13 November 2012

Dnr 2012/1940

European Commission
DG Internal Market and Services

Response to report by High-level Expert Group on reforming the structure of the EU banking sector

The Swedish National Debt Office (SNDO) appreciates this opportunity to give comments on the report of the High-level Expert Group. The report deals with important issues for the future of the European financial system.

The Group provides a useful and balanced analysis of the financial crisis and its origins. It also reviews the measures under way to reduce the risk of a repetition of this failure of banking and of banking policy, in particular, the Basel III/CRD IV proposals and the Commission's proposal for a directive on bank recovery and resolution.

While noting that few of these measures have yet been implemented or even finally decided, the Group concludes that they are insufficient and that further steps must be taken:

> "[D]espite these important initiatives and reforms, the Group has concluded that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within the banking group. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely linked with securities and derivatives markets" (p. iv).

Some members of the Group, however, argued for a more measured approach. They wanted to use the capital requirement rules to target risks in trading activities and to let the process involving design of appropriate recovery plans by banks and resolution plans by resolution authorities run its course.

General comments

The SNDO fully endorses the stated objective of the Group: "establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy

and the internal market". However, we would recommend the Commission not to act on the Group's proposal as it is unlikely to achieve this objective, especially in the current situation.

Our views are largely aligned with the minority members of the Group. Their suggested approach reflects the fact that proprietary trading and its consequences for risk taking are explicitly being dealt with in the capital regulations. And it is equally clear that trading activities will affect the measures adopted as a result of the future framework for recovery and resolution.

The SNDO finds it inadvisable to add an entirely new approach to the regulation of banks before we have even begun to see the effects of the other measures or, in the case of resolution, not even seen more than a first proposal. It is impossible – both theoretically and practically – to assess at this stage how well the measures already under way will work. It is therefore hard to understand the basis for the Group conclusion that it is *necessary* here and now to take further steps. A decision to require separation along the lines proposed by the Group should not be taken until other legislative reforms have taken effect.

It is also not clear how the Group has been able to assess the efficacy of the measures it proposes well enough to conclude that they are warranted. After all, they are largely untried. And questions do come to mind.

First, it seems clear that more banks have been brought down by significant losses from the types of activities that are supposed to remain in the deposit bank, in particular real estate lending, than those caused by losses in trading related activities, let alone market making (see the next section).

Second, there is no proper analysis of whether legal separation within a holding company is really sufficient to insulate the deposit bank from what happens to the trading bank. If they work under similar brands, contagion cannot be excluded. Considering that liquidity stress can be triggered by rumour rather than fact, this can adversely affect the deposit bank. Thus, the need for government intervention may still arise.

The Group may thus be advocating a measure that is neither necessary, nor sufficient to achieve the stated objective. A much more careful assessment of the cost and benefits must therefore be made before rules on mandatory separation are adopted.

The SNDO finds it difficult to avoid the impression that the Group has had its focus on *the policy instrument*, namely, separation of activities. As a result, it has paid insufficient attention to *the policy objective*, namely, financial stability and efficient provision of financial services to the economy. Such an approach is unlikely to give a reasonable outcome. In this preoccupation with instruments rather than underlying objectives, the SNDO sees parallels to other recent EU proposals that

we have found to be wanting, such as the financial transaction tax and the regulations on short selling.

Add to this that the pace and complexity of reform are already overwhelming, both for banks expected to adapt to the rules and for the authorities expected to apply them. The SNDO does not believe that another layer of reforms would be beneficial at this stage. It would add to the uncertainty about the conditions financial firms can expect to work under in the future. This would not promote a return to a situation where households, non-financial firms and sovereign borrowers can expect to have access to credit and other financial services on fair and reasonable terms.

In addition to these general concerns, the SNDO would like to make some more specific comments on the potential impact of the Group's proposal on the markets for sovereign debt. As the agency responsible for managing the Swedish central government debt, this issue is of special importance to us. This brings us to the effect that the Group's proposal could have for market making.

The role of market making in debt markets

Market making is an essential part of the infrastructure of fixed-income markets in most EU countries. As issuer of government debt, the SNDO is thus dependent on services provided by banks acting as market makers, in particular, authorised primary dealers. These services include both distribution of bonds in the primary market and pure market making in the secondary market, based on a commitment to quote two-way prices for our bonds to investors.

