

### Structural reforms of EU Credit Institutions and transparency of securities financing transactions

*Impact Assessment (SWD (2014) 30, SWD (2014) 31 (summary)) of Commission proposals for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU Credit Institutions (COM (2014) 43) and for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions (COM (2014) 40)*

#### Background

This note seeks to provide an initial analysis of the strengths and weaknesses of the Commission's Impact Assessment (IA) accompanying the two proposals on structural reforms of EU Credit Institutions and transparency of securities financing transactions, adopted on 29 January 2014. This initial appraisal refers primarily to the main analysis carried out in the IA<sup>1</sup>, relating to credit institutions, supported by reference to the extensive body of annexes accompanying it. On 3 July 2013, the European Parliament adopted, with a large majority, a resolution on 'reforming the structure of the EU banking sector' in which it urged the Commission 'to take into account the ECB's proposal to establish clear and enforceable criteria for separation' and stressed that 'separation should preserve the EU's single market and prevent its fragmentation, while respecting the diversity of national banking models'<sup>2</sup>. Background information on this topic may be found in a parallel briefing by EPRS Members' Research Service<sup>3</sup>.

#### Problem definition

##### *EU Credit Institutions*

The IA clearly identifies the problem in need of possible EU action and summarises it in the following table.

Problem driver	Problems	Consequences
Unrestricted co-existence of core banking services and trading activities contributing to the creation of TBTF/TCTF/TITF banks	Impediment to resolution and supervision	Systemic risk
	Distorted incentives for banks: excessive risk taking leading to excessive trading and balance sheet growth, misallocation of resources, distortion of competition, management and monitoring problems, conflicts of interest and culture shocks, flaws in standards	

TBTF/TCTF/TITF mean respectively too big, too complex and too interconnected to fail. As the Commission argues that solving these problems may push banks to migrate to the shadow banking system, the IA analyses in parallel the issues regarding securities financing transactions, which are part of the shadow banking universe. Re-hypothecation (see explanation in next section) is also dealt with under the second proposal.

Source: IA, part 1, p. 11.

<sup>1</sup> EU Credit Institutions: part 1, pp. 1 to 86; Securities financing transactions: Annex A13, part 3, pp. 255 to 287.

<sup>2</sup> (P7\_TA(2013)0317).

<sup>3</sup> PE 542.145.

### ***Securities financing transactions (SFT)***

The IA defines securities financing transactions as 'any transaction that uses assets belonging to the counterparty to generate financing means' (IA, part 3, p. 257). This can be illustrated with the example of securities lending, one of the main SFT. In it, the lender, for instance an asset manager, lends securities to the borrower, for instance an investment bank. The borrower in turn provides as guarantee some form of collateral, such as cash or securities, and pays the lender a fee. *Conflict of interests* are one of the main possible problems of SFT, 'because [the] more assets of the fund are lent out or [the] more of the collateral received as guarantee is of bad quality, the higher the lending fees that the manager can expect. On the other hand, high levels of securities lending and collateral of inferior quality increases investors' exposure to risk' (IA, part 3, p. 262). This problem is compounded by the *opacity of SFT*, which, for instance, makes it difficult for EU supervisory authorities to monitor them. *Re-hypothecation* is defined as 'any pre-default use of assets collateral by the collateral taker for their own purpose' (IA, part 3, p. 262). For instance, an asset manager, who received securities as collateral by an investment bank, uses the same collateral for their own transaction. The investment bank, in turn, benefits from lower fees. However, this means, *inter alia*, that the same collateral supports multiple deals and this creates financial systemic risk.

Securities financing transactions and re-hypothecation are part of the shadow banking system, which is half the size of the regulated banking sector, in terms of assets. Four fifths of shadow banking is either in the US or in the EU (and, within this global area, the US, the Eurozone and the UK account respectively for 46%, 38% and 16%: IA, part 1, p. 32).

