European Banking Federation

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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

Response from the European Banking Federation on the final report from the High-level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen

EBF has actively engaged with the work of the High-level Expert Group (HLEG) on reforming the structure of the EU banking sector chaired by Erkki Liikanen since its establishment in February 2012 and has responded constructively to the consultation issued by the HLEG 3 May this year[1] and developed a study on possible structural reform, forwarded to the HLEG in June 2012[2]. Therefore, EBF welcomes the possibility to give our input to the final report from the HLEG.

1. Key points

- The EBF salutes the very thorough and considered analysis conducted by the HLEG which acknowledges that no particular business model was more or less vulnerable in the crisis, that the benefits of the universal banking model should be retained, that the Single Market should remain intact and that the regulatory reform agenda represents a substantive and robust response to addressing the deficiencies made apparent during the financial crisis. This analysis aligns well with the analysis made by the EBF in our study on the need for possible structural reforms[3].

- Given this analysis the final recommendations of the HLEG calling for mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold are open to legitimate challenge. EBF contends that a compelling case for mandatory separation has not been made in the report.

[1] http://www.ebf-fbe.eu/uploads/D0893C-2012-EBF%20response%20to%20the%20Consultation%20by%20the%20Liikanen%20High-level%20Expert%20Group%20on%20possible%20reforms%20to%20the%20structure%20of%20the%20EU%20banking%20sector.pdf

[2] http://www.ebf-fbe.eu/uploads/EBF%20study%20on%20the%20issue%20of%20possible%20reforms%20to%20the%20structure%20of%20the%20EU%20banking%20sector.pdf

[3] See footnote 2.

- In addition, in EBF's view the recommendation for mandatory separation is very general in nature; it does not adequately address the riskiness of assets; it does not solve the issue of systemic risk; it has distortive effects upon bank functions of vital importance to customers and the European economy; it will impact negatively on banks' ability to lend to the economy; it will reduce diversification benefits of the universal banking model, it will reduce the competitiveness of the European financial sector compared to financial sectors not affected by this recommendation, and it will lead to a further fragmentation of the Single Market.

- Instead of the proposed mandatory separation, EBF supports the HLEG recommendation to strengthen further the use of Recovery and Resolution Plans (RRPs) as proposed in avenue 1, as it fits better with the current regulatory reform agenda and can be incorporated with considerable less distortive impact than mandatory separation. By (only) pointing at the possibility of mandatory legal separation however, the HLEG creates the risk that resolution authorities skip the less far reaching and more proportionate measures and resort to the ultimate and far more damaging measure of mandatory legal separation. The EBF therefore recommends that any impediments to resolvability are addressed along the lines of the better balanced provisions of the European Commission's proposal for a Bank Recovery and Resolution Directive (BRRD).
- The effective use of RRPs must be seen in the context of a well-functioning crisis management framework in concurrence with the BRRD proposal and should be based on an ongoing dialogue between the supervisor and the individual bank. Separation of certain activities conditional on the RRP should be the last resort, the supervisor should not impose structural measures on banks that are going concern and banks should have legal recourse to such supervisory decisions.
- The HLEG does not address the potential economic consequences of implementing the proposed mandatory separation of trading activities. However, mandatory separation of trading activities would lead to higher costs that would hit bank customers in particular. Hence, EBF calls for an impact assessment of any legislative proposals.

- EBF is yet to be convinced of the use of a designated bail-in category as recommended by the HLEG set against the proposition put forward in the BRRD proposal that a broad range of instruments should be eligible for bail-in within a statutory regime.

- EBF would argue that the introduction of floors for risk weights and hence also the recommended floor for the trading book constitutes a significant threat to risk modeling and to the principle of calibrating capital requirements according to actual risks. EBF is involved in an ongoing dialogue with policymakers to improve the internal models of banks.

