Financial Stability Department
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European Commission
Michel Barnier
Internal Market and Services

Response by Sveriges Riksbank to the consultation paper "Reforming the structure of the EU banking sector"

Summary

The Riksbank welcomes the consultation on the need for structural reforms of the EU banking sector. The consultation paper asks relevant questions and displays an open-minded attitude on this complex, but very important, issue.

As stated in our response to the high-level Expert Group report[1], 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 other activities of the bank.

The Riksbank agrees that further structural reforms may be justified to enhance the efficiency and stability of the EU banking sector. However, it is essential that a thorough impact assessment and cost-benefit analysis is conducted before proceeding with any legislative work. The merits of further structural reforms will be dependent on the details of the legislative proposal, as well as on the interaction of those details with each other and with existing or developing rules and institutions. Such an exercise may also lead to a conclusion that the degree of structural reforms justified could differ between member states.

For a cost-benefit analysis to be of maximum value, it should feature a description of: (i) what problems the planned measures are addressing, (ii) what the measures intend to achieve, (iii) a comprehensive analysis of how different policy options could reach

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[1] *Response by Sveriges Riksbank to the report by the high-level Expert Group on reforming the structure of the EU banking sector* (available at
http://www.riksbank.se/Documents/Konsultationssvar/2012/kon_response_121113.pdf)

the objectives, and (iv) the costs (including risks and side-effects) of the different options. The calculation of benefits and costs should encompass both normal and stressed scenarios.

The Riksbank would also like to emphasize that such structural reforms should be regarded as complements to enhanced capital and liquidity requirements and other reforms already agreed upon. Structural reforms should not be allowed to dilute e.g. the Basel III requirements. Against this background, we want to stress the importance of keeping the current reform work in pace. In the interest of reaching globally consistent regulatory framework we believe that further reforms should be coordinated through the regulatory bodies, such as the FSB and the Basel Committee, as well as the G20.

The Riksbank urges the Commission to ensure that the cost-benefit analysis performed by the Commission is sufficiently thorough and that the results thereof are assessed carefully before proposing any structural regulatory reforms in the EU banking sector. Structural reforms may potentially be useful or even necessary. However, such reforms should be decided on only when sufficient information about both the costs and the benefits are clearly analysed and discussed. In this context, we want to stress that this discussion should take place in broad cooperation between all member states of the EU.

Question 1

Can structural reform of the largest and most complex banking groups address and alleviate these [intra-group complexity, intra-group subsidies, and excessive risk-taking incentives] problems?

The Riksbank agrees with the overall conclusion that further structural reforms may be justified to enhance the efficiency and stability of the EU banking sector. We are supportive of measures aimed at shielding taxpayers from having to bail out banks and protecting depositors from banking failures.

However, in order to understand the potential effects of the proposed reforms we would like to stress the need of a thorough impact assessment and cost-benefit analysis. Such an exercise should feature a clear description of what problems the planned measures are addressing and what the measures intend to achieve. It should entail as a comprehensive analysis of how well different policy options – including status quo on structural separation – could reach the objectives, and of the costs (including risks and side-effects) of the different options. The calculation of benefits and costs has to encompass both normal and stressed scenarios. The impact assessment and cost-benefit analysis should precede any legislative work.

One principle must also be observed: the structural reform should not make it possible to deviate from the Basel III requirements, for example by easing capital requirements for certain types of banks. Nor should it allow banks to move parts of their business outside the scope of the regulatory perimeter. This would undo the benefits of Basel III and the more robust requirements that the framework imposes. Time series over longer horizons reveal that banks of today have very low equity-to-assets ratios. In comparison to companies in other sectors the equity ratios are only one fifth, or even a tenth. Even under the new and stricter rules on capital, banks will continue to have capital that only amount to a few per cent of the assets. For risk-adjusted measures of capital, the Basel III monitoring exercise from BIS and EBA show that European banks on average have CET1 ratios that barely exceed the minimum requirement.[2] The Riksbank's view is that the first line of defence is to ensure that banks have sufficient levels of capital.

The Basel Committee has lately evaluated what it can do to simplify the Basel III framework. To this end, the steps being taken to simplify banking structures can be seen as being in line with the efforts of the Basel Committee.

Thus, the Riksbank's view is that further structural reforms may well be justified to enhance the efficiency and stability of the EU banking sector. Not least since the real economy in EU is particularly dependent of bank funding, but also since the EU banking sector is large and the potential burden for European taxpayers consequently is considerable. However, such structural reforms should be regarded as complements to the reforms that have already been agreed upon.

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?

Assuming that there is a need for structural reforms to enhance the stability in the European banking sector and to help restore confidence in Europe, the Riksbank agrees that there may be a need for an EU-wide approach to regulation.

