IRSG briefing on the Bank Structural Reform Agenda

The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to be one of the leading cross-sectoral groups in Europe for the financial and related professional services industries to discuss and act upon regulatory developments. It is an advisory body both to the City of London Corporation and to TheCityUK.

The IRSG agrees with the Commission's objective to enhance European financial stability and has been supportive of the many measures put in place under the 'new financial system for Europe' programme. Many positive changes have been made to regulation and supervision of the banking system and these should be permitted to take effect before further initiatives are progressed. This would also be consistent with the delivery of the Commission's goals to promote sustainable growth, and the further development of a European capital markets union. We consider that it is particularly important in this context to ensure that any further regulatory changes foster a long-term growth agenda and do not unnecessarily hamper the flow of finance and credit to the European economy. In that context, we would like to offer the following observations on the European Commission's proposal on bank structural reform.

Necessity of Structural Reform proposal

The IRSG is of the opinion that the legislative framework needed to address 'too big to fail' has largely been completed. Much has already been done to make reforms that will result in banks which are more structurally sound and these reforms should be given time to prove their effectiveness. Most significantly, the resolvability agenda is in the midst of implementation, and under the Bank Recovery and Resolution Directive there are significant structural intervention powers available to supervisors and resolution authorities where there are concerns about the structures of individual banks. Much of the debate around bank structural reform is ultimately about resolvability and the continuity of critical functions. This year and next will see the authorities apply their new powers in this area, and we believe that the resolvability agenda should be allowed to play out further.

Given the simultaneous introduction of other reforms such as the CRD IV/CRR package, strengthened supervision through the Banking Union, the DGS Directive, EMIR and MIFID II, the need for additional powers to require changes to banks' structures has not been sufficiently demonstrated.

Furthermore, the results of the Asset Quality Review and 2014 stress-tests, coordinated by the ECB and the EBA showed that the larger banks, particularly the Global Systemically Important Banks (GSIBs), are now much safer than before the financial crisis. No European GSIBs failed the assessment, and among the 9 banks with capital shortfalls required to submit a capital plan, only one would have come under the scope (Article 3) of the Commission's proposal.

It is also the case that the impact assessment for the current proposal was based on data which is now several years out of date and pre-dates the significant recapitalisation of the European banking sector in the period 2013 to 2014. We consider that as a minimum it would be prudent to conduct an updated impact assessment taking into consideration data such as the Asset Quality Reviews carried out in 2014.

The Commission proposal has major flaws that by their very nature will prove problematic. In particular, basing the 'Core Credit Institution' (CCI) on new DGSD definitions would in effect divide corporate deposit-taking from other corporate and investment banking services. It is also unclear whether deposits from other Financial Institutions could be placed with the CCI given that these are not covered by the DGSD and so

may inadvertently be excluded. The CCI definition also lacks a de minimis threshold based on the scale of deposit-taking and has extra-territorial effect. The effect would be highly disruptive in terms of the services which any banks subject to these measures could provide for instance to mid-sized and corporate customers. They also conflict with the basis upon which UK banks are proceeding to implement 'Vickers' ring-fencing under the legislation enacted in December 2013.

Domestic EU Structural reform measures already in development

A more general consideration is that national measures have already been placed on the statute book in a number of leading jurisdictions, and a timetable set for the implementation of the measures in question. The legislatures in each of these countries believe that national measures have been completed in the public interest within the principle of subsidiarity as defined in Article 5 of the Treaty of the Union. More specifically – and as an organisation with a firm basis in the UK – we believe it should be made clear that the UK in particular is already well advanced in implementing its own far-reaching ring-fencing regime. The UK has been acknowledged - even by many stakeholders in the EU - as having led the world in delivering a robust and ground-breaking regime, which we believe meets the objectives set by the European Commission in its BSR. Therefore – as acknowledged by the Commission with their inclusion of a derogation - the result of the European proposals should be at the very least fully compatible with the UK regime, with UK ring-fenced banks facing no further changes as a result. A lack of certainty as to whether or not these measures will be respected only adds to the complexity of the major business reorganisations resulting from these measures, and the ongoing uncertainty for markets, investors, and customers.