- In regard to the recommendation for an extra non-risk based capital buffer for the trading book on top of the risk-based requirements (Basel II.5 and Basel III) EBF finds that any additional steps in this direction should await the finalisation of the review of the trading book and take into account the buffers already proposed in the CRD IV/CRR. The same goes for the HLEG recommendation for introducing LTV/LTI caps for real estate related lending: CRD IV/CRR already gives national supervisors a number of tools to address macro-prudential risks.

2. General consideration of the final report from the HLEG.

In EBF's view the final report is a very good analysis of the causes of the crisis and a thorough review of the European banking sector and the progress of the regulatory reform agenda. EBF agrees with the overall conclusions of the report which point out that business models were not a primary driver in the financial crisis, recognises the benefits of the universal banking model, acknowledges that regulatory reforms have come a long way and emphasizes that the Single Market should remain intact.

This analysis notwithstanding, the HLEG ends up recommending mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold. EBF does not support this recommendation. In EBF's view it is not consistent with the main conclusions of the analysis presented in the report. In addition, it is very general in nature; it does not adequately address the riskiness of assets; it does not solve the issue of systemic risk identified as a main concern by the HLEG; it has a distortive effect upon banks' functions of vital importance to customers and the European economy (notably, the recommendation does not appear to be based on any analysis or study on the viability of the separated entity); it will impact negatively on banks' ability to lend to the economy; it will reduce diversification benefits of the universal banking model, it will reduce the competitiveness of the European financial sector compared to financial sector not affected by this recommendation, and it will lead to a further fragmentation of the Single Market.

Furthermore, even though the HLEG acknowledges the aims and achievements of the current regulatory reform agenda, the HLEG in the recommendations 5.5.2 - 5.5.5 in the report proposes to add further regulatory reform measures along the same lines, for example on governance and capital requirements. Whilst EBF can see merit in giving further consideration to some of the recommendations and in particular supports the recommendation to strengthen the use of RRPs, EBF would however like to reiterate our message put forward in our response to the HLEG consultation issued in May this year: many regulatory reform measures, of considerable impact, are still 'on the table' and the final outcomes of those remain to be fully assessed and evaluated, including the impact thereof on the European banking sector. Furthermore, the proposal for a Banking Union - which EBF supports[4] - represents a paradigm shift against which the current reform agenda needs to be analysed and fully absorbed. Therefore, EBF considers it necessary to finalise the current regulatory reform agenda and consider its aggregate impact on the functioning of the European banking sector and the European economy before considering further action as proposed in the HLEG recommendations 5.5.3-5.5.5.

3. The recommendations

Below EBF will give its views on each of the recommendations put forward in the final report of the HLEG.

3.1. Recommendations 5.5.1 and 5.5.2

In *recommendation 5.5.1* the HLEG recommends mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold. EBF understands that as a

[4] http://www.ebf-fbe.eu/uploads/D1794D-2012-Final%20EBF%20position%20on%20a%20Single%20Supervisory%20Mechanism%20(SSM).pdf

first rough “test” all banks that have assets held for trading and available for sale (AFS), as currently defined, exceeding a threshold of 15-25 % of the bank’s total assets or a threshold of EUR 100bn will proceed to a second stage. At the second stage the banks’ trading activities will be more closely scrutinised on the basis of a threshold which the European Commission is to calibrate and following this examination the supervisor will determine the share of trading activities to be separated.

Furthermore, *recommendation 5.5.2* proposes that conditional on the RRP the scope of activities to be separated into a separate trading entity can be wider than under the mandatory separation. According to the HLEG in the RRP a bank should also be able to demonstrate its ability to segregate retail banking activities from trading activities and to wind down trading risk positions without impacting on the financial health of the bank or contribute to systemic risk. If the supervisor, based on harmonised assessment standards, does not find that the bank can adequately prove its resolvability for trading activities which are not already subject to mandatory separation, it can ask for those activities to be separated as well.

3.1.1. EBF assessment

Mandatory separation <u>and</u> possible additional separation will impact EU banks negatively...