Such market making ensures that investors are able to buy and sell bonds at low costs. Low costs mean both small spreads between buy and sell prices and a small impact on market prices when they trade. Such a liquid secondary market reduces borrowing costs for the government as issuer. It also reduces funding risks, since in a liquid market the SNDO can expect to find a broad and diverse group of investors willing to buy and trade our debt instruments in case we need to expand our issuance.

The importance of market making has been acknowledged in recent legislative discussions. For example, the rules on short-selling include explicit exemption for authorised primary dealers and other market makers. Also in the discussion on MiFID/MiFIR, the importance of adjusting transparency requirements to ensure that market making remains feasible has played a central role.

We find no such recognition of the role of market making in the Group's proposal. Without any real analysis about what the effects would be the Group suggests that market making should be bundled up with proprietary trading. The arguments are, first, that this makes the proposal "sufficiently simple so as to ensure harmonised implementation across Member States" and, second, that the proposed separation avoids "the ambiguity of defining separately the two activities" (p. vii).

“Simplicity” is sometimes a virtue, but when it involves not acknowledging differences that are real, it is not so. Market making properly defined is quite different from proprietary trading. For example, a market maker rarely holds large inventories, but will endeavour to earn a margin from turning bonds over quickly and efficiently. The business is primarily based on the spread between sell and buy prices. It is thus essentially a low margin activity, but also one that involves limited risks.

If burdened by the higher capital requirements that will face a specialised trading bank, banks may well respond by increasing margins or by abandoning market making altogether. Banks may also have incentives to curtail market making activity in government bonds to avoid exceeding the thresholds for separation, instead focusing that part of the balance sheet on activities with higher margins. This will hurt liquidity and market depth. This will be costly for governments, who will face higher funding costs. This is the primary concern for the SNDO, of course.

But a reduction in market liquidity is serious also from the point of view of financial stability. Liquid securities markets are crucial in this regard. This is illustrated by the fact that a key element in the new regulatory framework for liquidity risks is that financial institutions are required to hold buffers of liquid securities. This is intended to ensure that they can withstand a squeeze on access to funding for a certain period.

But securities are not liquid in the abstract. The test of buffer assets is whether they can actually be sold (or used as collateral) when the need arises. If there are few market makers and the only investors are those that are prohibited from trading (such as the banks subject to liquidity requirements) or those that are not interested in trading, the only use for liquidity buffers will be as collateral for loans from central banks. This may be enough to prevent a system collapse, but it is clearly not what the liquidity requirements are intended to achieve.

While on the subject of liquidity buffers, we note a potential consistency problem in the suggested procedure for deciding whether separation should be imposed on a bank. The Group sets as a criterion for mandatory separation that “a bank’s assets held for trading and available for sale, as currently defined, exceed (1) a relative examination threshold of 15-25% of the bank’s total assets” (p. 101).

However, it is quite possible that a bank’s liquidity buffer will make up 20 per cent or more of total assets. Unless these assets are exempted from the calculation, one might end up in the odd situation that at least a part of the liquidity buffer has to be transferred to the trading bank. This could prevent the deposit bank from holding a solid liquidity buffer, possibly even from meeting its liquidity requirements by holding tradable securities.

This interpretation may be a misreading of the Group’s proposal. All the same, it illustrates that holdings of (liquid) securities by banks are not an anomaly, but an

integral part of the balance sheet of a well-managed institution, as seen also from the liquidity rules in Basel III/CRD IV.

To conclude, the SNDO is concerned that forced separation could hurt the market making function in fixed-income markets. This would have adverse effects. In particular, it would increase the costs and risks borne by both sovereign borrowers and the financial sector as a whole.

It should also be noted that the importance of this issue varies between members states. For Sweden, a country with a small central government debt (in relative *and* absolute terms) and its own currency, market making is thus more important as a means to secure liquid markets than for the bigger and more indebted member states.

A measure that is "sufficiently simple to ensure harmonised implementation across Member States", as the Group puts it, can therefore have effects that are anything but harmonised. Again, differences of this kind are key issues in the implementation of other legislation, e.g. MiFID/MiFIR. At a minimum, we expect such considerations to play an important role if the Commission were to proceed to prepare a legislative proposal on the basis of the Group's report.

The decision to submit this response has been taken by Bo Lundgren, Director General of the Swedish National Debt Office, based on a presentation by Lars Hörngren, Chief Economist.

Bo Lundgren

Lars Hörngren