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High-level Expert Group on Reforming the Structure of the European Banking Sector

Consultation Response

June 2012

About AFME

The Association for Financial Markets in Europe is the voice of Europe's wholesale financial markets. We represent the leading global and European banks and other significant capital market players.

Our purpose is to provide a practical, constructive market view to policymakers on the significant reforms taking place in the European financial system.

We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

Focus - on a wide range of market, business and prudential issues

Expertise - deep policy and technical skills

Strong relationships - with European and global policymakers

Breadth - broad global and European membership

Pan-European - organisation and perspective

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

On behalf of our members, we:

- Offer a single voice for the European capital markets participants and advocate their views at national, European and global levels;
- Develop a constructive dialogue on market and regulatory policy with legislators and regulators;
- Contribute policy and advocacy expertise to help achieve a balanced and stable regulatory environment; and
- Promote the contribution of the financial sector to society.

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1 EXECUTIVE SUMMARY

This paper represents AFME's response to the consultation of the High-level Expert Group on reforming the structure of the EU banking sector ('the HLEG').

The European banking sector is diverse and complex. While there is evidence of significant integration in several product markets and areas of activity there is also wide diversity at firm and country level and the overall sector remains greatly fragmented.

The sector both within Europe but also globally is already facing an immense post-crisis regulatory reform programme with the overarching objective of reducing the probability and impact of bank failures and thereby lessening significantly the risk of future taxpayer-funded bailouts. AFME and its members fully support this objective and are firmly committed to helping to establish a safe, stable and efficient European banking sector.

These reforms, combined with market and economic conditions, are already driving significant structural changes across the banking industry as banks seek to deleverage and de-risk their balance sheets and re-evaluate their activities and overall business models in the face of higher regulatory costs and lower returns.

AFME believes that structural regulation, including specific controls on activities, risks producing sub-optimal outcomes and is unnecessary or inappropriate for the European banking markets. The history of the financial crisis uncovers no link between the losses experienced by banks and their particular business models or size. Rather, large diversified banks have been a source of stability for financial markets, while the source of banks' losses during the crisis arose more from poor judgments about credit risk on "regular" lending than from exposure to structured credit. It would seem clear therefore that even before the crisis, EU policymakers could not have identified and implemented a corporate structure for banks which would have significantly improved outcomes. Indeed, it is not obvious that even with the evidence of the global crisis that they could do so today. Nor would we consider such an outcome as desirable as structural diversity amongst banks is more likely to lead to market stability than the adoption of a single uniform model.

Notwithstanding this, a number of jurisdictions have introduced structural regulation to address particular issues in their own financial sectors. This is the case in the United States with Paul Volcker's proposals to prohibit banks from undertaking proprietary trading and in the United Kingdom with Sir John Vickers' recommendations to ring-fence retail banking activities. AFME believes that the objectives underlying these structural regulations can be met better through appropriate risk management, capital allocation, supervision, and effective recovery and resolution regimes.

The planned regulatory interventions in both the US and the UK do not offer any precedent for similar action across Europe and if anything they suggest the contrary. The Volcker proposals threaten a significant negative impact on market liquidity and face considerable implementation issues. Elsewhere, the Vickers proposals are addressing a UK market which has a particularly high banking concentration relative to GDP (556% compared to EU-27 average of 349%) suggesting that, quite apart from questions of principle and the significant practical difficulties in attempting to introduce similar structural reforms across 27 Member States, such a move is also unnecessary. In addition it

would risk inhibiting the further development of a single market in financial services, and exacerbating the risks to the European economy from fragmented, but nationally concentrated markets.

Similarly, the evidence of Glass-Steagall in the US or Article 65 in Japan suggests many negative consequences may arise from the formal separation of activities. Glass-Steagall would not have prevented banks from making investments which brought them down, nor would it have dealt with their inadequate capital levels. Article 65 which prevented banks in Japan from issuing equity and debt securities had severe negative consequences for the funding of the Japanese corporate and retail sectors. Indeed, the European Union in the past made representations requesting the removal of Article 65. AFME also understands that the Commission's impact study accompanying its Crisis Management Directive is likely to note that the separation of retail, wholesale and investment banking activities does not seem to deliver the desired financial stability.

AFME believes that the regulatory reform programme already underway, including the work on Resolution and Recovery, will better achieve the objectives of the HLEG and that the focus of policy-makers should be on completing that programme and allowing it time to function. The programme will not only continue to drive structural change amongst the banking industry without the need for additional intervention but will significantly reduce both the probability and impact of individual bank failure and the overall level of systemic risk. It will be assisted in this by a credible bank recovery and resolution regime which will remove the possibility of taxpayer-funded bailouts and ensure that even the largest banks are resolvable.

AFME and its members therefore respectfully suggest that the HLEG proceed with considerable caution before recommending any interventions in the European banking markets, with any such interventions subjected to highly rigorous cost benefit analysis. Given the substantial regulatory and structural changes already underway, the burden of proof to be satisfied to justify further intervention at this stage is in our view particularly high. Indeed there is a growing recognition within the IMF and amongst certain central bankers that even the announced regulatory changes need to be appropriately paced. Any attempt either to control activities or impose structures on European banks, or even the announcement of an intention to do so, is likely to create uncertainty. Were regulators to seek to introduce a one-size-fits-all approach, any such proposals risk limiting the diversity and evolution of banking sectors within Europe, reducing the resilience of the system and slowing the integration of banking markets already stalled by the financial crisis.

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2 INTRODUCTION

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the **Consultation by the High-level Expert Group on reforming the structure of the European banking sector** ('the HLEG'). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

This paper represents AFME's response to the consultation of the High-level Expert Group on reforming the structure of the EU banking sector ('the HLEG'). In this paper, AFME responds to the consultation questions addressed to banks from a broad sector perspective, particularly focussing on the issues pertaining to larger and cross-border banks engaged in the wholesale financial markets.

The answers to the specific questions asked by the HLEG are contained in Annex I, with supporting analysis contained throughout the paper. We note that decisions about structural separation or activity restrictions must necessarily take into account the context of the sector for which they are being made, so we have endeavoured to provide background information about the sector wherever it is necessary to justify a conclusion being drawn. In the paper we focus primarily on European countries that are the home jurisdictions for a Global Systemically Important Bank (G-SIB), but also draw on examples from the US as another jurisdiction that hosts G-SIBs and has undertaken structural reforms.

The paper is structured as follows:

- Section 3 describes the shape of the European banking sector
- Section 4 describes the drivers of structural reform
- Section 5 sets out factors the HLEG should consider in making any recommendations for structural regulation
- Section 6 summarises AFME's conclusions
- Annex I contains AFME's responses to the consultation questions
- Annex II contains an overview of selected European banking markets
- Annex III summarises completed and ongoing regulatory reforms
- Annex IV contains a breakdown of geographical exposures for European G-SIBs

3 THE EU BANKING SECTOR

The European banking sector is diverse and complex. There is evidence of significant integration in several product markets and areas of activity. Equally, there is evidence of wide diversity at firm and country level. In this section we discuss the differences between the sizes of banking sectors in a sample of EU Member States and also compare them to those of the US and Switzerland. The US and Switzerland are included in the sample as their specific issues with banking concentration has led to two very different solutions (structural restrictions and gold-plating Basel III). We also discuss some of the underlying reasons why the European banking sectors remain fragmented – indeed, why the European market can arguably be viewed as a series of connected rather than a single market – and explain why a market dominated by small regional institutions, without a wide variety of participants with different geographical and economic footprints poses a risk to the economy. The EU banking market can also be distinguished from that of the US. In the US the capital markets are well developed compared to Europe with the large majority of credit intermediation conducted through the bond market. By contrast, in Europe (and indeed in Asia) the banking sector is responsible for the bulk of credit intermediation. This clearly has consequences for the impact which regulation has on the supply and pricing of funding available from banks to support the companies and small businesses of Europe and through them, the real economy.

3.1 Market Structure

Economic development, language and other market entry barriers have caused the banking sectors in different Member States to develop at different paces and in different directions from one another. In several EU Member States the banking sectors are dominated by mutual savings or cooperative banks. Whereas in some countries savings and cooperative banks have large central organisations (for example Credit Agricole and BPCE, both G-SIBs) that also provide cross-border, investment banking and large corporate services, some of the savings and cooperative banking sectors operate a decentralised model and concentrate on serving local retail customers and SME businesses.

On the other hand, some EU Member States host banking sectors where large commercial banks with significant cross-border activity are the dominant business model. These commercial banks' business models as well as their geographical footprints are significantly different from one another. Whereas some of the G-SIBs contribute to national level sector concentration, some have relatively small footprints in their domestic retail and SME banking markets and focus instead on international business activity, helping to foster trade and investment links between the EU and the rest of the world. AFME sees the diversity of the business models and global footprints as strength of the European banking sector.

3.2 Market Size

The assets of EU banking institutions have been growing considerably faster than EU GDP over the past decade. While overall banking assets shrank by € 460bn in 2009 in nominal terms, banking assets have since increased more in line with the EU economy. However, the growth rates vary significantly between the Member States and countries with less developed banking sectors or with property booms experienced double-digit growth during 2001 and 2008. Even in 2009, banking assets

increased in the new Member States and also in Denmark, Finland, France, Germany, Sweden and the UK. These increases were offset by severe asset contractions especially in countries with high asset growth prior to the crisis and regional property booms. (ECB, 2010)

Table 1 shows that the sizes of national banking sectors vary materially between the European Union Member States. Whereas all European countries host banking sectors bigger than their domestic economies and the overall EU – 27 banking assets are 349% of the GDP, Britain, host to the biggest financial centre in the world, has the largest banking sector in terms of assets to GDP ratio at 556%. The smallest banking sectors in the Member State sample are in Germany (161%) and Italy (158%). Comparing the EU banking sectors to those of Switzerland and the US, the Swiss banking sector has much higher bank assets to GDP ratio (621%) and the US a much smaller banking sector (99%).

The size of the Swiss banking sector is driven by its status as a global financial hub and, more importantly, as a home to two of the top 25 banks in the world (UBS, 362%; Credit Suisse, 245% assets to GDP ratio in 2007). Compared to the US banking sector, the EU banks hold on average five times more assets than the US banks, taking in 60% more deposits and lending more than twice as much per capita than banks in the US. This difference reflects the EU economy as one that is banking based, unlike a more capital markets based financial model in the US. Over 50 % of European corporate funding comes directly from, or indirectly, via banks. The importance of the sector to business activity in the EU means the impact of structural measures must be carefully thought through.

The size of the sector in some jurisdictions has driven the decisions of certain policy-makers to impose additional regulatory requirements. In the UK this has taken the form of proposals for ring-fencing retail banking as recommended in Sir John Vickers Independent Commission on Banking Report, while in Switzerland it has resulted in additional capital requirements (the so-called 'Swiss-finish'). The two opposing approaches demonstrate the different solutions to a similar problem. However, the data (Annex II) demonstrates that not all jurisdictions face the same issues and therefore there is no common basis for such reforms to be put in place across Member States.

Table 1: Banking assets* to host country GDP 2010

Country:	GDP in US $ bn:	Bank assets to GDP (%)
Switzerland	527.9	621%
United Kingdom	2,263.1	556%
Sweden	462.1	368%
France	2562.8	366%
EU - 27	16,276.0	349%
Netherlands	780.7	334%
Belgium	470.2	329%
Spain	1,395.0	242%
Germany	3,286.5	161%
Italy	2,060.9	158%
United States	14,526.6	99%
Average:		326%

* Total assets of commercial banks, including subsidiaries

Source: IMF: Global Financial Stability Report 2012

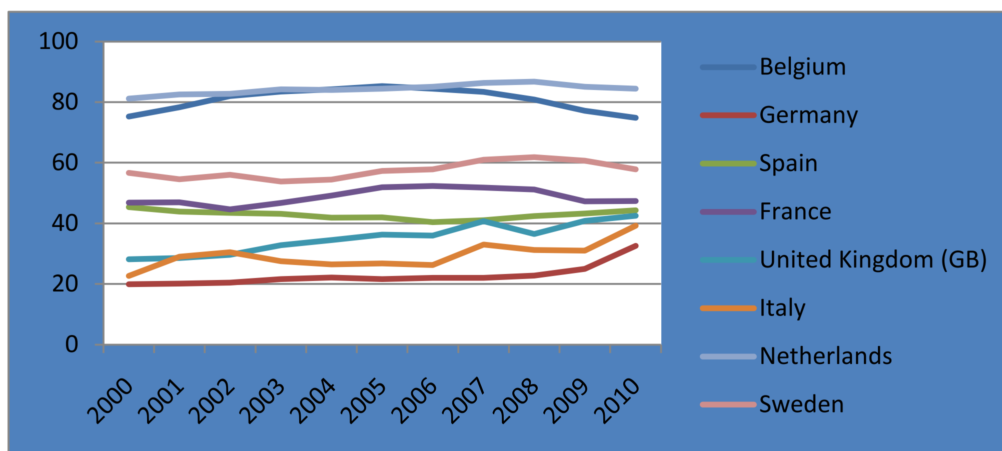
The EU market remains fragmented for many reasons, such as economic development, language, national policy responses to the crisis and other entry barriers (EBF, 2012; ECB, 2010). This fragmentation is at the core of European small banks' business models as they aim to fulfil a niche-market function. Furthermore, European banks are responding to demands for specific services and thus perform their roles (as cross-border, cooperative, savings, universal banks etc.) as required by EU citizens and businesses alike.

3.3 Concentration

In this section we show that some of the national banking sectors are highly concentrated, and that the concentration levels are changing rapidly for a number of reasons.

