

BANK STRUCTURAL REFORM – POSITION OF THE EUROSISTEM ON THE COMMISSION’S CONSULTATION DOCUMENT

This document provides the Eurosystem’s reply to the Consultation Document by the European Commission on the “*Report of the High-level Expert Group on Bank Structural Reform*” (the "Liikanen Report"). It comprises two parts: the first provides some general observations while the second part addresses the five recommendations of the Liikanen report, namely the (i) introduction of mandatory separation of proprietary trading and other significant trading activities to a separate legal entity within the same banking group; (ii) wider structural separation conditional on supervisory judgment based on a resolvability assessment; (iii) designation of dedicated bail-in instruments; (iv) increase of non-risk weighted capital buffers for trading activities and stricter requirements for real estate lending; and (v) strengthening of governance and control of banks.

1. General observations

The Eurosystem welcomes the work carried out by the High-level Expert Group and considers the proposals set forth as providing important directional steps towards strengthening the resilience of the financial system and enhancing the resolvability of financial institutions in Europe. In this context, the Eurosystem also welcomes that the proposals aim at safeguarding the diversity of the EU banking sector and considers them to be compatible with the prevailing universal banking model in Europe. Diversity implies that different institutional forms, business and earnings models coexist which strengthens resilience and mitigates contagion vulnerabilities.

The Eurosystem is of the view that an impact assessment needs to be carried out as a matter of priority in order to gauge the possible impact of the proposals in the EU. Indeed, the proposals set forth in the report may have a significantly different impact across the EU given differences in the structure of the banking sectors. This may have different consequences in terms of divergent funding costs as well possible unintended consequences namely on the real economy of Member States. This needs to be assessed. Moreover, the analysis should be comprehensive, thus also taking into account the impact of measures currently being developed by the Basel Committee on Banking Supervision as well as by the European

Banking Authority concerning, inter alia, the treatment of market risk in the trading book, large exposures, review of the standardised approach. The specific observations below should be seen against the background that this impact assessment has been carried out with positive results.

Finally, the Eurosystem notes that the introduction of structural measures is a topical issue which is currently being considered not only within the European Union but also internationally. In some cases decisions have already been taken, namely in the United Kingdom and the United States. Given that these measures are primarily addressing internationally active banks, the Eurosystem considers it important that coordination and consistency is pursued in this area both at the European and international levels in order to avoid regulatory arbitrage and ensure a level playing field for financial institutions that are active across jurisdictions.

2. Specific observations

Mandatory separation of proprietary trading and other significant trading activities

In general, the Eurosystem sees merit in separating certain high risk activities of financial institutions that are not associated to the provision of client-related services. This separation can be supported insofar it provides an effective tool to protect depositors from being exposed to the losses from these high risk activities, eliminate the cross-subsidisation that results from low-cost deposit funding subject to the safety net being used to fund risky activities, reduce complexity, enhance resolvability and thus limit taxpayers' exposure to potential losses originating from these high-risk trading activities.

Concerning the concrete proposal in the report, the Eurosystem is of the view that the activities subject to mandatory separation would need to be established on the basis of clear and reasonably enforceable criteria, taking into account that financial innovation would naturally contribute to blur the boundaries. In this regard, further analysis is warranted on the possible scope for allowing market-making to be carried out by the deposit taking entity, subject to certain limits. The report refers to the separation of economic activity being carried out on the basis of accounting rules. In our view, the recognition and measurement of financial instruments under IFRS should not be the only basis for separation as it may provide sufficient discretion for banks to e.g. restructure financial transactions and use the scope provided by accounting rules to circumvent separation rules.

In order to ensure a consistent treatment across the EU, the EBA in cooperation with competent authorities, including the ECB, should play a key role in this context by developing relevant binding standards, including the calibration of the appropriate thresholds for mandatory separation to be applied by competent authorities.

Furthermore, as regards inter-linkages between deposit-taking and trading entities, the Eurosystem would like to point out that keeping both entities within a single bank holding will not entirely eliminate the risk of spillover effects. In stress situations, reputational risk may spread within the banking group thus reducing the potential benefits of separation.

