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EBF COMMENTS TO THE PROPOSAL OF THE EUROPEAN COMMISSION ON CCPs RECOVERY AND RESOLUTION

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EXECUTIVE SUMMARY

The EBF welcomes the proposal of the European Commission and strongly believes it provides the basis for standards, as well as national and regional mandates for recovery and resolution measures in the unlikely event of a CCP default. However, the EBF believes certain clarifications will be essential in order to guarantee a proper functioning of the foreseen system. We hope that co-legislators and supervisory authorities share this view. In this context, we set out below the key priority issues which we believe the co-legislators should address when discussing the proposal:

- The proposed composition and the potentially large number of stakeholders involved in resolution planning phase would be contrary to the ultimate need for quick decision making to ensure financial stability and avoid a further increase of systemic implications if recovery events occur;
- the various recovery and resolution scenarios should reflect the diversity between products, levels of liquidity, type of market participants and trading methods, so to align appropriate recovery and resolution scenarios based on the predictability and possible success of preventing the failure of the CCP;
- the basis for a successful recovery and resolution is tailored to the specific CCP according to a range of objective criteria and available tools. What is more, the EBF's key principle for CCP recovery and resolution is that the burden should be shared between all participants in the chain and must not be unlimited;
- a clear distinction between Default Losses and Non-Default Losses for the purpose of the contributions in the recovery and resolution proceedings is strongly needed. In particular, the regulation should clarify that clearing participants shall not contribute, through the waterfall, to losses incurred in a non-default scenario;
- it is necessary to involve clearing members in the recovery planning process;
- in general, an early intervention by a resolution authority shall be justified only upon condition that the rulebook-led recovery measures are not successful, losses are unsustainable or likely to exhaust the financial resources of the CCP, or extreme market conditions dictate so. The intervention of the resolution authority should be subject to appropriate safeguards, such as ensuring that the adopted resolution scenario properly takes into consideration the interests of all involved stakeholders, all losses are subject to appropriate caps, and the No Creditor Worse Off principle is respected; and
- a clear framework should be provided which describes in detail how supervisors, in the event of a CCP encountering difficulty, should consult, cooperate and coordinate at international level in order to mitigate financial markets disruptions.

EBF POSITION

1. INTRODUCTION

The European Banking Federation (EBF) takes note of the recently-published CCPs recovery and resolution proposal by the European Commission (the "Proposal").

Since the financial crisis, central clearing counterparties have become critical nodes in the financial system, because they manage significant amounts of counterparty risk and link multiple banks, other financial counterparties and some corporates. The EBF is strongly supportive of developing an appropriate global recovery and resolution framework to address systemic risk in the event of failure of a central counterparty (the "CCP").

Whilst the scale and importance of CCPs in Europe, as previously stated by the European Commission, are set to increase due to the implementation of the G20 commitment related to OTC derivatives, recovery and resolution measures will concern all CCPs, irrespective of the products they clear. These could be equities, bonds as well as derivatives contracts or securities financing transactions.

Furthermore, it should be kept in mind that CCPs offer clearing services for cash equity and fixed income in addition to derivatives. Although the transactions are smaller in value cleared, they have their own risks and specifics (e.g. interoperability).

The EBF therefore believes that the basis for a successful recovery and resolution is tailored to the specific CCP according to a range of objective criteria and available tools. Such applicable tools should be pre-defined and reflected in CCP rulebooks and mandates of resolution authorities (the "RA") in order to ensure much-needed predictability and transparency. Some tools (such as Initial Margin Haircutting) are undesirable in all circumstances and should not be permitted to form part of recovery and resolution plans.

Transparency and certainty are also crucial. Participants have to be able to assess their risks at any time. They need to know to what extent they could be asked to contribute and agree on an ex-ante basis on any binding rules to be applied. This would be in line with Principle 23 of CMPI-IOSCO's Principles for Financial Market Infrastructure (the "PFMI"), which requires information to be disclosed to all participants in order to allow them to "assess the risks they could incur by participating in the FMI"¹.

Besides tailored solutions based on the products and characteristics of the CCP, the EBF's key principle for CCP recovery and resolution is that the burden should be shared between all stakeholders (i.e. shareholders, members, and users) and must not be unlimited.