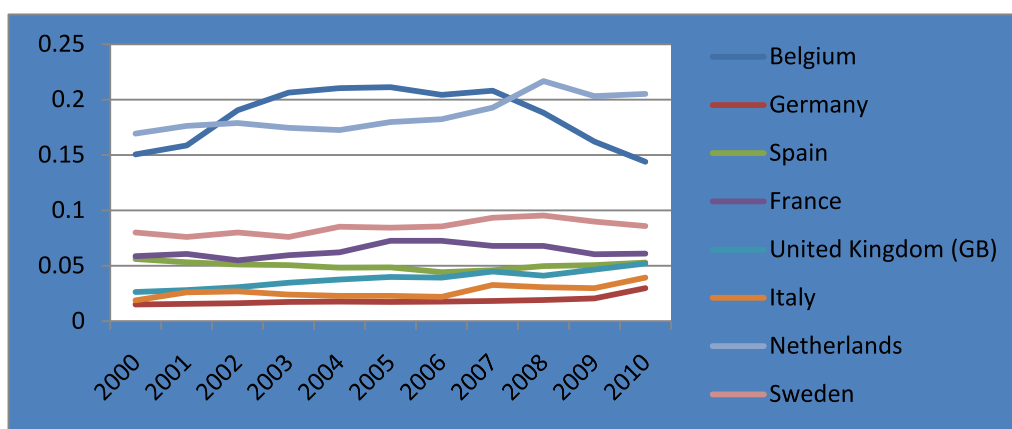
To further understand how the banking sectors differ from one Member State to another, we investigate the concentration levels in a sample of national level data. Consolidation of the banking sector started long before the recent financial crisis. With regard to individual Member States, concentration levels as measured by both the top five institutions by assets to total banking assets (CR5) and the Herfindahl index show that there are significant differences between countries (see Figures 1 and 2). Belgium, the Netherlands and Sweden have the highest concentration levels in the sample whereas the largest countries (Germany, France, UK, Italy and Spain) have the most diffused markets. It can also be observed that the countries that had the lowest concentration levels at the beginning of the observation period have seen the highest increases in concentration. There are various underlying reasons for the increased concentrations. Whereas some of the concentration is due to voluntary merger and acquisition and some has been forced upon the organisations due to business continuity issues or failures, there are other reasons such as consumer behaviour, competition and mismatches between available domestic deposits and investment opportunities in the country (especially in new Member States).

Figure 1: Shares of the Five Largest Credit Institutions in Total Assets (CR5)



Source: ECB database

Figure 2: Herfindahl Index* for Credit Institutions Total Assets (%)



Source: ECB database

*The Herfindahl index is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. It is defined as the sum of the squares of the market-shares of the 50 largest firms. The result is proportional to the average market share, weighted by market share.

3.4 Degree of State Intervention

National level crisis management mechanisms were another important factor in the evolution and diversity of European banking sectors. As most Member States did not have adequate crisis management mechanisms for the resolution of banks, even relatively small banks were deemed too systemic to fail (ECB, 2010). Consequently the region dealt with only a few liquidations of small banks whereas in the US banking sector hundreds of small and medium sized banks were liquidated, resulting in much higher overall capital injections in Europe than in the US relative to the associated banking losses. The amount of financial support to banks in the EU varies from one country to another

(Table 2). This has slowed the European banking sector integration and without a coordinated EU level policy action, the banking sectors may disintegrate even further (ECB, 2010).

Furthermore, national level responses have added to the domestication of the banking sectors and have in turn reduced the availability of alternative banking service providers, particularly in markets dominated by regional institutions that may be more exposed to idiosyncratic events. Some banks have retreated back to their home countries to meet set domestic lending targets or to meet capital requirements through reducing their non-core assets. This increases the concentration risk associated with dominant local banks running into trouble and thus the resilience of the banking services in a given region.

Table 2: Utilised aid to financial institutions2008-2010

Total for 2008 - 2010										
Member States	Recapitalisation measures		Guarantees		Asset relief interventions		Liquidity measures other than guarantees		Total for 2008 -2010	
in billion €	in billion €	as % of 2010 GDP	in billion €	as % of 2010 GDP	in billion €	as % of 2010 GDP	in billion €	as % of 2010 GDP	in billion €	as % of 2010 GDP
Belgium	20.4	5.8%	44.2	12.5%	7.7	2.2%	0.0	0.0%	72.4	20.5%
Denmark	10.4	4.5%	145.0	61.9%	0.0	0.0%	2.0	0.8%	157.4	67.2%
Germany	56.6	2.3%	135.0	5.4%	56.2	2.3%	4.8	0.2%	252.6	10.1%
Ireland	46.3	30.1%	360.0	233.9%	7.0	4.6%	0.0	0.0%	413.3	268.5%
Greece	3.8	1.6%	27.5	11.9%	0.0	0.0%	7.6	3.3%	38.9	16.9%
Spain	10.8	1.0%	55.8	5.3%	2.9	0.3%	19.3	1.8%	88.8	8.4%
France	22.5	1.2%	92.7	4.8%	1.2	0.1%	0.0	0.0%	116.4	6.0%
Italy	4.1	0.3%	0.0	0.0%	0.0	0.0%	0.0	0.0%	4.1	0.3%
Luxembourg	2.6	6.3%	2.2	5.2%	0.0	0.0%	0.2	0.5%	4.9	11.9%
Netherlands	18.9	3.2%	40.9	6.9%	5.0	0.9%	30.4	5.1%	95.2	16.1%
Austria	7.4	2.6%	19.3	6.8%	0.4	0.1%	0.0	0.0%	27.1	9.5%
Sweden	0.8	0.2%	19.9	5.8%	0.0	0.0%	0.0	0.0%	20.7	6.0%
United Kingdom	82.9	4.9%	158.4	9.3%	40.4	2.4%	19.8	1.2%	301.5	17.8%
Total EU27	287.8	2.4%	1111.8	9.1%	121.2	1.0%	87.2	0.7%	1608.0	13.1%

Source: EC, 2011

If the evolution of the national banking sectors and the integration into a single market is distorted for an extended period of time through support mechanisms, it is difficult to see how a structural reform can be applied throughout the region. This is especially the case at the same time as the current national restructuring programmes, refinancing programmes of the ECB and the ongoing regional regulations (Basel III etc.) make the future landscape of EU banking sector and the mix of business models uncertain. AFME's view is that until the effects of seeing through these reforms to the European banking sector are fully known, it cannot be fully assessed whether structural restrictions can provide any incremental benefits to the system by reducing the probability of default.

4 DRIVERS OF STRUCTURAL REFORM

The banking sector is already undergoing significant structural reform, driven by regulatory change, by market and economic fundamentals, and by structural reform in particular jurisdictions. These are outlined below in turn and their relation to the HLEG's work examined.

4.1 Change Driven by Regulatory Reform

In this section we summarise the regulatory and other main reforms that are currently underway or complete (please see Annex III for a detailed description of the reforms). AFME and its members support the need for higher prudential standards following the financial crisis and believe that their implementation will reduce significantly the need for additional structural reform of the European banking sector. Collectively the reforms decrease the probability and impact of failures in the system and thereby reduce the chances of system end-users (retail, SME, corporate, institutional) from being negatively impacted and taxpayers having to support failing institutions.

The immense reform programme that followed the financial crisis has four main elements:

- New and strengthened prudential requirements
- Enhancements to market infrastructures
- Raised supervisory standards
- Effective recovery and resolution mechanisms

All four elements of the programme are meant to be complementary to one another and mutually re-enforcing. The reforms also share a common purpose namely to reduce the probability of bank failures and their systemic consequences and in particular to prevent the need for taxpayer funded bailouts of individual banks or the banking system as a whole. Each of these elements is discussed briefly below with more detail provided in Annex III.

New prudential requirements aim to lower the probability of bank failure through reducing overall balance sheet leverage and improving solvency and funding. They do this primarily through substantially raising the quantity and quality of capital and liquidity that must be held and by extending the range and refining the calibration of the risks that need to be addressed. Although all banks are facing significantly higher prudential requirements, new regulations will, for the first time, explicitly require the largest most systemically important institutions to hold an extra buffer of capital. While some of the planned changes are well developed, others such as those contained in the Fundamental Review of the Trading Book are still being discussed between the Basel Committee and the industry.

In tandem with these reforms, very good progress is being made in strengthening market infrastructures through the centralised clearing of derivatives and the planned introduction of Legal Entity Identifiers. Elsewhere, enhancements are being incorporated into the supervisory process including significantly expanded macro-prudential oversight, increasing use of peer reviews, the strengthening of the operations of colleges of supervisors, the regular use of stress testing, significantly expanded data requirements and changes to remuneration practices.

Resolution regimes are the other key feature of the reform of financial regulation. The G20 has mandated that G-SIBs are required to have Recovery and Resolution Plans (RRPS) in place by the end of 2012. The impending crisis management directive will put this requirement in place in Europe. Resolvability assessments are a key part of RRPs. Under this process supervisory or resolution authorities will have the power to require banks to make changes (e.g. to business practices, structure, or organisation) to improve resolvability, considering both cost and complexity on a bank by bank basis. The authorities will also be able to require certain systemically important functions to be segregated in legally and operationally independent entities to shield them from problems elsewhere in the group.

The ability of supervisory or resolution authorities to require certain systemically important functions to be segregated in legally and operationally independent entities is very relevant to the work of the HLEG. The resolvability assessments represent a tailored approach to addressing many of the same objectives in the mandate of the HLEG. The unique characteristics of each firm's business model, organisation, and structure should be taken into account to ensure a structural solution that will make resolution a credible option, reducing the impact of the failure of a bank and thereby reducing the risk in the system as a whole, while at the same time respecting specificities of each bank group. A tailored, iterative approach will take into account the subtleties of each jurisdiction and organisation to ensure the solution is appropriate for the circumstances. AFME recommends that this tailored, iterative approach be embraced and implemented.

As a whole, these reforms decrease the probability of failures in the system and the impact of any failures. So much so, in fact, that the balance of opinion may be swinging away from the immediate need to make the system safer and towards consideration of the impact of the reforms on the economy. Senior IMF and central bank officials have recently questioned the pace of reforms – querying whether their implementation is proceeding too quickly to the detriment of economic activity. As banks withdraw from business lines – see Figure 4 in section 4.2.1 – it will take time for capital markets and other providers of finance to take their place. To the extent that there is any lag in this process the economy could be starved of the financing and services previously provided by the banking sector. Accordingly, AFME recommends that the revitalisation of the securitisation market is fostered by policy-makers. Securitisation can assist banks to meet their new regulatory capital targets while still providing finance to the economy.

AFME believes that in total the reforms decrease the case for structural regulation of the European banking sector. Both the risk of individual bank failure and the level of systemic risk will decrease due to these reforms, and a credible bank resolution regime will ensure that large banks are resolvable. In this context it is difficult to envisage large incremental benefits from any additional structural reforms. AFME therefore recommends that the HLEG carries out and publishes an analysis of the incremental benefit (i.e. an impact assessment) of any proposed structural reforms.

4.2 Change Driven by Market and Economic Factors

Coupled with the regulatory reforms outlined above market and economic conditions are driving considerable change in the banking sector. Following a sustained period of expansion and rising profitability during much of the previous decade, since 2008 the investment banking industry in

particular has experienced considerable volatility, contraction and falling returns (McKinsey, 2011), although banks with a diversified income base have been able to weather this period. At the industry level there is evidence that a profound and prolonged restructuring is underway, both within Europe and globally (IMF, 2012). In terms of commercial strategy, several trends result, which are evident both across the investment banking sector in Europe and in the business strategies of individual firms. These trends include:

i. Deleveraging – leverage ratios have reduced significantly compared to the pre-crisis period as firms have reduced the size of their balance sheets and sought to rebuild their capital base. This trend is firmly aligned with the direction of the Basel III banking reforms.
ii. De-risking – the financial crisis has significantly reduced the risk appetite of institutions and investors and banks have been moving towards smaller and safer balance sheets.
iii. Narrowing scope – a number of firms appear to be retreating from a 'full service' investment banking model in order to concentrate on business lines where they have significant scale or other sources of competitive advantage.
iv. Regionalisation – investment banking remains a truly global industry. However, a number of firms have to some extent retreated from overseas operations in order to focus more on their domestic market. Some of these cases involve overseas divestments – particularly those made by European firms –which may also have been made in order to increase banks' capital ratios.

The investment banking industry is dealing with two significant, and linked, financial pressures:

v. Higher funding costs – generally the cost of capital for the financial sector has risen significantly compared to the pre-crisis period. This may reflect a number of factors including an increase in the risk premium for investment in financial institutions; lower liquidity, particularly in inter-bank markets; and the (anticipated) impact of regulatory change.
vi. Lower returns – profitability in the investment banking industry is down significantly from pre-crisis levels, both in absolute terms and based on relative measures such as return on equity. The medium-term expectations for the industry are based on a sustained period of generally lower profitability, though returns may be higher for scale players or smaller firms with clearly defined areas of competitive advantage.

Cumulatively these factors have changed the business mix and had an impact on corporate clients.

4.2.1 Business Mix

It is evident that the combination of regulatory and market factors is resulting in banks changing the range of businesses in which they engage. Also, State Aid decisions are driving both the business mix and geographical reach of a number of banks. This is regardless of the fact that diversified banks with broad revenue lines and regional footprints fared better during the crisis than narrow banks. The business mixes of a number of large European banks are changing, as are their domestic and cross-border operations in various business lines, including investment (Figure 3).

Figure 3: EU banks with announced changes to business strategy

[1] Includes interbank lending and commercial real estate loans; and working capital, project, and specialized finance, including leasing, equipment, trade, and commodities finance.
[2] Includes companies that specialize in car, aircraft, shipping, leasing, project, and structured finance; investment banks; and municipal bond agencies.
[3] All EU and non-EU countries in eastern Europe, including Poland, Russia, and Turkey.
[4] Has received government financial support.

