BUSINESSEUROPE

POSITION PAPER

5 December 2014

Reforming the Structure of the EU Banking Sector

KEY MESSAGES

1 The Commission proposal for a Regulation on structural measures improving the resilience of EU credit institutions should be assessed in the light of the different financial reforms in order to avoid unintended consequences and detrimental cumulative effects.

2 Companies support the universal banking model. They benefit from banking with large and diverse banks as they often need the balance sheet of large banks with international presence to support them.

3 The EU should focus on measures that reduce barriers to entry into the banking market. This will encourage more diverse forms of finance - including non-bank finance - and ensure that the EU remains an attractive market increasing the choice and possibilities for businesses to access the finance they need to create growth and jobs.

WHAT DOES BUSINESSEUROPE AIM FOR?

- Ensure that core banks are allowed to sell 'over-the-counter' (OTC) derivatives that are not eligible for clearing to non-financial companies using them for hedging purposes.
- Ensure that core banks will be able to engage in market making activities so that there is sufficient market liquidity for bonds and stocks and also for derivatives used for hedging purposes. This will avoid harmful price volatility, both in hedging and financing.
- Avoid that universal banks will be required to implement conflicting reform measures within Member States.

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COMMISSION PROPOSAL FOR A REGULATION ON STRUCTURAL MEASURES IMPROVING THE RESILIENCE OF EU CREDIT INSTITUTIONS

Introduction

Safeguarding financial stability and the continuity of banking and market services are important policy goals that will ensure companies can access the finance they need to create growth and jobs. Since the outbreak of the crisis, an extensive reform of financial services has made the financial system sounder. Improved financial supervision through the European Supervisory Authorities, which has further been supported by a Single Supervisory Mechanism in the Eurozone, will significantly improve cross-border oversight and should contribute to greater financial stability. Improved capital and liquidity measures will build a more resilient banking sector and improve the banking sector's ability to absorb shocks arising from financial and economic stress. Agreed arrangements for early intervention and resolution will also help to curb excessive risk-taking through greater market discipline. The Commission proposal for a Regulation on structural measures improving the resilience of EU credit institutions should be assessed in the light of these different financial reforms in order to avoid unintended consequences and detrimental cumulative effects. Such an evaluation is especially important in view of the fact that the recent combined asset quality review and stress test exercise showed that the larger banks, and particularly the global systemically important banks (GSIBs), are now safer than before the crisis and that the prospect of future failure is unlikely.

Businesses' needs

European businesses, and especially smaller and medium-sized businesses, are highly dependent on bank lending. Europe's banks hold a far higher share of total financial assets, typically around 60%, than in the US where the figure is closer to 20%. Companies need access to finance from the international banks that are active in the EU and businesses value diversity in the finance market. These banks provide liquidity to the financial markets – through market-making activities - and are active in specialist financing and business niches. They need to be healthy to support EU business and the broader economy.

Companies benefit from banking with large and diverse banks. They often need the balance sheet of large banks with international presence to support them, for example in the case of large infrastructure projects or when debt or equity capital issuance has to be underwritten. Large and diverse banks have more flexibility to use their balance sheets, using funding across customer groups and from a diverse range of sources which permits more extensive lending activity.

Companies use a wide variety of banking products. Typically, smaller businesses use a narrower range of products but as soon as a business starts to grow, and becomes more international and complex, it needs more sophisticated products. Not only does it

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need to invest and finance its business but also to manage its interest, foreign exchange and commodity risk.

Although it is common for companies to use several banks, it is often more efficient, especially for growing and small and medium-sized companies, to source integrated services – including lending and market services - from just one bank with which they have a long standing relationship and which understands the needs of the company concerned. Such an institution can make quick, qualitative judgements about the credit quality of the company concerned. If a single bank can provide such a wide range of banking products and market activities, it can also reduce complexity and therefore the operational risk of the company concerned. Ultimately businesses support the universal banking model.

Risk management services

The proposed Regulation will lead to a de facto prohibition on the provision of certain risk management services to non-financial companies for core banks if those institutions are split into a core credit institution and a trading unit. This is because the former can only provide risk management services to non-financial customers when they are limited to derivatives eligible for central counterparty clearing. However, these derivatives are only a subset of the whole range of derivatives required by non-financial companies.

