

11 July 2013

Mr Alain Deckers
Internal Market and Services DG
Capital and companies
Unit H2 – Banks and Financial conglomerates II

By email: markt-sr-consultation@ec.europa.eu

Response submission from AFME and ISDA to the consultation by the Commission on the structural reform of the banking sector

Dear Mr Deckers,

AFME¹ and ISDA² welcome the opportunity to comment on this important consultation on reforming the structure of the EU banking sector. Our response to the consultation is attached to this letter.

Our members fully support the Commission in its objectives of seeking to reduce risk in banks and the banking system including through strengthening the prudential framework, improving the resolvability of

¹ The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

² Since its founding in 1985, the International Swaps and Derivatives Association (ISDA) has worked to make over-the-counter (OTC) derivatives markets safe and efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. ISDA is listed on the EU Register of Interest Representatives, registration number: 46643241096-93.

banks, promoting competition and maintaining the integrity of the internal market, in line with the global reform priorities.

At the same time, we are concerned about some of the options the Commission seem to be considering for reforming the structure of the banking sector. Specifically, we believe that, if implemented, they could have a very significant negative impact on the ability of the banking sector to play its full part in supporting a return to growth of the European economy and lead to negative consequences for financial stability.

We further believe that the Commission's proposals to separate significant securities trading activities into separately capitalised entities sit oddly with the consideration – supported also by the High Level Expert Group (HLEG) – that there is no link between the losses experienced by banks during the crisis and their particular business models or size. As recognised by the HLEG, the crucial factors which caused losses were weaknesses in controls, lack of funding diversification, poor risk management and inadequate levels of capital and liquidity.

Our principal concern is that the diversity of the financial system – which is a source of strength – is preserved. We view any one-size-fits-all structural measures as threatening this diversity and hence detrimental to the effectiveness and stability of the European financial system. A healthier financial Single Market that corrects the pre-crisis excesses while supporting more robust growth across the region requires an increased diversity in local banking sectors. It also needs well-diversified funding sources, effective risk-transfer and strong capabilities in the distribution of originated credit to the end-investors.

The underlying danger is that carved-out trading entities will experience severe changes to their franchises' business position due to mitigation of synergies between the client bases of the wider group and the trading entity. Furthermore, there will be a reduction in the diversity of both their funding sources and revenue streams and consequently significant damage to their market position, due to 'doubling up' on the economic impact from already-agreed additional capital, leverage and liquidity requirements.

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This will be particularly severe if the assumption is made of material restrictions to group support. In such circumstances we believe that separation will lead to ratings downgrades of several notches, increasing the entity's funding costs and collateral requirements from its counterparties, reflecting the fragility of a narrow model. Were this to be the case, the actual impact of the separation, especially on the carved-out entity, is likely to go well beyond the intended objective of eliminating any potential government support for trading activities and result in a significant withdrawal of capacity.

The joint associations are concerned that if funding and capital available for market making activities in banks is significantly reduced through structural restrictions, secondary market liquidity provision will be more restricted and thus capital markets financing will become punitively expensive, reducing the diversity of the European funding model. This in turn would be damaging to the overarching growth objective which we believe the Commission supports.

In summary, structural separation of all of EU banks' trading activities is likely to lead to major changes in the structure of European capital markets. In effect, it would establish substantial barriers to entry for EU based banks, force the withdrawal of smaller and mid-sized service providers that depend on an overall relationship-based business model and restrict the ability of large banks to develop their business models to accommodate for changes in client and market requirements.

We believe that regulatory policies, in order to promote resiliency of the financial systems as a whole, should endorse diversity in bank business models. Therefore, we believe that the Commission's objectives, to eliminate any distortion (e.g. rating uplift) related to expected government bail-outs and to ascertain that the banking sector's objectives are aligned with those of its clients, are better achieved through implementation of more business specific measures, such as under the Recovery and Resolution Directive (RRD), rather than through a one-size-fits-all structural measure.

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We look forward to a thorough cost-benefit analysis being undertaken by the Commission into the options for structural separation and remain available to provide any further contribution as may be necessary.

Yours sincerely,



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Consultation response

11 July 2013

Structural reform of the EU banking sector

Executive summary

This paper represents the AFME and ISDA ('the joint associations') response to the consultation of the European Commission on reforming the structure of the EU banking sector. We summarise our views on the Commission's consultation paper below. The subsequent sections provide answers to the specific questions raised.

- AFME and ISDA believe that one-size-fits-all structural reform does not address the problems that the Commission aims to address. This is because the Commission's concerns are already being addressed in the current legislative proposals (CRD IV, MiFID/R, OTC derivatives regulation and the RRD) as well as through improvements in banking supervision. We believe that sub-optimal structural measures will be detrimental to the effectiveness of the current regulatory agenda. Extensive market – and regulatory – driven structural change is already underway, and this will result in more robust funding policies, lower leverage, elimination of excessive risk taking in trading activities and stronger governance.
- A one-size-fits-all structural reform, including specific controls on activities, risks producing sub-optimal outcomes and 'doubles up' on the economic impact from additional capital, leverage and liquidity requirements. We believe this proposal is unnecessary as the analysis on the financial crisis has uncovered no link between the losses experienced by banks and their particular business models or size. As the Liikanen report itself highlights, the crisis was caused by weaknesses in controls, lack of funding diversification, poor risk management and inadequate levels of capital and liquidity.
- The industry supports a healthier model of a financial Single Market that corrects the pre-crisis excesses while supporting more robust growth across the region. This involves diversification of funding sources, more effective risk-transfer and distribution of originated credit to the end-investors and increased diversity in local banking sectors. We believe that regulatory policies, in order to promote resiliency of the financial system as a whole, should promote diversity in bank business models, allow banks to provide end-users with both lending and capital markets intermediation services whilst also ensuring that there is additional safety against any local economic disturbances.
- The rating methodologies of the big rating agencies are favourable to well capitalised banks with stable business models, revenues and funding sources. The proposed separation will cause the carved out trading entity to face severely reduced diversity of revenue streams, lower diversity of funding sources and business position - and assuming material restrictions to group support - the separation will lead to ratings downgrades of several notches, increasing the entity's funding costs and collateral requirements from its counterparts, reflecting the fragility of a narrow model. Therefore, the actual impact of the separation, especially to the trading entity, goes well beyond the intended objective of eliminating any potential government support for trading activities to the extent that we expect it to cause a significant withdrawal of capacity.
- The economic benefits of an integrated business model are that client transactions can be managed across the legal entity structures and resources can be deployed to best facilitate the cost-efficient execution of client requirements. The integrated model also allows for more centralised control over activities at the legal entity level and application of group-wide standards. If structural separation is

applied, then to the extent that this not only leads to the breakup of the integrated model but in addition requires the segregation of management, corporate governance and finances, most of these benefits will be lost. Costs for clients will inevitably rise, capacity is highly likely to be reduced and risks including reputational contagion will increase.

- European businesses and sovereigns rely on banks with strong balance sheets and capital markets capacity to support their primary issuances and secondary market liquidity of the securities and maintain their access to cost efficient funding solutions. These clients require large scale hedging products to mitigate interest rate, credit and foreign exchange risks in for example government bond issuances.
- The joint associations are concerned that if funding and capital available for market making activities in banks is significantly reduced through structural restrictions, secondary market liquidity provision will be significantly impaired.
- Market making represents the main trading business undertaken by banks. Through the provision of liquidity to meet investor demand, market making plays an important role in helping to manage risk across the financial system. Market makers help to bridge the varying requirements – including time preferences, investment mandates and risk appetites – of investors (retail and institutional) and users of capital (corporates and consumers) - which are often highly diverse.
- Market making should be understood as a dynamic set of activities in categories of financial instruments which, viewed holistically, relate to the provision of liquidity and services to customers. Market-making comprises a broad set of activities supporting the provision of liquidity to market participants on a consistent and reliable basis throughout market cycles. Focusing on whether the activities of a given trading unit are customer-related or intended to support customer-related activities is a key to understanding the difference between market-making and proprietary trading businesses. Market making is not amenable to a hard and fast definition or to a transaction-by-transaction determination. Market makers must risk manage the inventories of positions they take in performing their role.
- In summary, structural separation of all of EU banks' trading activities is likely to lead to major changes in the structure of European capital markets as well as banking sectors. In effect, it would establish substantial barriers to entry for EU based banks, force the withdrawal of smaller and mid-sized service providers that depend on overall relationship based business model (to attract clients and to be able to provide the capital markets services at competitive prices) and restrict the ability of large banks to develop their business models to accommodate for changes in client and market requirements.
- Regarding the thresholds for separation, the joint associations do not believe that thresholds based on accounting definitions, relying on publicly available data, will provide the right framework for identifying high-risk activities that in order to avoid contagion should be separated ex ante from the deposit-taking activities of a banking group. We disagree with the notion that size necessarily equals complexity and therefore we believe that any systemic issues that are purely due to the size of an institution, are already addressed in the existing regulatory framework in G-SIB and systemic capital buffers and leverage ratio.
- Instead of the proposed approaches, the joint associations believe that it would be more appropriate to adopt a more risk sensitive ex-post approach that draws on non-disclosed supervisory data, such as the German, French and EU RRDs to identify high-risk, complex operating models that reduce the resiliency of a particular entity and the wider financial system. In this regard, we believe that the main objective should be to ensure that supervisors have the appropriate powers to address prudential weaknesses in a bank's operating model and, if deemed necessary, separate irresolvable structures.
- We are also concerned that the Commission is conducting an impact analysis on two of the implementation scenarios rather than analysing a wider variety of potential structural measures and

conducting a thorough cost-benefit analysis of the options. Without undertaking a proper cost-benefit analysis, which considers the incremental costs and benefits of structural reform, it is not clear how the Commission will be able to draw reasonable conclusions that the incremental benefits, beyond those arising from other reforms being implemented including CRD IV and RRD, would exceed the costs.