¹ See Principle 23, Key consideration 2 in CPSS-IOSCO – Principles for financial market infrastructures – April 2012.

2. EBF VIEW ON THE PROPOSAL OF THE COMMISSION ON THE CCPs RECOVERY AND RESOLUTION

2.1 *Composition of Resolution Colleges and involvement of clearing members in recovery planning*

The EBF is concerned that the proposed composition and the potentially large number of stakeholders involved in the resolution planning phase would be contrary to the ultimate need for quick decision making aimed at ensuring financial stability and avoiding a further increase of systemic implications should a recovery event occur. This particularly relates to the composition of the resolution colleges of pan-European CCPs with a large number of clearing members (the “**Clearing Members**”). Although the role of the colleges is limited in the resolution process itself (this is rather the competent authority or the RA), we welcome the broad inclusion of the wide range of stakeholders in the resolution colleges to ensure the interest of all affected parties in the preparation of resolution plans, particularly to take the interests of clearing participants and underlying clients and markets into account. For the resolution process itself, the ability to take swift action should always be the main objective. This could be hampered by either extremely detailed plans or watered down compromises as a result of the composition and/or differences in interest within the resolution colleges.

In addition, the EBF would like to highlight the necessity to involve Clearing Members in the recovery planning process. As set out in section 4.2.3. of the Proposal’s explanatory memorandum, it is required that recovery “plans should constitute arrangements agreed between CCPs and their Clearing Members to reinforce their effectiveness in all cases”. This should also be reflected in Chapter 1 of the CCP recovery and resolution regulation (the “**Regulation**”). Article 9, paragraph 8, of the Proposal merely requires that the CCP board takes into account the advice of its risk committee. Members and users of the CCP should be consulted on certain mandatory issues (such as, for instance, any increment of their quantum of potential losses, changes to the levels of contributions to mutualised resources, changes to the sequence and loss allocation mechanisms in the default management process, etc.), and procedures should be established on how their views should be taken into consideration.

2.2 *Recognising the key differences between different types of products such as ETD, OTC derivatives, Securities, and Repo cleared by a CCP*

Despite the trend of growing standardisation, the global derivative markets are still very diverse in nature. Both Exchange Traded Derivatives (ETD) and OTC Derivative products are cleared by CCPs, although ETD and OTC derivatives can trade through different mechanisms and, in some cases, present different risk profiles.

The EBF believes that CCPs clearing products with inherently different risks profiles and characteristics may need to develop different approaches to recovery and resolution. It is well understood for instance that tools like Variation Margin Gains Haircutting (the “**VMGH**”) are inappropriate for instruments subject to T+2 settlement discipline (securities) or markets with daily settlement of positions (repos), and, as such, should not be mandated in any circumstances.

EBF therefore strongly advocates the recognition of these differences in the applicable recovery and resolution scenarios and tools.

In general, the EBF firmly believes in a more per product model at CCPs, that is to say segmented default funds for the different risks presented by different asset classes, rather than a single default fund spanning multiple asset classes. We believe this would be beneficial both under a Risk Weighted Asset (RWA) perspective and for the potential recovery or resolution of a CCP segment. For example, equity segments should have a default fund and default waterfall completely segregated from fixed income based OTC default funds and waterfalls, because the 1.) asset classes, 2.) markets, and 3.) market participants differ substantially in terms of risks, liquidity and likelihood of prompt re-establishment of a matched book at the CCP exposures. Furthermore, the recovery or resolution of a mono-product CCP is likely to be more straightforward compared to a multi-asset or interoperable CCP segment in times of stress. More differentiation between different asset classes could also prevent the spill-over effects where a problem arising in one market might spread to otherwise segments.

2.3 Differentiation between default losses (DLs) and non-default losses (NDLs) in terms of contribution to recovery and resolution

The Proposal does not clarify that clearing participants shall not contribute, through the waterfall, to losses incurred in a non-default scenario. Such losses should be for the account of the shareholders in the first instance. In the event that shareholders' funds are insufficient, shareholders could have the opportunity to voluntarily recapitalise CCPs.

