Submission to the House of Lords EU Sub-Committee on Economic and Financial Affairs

1. The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the Sub-Committee’s call for evidence.

2. AFME represents a broad array of European and global participants in the wholesale financial markets: our Members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. Whilst AFME is a European trade association, given the importance of the London markets, both to the European Union as a whole and to the many EU and international firms that have operations in, or provide services on a cross-border basis into London, we consider it important to engage proactively and constructively in debates that determine the environment in which our members undertake their business.

3. We welcome the call for evidence, particularly given the importance of the banking sector to the UK and wider European economy. We recognise that the themes of the Sub-Committee’s work – to establish whether the proposed actions can adversely affect London’s position as the leading financial centre in Europe or undermine the Single Market - are now the central questions to be addressed in the UK against the background of significant regulatory change and restructuring that is underway.

4. Given AFME’s role, we have concluded that at this stage we can best contribute to the Sub-Committee’s work by providing a high-level response – broadly covering the questions set out in the inquiry document. We hope our contribution provides a fact based overview of the key challenges and areas of concern into which the Sub-Committee might find it helpful to refer to in its deliberations.

Banking reform, banking union and the euro area crisis

5. The banking sectors in Europe are fragmented along national borders: rather than operating as a true single market, the financial crisis has affected the Member States differently, with the extent varying according to the structure of the state specific banking sectors or individual institutions within the system. Whereas for some jurisdictions the authorities’ problems centered on the failure of a handful of large institutions, in other countries small regional mutual banks were the root cause of the domestic crisis and the resulting taxpayer bailouts. The consequences were further exacerbated because most
Member States did not have adequate crisis management mechanisms for the resolution of banks and thus even relatively small banks were deemed too systemic to fail. Thus the EU dealt with only a few liquidations (as distinct from forced mergers) of small banks, compared to the United States, resulting in much higher overall capital injections in Europe than in the US relative to the associated banking losses.

6. The subsequent national level crisis management actions and regulatory programmes have been important factors in driving the evolution and diversity of the banking sectors in Europe and the systemic weakness of the European banking system. Furthermore, responses to the crisis have added to the domestication of the banking sectors and banks have sought to revisit their business models in the face of the new regulatory realities. This in turn is reducing the availability of alternative banking service providers and regional competition leading to generic weaknesses in particular regions as local banking sectors may lack the diversity of bank business models, sizes and bank-specific geographical footprints to render them able to absorb losses during prolonged stress periods that impact the particular region.

7. (Banking Union) AFME regards banking union as discussed in the Van Rompuy report presented to the June European Council as an important step in addressing the Eurozone crisis. In this context, the Commission’s proposal for the creation of a Single Supervisory Mechanism, represents an important element in restoring confidence in Europe’s financial system and wider economy.

The creation of a strong banking union, built around a credible and effective single supervisor, should break the link between the solvency of Europe’s banks and its sovereigns, which has been a significant cause of instability in recent years.

Of course there are many important challenges which will need to be overcome and issues to be resolved. These include ensuring an appropriate allocation of responsibilities and powers between the ECB and national competent authorities within and outside the banking union; understanding the implications for day-to-day supervision under the new framework; ensuring the effective functioning of the single market in financial services, and achieving transition to the new arrangements in what is very challenging timetable. There is also the challenge of agreeing the common backstop arrangements for resolution and depositor protection which will be proposed later in the process. Moreover, it is still not fully clear how banking union proposals will impact on existing and proposed legislation, such as the Capital Requirements Directive 4, the Recovery and Resolution Directive and the DGS legislation.

In order to contribute constructively to the work to develop and implement the new arrangements, AFME is working to develop its analysis and suggestions on a number of aspects. In particular it will seek to contribute from the practical perspective of the diverse range of European banks affected in one way or another by the proposed new arrangements. We will be developing our analysis over the coming period and would welcome the opportunity to share this with the Sub-Committee.

8. AFME’s view is that structural regulation of banks, including specific controls on particular business activities within a business model, risks producing suboptimal outcomes and is unnecessary or inappropriate for the European banking markets. Before considering the imposition of Europe-wide structural changes, the High-Level Expert Group (HLEG) should examine carefully what incremental benefits such changes might
bring about in addition to those likely to result directly or indirectly from already planned regulatory initiatives. These perceived benefits would need to be carefully weighed against the costs of the potential continual slowing of European economic recovery and progress towards the creation of a single European banking market. Structural changes proposed to date, including those related to controlling certain activities, aim to address perceived national issues and are proving challenging to implement for several reasons, including their resulting impact on market liquidity, as well as extraterritorial and boundary issues. Therefore, the feasibility of similar proposals for structural change being successfully introduced across 27 member states with differing banking and legal systems needs to be carefully considered. The HLEG also needs to examine the potential damage of a one-size-fits-all approach could cause in limiting the diversity and evolution of banking sectors across Europe and thereby reducing the resilience of the system as a whole.

