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EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

PROPOSAL OF A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on structural measures improving the resilience of EU credit institutions
and
the Proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions

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1. INTRODUCTION

Over the last decades, the size of the EU financial system has increased rapidly, significantly outpacing GDP growth. EU financial institutions, and banks in particular, have expanded in scale, scope and complexity. This has led to the emergence of large financial 'one-stop shops' combining within one entity or group the provision of a diverse set of services. This process allowed banks both to provide a broader range of services to their clients, as well as responding to the increasingly sophisticated needs of their global clients. Notwithstanding these benefits, the unprecedented and extraordinary state sector-wide support to banks following the financial crisis has clearly illustrated the negative impact on financial stability arising from an ever more global and integrated financial system with ever larger financial service providers.

As a response to the financial crisis, the European Union (the "EU") and its Member States have engaged in a fundamental overhaul of bank regulation and supervision. In the area of banking, the EU has initiated a number of reforms to increase the resilience of banks and to reduce the impact of potential bank failures.

Despite this broad-ranging reform agenda, concerns remain that some banks remain too large and complex to manage, monitor, and supervise in good times and still challenging to resolve in bad times. Several countries have therefore either decided to reform the structure of their banks or are considering such reforms. The European Parliament as well as international institutions have further highlighted the role of structural reforms in tackling problems of too-big-to-fail ("TBTF")[1] banks.

In this context, Commissioner Barnier set up a High-level Expert Group ("HLEG") under the chairmanship of Erkki Liikanen, governor of the Bank of Finland. Its mandate was to assess the need for structural reform of the EU banking sector. The HLEG recommended the mandatory separation of proprietary trading and other high-risk trading activities into a separate legal entity within the banking group.

This impact assessment assesses problems related to the corporate structure of TBTF banks (chapter 2); identifies the objectives of structural reform (chapter 3); identifies the range of options considered for reforming the structure of banks (chapter 4) and assesses the benefits and costs to society of those reform options (chapter 5). The main findings are summarised below.

2. PROBLEM DEFINITION

The EU has traditionally had a diverse banking system. This is a source of strength. Even so, over time the market has also evolved to produce a few large, complex, interconnected banking groups. These banks typically combine retail and commercial banking activities and wholesale and investment banking activities in one corporate entity or in a combination of closely connected entities with limited restrictions on interactions. Being deposit-taking banks, they are by nature exposed to potentially damaging runs. To ensure depositor confidence a number of explicit public safety nets (such as deposit insurance) and implicit safety nets (bail outs) de facto have been put in place. However, in light of the public safety

[1] Too-big-to-fail is meant to cover too-interconnected-to-fail (TITF), too-complex-to-fail (TCTF), and too-systemically-important-to-fail (TSITF). See European Commission (2013), "Structural reform in the EU banking sector: Motivation, Scope and Consequences", Chapter 3 of the European Financial Stability and Integration Report 2012, 24 April, SWD(2013) 156 final.

nets, the unrestricted co-existence of activities contributes to a number of problems, including (i) impediments to orderly resolution and recovery; (ii) moral hazard, excessive balance sheet growth and excessive trading; (iii) conflicts of interests and transaction-oriented bank culture; and (iv) distortions of competition.

The EU has already initiated a number of reforms to increase the resilience of banks and to reduce the probability and impact of bank failure. These reforms include strengthening banks' solvency (the capital requirements regulation and directive, CRR/CRDIV); strengthening bank resolvability (the Bank Recovery and Resolution Directive, BRRD); better guaranteeing deposits (revised Deposit Guarantee Schemes directive, DGS); addressing the risks of derivatives and to improve market infrastructures (European Market Infrastructure Regulation, EMIR, and related revisions to the Markets in Financial Instruments Directive, MiFID). Additionally, in order to break the negative feedback cycle between the sovereign and banking risks and to restore confidence in the euro and the banking system, the European Commission has called for further development of a Banking Union, including the single rule book that will be applicable to all banks in the entire EU, the Single Supervisory Mechanism ("SSM") and the Single Resolution Mechanism (SRM), which will be mandatory for members of the euro area but open to voluntary participation for all other Member States.