Furthermore, this indicates that CCP capital should be appropriately scaled relative to such risks. Should there be losses in excess of shareholders' funds that the shareholders do not opt to cover, they should be borne in line with normal insolvency proceedings and should give rise to a senior debt claim in favour of those who have borne the losses. Default Fund(s) and Initial Margin should be appropriately segregated and be bankruptcy remote.

In situations where a CCP default is caused by (operational) mismanagement – for example, cyberattack, fraud, investment losses, mismanagement or other decisions taken (or not taken) by CCP management and/or employees – **this can and must not be an obligation for third parties to resolve.** As in every other corporate default situation, losses need in this situation to be carried out by the shareholders. Only by making shareholders fully responsible for bearing other losses, authorities can ensure appropriate amounts of "skin-in-the-game" (the "SITG") for the CCP owners.

2.4 No Creditor Worse Off principle

The EBF believes that the No Creditor Worse Off principle (the "NCWO") is crucial as it ensures that no unlimited exposure is created for Clearing Members and other creditors. The definition of the NCWO principle implies the distinction between Default Losses (DLs) and Non-Default Losses (NDLs), as referred to above. In particular:

- **For DLs, the counterfactual is the CCP recovery plan or other contractual arrangements;**
- **For NDLs, the counterfactual is the normal insolvency proceedings.**

It should be clarified that in **both** cases, the counterfactual is the normal insolvency. For DLs, the CCP recovery plan and other contractual arrangements need to be taken into account additionally. However, the normal insolvency should still be defined in the NCWO principle as otherwise it could be doubtful whether the Clearing Members' liability is truly limited.

As an example, the EBF would like to point to the fact that no limitation exists

in the Proposal as to how many times a cash call pursuant to Article 31 of the Proposal could be made. Any non-payment of a cash call by a Clearing Member could be regarded as a new default, possibly triggering new measures by the RA against the other (non-defaulting) Clearing Members who have paid their cash calls. These new measures can include new cash calls. It is furthermore not ensured that the CCP recovery plan defines the normal insolvency proceedings as the NCWO principle. Therefore, a clarification is needed in Article 23 (c) and Article 60 of the Regulation.

The practical calculation of the counterfactual for default losses may be challenging and CCPs should clearly specify the methodology in detail. CCPs should work with the Clearing Members and clients in order to define it more precisely and agree these arrangements in advance with the RA.

2.5 Appropriate tools for the recovery CCPs as a result of default losses

It should be underlined that rulebooks of CCPs already provide for a range of solutions to return to a Business as Usual (BAU) scenario upon the default of a Clearing Member. Furthermore, as part of the PFMI (implemented in the EEA as EMIR), each CCP has a "waterfall " in place establishing basic principles for the management of member defaults.

These default management processes (the "DMP") already include: 1.) use of the margins and default funds contributions of the defaulting member; 2.) use of the SITG of the CCP; 3.) depletion of the default fund contributions of all members; and 4.) additional cash calls to the remaining members. Only after the above-mentioned measures have been exhausted or have failed other recovery – and potential resolution – scenarios come into play in order for the CCP to return to a matched book and cover losses.

We also believe that any additional measure to safeguard resilience of the CCP should become part of a recovery framework that is robust, transparent, member/user-led, tailored to the CCP and clearly defined in the rulebook and/or recovery plan. The recovery plan should be designed with the involvement of and should be available to Clearing Members as it is only right that those who will ultimately pay the price should have an understanding of the recovery plan ex-ante in order to assess their risk when becoming a member of the CCP. This framework should take into account the guidance issued by CPMI and IOSCO on recovery and resolution plans.

In this context, we believe an early intervention by a RA is justified only if the rulebook-led recovery measures are not successful (for example, it has not proved possible to re-establish a matched book), **losses are unsustainable or likely to exhaust the financial resources of the CCP, or extreme market conditions dictate so.** The RA should be able to take quick and well-informed decisions before the financial resources are exhausted to ensure that some resources are available during a resolution. In addition, the RA should continue, where possible, to follow the rulebook-led measures and sequence of the available tools in order to ensure continuity and predictability for all affected members and stakeholders.

Below, we have listed a range of rulebook-led measures that could be possible options in a recovery or a resolution scenario, noting that some tools might only be available in resolution rather than recovery.

