"Banking Structure Reform: How to preserve the diversity of bank business models?"

The Commission published on 29th January 2014 a proposal for a regulation on structural measures improving the resilience of EU credit institutions (2014/0020 (COD)). The bank structural reform proposal (BSR) aims at preventing systemic risks and financial stress, to tackle the "too big to fail" issue and to strengthen the resilience of the EU banking sector while ensuring that banks continue to finance economic activity and growth. It proposes to do this by (a) requiring the separation of trading activities into legally and economically distinct entities and (b) prohibiting proprietary trading and the holding and acquisition of units of Alternative Investment Funds (AIFs). It also prohibits holding shares of a company which does proprietary trading or which acquires units of AIFs. The proposed regulation would only apply to financial institutions meeting specific quantitative thresholds with respect to their volumes of assets and trading activities. These limits are yet to be defined but the intention appears to be to capture the 30 largest banks in the EU.

The proposal has generated significant comments and debates within and beyond the EU institutions, as had the report of the High Level Expert Group (HLEG) on the structure of the EU banking sector chaired by Erkii Liikanen, to which the proposed legislation responds. The report of the HLEG concluded that there was no confirmed link between bank failures and the structure or business model of banks; it also highlighted the value of diversity in bank business models to the European economy. Structural reforms were only one of the recommendations made by the HLEG report. The BSR proposal assumes that trading, whether client focused or proprietary in nature, is a riskier activity that needs to be segregated from other banking activities. Examples of bank failures such as Lehman Brothers and Northern Rock show the range of banks that might pose systemic risks. Yet, large, diversified banks are the most likely to be impacted by the proposed rule. This briefing will thus concentrate on explaining how the proposal may impact the concerned institutions.

What is in the proposed regulation?

The Commission indeed said that the proposed new rules were aimed at stopping the biggest and most complex banks from engaging in proprietary trading and from acquiring or retaining shares of hedge funds or of entities that engage in proprietary trading. The new rules would also require supervisors to transfer other trading activities (such as market-making, investments in and acting as a sponsor for securitisation, and trading in certain derivatives) to separately capitalized and liquidity managed legal trading entities within the group, i.e. outside the deposit-taking "core credit institution" (CCI).

The aim of these proposals is to enhance resolvability of large and complex banks, support financial stability by preventing the use of retail deposits to subsidize speculative trading activities and at the same time encourage more bank financing of the real economy.

Impact on the universal banking model

Universal banks play a distinct and important role in the financing of the European economy, and are able to bring material benefits to clients and investors (through risk diversification, integrated financial solutions for clients, extensive consumer choice and via long-term client banking relationships that enforce provision of services through economic cycles, etc.).

Whilst like narrower commercial or retail banks they extend loans to individuals and corporates, large European universal banks also play an important role in providing access to a much wider range of financing and investment options in international capital markets. This allows for instance a European company looking to grow to access investments from the US or Asia Pacific, in addition to the EU, and pension funds can diversify investments across regions. Larger universal banks also provide risk management services – sometimes referred to as hedging – to help SMEs and larger companies manage financial risks (i.e. exchange rates, interest rates, credit risk) – which may arise as part of their activities.

The value of universal banks' services towards European businesses was highlighted by business organisations such as the BDI, MEDEF and CBI in their comments on the Commission's proposal, whereby they voiced concerns around the potential disruption to EU financial markets that could result from the proposed Regulation and the implications for firms relying on universal banks to provide access to finance and risk management services.

The separation of trading activities would call into question two major advantages: first, banks' ability to provide capital markets based funding and risk mitigation products to clients and second, their ability to provide liquidity to issuers and investors in those instruments. Notably, the separation of market-making activities for corporate debt would negatively impact corporates' financing and hedging costs, hampering credit demand and growth, as evidenced by recent analysis carried out by PWC on impacts of structural reform (http://www.afme.eu/Industry-Structure).

Furthermore, income and risk diversification previously deriving from the universal banking model would be lost, potentially driving lower ratings for the narrow scope trading entities and making most of them unviable. In fact, the sum of the risks of the trading entity and the commercial bank would be higher than the risks of the Group before ring-fencing, although the activities would remain unchanged.

In Europe, there is a great diversity across bank business models but generally universal banks have capital markets activities of a rather limited size. As a consequence, the ring-fencing of these activities would lead to small, stand-alone trading entities, which, considering their higher liquidity and capital needs, would likely be non-viable. According to a Bank of France study refinancing costs for a stand-alone entity would be 220bp more than before separation. Even the largest banks in Europe have stated that separation along the lines proposed by the Commission would render them uncompetitive internationally.