As was stated above, EBF does not support mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold. Furthermore, EBF does not support the proposed combination of mandatory separation *and additionally* possible further separation of trading activities conditional upon the RRP. In EBF’s view this combination is not consistent with the two avenues outlined in the report. The HLEG pointed to *either* Avenue 1 which proposes separation of trading activities conditional on the firm-specific RRP and an additional non-risk weighted capital buffer for banks with significant trading activity *or* Avenue 2 which proposes immediate/mandatory separation of trading activities over a certain threshold for all banks without a prior supervisory evaluation of RRPs and a similar additional non-risk weighted capital buffer for trading activities as in avenue 1. Nevertheless, *the HLEG ends up proposing both*, i.e. both mandatory separation of trading activities over a certain threshold <u>and</u> the use of the RRPs to demand additional separation of trading activities. This combination will have even more far-reaching consequences than the proposed mandatory separation in itself and should in EBF’s view not be chosen.

… But strengthened RRPs are an important part of the solution to enhance resolvability

This being said, EBF supports the emphasis on further strengthening of RRPs as proposed in avenue 1. In EBF’s response to the first consultation of the HLEG EBF already pointed out that the strengthening of the RRP is an important tool to enhance the resolvability of banks without the detrimental side-effects upon the functioning of the Single Market and banks’ ability to serve the wider economy that functional separation entail. Strengthened RRPs should be viewed within the context of an overall crisis management framework along the lines of the European Commission’s BRRD proposal. However, it should be emphasized that the RRP is a preventive and dynamic tool subject to a close and ongoing dialogue between the individual bank and its supervisory authority and hence any recommendation for separation of trading activities conditional upon the individual bank's RRP should be seen as a last resort, where the two parties in their dialogue have not found other solutions to enhance the resolvability of the bank. Supervisors should not be able to take structural measures within banks that are going concern and banks should have the ability to establish legal recourse, with a suspensive condition, against a possible supervisory decision proposing separation.

3.1.2. Why mandatory separation will not work

In this section EBF explains why mandatory separation would be highly detrimental to the EU banking sector, the Single Market and the EU economy – and hence why EBF cannot support the recommendation for mandatory separation as proposed by the HLEG.

The broad scope will have distortive effects on vital functions for customers and the economy

Overall the recommendation for mandatory separation of proprietary trading activities and other significant trading activities over a certain threshold is based on the assumption that it will be difficult to separate pure proprietary trading activities from those linked to market making activities. Hence the conclusion is that, facing such an obstacle, it is easier to recommend a separation of a broad (pure proprietary trading activities but also all other market making activities) scope of the banking business. This recommendation then tries to circumvent one problem but at the same time it creates many new problems.

In EBF's view the proposed criteria for making a first selection based on banks' assets held for trading and available for sale (AFS) is very broad. This approach does not adequately take into account the level of risk of the different assets within the trading book and the AFS category and/or to what extent the risk of an asset is off-set - entirely or partially - by a corresponding hedge. As a consequence of this broad scope many banks would be perceived as having potentially risky trading positions and therefore would proceed to the second examination stage where the calibration of the final threshold is not yet known. In other words, a number of banks would become under scrutiny for "risky trading activities", although the "riskiness" of their assets does not necessarily justify this.

A further disadvantage of the broad scope is that the 27 member states represent great heterogeneity of business models. Thus, making a "one size fits all" solution for all EU member states will inevitably affect local business models that continued to perform well during the crisis. A simple comparison of the accounting measure "assets held for trading and AFS" between European financial institutions is thus too simplistic as different financial systems produce different outcomes.

