

The European Commission’s proposal for a regulation on structural measures improving the resilience of EU credit institutions: A critical assessment of the EBF Banking Structural Reform Expert Group

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1. Summary

This report, drafted by the EBF expert group on bank structural reform, analyses the likely consequences of the European Commission's proposal for bank structural reform (BSR) for end users of financial products and the real economy. The report points to the following key findings:

- **The BSR appears redundant with other reforms.** The objectives of the separation seen by the European Commission are actually already under the scrutiny of ongoing regulatory changes (CRDIV/CRR, BRRD, SSM/SRF, TLAC, etc.).
- **Separation is expected to increase funding costs for the trading entity.** Such increase may even incentivise it to cease certain trading activities. EU separated trading entities would have difficulties surviving, as they would have to exit some unprofitable markets, and would be “forced” to exit other markets as they would not be able to offer competitive prices to their clients compared to third-country dedicated trading entities.
- **Separation is expected to increase funding costs for the core bank,** because of separation on market making costs for European entities and duplicity of some compliance with many existing and coming regulations – for example the need for the CCI to acquire high quality liquid assets (HQLA) in the market to comply with the Liquidity Coverage ratio (LCR); or the prevalence of preferred depositors in the CCI resulting in equity and bond holders asking for a higher risk premia for holding bail-in able debt.
- **Those expected increases in funding costs will result in higher costs for the real economy** for accessing the products and services offered by the trading entity, with important repercussion on hedging strategies and risk management costs:
 - **The BSR proposal would lead to a poor functioning of the secondary market and consequently an additional illiquidity premium for primary issues.** Examples based on three reference values demonstrate that an increase of only 1 basis point in the yield of a bond would result in an additional average cost of funding for issuers located in the European Union (including sovereigns) of about EUR 0.75 billion yearly. For an increase of 5 basis points in bond yields the additional average cost of funding would be EUR 3.7 billion yearly. And for an increase of 10 basis points in bond yields the additional average cost of funding would be EUR 7.49 billion yearly.
 - **The core credit institution would only be able to provide corporates with standard risk management products.** This will lead to higher costs for companies and institutional investors that, to a large degree, need to use non-standardised products

to manage their business-related risks. The likely consequence is that corporates will end up not hedging their risk or taking extra risk due to the hedging mismatch stemming from not having adequate access and/or raised costs for non-cleared derivatives. This is particularly true for SMEs who will have less access to non-standardised products than large corporates.

- **The important role that universal banks currently play in facilitating the access for SMEs to an external investor base would be interrupted** as separation requirements would make European universal banks less able to play this role due to competition from third-country dedicated trading entities. This could be to the disadvantage of smaller institutional investors and medium-sized companies in Europe that are currently being served by EU universal banks, as it is not sure that large and global trading entities would be interested in serving this client segment.

2. Introduction

On 29 January 2014 the European Commission (EC) released its proposal for *a regulation on structural measures improving the resilience of EU credit institutions*¹ - more commonly known as the bank structural reform (BSR) proposal.

The European Banking Federation (EBF) does not support this proposal as we believe that it would be detrimental to the ability of European universal banks to serve their customers and supply financing to the real economy. In the EBF's view the proposal is contradictory to the Juncker Commission's economic growth agenda and to its objective of supporting long-term financing of the European economy². Furthermore, the EBF does not agree with the economic analysis and rationale behind the proposal. In particular we disagree with the EC's arguments regarding the perceived riskiness of trading activities for financial stability and the need for additional structural reform, as the risks in the banking industry have been significantly reduced due to several ongoing regulatory changes including the recovery and resolution directive (BRRD), which already provides resolution authorities with the right to demand structural changes from banks otherwise deemed 'Too Big To Fail' (TBTF).

To better understand the likely consequences of the BSR proposal for end users of financial products and the real economy, the EBF decided to turn to the expertise of its members and set up an expert group of practitioners from the banking industry. This report reflects the views of the EBF experts on the impact that the EC BSR proposal would have on end-users, such as corporates and institutional investors, and the financing of the real economy.

¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0043&from=EN>

² <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014DC0168&from=EN>

3. Separation and its impact on the real economy

The European Commission's assessment of the economic impact of the BSR proposal on stakeholders remains high-level and qualitative. It omits important end-users such as institutional investors and without any real analysis dismisses any concerns over impact on market liquidity, labelling such concerns as exaggerated³. In this section we challenge those findings by demonstrating and - where possible - providing quantitative evidence that the BSR proposal would have a severe impact on end-users, the well-functioning of European financial markets and ultimately economic growth.

3.1. Separation would increase funding costs for the trading entity *and* the core bank

3.1.1. Increased funding costs for the trading entity

In the EBF expert group's view, the key impact for the separated banking group would be an increase in the funding costs for the separated trading entity. As the liquidity would be trapped in the retail bank the trading entity would have to directly raise funds in the market. The increase in funding costs for the trading entity is mainly connected to issuance of senior unsecured debt over various maturities by an entity that would be perceived (but not necessarily be) more risky than the original banking group.

The increase in funding costs of the segregated trading entity is estimated by a March 2014 Banque de France study⁴ at 220 basis points. This increase would undermine both the trading entity's ability to refinance itself under satisfactory conditions as well as its capacity to act as an acceptable counterparty for credit-risk purposes, compared to non-EU banks. It would actually condemn the separate trading entity to cease activities which would no longer be cost efficient in the face of unfaltering competition from large American and Asian universal banks.

3.1.2. Increased costs for the core credit institution

Furthermore, the EBF expert group finds it unlikely that the core credit institution (CCI) would benefit from a decrease in funding costs from separation, as the Commission suggests⁵. Actually, the EBF expert group believes that the funding costs of the CCI could increase for several reasons.