Auctions:

Most CCP rulebooks already prescribe auction processes to ensure the return to a matched book as part of their DMP. Such auctions should be subject to clear rules and guidelines and should continue as long as necessary with no options for CCPs to reject bids.

We do not believe that it would be appropriate to grant the CCP any right within its recovery plan to assess whether any such bids are not economically reasonable and reject them if they are not. On the other hand, CCPs should not be granted powers to oblige Clearing Members to bid, given that Clearing Members are usually subject to other regulations and risk controls that might preclude bidding. Typically, the juniorisation of the default funds contributions of non-bidders and “bad-bidders” (i.e. those who submit a bid which is designed with the intention of not winning the auction) should be used to incentivise active participation in auction.

The purpose of the auction is to re-establish a matched book, as well as to establish the market price for the re-allocated positions. A single bid is sufficient to achieve these objectives as long as it is a binding one.

In doing so, the quantum of any potential loss will be established and should be allocated accordingly. Rejection of bids by the CCP should, prima facie, indicate a potential trigger for resolution.

In any case, we believe that only the depletion of the waterfall resources and an unsuccessful auction could trigger the further sequence of other tools.

Increased skin-in-the game (SITG):

The EBF supports a more substantial SITG of the CCP shareholders, at the beginning of the default waterfall before the CCP uses any funded or unfunded mutualised resources. The remaining equity of the shareholders should be used after assessments on Clearing Members and before losses are allocated. In many cases, the exposure of CCP shareholders early in the waterfall is relatively limited and the EBF believes that an amount at least equivalent to the default funds contribution of the largest Clearing Member is more appropriate. Furthermore, all participants of the CCP are exposed to the long term effects of the decisions of CCP management and some element of deferred compensation of CCP managers should be included in the SITG element. In line with the “defaulter pays” principle, the CCP or its shareholders should bear the losses before or, in any case, no later than non-defaulting participants would bear them. We therefore support the idea of requiring the CCP to contribute a second tranche of the SITG to the loss allocation, after the pre-funded resources have been exhausted.

Variation margin gains haircutting (VMGH):

The EBF believes a clear definition of this concept is required. Specifically, the amount of Variation Margin gains available to be haircut on the part of each Clearing Member or client should be the cumulative gains that have arisen across the entire portfolio of that Clearing Member/client, and not the result of a “cherry pick” of subsets of trades, contracts or products. What is more, such gains should be calculated since the default, used for a short, clearly defined period of time, and capped.

As such, the VMGH should take the crucial role of market makers and liquidity providers with matched books into account. It should be noted that VMGH for CCPs clearing ETD and OTC derivative markets should not be considered a “painless” solution and could potentially have significant effects on market liquidity with key market participants seeking to exit as quickly as possible. Notwithstanding that, a major benefit of the VMGH is that it incentivises those participants with gains to flatten their positions, thus providing liquidity with which the CCP can re-establish a matched book.

Initial margin haircutting:

The EBF believes that initial margin haircutting is not an appropriate recovery and resolution tool, on the grounds that it:

- Incentivises clearing participants to exit trades in a disorderly manner rather than focusing on better risk management and participating in the CCP default management process. In effect, the first participant to exit the CCP would stand the gain the most, encouraging “run” type behaviour;
- Is not guaranteed to be of a sufficient size to cover uncovered CCP liabilities;
- Would disincentivise market participants from using clearing services at all; and
- Would cause conflicts with jurisdictions where initial margin must be posted on a bankruptcy remote basis, and would be inequitable where some participants in a given CCP are able to post on a bankruptcy remote basis whereas some are not.

Therefore, the EBF believes that the “bankruptcy remote” characteristic of Initial Margins deserves to be clearly reaffirmed.