- One example of the distortive effects of the proposed broad threshold is for banks that hold a large amount of sovereign bonds as part of their AFS portfolio. Usually sovereign bonds are not high-risk assets with a clear speculative purpose but nevertheless they could end up being separated from the deposit bank. Moreover, a very significant part of those sovereign bonds are used for hedging purposes in the framework of asset liability management (ALM). In this sense it is important to take into account that the AFS category is a residual category as it is defined under IAS 39 (currently under reviewing*) "available-for-sale financial assets are those non-derivative financial assets that are designated as available for sale or* ***are not*** *classified as (a) loans and receivables, (b) held to maturity investments or (c) financial assets at fair value through profit or loss.*

- Furthermore, in order to comply with Basel III/CRD IV/CRR liquidity requirements (LCR) banks will have to hold a certain amount of high quality assets in order to maintain sufficient levels of liquidity to be able to withstand situations of liquidity stress. These assets, which are by virtue of legislation low risk assets - for example covered bonds and sovereign bonds - will also come into consideration for possible separation, as they are often placed in the AFS category (partly due to the current strict criteria for assets to be placed in the held-to-maturity (HTM) category).
- Moreover, the HLEG categorises market-making as a trading activity to be separated. Market-making is not a speculative, high-risk activity which needs to be separated but an essential service that banks perform for corporate customers and governments and hence a service that proves useful to the economy, investment and employment. Separation of market-making activities could reduce the capacity to provide liquidity in for example government, covered and corporate bonds.
- Also, in this context, shares of banks/insurances held for structural organisation of the financial group should not be perceived as highly risky activities.

The uncertainty that such low-risk assets could come into consideration for separation could have the distortive impact that the demand for government bonds would drop leading to increased financial instability within Europe. Furthermore, it would also be damaging to the liquidity function of the deposit bank and to the centralized liquidity risk management of the group if these assets were to be separated. Hence, the proposed threshold creates considerable uncertainty among banks as to the future treatment of a broad range of assets. It is crucial that banks can get legal certainty as to how and/or whether their business will be impacted by future regulation - especially in the current context with many far-reaching and on-going regulatory reforms of which the end-result is not known by European banks.

On the basis of the aforementioned points EBF does not support the recommendation for mandatory separation. Instead, a solution that targets high-risk and speculative trading activities - i.e. the sole proprietary trading activities with no link to clients' needs and dedicated only to increase the revenues of the bank - should be pursued; and by other means than mandatory separation. One example could be the enhanced use of RRPs as mentioned. In order to ensure a level playing field in this regard EBA could have a decisive role in defining high-risk and speculative trading activities.

Furthermore, it is EBF's general view that the transactions (loans, derivatives, etc.) entered into with EU-regulated investment funds should not be seen as high-risk activities. EU-regulated investment funds are those covered by the Directives UCITS and the by the Directive on Alternative Investment Fund Managers (the AIFMD). In the report the HLEG categorises exposures to regulated money market (UCITS) funds as being less risky and hence permitted in the deposit bank. In EBF's view all UCITS investment funds should be categorised as less risky activities and not only UCITS money market funds. Furthermore, EBF finds that it is important to distinguish between EU-regulated and unregulated hedge funds when determining riskiness of hedge fund activities. The HLEG perceives unsecured credit exposures to hedge funds as high-risk activities and hence recommends assigning those activities to the trading entity. Again, EBF finds that a distinction should be made between EU-regulated and unregulated hedge funds. Therefore, exposures to funds falling within the scope of the Directive on Alternative Investment Fund Managers (the AIFMD) should not be perceived as risky or speculative activities for which extra measures needs to be undertaken.

The recommendation for a separate trading entity is not viable

The HLEG does not address the issue of the future viability of the proposed separate trading entity. However, there is the very likely risk that trading activities separated into the independent trading entity would be downgraded by credit rating agencies. This could weaken the funding possibilities of the entity in the market. The result of the downgrading of the newly created subsidiaries will be that some market activities will not be viable in Europe and that clients won't be able to find the service they need at a reasonable price. A likely scenario is that non-EU banks could substitute European banks in providing those financial services not permitted under the "deposit bank" to European corporates and public authorities. Another risk is that the biggest players in the markets will increase their market share due to the decision of the smaller players to exit from trading activities.