- The joint associations disagree that the Commission's matrix of structural separation options captures an option that best addresses the Commission's problems. Rather, we agree with the IMF that a much more flexible framework that promotes good supervision and clearly-defined mandated powers to demand structural changes where necessary in order to ensure resolvability, would provide for the right level of harmony while also accommodating the national level differences in priorities.
- We are also concerned that the Commission is not considering a minimum harmonisation (such as the RRD based conditional ex post separation) nor the narrow ring-fencing option as it is only consulting on the medium and large ring-fenced trading entity in its data template.
- Given the freedom for firms to make their own assumptions for the economic environment, capital requirements for the trading entity, the wider CRD IV and BRRD implementations and the businesses that can be transferred to the trading entity or deposit bank, we wonder how realistic it is that the Commission can draw conclusions from the data gathering exercise.

The joint associations and our members therefore respectfully suggest that the Commission proceed with considerable caution before recommending any interventions in the European banking markets, with any such interventions subjected to highly rigorous cost-benefit analysis. Given the substantial regulatory and structural changes already underway, the burden of proof to be satisfied to justify further intervention at this stage is in our view particularly high.

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Question 1: Can structural reform of the largest and most complex banking groups address and alleviate these problems? Please substantiate your answer.

We believe that one-size-fits-all structural reform does not address these problems. This is as the Commission's concerns on how some large banking groups are structured are already being addressed in the current legislative proposals (CRD IV, MiFID, MIFIR, OTC derivatives regulation and the RRD) as well as through improvements in banking supervision. On the contrary, we believe that suboptimal structural measures are detrimental to the effectiveness of the current regulatory agenda, given that an extensive market - and regulation- driven structural change which will result in more robust funding policies, lower leverage, elimination of excessive risk taking in trading activities and stronger governance, is already underway.

We address the Commission's four key concerns that it identifies as the key drivers why structural measures are required below.

Responses to Commission's key concerns regarding large banking groups

1. **Accumulation of risks and risk-taking incentives:** As the HLEG's analysis reveals, it was not trading that caused the crisis. The majority of institutions failed because of vulnerable business models, poor lending policies and the fact that financial institutions invested in high-risk loans (such as sub-prime mortgages), while holding insufficient capital reserves to absorb the incurred losses. The group also identified that reliance on short-term funding was a major contributor to the crisis. The Commission's proposals for ex ante separation of significant trading activities would not address these issues and they also ignore the fact that the majority of the losses in the financial crisis, particularly property exposures, were held in banking books rather than trading books.

Since the crisis the extent to which banks carry out proprietary trading has been reduced significantly. Many banks have ceased to engage in the activity. The changes in the regulatory framework and political pressures have made it uneconomical and undesirable. Given this reduction in proprietary trading activities since the crisis, the level of systemic risk associated with trading in general has been significantly reduced.

The vast majority of risks assumed by banks are on behalf of their customers in the form of credit and market risks. However, most of the risks that banks absorb relate to counterparty credit quality, which tends to change throughout the economic cycle. The BIS (2013) also identifies that market risk in the trading books generally forms only a proportion of the overall risk weighted assets (RWAs) of large European banks, depending on the bank specific business models. A separation of market making activities is likely to have limited systemic benefits, while undermining banks' ability to promote more effective risk transfer across the financial system. The extent to which banks assume risk related to market making activities is closely controlled through limits and other measures and must be supported by adequate capital backing against the possibility of losses.

Therefore, structural separation is likely to cause further accumulation of risks in the deposit banks, if market making activities are reduced, while also limiting the deposit banks' access to wholesale markets, thus making them more likely to encounter difficulties. For example Cajas limited access to wholesale markets and inability to raise capital were material contributors to the Spanish banking crisis, as identified also by the Commission in its assessments for government bail-outs of several Spanish banks.

2. **Implicit subsidy:** We believe there needs to be a clear distinction between the ratings uplift achieved through diversification benefits and through government support (implicit subsidy). The Commission's objective should be to eliminate any uplift related to expected government bail-outs. We believe that this objective is better achieved through implementation of more business specific measures, such as

under the Recovery and Resolution Directive (RRD), rather than through a one-size-fits-all structural measure that is likely to limit the diversification benefits achieved by firms, and reduce banks' loss absorbency instead of mitigating the ratings uplift derived from expected government support. On the contrary, we expect that the less diversified deposit banks are more likely to be bailed out (due to reduced capacity to access wholesale markets, hedge and securitize asset portfolios) rather than be resolved if some of the proposed structural measures are implemented, thus increasing the implicit subsidy for retail activities.

In this context, we note that the large rating agencies have already indicated that they will continue to review the ring-fenced entities on a case-by-case basis and that the loss of diversity of revenue streams and the changes in a particular business' market positioning is likely to have a much more significant impact on the rating of the business than the loss of any government guarantees.

We also understand from the rating methodologies of the big rating agencies that the ring-fencing proposals based on the Liikanen recommendations will not necessarily improve the ratings of the deposit banks. On the contrary, we believe that the deposit banks may become more dependent on interest rate margin as a source of income under some of the structural proposals and thus become more exposed to low returns during stressed, low interest rate periods without having the ability to offset any potential losses with revenues from other activities. In other words, we understand that the existing rating methodologies do not support the idea that a one-size-fits-all separation of businesses without consideration of their individual strengths and weaknesses would automatically create stronger and more sustainable banking businesses, whether in the context of deposit banks or trading businesses.

3. **Complexity and interconnectedness:** The Commission's consultation paper argues that separation of (significant trading) activities is the most direct instrument to tackle banks' complexity and interconnectedness. It also suggests that incentives for responsible risk-taking in the trading arm would be reduced as it would not be able to profit from liquidity, funding and solvency support from other parts of the group.

We would firstly like to note that some of the complexity in the banking system was created by the consolidation process over the years leading up to the financial crisis and consolidation caused by the financial crisis. The ongoing bank specific processes of simplifying business structures and consolidating balance sheets to limit external transactions is further complicated by the need to establish recovery and resolution plans. Therefore, an additional layer of complexity and uncertainty brought forward by structural proposals does nothing but slow down this process as businesses cannot commit to their simplification strategies, due to significant financial costs of getting them wrong, until there is more regulatory certainty on how businesses can be grouped together in a cost efficient way.

Secondly, on the general point of group support, we observe that the Commission's proposal for a BRRD anticipates the possibility that a bank may wish to provide support to a failing part of its operation in order to facilitate its recovery. It is therefore highly unlikely that mandatory structural separation could be, or indeed should be, used to prevent such support from being offered provided that this did not compromise the viability of the Group providing that support. Indeed, the non-availability of such support might run counter to a key objective of the HLEG: reducing the risks that firms pose to the financial system.

Thirdly, the joint associations are also concerned that structural separation will in fact make both the deposit bank and the trading entity more interconnected with the rest of the financial markets. With reduced ability to allocate funding and capital internally due to the large exposure limits, both the deposit bank and the trading entity will need to access hedging services and raise term funding (most European banks have loan/deposit ratios of over 100 % and have significant maturity mismatches between the asset and liability portfolios) from the capital markets. The risk for the deposit bank is that

if it has not got sufficient long-term liabilities and that it will be more dependent on its liquid asset buffer for liquidity management purposes, which increases the link between the sovereigns and banks.

Finally, with regard to the risks that stem from perceived systemic risks built in the large financial institutions, we argue that this is already being directly addressed through requirements that globally systemically important banks (G-SIBs) and domestically systemically important banks hold a separate capital buffer against this risk. Some 40% of the weighting within the proposed scorecard determining the level of extra capital required by G-SIBs is allocated to interconnectedness and complexity, with the value of OTC derivatives, level 3 assets, trading book and available for sale (AFS) values all contributing to the calculation of complexity.

Requiring mandatory separation of trading activities and their separate capitalisation would therefore lead to potential double counting of capital requirements. In this context, we note that the Bank for International Settlements calculates that an increase in equity capital ratios to 11% will significantly reduce the probability of a systemic banking crisis. Thus, further structural reform may have only marginal systemic benefits while impacting economic growth, considering that according to the EBA's study on 61 large European banks, the average CT1 ratio of the banks surveyed was already at 11% at the end of June 2012.

We also continue to highlight that the competent authorities will have the power to address complex organisational structures through the forthcoming BRRD mandates, if needed to ensure resolvability and continuity of critical functions, rather than in response to arbitrary generic criteria that ill-fits the diverse European banking industry.

4. **Depositor cross-subsidies:** While we fully accept that trading activities should be prudently funded and capitalised, this does not require that they be housed in a separate legal entity. It is important to recognise that trading entities are not to a material extent, or in general, funded by insured deposits. In the majority of European Member States banks have a ratio of customer deposits to customer loans of less than one (especially if excluding deposits raised in other jurisdictions). Put simply, this means that they have no excess deposits over and above those needed to fund customer lending, so trading activities are much more likely to be funded through the wholesale and secured borrowing markets as is a large proportion of the customer lending activity.

