of the threshold to be applied by National supervisors in order to ensure a clear identification of the banks for which a ring-fence of trading activities is relevant. As a preliminary remark, it should be underlined that some of the assets which are referred to for the first threshold may be similar to the assets required for the Liquidity Coverage Ratio, which may not be satisfactory, if one wants to avoid conflicting regulations. Therefore, the EBA suggests that available for sale components of liquidity portfolios are excluded from the first threshold calculation. To ensure a consistent application of these thresholds in the Single Market, there should be a need for technical standards to adopt a common definition and accounting framework. Moreover, the EBA could provide some mediation at the EU level to ensure consistent application across the EU.

15. Regarding the activities to be ring-fenced, the Report introduces some exceptions by stating that "*the provision of hedging services to non-banking clients which fall within narrow position risk limits in relation to own funds, to be defined in regulation, and securities underwriting and related activities do not have to be separated*". To ensure a consistent application of such exceptions across the EU, the EBA stands ready to contribute to the definition of these hedging services.

16. According to the Report, "*transfer of risks or funds between the deposit bank and the trading entity within the same group would be on market-based terms and restricted according to the normal large exposures rules on interbank* exposures". In such organisation, there will be a need for clear rules on the transfer of risks between the "deposit bank" and the "trading entity" in a bank holding company. However, the abovementioned restriction according to the normal large exposures rules on interbank exposures is not applicable in the current framework since the treatment of credit institutions' intra-group exposures is not harmonised. Article 113 (4)(c) of the 2006/48 Directive offers Member States the possibility to "*fully or partially exempt exposures, including participations or other kinds of holdings, incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject*". An update of the large exposures regulation – which is foreseen in the Report - will

therefore be necessary to implement these rules on risk transfer between a deposit bank and a trading entity within a group.

17. Moreover, any financial support between the deposit bank and the trading entity will have to be ruled by clear and transparent principles that would go beyond simple reference to market price. The EBA stands ready to provide its expertise in setting up such standards and monitor their correct application throughout the EU.

18. The EBA also underlines that the draft Directive establishing a framework for the recovery and resolution of credit institutions and investment firms ("BRR" Directive) introduces measures on intra-group financial support. Thus, Institutions operating within the same group should be able to enter into agreements to provide financial support to other entities within the group experiencing financial difficulties. Such release of the legal restrictions for intra-group financial support within a group would have to be implemented consistently with intra-group financing restrictions between "deposit" and "trading" institutions.

19. Regarding additional functional separation of activities in the context of recovery and resolution plans, the EBA stands ready to promote a consistent application of recovery and resolution plans' content and assessment across the EU. To fulfil this objective, the EBA should set binding technical standards to be applied by national supervisors (including the ECB) and resolution authorities. The EBA should then have a mandate to conduct a rigorous review to check that consistency has been achieved. To ensure a consistent application of these standards on recovery and resolution, such ex post review will be a crucial component.

20. As already mentioned in the general comments, the Report suggests possible amendments to the use of the bail-in instrument as a resolution tool. The EBA agrees that "*such debt should be held outside the banking system*" which would require appropriate mechanisms in order to prevent the acquisition of such securities by the banking sector (e.g. introducing a particular risk-weight for such debt). Moreover, the EBA welcomes the suggestion to use bail-in instruments (i) in remuneration schemes for top management and (ii) by introducing a mandatory share of variable remuneration into bail-in bonds. Such measures could be adopted in a swift manner and may efficiently contribute to the overall efforts to reduce moral hazard and restore confidence between the public and the banking system.

21. As regards the recommendations to improve the robustness of the trading book capital requirement by i) setting an extra, non-risk based, capital buffer requirement for all trading book assets; and/or by ii) introducing a strict floor risk-based requirement, the EBA understands that the Group's initiative is brought to the general review of the capital requirements in the trading book conducted under the aegis of the Basel Committee which would bring a global answer to this particular issue. The EBA considers that such extra capital buffer may be justified with reference to market risk and operational risk, but one should underline that a major driver for bringing down banks during the crisis (or at least generating systemic risk that justified public bail-outs) has been counterparty risk, especially in derivatives transactions. Any additional capital requirement related to trading assets should, therefore, also refer to counterparty risk and explicitly mention derivatives transaction

together with trading operations in order to capture the underlying risk generated by these activities.

22. Finally, the Report calls for a consistent application of loan-to-value and loan-to-income ratio in all member states, which is strongly supported by the EBA. To ensure this consistency, *ex post* monitoring should be conducted by microprudential and/or macroprudential authorities across the EU.

This opinion will be published on the EBA's website.

Done at London, 11 December 2012.

[signed]
Andrea Enria
Chairperson
For the Board of Supervisors