

EBF Key Information Document

The Liikanen Report

Mandatory separation of high-risk trading activities

The Voice of Europe's Banks

Launched in 1960, the European Banking Federation (EBF) is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU.

BACKGROUND INFORMATION

In February 2012, the European Commission mandated an independent group chaired by Erkki Liikanen, Finnish Central Bank Governor - the so-called High-level Expert Group (HLEG) - to consider the need for structural reforms of the EU banking sector in addition to the ongoing regulatory reform agenda.

The HLEG can be seen as a response to the debate on structural reform emerging in certain jurisdictions, notably in the UK with the Vickers report calling for a ring-fence of banks' retail activities, and in the US with the Volcker Rule proposing a ban for commercial banks to engage in proprietary trading. In its final report the HLEG recommends that it should be mandatory for banks that exceed a certain threshold of proprietary trading and other significant trading activities to separate those activities into a stand-alone trading entity, so-called mandatory separation.

The HLEG report has been subject to a public consultation and is currently being considered by the European Commission.

SUMMARY OF EBF ANALYSIS

The EBF shares the aim of the HLEG mandate of ensuring a safe, stable and efficient banking sector serving the need of the EU economy, citizens and the internal market. The EBF agrees with the main conclusions of the HLEG report, which acknowledges in particular that:

- no particular business model proved more or less vulnerable in the crisis;
- the benefits of the universal banking model should be retained;
- the regulatory reform agenda goes a long way in addressing the deficiencies of the financial crisis; and
- the Single Market should remain intact.

However, the EBF main concern relates to the HLEG recommendation calling for mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold. The EBF considers that a compelling case for mandatory separation has not been made in the report. The EBF does not support this mandatory separation, as it:

- does not address the issue of systemic risk identified as a main concern by the HLEG;
- fails to identify and target the risk associated with banks' high-risk trading activities;
- has a distortive effect upon vital client-related activities, e.g. market-making;
- will reduce diversification benefits of the universal banking model;
- will reduce banks' lending ability and hence restrict economic growth;
- will reduce the competitiveness of the European financial sector vis-à-vis 3rd countries;
- will undermine the benefits of the Single Market by restricting cross-border activities.

EBF KEY RECOMMENDATIONS

1. The EBF proposes to target high-risk and speculative trading activities (i.e. proprietary trading activities with no link to clients' needs) by other regulatory measures than mandatory separation.
2. Strengthening the use of Recovery and Resolution Plans (RRP) as recommended in the HLEG's avenue 1 fits better with the regulatory reform agenda and will have considerably less distortive impact. However, the most critical step to enhance the resolvability of banks is to reach an agreement on the proposal for a Bank Recovery & Resolution Directive establishing a full EU crisis intervention framework. Separation of trading activities conditional on the RRP should be the last resort and should not be imposed on banks that are going concern.
3. Effective supervision is also an important measure to target high-risk trading activities. The proposal for a SSM, alongside the current set-up of the three ESAs and the ESRB, will considerably strengthen the micro- and macro-prudential supervision of European banks.
4. The EBF finds that additional steps, if any, in direction of the HLEG recommendation for an extra non-risk based capital buffer for the trading book should await the finalisation of the review of the trading book and take into account the buffers already proposed in the CRD IV/CRR.
5. The EBF calls for an impact assessment of any legislative proposal. The HLEG does not address the potential economic consequences of implementing mandatory separation, in particular higher costs for customers.

1. IMPACT ON VITAL FUNCTIONS TO CONSUMERS/INVESTORS

The scope for mandatory separation recommended by the HLEG is too broad and will have a negative impact on functions of vital importance to consumers and hence the European economy in more ways:

1. The HLEG recommends the separation of market-making activities into the trading entity. However, market-making is not a speculative, high-risk activity but an essential service that banks perform for corporate customers, governments etc. and hence a service that proves useful to the economy, investment and employment. Separation of market-making activities could reduce the capacity to provide liquidity in markets that are largely driven by market-making such as government bond, covered bond and corporate bond markets. This would lead to more volatile prices and higher costs of financing for consumers, governments, and businesses.
2. The HLEG allows provision of hedging services that fall within narrow risk position limits within the deposit bank. However, it is important to stress that in general the provision of hedging services to customers is a useful activity. It is an indispensable risk management tool for enterprises to secure themselves e.g. against negative price developments in the markets. The possible separation of (some) provision of hedging services would increase financing costs for enterprises and possibly lead to a reduction in the use of risk management tools by enterprises.
3. The use of the accounting category Available-For-Sale (AFS) for the examination threshold includes assets which are not high-risk or speculative, for example assets held to comply with liquidity requirements (LCR) or government bonds. A special case are countries (e.g. Belgium) that have excess deposits, which banks to a large degree transform into investments in government bonds, held in the AFS portfolio. This brings traditional savings banks in the scope for mandatory separation as well. The uncertainty that such low-risk and highly liquid assets will be considered for mandatory separation could negatively impact the demand for such assets, leading to increased financial instability within Europe. Separating such assets would be damaging to the liquidity function of the deposit bank and to the centralized liquidity risk management of the banking group.

Mandatory separation will reduce diversification benefits of Universal Banks which combine different banking services, for example retail, business and corporate banking and investment services. They function as one-stop shops and can serve customers with more complex needs, e.g. SMEs which increasingly demand investment banking products.

2. IMPACT ON THE MARKETPLACE/COMPETITIVENESS

The HLEG does not consider the viability of the stand-alone trading entity. However, it is very likely that it will be downgraded by credit rating agencies due to the increase in its risk position. This could weaken the funding possibilities of the entity in the market. As a result, some market activities will not be viable in Europe and clients won't be able to find the service they need at a reasonable price. A likely scenario is that non-EU banks could substitute European banks in providing those financial services not permitted under the 'deposit bank' to European corporates and public authorities. Another risk is that the biggest players in the markets will increase their market share due to the decision of the smaller players to exit from trading activities.

3. IMPACT ON BANKS' ABILITY TO LEND TO THE REAL ECONOMY

Apart from the higher capital requirements the trading entity would have to meet, higher administrative costs are likely to occur as the HLEG demands separate reporting, separate disclosure of stand-alone results and balance sheets as well as separate governance structures. In summary, the aggregate costs stemming from mandatory separation will weigh heavily upon banks and increase the price of financial services for the wider economy, and hence have a negative impact on growth creation in Europe.

It should be kept in mind that the ongoing regulatory reform agenda is in itself a structural change that already has - and will lead to - further restructuring of the European banking sector. For example the Basel III liquidity and capital requirements together with the bank resolution measures will pressure banks to improve cost-effectiveness, raise their capital levels and further lay off non-core assets. An IMF Study shows that large EU banks have already cut back sharply on their trading activities, especially proprietary trading, and that they expect to shrink their balance sheets by 2 trillion euro by end-2013 or up to 7% of total assets, mainly by selling of securities and non-core assets.



For more information, please contact:

Vibe Balthazar-Christensen
Policy Adviser, Banking Supervision
v.balthazar-christensen@ebf-fbe.eu
Avenue des Arts, 56 B-1000 Brussels

The European banking sector
in figures

- Funds some 75% of the European economy
- Holds over EUR 22.2 trillion in deposit
- Serves 400 million customers (via 434,00 branches & 236,000 ATMs)
- Makes available EUR 24.5 trillion in loans to their custom-