Separation will considerably raise banks' costs affecting their ability to lend to the real economy

It is proposed that the deposit bank and the trading entity will have to maintain separate ring-fenced capital - including buffers and pillar II requirements; they must fund themselves separately and meet other prudential regulatory requirements on a stand-alone basis. This considerable augmentation of capital requirements will impact on banks' ability to lend to the real economy and hence become a further impediment to growth within the Euro-area.

Furthermore, the funding costs will augment considerably for the trading entity, as it will have a lower rating than the deposit bank. This could lead to a general rise in funding cost for all banks with spill-over effects to the real economy.

Moreover, the recommendation to split up into two separate entities the trading arm and the deposit bank includes a considerable rise in administrative costs as the recommendation demands separate reporting, separate disclosure of stand-alone results and balance sheets; independent boards and governance etc. In summary the aggregate costs stemming from the proposed separation of activities will weigh heavily upon banks and increase the price of financial services. This was also pointed out by the HLEG itself when looking at the disadvantages of mandatory separation.

Impact on the universal banking model

On a separate note it could be questioned whether the universal banking model remains as intact as the HLEG claims in the case of mandatory separation and whether the customers will really have the same experience of a one-stop shop just because the two entirely separate entities are allowed to function within the same banking structure. For example, the recommendation that each entity will be required to have separate independent boards and governance structures (suggested in avenue 2) raises the question whether a uniform client strategy can be upheld. Furthermore, the diversification benefits of the universal banking model will be clearly reduced by separating certain trading activities and demanding that funding, governance and capital requirements be full-filled on a stand-alone basis.

Two-tier system could harm competition within EU …

Mandatory separation of trading activities for all banks exceeding a certain threshold could furthermore harm competition within the EU by creating a two-tier system where banks with risky trading positions below the threshold get an advantage over banks exceeding the threshold. The HLEG itself has pointed to the possibility that mandatory separation could have an impact, in particular on the location of trading activities, if the EU's overall regulatory stance should be substantially stricter than that of other key jurisdictions. Viewed against the backdrop of the current EU regulatory reform agenda EBF is convinced that this is the case. There is hence a need to conduct a thorough impact assessment of any legislative proposals - both in regard to the impact of the separation of proprietary trading activities and related activities as well as the impact of the recommended package in its entirety.

... And lead to further fragmentation of the Single Market

The recommendation entails a clear risk of fragmentation of the Single Market. The proposed separation of trading activities over a certain threshold by the HLEG will come as an add-on to national structural reform proposals like for example Vickers in the UK, Volckers in the US, and upcoming proposals in France (and further Member States contemplating such approaches, like Holland and Belgium). Hence, contrary to what the HLEG report claims the proposed mandatory separation of activities will seriously undermine the benefits of the Single Market and make operations for cross-border banks more burdensome and costly. This will in turn harm the competitive situation of European banks internationally. It is a general concern of EBF that additional EU financial services regulation be consistent with international rules in order to promote an international level playing field for banks and to not harm the competitiveness of European banks with additional and distinct regional and national rules.

3.2. Recommendation 5.5.3

The HLEG points to the bail-in tool as a vital part of the recovery and resolution framework proposed in the BRRD proposal in order to ensure involvement of investors in resolution of banks going forward. However, in order to enhance predictability in the market-place and create further clarity within the hierarchy of debt commitments, the HLEG proposes to further develop the bail-in framework by designating bail-in to a specific category of debt instruments. Such a designated bail-in instrument would be subject to a phase-in period. Banks can however still issue bail-in able debt instruments with common equity as proposed in the current BRRD - the HLEG points out that this could be useful for smaller institutions. Furthermore, it is proposed that the bail-in instruments should not be held within the banking sector but only by non-bank institutional investors.