The blended funding rate that diversified banks achieve from variety of funding sources allows the treasury function to provide funding at the appropriate cost (depending on the expected tenor of the underlying business positions). While there was evidence that in some cases firm's transfer pricing mechanisms failed to address market liquidity issues of some trading positions (e.g. in mortgage securities) during the financial crisis, substantial improvements have since been (and are in the pipeline) to improve the liquidity, stress-testing and trading book capital frameworks and consequently to the overall allocation of funding and capital.

5. **Private interests, conflicts of interest and social usefulness:** To best address the conflicts of interest that can arise especially from activities such as proprietary trading, reasonable steps should be taken to prevent or control the different interests. For example in the French regulatory provisions (both Financial and Monetary Code and General Regulation of the AMF), banks, as investment service providers, must take all measures to prevent conflicts of interests that could adversely affect the interests of their clients. In addition, the UK FCA has an established policy on how they manage conflicts of interest that arise from firms' proprietary trading activities. There are clear requirements for firms that combine proprietary trading and client activities to identify, manage and disclose any conflicts of interest that arise from the proprietary trading activities. The FCA is also widening the scope to which its supervisory conduct policy applies beyond just the prudential risks.

Meanwhile, the EU is currently reviewing legislation that already provides national Competent Authorities and ESMA with effective tools, including criminal sanctions, to deal with situations of

market abuse, conflict of interests and excessive rent-seeking behaviours. These are the Market Abuse Regulation and Directive.

To conclude, the joint associations believe that the best way to address the alignment of private and wider economic interests is to ensure that banks are adequately capitalised and have sufficient liquid asset reserves to make the sector more resilient during times of economic stress periods as a going concern. We also believe that banks should be resolvable and positions should be easily transferred when banks are resolved as gone concern. Furthermore, to align the interests of customers and banks, we must ensure (similarly to any other sector) that the sector is competitive and natural evolution of business models is allowed to take place so that businesses that best serve their clients' needs can flourish and grow at the expense of inefficient competitors.

We therefore urge that Commission conduct a thorough cost-benefit analysis on top of the impact assessment that it is gathering the data for. This is also the greatest material weakness of the Liikanen report; it does not assess the consequences of the recommendations – the viability of the created structures and their ability to support the European economy.

Question 2: Do you consider that an EU proposal in the field of structural reform is needed? What are the possible advantages or drawbacks associated with such reforms? Please substantiate your answer.

The joint associations do not believe that there is a need for EU proposal for a one-size-fits-all structural reform. Such structural regulation, including specific controls on activities, risks producing sub-optimal outcomes and 'doubles up' on the economic impact from additional capital requirements and structural separation. We believe it unnecessary for the European banking markets as the financial crisis has uncovered no link between the losses experienced by banks and their particular business models or size but that the crisis was caused by weaknesses in controls, lack of funding diversification, poor risk management and inadequate levels of capital and liquidity.

European businesses and sovereigns are dependent on banks with strong balance sheets and capital markets capacity to support their primary issuances and secondary market liquidity of the securities and maintain their access to cost efficient funding solutions. These clients require large scale hedging products to mitigate interest rate, credit and foreign exchange risks in for example government bond issuances.

The Commission should also consider the diversity of banking sectors in Europe in its assessment if any structural measures on an EU-level are needed. The measures taken by some of the Member States are being introduced to address specificities in their national banking sectors and therefore do not reflect problems that are evident across the banking sectors in the EU. If extra-territoriality issues are carefully mitigated, Member States should have flexibility to address national concerns within any framework proposed by the Commission.

The industry supports a healthier model of a financial Single Market that corrects the pre-crisis excesses while supporting more robust growth across the region. This involves diversification of funding sources, more effective risk-transfer and distribution of originated credit to final investors and increased diversity in local banking sectors. We believe that regulatory policies, in order to promote resiliency of the financial systems as a whole, should promote diversity in bank business models, allow banks to provide end-users with both lending and capital markets intermediation services whilst also ensuring that there is additional safety against any local economic disturbances, mitigated by diversity in the bank specific geographical footprints. We also highlight that the flexibility in the system that stems from the integrated banking model's ability to adjust to the economic environment and distribute assets and risks either to the end investors or hold more on the balance sheet, depending on the appetite for new issues in the capital markets or capacity of the banking system is pivotal in ensuring that counter-cyclical balancing can occur without significant systemic disruptions.

Considering that the likelihood of failure will be materially reduced through the CRD IV and RRD reforms and other ongoing regulatory reviews, the main objective for structural reform appears to be limiting the severity of a potential crisis in case a large banking group fails. We support an approach which focuses on making sure that large banks are effectively resolvable, while preserving the continuity of critical functions, under their Recovery and Resolution Plans. This:

- Allows for a natural evolution of the European banking system to take place;
- Does not have high ex ante costs similar to a one-size-fits-all separation;
- Complements other regulatory reforms that address the same systemic issues as the proposed mandatory structural reform; and
- Does not increase pro-cyclicality in the system as it does not directly reduce loss absorbance between non correlated businesses.

We therefore believe that rather than seeking to impose the same structural arrangements on all banks regardless of existing business models, it should be left to the judgment of the management who have intimate knowledge of their banks to determine how best to structure their groups – with the authorities having a mandated power subject to clear criteria to demand structural changes in those cases where banks'

managements, having been given the opportunity to do so, have failed to demonstrate the resolvability of their institutions.

We also like to note that a recent IMF paper on structural reform (2013) is aligned with the industry view that better alternative to a mandatory, one-size-fits-all, structural separation is achieving full resolvability of banks, so that the continuity of critical functions is ensured and the “Too big to fail” problem eradicated. The adoption of the BRRD will represent a crucial step in this direction. It confers powers on authorities to require banks to amend their legal or operational structures should this be necessary to achieve transparency and resolvability.

In order to demonstrate why structural separation is the wrong solution to the European banking structure conundrum, we address some of the specificities of the European economy and its funding model and the systemic risks that banks pose below.

Consequences for the European economy and funding structures

European long-term funding markets have traditionally been dependent on the maturity transformation provided by banks. This is demonstrated by the fact that European corporations currently raise a far greater proportion of their funding needs from the banking sector than via the capital markets compared to their US counterparts. Bank lending in Europe currently accounts for over 80% of corporate financing, while 70% of such financing needs are met by the capital markets in the US.

Another European specificity is that European banks’ loan books cannot be funded from the European deposit base, with average lending representing 118% of customer deposits, compared to just 62% in the US and 78% in Japan, reflecting the structural differences between the jurisdictions (IMF, 2012). According to the IMF’s 2012 sample of large European banks, the shortfall between available customer deposits and outstanding loans is over US\$3 trillion, while the US bank sample has a customer deposit surplus of US\$1.8 trillion. The material shortfall of customer funding in Europe is made good by borrowing from the wholesale markets.

This dependency on bank funding and banks’ dependency on wholesale funding exacerbates the economic impact of changes in bank borrowing and lending rates in Europe. Several studies estimate that the increase in lending spreads, driven by the Basel III implementation, to be between 40 and 364 basis points globally. It can be expected that the consequent impact on European GDP will be higher than in other regions due to lower availability of alternative funding sources.

In addition to the pricing pressures, IMF (Oct 2012) expects the balance sheets of the biggest banks in Europe to shrink by \$2.8–4.5 trillion or 7.3-12 % of total assets through 2012 and 2013 as a direct consequence of the changes into the regulatory requirements (CRD IV). This deleveraging of bank balance sheets will have a systemic impact on retail, government and corporate funding in Europe and put additional pressure on capital markets to pick up the slack.

Notwithstanding this, there are green shoots as the European corporates continue to replace bank borrowing with bond financing through their existing relationships with European universal banks or investment banking arms of third country institutions. Recent figures by Dealogic and JP Morgan reveal that high-yield issuances in European currencies are at their all time high and that yields have dropped to historic lows, driven by mixture of reduction in the availability of low cost bank funding, low interest rate environment and investor demand for higher yielding investments.

There is however some way to go. Barclays Research has estimated that were Europe's corporate debt market to develop along US lines, then bank lending as a percentage of customer deposits could shrink by c. 15 percentage points. This would substantially decrease the current overreliance in Europe on bank lending as well as banks’ requirements for wholesale financing. The better balancing of bank funding and lending should also have a positive impact on customer loan pricing.

At this juncture, when traditional bank financing is becoming scarcer, the joint associations do not believe that the introduction of structural reforms that will further reduce the capacity of the capital markets, on which the

growth of the European economy is likely to depend on in the future, is desirable and in fact will have an adverse impact on the real economy. In table 1 below we summarise some of the key structural problems with the European funding model.

Table I: European funding structures:

- European corporations currently raise a far greater proportion of their funding needs from the banking sector than via the capital markets, whereas in the US the opposite is the case. Bank lending in Europe accounts for over 80% of corporate financing. By contrast, in the US, 70% of such financing needs are met by the capital markets (See table 1 below). The European situation is already changing as corporates continue to replace bank borrowing with bond financing through their existing relationships with European universal banks or through the investment banking arms of third country banks. Structural separation would undermine this development
- European banks are also struggling to fund their loan books, with average lending representing 118% of customer deposits, compared to just 62% in the US and 78% in Japan (Source: IMF).
- According to the IMF's 2012 sample of large European banks, the shortfall between available customer deposits and outstanding loans is over US\$3 trillion, while for the US bank sample there is a surplus of customer deposits of US\$1.8 trillion. This shortfall of customer funding in Europe is made good by borrowing on the wholesale markets including from the ECB. Structural reforms would only serve to exacerbate this problem as liquidity is trapped in smaller banking units and retail banks' become more dependent on wholesale funding
- The pressure from increased regulation, tight funding availability and tough economic conditions has led to a substantial increase in loan pricing. The 2012 ECB bank lending survey indicates that this trend is likely to continue, with most banks expecting to increase margins on loans to large corporates and on riskier loans
- European dependency on bank funding exacerbates the economic impact of bank lending rates. Several studies estimate the increase in lending spreads to be between 40 and 364 basis points globally, due to Basel III implementation. We expect the consequent impact on European GDP to be higher than in other regions due to lower availability of alternative funding sources

As evidenced above, we conclude that structural separation is likely to reduce systemic stability as it will reduce the availability of already limited capital markets based funding and thus increase Europe's reliance on its banks to raise deposits and funding from other jurisdictions and lend it to European borrowers.