An EU-wide approach might ensure there is no scope for cross-border regulatory arbitrage. Given that there are currently different national reform proposals underway in the EU, there is a need to make sure these do not counter each other or the reform agenda, causing increased complexity and risks of fragmentation.

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[2] This refers to the CET1 (Common Equity Tier 1) ratio according to the Basel III Accord and includes the capital conservation buffer requirement.

The Riksbank sees that the EU could have a role in harmonizing structural reforms, but this should only be as a minimum requirement. An EU reform should not impose restrictions that may hinder member states to introduce stricter requirements should they deem such measures appropriate, given the size or other characteristics of their respective banking sectors.

The Riksbank would also like to stress the importance of transparency regarding policies applied and that a harmonized EU framework should be consistent with the regulatory framework agreed upon by the BCBS and the FSB.

Structural reform proposals should aim at addressing regulatory arbitrage and lead to improvements in the functioning of the financial markets. However, it is not certain that there is a one-size-fits-all model to be found. The Riksbank therefore encourages the Commission to elaborate further how the EU-wide approach, harmonized at a minimum level, can be designed. Possibly, such a framework could provide member states with a menu of options to choose from. This would allow member states necessary flexibility, while at the same time reducing the regulatory uncertainty and complexity to banks, markets and the general public.

Question 3

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

Defining trading activity in order to analyse whether structural separation could be justified and, if so, determine the scope of institutions subject to a separation requirement is a difficult and complex task. At this stage, neither of the suggested definitions seems to be a perfect indicator of systemically risky trading activities. We would be cautious to put overly reliance on one sole mechanical formula.

The Riksbank argues that it may not be adequate to define trading activity solely based on accounting classifications of financial assets and liabilities. In particular, Liquidity Coverage Ratio (LCR) rules require banks to hold liquidity buffers to increase the resilience of banks and thereby the financial system. It seems to be counter-intuitive to treat High Quality Liquid Assets (HQLA) held to meet the LCR as risky trading positions, although they may be classified as speculative positions in the accounting framework. It could therefore be reasonable to exclude LCR eligible

[3] (i) Using the HLEG definition (Assets held for trading and available for sale); (ii) A more narrow definition that excludes available for sale assets as mostly composed of securities held for liquidity purposes; (iii) A definition focused on the gross volume of trading activity, which is likely to focus on proprietary traders and market-makers; (iv) A definition focused on net volumes, which is likely to only capture those institutions that have a higher share of unbalanced risk trading (proprietary traders).

assets, as banks otherwise would be given incentives to decrease the liquidity buffers due to risk of separation of trading activities.

The Riksbank further agrees to include trading securities and derivatives on the liability side as well and not focus only on the asset side (as in the original proposal). In doing so, market value losses would also be included and thereby, implicitly, would one be able to capture the trading activities behind the losses. However, using only market values for derivatives could mask banks real underlying trading activities as market values would only be reflective of current profit and loss and do not incorporate underlying market risk. In particular, method 4 could be complemented by a similar conceptual idea based on nominal amounts rather than market values. Nevertheless, measurements based on notional amounts would also be imperfect as they, for instance, would not appropriately capture non-directional, notional neutral trades. On the other hand, cash positions hedged with derivatives could lead to an overestimation of the risk banks have as such cross-asset class positions would not be netted in the proposed calculations.

Due to the complexity of the task it is unlikely that one method alone would be sufficient to appropriately identify trading activity. The Riksbank would therefore welcome the Commission to look into complementary methodologies and evaluate them. In particular, the BCBS market risk framework, an established internationally agreed framework to calculate capital requirement for market, could potentially be leveraged off.

Question 4

Which of the approaches outlined above[4] is the most appropriate? Are there any alternative approaches? Please substantiate your answer.

As pointed out in the introduction, the Riksbank welcomes a thorough cost-benefit analysis, the results of which have to be assessed carefully before any structural reforms in the EU banking sector are being proposed.

In order to understand the effects of the different approaches to separation an assessment is needed, and should include guiding conclusions as to how any threshold for separation should be calibrated and to what extent national discretion would be appropriate.[5] Those conclusions may of course depend on the parameters of the assessment, i.e. how different problems (e.g. intra-group subsidies from

[4] (i) Ex post separation subject to constrained discretion by the supervisor; (ii) Ex ante separation subject to evaluation by the supervisor; (iii) Ex ante separation.

[5] It could be noted that the Riksbank finds the use of "ex ante" and "ex post" to denote the alternative approaches unfortunate, as this could be interpreted as before or after the emergence of a crisis or risk thereof, rather than the (in all likelihood) intended before or after comparing individual bank data to a certain thresholds.

insured deposits versus intra-group complexity) and intended outcomes are weighted against each other.