3.2.1. EBF assessment

The EBF is yet to be convinced that a designated bail-in category, as recommended by the HLEG, is the way forward set against the proposition put forward in the BRRD proposal that a broad range of instruments should be eligible for bail-in. In EBF's view, concerning the broad scope proposed in the BRRD proposal, further assessment is needed concerning the exclusion of short-dated instruments and derivatives. Policy makers should further consult with investors to ensure that an appropriate balance is reached to ensure sufficient bail-inable debt at an acceptable funding cost. In regard to the status of short-dated unsecured liabilities within bail-in there are differing views within the EBF membership. This range runs from suggestions to remove the exclusion altogether, to suggestions that one month is inappropriately short and longer periods (e.g. 6 months) link better with other supervisory monitoring requirements (especially NSFR). Also, EBF Members strongly believe that derivative positions should not be included into the scope.

In EBF's view it is difficult to see whether there could be a market for designated bail-in instruments and at what price. In general, it is important that the end solution allows as many banks as possible to have access to bail-in type instruments at prices that are absorbable.

EBF partly understands the recommendation that designated bail-in instruments should only be held outside the banking sector in order to limit inter-connectedness within the banking system. However, this recommendation is perhaps less feasible as the vast majority of potential investors for such instruments are banks. Moreover, it should be taken into account that other parts of the on-going regulatory reforms (like Solvency II) would diminish the capacity of non-banking sectors to invest in such instruments. This could also be the case for other relevant investors as UCITS and other investment funds.

Furthermore considering how banks are interconnected (for instance via CDS and derivative instruments), the recommendation that banks cannot sell bail-in able debt to other banks would most probably only reduce the risk of contagion in the system to a small degree. On the other hand this recommendation would have a considerable impact on the cost of funding. Hence, in EBF's view the expected negative impact of this recommendation would outweigh the expected benefits.

3.3. Recommendation 5.5.4

The HLEG proposes a review of capital requirements for the trading book and real-estate lending. To improve trading book capital requirements it is proposed that banks with trading activities over a certain threshold must hold a non-risk weighted capital buffer of CET1 on top of Basel II.5 & III requirements to address market (especially tail risk) and operational risk arising from complex market activities, *and/or* to introduce a robust floor for risk-based requirements.

Furthermore, in order to prevent systemic risk originating from excessive lending to the real estate sector and from what the HLEG sees as relatively low RWA levels for real estate exposures, the HLEG proposes that the European Commission should consider further measures regarding the treatment of real estate related lending within the capital requirement framework. The HLEG strongly recommends the use of loan-to-value (LTV) and/or loan-to-income (LTI) caps as macro-prudential tools.

3.3.1. EBF assessment

Firstly, the EBF would like to remind that, without prejudice to the potential need for further revisions; one of the key elements in the regulatory overhaul underway is the review of the capital requirements for market risk and the trading book. EU has shown a strong and timely commitment to the enforcement and effective implementation of Basel II.5, which encompasses measures geared to mitigate and adequately back risks that were not tackled entirely by the former Basel II regime like the incremental risk charge to capture default and migration risk at a longer liquidity horizon, the stressed value-at-risk based on historical data from a continuous 12-month period of significant financial stress and the treatment of securitization positions in the trading book under the more conservative rules applied to the banking book. As a consequence, the capital requirements of EU banks for market risks have roughly doubled and the total risk-weighted assets have increased more than 6%.

Secondly, the current BCBS fundamental review of the trading book is meant to tackle the remaining concerns as to the prudential requirements for this portfolio. This review will take at least until the end of 2013. Before considering further European measures, EBF believes that the European Commission should first await the results of the review. It is quite possible that additional measures will then no longer be necessary. It is, for example, planned to replace value-at-risk (VaR) with expected shortfall (ES) as a risk metric. From a theoretical perspective ES is seen as being better able to capture tail risks (pointed to as a specific concern by the HLEG) than VaR. It should also be noted that banks have for some time now been making considerable efforts to improve estimates of loss distribution in their trading segment. Normal distribution has no longer been used for loss distribution for some time now; fat-tailed distribution is instead the general standard.