Source: IMF, 2012

The Single Market in financial services has allowed the European banks to become bigger and to extend their global footprints. The impact of the increase in size and increased competition within the banking sectors has been lower borrowing costs for consumers and businesses. Barrell et al (2010) identified that larger banks in the Single Market have smaller spreads between borrowing and lending rates, which, due to competition for deposits, implies that they charge less than smaller banks for lending. Consequently, household incomes have gone up as a lower proportion is distributed to interest payments and thus household consumption has increased. For corporates, lower borrowing costs have meant a decrease in capital expenditure, raising the sustainable output substantially in the long run. Although lower spreads between borrowing and lending rates do indicate that larger banks take on more risk, the research articles referred to above indicate that diversified banks with broad revenue lines and regional footprints fared the crisis better than narrow banks. The ECB (2011) analysis of European bank business models in the crisis reflects this.

4.2.2 Impact on Corporate Clients

The IMF (2012) reviewed the business plans of 58 large EU-based banks and identified that the banks' responses to the crisis and the imminent regulatory requirements will, under a specified current policy scenario, reduce their assets by $2 trillion over the next two years, which in turn will have a drastic impact on the cross-border and cross-business line services they provide. The impacts on universal and commercial banking models are severe and cuts are expected to occur in investment, corporate and retail banking and non-banking/shadow banking businesses.

This could have a number of impacts on corporate services. First, banks are expecting to cut trading within their investment banks due to decreased profitability and higher capital requirements. Whereas the cuts will reduce proprietary trading and other trading book exposures that do not directly impact the corporate client, the indirect costs of and reductions in trading in non-standard derivatives and structured products will reduce the availability and impact the pricing of hedging, loans and market based financing products. Secondly, corporate banking is likely to be scaled back, directly impacting capital and liquidity intensive products such as project and trade finance, syndicate loans, factoring, leasing and commodities trading. Thirdly, universal banks have started selling non-bank financial companies, including in insurance, finance and real estate investment, limiting the cross-sale opportunities for banks and the ability of clients to access all services under one umbrella. The retreat of many banks from business lines and geographies will decrease the level of competition within the sector.

From a large corporate client viewpoint (CBI, 2011) there are several benefits in the universal banking model that may become more expensive as a consequence of the regulatory responses and reduced competition. Global businesses often need a bank with a substantial balance sheet to support large transactions such as infrastructure projects or debt and equity underwriting. Although these transactions can be syndicated and thus individual banks' exposure reduced, regulatory large exposures or internal risk limits require a bank that can manage big positions on its balance sheet so that the transactions can be completed efficiently. Furthermore, these capital markets services require the bank to be able to distribute a corporation's debt and equity to investors across the globe.

Complex international businesses also need integrated services to support the organisation's funding requirements and risk management needs. Although these companies often have multiple banking relationships, they can net their credit risk and funding requirements within a single relationship. Effectively the netting of costs and risks of various long and short positions, and the associated bank credit valuation adjustments, achieves economies of scale and hence the overall cost of the products and funding requirements is reduced. As an example, if an overdraft in one account can be offset with a positive balance in another and the regional liquidity pooled together, the amount of working capital is increased and funding costs reduced. Cash management products also allow multinational corporations to reduce their operational risks and enhance the effectiveness of cross-border transaction management, hence allowing the companies to concentrate on their core businesses rather than transaction management. (CBI, 2011)

Considering the wide-ranging reductions in investment and corporate banking services announced by large European banks, there may be a squeeze in the market that can raise the cost of services to large

corporations. However, a more imminent problem for corporations relates to the shrinking bank balance sheets and the maturing corporate debt. Standard and Poor's study (2012) estimates that bank loan and debt capital markets will need to finance $ 43-46 trillion of corporate borrowing between 2012 and 2016 globally, of which European corporations account for approximately half. According to the study, extending the debt requires the regulators, governments and central banks to carefully assess the options to make the financial sector more stable without choking growth and the banks' ability to finance the Single Market's real economy. This issue needs to be pondered carefully to ensure businesses can access finance, grow and hence benefit the European economy. Introducing structural restrictions for the already shrinking large European commercial and universal banks could reduce the financing available even further. It can also make it costlier to the businesses as liquidity may get trapped into smaller pockets on a national level rather than facilitating cross-regional flows of capital and financial services to the end user.

4.3 Change Driven by Structural Regulation

A number of jurisdictions have introduced structural regulation to address particular issues in their own financial sectors. These are outlined in turn below.

4.3.1 Dodd-Frank and the Volcker Rule

The Dodd-Frank framework and the Volcker rule are being implemented in the US. It has been widely observed that distinguishing impermissible proprietary trading activities from permissible and critically necessary activities such as market making, hedging, and underwriting has proved both extremely difficult to do and extremely burdensome to implement as a compliance matter. Considering the low proportion of bank losses (Tricumen, 2012) due to proprietary trading during the crisis (4%), it is arguable whether such a restriction will achieve any incremental benefits for the stability of the financial sector. Instead it could create only an additional compliance burden to an already heavily regulated industry.

Another risk in implementing the Volcker rule was identified in a study by Oliver Wyman (2011). They argue that an overly restrictive implementation of the Volcker rule, as proposed, has a disastrous impact on US corporate credit market. The findings in reduction of liquidity to US corporate bonds are:

- Cost to investors: $90-315 bn mark-to-market loss of value to existing holdings as these assets become less liquid and therefore less valuable
- Cost to corporate issuers: $12-43 bn per annum in borrowing costs over time, as investors demand higher interest payments on the less liquid securities they hold
- Cost investors an additional $1-4 bn in annual transaction costs as level and depth of liquidity (e.g. due to bank market making reductions) in the asset class is reduced

If the worst case scenario is realised, it is a big price to pay for relatively small losses caused by the pure proprietary trading activity. Therefore, AFME is against the implementation of this type of activity restriction which is likely to have little incremental benefit in making the banks safer and can have a substantial cost to the real economy attached to it.

4.3.2 Vickers Ring-Fencing

Several European countries have introduced regulations that are stricter than the proposed Basel III rules. An additional measure in the UK, proposed by the UK Independent Commission on Banking, is ring-fencing. This describes the process of insulating economically important basic services of the bank (retail deposits, payments and SME services), where continuity of service is vital, from potential losses which might occur from other non retail banking activities, and specifically investment banking. According to Deutsche Bank's independent Equity Research Team (2012), the UK ring-fence approach allows for a lot of flexibility but "*creates substantial issues in two ways, the latter of which could have very substantial impact if ring-fencing were adopted outside of the UK.*

- *First, where a bank has a surplus of domestic retail funding, this liquidity can become 'trapped' within the retail ring-fenced bank. The bank then has no choice but to lay off the surplus liquidity in treasury securities.*
- *Second, out-of-ring-fence businesses will not be able to be retail funded. This means that an investment banking business outside of the ring-fence would have to be funded on an arm's length basis. We can see from pure broker-dealer type investment banks in the US that funding costs for this type of bank might be 100bp to 150bp (more in times of stress) higher than for an integrated universal bank.*
- *This also has specific application to foreign asset-heavy retail banking businesses. Several European banks (Italian, Belgian, Austrian) deployed surplus domestic deposits to fund CEE loan books, for example".*

Thus ring-fencing as intended by Vickers increases the stability of domestic retail-heavy banks at the cost of reducing flexibility and potentially increasing funding costs. Deutsche (2012) also argue that if similar regime was introduced across Europe, approximately € 2 trillion would be trapped in domestic ring-fenced entities with an added theoretical interest cost of around € 70 billion. The interest cost is calculated from additional wholesale funding costs outside the ring-fence at 150 basis points on all funding and the additional wholesale cost to replace the trapped liquidity. However, according to the study, the costs would decrease over time as mitigating actions are taken by the banks subject to the regulations.

As Vickers is a solution to a particular banking sector with specific characteristics that do not necessarily exist in other Member States, which have smaller banking markets in relation to the size of their economies, the implementation of the regime in an EU-wide context would have undesired effects that would undermine the Single Market while implementation of such regulations may not add to the stability of the EU banking sector.

4.4 Section Conclusions

As discussed above the historic or proposed structural restrictions are beneficial neither to the Single Market nor to the economy in Europe. The structural changes to date have to be seen from a national viewpoint and thus they do not fit with a 27 nation region with fragmented economies and legal and banking structures. Indeed, our view is that the UK and US are implementing the rules as a direct response to particular issues in their banking systems and that similar structural restrictions applied

throughout a diverse European large bank population would make the sector more homogenous and thus more exposed to systemic risk.

Furthermore, the intended consequences are likely to cause additional strains to the export-led industries of Europe with little incremental benefit. The nature of these restrictions, as an additional layer to the existing constraints on lending caused by current regulatory responses and market pressures, could further limit banks' ability to lend to individuals, SMEs and large corporates. Thus, if the HLEG is to propose any structural regulation, AFME recommends that the incremental benefits and regulatory externalities are carefully considered.

Contrary to the direction of travel in Europe, proposals are being formulated in China and South Korea to reduce restrictions. The China Securities Regulatory Commission's and South Korea's Financial Services Commission's proposals are aimed at further developing and stabilising local capital markets and at improving the domestic investment banks' ability to compete with services offered by foreign banks for deals in debt finance, international projects and mergers and acquisitions. The proposals suggest that increased size and greater range of services provided promote the competitiveness and stability of the sector, while also encouraging domestic and international growth of large companies. These initiatives indicate that activity restrictions and limited sizes of banks do not promote financial market efficiency and economic growth. Rather they acknowledge that the global nature of large businesses and resulting demand for complex financing deals requires banks with the size and the scope to be able to complete the transactions.

The ability to implement reforms across the EU should be considered. The US has a harmonised legal system and yet implementing the Volcker rule is proving very complicated. It is arguable whether implementing structural restrictions in a region of 27 different legal systems and taxation frameworks, fragmented banking markets with different ownership structures and existing national structural restrictions is likely to be achievable. Indeed, the existence of VAT groups could militate against the ability to effectively separate activities from a group.

5 CREATING 'OPTIMAL' BANKING STRUCTURES

AFME does not believe that there is one "optimal" bank structure which will ensure financial stability. Therefore, in proposing any structural regulation of the banking sector AFME believes that the HLEG should consider a number of factors, which are outlined in this section.

5.1 Objectives for any Structural Regulation

The objective of any structural regulation proposals should be, to establish a safe, stable and efficient banking system serving the needs of citizens and customers and that are capable of meeting the infrastructure and trading requirements that are essential for the restoration of economic growth in the EU. It is clear that any reform would introduce complex trade-offs. In this respect it will be imperative to conduct a thorough impact study to identify the balance of costs and benefits. Given the existing very extensive regulatory reform programme the burden of proof that further interventions would, despite their negative economic consequences, be justifiable on the grounds of increased safety and stability of the banking system is particularly high. As acknowledged at the recent conference in the European Parliament, 'How to Restructure the EU Banking Sector' (25 May, 2012), structural regulation is only one tool in a wider toolkit that aims to make the banks safer. Any structural regulation proposals should, as mentioned above, take into account the changes in other regulations in order to identify any remaining objectives that have not yet been addressed.

Thus, AFME proposes that such measures should include careful analysis of the incremental benefits that structural restrictions can achieve, in addition to the benefits achieved by the current regulatory initiatives. These measures should carefully analyse the incremental reductions in, for example, system-wide probability of default (PD) and loss given default (LGD). These incremental reductions need to be carefully weighed against any long-term reductions in the efficiency of the financial markets; any additional risks created in the system or decreases in competition as the result of structural regulation; and economic externalities of such restrictions that can slow down economic growth of the EU.

Finally, the objectives of any structural regulation proposals need to be clearly defined to help avoid unwanted consequences and to provide a basis on which to assess any proposals.

5.2 Business Models and the Crisis

No discussion about structural regulation can take place without the context of the financial crisis being considered. If the objective is a safer financial system it is necessary to empirically examine the causes of both instability and stability in the crisis. While a full summary of the banking sectors in selected countries is given in Annex II, here we outline how there was no direct link between the losses experienced by banks and their particular business models or size.

A study by Barclays (2010) identifies that a screen by size would not have predicted the banking failures during 2008 and 2009 as big and small, narrow and diversified, failures occurred in all types of banks. There is also evidence that supports the universal banking model (and more generally diverse entities over narrow ones) due to losses from one line of business being offset by profits from another. For example, a recent study by Nomura (summarised in Wall Street Journal, 2012) estimates

that BBVA, Santander and Sabadell, all large diversified universal banks, are the only Spanish banks that will not require a recapitalisation. Diversification can also offset volatilities in business line profitability and thus enable banks to better weather longer disturbances to the financial markets compared to a narrowly focussed bank (Annex IV). In addition, some banks came out of the crisis strongly due to geographical diversification benefits (for example Asian markets showed resilience during the crisis).

Due to the significance of the big banks to the purposes of the HLEG, impairment losses by various big European banks are summarised in Table 3. Whereas it can be seen that structured credit related losses were mainly incurred in the trading book (losses taken through revenue), the total structured credit losses were only just over a third of total banking losses in the sample. There were also big differences between institutions as to whether the impairments were realised in the banking or trading books. It can also be observed that where the losses occurred varies regionally as well as from one institution to another, implying that large banks in Europe were exposed to various different risks, due to their different business models and regional exposures. In addition, and in direct contradiction to common perceptions about the banking crisis, the biggest proportion of banking losses in the big European banks were driven by impairments in other banking activities such as loan losses rather than structured credit, linking the losses directly to lending to the real economy.