Consequences for the stability of the European banking sectors

The joint associations believe that there are several unintended consequences that arise from the proposed one-size-fits-all mandatory separations. Instead, diversified business models and diversity in geographic footprints of banking institutions were sources of stability and provided much needed funding to the economy throughout the crisis. Breaking up large banks into separately funded, less flexible entities will undermine their ability to provide through the cycle services to the European economy and also materially reduce the benefits of the Single Market in financial services as the separation encourages local, "trapped" pools of liquidity and capital. This development will directly decrease diversity benefits in the overall banking sector and increase homogeneity at a local level as the exposures of local banks and the subsidiaries of multinational banks become more aligned.

Such structural measures will also create barriers to entry for EU banks and reduce competition as EU firms withdraw from activities that they no longer consider to be economically viable. When overall client relationship based pricing is no longer workable due to limited synergy benefits in providing services across the separated business lines. Consequently, we believe that the structural restrictions proposed are likely to reduce the efficiency with which financial services can be provided, materially increasing the costs to households and corporates, something which the HLEG also acknowledged in its report.

On the other hand, structural separation will cause the deposit banks to lose access to the internal capital markets for investment of potential excess deposits and thus, they are likely to make higher risk direct investments in search of yield with the excess funding. It can also be argued that long periods of low benchmark interest rates will eat into the interest rate revenues in traditional deposit taking and lending activities, limiting the deposit banks' ability to counter the low interest rate returns by fee revenues from other business lines. This is likely to make the deposit banks more vulnerable to any unexpected losses during periods of generally low economic activity, as also identified by for example the Finnish Financial Supervisory Authority in its stress tests in 2013.

The BIS working paper 412 (2013) identifies several further risks in mandatory structural restrictions that need to be fully considered in the Commission's impact assessment and cost-benefit analysis:

- Activities shift to unregulated sectors;
- Structural separation limits banks' ability to provide international banking services and to allocate capital and funding within the globally or regionally operating banking group; and
- Structural regulation may create business models that are, in fact, more difficult to supervise and resolve. For example, resolution strategies may be rather complex to design and implement for globally operating banks that have to face increasing heterogeneity in permitted business models at the national level.

Question 3: Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator.

As indicated in the HLEG's analysis, trading activities are no more likely to give rise to systemic risk than other banking activities. There is substantial evidence that poor controls and risk management failures have led to several isolated incidents of substantial trading losses over the past decades. As was pointed out in AFME's June response to the HLEG's consultation, market related activities which the Commission now proposes to separate accounted for only a minority of the losses that were incurred during the financial crisis.

We also disagree that the Commission should start looking at indicators for particular trading activities before having decided upon the activities that need separating.

Market making represents the main trading business undertaken by banks. Through the provision of liquidity to meet investor demand, market making plays an important role in helping to manage risk across the financial system. Market makers help to bridge the varying requirements – including time preferences, investment mandates and risk appetites – of investors (retail and institutional) and users of capital (corporates and consumers), which are often highly diverse.

It is acknowledged that market making exposes banks to financial risk as they may not be able to sell or buy securities at a profitable price. This is why, from a regulatory perspective, market makers need to have strong risk management processes and controls in place and are subject to strict regulatory requirements.

Mandatory structural separation may lead banks to significantly reduce the amount of capital allocated to market making activities or to withdraw from such activities altogether. With less capital, the role of market makers in absorbing risk would be greatly diminished to the detriment of the end customer.

We therefore recommend that the Commission conducts a thorough analysis first to determine which activities are critical to the economy and cannot be separated from complementary on-balance sheet activities in order to support European businesses and the wider economy. In addition, we note that the indicators proposed by the Commission are not risk based. Volumes, even on a net basis, are not a good proxy for risks in a given trading activity, for example for highly rated government bonds. With this in mind, we consider that many indicators are already available in the current regulation for trading risk capital rules and they will be significantly enhanced once the Basel Committee's Fundamental Review of the Trading Book has completed its assessment and made proposals.

Question 4: Which of the approaches outlines above is the most appropriate? Are there any alternative approaches? Please substantiate your answer.

The joint associations do not believe that thresholds based on accounting definitions, relying on publicly available data, will provide the right framework for identifying high-risk activities that in order to avoid contagion should be separated ex ante from the deposit taking activities of a banking group. We disagree with the notion that size necessarily equals complexity and therefore we believe that any systemic issues that are purely due to the size of an institution, are already addressed in the existing regulatory framework in G-SIB and systemic capital buffers and leverage ratio.

Instead of the proposed approaches, the joint associations believe that a more risk sensitive ex post approach that draws on non-disclosed supervisory data, such as the German, French and EU RRDs to identify high-risk, complex operating models that reduce the resiliency of a particular entity and the wider financial system is more appropriate. In this regard, we believe that the main objective should be to ensure that supervisors have the appropriate powers to address prudential weaknesses in a bank's operating model and, if deemed necessary, separate irresolvable structures. We also believe that the issue should be considered, to achieve a harmonious implementation of processes to review the resolvability of banking structures, in the wider context of the Single Supervisory Mechanism.

Question 5: What are the costs and benefits of separating market making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?

The joint associations believe that the introduction of structural regulation that separates market making and underwriting activities that will further reduce the capacity of the capital markets to manage risk and provide funding to the economy is not desirable or beneficial neither from a systemic safety nor an economic perspective.

There is a clear interdependence between the ability to underwrite securities effectively and access to secondary markets. We also agree with the wider point made for example by the PCBS (p. 20, 2013) that *“banks have a natural advantage in acting as market-makers because of the high capital requirements associated with it, the fact that banks have a variety of other relationships with their clients who want to make trades, and the fact that acting as a market-maker is often a natural follow-on activity for whichever banks underwrote the issuance”*.

From the debt and equity issuers' perspective, they typically expect that the dealer bank will provide ongoing secondary market liquidity in their new issue. Therefore, we do not believe that underwriting and secondary markets can be provided by different entities and to be able to provide these services (and mitigate the risks involved) to larger corporates and governments, economies of scale are needed. This has also been reflected for example in the Swedish National Debt Management Office's response to the Liikanen consultation. Without taking this practical issue into account, it is difficult to see how the Commission aims to assess the impacts of the potential separation of market making activities.

The joint associations are also concerned that if funding and capital available for market making activities in banks is significantly reduced through structural restrictions, secondary market liquidity will only be able to be provided by a more limited range of participants. The evidence suggests that such non-bank entities provide plenty of liquidity during good times but the liquidity may evaporate very quickly during market stress periods, increasing volatility and cyclicalit.

We note that the Commission has put forward definitions of proprietary trading and market making. Notwithstanding our strong view that mandatory structural separation is undesirable for the European financial system, including on the basis of the distinction between market making and proprietary trading, we nonetheless take the opportunity to briefly comment on the Commission's understanding of these two types of activities.

It is important to stress that whilst both activities are distinct, as discussed below, the distinction is not amenable to a hard and fast definition or to a transaction-by-transaction determination. Market making should be understood as a dynamic set of activities in categories of financial instruments which, viewed holistically, relate to the provision of liquidity and services to customers.

Market making comprises a broad set of activities supporting the provision of liquidity to market participants on a consistent and reliable basis throughout market cycles. The activities of a trading unit supporting market making business are potentially amenable to an ex-post supervisory assessment in accordance with criteria characterising market making activities. A non-exhaustive list of characteristics could include, among others:

- **Provision of liquidity.** A market-maker will absorb an investor's need for immediate demand or supply of an asset or financial instrument and charge a premium for the service provided. Clients can obtain quotes from several market makers for a particular asset or transaction which helps them to achieve better cost efficiencies. In addition to the Over-The-Counter (OTC) markets, investors can access directly/indirectly the liquidity provided by market-makers on trading venues.

- Business model. The market making business model depends upon intermediation between clients and investors, liquidity provision and the inventory management associated with those activities.
- Provision of trading services and execution strategy. Market making service providers' execution strategy interacts with their customers' regarding their trading, financial and business objectives.
- Provision of analysis and dissemination services. Market making servicing units devote significant resources to providing market, trading, research, and execution analysis that is disseminated to customers to aid the execution of the customer's investing strategies.

Focusing on whether the activities of a given trading unit are customer-related or intended to support customer-related activities is key to understanding the difference between market making and proprietary trading businesses. A unit's market making activities are characterised and distinguished from other activities by the significant presence of the above factors. A unit that is assigned the task of pure proprietary trading would not share these characteristics in a meaningful and material sense.

It is important to note that market makers must risk manage the inventories of positions they take in performing their role. This will be done partly through sensible judgements around potential supply and demand for a particular instrument; and partly through the hedging of positions arising as a result of market making. For this reason, market making activities need to be viewed holistically (on a portfolio basis and across different asset classes) and not on a trade-by-trade approach.