### **Objectives of the legislative proposals**

Quoting from the Commission IA, the stated objectives for each proposal are:

	<i>EU Credit Institutions</i>	<i>Securities financing transactions</i>
General	(1) Reducing the risk of systemic instability – reducing the risks of banks becoming or wanting to become TBTF, TCTF and TITF (2) Reducing Single Market fragmentation	(1) Ensure financial stability in the internal market by preventing the build-up of systemic risks; (2) Increase the protection of investors and clients.
Specific	(1) Facilitate bank resolution and recovery; (2) Facilitate management, monitoring and supervision; (3) Reduce moral hazard; (4) Reduce conflicts of interest, improve bank culture and standards; (5) Reduce capital and resource misallocation; and (6) Improve competition.	(1) Ensure that the systemic risks of the SFT markets are adequately monitored; (2) Ensure that SFTs profit to investors first; (3) Limit the potential risks for clients and counterparties linked to re-hypothecation.
Operational	(1) Reduce the size of implicit public subsidies... of TBTF banks; (2) Reduce excessive trading by TBTF banks; increase the lending to non-financial customers as a percentage of total assets.	(1) Make frequent and granular information on SFT markets available to regulatory authorities; (2) Increase the transparency toward the fund investors over the use of SFTs and other financing structures; (3) Reduce the uncertainty about the extent to which assets have been re-hypothecated.

Source: IA, part 1, p. 26; part 3, pp. 266-267.

The two proposals share the *general* objective of achieving systemic stability. There is then complementarity, as the first proposal has a clearer European internal market aim, whereas the second has a more clearly-stated investor protection angle. It is however unclear whether the intended protection is set at the level of

the retail investor, such as a citizen, or the institutional investor, such as an insurance company, pension fund or investment fund. Moreover, monitoring is a common *specific* objective of both proposals. Finally, all *operational* objectives of the proposal on securities financing transactions revolve around transparency measures, aimed at reducing the opacity of SFT. It could be considered that the conflicts of interests which had been identified as an additional problem are dealt with by the first proposal.

Analysing more in-depth the IA on *EU Credit Institutions*, the stated objectives reflect, by and large, the principles for structural reforms set out by the European Parliament in its Resolution of July 2013 referred to above. Moreover, they broadly correspond to the problem definition provided. It is worth noting that the objectives spell out more clearly the macroeconomic risk that regulatory responses to the identified problems, if left to the national level, may lead to Single Market fragmentation. Secondly, whereas the problem description had identified excessive risk-taking (and moral hazard), possibly by all banks, as a more direct problem, the operational objectives put emphasis more clearly on 'too big to fail banks' only. Bank size would appear to be an essential issue, as some of the banks which went bankrupt in the current crisis were relatively small. The analysis performed by the Commission's Joint Research Centre demonstrates, however, that larger banks are more likely to benefit from state support.

## **Subsidiarity / proportionality**

### *EU Credit Institutions*

The IA checks the regulatory option in light of the principle of subsidiarity (IA, part 1, pp. 24-25). This aspect is then further developed by the Explanatory Memorandum, which states, for instance: 'Without a Union-wide approach banks will be forced to adapt their structure and operation along national boundaries, thereby making them even more complex and increasing fragmentation' (COM(2014) 43, p. 5). The French Senate issued a rare Reasoned Opinion<sup>4</sup> on this proposal, in which it argues that the derogation process foreseen in Article 21 risks creating an uneven playing field within the EU and undermine financial integration (see section on Coherence below), and that there is excessive use of delegated acts. It also states that the impact assessment accompanying the proposal is not sufficiently developed. In this respect, it identifies some weaknesses particularly related to the necessity of the proposed measures in order to achieve financial stability; the risk of migration to the shadow banking sector, and the impact of the proposal on EU financing and on the competitiveness of the EU banking sector.

### *Securities financing transactions*

No national parliaments issued reasoned opinions on this proposal.



















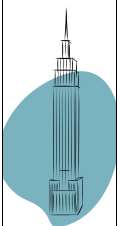
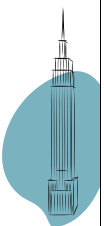









The deadline for national parliaments to provide comments for both proposals was 16 April 2014.

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<sup>4</sup> <http://www.ipex.eu/IPEXL-WEB/scrutiny/COD20140020/frsen.do>

## Range of options considered

### Infographic: Options considered in the IA on EU Credit Institutions

		Strength of separation								
Activities: <i>what</i> is separated from core banking? e.g....		Current requirements			Stricter requirements			Complete		
		Subsidiarisation: different business units = separate legal entities			Subsidiarisation with reforms of intra-group links			Ownership: different activities provided by different firms with unaffiliated different owners		
	Proprietary trading + exposures to hedge funds		A			B			C	
									 2014 Volcker	
	All of the above + Market-making		D			 Liikanen report  E  + wider separation			F	
	All investment banking activities		G			 Banking Holding Company  H 			 1933 Glass- Steagall  I  + Electrified Fence	

Source: IA, part 1, p. 34.