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Table 3: Profit and loss charges in structured and ordinary credit during 2007-2009

Bank:	Total 2007-2009:	Structured credit charges taken through revenue:	Structured credit charges taken through impairment:	Other impairments charges:
ING	100%	53%	0%	47%
KBC	100%	57%	4%	39%
BNP Paribas	100%	17%	10%	73%
Credit Agricole	100%	50%	1%	49%
SocGen	100%	48%	0%	52%
Commerzbank	100%	32%	9%	59%
Deutsche Bank	100%	71%	0%	29%
Deutsche Postbank	100%	62%	1%	37%
Intesa SanPaolo	100%	12%	0%	88%
Monte dei Paschi	100%	0%	0%	100%
UBI	100%	0%	0%	100%
UniCredit	100%	19%	2%	78%
Danske Bank	100%	0%	0%	100%
DnB	100%	0%	0%	100%
Nordea	100%	0%	0%	100%
SEB	100%	19%	0%	81%
SHB	100%	0%	0%	100%
Swedbank	100%	0%	0%	100%
BBVA	100%	2%	3%	95%
Bankinter	100%	0%	0%	100%
Banco Popular	100%	0%	0%	100%
Banco Sabadell	100%	0%	0%	100%
Santander	100%	3%	0%	97%
Credit Suisse	100%	91%	0%	9%
UBS	100%	92%	0%	8%
Barclays	100%	44%	15%	41%
HSBC	100%	10%	3%	87%
Lloyds Banking Group	100%	3%	2%	95%
RBS	100%	35%	5%	60%
Standard Chartered	100%	9%	0%	91%
Total €m:	**422,905**	**140,285**	**14,203**	**268,417**
As percentage:		**33%**	**3%**	**63%**

Source: Barclays Equity Research estimates

An article in the New York Times by Andrew Ross Sorkin (2012) outlined how banking crises often start with banks making basic loans. In the US, the crisis started with several investment bank failures, followed by retail/mortgage banks and insurance companies. The crisis spread into large diversified commercial banks, such as Bank of America and Wachovia, only after they acquired troubled mortgage banks (Countrywide Financial and Golden West, respectively). This indicates that structural restrictions would not have saved the banks from the crisis as the losses occurred first in narrow focus banks and spread into the diversified banks after Bear Sterns, Lehman Brothers, AIG, Fannie Mae and Freddie Mac were either fallen or teetering.

Another important factor from a EU taxpayer perspective is where the losses occurred for institutions that required government bailouts. We can observe several reasons in Table 4 that led to the government interventions, ranging from mergers and acquisitions based on optimistic valuation of the acquired assets, to structured product portfolios, to losses in monoline insurance, sub-prime lending and securitisation portfolios and off balance sheet commitments. It is also evident that there are significant regional differences in the root cause, again highlighting the fragmentation of the banking sector in Europe.

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Table 4: Bailed out banks

COUNTRY	BANK	TYPE OF DECISION	Business model:	Loss leaders:
Belgium	KBC	Restructuring	Retail, private banking and insurance	CDO investment portfolio
Belgium / Luxembourg / France	Dexia	Restructuring	Public finance, retail and insurance	AFS securities, inter-bank exposures and monoline insurance
Belgium / Luxembourg / Netherlands	Fortis Bank Belgium and Luxembourg	Restructuring	Retail, corporate banking	Acquisition of ABN, structured investments, loss of confidence
Germany	WestLB	Restructuring		Securitisation portfolios, SPV financing
	Sachsen LB	Restructuring	SME banking, central bank to savings banks	Securitisation portfolios, SPV financing
	IKB	Restructuring		International structured loan portfolios
	LBBW	Restructuring	SME banking, central bank to savings banks	Securitisation portfolios, SPV financing
	HSH Nordbank	Restructuring		Securitisation portfolios, SPV financing
	Hypo Real Estate	Restructuring		Deteriorating credit quality of DEPFA plc public finance portfolios
	Sparkasse Köln-Bonn	Restructuring	Savings bank	Securitisation portfolios
	Commerzbank	Restructuring	Commercial bank	Acquisition of Dresdner and resulting funding gap,, commercial real estate, sovereign debt
Netherlands	ABN Amro/Fortis Nederlands	Restructuring	Retail, corporate banking	Acquisition of ABN, structured investments, loss of confidence
	ING	Restructuring		US sub-prime credit insurance, commercial real estate, sub-prime securitization portfolios
Spain	CCM	Liquidation		Spanish housing market
	Caja Sur	Liquidation	Cooperative/retail	Spanish housing market
Sweden	Carnegie	Restructuring	Invetment bank	Large loan exposures/losses
United Kingdom	Bradford & Bingley	Liquidation	Building society	UK sub-prime mortgages
	RBS	Restructuring	Retail, corporate, invetment banking	ABN AMRO acquisition whose asset quality deteriorated rapidly and the resulting funding gap, US sub-prime mortgages
	Lloyds Banking Group	Restructuring	Retail banking	UK real estate
	Northern Rock	Restructuring	Retail/mortgage	Reliance on wholesale markets, liquidity, UK real estate assets
	Dunfermline	Liquidation		UK property investments

Sources: EC (2011), AFME Staff

The financial crisis exposed a weakness particularly in the German landesbanken model, which lacked effective risk management structures and business models even before the crisis (EC, 2012). Although the main objective of landesbanken was to engage in wholesale banking to support the local economy by financing SMEs and other corporate clients, they had ventured into investing in foreign commercial property, sub-prime securities and several of the banks operated special purpose vehicles. These thinly-capitalised, highly-leveraged banks also lacked liquidity in their portfolios and thus became quickly unsustainable during the run-up to the crisis and failures started even before the Lehman's collapse. Under the forthcoming Basel III rules, the landesbanken could not have run these business models and furthermore it appears that similarly to what happened in the US, it is unclear if any structural restrictions would have saved the banks from failures or limited the losses.

Another heavily criticised aspect of certain banking models not visible in the tables is bank losses from the proprietary investment desks of banks. A study by Tricumen (2012) encompassing the four biggest US banks and 10 domestic and foreign banks operating in the UK, reveals that out of $365 billion of losses accumulated by the banks, only $14 billion (or 4%) was due to proprietary trading. It also shows that mortgages and asset-backed securities accounted for $206 billion of losses, syndicated lending $80 billion and equity derivatives $13 billion.

An empirical examination suggests that large diversified banks are a source of stability for financial markets and that the sources of banks' losses during the crisis have largely been from poor judgments about credit risk. There is no clear evidence that a particular business model or a particular bank structure has contributed disproportionately either to losses or government bail-outs. In this respect, AFME believes that the forthcoming impact study accompanying the Crisis Management Directive is likely to note that the separation of retail, wholesale and investment banking activities does not appear to deliver the desired financial stability.

5.3 Benefits of Diversity

As well as providing stability for individual institutions, outlined above, diversity increases systemic resilience. Apart from the stability externality generated by banks with diverse activities that contribute to a more stable system, there is also a benefit in diversity between different banks. The probability of two banks failing at the same time is greatly reduced if banks have different structures, exposures, activities, and geographical footprints. As discussed in preceding sections the European banking system is characterised by such diversity (albeit fragmented on national lines) – which is a source of its strength.

It can be argued that to avoid local banking disturbances, and to avoid local disturbances that could contaminate the wider European sector, banking sectors in Europe would benefit from more diversity at a regional level – a mix of small, medium and large local banks as well as diversified cross-border banks with diverse sources of income in terms of products and geographical exposures. Countries or regions with only local banks that lack diversity are less able to absorb losses during prolonged regional stress periods (e.g. idiosyncratic shocks such as a sovereign debt crisis, loss of a significant regional employer or regional asset bubbles). A combination of business model and geographical footprint diversity would benefit the resilience of the fragmented European banking sectors.

The example of the Irish banking system is illustrative of this point. All of the Irish banks became over-exposed to the commercial and residential property sectors, creating a systemic event for Ireland. Considering a hypothetical counterfactual example – if all European banks had the same bad exposures as the Irish banks at the same time, any issues would become magnified. Diversity has benefited the European system, as would the presence of cross-border banks benefit the Irish economy by ensuring diversity of credit supply.

Any structural regulation that affects particular business models harder than others may reduce the banking services available in a given region of the single market. Until the resulting gap is filled by firms that can provide the services with structural and capital efficiency there could be damage to the real economy as businesses that depend on bank financing or require a service provider to access the financial markets may not be able to finance their activities.

It seems likely that structural regulation or any one-size-fits-all approach could limit the diversity and evolution of banking sectors and thus reduce the resilience of the system. Bearing in mind the ongoing structural changes to banking models in Europe, dictated by the economic circumstances and ongoing regulatory changes, AFME recommends a cautious approach in proposing any structural restrictions that could reverse progress towards a single market.

5.4 Risks of Sub-Optimal Interventions

It is clear that the EU policymakers could not have implemented structural restrictions to avoid the financial crisis ex-ante and it is far from clear that they could do so now, even with the global evidence from the crisis. Thus, it is pivotal that the risks from any sub-optimal interventions into the evolution of the European banking sectors are carefully considered by the EU policymakers.

In the aftermath of the recent financial crisis there have been calls to reinstate the Glass-Steagall Act or impose similar restrictions. As a result, a number of articles have examined Glass-Steagall in the context of the current crisis. Markham (2010) and White (2010) argue that the repeal of the Glass-Steagall Act did not lay the groundwork for the current crisis as Glass-Steagall would not have prevented banks from making the investments that brought them down, nor would it have dealt with their inadequate capital levels. Similarly, Glass-Steagall would not have been a barrier to entering the over-the-counter derivatives businesses. It has also been noted by Kregal (2010) that the innovations in short-term business financing would make the separation of deposit-taking banks from securities market activities extremely difficult.

Notably, even Paul Volcker, former Federal Reserve Chairman, said in a 2009 speech that he is "*not proposing a return to Glass-Steagall*" because he regards securities underwriting as *"a reasonable banking function analogous to lending."* This contrasts with some of the proposals made by other commentators who have suggested that customer lending should represent at least a minimum ratio of deposits. It also conflicts with the sometimes heard argument that only direct lending activities support the real economy, which of course is wrong. For example, if any restrictions on proprietary trading proposed by the Volcker Rule are to include market making activities, i.e. putting capital at risk to support buying and selling of securities in support of customer orders, this would have severe consequences for the liquidity of the financial markets. This is particularly relevant for the Fixed Income markets, as explained earlier in this paper at section 3.3.1. In addition, losses that stemmed

from market making activities were relatively small during the crisis and thus restrictions on such activity are disproportionate (Tricumen, 2012).

Furthermore, as can be seen in the literature on Japan's Article 65, which also required the segregation of banks from investment bank and brokerage businesses, there are several negative impacts on the rules (Patrikis, 1998; Nakajima, 1996). Patrikis (1998) suggests that reforming Article 65 would increase competition in the financial sector which "*should raise the efficiency with which Japan's savings are invested, which may ultimately boost Japan's prospects for sustained economic growth."* Furthermore, he argues that prohibition of banks entering the issuance of equity and debt securities had severe consequences on the Japanese corporate and retail sectors due to heavy reliance on bank lending and limited investment product availability respectively. Interestingly, the EU made proposals for regulatory reform in Japan, including a request to abolish Article 65, noting that the Article has significant detrimental effects on foreign financial services firms. It states that the barriers due to the separation *"have been particularly detrimental to European financial services firms as most are part of universal banking groups".* Clearly, by introducing similar regulations in the EU, the impact on certain business models would be disastrous and thus make the banking sectors less versatile.

Directly related to the reliance on bank lending, it can be argued that in the current global environment, ring-fence type solutions that limit the corporate clients' ability to access debt and equity funding could seriously damage the European corporate sector. Furthermore, big banks with global reach and more market information are able to contribute to price discovery and thus benefit the competitiveness of local and regional economies by reducing pricing anomalies.

Finally, we are concerned that structural restrictions may create "bank clones", similar organisations across the EU with limited diversity in terms of business model, ownership structure and asset and liability bases. The current diversity in types of organisations in the EU, inclusive of cooperatives, savings banks and shareholder owned banks with various geographical footprints and objectives needs to be seen as richness and should be supported by regulations that do not favour a particular business model.

6 CONCLUSIONS

The European banking sector is diverse and complex. While there is evidence of significant integration in several product markets and areas of activity there is also wide diversity at firm and country level and the overall sector remains greatly fragmented. Countries that are implementing structural restrictions (the US and UK) or gold plating the current regulatory rules (Switzerland) are doing so in response to specific risks they have identified in their national sector. AFME is concerned that proposals for structural reform could inhibit the further development for a single market in financial services, and further exacerbate the risks to the economy of fragmented, but nationally concentrated markets. AFME recommends that the HLEG takes a cautious approach to proposing reforms that could reverse progress towards a single market.

Banks provide, directly or indirectly, around 50% of corporate funding in the EU. The role of large banks is essential in ensuring growth and international competitiveness. Universal banks add to the stability and resilience of the markets, limiting the impacts of national or regional idiosyncratic shocks. Furthermore, the business models as well as their geographical footprints of the European bank are significantly different from one another. Whereas, some of the G-SIBs increase the national level concentration of the banking sectors, some have relatively small footprints in their domestic retail and SME banking. Therefore, we argue that it is ill-advised to apply one-size-fits-all restrictions on the European G-SIB population.

The current regulatory responses, if implemented simultaneously and harmoniously across the region and even better globally, will reduce the systemic risks inherent in the system in the run-up to any future crisis and thus make the EU banking sector more resilient and the large institutions resolvable. These reforms will in aggregate significantly reduce both the probability and impact of default in the banking system and combined with improvements to market infrastructures, such as the centralised clearing of derivatives and introduction of Legal Entity Identifiers, substantially lower the threat of systemic crisis. Such threats will be further reduced through the implementation of recovery and resolution regimes and European crisis management proposals including the introduction of resolvability assessments.

Regulations are already shifting the big banks' business plans, which are likely to have material impacts on financing and other European corporate client services. We oppose further restrictive measures aimed at reducing lending to the export and other industries in Europe as such measures would undermine the competitiveness of the European businesses. This view is re-enforced by the fact that substantial structural changes are already underway across the industry driven by the post-crisis reform programme as well as changes to market and economic fundamentals and already announced structural reforms. These trends are leading to significant deleveraging and de-risking of banks' balance sheets as well as the re-evaluation of business models as institutions seek to narrow both the functional and geographical scope of their activities.