Despite this broad-ranging reform agenda many regulators, supervisors and academics continue to express concerns that the largest banking groups remain too large and complex to manage, monitor, and supervise in good times and possibly challenging to resolve in bad times. Structural reforms have therefore been put forward as a complementary way of dealing with the problems outlined above. For example, structural reforms could complement the current regulatory reform agenda. The CRDR/CRDIV and BRRD already will provide supervisors/competent resolution authorities with powers to intervene and pre-empt bank crises by restructuring and/or resolving a financial institution triggered by prudential or resolvability concerns. Structural reform could complement these regulatory reforms and increase their effectiveness for too large and complex banks. For example, structural reform will increase the options available to the authorities when dealing with large banking groups. It also provides a direct way of addressing intra-group complexity, intra-group subsidies, and excessive risk-taking incentives. In addition, structural reforms aim at a broader set of objectives, such as ensuring that the deposit taking bank is not unduly influenced by a short term oriented trading culture and prone to conflicts of interest to the detriment of its customers. The changes implied by structural reform imposed on the limited set of TBTF banks under consideration could therefore complement existing powers.

3. ANALYSIS OF SUBSIDIARITY

An increasing number of Member States are currently pursuing different forms of structural reforms of banks in their jurisdictions. Given the fundamental freedoms set out in the Treaty of the Functioning of the European Union (the "TFEU") divergent national legislation may affect capital movements and establishment decisions of market participants and could also undermine efforts to achieve a single rulebook applicable throughout the Internal Market. It can also create specific problems regarding supervision, notably for cross-border banks.

Therefore, action at European level is needed.

4. OBJECTIVES

The overall objectives of structural reform are first to reduce the risk of systemic instability by reducing the risks of banks becoming or wanting to become TBTF, TCTF and TITF. A key objective of structural reform is to make banks that provide essential services to the real

economy more resilient in the event of endogenous or exogenous shocks but also more resolvable in the event of a failure, thus reducing the severity of future financial crises. A second general objective is to reduce single market fragmentation. Many of the banks that will be affected by structural reform legislation operate across borders and seek to benefit from the opportunities created by the single financial market. A common legislative framework on structural reform would prevent the fragmentation of the Internal Market and increase the effectiveness of the future SSM and SRM.

Within these overarching objectives, structural reform addresses the following specific objectives: (1) facilitate bank resolution and recovery; (2) facilitate management, monitoring and supervision; (3) reduce moral hazard; (4) reduce conflicts of interest and improve bank culture; (5) reduce capital and resource misallocation; and (6) improve competition.

The following set of quantifiable operational objectives would form the base of future evaluations: (1) Reduction of the size of implicit public subsidies (as reflected in the funding cost advantage of TBTF banks); (2) Reduction of excessive trading by TBTF banks (and increase the relative share of credit provision to non-financial customers).

5. POLICY OPTIONS

Reforming the structure of banks requires a decision on what activities to separate and how strong the separation should be. Chapter 4 of the report therefore presents a number of options in each area. The combination of these gives rise to a number of reform options to be assessed both against the baseline scenario of no further policy action at EU level as well as against each other.

Activities

The banking activities undertaken by large EU banking groups today range from retail and commercial banking (RCB) activities to wholesale and investment banking (WIB) activities. Examples of RCB activities include, amongst others, insured deposit taking, lending to households and SMEs, and the provision of payment system services. Examples of WIB include, amongst others, underwriting, market making, brokerage services, and proprietary trading. The report considers three stylised options for separating activities:

(1) **“Narrow” trading entity and “broad” deposit entity**: A first polar case is that in which only relatively few trading activities are being separated from a broad deposit entity, namely those types of trading where traders are speculating on markets using the bank’s capital and borrowed money, for no purpose other than to make a profit and without any connection to trading on behalf of customers (that is proprietary trading);

(2) **“Medium” trading entity and “medium” deposit entity**: A second option is one in which market making, complex derivatives and complex securitisation are added to the above set of activities; and

(3) **Broad” trading entity and “narrow” deposit entity**: This option would foresee the separation of all wholesale and investment banking activities.