One likely effect could be that the CCI would have to issue additional long-term debt in the capital markets and invest in high quality liquid assets (HQLA) in order to meet the requirements of the LCR,

³ Part 1 of EC IA for BSR proposal: http://eur-lex.europa.eu/resource.html?uri=cellar:e186dd0b-89b3-11e3-87da-01aa75ed71a1.0001.01/DOC_1&format=PDF

⁴ "Reforming the structures of the EU banking sector Risks and challenges » Régis Breton and Laurent Clerc, Financial Stability Directorate Banque de France, March 2014

⁵ According to part 1 of the EC impact assesment, p.72 "*Funding costs are likely to be unaffected for the deposit taking entities...*". Link: http://eur-lex.europa.eu/resource.html?uri=cellar:e186dd0b-89b3-11e3-87da-01aa75ed71a1.0001.01/DOC_1&format=PDF

since HQLA held in the trading book for market making purposes would no longer be available for liquidity management purposes. In addition, the CCI would have to implement collateral management systems and hold HQLA to face the implication of the new risk-mitigation techniques framework to which the CCI would be subject when managing its own risks or providing permitted services to its customers.

Also, the interaction between separation requirements (the BSR proposal) and bail-in requirements (the BRRD) could lead to a concentration of risk that could further increase funding costs for the CCI.

More specific, in the CCI the equity and bond investors would have to shoulder a concentration of the total risk on their securities because a very significant part of the liabilities of the deposit bank consist of deposits (particularly when compared to a pure trading entity or even to a universal bank) and depositors are preferred creditors according to the BRRD. As a consequence those investors would demand higher risk premia.

Moreover, as a consequence of separation of market making activities, the liquidity in the covered bond market might very well be negatively affected resulting in higher cost for issuance of covered bonds and senior debt for the CCI. The reason for this is that if market making activities of universal banks are to be separated, the cost of providing market making services would increase, and as a consequence, the supply of market making services could decrease, as it is likely that some market makers would reduce or cease their market making activities. This would ultimately lead to increased costs of primary issues in the market (see also sections 2.2.2 and 2.2.3). This is a feedback loop effect of the EC BSR proposal that will also increase the funding costs for the CCI.

Another feedback loop effect of the BSR proposal will come from rating agencies, which pay close attention to the profitability of banks and whose rating directly impact a bank's funding costs. Also, funding markets in general take it as a sign of financial health that an institution generates healthy returns. Both the trading entity and the CCI would be exposed to this feedback loop effect since costs are expected to increase for both of the entities. In addition, there is the possibility that the relative profitability of the CCI would drop - due to the expected lower return on equity (ROE) for standardised low-margin activities allowed in the CCI, such as retail services and trading of government bonds - and therefore the rating of certain CCI's might drop resulting in an increased cost of funding. Moreover, since the BSR brings a specialization of business models, there is a loss of the diversification effects that will increase risk and thus, lower the ratings.

3.1.3 Increased operational costs from separation

According to the EC BSR proposal, the requirements that shall apply to the two distinct units on a sub-consolidated basis include separate funding operations and compliance with the various regulatory requirements on capital and liquidity, leverage, large exposures and disclosure. This also implies that each unit must have in place their own arrangements and processes taking care of credit and

counterparty risk as well as other risk categories, Internal Capital Adequacy Assessment Process (ICAAP), recovery and resolution planning, ECB/EBA stress tests and so on. Furthermore, internal policies, instructions and guidelines would need to be produced and maintained in two places. This would imply a full corporate governance structure for each unit and duplication of staff functions.

It is of course difficult to estimate the effect on operational costs as this will vary depending on the structure and business model of each bank. For example, some universal banks are diversified into trading activities by an in-house diversification, whereas other institutions have organised their trading activities in separate subsidiaries.

The impact assessment accompanying the EC BSR proposal refers to findings from submitted data templates where three banking groups estimate that their operating costs will increase by 1 to 9 %, whereas two banking groups report decreases of total costs of 2 to 11 %⁶. The impact assessment claims several inconsistencies in the submissions and the EBF expert group takes it that the latter group must reflect a cost reduction in the core banking unit as such, after the separation of the trading unit. Otherwise the reported cost reduction does not make sense.

The EBF expert group notes that on the separation issue related to the retail ring-fencing in the UK, the Independent Commission on Banking refers to increases in operating costs of £0.5bn per annum for the four largest UK banks in aggregate⁷.

In the EBF expert group's view it is hence clear that there will be a cost increase for separated banks, affecting both the CCI and the trading entity. Such cost increases due to changes in the legal, organisation and operational structure of affected banking groups, are of a permanent nature and will over time be passed on to clients as result of less cost efficient, separated institutions.

3.2. Separation would raise funding costs for end-users and have an unintended impact on market functioning

As we have seen in section 3.1 a number of mechanisms would drive cost increase for the separated entities. In this section the EBF expert group elaborates more on what this could imply for end-users and for the well-functioning of financial markets in Europe. In the EBF expert group's view the estimation of the potential impact on end-users from separation was under-analysed in the EC impact assessment accompanying the BSR proposal.

⁶ http://eur-lex.europa.eu/resource.html?uri=cellar:e186dd0b-89b3-11e3-87da-01aa75ed71a1.0001.01/DOC_3&format=PDF - see p. 249

⁷ P. 302 final ICB report: <http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf>

3.2.1 The role of market making for the well-functioning of the secondary and primary market

Market making in the broadest sense means to stand ready to quote prices for the purchase or sale of financial instruments either on an ongoing basis or in response to client enquiries. In the existing market structure in the European Union, market making services are primarily provided by universal banks. The view of the EBF expert group is that market making delivers significant value to the performance of the real economy and that separation of market making would impair the liquidity in European capital markets and raise cost for end-users.

There is a direct relationship between banks' willingness to provide market making services, the cost of financing and the cost of managing risk for the real economy. The primary role of banks' market making activity is to intermediate the transfer of risk from the corporate and public sector to institutional investors: market making enables the efficient allocation of investors' financing capacity

and risk appetite to the investment and risk management needs of companies and public institutions. The liquidity and price transparency resulting from banks' willingness to make prices reduces liquidity premia and risk premia demanded by institutional investors for holding positions in securities and derivatives.