Finally, a discussion on reducing the systemic risk and limiting the potential losses of taxpayers via the application of structural measures is not complete without addressing the issue of size and interconnectedness. Even with mandatory separation, if the trading entity is too systemic, large and interconnected, resolution may be difficult and once again taxpayers may eventually be involved. This should be avoided. In this context, further research is warranted to understand and assess the implications of size and interconnectedness.

Additional separation of activities conditional on the recovery and resolution plan (RRPs)

The Eurosystem supports the proposal on possible additional separation of activities conditional on the RRP. This proposal aims at having simpler banking groups, reducing intra-group contagion in order to improve resolvability and enhancing transparency and thus market discipline. If RRP lack feasibility, the resolution authority in cooperation with the competent authority should have the power and the tools to introduce additional structural measures to improve resolvability.¹ In case additional structural separation of activities is required, communication to the public in a clear and comprehensive manner would be important.

As envisaged in the Recovery and Resolution Directive, the EBA in cooperation with competent authorities, also including the ECB, should develop a general framework and high-level guidance for supervisory assessment of resolvability to be applied by national authorities in the EU which would be consistent with the “Key Attributes of Effective Resolution Regimes for Financial Institutions” developed by the Financial Stability Board. This guidance would contribute towards ensuring a consistent framework within the EU.

Finally, as experience has shown, structural measures are prone to spur innovative solutions for circumvention. This calls for more intensive supervision, in order to ensure that the structural measures remain effective and if need are adapted in a way that addresses the development of risks. This monitoring should in particular take into account possible movement of activities outside the perimeter of regulation and supervision or lead to the relocation of activities to jurisdictions that are less stringent.

¹ However, in accordance with the FSB Key Attributes of Effective Resolution 10.5, when imposing changes to the legal and operational structure of banking groups, the relevant impact on their business models should be duly taken into account.

Designated bail-in instruments as a resolution tool

On the proposals for bail-in, the Eurosystem is supportive of the introduction of bail-in as it will be critical to ensure that taxpayers' exposure to losses if a bank fails is minimised. The proposal for a designated bail-in instrument is seen as providing legal certainty and incentives for investors to better monitor banks and reduces the implicit government subsidy for the too-big-to-fail entities. While this is acknowledged, it is important that the recommendation on bail-in be consistent with the upcoming Bank Recovery and Resolution Directive. The wider scope of bail-in in the Directive has important financial stability implications as it has the benefit of providing a better protection against the use of taxpayers' money. The benefits of both proposals could potentially be reaped by coupling the possible introduction for systemic banks designated by supervisors of a minimum bail-in requirement for a targeted level of dedicated bail-in-able debt while still maintaining the overall wider scope of bail-in as proposed in the Directive. The Eurosystem further recommends that EBA provides an assessment to the Commission of the impact of this requirement for financial institutions including whether it would be beneficial to introduce a requirement prohibiting or limiting that instruments eligible for bail-in are held within the banking sector. However, irrespective of the exact scope, it is key that further work is carried out regarding the practical and operational implications of bail-in.

Increase of capital buffers for trading activities and stricter requirements for real estate lending

The report recommends higher capital buffers for trading assets, stricter requirements for real estate related lending and a more consistent treatment of risks in internal models. As also acknowledged in the Report, the Eurosystem would like to point out the importance of the current work of the Basel Committee on Banking Supervision (BCBS) and of the European Banking Authority (EBA) related to these issues. Given the significant interactions and possible overlaps of the different measures, the Eurosystem deems it essential that the ongoing work is concluded and a review is carried out to identify remaining gaps before additional measures are introduced. As previously mentioned, the Eurosystem considers it necessary that a comprehensive impact assessment for the EU is carried out that should encompass the impact of reforms already undertaken. Subject to the afore-mentioned impact assessment, if additional measures were to be warranted, the Eurosystem would like to highlight the following on the proposed measures.