We also note that applying such ring-fencing requirements to a subset of market participants would create level playing field issues outside of the EU as well as within the Single Market due to extraterritorial impacts and suitability of such measures to different existing business models.

The next sections discuss the impacts of structural separation firstly to the trading units and secondly to the customers.

Impact on the banks' capital markets units

The joint associations believe that a ring-fenced trading entity is likely to face significant challenges including increases in capital, funding and other costs which may threaten its ability to support European capital markets.

The rating methodologies of the big rating agencies are favourable to strongly capitalised banks with stable business models, revenues and funding sources, which has resulted in most of the highest bank credit ratings to be given to large and well diversified banks (See table 2 below).

The proposed separation will cause the trading entity to face severely reduced diversity of revenue streams, lower diversity of funding sources (additionally corporate deposits are considered much more volatile than retail deposits by most rating methodologies and the current regulatory liquidity coverage ratio) and – assuming restrictions to potential group support - the separation will likely lead to ratings downgrades of several notches (see table 2), increasing the entity's funding costs and collateral requirements from its counterparts (reflecting the "monoline" status). On the other hand, the deposit banks' ability to provide a diverse range of services to their customer base will likely be impaired, which could have an adverse impact on the creditworthiness of the deposit entities.

We believe that the current macro factors are likely to be bad for both the deposit and trading entities if separated. However, the bank specific factors would clearly put more pressure on the ratings of the carved out trading entities than on the rest of the banks. This is as the trading entities may not have the right competitive positions (as it has to move towards standalone transactional pricing model) nor the capital and earnings

profiles that are required for a credit rating that allows for continuation of operations at reasonable funding and capital costs.

Furthermore, the reduced group support will further shave off notches from the ratings of the trading entities. Therefore, the actual impact of the separation, especially to the trading entity goes well beyond the intended objective of structural separation of eliminating any potential government support for trading activities, to the extent that we expect it to cause a radical withdrawal of capacity.

Table 2: Generic bank rating frameworks

Macro factors:	Bank specific factors:	External support:
Analysis of the economic environment, for example: <ul style="list-style-type: none"> Health of the operating economy Size and growth of the economy Political stability Structural changes in the economy 	Competitive position: <ul style="list-style-type: none"> Strength and depth of the franchise Ability to maintain existing client relationships/revenues and to generate new products and services Ability to win new business Geographical scope Management strategy 	Ownership/Group support: <ul style="list-style-type: none"> Stability of the shareholding structure Willingness and ability to support the bank Influence over decision making and wider interests
Analysis of the operating environment : <ul style="list-style-type: none"> Industry competitiveness and concentration Industry profitability Quality of regulation Accounting policies History of bank failures 	Capital and earnings: <ul style="list-style-type: none"> Stability and quality of earnings Historical performance and future performance indicators compared to peers Earnings by business lines Provisioning levels and the bank’s ability to absorb losses from one business line with profits from another line 	Government support: <ul style="list-style-type: none"> Willingness of the government to bail out the bank Government’s strategy as an owner
	Funding and liquidity: <ul style="list-style-type: none"> Proportion of retail and wholesale funding and concentration of funding sources. Rating agencies prefer retail over corporate deposits as much more stable source of funding Maturity profile of funding by proportion of liabilities Potential replacement cost Geographical scope and currency of funding Access to capital markets Credit lines and access to central bank discount windows 	
	Risk position: <ul style="list-style-type: none"> Capitalisation Credit risk (on-balance sheet loans and securities and off-balance sheet commitments) Securitisation; ability to securitise assets improves funding profile and may have a positive impact on earnings performance and reduce leverage Operational risks 	

Source: Standard and Poor’s, Fitch and Moody’s rating frameworks and discussions with the agencies

Additionally, markets and regulators will demand higher level of standalone capital to reflect the loss of diversification benefits and to support an acceptable debt rating for counterparties to be able to trade with the unit, reducing the capital available for other client activities at a time when return on equity in European trading activities is already very low and subject to further reduction accounting for the impact of CRD IV, MiFid, EMIR, CCPs and OTC margin requirements, making it difficult for investors to accept the uncertainty and returns of an investment in such businesses.

As an example, transfer of contracts (from the universal bank to the ring-fenced trading entity) can dramatically increase market uncertainty, as we demonstrate in Annex I. This is as counterparties are likely to request a renegotiation of relevant clauses, since risk parameters of the new entity are expected to change. Finally, we believe that the separation will give rise to one-off costs as well as on-going operational costs including costs associated with duplicated infrastructure.

Given the uncertainty and limited returns on equity, we expect the market to undergo a major consolidation, withdraw capacity and re-price, with material impacts on market liquidity, competition and client activity, which all together will reduce systemic stability of the European financial sector.

Impact on clients

A lot has changed since the days of Glass-Steagall in the US and Article 65 in Japan in terms of client requirements and nature of large global businesses. As highlighted in the responses to the recent consultations on the UK Vickers and European Liikanen proposals, there is broad consensus among industrial business associations on the value of integrated banking and markets services that provide them with access to a wide range of financial services (e.g. cash management products, commercial paper and back-up credit lines, currency, commodities and interest rate products, trade finance) under one umbrella and at competitive prices. This client requirement is also evidenced in the evolution of banks and the creation of combined corporate and investment banking divisions.

The proposed structural reform would present an artificial separation of activities that directly relate to servicing client needs, creating a boundary that necessarily reduces the efficiency of banks' capital and liquidity allocation, efficiency risk management (hedged are split between the two separate entities) and synergies that can be achieved through pricing based on the overall efficiency of the business model and client relationship are lost. The impact will be a material shift towards transaction based pricing of client activity, which is likely to change the costs of capital markets services, especially for smaller businesses and transactions, and may become prohibitive.

As a result of the above, structural separation would place at serious risk the ability of the capital markets to assist in meeting European financing needs at a time of very subdued bank lending. S&P estimates that European borrowers have new financing needs of US\$1.9-\$2.3 trn and US\$8.6 trn in refinancing needs for existing debt by the end of 2016, in total equivalent to around 75% of EU GDP.

In 2011, European governments issued €1.1trn of debt. Supranational development banks issued €185bn of debt and corporate debt issued (including bank debt) was €790bn. Covered bonds and securitisations placed with investors topped €397bn and €88bn respectively. In terms of equities, €123bn of European IPOs and secondary offerings were underwritten. The significant amount of funding that is provided by the European banking industry would be drastically constrained by moves towards mandatory separation as the balance sheet flexibility and resource allocation is constrained.

To be able to provide these services (and mitigate the risks involved), especially to larger corporates and governments, economies of scale are needed (see Swedish National Debt office's response to the first HLEG consultation). Thus, mandatory structural separation may result in a much higher concentration of investment banking activities to a few large players that can allocate balance sheet capacity to serve such clients. The impact of which is likely to be a reduction in competition – potentially resulting in higher costs for the end-users of financial services.

Impact on issuers and primary markets

The provision of liquidity in the secondary market by market makers is crucial to the availability of funding options for businesses in the primary markets.

The role of market-making is essential to developing a full understanding of long-term financing and the market mechanisms needed to support it in the context of the Commission's recent Green Paper on the subject.

Intermediation in the form of market making helps to align the varying requirements of market participants, transferring risk to those better able to absorb it, helping businesses plan and cope with change and facilitating higher levels of economic activity. Market makers contribute to allocating capital to the most efficient investments within the economy and providing mechanisms for saving, risk pooling and management.

Market makers significantly reduce transactions costs in the economy – by for example minimising the costs for borrowers in relation to the number of investors that would otherwise have to be approached and to the variety of terms that they would demand.

Should banks withdraw from or reduce the extent of their market-making activities as a consequence of structural separation, this is likely to lead to a reduction in available liquidity for the relevant market. This will affect the ability of issuers to access financing for new commercial opportunities and a range of projects requiring long-lived capital. AFME research has shown that the adverse impact of a decline in liquidity tends to fall on less liquid instruments in particular, typically those related to small and medium enterprises (SMEs) and project finance – precisely the types of investment highlighted in the Commission's Green Paper *Long-Term Financing of the European Economy*.

Structural separation will constrain the ability of market making entities to hedge risks and effectively manage their inventories. If the regulatory environment forces market makers to increase their transaction costs, price adversely, restrict their client base or pull away from the market entirely, liquidity will be quickly drained from these markets.

Question 6: Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?

We understand that this is a conduct concern and is based on the relatively narrow mandate that ring-fenced deposit banks had under the original Vickers proposals. We would like to note that there is no evidence that such activities have created systemic risks or have directly contributed significantly to the demise of a financial institution.

As an example, if a bank has multiple clients with offsetting hedging requirements, a bank can provide these services without any market transactions that would increase inter-connectedness of the system. However, if all of the transactions are provided on an agency basis, each transaction will be hedged by a transaction in the market. Additionally the consequent costs - if the transactions are conducted on an agency basis without the banks' ability to net the transactions and risk manage internally - are likely to cause risk management services to become much more costly as the intermediation chains are extended (for example refer to Annex I, paragraph 1.1).

Similarly to the HM Treasury's report on Banking Reform, we also note the broad range of EU wide and international reforms on derivatives regulation (such as OTC clearing and margin requirements) that have significantly mitigated the risks that derivatives can pose to resolvability of an individual institution.