A pension fund, for example, can invest in investment grade bonds only and holds, amongst other investments, issues from an entity that suffers a reduction in its creditworthiness under the threshold of the investment grade. A liquid secondary market will provide the pension fund with a possible cost-effective exit from the position held without generating a loss that could impair its ability to face its obligations. The cost effectiveness of the solution is given by – in absence of an equivalent and opposite interest from other buy-and-hold market participant – market makers.

From a practical point of view a well-functioning secondary market is therefore of paramount importance for the optimal performance of a primary market. Without the ability for the end-users to be able to close positions in a short amount of time and with a minimal cost, market participants will require an additional "illiquidity premium" – an extra return – on all primary market issues, to face potential losses in case of sale of a position where no order-match can be found in the market (as can be observed during periods of market stress). On top of this illiquidity premium, a poor functioning secondary market will erode the proper and transparent price discovery mechanism for primary issuance leading to a further cost increase of new issuances. Market making and the role of liquidity is further explained in the [annex](#).

The requirements for banks to monitor and manage risks associated with market making have been greatly enhanced through strict regulation in the aftermath of the financial crisis. Today, banks are also required to hold significantly higher amounts of capital specifically to ensure their ability to absorb potential losses from market making activities. Through these measures, the risks to the financial system from banks' market making activities have been greatly reduced. In the view of the EBF expert

group the risks to the financial system would significantly increase if market making services would migrate to the shadow banking system as a result of the EC BSR proposals.

3.2.3 Estimation of impact on funding costs for primary market participants

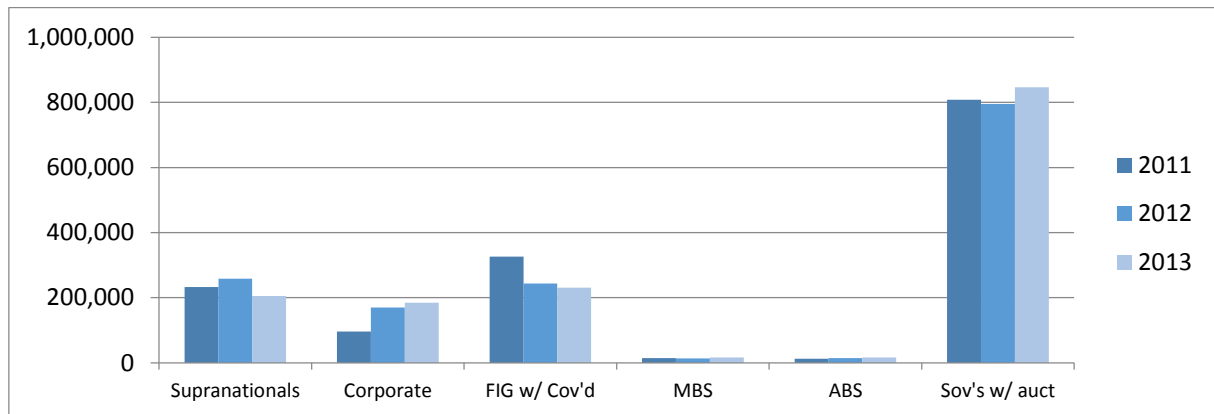
The BSR proposal would lead to a poor functioning of the secondary market and as a consequence will lead to a wider bid-ask spread, increase in investment and hedging costs, an additional illiquidity premium and an inefficient price discovery/setting for primary issues.

To assess the ongoing costs to the European economy from separation we consider as an example the expected costs born via the primary market. We use volumes of bonds issued by different categories of market participants for the years 2011, 2012, 2013 as displayed in the table below. We do not take into account the initial value losses generated by the widening of the spread in the investment portfolio's valuation nor potential volumes decrease as a result of the increased cost of funding.

Table: Notional values of issues 2011-2013 divided by different categories of European Issuers (FIG includes Covered Bond issues and Sovereign includes Auctions)

Year	Supranationals	Corporate	FIG w/ Cov'd	MBS	ABS	Sov's w/ auct	Total EU
2011	233,017	96,699	326,816	15,075	12,655	807,587	1,491,849
2012	258,345	170,122	243,895	13,542	15,142	794,873	1,495,920
2013	205,199	184,566	231,143	16,223	16,733	846,731	1,500,594
Total	696,561	451,387	801,854	44,840	44,530	2,449,190	4,488,363

Data in Euro Millions - source BBE



On the basis of the displayed volumes for the years 2011-2013 we consider how an increase of respectively 1 and 5 and 10 basis points in the yield of a bond could impact funding costs for market participants in the primary market. These three values are chosen as reference values to demonstrate

the potential impact in terms of an increase in absolute funding cost from a minimum increase in yield values as a consequence of separation⁸.

Example i): When we consider the total negative impact on new issuances' pricing of 1 basis point (0,01%) yield widening and an average maturity of the issued bonds of 5 years⁹ the economic cost of such widening for the issues in the years 2011-13 would be as follows:

Additional Systemic Funding Costs via Bond issues (EU wide) for 1 basis points increase in the yield

Year	Suprationals	Corporate	FIG w/ Cov'd	MBS	ABS	Sov's w/ auct	Total EU
2011	116,51	48,35	163,41	7,54	6,33	403,79	745,92
2012	129,17	85,06	121,95	6,77	7,57	397,44	747,96
2013	102,60	92,28	115,57	8,11	8,37	423,37	750,30
Total	348,28	225,69	400,93	22,42	22,27	1.224,60	2.244,18

Data in Euro Millions - source BBG

(hypothesis avg maturity 5 yrs, spread widening 1 bp constant no PV)

Example ii): For an increase of 5 basis points in the bond yield the impact would be as follows:

Additional Systemic Funding Costs via Bond issues (EU wide) for a 5 basis points increase in the yield

Year	Suprationals	Corporate	FIG w/ Cov'd	MBS	ABS	Sov's w/ auct	Total EU
2011	582,54	241,75	817,04	37,69	31,64	2.018,97	3.729,62
2012	645,86	425,31	609,74	33,86	37,86	1.987,18	3.739,80
2013	513,00	461,41	577,86	40,56	41,83	2.116,83	3.751,49
Total	1.741,40	1.128,47	2.004,64	112,10	111,33	6.122,98	11.220,91

Data in Euro Millions - source BBG

(hypothesis avg maturity 5 yrs, spread widening 5 bps constant no PV)

Example iii): For an increase in the bond yield of 10 basis points the impact would be as per below. Such an increase could particularly be likely for less liquid instruments like corporate bonds, FIG, MBS and ABS.