The proposed Directive for bank recovery and resolution and European Deposit Guarantee Schemes (DGS)

9. AFME welcomes the proposed Resolution Directive and its objectives, although we believe that there are some areas in which the Directive can be improved and we are closely engaging in that process. Tackling the issue of financial institutions being deemed too-big-to-fail by introducing credible resolution regimes that impose losses on creditors is one of the industry’s highest priorities at this stage: until firms are demonstrably resolvable the industry will face relentless pressure for more regulation. On the other hand, once resolution regimes are credibly established, policymakers should be able to revisit the need for higher capital levels, liquid asset buffers and structural restrictions that hinder growth. It is important to note that the industry’s view is that the Directive will be required regardless of the outcome of the Banking Union debate. Even within a Banking Union, it is recognised that a framework will be instrumental in ensuring consistent powers for resolution authorities and arrangements for groups, for example. A framework is needed also for those member states that remain outside of banking union. We discuss below some of the key components of the Resolution Directive, namely the resolution authority and bail-in, while we continue to evaluate other aspects of the Directive such as deposit guarantee schemes/resolution funds.

10. The proposed Directive includes resolution authorities within the EBA framework to coexist with banking supervisors, similar to that of the US FDIC approach. This approach may be efficient from an information sharing and speed of decision-making perspective but there may also be concerns relating to institutional conflicts within the EBA framework as a supervisor and resolution authority may have differing views. In many countries the roles are currently separated so one institution will provide a check on the other. These potential conflicts will need to be managed within the EBA structure, and we suggest that to avoid institutional conflicts, policymakers should carefully consider existing governance models prior to establishing a structure comprising of a combined resolution authority and banking supervisor.

11. AFME and its members welcome the proposal for a bail-in tool. It will provide the basis for many but not all G-SIBs to demonstrate that they are resolvable, depending on the firm specific balance sheet structures and if debt instrument issuance is part of the business model. We believe that the impact on bank funding costs from the bail-in tool will be limited provided that protections are included in the Directive, such as no-
creditor-worse-off and respect for the creditor hierarchy (core principles in the proposed Directive) and a requirement for resolution authorities to use the least cost alternative (something we believe should be a core principle of the Directive). For properly functioning financial markets it is important that the implicit state guarantee is removed and creditors are exposed to the full costs and benefits of their investment decisions.

Conclusions

12. Overall, the impacts of structural changes on the supervisory architecture, bank restructuring, regulatory overhaul and the resolution directive are too wide ranging to enable the formation of an objective view of all the consequences that may impact London as a financial centre for Europe and the Single Market. However, the evidence suggests that these changes, together with shifts in market and economic fundamentals and already announced national reform proposals are driving significant structural changes across the industry. This is being manifested in the considerable deleveraging and de-risking of banks’ balance sheets as well as in the re-evaluation of business models as institutions seek to narrow both the functional and geographical scope of their activities and steer away from businesses that absorb disproportionate amounts of capital under the new regulatory rules. As a result of these responses to change there is a risk that key European financial centres as well as the future of the single banking market may be undermined. This is due to the likely reductions in cross-border activity, bank business model diversity and geographical footprints, as well as to the higher costs associated with capital markets activity. Unless there is a concerted effort to boost the European capital markets and economic integration in the form of building confidence in the Monetary Union, key European finance centres and the Single Market are the likely to suffer as cross-border transactions, foreign exchange and capital markets activity, parts of the banking sector that London has traditionally prospered on, will be undermined.

13. However, it is worth noting the recent Financial Centre Roundtable discussion in Brussels (6 September), in which Commissioner Barnier highlighted the importance of financial centres supporting economic growth in the EU and linking the Single market to the wider global economy. AFME’s view is that with the availability of bank funding in Europe under pressure, it will be vital to reduce Europe’s dependence on this source of financing by developing deeper, more liquid capital markets that are linked to other global financial centres and alternative sources of finance. Only by doing so will it become possible to meet the significant corporate debt refinancing requirements that will arise over the next couple of years, and at the same time to satisfy new lending needs. With this in mind, London can have an important role to play in assisting Europe to develop the deeper capital markets that will be essential to ensuring the financing of future economic growth.

Association for Financial Markets in Europe

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You can access the House of Lords’ Inquiry into Reform of the EU Banking Sector: Call for Evidence here.