This Infographic presents the nine main options considered for addressing the problem. It reworks a table (IA, part 1, p. 34) which, as the Commission points out, is a simplification and might contain differences with national initiatives mentioned (France, Germany, UK and the US). For each option, the bank on the right depicts core banking, whereas the tall bank represents other activities to be separated. US banks are depicted differently as they are, in accounting and legal terms, different from EU banks. The Commission's preferred options are greyed out. They imply that the largest and most complex banks would have to stop engaging in proprietary trading (option C); and that supervisors would have the power to require those banks to

separate certain potentially risky trading activities from their deposit-taking business, if this compromises financial stability (option E).

#### *Securities financing transactions*

The IA considers several possibilities to increase transparency toward regulatory authorities and fund investors. The Commission's preferred course of action foresees that each counterparty will have to report SFTs to a trade repository; and that funds will have to provide investors with ex-ante and ex-post information.

As far as re-hypothecation is concerned, it is worth mentioning the US re-hypothecation cap and the package of retained options. The latter foresees that all counterparties providing collateral will have to give prior consent to re-hypothecate; and that the financial instruments are transferred to an account opened in the name of the receiving counterparty. The US cap, as explained in the Commission IA, means that re-hypothecation is limited by two thresholds (50% and 140%: IA, part 3, p. 278). Taking an example, a customer buys securities worth €80,000 from a broker-dealer. To finance the purchase, the purchaser can borrow from the broker-dealer up to 50% of the purchase price (€40,000), it becomes immediately the securities' owner and pays the broker-dealer an interest. In turn, the broker dealer can e.g. ask for a bank loan and pledge as collateral, i.e. *re-hypothecate up to 140% of the client liabilities*: €56,000 (140% of €40,000) (Source, US Securities and Exchange Commission, Key. SEC Financial Responsibility Rules, Appendix 11, pp. 137-138).

### **Scope of the Impact Assessment**

#### *EU Credit Institutions*

The IA assesses all main options for their impacts on the more relevant economic and social aspects. This includes impacts on stakeholders, notably on the banking sector, and on economic growth. Pros and cons of various options are generally openly acknowledged. For instance, and importantly, the IA admits that the proposal would increase funding costs for some trading entities, as opposed to deposit-taking entities. However, the IA clarifies that this is an intended effect, as banks which enjoyed a public subsidy financed by taxpayers would lose the uncompetitive advantage they benefited from (IA, part 1, p. 68). Arguments are generally well-presented. The IA analyses especially the systems of the United Kingdom, France, Germany, and, to a lesser extent, Italy, Belgium and the Netherlands. As far as European regions are concerned, the IA states that structural reforms 'would... not concern the vast majority of local and regional banks, such as small cooperative and savings banks...' (IA, part 1, p. 35). It is now possible to take into account the opinions of the Committee of the Regions and of the European Economic and Social Committee, both issued during the summer of 2014. The EESC expressed its firm support for the Regulation, signalling however that the impact on jobs in the financial industry should be given more consideration. The Committee of the Regions supported both regulations under review, regretting that the proposals made by the Liikanen report had been watered down.

#### *Securities financing transactions*

Whereas the economic and social aspects are at least mentioned, the analysis is less in depth than in the parallel IA on EU Credit Institutions. Although there are some references to stakeholder consultation and relevant literature, in some cases statements appear plausible, but are not backed up by evidence, particularly as far as the impacts of the proposal are concerned (IA, part 3, pp. 281-282).

### **Budgetary or public finance implications**

#### *EU Credit Institutions*

The IA states that 'taxpayer support to date that benefits the EU banking sector amounts to 40 per cent of EU GDP' (IA, part 1, p. 9). Alternative consistent quantifications of costs to taxpayers of the current financial crisis are provided. The IA then argues that the adopted reforms have not solved all the problems of the banking sector which have had these public finance implications. It concludes that, although structural

reforms are expected to result in increased private funding costs for some banks, this does not necessarily lead to higher public costs for society at large, including for taxpayers (IA, part 1, pp. 39 to 43).