Additional Systemic Funding Costs via Bond issues (EU wide) for a 10 basis points increase in the yield

Year	Suprationals	Corporate	FIG w/ Cov'd	MBS	ABS	Sov's w/ auct	Total EU
2011	1.165,09	483,50	1.634,08	75,37	63,28	4.037,93	7.459,25
2012	1.291,73	850,61	1.219,48	67,71	75,71	3.974,36	7.479,60
2013	1.025,99	922,83	1.155,72	81,12	83,66	4.233,65	7.502,97
Total	3.482,80	2.256,94	4.009,27	224,20	222,65	12.245,95	22.441,82

Data in Euro Millions - source BBG

(hypothesis avg maturity 5 yrs, spread widening 10 bps constant no PV)

As demonstrated in example 1, on average, for each of the years considered, an increase of **only 1 basis point** in the yield of a bond would result in an **additional cost of funding**, for entities located in

⁸ Should we measure the "real" impact on the economy of a yield increase it would require a more in depth and resource demanding analysis taking into account for example elasticity curves demand(of funding) vs cost of funding, and volume reduction plus increase of cost as variables to be identified.

⁹ PV effects were deemed to be irrelevant for the purposes of this analysis. As of 29th of July the PV for a 5 years strip of coupons was 98.16%.

the European Union (including sovereigns) **of about EUR 0,75 billion per annum or EUR 2,2 billion aggregated for the three years under analysis** without considering the potential losses generated by the widening of the spread in the investment portfolio's valuation.

For an **increase of 5 basis points** in the yield of a bond the additional cost of funding would be **EUR 3.7 billion per annum or EUR 11.2 in aggregate** for the three years considered. And finally, as demonstrated in example iii) for an **increase of 10 basis points** in the yield of a bond the additional cost of funding would be **EUR 7, 49 Billion per annum or EUR 22,4 billion in aggregate** for the years considered.

Bearing in mind that the financing of growth via the European Capital Markets is already very important and will become more crucial going forward, as indicated by the European Commission in its Communication on long-term financing of the European economy¹⁰ as well its plan of establishing a Capital Markets Union, the EBF expert group believes that the extra cost of funding is a burden that will mostly be carried by consumers. If we extend the extra cost exercise to secondary markets, where volumes are at least equal to those of primary markets, and considering that liquidity is lower for the secondary market than the primary, the impact could be devastating for the European economy.

It also is worth mentioning that, due to the differences in funding cost increase for the trading entity and the CCI, the extra costs associated with accessing the European capital markets will create an arbitrage versus the standard financing, i.e. loans, provided by the CCI. An entity that needs funding

would hence be facing two different alternatives: either to access the bond market (banking system disintermediation) which will require a higher funding cost related to the liquidity premium requested by the market, or to access the standard financial market by requesting a loan via a CCI. Considering the different increases in liquidity costs for the two entities and in particular a lower increase in the funding cost for the CCI, the entity requesting the funds might find it more attractive or economically viable to recur to the standard loan market rather than accessing the EU Capital Markets via a bond issuance. This is clearly against the intentions of the European Union of fostering the disintermediation of the financing world from the banking system.

3.3. Separation would impair end-users ability to cover their business-related risks

3.3.1. Why hedging services are necessary for end-users

Hedging techniques are an intrinsic part of financial markets and are used to reduce any losses and to protect any gains deriving from a corporate's economic activity.

¹⁰ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014DC0168&from=EN>

The use of derivatives is very widespread among corporates, as we can see from the Oliver Wyman report *the impact of the EU-11 Financial Transaction Tax on end-users* (the EBF vehemently opposes the FTT)¹¹.

EXHIBIT 34: DERIVATIVES NOTIONAL TURNOVER (€ TN, 2010)

	OTC derivatives		Exchange-traded derivatives		
	Rates	FX	Rates	FX	Equities
Global	518	630	1,311	30	187
EU-11 end-users	26.4	23.2	161.3	0.1	7.1
<i>Of which:</i>					
• Corporates	11.0	11.6	42.6	<0.1	1.5
• Asset managers	8.0	9.4	95.2	<0.1	4.1
• Pension funds	2.5	0.8	7.2	<0.1	0.8
• Insurers	4.9	1.4	16.3	<0.1	0.6

Source: Bank for International Settlements, Oliver Wyman proprietary data and analysis

Derivatives traded by corporates belong mainly to the FX and interest rates categories; this is consistent with the hedging purpose of their derivatives traded, because interest rates and FX are the main risks companies face in their balance sheet, arising from the real economic activities they undertake within their business.

There are no public figures on what proportion of derivatives traded by corporates are accounted as hedging transactions. However, in the EMIR reporting obligation several major European companies have declared themselves as NFC-, meaning that the amount of derivatives they trade for non-hedging purposes do not surpass the thresholds stated in the regulation. Hence, it is not far-fetched to assume that in general, corporates use derivatives for risk hedging purposes, not speculation.