Impact on customers

This loss of competitiveness and market-making capacity of European universal banks would have a direct impact on customers across the banking sector. As underlined by the ECB in its opinion on the BSR proposal, market-making has many benefits for all market participants. Through their capital markets activities, banks offer a wide range of services and products that help their corporate customers manage many types of financial risks such as credit risk, market risk, interest rate risk and currency risk. Market-making in financial instruments is an essential economic function which is directly linked to these client activities. In addition, the proposal restricts the types of derivatives that a CCI may use for risk management (i.e. OTC derivatives are not allowed). This would reduce the capacity of clients to hedge against commercial risks, which would hinder business development and investment in Europe. To ensure the continued availability of services that are beneficial for all market participants, it is therefore essential that the legislation differentiate between proprietary trading and client-driven market-making activities.

While the ongoing regulatory agenda has already reduced bank market-making inventories, the BSR proposal is likely to further limit banks' ability to provide liquidity in secondary markets, leaving investors unable to exit or enter into larger scale investments over short time horizons without moving the overall market for that investment product. This could have an impact on other initiatives currently being pursued to encourage long term investment and growth, such as the Capital Markets Union initiative. Without bank intermediation, many of the industry experts find it hard to understand how the role of capital markets' financing can be enhanced through the Capital Markets Union (CMU).

Impact on Alternative Investment Funds

The relevant banks in scope are not allowed to do proprietary trading including holding and acquisition of units of AIFs according to AIFMD (2011/61/EU). This also prohibits holding shares of a company which does proprietary trading or which acquires units of AIFs.

With regard to AIFs the Commission intends to include hedge funds in the scope of the ban of certain trading activities in order to reduce excessive risk taking. But the Commission does not further differentiate between different types of AIFs, namely hedge funds and other AIFs with a conservative risk-profile comparable to UCITS (undertakings for collective investment in transferable securities – Directive 2009/65/EC). Contrary to other AIFs and UCITS, hedge funds use leverage to a substantial degree.

Consequently, the prohibition of investments in all AIFs that use any leverage (including those with a more conservative risk-profile) would call into question banks' ability to indirectly provide liquidity to a diversity of issuers (public sector and corporates including small and medium-sized enterprises) and to provide investment solutions for investors (mainly pension funds and insurers that form part of the banking group). The extensive prohibition also bears the risk of creating disturbances on the European path towards growth and competeveness.

Level playing field implications at global level

In practice an EU G-SIBs would be subject to the BSR globally, including in markets where such rules would not be applied locally. This would create competitive disadvantages, as well as supervisory challenges when the local competent authority would prefer the activities to be carried out within one entity. The same bank – at least its US facing arm – would also be subject to the Volcker rule with its variations in scope and reporting requirements.

Documentation (Derivatives contracts)

The legal separation of trading activities would require financial institutions with open contracts with clients (corporates and pension funds) to transfer those contracts to another, separate trading entity within the group. Since that stand-alone entity would have a different risk profile and therefore a different rating, the relevant counterparty would request to revisit the terms of the contract. This would lead to a widespread renegotiation of derivative contracts, within a very short period of time, giving rise to legal uncertainty, undermined hedging and market disruption.

Benefits of the proposal

The costs of the proposal could be a price worth paying if there were significant benefits arising from the proposed reform in terms of increased resilience, resolvability and stability of the banking sector. To assess the balance of benefits against costs, it is vital to examine the existing regulatory landscape and ask where additional benefits would arise.

Out of the 20 banks which failed the asset quality review & stress test exercise of 2014, only one would have met the thresholds beyond which a bank may be required to isolate its trading activities (according to the BSR proposal's thresholds). Furthermore, the ECB reports on the AQR mentions (p.63) that "higher shortfalls were identified for small to mid-sized banks, and the banks with DG Competition-approved restructuring plans which used a dynamic balance sheet assumption in the stress test as per the EBA methodology". These show that larger banks are not necessarily the most fragile.

The many legislative initiatives undertaken, notably on resolution and increase capital requirements, already address many of the same concerns identified by the European Commission. As Danièle Nouy, Chair of the SSM, declared in her address to the French National Assembly on 16 December 2014, the more the resolution mechanism is credible and operational, the less the issue of banking separation needs to be addressed. Mark Carney, Chairman of the FSB, also indicated that the new Total Loss Absorption Capacity ratio (TLAC), to be required at global level, meant the end of the too-big-to-fail issue.

All these reforms and the regulations already in place to improve the resilience of the financial market, including UK, France and Germany need to be implemented, embedded and assessed before embarking on further reform. In any case, past reforms and any newly proposed regulation should be subject to a thorough assessment of their impact on both economic growth and financial stability.

Conclusion

The range of possible consequences of implementing the BSR as proposed shows how deep its impact may be from an economic perspective in terms of jobs, growth and investment. Since the High Level Expert Group's recommendations came out over two years ago and the Commission's proposal was published a year ago, new initiatives have shed additional light on the robustness of the financial sector, namely the AQR results and at the global level the TLAC proposal. Furthermore, the Commission's impact assessment accompanying the BSR proposal is based on data from the crisis period and does not take into account the enhancements to the financial services regulatory environment that have led to deep changes in financial entities in terms of prudential management, strategic orientation and governance arrangements. All this should be thoroughly taken into account in the current policy debate.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

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