Partial tear-up:

Another scenario in recovery or resolution could be partial tear-up (the “**PTU**”) or close-out of the contracts, with the applicable methodology and sequence based on pre-defined arrangements in the rulebook. The EBF believes that the minimum number of contracts should be torn up, so that the CCP can re-establish a matched book in the absence of those contracts that previously prevented it. At the same time, the pricing of such contracts could become difficult depending on: 1.) the financial instrument cleared; 2.) the underlying market cleared; 3.) the market conditions (such as market liquidity); 4.) the availability of reliable reference prices (e.g., market prices, prices from comparable markets, quotes, model prices); and 5) the time elapsed since the default. As a result, **PTU should only be applied under the supervision of the competent authorities or the RA, although a de minimis exemption calibrated to the value of the segment concerned could be envisaged. In addition, the EBF urges that PTU follows the procedures as pre-defined in the rulebook in a carefully tailored, clear, agreed and well-documented process.**

It should be noted that a PTU can result in losses for the Clearing Member and/or their clients because the price at which a PTU takes place will differ from the actual replacement cost and/or also from the valuation price at the last CCP margin call or last settlement price. In this way, PTU or close-out includes elements of a loss allocation mechanism already, though it is primarily a tool for a CCP to return to a matched book.

Depending on the proceeds from PTU or close-out a CCP might still have to bear and/or to re-allocate remaining default loss.

External liquidity providers:

The EBF sees the benefits of central banks as a *liquidity provider of last resort*. The EBF appreciates that this could lead to a certain degree of “moral hazard”, but believes that in clearly specified circumstances (such as liquidity support for Repo markets) such intervention could be highly beneficial.

2.6 CCP-debtor warrant for successful recovery or resolution

A provision should be added to the Regulation that any party carrying the burden of the CCP recovery or resolution (by, for instance, assuming

losses, making cash payments or suffering by any of the measures mentioned in Article 48 or 49 of the Proposal) **is granted a debtor warrant by the CCP.**

In a successful recovery or resolution, all payments made by or losses allocated to the CCP's creditors (e.g. Clearing Members) should be repaid from future profits of the CCP after the recovery or resolution.

2.7 Safeguarding financial stability

The EBF believes the primary way of mitigating CCP defaults is to strengthen CCPs in going concern, by increased supervision, ensuring CCPs are sufficiently capitalised and to introduce the proposed recovery planning requirements.

Should the unlikely situation appear that a CCP will not be able to meet its obligations following depletion of the default waterfall and a failed recovery, **we urge a resolution action with a minimum transmission into the financial system as it is the only way to effectively ensure the continued operation of the CCP without risking contagion effects within the wider financial system.**

In its current form, the Proposal does not include a loss transmission mechanism comparable to the provisions in the Bank Recovery and Resolution Directive (BRRD). This mechanism is backed by the MREL to ensure predictability on how losses will be allocated should a bank be placed in resolution. The Proposal does not include any equivalent safeguards for members, thus making loss allocation amongst CCP members unpredictable and contagious.

Further, we find it to be in direct conflict with the purpose of recovery and resolution. The loss transmission mechanism will, at best, rapidly spread instability across the financial system and, at worst, push a number of Clearing Members into resolution.

2.8 Stress testing

To ensure transparency for those stakeholders potentially impacted by recovery plans, **stakeholders must be able to accurately assess their potential exposure across CCPs.** The use of varying methodologies by CCPs to measure and quantify risk can reduce the accuracy of comparisons between them for transparency purposes, particularly as CCPs do not commonly share their stress scenarios and stress test methodologies with Clearing Members or their clients. In addition, liability rules are applied inconsistently across CCPs, which means participants face a greater challenge predicting their exposure with a degree of certainty.

Consistency across CCPs in this area would help to ensure an appropriate level of transparency, as this will assist stakeholders in predicting what their exposure will be. A recovery and resolution regime would be well-served by the development of regulatory-designed CCP stress-testing standards, drawing on CPMI/IOSCO principles to ensure consistency at a global level. Development of these standards should include:

- Mandating CCPs with multiple clearing services backed by limited recourse to guarantee funds to meet stress testing standards that test these clearing services both individually and cumulatively;
- Requiring CCPs to use testing scenarios based on both historic events and plausible hypothetical or theoretical future events. For historic events, where appropriate historic data does not exist, CCPs should develop scenarios based on the historic market behaviour of similar product types. Equally, and following consultation with members, CCPs should be able to discount historic scenarios that are no longer

- relevant or acceptable;
- Requiring CCPs to meet stress testing standards with regard to scenarios that test the impact of macro-economic events (such as sovereign default) and the idiosyncratic characteristics of individual asset classes;
- Standards that require stress testing scenarios to consider multiple combinations of Clearing Member failure, testing not just on the impact of the failure of the two largest Clearing Members, but also the possible failure of any combination of small, medium or large Clearing Members;
- Standards that require the reverse stress testing of Clearing Members, although this information should be used to inform the individual Clearing Member of their potential exposures and risk profile; and
- Annual testing or more regularly if risk factors or market conditions render it necessary. Furthermore, the scenarios themselves should be reviewed at least annually by the relevant authorities.