Against this backdrop, costs to regulators and national supervisors are analysed. One of the main points made is that '[m]ore simplicity in terms of corporate structure of banks would normally allow simplifying regulation and supervision of banks, and potentially render supervision and regulation more effective' (IA, part 1, p. 77).

#### *Securities financing transactions*

The IA makes some statements about the impact of the proposal for Member States, generally arguing that this would not be material. However, the evidence underpinning these statements is less developed than that provided for the parallel IA on Credit Institutions (IA, part 3, p. 282).

### **SME test / Competitiveness**

#### *EU Credit Institutions*

Firstly, the IA takes as a starting point that, in the years leading up to the financial crisis, lending to businesses, including SMEs, has been partly replaced by intra-financial-sector lending. This, in turn, would have impacted negatively on growth (IA, part 1, pp. 13-15). Coherently, one of the objectives of this proposal is to increase lending to non-financial customers as a percentage of total assets. This should contribute to the competitiveness of EU businesses. Secondly, the IA argues that 'SMEs will primarily be banking with the deposit taking subsidiary whose funding costs should not be negatively affected by the separation of trading activities, hence there should be no impact on borrowing rates or deposit rates of SMEs' (IA, part 1, p. 75). Finally, the IA states that SMEs met the Liikanen group (IA, part 1, p. 6) and there are signs that some non-financial companies responded to the consultation process (e.g. IA, part 2, p. 36). However, the input provided by SMEs does not seem to be explicitly analysed at great length.

#### *Securities financing transactions*

The analysis of the impact on SMEs, broadly considered to be either negligible or positive, is limited to some general statements (IA, part 3, p. 281).

### **Simplification and other regulatory implications**

Firstly, the IA deals with the coherence between these proposals and other reforms in the banking sector. In summary, the Commission argues that the selected structural reforms are a complementary tool to the Capital requirements reforms; could help the orderly resolution of banks foreseen in the Bank Recovery and Resolution Directive, and may be a necessary step if the Banking Union is to succeed (IA, part 1, pp. 18 to 22). Secondly, the proposal on *securities financing transactions* is presented as complementary to structural reforms.

### **Relations with third countries**

#### *EU Credit Institutions*

The IA benchmarks the options considered against the parallel reforms undertaken in third countries, and particularly the US. The US system is analysed in depth, not only in relation to the latest reforms, particularly the Volcker rule, but also as regards other initiatives leading to it. The Commission states that its preferred options either correspond to the Volcker rule (option C above) or would be similar to rules applying to US groups (option E above). Therefore, they are not expected to affect the competitiveness of the European banking system vis-à-vis the US one (IA, part 1, p. 69).

#### *Securities financing transactions*

The IA analyses the US system, in particular with regard to the US re-hypothecation cap, which is discarded on the grounds of its negative impacts on liquidity and economic growth, and because, the IA argues, there is currently not enough data justifying that this is set at the right level (IA, part 3, pp. 278-279).

## Quality of data, research and analysis

### *EU credit institutions*

The IA and its annexes present a wealth of information drawn from a broad selection of sources, ranging from international organisations (International Monetary Fund, OECD), to national supervisors, to academics. In addition, there is an extensive use of the Commission's Joint Research Centre, which performed modelling and econometric analysis. Overall, this part of the IA provides a clear overview of the issues at stake and is a good basis for consideration of the legislative proposal to which it refers. There seems to be a presentation issue, however. Because of the complexity of the subject, essential elements can tend to be overlooked in such an extensive body of analysis. For instance, the conclusions of the modelling performed in-house by the Commission's Joint Research Centre are not always easily accessible. A shorter, more focused explanation might have facilitated understanding of the issues.

### *Securities financing transactions*

This part of the impact assessment appears to have been added only at a later stage of the process (see second opinion of the Commission's Impact Assessment Board) and this might explain the arguably lower level of quality, compared with the assessment on the *structural reforms*. This important piece of analysis also suffers from a presentation issue, appearing as it does within the very last annex in the third part of the Impact Assessment, after over 500 pages of less essential elements.

## Stakeholder consultation

Consultation appears to have been extensive, on the face of it, particularly for the structural measures' reforms. The IA on *EU Credit Institutions* openly acknowledges that opinions are broadly split on the measures to be taken between the banking industry and consumers. As far as *SFTs* are concerned, the IA reports that the relevant consultation of stakeholders, for instance the one performed by the Financial Stability Board, signalled a broad support for increasing the transparency of this market (IA, part 3, p. 267).