Potential tension between financial regulatory reform and promoting jobs and growth

Financial stability has rightly been the focus of the legislative agenda over the past 5 years, but we must now look at how we can promote business investment and trade in the face of bank deleveraging. This is clearly a view shared by the European Commission as evidenced in its potentially far-reaching proposal for a Capital Markets Union. Such a Capital Markets Union cannot comprise only measures focused upon issuers and investors: banks play a key role in acting as intermediaries in the financial markets. We would like to highlight the potential tension between the proposal of structural reform of universal banks and the Commission's drive to promote jobs and growth and to encourage long-term investment by the financial sector.

Significant reforms to the capital and liquidity requirements for banks have already been adopted, with further measures to be introduced over the next few years. These could have significant implications for banks' supply of trading liquidity to investors and issuers. With regard to the global regulatory direction in addressing trading risks, the Basel Committee is currently undertaking a fundamental review of the trading book prudential rules. The proposed framework will fundamentally change the transparency of trading activities and supervisors ability to address risks that arise on a trading desk level, providing the authorities with a much more targeted tool than a blunt separation to curtail risk taking at trading desks. Using the BRRD and other tools available to supervisors, the objectives of the BSR can be achieved in a more targeted way, addressing idiosyncratic risks and risks that each institution poses to the wider financial system without the wide ranging negative impacts to the wider economy that would result from a blunt separation.

We believe that potentially impacting market-making could increase the cost for businesses seeking to raise finance in capital markets and will have adverse effects on the financing of the EU economy. PwC have estimated that the increased cost of capital market finance could lead to a 5% loss in profits for non-financial

businesses. The proposed Capital Markets Union will play an important part in boosting growth and employment across Europe, increasing the available sources of finance for businesses. As Gunnar Hökmark highlights in his EP report, a well-functioning Capital Markets Union requires that the channels for financing growth and new jobs are open, and that investment in new industry and new businesses can be provided all over the Union. The Commission's proposal on banking structural reform, as it currently stands, could hamper the success of the CMU's core initiatives.

As for end-users, the biggest impact of structural reform for customers is likely to be an increase in the cost of finance for corporate borrowers .The cost increases will in all likelihood be concentrated on the smaller users of debt capital markets where liquidity is already weakest and sensitivity to prices is higher. Pension and fund investors may also face higher transaction costs of trading capital market instruments. The cumulative impact of the MiFID II fixed income transparency proposals and the increasing costs of market making will mean issuing bonds will become less attractive. Asset Managers will face wider spreads and less liquidity, particularly for SME bonds. That will ultimately have a negative impact on pricing and the ability of SME's to access the capital markets cost-effectively.[1]

The continued pressure on the financial sector will have a cumulative impact on the availability and cost of credit and lending to the wider economy. For instance the proposed FTT could serve to dampen the economic recovery across Europe, slowing investment, consumption, job creation and growth, especially in participating member states such as Germany and Italy. Countries planning to introduce the FTT are likely to suffer significant losses in household savings portfolios as a result of taxing a broad range of financial instruments. In larger states with sizeable capital markets, this loss could amount to as much as €205bn, or 16% of the total value of equity and debt holdings. If the FTT is borne by the end-users of financial services, this will hold back household consumption and reduce economic growth.[2]

There are already signs that existing legislative proposals may negatively impact markets' abilities to finance growth. It is therefore important that any new proposal is measured against a long-term growth objective and assessed for its incremental costs and benefits in relation to the existing and comprehensive reform agenda.

Need for certainty for markets

What is needed at present is greater certainty about Europe's capacity for economic growth which, in turn, needs to be underpinned with a more certain and steady European legislative environment for borrowers, investors and the providers of capital and credit. Protracted negotiation of legislation relating to banking structure has the potential to extend and increase current legislative uncertainty when it would be in the greater interest of the European Union to conclude the current cycle of major legislative changes for financial services institutions as quickly as is practicable and allow their effects to become apparent. It is now three years since the European Commission commissioned Mr Liikanen to examine the case for structural reform. It is a year since the Commission produced draft legislation. Neither the Parliament nor the Council seems likely to reach consensus positions in the near term. Markets can be neither expected nor presumed to function normally while this dossier remains both unresolved and with a very wide spectrum of potential outcomes.

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[1] Ibid.

[2] City of London study on the effects of a financial transaction tax on European household's savings (February 2014)