Strength

When determining the strength of separation, a starting point is to consider three broad forms: (i) accounting separation; (ii) functional separation through subsidiarisation; and (iii) ownership separation or prohibition of certain business lines. These forms of separation display a varying degree of severity and intrusiveness in banks’ business structure.

Accounting separation (obliging banks to publish more information about their different business lines) is unlikely to achieve the objectives outlined above and is therefore discarded. Functional separation through subsidiarisation would require banking groups to separate the activities of different business units into separate subsidiaries (legal entities) but they could continue to provide their clients with a diverse set of banking services ("structured universal banking"). The report considers two different subsidiarisation options, based on a set of different legal, economic and governance rules of subsidiarisation (limited vs stricter subsidiarisation). Ownership separation would require that certain business lines are provided by firms that are not affiliated with the banking group. More specifically the three options considered in the report are:

(1) **Subsidiarisation with intra-group links restricted according to current rules**: in terms of legal separation, this option would require a separate legal entity. In terms of economic separation, it would restrict itself to the economic and governance requirements that currently result from this degree of legal separation;

(2) **Subsidiarisation with tighter restrictions on intra-group links**: in order to more effectively address intra-group funding subsidies, this option would require a more significant degree of subsidiarisation in legal, economic and/or governance terms (such as rules on ownership rules and intra-group exposure limits) ; or

(3) **Ownership separation**: under this option, banking groups would not be allowed to engage in certain activities. They would accordingly have to divest or wind down any such activities that they currently engage in.

Reform options

On the basis of the above, the combination of the different range of trading and capital markets activities to be separated and strengths of separation yields nine stylised reform options, as visualised in matrix form in Table 1. To the extent possible and for illustration purposes only, the Commission services have mapped the different structural reform proposals and/or legislative initiatives into the matrix.

Table 1: Overview of options

Activities\ strength	**Functional separation 1 (SUB)** *Current requirements*	**Functional separation 2 (SUB+)** *Stricter requirements*	**Ownership separation** *Ownership separation*
Narrow trading entity/ broad deposit entity *E.g. Proprietary trading + exposures to HF (PT)*	Option A	Option B [≈ FR, DE baseline]	Option C [≈ US Volcker]
Medium trading entity/ medium deposit entity *E.g. PT + market-making (MM)*	Option D	Option E [≈ HLEG; ≈ FR, DE if wider separation activated]	Option F
Broad trading entity/ narrow deposit entity *E.g. all investment banking activities*	Option G	Option H [≈ US BHC; ≈ UK]	Option I [≈ Glass-Steagall; ≈ UK with electrification of fence]

Implementation issues

The IA compares the benefits and costs to society of the options outlined in table 1 against each other and against the "no policy change" scenario. In addition, the IA also assesses three implementation issues common to all options:

- **Institutional scope**: a structural reform initiative should in principle target TBTF banks only and would accordingly only apply to a small subset of the more than 8,000 banks incorporated in the EU. Therefore, the reform does not affect small cooperative and savings banks that play an important role to serve the financing needs of local communities and small businesses. The report assesses different approaches to set thresholds in order to select relevant banks. It concludes that such thresholds should be based on a combination of a systemic risk metric and an accounting-based methodology. In addition to all European systemically important banks structural reform would apply to banks with trading activity above an absolute threshold of €70bn and a relative threshold of 10% of total assets. Small banks with less than €30bn in assets in principle would be excluded. . In practice and based on historic data, the Commission estimates that this may lead to 29 of the largest and most complex European banks being subject to structural separation;
- **Role of supervisors**: a separate issue is the role of supervisors in reviewing the scope of institutions as well as the activities subject to potential separation. As regards the institutional scope, any threshold may not always perfectly capture the right institutions. There should therefore be some room for supervisory judgement in assessing the institutional scope of separation resulting from an application of the thresholds elaborated above to ensure that the right banks are captured. Similarly, there should be room for supervisory judgement in determining the scope of activities to be separated should particular circumstances warrant it. However, supervisory judgement needs to be closely framed and constrained for political, practical and legal reasons. Otherwise inconsistent outcomes across the Internal Market can arise. The report outlines a number of principles guiding the supervisory

process foreseen under both options to ensure that it does not lead to distortions in the internal market; and