Historical evidence does not promote structural restrictions. Furthermore, the current restrictions can only be seen as national responses to particular problems and are proving difficult to implement even then, with potential unintended consequences. If structural restrictions were to be introduced in an EU-wide context, the costs and benefits need to be thoroughly assessed to avoid substantial costs

to the real economy without material incremental benefits to the resilience of the banking sector. Furthermore, applying sub-optimal restrictions increase the potential of build-up of systemic risk in the financial system.

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Annex I: Answers to the HLEG Consultation Questions

To what extent are the current and ongoing regulatory reforms sufficient to ensure a stable and efficient banking system and avoid systemic crises?

AFME believes that current and ongoing regulatory reforms are sufficient to ensure a stable and efficient banking system and avoid systemic crises. A regulatory reform programme of unprecedented scale and scope is underway at the global and European level to address weaknesses in the regulatory and supervisory systems, many of which became evident during the financial crisis. These reforms will in aggregate significantly reduce both the probability and impact of default in the banking system. Combined with improvements to market infrastructures, such as the centralised clearing of derivatives and introduction of Legal Entity Identifiers, they will substantially lower the threat of systemic crises. Such threats will be further reduced through the implementation of recovery and resolution regimes and European crisis management proposals including the introduction of resolvability assessments.

Please see Section 4.1 for a detailed elaboration of this position.

Which structural reforms would improve the safety and efficiency of the banking system in the EU in the near-term? In the long-term?

AFME believes that no further structural regulation is necessary to improve the safety of the banking system in the EU. The current and ongoing regulatory reform programme including planned improvements to market infrastructures, supervisory practices and resolution regimes has substantially strengthened both the resilience of individual banks and the banking system overall. At the same time 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 significant 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.

As a result any near-term proposals for further structural interventions would, in AFME's view, create uncertainty in the EU banking system and damage economic growth. If despite this structural changes were to be considered it would be imperative that they be properly evaluated against all alternative means of achieving the same objectives. In particular AFME recommends that any change proposals be accompanied by a detailed analysis of their incremental benefit. This should estimate the addition to systemic safety delivered by any proposal net of costs including any decreases in the efficiency of the banking system and the cost of such changes to the real economy. In the absence of an unequivocal net benefit AFME does not believe that additional structural reforms should be implemented. In this respect, and judged against the changes already underway across the banking system, the burden of proof that would need to be satisfied to justify further structural changes is in our opinion particularly high.

Please see Section 4 for a detailed elaboration of this position.

What are your views on the structural reform proposals to date (e.g. US Volcker Rule, UK ICB proposal)? What would be the implications of these proposals on your institution and the financial system as a whole?

The structure and diversity of the European banking sector combined with the ongoing EU-wide and national support operations argue for extreme caution before introducing any further structural changes at this juncture. AFME does not believe that the structural proposal but forward in the United States by Paul Volcker and in the United Kingdom by Sir John Vickers' Independent Commission on Banking are appropriate templates for Europe. We have reservations both as to the efficacy of such proposals and to their applicability to a highly diverse European banking system.

Volcker Proposals

It would appear that Volcker's proposal to prohibit banks from undertaking proprietary trading are based on two main arguments. The first is that such activities should not be supported by the taxpayer and the second is that commercial banks that hold a strong interest in proprietary trading should not be able to profit from the deposits of customers. AFME and its members are clear that they do not wish to be supported by taxpayers in respect of any or all of their activities. To the extent that there remains an implicit subsidy of banks this has fallen sharply since the financial crisis and can be expected to fall further as additional prudential reforms and credible recovery and resolution regimes are implemented.

Controls on proprietary trading, or indeed any other activity, need to be considered in terms of the risk of loss resulting from that activity in relation to the costs arising from its prohibition. They also need to be evaluated against alternative means of controlling the identified risks. The overarching goal for any activity is to ensure that it is properly understood, measured, supervised and capitalised regardless of where that activity is undertaken. Proscribing certain entities from undertaking particular activities must therefore satisfy a three part test: that the activities may give rise to significant institutional losses which could ultimately fall on taxpayers; that there is no reasonable alternative way of controlling the activities within the entity or entities; and that the benefits from having an entity or entities cease the activity clearly outweighs the systemic costs.

It is far from clear that Volcker's proposals satisfy these three tests. While history is not necessarily a guide to the future, proprietary trading losses were estimated to have accounted for only 4% of bank losses during the crisis (Tricumen, 2012). There appears to be no particular reason why such activities cannot be controlled within banking organisations by appropriate regulatory rules rather than banned. Furthermore, leaving aside the practical difficulties of identifying what constitutes proprietary trading and the compliance burden, a ban on such activities could be positively harmful to financial markets and the economy.

A study by Oliver Wyman (2011) of the cost of implementing the Volcker showed that, as proposed, it would have a fundamental knock-on effect on US corporate credit market due to its impact on market-making activities. The findings in relation to the reduction of liquidity to US corporate bonds are that it would:

- Cost investors: $90-315 bn mark-to-market loss of value to existing holdings as these assets become less liquid and therefore less valuable
- Cost corporate issuers: $12-43 bn per annum in borrowing costs over time, as investors demand higher interest payments on the less liquid securities they hold
- Cost investors an additional $1-4 bn in annual transaction costs as level and depth of liquidity in the asset class reduced.

It is also worth noting with regard to Volcker's second objection to proprietary trading – that it should not in effect profit from customer deposits – virtually all banks in Europe have loan to deposit ratios in excess of 100% implying that they are unable to fund even their customer lending from customer deposits and thus are unable to engage in proprietary activities funded by surplus deposits. Finally, even in the US which has a harmonised legal system, implementing the Volcker rule is proving very challenging and has caused concerns over its extraterritorial reach. It is arguable therefore whether imposing similar controls on activities in a region of 27 different legal systems is likely to be achievable even in the very unlikely event that it was considered desirable.

Vickers Proposals

AFME does not believe that it is either necessary or desirable to introduce Vickers style ring-fencing proposals into European banking markets. The Vickers ring-fencing arguments are based largely on a perceived need to insulate retail banking activities, where continuity of service is vital, from potential losses which might occur from other non retail banking activities, and specifically investment banking. A further objective is to make it easier to resolve a group containing both investment and retail banking activities. Apart from proposing the ring-fencing of core retail banking services, Vickers also recommends a minimum equity capital ratio equivalent to 10% of risk weighted assets together with additional loss absorbing group capital the size of which would be related to the systemic importance of the institution.

AFME considers that the risks associated with specific activities are most appropriately addressed through ensuring that they are adequately capitalised rather than by artificial separation, which not only gives rise to boundary issues but also risks reducing the diversification benefits available from outside the ring-fenced retail banking activities. In this respect we understand that the draft of the European Commission Crisis Resolution proposal impact assessment notes that the separation of retail, wholesale and investment banking does not deliver financial stability. With regard to the preservation of vital banking services in the event of the failure of an institution, we believe that this should be capable of being addressed through effective resolution and recovery planning and need not require structural separation.

AFME understands that it was not the intention of the ICB's report to give an international prescription or template that might be adopted elsewhere as, unlike other European banking markets, the UK has a particularly high banking concentration relative to GDP (556% compared to EU-27 average of 349%). Quite apart from the practical difficulties of doing so, attempting to introduce similar structural reforms to Vickers across Europe risks inhibiting the further development of a single market in financial services, and exacerbating the risks to the economy of fragmented, but nationally concentrated markets. Furthermore, as there is no evidence that investment banking

activity is considerably more hazardous than retail banking, the benefits of such segregation are questionable. AFME recommends that the HLEG should proceed with extreme caution before proposing reforms that could reverse progress towards a single market.

Please see Sections 3, 4.3 and 5 for a detailed elaboration of this position.

What are the main challenges of your financial institution as regards resolvability? Are you implementing structural changes to your institution in the framework of your recovery and resolution planning?

AFME endorses the development of credible institution-specific Recovery and Resolution Plans (RRPs) and strongly encourages authorities to form functioning Crisis Management Groups. AFME recommends that firms have a strong input into the development of RRPs so ownership of the plan is maintained within the organisation, ensuring the maximum effectiveness and appropriateness.

Please see Section 4.1 and Annex III for a detailed elaboration of this position.

Annex II: National Banking Sectors

Belgium and the Netherlands

Belgium and the Netherlands, which have the highest banking sector concentrations in the regional sample, high banking asset to GDP ratios and a shared language, depend to a large extent on a few large commercial banks. The high concentration of banking assets, which combined with low domestic growth potential and return on equity, led to international expansion of the biggest banks to broaden the revenue streams prior to the crisis. As a consequence, a significant cross-border expansion was funded by the strong domestic businesses that experienced little volatility prior to the crisis. However, both banking sectors experienced heavy losses during the crisis, leading to significant government interventions (see Table 2) and to nationalisation of some of the biggest banks. These events resulted in a significant restructuring of the banking sectors and the disappearance of large international banks, which merged into other institutions or were nationalised after several bailouts.

To conclude, both countries have banking sectors that have been fiercely competitive and international, and are highly concentrated. The Belgian banking sector has experienced a major restructuring that led to four large commercial banks, one local G-SIB (ING), two subsidiaries of foreign G-SIBs and a D-SIB. Although the Dutch banking sector shares a lot of the characteristics of the Belgian banking sector, it hosts more diverse business models in the top five institutions and has only one local G-SIB and one subsidiary of a foreign G-SIB (representing only 6% of total assets) in the top five banking institutions by assets. Thus, as a whole, the banking services may be less likely to experience severe disturbances due to another idiosyncratic shock or impacts of forthcoming regulations that may impact certain business models disproportionately.

Sweden

The most similar banking sector to that of Belgium and the Netherlands in the sample is that of Sweden, although the banking models have only recently converged as the new structures of the Belgian and Dutch banking sectors have unfolded. The Nordic banking crisis in the early 1990s led to a major restructuring of the banking sector with large commercial banks emerging as the dominant business model. Similar to the Belgian and Dutch banks' expansions abroad, most large Swedish and other Nordic banks also became active in other countries in the Nordic and Baltic regions, leading to the creation of pan-regional banks such as Nordea. These developments have led to one of the most efficient banking sectors in the EU, Swedish banks having one of the highest returns on equity and one of the lowest cost to income ratios (8.7 and 49% respectively).

Swedish banks suffered limited losses during the most recent crisis (see table 2), mainly stemming from losses in the Baltic region, indicating that the previous crisis helped the region to establish regulations and banking structures that are able to withstand some of the macro-economic headwinds that hit Norway, Denmark and Iceland as well as most of the other western economies. This is even though Swedish banks have the highest loans to deposits ratio in all the countries in the sample, indicating that a heavy reliance on wholesale financing did not necessarily lead to banking failures during the crisis. However and more importantly, a topical issue with the Swedish banking sector is

that Swedish banks took losses mainly on loans in less regulated Baltic countries, highlighting the problem of varying regulatory approaches that undermine the single market and the economy of the European Union as a whole.

France

With different banking sector characteristics to the countries assessed above, France is dominated by two large commercial banks and two large cooperative banking groups, of which all are domestic and have a G-SIB status. Apart from BNP Paribas, the French G-SIBs, one commercial bank (Societe Generale) and BPCE and Credit Agricole in their position as cooperative bank central organisations are mainly focused on domestic markets, providing banking products mainly to retail and SME clients. However, all of them also have subsidiaries that focus on corporate and investment banking activities to support the requirements of the international corporations. The French banking sector is also open to international markets and although foreign controlled credit institutions present only a small proportion of the banking assets, the population is high at 204 credit institutions at the end of 2010. These institutions are mainly from other EU Member States (125) and from the US (34), providing market access, cross-border corporate and custody services as well as private and retail banking.

As in Sweden, the French banks came through the crisis without major government bail outs considering the size of the institutions (see table 2), with the French government providing lower than average recapitalisation support and asset guarantees. The recapitalisation measures were targeted to Dexia (also supported by Belgian and Luxembourg governments), to the merger of Banque Populaire and Caisse D'Epargne and a temporary recapitalisation scheme to boost confidence in the six of the largest banking groups in France during the crisis. Since the crisis, the French banking system has continued to consolidate and refocus on customer business, aggressively reducing the loans to deposits ratios (136% in 2010), increasing capital buffers and reducing its reliance on money market funding. In 2010, French banking assets and the loans to deposits ratio were slightly above the average in the EU and the country sample but also had a high return on equity ratio (9.2%).

Germany

Although the German banking sector is relatively small in terms of assets to GDP (161%), it has the largest banking sector by total number of banks in the EU, with the highest branch density in Europe. Compared to the previous sample countries, the German banking sector is more dispersed, with a concentration ratio of the top five institutions (CR5) ratio of 33%. Compared to France, where large domestic banks manage 92% of the domestic banking assets, large German banks only manage 54%. Domestic medium-sized banks manage 28%, domestic small 8% and foreign controlled branches and subsidiaries 10%. Unlike the French banking sector, the German banking sector consists of three pillars: commercial banks, sizeable savings banks and their landesbanken central organisations, and to lesser extent cooperative banks.

Compared to other European countries, German commercial banks (Deutsche Bank, Commerzbank) have a relatively small market share of the retail deposits. Thus, they do not have a significant impact on the functioning of retail and SME sectors but have an important function in facilitating financing, cross-border services, access to capital markets and relationship banking to a wide variety of corporate clients, custodians and other financial companies and foreign banks. These big commercial

banks can provide these services due to their balance sheet sizes, expertise in financial markets and cross-border network.

