AFME Members’ Briefing Call –
Regulatory round-up
06 December 2012

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Opening remarks
Association For Financial Markets in Europe

CRD IV update
CRD IV: Background - Building Blocks

Basel III / CRD IV

- **Strengthening capital**
  - Changes definition of capital to improve quality, consistency and transparency of capital base, increase in the level of core equity and Tier 1 capital from 2% to 4.5% by 2019, and addition of capital conservation buffer.

- **Enhancing risk coverage**
  - Strengthen risk coverage of the framework with new standards for counterparty credit risk exposures from derivatives, repos and securities financing transactions.

- **Limiting Leverage**
  - New leverage ratio to constrain build-up of excessive leverage in banking system and provide protection against model risk and measurement error.

- **Limiting procyclicality**
  - Introduction of countercyclical buffers in addition to capital requirements that vary with the economic cycle.

- **Improving liquidity management**
  - New liquidity framework which includes two ratios – Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

CRD IV = CRD + CRR
Overview of the LCR

- The LCR aims to ensure that banks maintain adequate levels of unencumbered high quality assets against net outflows over a 30 day stressed period.

- The formula used is:

  \[
  \text{Unencumbered stock of high quality assets / total net cash outflows over a 30 day time period.}
  \]

Trialogue Progress

The European Commission presented substantial and positive changes to the CRD IV text in September which we have welcomed on the basis of our AFME positions. In particular:

- the deletion of Annex III left the range of assets that can be reported as liquid as essentially open, pending the outcome of the EBA review during the observation period;

- operational requirements in relation to the liquid assets buffer were relaxed substantially to include ‘assets available to the treasury when needed’;

- criteria in relation to meeting the requirements for ‘operational deposits’ were left open; and,
• prescribed run-off rates in relation to corporate (and other) outflows were removed pending further consideration.

Although these changes would be very positive, the extent to which they are likely to be accepted through the trialogues is not certain, and indications to date are that:

• There is still likely to be a substantial widening of the liquid assets buffer, including ‘asset backed instruments’;

• The definition of operational relationships for the purpose of classifying corporate deposits is likely to be extended;

• There is disagreement concerning run-off rates for corporate deposits - possible that a 75% run-off factor will remain, albeit with a requirement to review in the light of changes at BCBS level; and,

• Operational requirements in relation to the use of the liquid assets buffer may not change sufficiently – in contrast to the approach we are hearing the BCBS might take.
Overview of capital for systemic risk

- Institutions may have to hold additional regulatory capital to guard against systemic or macroprudential risk not covered elsewhere in the framework.
- Under international accords this additional capital is required for G-SIBs (Global Systemically Important Banks), in a range from 1% to 2.5% of risk-weighted assets depending on a G-SIB’s level of systemic importance, and for D-SIBs (Domestic SIBs) at a level determined by national authorities.

Trialogue progress

- The European Commission’s original proposed directive did not contain any buffers for systemic risk.
- Parliament’s position has been to designate certain institutions as G-SIBs, E-SIBs (i.e. European SIB), or D-SIBs and to have increasing levels of capital (up to 3%) depending on the level of a firm’s ‘systemic-ness’
  - Note that in the latest texts these are referred to as SII–Systemically Important Institutions
• Council’s position has been to allow the addition of a Systemic Risk Buffer (SRB) to minimum capital requirements, with Member State discretion up to a certain level (3%), with more central control by the Commission for amounts between 3% and 5%.
  • The Commission must take into account the opinions of the ESRB and the EBA and also the impact on the single market.
• The Commission initially proposed a compromise to have both buffers cumulatively: the SRB and the buffer for SIBs.
• The latest compromise from the Cypriot Presidency proposes retaining both buffers but with only the higher of the two requirements applying where a firm is subject to a SRB and a G-SIB buffer, subject to an overall limit on both of 10%.
  • AFME supports the ‘higher of’ approach, as opposed to a cumulative approach, as we view the SRB and the SIB buffers as different ways of addressing the same risk (which is why both buffers have not been mandated at a global level).
CRD IV: Other – Leverage Ratio and Counterparty Credit Risk (CCR)

- **Leverage Ratio (LR): Overview**
  - Non-risk based backstop measure to risk based capital requirements (the amount of capital in relation to total assets).
  - BCBS will test a minimum Tier 1 leverage ratio of 3% during the parallel run period.

- **Leverage Ratio: Trialogue Process**
  - The Council is still discussing the adoption of the LR (via delegated acts or co-decision) and whether or not there should be an early disclosure of the LR for SIFIs (i.e. one of the Parliament’s demands).

- **Counterparty Credit Risk (CCR): Overview**
  - Introduction of a new capital charge designed to capture potential mark-to-market losses for OTC derivatives.
  - Credit Valuation Adjustment (CVA) risk is the risk of loss to an institution from a deterioration in the creditworthiness of a counterparty.
  - Draft proposals for revising the capitalisation of exposures to central counterparties (CCPs).

- **CCR: Trialogue Process**
  - Discussion on the types and levels of CVA exemptions.
  - Transposing recent Basel paper on capital requirements for bank exposures to CCPs.
• Trialogue Process: Elements of CRD IV Remuneration proposal that are still under discussion

• Fixed to Variable Remuneration Ratio
  • Maximum ratio between non-deferred portion of variable component vs. the fixed component of total annual remuneration;
  • Maximum ratio between total variable component to the fixed component of total annual remuneration;
  • Shareholder involvement in determining maximum ratios.

• Thresholds for deferral of 60% of variable remuneration.

• Disclosure Requirements.
A presentation slide from the Association For Financial Markets in Europe. The title is "An overview of the Liikanen proposals," with additional text providing the location and dial-in information for the event.
Commissioner Barnier established the High Level Expert Group (HLEG) to examine the need for structural reforms of the EU banking sector.