A recent analysis¹² of the activity by different counterparties in the OTC derivatives market concludes that 65% of OTC interest rate derivatives market turnover involve an end-user. End-users are either non-financial counterparties (primarily corporates and governments) OR “other financial counterparties” (i.e. pension schemes, regional banks, insurance companies, mortgage providers and asset managers), which use derivatives primarily to hedge risk and create greater certainty in their financial outlook. Among the remaining 35% turnover, entered between dealers, most of it linked to client facilitation. It is also considered to have a positive effect for end-users. The notional outstanding amounts for the three categories are displayed in the table:

¹¹ <http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=9930>

¹² ISDA: *dispelling myths: end-user activity in OTC derivatives*

Table 1: OTC interest rate derivatives notional outstanding (\$ billions)

	H1 2012	H2 2012	H1 2013	H2 2013
Total	494,427	489,706	561,314	584,364
With reporting dealers	139,146	116,892	104,210	96,197
With other financial institutions	316,905	338,083	421,266	469,611
With non-financial customers	38,376	34,731	35,838	18,556

Source: BIS

Note: Drop in notional traded with non-financial customers in H2 2013 attributed to reclassification of contracts with central counterparties

Source: ISDA report, august 2014

3.3.2. Hedging in a separated scenario

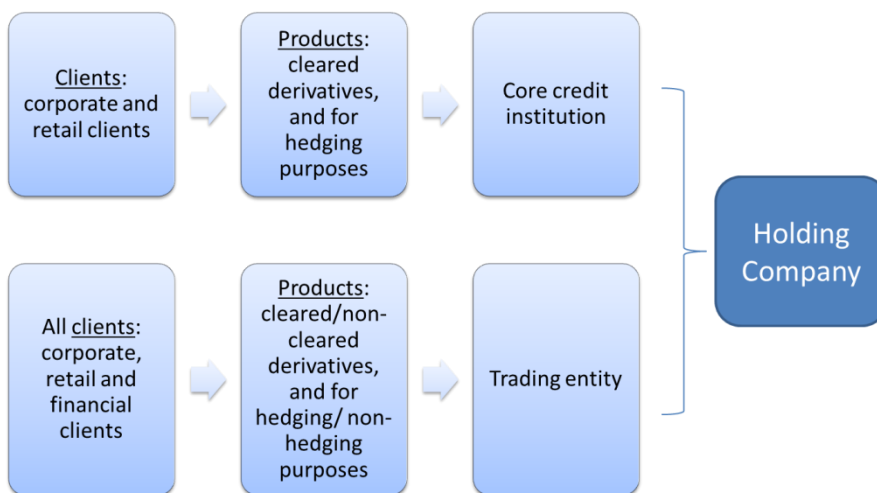


Illustration: example of separated bank as proposed by the EC BSR proposal.

3.3.2.1 The CCI would be limited to provide corporates with standard risk management products

According to the EC BSR proposal the core credit institution (CCI) would only be able to provide derivatives that can be cleared by CCPs subject to certain restrictions on instruments, clients and volume traded. As a consequence the CCI would not be able to offer all derivative products that clients frequently require.

Cross currency swaps are an important example in this respect: many companies issue debt in a foreign currency, if it provides them the opportunity to broaden their investor base or achieve lower funding costs. Cross-currency swaps are standard products that allow a company to perfectly hedge the foreign

currency risk as if they had taken out a loan in its domestic currency. However, no CCP is currently able to clear cross-currency swaps; therefore, the CCI could not offer this product to its clients. This constraint would not only impact CCIs' large corporate clients, but also SMEs who mainly use the private placement markets rather than the public bond markets: In 2013, approximately €15bn of corporate debt was raised through the German and French domestic private placement markets. A further \$15.3bn was raised in the US private placement market by European companies¹³. Thus, access to the private US dollar market appears almost as important to European SME as access to the Euro market.

Another example that could be relevant particularly for export-oriented SMEs are simple interest rate swaps in emerging market currencies. LCH Clear net Limited, the leading global CCP for interest rate swaps, is currently able to provide clearing in 17 different currencies. Derivatives in all other currencies are either not clearable or only clearable by CCPs in foreign countries. Thus, a CCI that were to provide financing and payment services to its clients in those currencies would not be able to hedge the resulting risks, since it would not be allowed to trade interest rate swaps unless they can be cleared.

3.3.2.2. The provision of (specialised) hedging services via a trading entity will be more expensive

The other possibility for corporate clients would be hedging their risks through a trading entity. The range of products they would be able to offer is much wider, including any kind of derivatives. However:

- i. As already described in section 3.1.1 the hedging services provided via a trading entity would be more costly due to the increase in costs due of the trading entity.
- ii. Furthermore, a trading entity would be more volatile and more fragile due to the lack of diversification in business and clients. Especially, in the case of Europe, where pure trading entities are rare, the clients would need to understand properly the risk profile of these kinds of entities.
- iii. Moreover, clients (especially SMEs) would not have a prior relationship with those trading entities, the potential result being a price increase on the trades or even, more likely, no trade at all. The reason for this is that the trading entity would tend to assess a new client more conservatively as it does not have full access to the credit assessment of the client. Furthermore, the benefit of netting among credit and debit positions will be reduced, and also as there would be less crossed business each entity would tend to analyse the client on a marginal basis instead of on a global basis. Finally, due to a more infrequent relationship with the client, it could be the case for the trading entity that it would lack some useful information about the client's needs in order to assess its risk and to provide the best hedging advice.

3.3.2.3. Separation would incentivise corporates to undertake inadequate risk management

¹³ "Trade bodies join forces to promote EU private placement market", International Capital Markets Association, June 12th 2014

As described in the two prior sections non-standard hedging (OTC) would be hit most severely by the EC BSR proposal.

In the EBF expert group's view it is very difficult for the market to reach a level of standardisation that can fully suit the corporate clients' needs. The hedging objective that they intend to fulfil is linked to a specific risk scenario that cannot always be matched to the standard characteristics of the derivatives available for clearing through a CCP. The less sophisticated the corporate client is, the more it will need a tailor-made hedging product that accommodates its specific needs.

Hence, if for example an SME is forced to fulfil all of its hedging needs using standard derivatives, a situation could arise, where it would be left with the choice of:

- not to hedge
- or to take extra risks (mismatch of the hedge) on the balance
- or to adopt its business cycle and therefore only close their sales at the dates when standard derivatives are settled

In either case the SME would be driven towards speculation, the one situation that it wanted to avoid by hedging outstanding real economy positions. Moreover, the CCI is not allowed to provide equity derivatives, leaving some of the risks unhedged in the case of companies that only trade with this kind of banks.