Therefore, we do not see why there would be a need for limiting banks' ability to provide such services more cost efficiently at the benefit of the clients as well as the bank. The provision of client services on a one-stop-shop, long-term relationship-based model also recognises the risks inherent in the client's operation and is better suited to assess the overall financial situation of the client. Fragmenting this view will evidently increase the costs to the client or increase the possibility that the risk in a client transaction is mispriced.

It is unclear why such measures should only apply to ring-fenced deposit banks as opposed to all deposit banks in the region. If only ring-fenced deposit banks were to comply with such activity limits, the proposed ring-fencing rules will distort competition and create an uneven playing field between different types of institutions in the Single Market and reduce diversity of the European banking sector.

We also understand that the Commission has discussed internally whether the deposit banks should be allowed to securitize their assets and offload portfolios from their balance sheets. We believe this to be prohibitive to prudent balance sheet risk management and makes deposit banks much more vulnerable during economic stress periods. We believe that this measure would weaken the resiliency of the banking sector as a whole as it limits the deposit banks' ability to reduce the size of their balance sheet and bolster their liquidity positions during difficult times. The dispersal of risks from the bank balance sheets to a wide variety of end-investors should, on the contrary, be seen as beneficial to the financial stability as risks are distributed more widely in the global financial system. The impacts of such inflexibility were evident for example during the Spanish "caja" crisis, as can be also seen in the Commission's own assessments (see the Commission's competition reports in relation to Spanish bank bail-outs) in relation to the Spanish State's bank bail-outs.

Question 7: As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?

The existing structural reform programmes generally seem to prefer vertical ownership structures that may not be the preference of banks universally, given their different business models, ownership structures (e.g. plc vs. mutually owned banking group and centralised vs. subsidiary model) and global footprints. We therefore question if the (preferred) holding company model is suitable for all large banks, especially as some banks prefer to raise debt locally due to different risk management and operational models. In this context, we agree with the conclusion in a recent BIS paper (WP 412, 2013), which identifies that structural separation may create business models that are more difficult to supervise and resolve.

The joint associations also caution the Commission not to force extraterritorial legal structures upon European banks that are detrimental to their competitiveness in jurisdictions where other banks do not have to comply with particular structural models. This is also recognised in the HMT's Banking Reform white paper, which states that UK banks' *"overseas operations will be exempt if they are resolvable without risk to UK taxpayers"*.

Similarly, we urge the Commission to consider the impacts of further balkanization of the European banking sector and funding of the Member State (MS) economies. While in short-term the ongoing re-domestication of funding may have increased the stability of the MS economies, the longer-term dangers, such as the increased sovereign-bank loop and reduction in the diversity of funding sources and availability of funding during local economic disruptions will substantially contribute towards an increase in the fragility of European economies while also limiting growth due to reduced flexibility in deploying funds most efficiently across the Single Market. This development will be magnified by functional separation as bank structures are broken into ever smaller units with limited flows of capital and liquidity between them.

There are also a number of crucial operational issues that need to be carefully considered in the cost-benefit analysis as they could have a material impact on the costs of the regime, listed below:

- Whether holders of existing bank debt would be affected, including whether bonds would need to be partially novated to the new trading entity and whether this would be feasible. Alternatively, if the existing bonds aren't novated, whether it is feasible for the 'old' entity to retire/repurchase/call outstanding bonds and reissue new ones;
- The effect on the hedging of bank default risk in the CDS market, as existing contracts do not capture the correct legal entity exposures;
- Whether existing contracts between a bank's trading businesses would need to be moved to a different legal entity, and if so, whether this legally feasible and whether it give rise to tax problems for corporates and investors;
- Whether the need to transfer master agreements and other contracts between or to trading entities could disrupt the markets;
- Implications for clearing and settlement;
- The gross costs of separation, for example in terms of the duplication of back office, risk functions and systems;
- The effect on the provision of client services where the customer relationship (for non-bank customers at least) remains with the parent and is back-to-backed with the trading entity. Such an arrangement would probably result in a double-counting of counterparty-risk RWAs as the internal transaction could not be netted in the absence of a consolidated capital account; and
- Whether it would be the trading entity or deposit bank that would face CCPs and hold CVA, margin and contract with the CCP.

We also provide a detailed Annex I, explaining the unintended impacts of structural reforms regarding the intra-group transaction exemption under EMIR, structural separation and transfer of OTC derivatives contracts.

Question 8: What are the relevant economic links and associated risks between intra-group entities?

The joint associations believe that it is complicated to assess how functional separation will work in practise as client transaction management does not often follow legal entity lines and transactions can be risk managed in an all together different jurisdiction than where the original transaction took place.

The economic benefits of an integrated business model are that client transactions can be managed across the legal entity structures and resources can be deployed to best facilitate the cost-efficient execution of client requirements. The integrated model also allows for more centralised control over activities at the legal entity level and application of group-wide standards. If structural separation is applied, then to the extent that this not only leads to the breakup of the integrated model but in addition requires the segregation of management, corporate governance and finances, most of these benefits will be lost. Costs for clients will inevitably rise, capacity is highly likely to be reduced and risks including reputational contagion will increase.

We would also like to point out a few examples of issues in the proposed structural measures that create supervisory and legal uncertainty and can have material unintended consequences. Please see a detailed response in Annex I.

Question 9: As regards full ownership separation, what are the associated costs and benefits?

As we have stated above in our answer to question three and considering the scale of bank proprietary businesses, we do not believe that there are true systemic benefits in the narrow trading entity separation, albeit it may sound politically appealing as it is not linked to serving client requirements. We believe that the Commission's resources are better utilised in addressing issues that have caused banking crises throughout the history, such as addressed through the ongoing regulatory reform (for example CRD IV, Banking Union and the BRRD). Consequently, we only discuss the impacts of the wider ownership separation scenarios below.

The joint associations believe that full ownership separation of investment and retail banking activities is the wrong solution to the wrong problem and does not reflect client requirements in this day and age nor does it deal with the root causes of the vast majority of historical financial crises.

In summary, legal separation of banks' trading activities is likely to lead to major changes in the structure of European capital markets as well as banking sectors. In effect, it would establish substantial barriers to entry especially into investment banking markets, force the withdrawal of smaller and mid-sized service providers that depend on overall relationship based business model (to attract clients and to be able to provide the capital markets services at competitive prices) and restrict the ability of large banks to develop their business models to accommodate for changes in client and market requirements. This is as ownership separation would take out any synergies between the provision of banking and risk management and capital markets services, while creating funding structures that do not reflect modern client requirements nor the needs of the wider economy. There could potentially be some leakage to less well regulated non-bank players while the remaining investment banking market would become more concentrated which is likely to create competitive distortions and be unhelpful for systemic stability and the Single Market.

Impact on clients

Full ownership separation of investment banking and commercial banking activities would prohibit banks from servicing their corporate and SME clients in a meaningful way and force especially smaller scale businesses to access investment banking services, including hedging transactions at standalone transactional pricing, making such transactions prohibitively expensive. We argue that in the context of European reliance on bank lending, in the current global environment, Glass-Steagall and Article 65 type solutions that limit the corporate clients' ability to access debt and equity funding could seriously damage the European corporate sector's competitiveness.

From a historical point of view, Patrikis (1998) suggested that reforming Article 65 in Japan would increase competition in the financial sector which "should raise the efficiency with which Japan's savings are invested, which may ultimately boost Japan's prospects for sustained economic growth." Furthermore, he argued that prohibition of banks entering the issuance of equity and debt securities had severe consequences on the Japanese corporate and retail sectors due to heavy reliance on bank lending and limited investment product availability respectively. Interestingly, the EU made proposals for regulatory reform in Japan, including a request to abolish Article 65, noting that the Article has significant detrimental effects on foreign financial services firms. It states that the barriers due to the separation "have been particularly detrimental to European financial services firms as most are part of universal banking groups".

From a large corporate client viewpoint (CBI, 2011) there are several benefits in the integrated banking model. Global businesses often need a bank with a substantial balance sheet to support large transactions such as infrastructure projects or debt and equity underwriting. Although these transactions can be syndicated and thus individual banks' exposure reduced, regulatory large exposures or internal risk limits require a bank that can manage big positions on its balance sheet so that the transactions can be completed efficiently. Furthermore, these capital markets services require the bank to be able to distribute a corporation's debt and equity to investors across the globe, wherever the lowest cost can be achieved.

Complex international businesses also need integrated services to support the organisation's funding requirements and risk management needs. Although these companies often have multiple banking relationships, they can net their credit risk and funding requirements within a single relationship. Effectively the netting of costs and risks of various long and short positions, and the associated bank credit valuation adjustments, achieves economies of scale and hence the overall cost of the products and funding requirements is reduced. As an example, if an overdraft in one account can be offset with a positive balance in another and the regional liquidity pooled together, the amount of working capital is increased and funding costs reduced. Cash management products also allow multinational corporations to reduce their operational risks and enhance the effectiveness of cross-border transaction management, hence allowing the companies to concentrate on their core businesses rather than transaction management. (CBI, 2011)

Impact on banks

On the other hand, we are concerned that full ownership separation will create "bank clones", similar organisations across the EU with limited diversity in terms of business model, ownership structure and asset and liability bases. The current diversity in types of organisations in the EU, inclusive of cooperatives, savings banks and shareholder owned banks with various geographical footprints and objectives create diversity benefits that include providing a wider array of products and services and increased competition for the end-users. We also note that integrated banks were a source of stability and provided much needed funding to the economy throughout the crisis. Breaking up such banks into separate "monoline" banks may undermine their ability to provide through the cycle services to the European economy.