- **Timeframe for implementation**: Structural separation, no matter how beneficial to society, will yield private costs. Furthermore, the transfer of existing assets and liabilities to a potentially new separate legal entity requires time. Finally, the EU has adopted or will soon adopt several initiatives in related areas, including Basel III, BRRD and the SRM that will not become fully applicable until 2018 or 2019. The report concludes that a similar transition period should be foreseen to implement a future structural reform initiative.

6. IMPACT AND COMPARISON OF REFORM OPTIONS

Chapter 5 of the report assesses and compares in qualitative terms the different reform options identified above. Two criteria are applied for the purpose of comparing the options. The first – effectiveness – measures the extent to which the specific reform objectives are being met, e.g. facilitating resolvability. The second – efficiency – assesses the costs to society incurred when implementing the respective reform options (mainly foregone economies of scale and scope). A third – coherence – measures the extent to which a reform option is in line with the Commission's overall policy objectives in general and complementary to the current reform agenda. As all options are broadly coherent with these objectives, this criterion is not used further to score options.

Assessment of reform options based on subsidiarisation according to current rules

Options A, D and G would deliver a certain degree of separation of the trading entity, but they risk being ineffective in achieving the specific objectives of facilitating resolvability and monitoring, reducing moral hazard, reducing conflicts of interest, reducing resource and capital and resource misallocation, and improving competition and are therefore discarded. This is due to the fact that mere subsidiarisation does not effectively sever the economic and operational links between the trading and deposit-taking subsidiaries.

Assessment of reform options based on subsidiarisation according to stricter rules

The options based on subsidiarisation according to stricter rules (B, E and H) are reform options that roughly correspond to reforms currently being pursued by EU Member States or recommended by the HLEG. These options would effectively sever the economic and operational links between the trading and deposit-taking subsidiaries. They would still enable banking groups to engage in a broad set of activities although some activities would have to be transferred to separate legal entities within the group (structured universal banking). Among the three options, the report finds that that implementing reform option E is the best way forward in the EU context and would represent a significant improvement over the no policy change alternative. Option E yields greater benefits compared to reform option B due to the latter option's narrower activity scope. Option E is also preferable to reform option H, additional activities are unlikely to bring significantly higher benefits while would impose further costs.

Assessment of reform options based on ownership separation

Options C, F and I have the potential to be the most effective set of options in terms of achieving the specific objectives. However, it is also the set of options that may come with the highest social costs in terms of foregone economies of scope. The report concludes that the social benefits associated with option C outweigh the social costs, as it addresses the risks, complexity and interconnectedness associated with proprietary trading (a trading activity that is inherently risky and is most prone to conflicts of interest) without incurring significant

social costs (given that it does not contribute to the financing of the economy). A significant positive balance between benefits and costs is more difficult to argue for options F and I. At this stage of economic knowledge and evidence and given the relatively high uncertainty, cautiousness as regards the activity scope for ownership separation of activities (are than proprietary trading) seems appropriate. Hence, the report finds that only option C provides a good net balance of social benefits and social costs and is worth exploring further.

Comparing retained options

The report therefore retains option C and E for further comparison in terms of benefits and costs to society. As regards the former it finds that option C is less effective than E in yielding such benefits due to its narrower activity scope. At the same time, option E may yield higher costs to society by virtue of its broader activity scope, which would have a larger effect on foregone economies of scope. Nevertheless, because of its significantly broader activity scope, option E delivers greater social benefits compared to option C and hence may be deemed more effective, at limited additional efficiency cost.