Asking the SMEs to hedge their risks through standard derivatives, fully understanding and assuming their hedging mismatches for basis or term differences, would be illusory. At the same time, the CCI, being specialised in retail products would not necessarily have the adequate expertise to explain to their clients the mismatch risk being assumed when using standard derivatives.

The direct provision of finance to all types of borrowers would require an unrealistically major reconfiguration of capital markets. And for certain types of lending, such as loans to SMEs and residential and commercial property lending, banks are arguably better placed to extend credit due to their branch network, credit assessment expertise and their operational capabilities.

Breaking the universal banking model, when the need has been assessed for corporate clients to access financial resources through capital markets, endangers the progress needed for corporates to develop their financial culture. We believe they will not be able to do it without the help from their traditional bank.

3.4. Separation would compromise SMEs access to capital-market based funding

The EC Communication on *Long-term Financing of the European Economy* points to the need for reducing European corporates' reliance on bank funding while providing institutional investors like

pension funds and insurance companies with investment opportunities for generating attractive pension returns. Some of the key conclusions from the EC communication are¹⁴:

- The European non-financial corporate sector remains much more reliant on bank financing (85%) than on the corporate bond market (15%) compared to the US where the proportion between bank loans to corporate bonds is 53% to 47%.
- The loan-to-deposit ratio remains high in Europe (130% in 2011) compared to the US (75%).
- Unless European corporates – especially SMEs – have access to alternative sources of financing any decline in bank lending is likely to have an adverse impact on corporates' ability to finance investment.
- The available evidence shows that, at the moment, debt capital markets are accessible mainly for large corporates as SMEs cannot afford the costs of bond issuance.

The EBF expert group finds that the EC BSR proposal is conflicting with this aim as it would compromise universal banks' ability to facilitate the transition to capital markets-based funding for SMEs.

Universal banks are organized to offer the full range of products to their corporate client base across all types of financing solutions and payment services. For SMEs aiming to diversify their financing sources it is critically important that their bank has the capability to offer alternative financing structures and to introduce the company to an investor base that is familiar with these products and can invest in them.

A number of standardised non-public debt instruments exist already which can be issued in smaller sizes and at comparatively low cost. Importantly, private placements do not require the high disclosure standards necessary for the issuance of bonds in the public markets. Thus, these products represent an easy entry to alternative financing sources of the capital market and are particularly attractive for SMEs with a growing business. Universal banks are ideally positioned to offer the whole value chain, from structuring and originating the debt of an SME to distributing it to investors, because they have known the company for some time and can explain its business model and credit story. These are important services for investors who may not have the skills to conduct a full credit analysis on their own or may not want to invest the necessary resources if they are only interested in a small investment. In the absence of detailed publicly available information, as is often the case for SMEs, investors need to rely on the quality of the originating bank's credit expertise.

Investors do however not need to rely entirely on trust since their interests will often be aligned with the originating bank, when the bank continues to have a credit exposure to the company. This is typically the case for universal banks that have a comprehensive business relationship with the SME

through the provision of credit lines, trade finance, and cash management services. However, separation could impair this important role that universal banks currently play in facilitating the access for SMEs to an external investor.

The reason for this is that EU universal banks would have incentive to stay below the separation triggers to avoid separation. However, banks with small trading operations will not be able to successfully compete against dedicated trading subsidiaries of non-EU banks, i.e. over time today's universal banks will be forced to concentrate on traditional commercial banking activities only and act as price takers in the capital markets. Subsidiaries of non-EU banks and shadow banks are likely to gain market share due to their continued ability to serve the needs of institutional investors and international corporates. However, the ability of EU universal banks to accompany their local and regional corporate client base throughout their journey towards a capital markets-based funding model would be compromised.

Given the importance of large EU banks to the provision of liquidity in the markets for financial instruments in the EU it is questionable whether and how a reduction in market making activity by EU universal banks could or would be replaced - particularly in their local markets. According to investor surveys for fixed income markets conducted in 2013, the five largest EU banks (Deutsche Bank, Barclays, Royal Bank of Scotland, Société Generale, BNP Paribas) accounted for a 38% market share in secondary market trading. The EBF expert group believes it is likely that the 38% market share would mostly be taken over by banks outside the Eurozone, if market making activities had to be separated. This would result in a further concentration of activities and could imply a more oligopolistic setting. Whilst in the long run one may expect a new equilibrium to be reached, in the short term uncertainty and significant market disruption, resulting from the exit of key players from segments of the market, could have material implications for overall market liquidity and ultimately financing of the real economy.

4. Regulatory reform already addresses Too-Big-To-Fail

In its impact assessment, the European Commission puts a lot of emphasis on the issue of implicit government guarantees. According to the EC some financial institutions, notably those deemed to be too-big-to-fail (TBTF), are said to benefit from an implicit government guarantee that enables systemic institutions to borrow at a lower cost than those not benefiting from it.

In the view of the EBF expert group it is important to stress that to the extent that such an implicit government guarantee exists it has been significantly reduced due to the ongoing regulatory changes (CRDIV/CRR, BRRD, SSM/SRF etc.).

For example, the bail-in rules transfer risk from taxpayers to unsecured bondholders. As a result of this increased risk, holders of bail-inable liabilities may be expected to ask, everything being equal, for a

higher return. The cost of funding for such liabilities would reflect more accurately their actual risks. Rating agencies has already announced their intention to reduce the benefit of the implicit guarantee allocated to banking institutions by downgrading their ratings for banks. It should also be noted that the BRRD already give resolution authorities the powers to separate activities, if the bank is not able to demonstrate that such activities are resolvable. Hence, the need for further added separation powers is hard to see.