The creation of narrower banks will also lead to substantial consolidation, especially in the investment banking sector as most of the new entities would not have the scale and scope required to provide cost efficient services on a standalone basis. The investment banking industry is already dealing with two significant, and linked, financial pressures:

- Higher funding costs – generally the cost of capital for the financial sector has risen significantly compared to the pre-crisis period. This may reflect a number of factors including an increase in the risk premium for investment in financial institutions; lower liquidity, particularly in inter-bank markets; and the impact of regulatory change.
- Lower returns – profitability in the investment banking industry is down significantly from pre-crisis levels, both in absolute terms and based on relative measures such as return on equity. The medium-term expectations for the industry are based on a sustained period of generally lower profitability, though returns may be higher for scale players or smaller firms with clearly defined areas of competitive advantage.

Therefore, investors are unlikely to find the returns on capital and funding on smaller European investment banks appealing, given the narrow focuses and competitive disadvantages due to lack of scale and scope. The evident conclusion is that the industry will need to withdraw capacity, re-price and consolidate, with material implications on market liquidity, competition, clients and systemic stability.

Benefits of diversity

As well as providing stability for individual institutions, diversity increases systemic resilience. Apart from the stability generated by banks with diverse activities that contribute to a more stable system, there is also a benefit in diversity between different banks. The probability of two banks failing at the same time is greatly reduced if banks have different structures, exposures, activities, and geographical footprints. As discussed in preceding sections the European banking system is characterised by such diversity (albeit fragmented on national lines) – which is a source of its strength.

It can be argued that to avoid local banking disturbances, and to avoid local disturbances that could contaminate the wider European sector, banking sectors in Europe would benefit from more diversity at a regional level – a mix of small, medium and large local banks as well as diversified cross-border banks with diverse sources of income in terms of products and geographical exposures. Countries or regions with only local banks that lack diversity are less able to absorb losses during prolonged regional stress periods (e.g. idiosyncratic shocks such as a sovereign debt crisis, loss of a significant regional employer or regional asset bubbles). A combination of business model and geographical footprint diversity would benefit the resilience of the fragmented European banking sectors.

The example of the Irish banking system is illustrative of this point. All of the Irish banks became over-exposed to the commercial and residential property sectors, creating a systemic event for Ireland. Considering a hypothetical counterfactual example – if all European banks had the same bad exposures as the Irish banks at the same time, any issues would become magnified. Diversity has benefited the European system, as would the presence of cross-border banks benefit the Irish economy by ensuring diversity of credit supply.

A study by Barclays (2010) identifies that a screen by size would not have predicted the banking failures during 2008 and 2009 as big and small, narrow and diversified, failures occurred in all types of banks. There is also evidence that supports the universal banking model (and more generally diverse entities over narrow ones) due to losses from one line of business being offset by profits from another. For example, a recent study by Nomura (summarised in Wall Street Journal, 2012) estimates that BBVA, Santander and Sabadell, all large diversified universal banks, are the only Spanish banks that will not require a recapitalisation. Diversification can also offset volatilities in business line profitability and thus enable banks to better weather longer disturbances to the financial markets compared to a narrowly focussed bank (Annex IV). In addition, some banks came out of the crisis strongly due to geographical diversification benefits (for example Asian markets showed resilience during the crisis).

Any structural regulation that affects particular business models harder than others may reduce the banking services available in a given region of the Single Market. Until the resulting gap is filled by firms that can provide the services with structural and capital efficiency there could be damage to the real economy as businesses that depend on bank financing or require a service provider to access the financial markets may not be able to finance their activities.

Question 10: Does the above matrix capture a sufficiently broad range of structural reform options?

The joint associations are concerned that the Commission's matrix does not include a risk sensitive conditional separation scenario, such as recommended by the IMF (2013, p. 23), based on firm specific RRD plans that targets risky operating models that do not provide sufficient evidence of resolvability.

We are also worried that the Commission is conducting an impact analysis on two of the implementation scenarios rather than analysing a wider variety of potential structural measures, instead of conducting a thorough cost-benefit analysis of the options. Without undertaking a proper cost-benefit analysis that considers the incremental costs and benefits of structural reform, it is not clear how the Commission will be able to draw reasonable conclusions that the benefits, beyond those arising from other reforms being implemented including CRD IV and RRD, would exceed the costs.

We believe that the Commission's objectives are better achieved through implementation of more business specific measures, such as under the Recovery and Resolution Directive (RRD), rather than through a one-size-fits-all structural measure, which is likely to limit the diversification benefits achieved by firms with significant systemic consequences.

We support the alternative approach that allows for des minimis harmonisation of structural measures and a natural evolution of bank structures to take place in order to support client requirements: Such structural changes might arise in the context of the Recovery and Resolution Planning, if needed to ensure resolvability and continuity of critical functions, rather than in response to arbitrary generic criteria. This would be a more tailored, risk sensitive and proportionate approach that takes into account the diversity of European banking models.

Question 11: Which option best addresses the problems identified? Please substantiate your answer.

The joint associations disagree that the matrix captures an option that best addresses the Commission's problems. Rather, we agree with the IMF's Staff Discussion Note (2013) that a much more flexible framework that promotes good supervision and clearly defined mandated powers to demand structural changes where necessary (such as given in the French and German RRD/structural proposals) would provide for the right level of harmony while also accommodating the national level differences in priorities of the approaches and for higher level of diversity within the European banking sector. We also believe that this type of conditional separation is less intrusive and does not limit the provision of essential customer services that are pivotal in order to restore economic growth in the region. We are also afraid, similarly to the BIS, that there are several unintended consequences apparent in one-size-fits-all structural reforms, particularly:

- It complicates cross-border resolution plans It undermines cross-border banking activity; and
- It will transfer activities into the shadow banking sector.

We therefore recommend the Commission to carefully assess the costs and incremental systemic benefits before making any proposals for mandatory structural reform.

We also note that there is overwhelming evidence that European bank lending is extremely weak and likely to remain so for some time. As a result banks are most unlikely to be able to assist in meeting Europe's financing needs in way of increasing lending. In order for economic growth not to be stifled further it is therefore imperative that capital markets are able not only to maintain their current role in facilitating borrowing by corporate customers but they must also be able to expand it significantly.

According to a new report from the Association for Financial Markets in Europe, "*Unlocking Funding for European Investment and Growth*", based on in-depth interviews with borrowers, investors and banks in nine EU countries, Europe's businesses want more flexibility in accessing funding, through expansion of capital markets channels such as European private placements, infrastructure, real estate, high yield and securitisation in order to improve distribution channels to capital markets to complement existing bank lending. Enforced structural separation of banks' trading operations will do nothing to assist this; indeed the opposite is the case. The issues that structural separation seeks to address are already being tackled elsewhere [in prospective regulation] at the same time EU policymakers have turned their minds to European financing issues.

We believe that it is clear that the current regulatory agenda provides the regulators with ample tools to deal with the Commission's objectives, as stated in the HLEG's mandate. However, the proposed structural separation appears unnecessary and is likely to have severe unintended consequences that limit the availability of funding, risk management products and cross-border financial services and consequently prolongs the period of low or negative growth – putting further pressure on the credit worthiness of European companies, nation states and consequently to the European banking system as the quality of the assets on their balance sheets deteriorate.

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Annex I: Unintended effects from Consultation proposals (intra-group transactions exemption, and transfer of OTC derivatives contracts)

These unintended effects are: Firstly, that of undermining the intra-group transaction (**IGT**) exemption recognised in EMIR (Art. 3.2.) which imposes conditions including consolidation on the exemption. Secondly, that of a **massive transfer** of OTC derivatives contracts (i.e., from the presently predominant one-stop-shop 'universal' bank, to the new separated entity). There are, of course, many other important issues addressed in the Consultation; the broader range of concerns is addressed in the joint AFME-ISDA document.

Our starting point is that **OTC derivatives** play an important positive supporting role in financial markets and the **real economy**¹. The total gross value of OTC derivatives outstanding globally (before netting and collateral) is \$25 trillion², reflecting the wide range of risks to which – and entities to whom – these contracts are relevant. The fact that OTC derivatives can be and are tailored to the exact requirements of companies, sovereigns, asset managers and banks, which are directly managing their asset-liability risks with these derivatives, means that they perform a targeted role which no other instrument (including listed derivatives) can play, in relation to risks that will continue to exist for savers and entrepreneurs.

In light of this, ISDA believes that any policy option considered in the 'Consultation', should always bear in mind an **overarching goal**: that of supporting the real economy by avoiding any undermining of effective risk-management tools used by market participants, such as IGT exemption and derivative contracts.

Our full commentary on the **unintended effects** caused by the Commission options on the use of IGT exemption and the transfer of OTC derivative contracts can be found below ; however, some key points are as follows:

- For consistency purposes, the policy options proposed in the 'Consultation' should preserve the benefits of the **intra-group transaction** exemption recognised in EMIR. The IGT exemption plays a vital role in the larger picture of risk-management services, by offsetting specific risks within the group, which, if addressed otherwise via clearing or exchange of collateral, may cause unintended effects, including:
 - **Drop in liquidity.** There would be an increase in hedging costs and a drop in liquidity, since risk-reducing efficiencies within a group would be limited or even precluded (due to the ring-fencing).
 - **Increase of inter-connectedness in the system.** Market participants would be forced to enter into bilateral transactions with other market participants, rather than offsetting specific risks via internal group back-to-back transactions (See point 1.1).
- **Transfer of open OTC derivatives contracts** (from the current-style universal bank to the ring-fenced trading entity), could result in the following:
 - **More market uncertainty.** Due to the different creditworthiness of the new entity, relevant counterparties would have a strong motivation to renegotiate the contract terms (risk parameters would not be the same due to the separation in some cases there would likely be a rating downgrading of several notches³);
 - **Risk management disruption.** As a result of the above-mentioned renegotiating process, many counterparties would either revise the conditions of the contracts to reflect the changes of the risk parameters (e.g., more collateral), or simply terminate the contract (refraining from 'novating' or signing a revised contract). In such events, valuable hedging transactions important for one or both counterparties could be ended (See point 1.2).

