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European Commission
Michel Barnier
Internal Market and Services

Response by Sveriges Riksbank to the report by the high-level Expert Group on reforming the structure of the EU banking sector

Introduction

The Riksbank welcomes the report of the high-level Expert Group on the need for structural reforms of the EU-banking sector. It provides a valuable summary of the developments in the European banking sector in the years leading up to and since the financial and economic crisis. It also highlights a number of relevant issues that regulators and policymakers should consider in their continued work to develop an adequate regulatory framework for the financial sector. The report also offers important reflections on the potential weaknesses of different reforms already initiated.

The Riksbank agrees with the overall conclusion of the group that further structural reforms may be justified to enhance the efficiency and stability of the EU:s banking sector, not least since the real economy in the EU is particularly dependent of bank funding, but also to safeguard European taxpayers' money against the risks that arise from the sheer size of the EU banking sector in relation to the overall economy.[1]

The report presents several interesting proposals and serves as a good starting point for discussions on further regulatory reforms. However in order to understand the potential effects of the suggested proposals, we recommend the EU-Commission to perform – without further delay – a thorough impact assessment and cost benefit analysis.

[1] In the EU as a whole, total bank assets correspond to 350 per cent of GDP.

We also want to highlight the importance of keeping the current reform work in pace. This applies especially to the complete, timely and consistent implementation of the Basel III requirements, agreed upon by the G20, the FSB and the Basel Committee. In our view structural reforms, in line with those suggested by the expert group, should first and foremost be regarded as complements to enhanced capital and liquidity requirements and other reforms already agreed upon.

In the interest of reaching globally, consistent solutions we also believe that further reforms should primarily be coordinated through the regulatory bodies mentioned above.

The Riksbank therefore urges the EU-Commission to present a more detailed plan for how the proposal of the Expert Group will be taken forward. In this context, we want to stress that this should be done in broad cooperation between all the member states of the EU.

1) Legal separation of certain particularly risky financial activities from deposit-taking banks

In general, the Riksbank is supportive of measures aimed at shielding taxpayers from having to bail out banks and protecting depositors from banking failures. It is also important that the parts of a banking group that provide the most valuable activities to the real economy are sufficiently protected from the risks arising from the other activities of the bank. Further attempts to unbundle complex bank activities, and to create incentives for banks to establish a more transparent organizational structure, are also desirable.

While generally supportive of the type of structural changes proposed we would like to stress the need of a thorough cost-benefit analysis. In the following sections we bring to attention a couple of issues that should be considered in such an analysis.

First of all, a legal separation does not necessarily hinder banks from transferring funds from the deposit-taking entity at a subsidized price to the trading entity. Conversely, the bank would still have both the ability and an incentive to do so, especially in an emergency situation. Furthermore, it does not seem obvious that a legal separation will reduce governments´ incentives to bail out troubled banks. Due to the impact of a failure of a systemically important bank, governments may want to protect them regardless from where the losses originate.

Another aspect to consider is the extent to which other channels of credit intermediation can absorb a potential shortfall of banking funding in the EU.

It is also unclear how a legal separation would be accomplished in banks with a wide range of cross-border activities. We therefore recommend the EU-commission to elaborate further on how cross-border issues could be managed in order to ensure a wide engagement and cooperation from the Member States of the EU.

2) A hierarchy of "bail-inable" debt instruments not to be held by banks

The Riksbank supports further developments of the framework for bail-in instruments within the Recovery and Resolution Directive. For investors to better understand the risk associated with bail-inable instruments, the use of such instruments must be predictable. It must also be clear how they relate within the hierarchy of debt commitments. Thus, to pre-define which instruments that could be subject to bail in seems like a reasonable suggestion.

However, to ensure the efficiency of bail-inable debt as a resolution tool we would like to see the bail-in requirement be assigned to a relative broad category of debt instruments. It would therefore be helpful with additional guidance on which instruments that could be considered.

Regarding the recommendation that bail-inable debt should not be held by banks, we find it an interesting proposal for limiting interconnectedness with in the banking sector. However, to fully understand the consequences for banks and other financial institutions, including potential spill over effects within the financial system, a more extensive analysis of the potential impacts is needed.

3) Capital requirements for trading book assets and real estate loans

The Riksbank shares the view of the Expert Group that a more consistent treatment of risk in internal models is needed and that risk weights, used to determine capital requirements, should be more robust. We therefore support the work of the Basel Committee on so called Level 3 assessments with the aim of ensuring consistency of the application of risk-weights. In addition, it is important that national authorities have other adequate tools in their toolbox, including capital buffers and sector-specific risk weights, in order to manage the risks and vulnerabilities.[2]

We welcome, the request for further measures regarding the treatment of real estate lending within the capital requirement framework. The Riksbank shares the view expressed by the Expert Group that caps on loan-to-value (LTV) and/or loan-to-income (LTI) should be included in the macro-prudential toolbox. However, it is vital that this does not limit the ability of regulators to use alternative tools to address systemic risks that may arise from real estate lending.

4) Improved governance

The report points out the failure of boards to rein in excessively risky behaviour and notes that "the increase in size and the advent of banks that are too-big-to-fail have further reduced market participants' incentives to monitor banks effectively".

The Riksbank welcomes the analysis of the remaining shortcomings in governance and control of banks. We find the suggestions of the group to be relevant and justified complements to the reforms currently being considered in this area. To let bonuses to bankers' be paid in debt instruments which can be written down if short-term profits yield long-term troubles, is an interesting proposal with a potential of actually ensuring that remuneration schemes are in proportion with long term sustainable performance. It is also pleasing that enhanced transparency and disclosures are brought to attention in this report. This is an issue of special concern to the Riksbank and something we continuously recommend our banks to show improvement in.

Stockholm, 13 November 2012

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[2] For more information on the Riskbank's view on tools needed to prevent risks that may threaten the stability of the financial system, see the Riksbank Study "Creating a Swedish toolkit for macroprudential policy".