This stress-testing regime must hold the confidence of market participants; regulatory-driven standardised and public stress testing will allow CCP participants to accurately and consistently assess their exposures across CCPs, and go some way to achieving this objective.

2.9 Application of national law for triggering resolution

It seems unclear whether national laws apply for the determination of the point in time a CCP resolution is triggered. Article 22 (2) of the Proposal requires one or more of the circumstances listed in order to deem a CCP failing. However, neither the dividing line between insolvency and resolution nor the exact point in time when a resolution is triggered, are defined.

2.10 Possible termination of open contracts

According to Article 27 of the Proposal, the RA is mandated to re-calculate the market value of all CCPs' open transactions and additional margin call from Clearing Members. In addition, the RA, according to Article 29, has the possibility to terminate non-defaulting Clearing Members' positions, either partially or fully, as part of a resolution.

Such tools involve a contagion risk among financial markets participants and are in this regard contrary to the purpose of establishing CCPs. In a stressed-market situation, should one or more Clearing Members have already turned into default and the CCP be also in risk of defaulting, investors will undoubtedly be looking for safe haven placements of funds and create a tightened liquidity situation. In addition, if non-defaulting Clearing Members are in such situations where: (1) they are asked to deposit further margin; and (2) have their CCP position terminated, either partially or fully, this could add stress to financial market participants in several dimensions, namely:

- Difficulty for financial market participants to deposit further margin due to the current state of market liquidity;
- Re-calculation of market values will have a direct effect on their Profit and Loss (P&L) statement;
- Market risk is increased for financial market participants since their hedged positions are suddenly open to market movements; and
- Market participants are put in a situation where – in order to reduce the market risk – they need to look for hedging solutions on a bilateral basis, leading to a surge in their credit risk.

In this context, with tight and stressed-market conditions, it is increasingly

challenging for market participants to execute the above-mentioned transactions at a fair market price, triggering as such additional losses and requiring further margin calls with damaging consequences.

2.11 Extraterritoriality

In the case of a default during a period of market stress, improper coordination among international authorities could exacerbate financial market disruption and threaten systemic stability. **A clear framework detailing how supervisors should consult, cooperate and coordinate in the event of a CCP encountering difficulty will help to mitigate those risks.** This cooperation should extend to the design, implementation and results of a standardised CCP stress testing framework, as previously referred to.

When viewed alongside the potentially competing domestic financial stability objectives of each supervisor, the case for such a framework is clear. One source of risk could arise where the home authority of a failing CCP prioritises the maintenance of a CCP's operations over the financial stability of a third country's financial system or local firms. In such cases, a downgrade of a government's credit rating may prompt a CCP to haircut any collateral received in that government's securities. This would have the knock-on effect of requiring firms who lodge that collateral to meet the subsequent margin call, which may result in a further negative pro-cyclical effect that causes added stress on that country's financial sector. This may further undermine the country's credit worthiness and prompt further downgrades, resulting in further margin calls etc. In such instances a clear cooperation framework would be needed to prevent such pro-cyclicality further undermining market stability.

2.12 Link to the clearing obligation in EMIR

According to the EMIR regulation, products encompassed by the clearing obligation under EMIR will need to get cleared by a CCP. In order to fulfil this requirement, at least two conditions need to be fulfilled: (1) a CCP other than the defaulted CCP needs to provide clearing services with the specific product; and (2) the Clearing Member will need to have an agreement in place with this other CCP. This potentially means that the Clearing Member will have to operate with an unhedged position for quite some time.

As the EBF has advocated in responses to the EMIR review (and also in responses to ESMAs consultation on establishing clearing obligation), there needs to be a possibility to immediately suspend the clearing obligation if the only CCP that clears the derivative enters into default or if other market conditions would require the clearing obligation to be suspended.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.5 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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