The mandate outlines the particular objectives the group must pursue when formulating any recommendation:

- A particular focus on Volcker Rule restrictions, Dodd-Frank size limits and Vickers structural separation of activities
- Reducing the risks of the banking system as a whole
- Reducing the risks that individual firms pose to the financial system
- Reducing moral hazard by making market exit a viable option also for largest and most complex institutions and thereby reduce government guarantees
- Promote competition
- Maintain the integrity of the internal market

The HLEG consulted various stakeholder groups and held an open consultation to which AFME responded, prior to completing their final report that was published 3 October.
AFME agrees with much of the HLEG’s background analysis including:

• The finding that no particular business model fared particularly well, or poorly, in the financial crisis;

• The recognition that losses were caused by poor risk management and funding policies rather than driven by particular structures;

• The acknowledgement that promoting diversity in bank business models at system level is beneficiary;

• The recognition of significant diversity among the larger universal banks driven by differences in their customer bases;

• The acceptance that “one stop shopping” is valuable to customers;

• The acknowledgement that derivatives are integral risk management tools for large and small non-financial corporations; and

• That the key objective is to ensure a banking sector that is capable of financing the real economy and pursuing its other functions that contribute to the prosperity of the EU citizens and the economy.
Banks above a threshold of €100bn in trading assets or trading activities of 15-25% of the bank’s total assets would be required to be put into an “examination” in which supervisors would determine the need to separate the trading businesses.

- All proprietary trading and assets or derivatives positions incurred in the process of market-making must be assigned to the separate legal entity;
- Further separation of trading activities conditional to resolvability under the RRP;
- The trading entity cannot fund itself with insured deposits or undertake retail payments;
- The deposit-funded entity is permitted to lend to companies, underwrite securities and offer a limited set of hedging services to clients; and
- Both entities can operate within a bank holding company, but must meet capital requirements independently and transfer risks on an arm’s length basis.
We have made the following main arguments against mandatory separation:

- It damages capital markets ability to meet European financing needs
- It threatens to increase structural fragility by reducing banks’ diversification
- It would trap capital and liquidity into smaller pockets, consequently reducing cross-border flows and undermining the Single Market;
- It ignores the fact that structural change is already taking place in response to market forces and the ongoing regulatory overhaul
- It threatens competition, limiting new entrants and forcing banks to withdraw
- It is unclear how Liikanen’s recommendations will fit with other proposals
- The HLEG’s objectives can be met through the implementation of the very comprehensive regulatory reform programme that is already underway.

AFME calls for an impact assessment of the HLEG’s recommendation. The assessment should take full account of the ongoing regulatory initiatives as well as the Banking Union and national level structural initiatives.
Liikanen: Avenue 1: AFME Position

- A minority of the HLEG recommended an alternative structural approach
- Known as Avenue 1 it proposes structural separation only if a bank is not resolvable
- AFME sees several advantages to this approach:
  - Protects the financial systems from particular risky business models;
  - Allows for a natural evolution of the European banking system to take place;
  - Complements other regulatory reforms that will address the same systemic issues as the HLEG’s structural reform;
  - Does not increase pro-cyclicality in the system: It only restricts funding flows and capital allocation if a bank is irresolvable under its RRP
- However Avenue 1 also calls for additional non-risk weighted capital requirements
- Additional capital requirements are also linked to deposit growth
- AFME believe that the BCBS is best able to determine capital requirements; and
- Linking capital needs to deposit growth rather than risk also makes no sense
- AFME recommends the Commission only to propose restrictions if a bank is unable to provide resolvability under its resolution plan;
HLEG made several other recommendations that interact with live dossiers such as the CRD IV and RRD:

- Possible further separation of other activities depending on the banks’ recovery and resolution plans;

- Developing the framework for bail-in instruments as resolution tools to facilitate their use;

- Reconsideration of risk weights for deposit banks and trading entities following the Basel Committee’s review of trading-book capital requirements; and

- Strengthening corporate governance reforms, including measures on remuneration.
AFME’s positions on the other recommendations are the following:

- **Resolvability**: Resolvability should be the focus and should be fit to a firm’s structure. The onus is on the firm to demonstrate it is resolvable;

- **Bail-in**: We support bail-in being applied to a wide class of liabilities. A specific bail-in instrument is tantamount to a new layer of regulatory capital;

- **Risk weights**: We do not support the introduction of additional non-risk weighted capital buffers. BCBS’ Trading Book Review is to deal with this issue;

- **Remuneration**: The HLEG’s proposals introduce fragility into the European banking system by encouraging growth in fixed remuneration;

- **Remuneration**: Use of bail-in bonds to fund remuneration could lead to employees of failed institutions holding a continuing stake in them.
The Commission is expected to publish a roadmap on bank structural reform and a legislative proposal during the first half of 2013;

Conclusion from the debate to date is that the focus is on how and when to implement Liikanen Group’s mandatory structural restriction proposals;

Diverging views in Council are expected on the issue of separation

- Some MSs agree with the HLEG conclusions that structural reform would make banks both more resilient and more resolvable;
- Some MSs believe that such reform would first require identifying more precisely the risky activities;
- There is a concern in some MSs that the proposal is too lenient, noting that the ring-fence would capture only a small subset of universal banks in the EU; and
- Other MSs are not yet convinced that structural reform is necessary or a priority.

The Commission may also have strong views on the competitiveness of European banks as well as on the integrity of the Single Market under the proposals

AFME has had initial discussions with some MS interlocutors and we are currently developing an advocacy strategy.
Association For Financial Markets in Europe

Questions and answers
The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

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