Also, it is worth mentioning the additional capital charges for G-SIBs and the increased costs and risks (sanctions) of compliance with a wide set of new regulations that would reduce potential “benefits” of the funding subsidy for G-SIBs. For example, the FSB is currently ironing out a total loss absorbing capacity (TLAC) requirement for G-SIBs ensuring that they have sufficient loss-absorbent capacity in the event of failure or resolution.

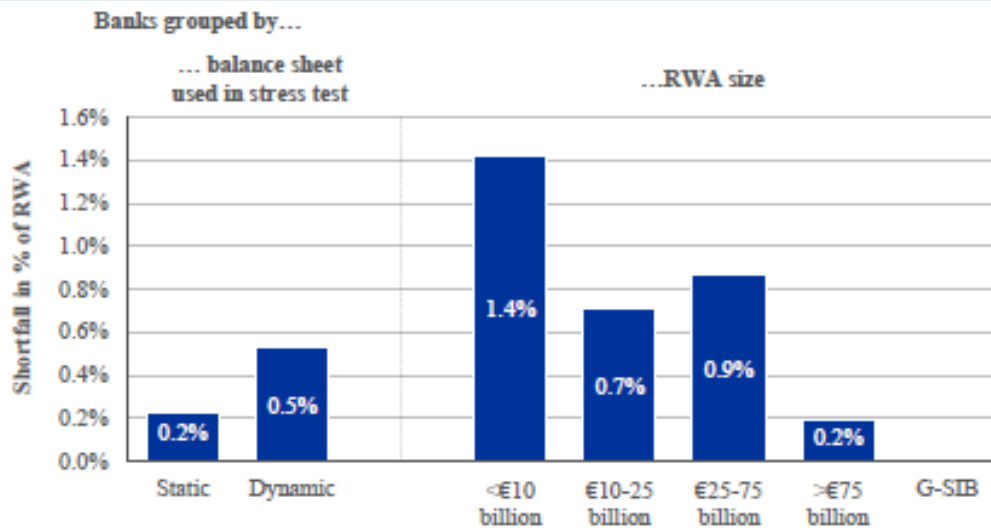
Moreover, the EBF expert group believes that the establishment of a European Single supervisor for the significant Eurozone banks will be instrumental in reducing the propensity that national supervisors could potentially have to resort to bail-out support for large national G-SIBs (to the degree the BRRD still allows for this).

Generally, it appears questionable whether this guarantee benefits only to large banks. According to the Commission, this is the case and this implies a distortion of competition to the detriment of the small players and a barrier to entry of new players. However, it seems smaller institutions also benefit from implicit support. For example, in the most recent cases for which the French government actually intervened (Dexia, PSA bank, Credit Immobilier de France), the size did not appear to have been a determining element. In addition to the question of the size, it is important to underline that the implicit guarantees is not specific to the structure of banks.

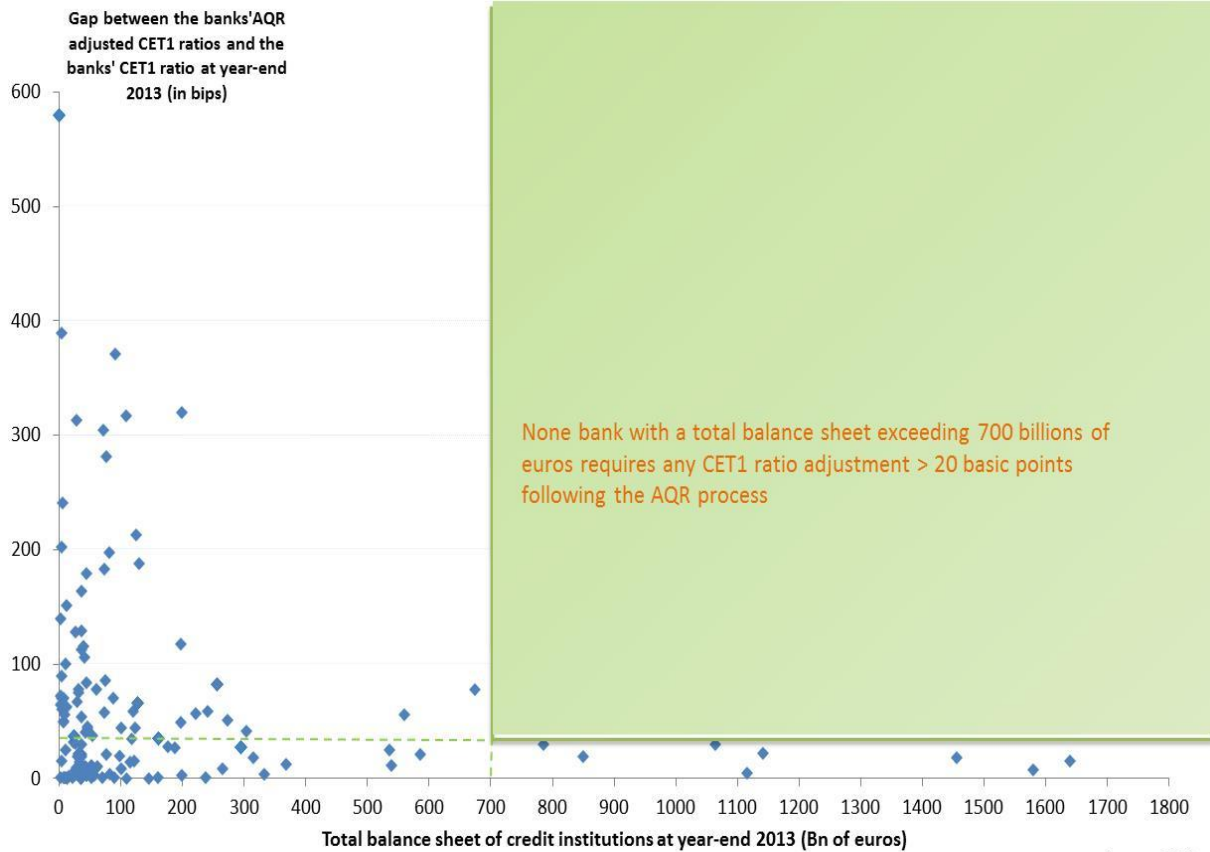
It is also worth pointing to the results of the ECB Comprehensive Assessment that evidenced that small and medium size banks are less well capitalised and less resilient to stress testing scenarios.