Non-financial companies use 'over-the-counter' (OTC) derivatives in conjunction with risk mitigation of underlying real economic risks which are not eligible for clearing because they are neither standardised nor liquid. The advantage of these 'over-the-counter' derivatives is that they are bilaterally negotiated contracts and that the terms of these contracts can vary considerably according to the needs of each party. The principal benefit of these contracts is that they can be customised to match particular risk exposures and provide targeted risk mitigation. Standardisation through reduced product flexibility would hamper the opportunity for end users to obtain exactly the risk management protection which they seek. This would reduce the ability of corporations to manage and hedge some of their financial risks and ultimately reduce the effectiveness of their risk management procedures.

This is why the legislator included a clearing exemption for non-financial companies in the European Markets Infrastructure Regulation (EMIR). It is crucial that new financial legislation does not undercut this exemption or discourage end users from entering into OTC derivative transactions by limiting banks' ability to provide these instruments or by forcing companies to obtain these products at higher prices via the trading entities which will also have a higher risk profile. This would reduce corporation's hedging activities, increasing not only the risk for the individual corporation concerned but eventually also for the economy as a whole. Reduced hedging will also lead to a different risk assessment of the non-financial companies concerned by capital markets which will negatively affect their cost of equity and financing.

Core credit institutions should thus be allowed to sell OTC derivatives that are not eligible for clearing to non-financial companies using them for hedging purposes.

In addition to that, the proposed Regulation also limits core credit institutions own options to hedge risks stemming from services to non-financial companies with other banks. This is also stricter than EMIR which does not restrict banks in concluding non-

cleared derivative contracts provided they pose collateral. Credit institutions will also not be allowed to use commodity derivatives and inflation rate derivatives preventing them from hedging such risk stemming from business with non-financial companies. This will discourage banks from offering these services at all forcing non-financial companies to obtain these services from the trading banks which may be less inclined to deal with smaller businesses making it more difficult for these firms to protect themselves against business risks which they are able to manage today.

Spun-off trading entities will have a higher risk profile than the remaining core bank which is likely to have a stronger balance sheet and hence a lower risk profile. Given the presumed lower capital of trading entities, both sides may have to reduce exposure to manage their counterparty risk. This would also mean less hedging can be done with such a trading entity than with the old combined bank, forcing non-financial companies to find additional counterparties. Prices are also likely to increase due to the higher costs of capital of such more volatile trading banks.

Proprietary trading and market making

The proposed Regulation prohibits proprietary trading and may lead to the separation of market making activities. This will have significant adverse effects on market liquidity, such as bonds and stocks (including those of non-financial companies) but also on derivatives used for hedging purposes. This will further lead to harmful price volatility, both in hedging and financing. The less liquid the respective instruments are, the more beneficial the role of the core bank as a market maker is. If these banks would no longer be able to engage in this activity, the costs of financing will increase again as already happened following the adoption of other financial reform measures. This is why, BUSINESSEUROPE, on several occasions, called for comprehensive quantitative impact studies on the cumulative effects and interplay of different financial reform measures on the financing of European companies.

Cumulative effects

A number of legislative projects, recently adopted, planned, and under discussion, have all impacts on financing conditions such as capital and liquidity requirements for banks, insurance companies and institutional investors; rules on private equity and money market funds; rules on financial instruments and derivatives; accounting requirements on how financial institutions account for bad loans; and financial tax and resolution schemes. The combined effects of all these rules, together with the new bank structural reform measures, may jeopardise European companies' access to financial markets on competitive terms and their ability to find long-term investors. Therefore, the proposal on structural reform measures should be put on hold until evidence on implementation of the other reforms indicates a clear need for further action.

Increase competition

BUSINESSEUROPE recommends that the EU focuses on measures that reduce barriers to entry into the banking market. This will encourage more diverse forms of finance - including non-bank finance - and ensure that the EU remains an attractive market increasing the choice and possibilities for businesses to access the finance they need to create growth and jobs.

Co-ordinated approach

Any proposals at the EU level should seek to work with, rather than against, reforms currently being implemented within individual Member States. BUSINESSEUROPE is concerned about the implications for businesses should the universal banks be required to implement conflicting reform measures within Member States. Given the range of reform measures already in train, this would seem to be an unnecessary additional burden on banks at a time when they should focus on supporting businesses in creating growth and jobs.

Conclusion

BUSINESSEUROPE is concerned that insufficient consideration has been given to the damaging effects of the Commission proposal on bank's ability to finance companies. Diversity in banks structures is a strength of the European banking system and research undertaken by the European Central Bank has shown that the resulting income diversification places broad-based universal banks in a better position to support their corporate and SME customer base during an economic downturn than banks with less diverse income streams. More consideration should be given to the consequences of the proposed changes to these arrangements. This is all the more important given that the EU is struggling to return to even relatively modest rates of economic growth.

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