Any floor will be detrimental to the development of risk models

The response of the EBF to the BCBS consultation[5] on the fundamental review of the trading book highlights that the incentives to risk modeling and risk management should be preserved. Nonetheless, the EBF sees the possible introduction of floors as a significant threat to risk modeling. For this reason, EBF cannot support the recommendation of the HLEG to introduce a floor for risk-based requirements in the trading book. Additional regulatory safeguards should not take the shape of regulatory floors; otherwise the interest to maintain and develop risk models could be removed. In any case, the results of the models would become useless for business purposes.

Trading book revision and CRD IV buffers to be considered before any additional steps are taken

Concerning the first option recommended by the HLEG, i.e. setting an extra non-risk based capital buffer, as already mentioned possible further steps in this direction should await the finalisation of the trading book review *and* the finalisation of the CRD IV/CRR, where in the current trilogue negotiations a whole range of buffers are already contemplated - and take into consideration the overall impact of this on European banks. Bearing this in mind it should be noted that any

[5] http://www.ebf-fbe.eu/uploads/D1211F-2012-EBF%20response%20to%20the%20BCBS%20consultation%20on%20FRTB_v4_Final.pdf

additional buffers - if any - would have to be designed to carefully consider proportionality across asset classes and instruments, which can be complex considering the differences in the valuation of notional amounts, margins, etc.

EBF committed to supervisory dialogue to further improve IRB models

Regarding the risk-weighted assets (RWA) calculated by individual banks' internal rating based (IRB) models, the EBF is of the view that any assessment should be done from the broader perspective of the role that IRB models play in risk management. It is imperative to start the discussion by acknowledging the continued commitment of European banks to the implementation of advanced risk measurement methodologies as envisaged by international prudential standard setters like the BCBS. The development of IRB models has brought about valuable improvements in risk information and risk management that otherwise would have been lost to banks and regulators. This being said, there may be differences in the outcomes of those models. Some of them reflect the actual differences in the characteristics of the (real estate) markets in EU countries whereas others may be the result of diverging supervisory practices. Therefore EBF is also supportive of the HLEG emphasis on a coordinated approach by the supervisory community when it comes to adequacy and consistency of the IRB-based capital requirements. The EBF is currently engaged in the discussion with policy makers and has contributed to better-informed decisions in this area with a thorough study on IRB models of residential mortgages[6].

HLEG Recommendations on LTV/LTI ratios and leverage ratios premature

Concerning the HLEG recommendation that strict caps to the LTV/LTI ratios should be provided in all Member States and implemented by national supervisors, EBF refers also this respect to the differences in the characteristics of the real estate markets in EU countries. Moreover, EBF emphasises that more attention has already been given to macro-prudential issues in the CRR/ CRD IV by introducing a number of tools for national authorities to address the issue. The experience of applying these rules should be assessed before considering any further measures.

The HLEG also mentions that the adequacy of certain other prudential rules should be assessed.

Firstly, the HLEG is of the opinion that more consideration should be given as to whether the planned leverage ratio requirement is sufficient. The EBF finds it premature to draw conclusions on this issue as the CRR sets out an in-depth monitoring period until year 2016 with the possibility to recalibrate the leverage ratio level before introducing the binding requirement.

Large exposure limits for intra-group exposures could harm groups' liquidity management

HLEG also suggests that the same large exposure limit (as to external counterparties) should be applied to intra-group exposures. The EBF urges that the impact of this rule should be carefully considered as it may e.g. hamper the centralised liquidity management at the group level. The tightened limit could also have negative effects from the perspective of a level playing field in case it would be applied only to banking groups subject to the separation requirement.

[6] http://www.ebf-fbe.eu/uploads/Study%20on%20Internal%20Rating%20Based%20(IRB)%20models%20in%20Europe-Website.pdf

3.4. Recommendation 5.5.5

The HLEG recommends enhanced governance in a number of ways by i) strengthening boards and management; ii) promote the risk management function; iii) rein in compensation for bank management and staff; iv) facilitate market monitoring and v) strengthen enforcement by competent authorities. This recommendation is based on the analysis that increased complexity, size and scope has made internal managerial control and external monitoring of excessive risk-taking by supervisors or market-participants more difficult.