Even so, the report finds that there may be ways of raising the limited effectiveness of option C and bringing it closer to option E. Option C could, for example, be complemented by an ex post (albeit framed) procedure for separating additional activities, notably market making, complex derivatives and complex securitisation ("option C+").. In a similar vein, there are ways of reducing the potential efficiency cost associated with option E should that cost be considered excessive (by e.g. exempting from the separation requirement certain activities where existing markets are particularly shallow and/or illiquid by means of a framed supervisory process, "option E-").

There are accordingly ways – the ones above are not the only ones – of making the options broadly comparable. However, considerations of a more political nature, such as complementarity with other policy objectives, timing of the reform, implementation difficulties, expected views and position of co-legislators etc., need to be taken into consideration before making a choice between these acceptable and justifiable options. As a result this report does not state a preference between the options.

Issues related to implementation

The options involve operational challenges. For option C+ the main implementation challenge stems from the difficulty of defining and disentangling proprietary trading from market-making. This makes it costly to comply with and supervise the implementation, particularly for C that requires full divestment. For option E- the main challenge stems from governing and monitoring inherently opaque intra-group linkages of legal, economic, governance and operational nature.

Supporting the qualitative assessment

Several important elements of the draft IA have been subject to extensive quantitative modelling or analysis. Firstly, quantitative work estimates the level of implicit subsidies. Implicit subsidies are found to be significant and to depend on the size of the bank, the level of interconnectedness with other banks, its level of leverage as well as the rating of the sovereign on which it is headquartered). Secondly, work on the calculation of thresholds has been used to identify relevant European banking groups. Thirdly, the analysis of the relative economic incentives of investment versus commercial banking activities shows that there are regulatory incentives for banks to engage in trading activities rather than deposit taking activities.

In order to support the qualitative assessment of reform options, the Commission services have attempted to quantify to the extent possible some of the costs and benefits that could

result from structural separation. However, given the inherent complexity and special nature of banking and given that many benefits and costs are dynamic in nature, no quantitative model exists that can fully estimate the social benefits and costs of structural reform proposals. This is further compounded by the lack of data. The Commission services have attempted to assess some of the costs (banks' private funding cost) and benefits. Notwithstanding the above-mentioned methodological and data limitations, the results are consistent with the conclusions arising from the qualitative analysis that separation of trading activities would produce economic benefits, such as reducing total losses generated by the banking system.

The Commission services also invited EU banks in the context of the stakeholder consultation to model and estimate the impact of stylised structural reform scenarios on the group's balance sheet, profit and loss account and selected other bank variables. A very limited number of banking groups responded. Moreover, the simulated impacts differed substantially between respondents and were not internally consistent.

Stakeholder views and impacts

As part of preparing this report, the Commission services held a public stakeholder consultation during the course of spring 2013. The Commission services received more than 500 replies, including a substantial number of responses from individuals and consumer associations. The consultation responses highlight a fault line between the responses of banks and consumers and individuals. The former are to an overwhelming extent against structural separation. The latter are largely in favour. These divergences are reflected in responses on the type and strength of structural measures and what activities to separate. The Commission services also held a public consultation about the HLEG's report in autumn 2012.

7. MONITORING AND EVALUATION

Monitoring will take place during the phase-in period. Ex-post evaluation of all new legislative measures is a priority for the Commission. Evaluations are planned about 4 years after the implementation deadline. The forthcoming proposal, once adopted, would also be subject to a complete evaluation in order to assess, among other things, how effective and efficient it has been in terms of achieving the objectives presented in this report and to decide whether new measures or amendments are needed.

In terms of sources of information that could be used during the evaluation, the data provided from the national central banks, the national regulators, European bodies such as the ECB, EBA and ESRB and from international organizations such as BIS, OECD, IMF and FSB. Relevant data could also be collected by relevant market participants or intermediaries. Relevant indicators to evaluate the proposal could include e.g. number and aggregate assets of banks subjected to structural separation requirements; measures of trading and lending activity; and, estimates of implicit public subsidies and reduction of artificial funding cost advantages.