However, one key principle when it comes to determining the degree of separation is transparency of the policy that is being implemented. National supervisors should under all circumstances clearly communicate to banks, markets and the general public which level of separation, if any, they will impose on banks and what considerations will be guiding their decisions on separation.

Questions 5 and 6

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

The question of which activities should be separated or not is pivotal. It must be addressed in a thorough cost-benefit analysis of policy options, which would be welcomed by the Riksbank. The results of the analysis have to be assessed carefully before any structural regulatory reforms in the EU banking sector are being proposed. The merits of further structural reforms will be dependent on the details of the legislative proposal, as well as on the interaction of those details with each other and with existing or developing rules. Which activities should be separated or not may depend on how different problems (e.g. intra-group subsidies from insured deposits versus intra-group complexity) and intended outcomes are weighted against each other.

The Riksbank thus considers the issues raised in question 5 and question 6 to be central in the cost-benefit analysis. Before seeing any results from such an analysis the Riksbank cannot take a definite position.

Questions 7, 8 and 9

- *As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?*
- *What are the relevant economic links and associated risks between intra-group entities?*
- *As regards full ownership separation, what are the associated costs and benefits?*

Another central dimension that should be addressed in a cost-benefit analysis is the strength of structural separation. Again, it must be addressed in a thorough cost-benefit analysis of policy options, which would be welcomed by the Riksbank. The recommended degree of separation may well depend on how different problems (e.g. intra-group subsidies from insured deposits versus intra-group complexity) and intended outcomes are weighted against each other. The results of such an analysis have to be assessed carefully before any structural regulatory reforms in the EU banking sector are being proposed.

The Riksbank finds it worth emphasizing that the analysis should be based on benefits and costs in both normal and stressed scenarios. Especially the rules on transfer of funds between entities would have to be analysed carefully under different market conditions. For instance, a functional separation could allow for the transfer of funds between legal entities, e.g. as group contributions from a parent entity to one of the subsidiaries or between sister companies. A mandatory separation would require thorough monitoring of group contributions and other transfer of funds between intra-group entities, especially in times of market distress. However, funds might need to be transferred from the trading entity to the deposit bank entity because of losses caused by traditional lending. It is particularly important that rules allow for desirable flexibility in times of financial distress, enabling a transfer under certain conditions, e.g. subject to regulatory approval. Such a transfer may have the benefit of decreasing the need of public support or intervention. A rule on transfer of funds must therefore be balanced and calibrated properly.

The Riksbank considers it premature to foresee how a cost-benefit analysis would assess the merits of different degrees of separation. However, the Riksbank would want to highlight some aspects. The Riksbank believes that also a 'weak' separation, such as accounting separation, could have positive effects on market discipline by enhancing transparency to markets, stakeholders and regulators. Such a separation would require business units to produce separate accounting reports on a regular basis. Those reports would be published and submitted to the regulator, who would be equipped with tools to intervene. Full ownership separation should be handled carefully. A separation would be justified only if gains for financial stability and reduction of systemic risk are significantly higher than the consequences to banks and the real economy. A cost-benefit analysis should explore other means that could lead to the same result without being too intrusive.

A question of great importance to the Riksbank is how cross-border issues could be managed in order to ensure transparency and legal certainty to stakeholders and regulators but also engagement and cooperation between authorities in the different Member States.

Questions 10 and 11

- *Does the above matrix capture a sufficiently broad range of structural reform options?*[6]
- *Which option best addresses the problems identified? Please substantiate your answer.*

The Riksbank finds a thorough cost-benefit analysis to be crucial for well-informed decision-making on structural reform. Such an analysis would need to address all relevant dimensions of structural separations. The matrix presented depicts two central dimensions, and is thus relevant to classify the range of policy options. However, the merits of further structural reforms will be dependent on the details of the legislative proposal, as well as on the interaction of those details with each other and with existing or developing rules and institutions. The cost-benefit analysis will probably need to examine at least some of the options illustrated by the matrix in finer detail.

The Riksbank would also want to emphasize that an impartial and thorough cost-benefit analysis must include the status quo alternative on structural separation, which could potentially dominate further structural reforms. In addition, such an analysis may also lead to a conclusion that the degree of structural reforms justified may differ between member states.

Therefore, the Riksbank considers it premature to foresee the outcome of a cost-benefit analysis. Before seeing any results from such an analysis the Riksbank cannot take a definite position on which option or options would be preferred for Sweden, other member states or the EU in general.

Stockholm, 28 June 2013

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[6] The question refers to the matrix in Table 1 on page 9 of the consultation document.