Indeed, the 25 banks (out of 130 of the most important ones in the Eurozone) that failed the Asset Quality Review and/or stress tests were all relatively small or medium size banks. One of the ECB slides used during the press conference on 26 October 2014 gives an overview of those 25 banks split by RWA bucket. As shown in the figure below, higher shortfalls were identified for small to mid-sized banks, whereas the EU G-SIBs performed very well both on the AQR tests (very thin % to adapt) and the stress tests.

Figure 23 Capital shortfall grouped by bank stress test balance sheet type and RWA size group



Below is another graph showing the decreasing link between balance sheet size and CET1 ratio adjustment following the AQR in amount. The larger the banks are, the narrower the CET 1 ratio adjustment is.



Source : ECB

The AQR adjustments are due to supervisory practices divergences and insufficient level of provision. The stress tests results show that the universal banks have proved strong resiliency.

5. Conclusion

On the basis of the findings of this report, the EBF expert group is concerned that the EC BSR proposal would have severe consequences for the European economy and the EBF expert group does not see how this harmonises with the European Commission's aim of creating a Capital Market Union and delivering long-term financing for the European economy.

In the EBF expert group's view, Europe needs a thriving and efficient capital market that is able to meet the challenges of funding the real economy.

Breaking the universal banking model, when the need has been assessed for corporate clients to access financial resources through capital markets, endangers the progress needed for corporates to diversify their sources of funding

Furthermore, the proposal will also lead to a re-pricing of certain types of lending, such as loans to SMEs and residential and commercial property lending. As banks are arguably better placed to extend

credit given their branch network, credit assessment expertise and their operational cap, any hit onto the CCI will have repercussions on SME lending too.

Europe needs a structure for banks that protects the real economy and the customers from systemic shocks.

Therefore, policy makers must seriously consider:

- whether breaking the universal banking model by separation of trading activities into separately capitalised entities will address any perceived remaining issues regarding risks in the banking system, and
- whether the possible unintended consequences of a Bank Structural Reform, such as higher costs, an unlevel playing field, less or no access to markets for SMEs etc., are in proportion to the incremental benefits.

Annex: definition of market making and the importance of market making

Definition of market-making

Market making consists of a dynamic set of activities which relate to the provision of liquidity and services to clients. Market making is fundamental for the correct, effective and efficient functioning of the financial markets. A financial entity can be defined as a market maker when it makes prices available on a routine basis and when it is always able and willing to transact pursuant to request of its counterparties on a specific asset.

Market makers, by buying and selling financial instruments from end-users and other market participants:

- provide liquidity in the markets (primary and secondary),
- facilitate the “price discovery” of the affected assets,
- allow end-users and other market participants efficient and instant purchase or sale of a financial product (investment or hedging related) when real interest from other participants does not exist. This so called warehousing function is of major importance for well-functioning financial markets; in fact market makers absorb the need of the client for immediate demand and supply of a financial product and by doing so, take over the risk involved from their client.

The market maker’s compensation is given by the difference from the purchase price (bid) of the asset and its sale price (ask). This difference represents the price of the position risk that the market maker assumes when operating on a continuous basis in a specific market. The vast majority of market makers do not operate as “order matching” entities (e.g. execute a trade between two counterparties that have opposite interests) but they assume and hold risk positions for the time necessary for the creation of such opposite interests.

Without market makers (or with a reduced number of market makers), the constant flow of transactions in a market would only be possible when the liquidity of such markets would be very high and where buyers and sellers of positions would be in roughly equal number. Without entities operating as market makers a market could expect no transactions (or a reduced number) until equivalent and opposite risk positions would be generated in the market. Markets with a low number of transactions, and/or large orders, would expect difficulties in having the proper level of liquidity and transparency greatly reducing its efficiency and increasing the costs associated to the asset traded, investment or hedging related.

Another important function covered by market makers in the financial markets is the information market makers provide to the market price discovery. The executable prices published on a regular basis by the market makers allow final customers to know the real market price of the positions held in their portfolios and to evaluate correctly their risk and return profiles.

Market makers are providers of hedging instruments for end-users. Often end-users require tailor-made instrument to hedge a particular risk for a certain amount of time, risk that cannot be undone directly on the market. Without market makers, hedges generated by an opposite position might not be sufficient to allow a proper coverage of the risk assumed by the end user and would result in higher management costs or a sub-optimal hedge of the identified and unwanted risks in investment portfolios and/or balance sheets.

A market maker, for the nature of the operations undertaken, assumes market and counterparty risks. These risks are managed through the use of active risk-management techniques, hedging strategies, market knowledge and expertise within the limits established by the bank's internal risk management units.

2.1.2. The role of liquidity

The ability to sell (or purchase) an asset in a short amount of time is a direct relation of the volume (time related) of the asset traded and its intrinsic cost (the bid-ask spread). Financial instruments are considered highly liquid when the volume traded (in a certain amount of time) is elevated and the correspondent bid-ask spread is moderate.

The liquidity of a financial asset determines the profile of portfolio composition of investors and, consequently, the financing used by corporate and financial intermediaries and sovereigns. Since financial markets are interconnected, investors and fund-raisers will consider the cost-efficiency ratio of the mix of products to invest in or used to generate the necessary funding. Not only the securities markets are interconnected (Equity vs Bonds vs Loans) but also the derivatives markets play a central role in determining which would be the best mix of investment/resources, in consideration of the efficiency (intended here as cost effectiveness vs. hedge ratio) of the hedging strategies that can be used to reduce the risks to which the market participant will be exposed to.

Increased funding costs, due to separation, will slow down the ratio at which a market maker can offer its services to end-users and will transfer the additional liquidity cost to the market participants. The result will be lower market liquidity in terms of higher bid-ask spreads, higher market volatility and reduced transactions volumes.