## Monitoring and evaluation

The IA on *EU Credit Institutions* clearly defines ten indicators that can be used in the ex post evaluation (IA, part 1, p. 81). Some indicators are also provided for the transparency of *securities financing transactions* (IA, part 3, p. 283).

## Commission Impact Assessment Board

The IA Board analysed this IA twice. The first IAB meeting was held with an oral procedure in October 2013 and resulted in a negative opinion. As is standard procedure at the Commission, the lead DG, the Directorate General for Internal Market and Services, resubmitted the IA, which was analysed by written procedure between December 2013 and January 2014. The major critical comments of the IA Board on the second draft IA may be found at the address [http://ec.europa.eu/smart-regulation/impact/ia\\_carried\\_out/docs/ia\\_2014/sec\\_2014\\_0079\\_en.pdf](http://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2014/sec_2014_0079_en.pdf). The IA seems to respond appropriately to most of the critical comments made, at least with regard to the IA on *EU Credit Institutions*, possibly with the exception of the need to better analyse the impact on Member States.

## Coherence between the Commission's legislative proposal and IA

### *EU Credit Institutions*

The main provisions of the legislative proposal appear to correspond to the IA, with the notable exception of the derogation from the separation requirements. According to the proposed Article 21, a Member State whose national primary legislation already complies with rather strict requirements may request the Commission to grant a derogation for a deposit-taking institution. Although the Commission would appraise compatibility of the national legislation, *inter alia*, with the functioning of the internal market, the fragmentation of the European internal market for financial services would, on the face of it, appear to be a relevant risk. As the IA states, '[g]iven the fundamental freedoms set out in the Treaty on the Functioning of the European Union (the "TFEU") divergent national legislation may affect capital movements and

establishment decisions of market participants' (IA, p. 22). Moreover, at the European level the derogation process would, essentially, revolve around the Commission, which would appraise compatibility of legislation, having consulted the European Banking Authority. It can be questioned whether this process is sufficiently robust, taking into account the stakes involved. In particular, the European Parliament does not appear to have an explicit role in this authorisation process. The Explanatory Memorandum mentions, for instance, that this derogation 'would allow Member States that are found to have already implemented 'super-equivalent' measures to avoid costly alignment of existing, effective provisions with these provisions' (COM(2014), 43, pp. 4-5). However, Article 21 is a substantive element the impact of which does not seem to have been analysed in the IA. The existence of this proposed derogation from the requirements of a Regulation is one of the observations made in the Reasoned Opinion issued by the French Senate.

### ***Securities financing transactions***

The proposal on securities financing transactions is presented as a necessary follow-up to the one on structural reforms of credit institutions. The Commission argues that more transparency is needed as reforms could push activities into the shadow banking sector. It is, at this stage, unclear how the two Regulations would interact in case of a derogation. Would a credit institution which is granted a derogation from the separation requirements be subject to the same transparency requirement as other credit institutions? Again, this point does not appear to be covered clearly by the IA.

## **Conclusions**

This appraisal is an initial analysis performed on a particularly complex and substantial body of work. Additional work can of course be performed on specific points, should the competent EP Committees so require. The main conclusions are that the IA on structural measures improving the resilience of EU Credit Institutions is a useful tool for policy-makers, which by and large respects the Commission's own internal IA guidelines. The parallel IA on reporting and transparency of securities financing transactions is usefully presented together with the first IA, signalling a positive shift of the Commission toward looking at IA in a more coherent manner. However, the level of analysis of this latter IA, seemingly introduced at a later stage of the process, appears to be less in-depth than the one on structural reforms.

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*This note, prepared by the Ex-Ante Impact Assessment Unit for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, analyses whether the principal criteria laid down in the Commission's own Impact Assessment Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal. It is drafted for informational and background purposes to assist the relevant parliamentary committee(s) and Members more widely in their work.*

This document is also available on the internet at: [www.europarl.europa.eu/committees/en/studies.html](http://www.europarl.europa.eu/committees/en/studies.html)

To contact the Ex-Ante Impact Assessment Unit, please e-mail: [impa-secretariat@ep.europa.eu](mailto:impa-secretariat@ep.europa.eu)

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