The financial crisis exposed a weakness particularly in the German landesbanken model, which lacked effective risk management structures and business models even before the crisis (EC, 2012). Although the main objective of landesbanken is to engage in wholesale banking to support the local economy by financing SMEs and other corporate clients, they had ventured into investing in foreign commercial property, sub-prime securities and several of the banks operated special purpose vehicles. To return the sector to a viable business model, the bailout measures require the sector to focus on its core business and to substantially downsize risk weighted assets and to sell non-core and international activities.

In addition to the restructuring of the landesbanken, Germany introduced a wider reform of its banking sector in January 2011. New legislation provided supervisors with recovery and resolution powers similar to Spain, Denmark and the UK and a restructuring fund that is funded by a bank levy.

Italy

The Italian banking sector has experienced considerable consolidation over the past decade but the process remains far from completed. Similarly to the German banking sector, large and medium-sized domestic banks dominate the market (66% and 25% of banking assets, respectively) and foreign controlled institutions hold a nine percent share of the market. Italy also has one of the lowest banking assets to GDP ratios among the European banks in the sample (158%) and the share of the top five banks is also at the lower end at 39%. Business models of the Italian banking sector are more similar to those of France than Germany, with three large commercial banks (UniCredit the only G-SIB) and cooperative banks dominating the sector. Italian banks generally still focus on traditional banking products but are now broadening their product offering, which is mainly provided in alliance with local insurance companies and asset managers, similarly to the German savings banking model.

Although the Italian banks had a limited exposure to US sub-prime mortgages and structured finance, they have experienced a significant increase in capital markets funding costs since the crisis started. Thus, the Italian government provided recapitalisation aid and a short-term swap programme to provide banks with assets that are eligible for refinancing operations within the Euro system and the inter-bank market. The Italian government spent 0.3% of the GDP in direct bank aid, much lower than the EU average. However, as a part of the bail-out was transferred to the ECB and interbank market via the swap-line scheme, it can be argued that the national crisis measures between the Member States make the direct use of state aid as a measure of banking losses less accurate and that the ECB funding scheme absorbed some of the national bank support measures indirectly.

Spain

The key issue with Spanish banking sector is that as the structural reformation is still ongoing, it would be difficult to apply EU-wide structural restrictions on top of the ongoing structural fire fight in the Spanish banking sector.

Historically, the Spanish banking sector has been fragmented and has had excess capacity in the system with almost twice as many branches per capita than the EU average. In a similar way to the

German and Italian banking sectors, large and medium sized domestic banks dominate the market (58% and 33%) and foreign controlled institutions hold an 8%share of the market. Although the biggest Spanish banks are publicly listed commercial banks (Santander and BBVA), they have a limited role in the Spanish retail market. Instead they focus on other regions (e.g. Latin America) and providing a wide range of financial services to corporate banking, SME and private clients.

Cajas, Spanish savings banks, controlled over half of the deposit base in Spain prior to the recent restructuring. However, low levels of efficiency, ownership structure (mutuals) and collapsing asset values reduced the saving banks' ability to bolster their capital levels during the crisis, while the wholesale market dried up, causing a liquidity squeeze and the creation of a state owned Fund for Orderly Bank Restructuring to bail out the troubled banks. The measures taken resulted in Spanish mutuals spinning off their banking businesses into newly formed commercial banks (e.g. Bankia) and also looking for private investment for the existing cajas. Spain has also recently issued further requirements for banks to increase provisions and capital to accommodate further problems with troubled real estate assets and has bailed out the newly formed banking group Bankia.

These troubles are unique to Spain; although the loans to deposit ratio is one of the lowest in the sample of EU Member States and the bailout measures were below average between 2008 and 2010, the cost of bail-outs has increased substantially since. Spanish banks continue to face problems with raising capital and money market funding. This demonstrates the fragility of the Spanish market with historically high reliance on small mutual savings banks banking model that ran into trouble caused by the Spanish real estate bubble. Furthermore, the belated effort to write down the value of real estate assets has raised concerns in the market about the size of the problem and thus limited the banks' ability to raise funding in the markets. The structural adjustment period is likely to take years to be resolved and the sector may struggle to comply with the proposed regulatory responses due to the amount of capital the banks need to raise.

The United Kingdom

After Switzerland, the UK has the highest banking assets to GDP ratio at 556%, and has a unique mix of institutions due to London's position as the world's biggest financial centre. Unlike most other countries in the sample, 67% of the banking assets are controlled by large domestic institutions and most of the remainder of banking assets belong to foreign controlled credit institutions. To further break down the banking asset distribution, foreign investment banks control 24% of the total assets and foreign retail banks less than six percent. However, in terms of the domestic retail market, major UK banks provide 78%, building societies and mutuals 9.5% and foreign owned retail banks 10.2% of the loans and advances to customers. The top five banks in UK are also all domestic G-SIBs and the top 20 banks by assets are inclusive of several non-domestic G-SIB institutions. On the other hand, to explain the global nature of the UK banking sector, UK owned banks have over 50% of their assets abroad. This is due to institutions such as HSBC and Standard Chartered that have a strong presence in Asia and the recent globalisation of other UK based commercial banks.

The origins of the financial crisis in the UK were many and varied, including excess liquidity and low real interest rates that consequently increased leverage and search for yield in the system. Furthermore, these developments led to increased securitisation processes in the originate-to-

distribute banking model. The impact of the financial crisis on the UK banks varied considerably from one institution to another, depending on several factors such as global footprint and overseas expansion, pre-crisis exposures and reliance on wholesale funding.

Whereas some of the largest institutions came out of the crisis relatively unscathed (e.g. HSBC, Standard Chartered), some institutions required extensive government support. None of four previously demutualised building societies existed as standalone banks in 2010 and were either liquidated, nationalised or merged with other banks. Of the big banks RBS, which was the biggest beneficiary of the government aid, had expanded rapidly in the UK and internationally and was hit by deteriorating asset quality in the US mortgage books and in the books of newly acquired ABN AMRO. As a result, the government support as a proportion of the GDP between 2008 and 2010 is the one of the highest in the EU. Another facet to the bail-outs and mergers relates to competition issues. As part of the bail-outs, some of the biggest UK banks are required to reduce their share of certain retail and SME markets, which will reduce concentration in these markets.

In response to the crisis, the FSA introduced a new liquidity regime, inclusive of reporting, stress-testing and minimum liquid asset buffers to cover several scenarios and wide ranging market disruptions. The UK government also set up an Independent Commission on Banking to review the need for structural and non-structural reforms to increase the stability and resilience of the UK banking sector. The outcome, the Vickers report, recommends the segregation of retail and investment banking activities. Whilst it does not require full structural separation, it identifies the need for the EEA market retail and SME businesses to operate separately, at arm's-length from the rest of the bank and the need to be capitalised separately and have their independent boards. The aim of this ring-fencing is to address the issues particularly relevant to the business models of the biggest UK banks with substantial retail and wholesale banking operations in the run up to the crisis.

Banking Sectors in the US and Switzerland

The US banking sector is unique compared to that of most other countries. A key distinction of the US banking sector is the lack of a nationwide branch network of commercial banks. Only a few of the largest US banks cover a large proportion of the 50 states and thus businesses operating nationally require a multitude of banking relationships. According to Wharton (2011), the consolidation process will continue and weaker banks will go through mergers and acquisitions, whilst stronger banks are expected to shore up their capital bases and competitive positions. It is also expected that the current US regulatory initiatives (Dodd-Frank and Consumer Protection Act) hit the small community banks hardest when the controls involving capital, liquidity and leverage are implemented.

Although the six biggest US banks (JP Morgan Chase, Goldman Sachs, Bank of America, Citigroup, Morgan Staley and Wells Fargo) have only 35% share of all deposits and 53% share of the assets, the systemic risk they pose lies in their trading revenues. In 2010 the four biggest banks' trading revenues ($56.1 billion) was 93% of all trading revenues by all banks and 74% of their income. The risk in this level of concentration is that the big banks have become increasingly inter-connected and a failure of any of them would have severe consequences to the others. This characteristic is not shared with the EU banking sector and thus similar restrictions will impact certain banking models in the EU

disproportionately. This has already been evidenced in the US, where small community banks will be given exemptions.

Somewhat similarly to the US, the too big to fail (TBTF) issue is particularly pronounced in Switzerland with high banking assets to GDP ratio and two resident G-SIBs (Credit Suisse and UBS). Although the "big two" have reduced their balance sheets substantially, particularly outside their home market, their share of the domestic market remains high and thus their systemic importance is maintained in Switzerland. To directly address the intrinsic problem of hosting two G-SIB banks in a relatively small country, the Swiss government's Too Big To Fail Commission set significantly higher capital requirements for the "big two" than the Basel III proposes. UBS and Credit Suisse are to hold minimum 10% of risk-weighted assets in common equity and additional 9%, which can be contingent convertible bonds (CoCo), taking the total capital requirement to 19%. This is a development, which, similarly to the regulations in the US, stem from national requirement to address risks particular to the local banking sector.

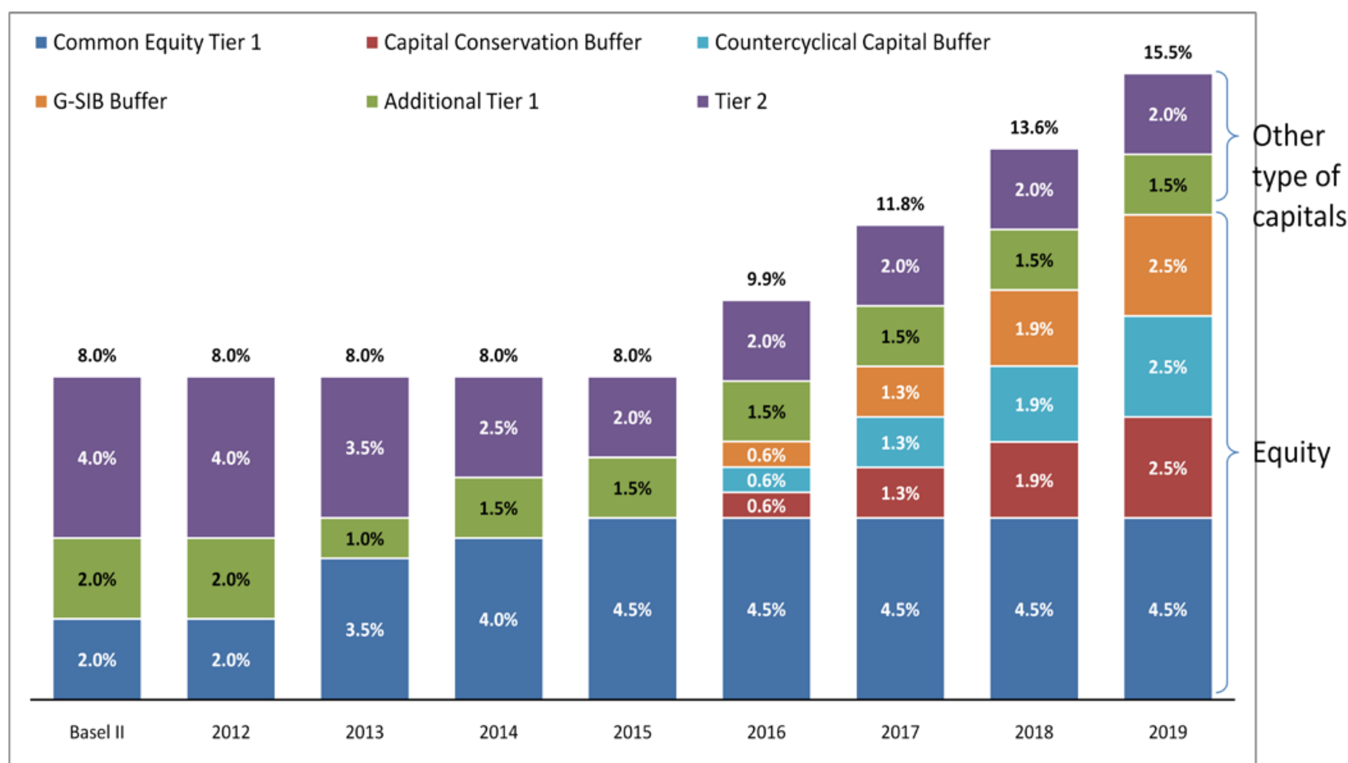
Annex III: Regulatory Reforms

In this annex we describe the regulatory reforms underway or complete.

Capital

Regulatory reforms and market expectations have both led to banks holding more capital and particularly more Common Equity Tier 1 (CET1) capital, the most loss-absorbing form of capital. Before the financial crisis banks were required to hold as a regulatory minimum 2% of their Risk-Weighted Assets (RWA) amount in CET1. This figure has now increased significantly – a bank will have to hold at least 7% CET1 (4.5% minimum CET1 and a 2.5% capital conservation buffer under Basel III). On top of this a bank may have to hold up to 2.5% CET1 as a countercyclical capital buffer and a bank designated as a G-SIB (Global Systemically Important Bank) will have to hold up to an additional 2.5% CET1 as a G-SIB buffer under international accords. Cumulatively a bank could therefore face a minimum regulatory requirement for CET1 of 12%. Though banks are not likely to face the maximum of all buffers the loss absorbency in banks' regulatory CET1 has increased by at least a factor of three and up to a factor six times since before the crisis (see the chart below).

Chart 1: Minimum Capital Requirements and Buffers Implementation Timetable



Note: This chart is for illustration purposes only and assumes the maximum amount for each buffer. In reality the amount required per firm will most-likely be less due to countercyclical and G-SIB buffers likely being less than 2.5% from 2019.

As well as the regulatory minimum for CET1 under international accords described above banks will hold additional CET1 as a 'buffer' over the minimum, as well as other forms of loss-absorbing capital.