3.4.1. EBF assessment

EBF understands and welcomes the HLEG's objective of strengthening the governance of banks on a sustainable basis. Shortcomings in remuneration schemes of risk takers, risk management and monitoring by administrative and supervisory boards may indeed have played a part in the financial crisis. At the same time, the HLEG fails to make clear that the governance and control mechanisms in place in many systemically important banks have done a good job. The in-depth analysis of the crisis in the report shows, moreover, that the causes of the crisis are manifold. Corporate governance in the narrower sense represents but one dimension.

When examining the HLEG's recommendations for enhanced governance the European Commission should bear in mind that, in regulatory terms, fundamental lessons have already been drawn from the crisis at EU member state level/European level and by banks themselves. Appropriate regulation is therefore already in place for many of the areas mentioned by the HLEG. Furthermore, banks will face new or additional requirements in the governance field under CRD IV which should be taken into account.

EBF assessment of the individual recommendations in 5.5.5

Ad i) Strengthening boards and management

Management board members and administrative/supervisory board members must have professional qualifications geared to a bank's needs - this is without doubt an essential condition for efficiently managing a bank or monitoring and advising the management. Banks will face new requirements in this area under CRD IV. Under Directive 2006/48/EC and in the future CRD IV supervisors will, in addition, be mandated to carefully evaluate the suitability of management and board candidates prior to their appointment. EBF therefore does not see a pressing need to introduce the recommended fit-and-proper test. On top of this, a potential candidate's professional suitability and trustworthiness is in any case informally discussed at length by supervisors and banks in practice before, for example, the appointment of a new administrative or supervisory board member is officially notified to supervisors. In addition, EBA is also currently working on the issue and more specifically on potential guidelines on the assessment of the management body.

Ad ii) Promote the risk management function

The HLEG is right to call for full implementation of the CRD III and CRD IV proposals in the field of risk management. Adoption of a uniform, pan-European approach is the condition for effective company-wide risk management. However, EBF wishes to point out that the recommended requirement for the Risk and Control Management to report to Risk and Audit Committees must not replace reports to the CEO.

Ad iii) Rein in compensation for bank management and staff

In regard to the recommendation to reform banks' incentive schemes EBF finds that the objectives pursued by the FSB and the European Commission - namely, ensuring that remuneration schemes more strongly incorporate components with a long-term incentive effect and appropriate risk character - are right from a risk perspective. With this in mind, the HLEG recommendation to pay a share of variable remuneration in the form of bail-in bonds is basically worth considering in EBF's view.

Instead of, as currently discussed, setting a maximum ratio of basic salary to bonuses or an absolute cap on remuneration (which are not risk sensitive), EBF believes that remuneration schemes should more strongly incorporate components with a long-term incentive effect and risk character. In addition shareholders should also be better entrusted with right to a "say on pay" and approve the remuneration scheme for directors of listed companies at shareholders meetings.

Ad iv) Facilitate market monitoring

While EBF agrees with the aim of the HLEG to enhance market discipline and market confidence, EBF nevertheless sees natural limitations on the extent to which comparability across banks can be achieved and would add that neither financial reporting nor leading disclosure practice is premised upon detailed financial reporting for each legal entity and main business line. Furthermore, it is not clear from the HLEG recommendation who is the intended recipient to this suggested increase in reported information. The supervisory authority already has access to all available information and in EBF's opinion it is questionable whether investors demand this further information.

Ad v) Strengthen enforcement by competent authorities

Regarding the recommendation to strengthen sanctioning there is no question in EBF's view that breaches of supervisory rules should be punished appropriately. However, the CRD IV proposal tightens the already existing rules on the design of national supervisory sanctions regimes (e.g. a claw-back in remuneration schemes) and pushes harder for a more coherent system of sanctions in the EU. EBF therefore sees no need for any additional regulatory action on sanctioning.