¹ [Non-cleared OTC derivatives. Their importance to the Global Economy. March 2013](#)

² \$24,740 billion of claims, as of end-2012, according to the Bank for International Settlements, though only \$3.6 trillion of gross counterparty risk (because of the effects of netting) – see <http://www.bis.org/statistics/dt1920a.pdf> .

³ Please refer to answer to Question 5-Impacts on the banks' capital market units in the joint AFME-ISDA response

In order to address the above-mentioned effects, ISDA supports the option developed in the answer to Question 11 of the joint AFME-ISDA response.

1 – Review of unintended effects

1.1 - Voiding the intra-group transaction (IGT) exemption in EMIR

1.1.1 - Criteria for using the IGT exemption in EMIR

The Regulation on OTC derivatives, CCPs and trade repositories (EMIR), recognises that financials carrying-out OTC intra-group transactions can be **exempted from clearing and margin requirements** for non-cleared derivatives (subject to certain conditions).

This exemption recognised in EMIR⁴ plays an important role in the real economy, since it allows for maximum offset of market risk, with real benefits (e.g., minimum costs and liquidity) for the individual firms, the group, and by extension to the system as a whole. Otherwise, submitting specific intra-group risks to clearing or exchange of collateral would limit the efficiency of the intra-group risk-management process, and therefore give rise to **unintended effects**. In light of this, the main conditions for such an exemption are stipulated in the following EMIR provisions:

- **Art. 3.2a** establishes several conditions to allow an IGT exemption. Among them, the most relevant are that counterparties shall be included on the same consolidated basis, and shall also be subject to appropriate centralised risk evaluation measurement and control procedures.
- **Art. 4.2** recognises the exemption from clearing when the conditions described in Art. 3.1 are met.
- **Art. 11.5** sets out the requirements for counterparties established in the same Member State to be exempt from the margin requirements that are set out in Art. 11.3; e.g., exemption requires that there is no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties.
- **Art. 11.6** lists the conditions for counterparties established in different Member States to use the exemption on margin requirements. These also include, as above, the absence of current or foreseen practical or legal impediments to the prompt transfer of own funds or repayment of liabilities between counterparties.

1.1.2 - Issues

Regrettably, the market-helpful IGT exemption established by EMIR, may be diluted by the upcoming reform of the EU banking sector. Our concern is that, depending on the policy option taken by the Commission in the legislative proposal, the benefits provided by such an exemption (e.g. risk management, less inter-connectedness) could either be seriously undermined or even eliminated. The cause would be that, depending on the level and strength of the **ring-fencing of certain activities**, such in fact would make impossible 'a consolidation on full basis' or 'the appropriate centralised risk evaluation measurement and control procedures' as per Art.3.2a, or would establish 'a practical or legal impediment' as mentioned in Art. 11.5 and 11.6.

In light of this background, unless the future EU banking reform adequately preserves the IGT exemption, the following may occur:

⁴ Recital 38 (EMIR) - It is recognised that intragroup transactions may be necessary for aggregating risks within a group structure and that intragroup risks are therefore specific. Since the submission of those transactions to the clearing obligation may limit the efficiency of those intragroup risk-management processes, an exemption of intragroup transactions from the clearing obligation may be beneficial, provided that this exemption does not increase systemic risk.

- **Drop in liquidity.** There would be an increase in hedging costs and a drop in liquidity (no risk-reducing efficiencies). Transactions between the market making entity and the deposit bank would have to either be subject to clearing or exchange of collateral. As a result, **valuable liquidity** would be soaked up (in clearing and collateral requirements), which could have been otherwise used to invest, or to make hedging less expensive. This problem could be exacerbated by very high Initial Margin requirements likely to be required in EMIR⁵ for exchange of collateral in Art. 11.3 (as implied by the latest [BCBS-IOSCO Consultation](#)).
- **Increase of inter-connectedness.** Unless the IGT exemption is preserved, entering into internal group back-to-back transactions could be hindered (depending on the level of separation). This could result in higher levels of inter-connectedness in the financial system, since banks would be forced to enter into bilateral transactions with other market participants, rather than **offsetting specific risks** via internal group back-to-back transactions. This could result in increasing interbank exposures, given that some of such transactions would not necessarily be cleared (transactions most likely to be tailored).
- **More operational risk.** Requiring clearing of intra-group transactions would create more operational risk. Most groups have only a small number of entities that are clearing members of a CCP. These CCP clearing members, are typically not the group's risk aggregation entities, nor are they client-facing entities. Thus, a typical intra-group transaction between a client facing entity ('CFE') and a risk aggregation entity ('RAE') would have to be cleared by both CFE and RAE – as clients of the group clearing member ('CM'). One trade, CFE to RAE, would therefore **generate four separate transactions** (with subsequent operational burdens and costs):

1 - CFE to CM >> 2 - CM to CCP >> 3 - CCP to CM >> 4 - CM to RAE.

- **Higher counterparty risk.** This clearing approach (see previous point) **multiplies rather than eliminates** intra-group transactions. In the above-mentioned example, one intra-group trade CFE to RAE has become **two**, 'CFE to CM (1)' and 'CM to RAE (4)'. As a result, there would be a significant increase in counterparty risk, which would need to be covered with the required collateral (see 'Drop in liquidity').

To sum up, given that there are already criteria in EMIR designed to ensure IGTs capable of exemption are adequately policed from a prudential, and risk management perspective; any overly of legislation (diluting IGT exemption), runs risks of inconsistency with how derivatives market users treat such transactions under EMIR (which, in turn, would lead to higher market uncertainty and systemic risk.)

1.2 - Transfer of open OTC derivative contracts

Another unintended consequence of applying **any of the options** listed in Table 1 of the Consultation (as a result of the prescribed legal separation), would be that customers will be required **to transfer (or 'novate')** open OTC derivative contracts (notably ISDA MA⁶) – and the counterparty credit relationships inherent in them – to a ring-fenced entity. In other words, customer X stops facing financial-group entity Y, and instead faces ring-fenced financial-group entity Z for all open contracts, as well as any new ones.

⁵ These standards (to be published) are expected to be based on the regulatory framework on minimum standards for margin requirements for uncleared derivatives issued by the BCBS-IOSCO. With this goal, a [second consultation](#) (the 'Consultation') was launched in February 2013 making some proposals establishing very high levels of Initial Margin.

⁶ The ISDA Master Agreement (MA) is by far the most commonly used contract used to document a wide range of OTC derivative transactions between two parties. It is composed of two parts: A pre-set body, listing the credit, legal and operational terms of the contract; and the Schedule to the pre-printed body, which contains the customised terms [negotiated](#) between the parties, such as the ATE. The ISDA MA is designed to facilitate close-out netting, i.e., the process of terminating the outstanding transactions, determining their value, and offsetting one or more positive exposures against one or more negative exposures, with the aim of calculating a net balance (to be paid or received).

Unless the European Commission considers another option (that is, without mandatory transfer), the following unintended consequences could be noted:

- **Higher operational risk.** This would be a major logistical exercise, potentially entailing each and every customer of each affected firm being requested to give formal consent to the change. This would, therefore, be a question of massive scale, involving **thousands of customers** (e.g., corporates and insurance companies), which would be required to move the derivative contracts to the new entity in the same window of time. What would happen where consent is not given?
- **More market uncertainty.** As a result of the different creditworthiness of the new entity, relevant counterparties (ranging from asset managers to pension funds), would have a **strong motivation to revise the contract terms** (risk parameters would not be the same due to the separation and in some cases there could be a rating downgrading of several notches⁷). It is of concern that this new situation could open a massive and complete **renegotiation of derivative contracts** occurring within the same period of time, with significant systemic and possibly de-stabilising effects. The resulting market uncertainty, mostly within the EU, would be exacerbated by all major European banks (playing key roles in the EU economy), simultaneously renegotiating all their derivatives contracts among themselves.
- **Risk management disruption.** As a result of the renegotiating process, we are concerned that a significant disruption of risk management (for relevant banks and their counterparties), would occur. Many counterparties would either **change the conditions of the contracts** to reflect the changes of the risk parameters (e.g., require more collateral), or **simply terminate the contract** since no agreement would be feasible (i.e., refraining from 'novating' or signing a revised contract).
- **Reduction of the number of hedging transactions.** If the contract was terminated (see above), valuable hedging transactions important for one or both counterparties could be ended. This would increase their market exposure, unless they are able to re-establish hedges tailored to their needs. They might be unable to do so at a reasonable cost or at all, leaving themselves unhedged and potentially putting their investors at risk.

In conclusion, transfer of contracts (from the universal bank to the ring-fenced trading entity) can dramatically increase market uncertainty. Counterparties are likely to request a renegotiation of relevant clauses, since risk parameters of the new entity are expected to change.

2 - Alternative option

Please refer to the response to Question 11 provided in the main response.

⁷ See footnote 2