Banks will also face supervisory requirements to hold additional capital (so-called Pillar 2 add-ons) and possible national level minimum capital requirements that are above the internationally-agreed minimum. Banks will also issue Additional Tier 1 (AT1) and Tier 2 (T2) capital that is written down or converted into CET1 upon trigger events – such as the CET1 falling below a certain level. On top of this certain liabilities of a bank will be subject to write-down or bail-in in the case of a bank's failure.

All of the measures described above will act to significantly increase the loss absorbency in banks and in the banking system, decreasing both the probability of failure and the losses associated with failure. They also will require banks to raise their capital ratios, which can either be done by increasing capital (e.g. by retaining earnings or raising fresh capital from the market) or by decreasing assets (e.g. by not renewing loan facilities as they are repaid or by selling asset portfolios). The estimates of the scale of the actions needed to achieve the new ratios vary. The Basel Committee estimates that 103 of the largest banks globally with need to raise €486bn. However, other estimates are higher, including from Fitch, which estimates that the 29 largest banks (the Global Systemically Important Banks, or G-SIBs) alone will have to raise $566bn in capital or sell $5.5tn in assets. As well as raising capital or delevering in order to meet new capital requirements there will be some business lines where the new capital requirements will decrease bank profitability such that banks will either have to increase their returns from such business lines or where that is not possible to exit the business and allow it be taken up by non-bank financial institutions.

It is clear that the scale of capital raising and the increases in capital requirements will decrease the footprint of the banking sector in the economy. This will have knock-on implications for the competitive provision of financial services to end users and decrease the amount of bank credit available. This will be taken up by non-bank financial entities but there will be a transition period before the markets and capital to facilitate such activity emerges. Thus, there is a risk of a credit-tightening to the economy. The Basel Committee (2010) has estimated the impact of changes in capital levels on the probability of the occurrence of a systemic banking crisis. Its results show that the incremental benefit of higher capital and liquidity requirements decline as the system becomes better capitalised, thus arguing that the benefits of tighter standards plateau. This needs to be considered against the potential costs.

The deleveraging in the European banking sector, some of which can be attributed to the regulatory changes, is already evident. Barclays Research estimates indicate that for 32 of the largest European banks the average leverage ratio has decreased from 37 times in 2007 to 25 times in 2011.

Risk-Weighted Assets

Risk-Weighted Assets (RWAs) have also been the subject reforms. So as well as the headline capital levels increasing (discussed above), the RWA figure to which the capital percentage is applied has also been addressed. In Europe these were largely applied under CRD III and CRD IV.

First, CRD III implemented increased risk weights for positions in the trading book, particularly introducing stressed Value at Risk (VaR) and an incremental risk charge (IRC). Both stressed VaR and the IRC seek to take a more conservative approach to market risk and have led to significant increases in the market risk RWAs.

Second, CRD III also drastically increased the capital requirements for re-securitisations. Re-securitisation positions are now risk-weighted at 1250% – effectively requiring a bank to hold 100% capital against such exposures.

Third, CRD IV has introduced additional capital requirements for counterparty credit risk (CCR) which will add to a bank's RWA. CCR covers the risk of the deterioration in the creditworthiness of a counterparty to a derivative or securities financing transaction. Even though a counterparty has not defaulted a decrease in the creditworthiness of a counterparty can cause a loss for a bank.

Fourth, banks' exposures to the default funds of central counterparties will now attract capital requirements.

On top of these changes the Basel Committee is carrying out a review of RWA consistency to ensure the Basel rules are being implemented in a similar manner across banks and jurisdictions. This task is being carried out by two separate groups, one for each of the banking book and the trading book, which will use onsite reviews of banks and hypothetical portfolio exercises, amongst other tools. The outcome of the work will identify any areas of material inconsistencies in RWA calculation and may include policy recommendations to increase consistency. The review will increase the confidence with which RWAs can be calculated and give more confidence in the stability of the sector.

Liquidity

Liquidity has also been the focus of reforms, with a first ever global agreement on the approach to regulating bank liquidity included in Basel III. Basel III introduces a Liquidity Coverage Ratio (LCR), which addresses liquidity risk at a 30-day horizon, and a Net Stable Funding Ratio (NSFR), which uses a one-year horizon and aims to ensure stability in the funding models of banks.

Though there is still a significant amount of work to be completed to ensure the liquidity rules (both the LCR and NSFR) are properly designed and calibrated the approach in Basel III provides a basis for supervisors to have a strong dialogue with banks about their liquidity management. The focus on liquidity will ensure that supervisors and the markets are more comforted about the ability of banks to withstand shocks and periods of idiosyncratic risk. This will add to the stability of the system and will decrease the probability of a bank failing.

Reform of the Trading Book

The Basel Committee is undertaking a major review of the framework for market risk, called the Fundamental Review of the Trading Book. In the review, currently in the consultative phase, the Basel Committee makes proposals for a number of specific measures to improve trading book capital requirements, including:

- Defining the boundary between the trading book and the banking book to reduce the scope for regulatory arbitrage
- Moving from VaR to an 'expected shortfall' approach
- Calibrating the approach for a period of significant financial stress, consistent with the stressed VaR approach mentioned above
- Incorporating the risk of market illiquidity into the framework
- Reducing model risk in the internal models-based approach

- Revising the standardised approach to be more risk-sensitive
- Strengthening the relationship between the models-based and standardised approaches

While it is too early to forecast the outcome of this major review by the Basel Committee it will certainly lead to a more refined approach to the risks carried a bank's trading book and provides policy-makers with the opportunity to address any existing deficiencies. The relevance of this for the review of the High Level Expert Group should not be underestimated. By giving policy-makers a blank page to address risk in the trading book the Fundamental Review of the Trading Book should address many of the presumed concerns about bank activities that may be used to justify structural separation or activity restrictions.

Enhanced Supervision

One of the outcomes of the financial crisis has been a renewed focus on stronger supervision of financial sector entities. This encompasses various formal aspects, where structures have been put in place for stronger supervision, and informal aspects, where supervisors have increased their vigilance and enquiry across a range of existing regulatory powers (e.g. a heightened monitoring of liquidity positions). The Basel Committee consulted in December 2011 on principles for effective banking supervision.

Structures for the supervision of cross-border banking groups were put in place under CRD II. Colleges of supervisors were established for banks operating in more than one member state to enable better sharing of intelligence and to provide a clearer definition of the rights and responsibilities for home and host supervisors. The colleges should contribute to a convergence in supervisory approach and a deeper understanding of the risks across a cross-border banking group.

The Basel Committee has set up a system of peer reviews to ensure compliance of national implementations with the minimum requirements. The peer reviews will extend to entity-level implementation to ensure a consistent supervisory outcome across jurisdictions. Deficiencies will be identified and assessed for their impact on the international level playing-field.

New data requirements for G-SIBs will ensure that supervisors have access to detailed information on the exposures of each G-SIB. This will help supervisors assess the risks for each G-SIB, as well as improving the information about the inter-linkages between institutions.

All of these measures will strengthen the supervision of the banking sector as a complement to the enhanced regulatory standards described in this section. Parallel to this enhanced micro-level supervision is enhanced macro-supervision of the financial system. The creation of the European Systemic Risk Board and the enhancement of the Financial Stability Board (FSB) at global level will address emerging risks and enhance systemic stability.

Stress Testing

Supervisors globally have carried out stress-tests over the period of the crisis to ensure the banking sector can withstand various adverse scenarios. These have been carried out both at national level and also coordinated at European level by the EBA and have focussed on both capital and liquidity. A considerable amount of effort has been invested in this supervisory tool by both supervisors and the industry.

Resolution

The introduction of resolution regimes is a cornerstone of the reform of financial regulation. Whereas many of the reforms outlined in this section reduce the probability of default resolution regimes address the impact of default.

While some national authorities have introduced resolution requirements, at a global level the FSB's publication in October 2011 of 'Key Attributes of Effective Resolution Regimes for Financial Institutions' was an important step forward toward the adoption of harmonised G-SIB resolution regimes in key national jurisdictions. The final paper embodies principles and attributes that are critical to workable regimes for orderly resolution, including an alternative resolution regime for G-SIBs that would, among other things: facilitate recapitalisation and bail-in; allow for speedy resolution of creditor claims; facilitate access to temporary government liquidity funding, without exposing taxpayers to loss; and establish a legal and contractual framework for cross-border cooperation in resolving cross-border G-SIBs. A proposal for an EU bank recovery and resolution directive is expected imminently to implement these requirements in Europe.

The G20 has mandated that G-SIBs be required to have in place by the end of 2012 a Recovery and Resolution Plan (RRP) that will provide a strategic roadmap for authorities to unwind the firm. Each G-SIB will have a Crisis Management Group (CMG) comprising the home regulatory authority and key host authorities and will be built on the colleges of supervisors put in place to enhance supervision of cross-border banks.

The RRP will be a priority within G-SIBs, with a board level representative of each firm required to keep the RRP up-to-date and coordinate its annual review and resolvability assessment by the firm's CMG under its cross-border cooperation agreement. Institution-specific cross-border cooperation agreements must be put in place by authorities by the end of 2012.

The resolvability assessment is a key part of the recovery and resolution regime. The resolvability assessment is co-ordinated within a firm's CMG and evaluates the feasibility and credibility of a group's resolution strategies. It considers in particular: the continuing functioning of critical financial services and payment, clearing and settlement functions; intra-group exposures and their impact if they are unwound; the capacity of the firm to deliver information to support the resolution, and; the robustness of cross-border cooperation and information sharing arrangements.

Supervisory or resolution authorities will have the power to require banks to make changes (e.g. to business practices, structure, or organisation) to improve resolvability, considering both cost and complexity. The authorities will also be able to require certain systemically important functions to be segregated in legally and operationally independent entities to shield them from problems elsewhere in the group.

The ability of supervisory or resolution authorities to require certain systemically important functions to be segregated in legally and operationally independent entities is very relevant to the work of the HLEG. The resolvability assessments carried out by the host authority in coordination with a firm's CMG represent a tailored approach to addressing many of the same objectives in the mandate of the Expert Group. The unique characteristics of each firm's business model, organisation, and structure

can be taken account of to ensure a structural solution that will make resolution a credible option, reducing the impact of the failure of a bank and thereby reducing the risk in the system as a whole. A tailored approach will take into account the subtleties of each jurisdiction and organisation to ensure the solution is appropriate for the circumstances. AFME recommends that this tailored approach be embraced and implemented.

Market Infrastructure

Market infrastructures were identified as a potential weakness since the onset of the financial crisis. Thus, measures are being put in place to ensure a more robust financial system. The G20 has committed to ensure that all standardised OTC derivative contracts are cleared through central counterparties by the end of 2012. In the EU this commitment is being implemented through the European Market Infrastructure Regulation, or EMIR. OTC derivative contracts will have to be reported to trade repositories, giving supervisors the information to determine the connections between market participants in their assessments of systemic risk.

Another initiative that will create a step-change in the ability of supervisors and market participants to measure and monitor risk is the Legal Entity Identifier (LEI) initiative. The initiative will create a unique ID associated with a single legal entity, allowing for consistent identification of parties to financial transactions. A global, standardised LEI will enable organisations to more effectively measure and manage counterparty exposure, while providing substantial operational efficiencies and customer service improvements to the industry. Through a coordinated initiative between GFMA (to which AFME is affiliated) and other trade associations, the industry has been working to develop a global, consensus-based LEI solution.

Other Changes

A number of other changes have been made to improve the robustness of the financial system, including:

- Large exposures: Tightening under CRD II the treatment in the large exposures regime, including for exposures to other banks
- Securitisation: Requiring under CRD II risk retention for securitisation originators and due diligence by investing firms, while increasing securitisation disclosure under CRD III
- Remuneration: Introducing under CRD III remuneration rules aimed at aligning incentives with appropriate risk-taking
- Disclosure: The level of banks' financial and risk disclosure to the market has increased substantially and is set to increase again following recent consideration by the Basel Committee of requirements to disclose the components of a bank's own funds

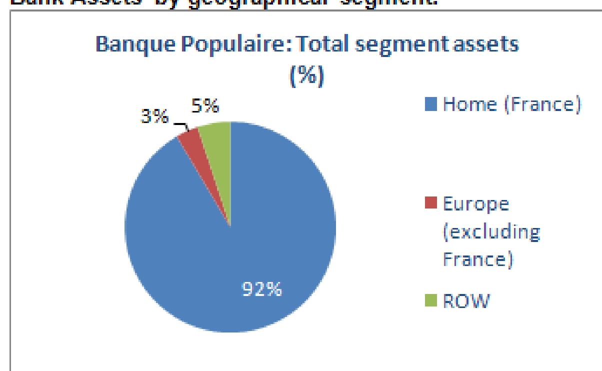
Annex IV: G-SIB Geographical and Income Data

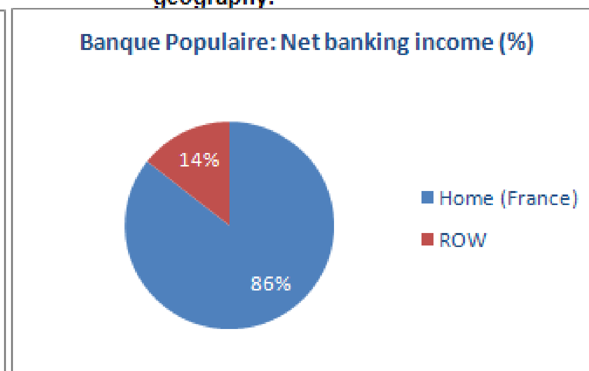
The sample is inclusive of European and American G-SIBs. Sources are mainly drawn from published annual reports.