Regarding the proposal on setting an additional non-risk based capital buffer requirement on trading activities, further clarification is needed on whether this buffer is to be drawn down when deemed appropriate (i.e. subject to restrictions on capital distribution similar to the capital conservation buffer) or whether it would rather serve as a minimum requirement that banks should comply with at all times. It should be noted

that the addition of a further capital buffer for European banks would need to be duly assessed as it would come on top of several other new requirements, including the counter-cyclical capital buffer, the capital conservation buffer, the additional capital charge for Systemically Important Financial Institutions ('SIFI buffer') and, possibly, the Systemic Risk Buffer, applied for all credit institutions in a given jurisdiction if structural features of the financial system justify.

Regarding the possible introduction of a robust floor on internal model-based risk weighted assets (RWAs), further clarification is warranted on its definition and level as well as the relationship with other 'floors' currently in place or planned to be introduced in the context of Basel III. As noted also in the Report, the BCBS currently works on replacing the Basel I capital floor by a revised standardised approach that would be used as a benchmark/floor. Further, the interaction with the leverage ratio which functions as a backstop to the risk-based framework has to be clarified in order to ensure a consistent approach.

Regarding the proposals on the treatment of risk weights for internal models, the Eurosystem would like to emphasise the importance that the current work of the BCBS and the EBA towards a more homogeneous treatment of risk weights calculated by individual banks' internal models in order to achieve greater consistency and adequacy of RWAs across banks. This work should be duly taken into account. Furthermore, due care should be taken that this recommendation does not potentially result in unduly homogeneous models. This could lead to reducing diversity or inadequate risk assessments and potentially triggering similar response from banks to market developments, thus increasing the risk of the amplification of market swings. In this context, however, the Eurosystem recognises the need to harmonise banks' internal models in such a way that portfolios exposed to a similar level of risk, should not attract unduly different own funds requirements.

Regarding real estate lending, the report argues that current levels of risk-weighted assets based on banks' internal models and historical loss data tend to be low compared to the losses incurred in past real-estate crises. The Eurosystem agrees that current RWAs are highly diverse across institutions and can be inadequate for real-estate lending as several inconsistencies in internal, model-based, capital estimates – particularly in retail real estate – have emerged. A review is therefore supported.

The Eurosystem also supports the proposal to include Loan-To-Value (LTV) and Loan-To-Income (LTI) ratios in the set of macro-prudential instruments. However, the introduction of uniform LTV/LTI caps that are calibrated at the same level in all EU member states is not supported. In this regard, the Eurosystem is of the view that macro-prudential authorities should have the flexibility to use and calibrate these instruments as they deem appropriate to address the building up of risks in different jurisdictions. At the same time, it is

important to work, at the EU level, for a higher degree of harmonisation of the statistical information that can be used to frame in a consistent way the policy decisions of individual Member States.

Regarding the proposals to revise the adequacy of the current large exposures regime, namely in what pertains to intra-group transfers, there is ongoing work by the BCBS. This work should be concluded and only be reassessed if gaps remain. Moreover, it is key that the treatment of intra-group exposures under the large exposures regime is congruent with the measures proposed in the Bank Recovery and Resolution Directive concerning intra-group support.

Strengthening the governance and control of banks

The financial crisis has clearly highlighted that the governance and control mechanisms of banks failed to rein in excessive risk taking. Hence, the Eurosystem highly welcomes the proposals on strengthened governance of banks and tighter measures on remuneration which are of major relevance for enhancing financial stability. In addition to shortcomings in risk management and assessment, the disperse control by shareholders and the relative opacity of banking groups have contributed to the insufficient market discipline and the build-up of risks in the financial system. Therefore, measures that restrain individual incentives to risk-taking and align the incentives of management with all stakeholders, such as requiring that a share of variable remuneration be in the form of bail-in bonds or capping paid-out bonuses to variable remuneration for each risk taker and to paid-out dividends, should be further assessed and pursued.

In this regard an internationally coordinated approach should be sought under the aegis of the Financial Stability Board.² This should ensure that the EU banking sector, while better aligning incentives of performance to long-term sustainability is still in a position to attract and retain high performing human capital. Therefore, additional measures on remuneration should be coordinated at the international level.

² To note, on compensation practices, Europe was among the first jurisdictions to incorporate into regulation the *Principles for sound compensation practices* developed by the FSB.