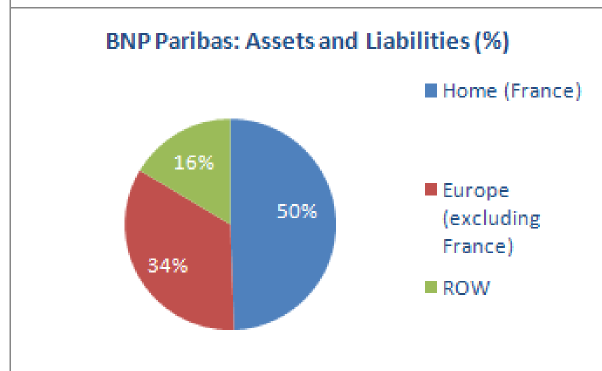
Geographical Data:

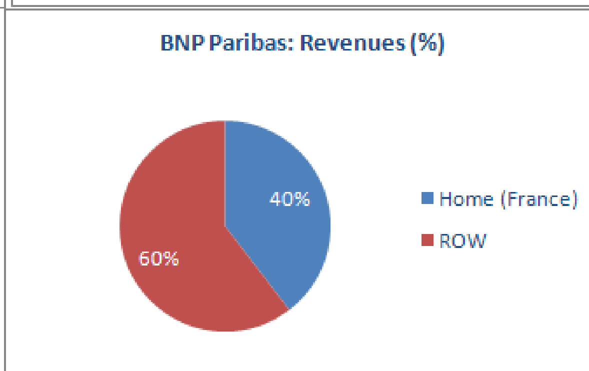
Bank Assets by geographical segment:

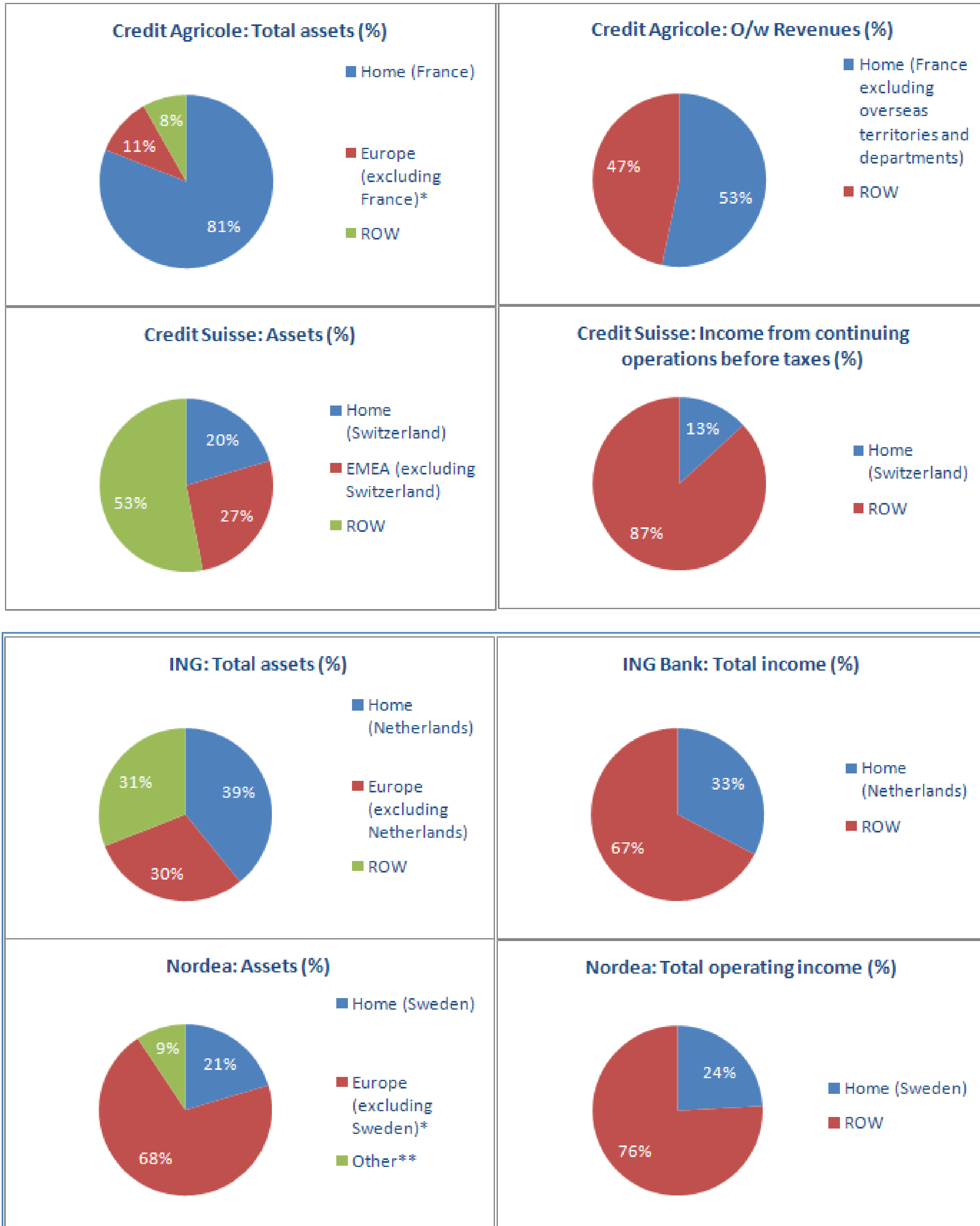
Bank income/ revenue by geography:











Credit Agricole: Total assets (%)
8%
11%
81%
Home (France)
Europe (excluding France)*
ROW
Credit Agricole: O/w Revenues (%)
47%
53%
Home (France excluding overseas territories and departments)
ROW
Credit Suisse: Assets (%)
20%
53%
27%
Home (Switzerland)
EMEA (excluding Switzerland)
ROW
Credit Suisse: Income from continuing operations before taxes (%)
13%
87%
Home (Switzerland)
ROW
ING: Total assets (%)
31%
39%
30%
Home (Netherlands)
Europe (excluding Netherlands)
ROW
ING Bank: Total income (%)
33%
67%
Home (Netherlands)
ROW
Nordea: Assets (%)
9%
21%
68%
Home (Sweden)
Europe (excluding Sweden)*
Other**
Nordea: Total operating income (%)
24%
76%
Home (Sweden)
ROW

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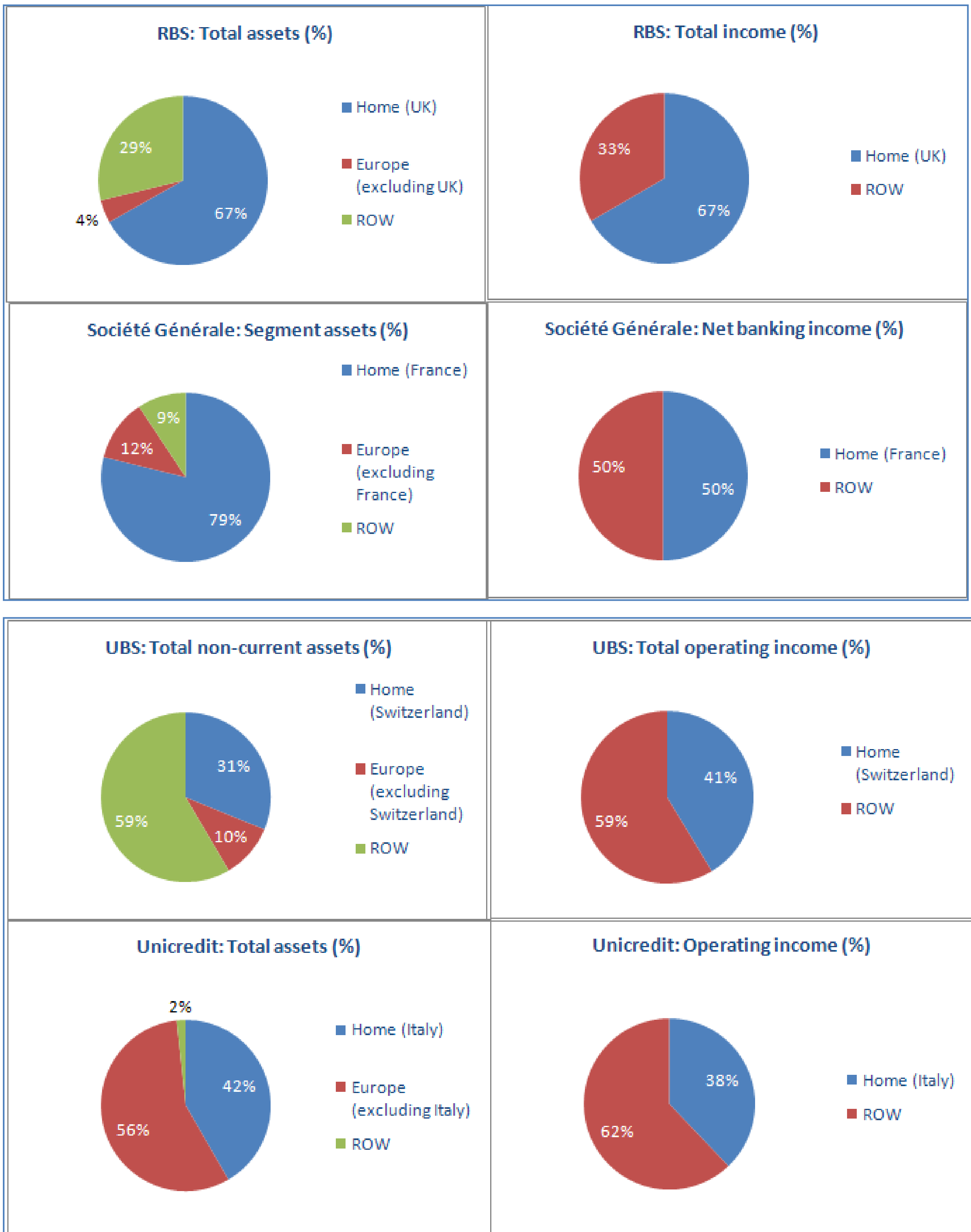

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Income data:

Citigroup		
Net income/loss ($m)	2007	2011
Global Consumer	7,868	6,196
Markets and Banking - Securities and Banking	-7,604	4,895
Markets and Banking - Transaction Services	2,215	3,407
Markets and Banking - Other	136	-
Global Wealth Management	1,974	-
Alternative Investments	672	-
Corporate / Other	-1,644	-871
Brokerage and Asset Management	-	-286
Local Consumer Lending	-	-2,834
Special Asset Pool	-	596
Total	*3,617*	*11,103*

Commerzbank		
Pre-tax profit (€m)	2007	2011
Private and Business Customers	401	47
Mittelstandsbank	1,252	1,598
Corporates & Markets	15	786
Commercial Real Estate	447	-
Public Finance and Treasury	-90	-
Others and Consolidation	480	-505
Central & Eastern Europe	-	53
Asset based finance	-	-1,301
Portfolio restructuring unit	-	675
Total	*2,505*	*1,353*

Credit Agricole		
Pre-tax income (€m)	2007	2011
French Retail Banking - Regional Banks	865	1,008
French Retail Banking - LCL	831	1,040
International Retail Banking	815	-2,419
Specialised Financial Services	945	343
Asset Management, Insurance and Private Banking	2,730	1,670
Corporate and Investment Banking	-1,579	229
Proprietary Asset Management and other activities / Corporate centre	210	-2,057
Total	*4,817*	*-186*

HSBC		
Profit before tax ($m)	2007	2011
Personal Financial Services/ Retail Banking and Wealth Management	5,900	4,270
Commercial banking	7,145	7,947
Global Banking & Markets	6,121	7,049
Private banking	1,511	944
Other	3,535	1,662
Total	*24,212*	*21,872*

JPMorgan Chase		
Net income/loss ($m)	2007	2011
Investment Bank	3,139	6,789
Retail Financial Services	3,035	1,678
Card Services / Card Services & Auto	2,919	4,544
Commercial Banking	1,134	2,367
Treasury & Securities Services	1,397	1,204
Asset Management	1,966	1,592
Corporate/ Private Equity	1,775	802
Total	*15,365*	*18,976*

Société Générale		
Gross operating income (€m)	2007	2011
French Networks	2,492	2,917
International Retail Banking	1,458	2,029
Financial Services/ Specialised Financial Services and Insurance	1,312	1,597
Global investment Management & Services	1,033	202
Corporate & Investment Banking	1,097	1,232
Corporate Centre	226	623
Total	*7,618*	*8,600*

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Lloyds Banking Group		
Profit (loss) before tax (£m)	2007	2011
UK Retail Banking	1,732	-
Insurance and Investments	828	-
Wholesale and International Banking	1,822	-
Central group items	-382	-
	2007	2011
Retail	-	3,636
Wholesale	-	828
Commercial	-	499
Wealth and International	-	-3,936
Insurance	-	1,422
Other	-	236
Total	*4,000*	*2,685*

Barclays		
Profit before tax (£m)	2007	2011
UK Banking		
UK Retail Banking	1,282	1,020
Barclays Commercial Bank	1,371	-
Barclaycard	540	561
International Retail and Commercial Banking - Excluding Absa	246	-
International Retail and Commercial Banking - Absa	689	-
Barclays Capital	2,335	2,965
Barclays Global Investors	734	-
Barclays Wealth	307	207
Head office functions and other operations	-428	2,709
	-	-
Europe RBB	-	-661
Africa RBB	-	910
Barclays Corporate	-	-70
Investment Management	-	-1,762
Total	*7,076*	*5,879*

BNP Paribas		
Pre-tax net income (€m)	2007	2011
French Retail Banking	1,752	1,942
BNL banca commerciale	566	502
IRFS	2,275	-
AMS	1,980	-
Corporate and Investment Banking - Advisory & Capital Markets	2,018	1,272
Corporate and Investment Banking - Financing	1,559	2,338
Other Activities	908	- 1,419
Belux Retail Banking	-	819
Personal Finance	-	1,193
Other retail banking activities	-	1,431
Investment Solutions	-	1,573
Total	*11,058*	*9,651*