Opinion

to Directorate General Internal Market and Services: Consultation Paper on Reforming the Structure of the EU Banking Sector

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Opinion of the German Banking Industry Committee: Consultation Paper on Reforming the Structure of the EU Banking Sector

Question 1
"Can structural reform of the largest and most complex banking groups address and alleviate these problems? Please substantiate your answer."

The German Banking Industry Committee (GBIC), known domestically as *Die Deutsche Kreditwirtschaft*, supports the European Commission in its endeavour to increase financial market stability. Stable financial markets are of vital interest to the banking sector.

Yet to this day, there is no empirical evidence whatsoever to sustain that separate banking systems can prevent a financial crisis, or that they are more stable in the event of such a crisis than a universal banking system. The recent crisis has many and varied causes, as the Liikanen report so thoroughly details. Undoubtedly, banks have been instrumental in both igniting and aggravating the crisis. Criticism maintaining that large institutions cannot exit the market without burdening taxpayers is entirely justified.

Legislators and regulators have responded by taking numerous measures. They have tightened capital and risk management requirements, granted supervisors more powers or are planning to do so, and initiated a reasonable solution to the problem of banks becoming *too big to fail* (TBTF) by proposing the pending Bank Recovery and Resolution Directive (BRRD). Recovery and resolution planning as stipulated therein is more appropriate and refined an approach than restructuring an institution, absent any such plan, simply upon its crossing any regulatory threshold. Rather than indiscriminately redesign or prohibit an organization's structure as soon as such metrics have been transgressed, supervisors will be able to assess case by case whether the institution or group in question is recoverable or resolvable within present structures, and whether there are any (structural) barriers that need to be removed. In terms of constitutional law, recovery and resolution planning requirements and regulatory resolvability enforcement compare favourably to a comprehensive structural reform since they are at least as effective, yet less intrusive.

Another point to be considered are the symbiotic relations between the banking sector and the real economy. Besides long-term debt finance intermediated by banks, an export-oriented, predominantly medium-sized business community such as Germany's needs capital market products for corporate finance and international business, that is, the gamut of client-driven investment banking services.

Furthermore, standalone trading entities would mostly fail to come up with a sustainable business model, and hence close shop sooner or later. Few players would survive on this market segment, turning it into an oligopoly of investment banking giants accumulating all types of risks in their books, and driving price levels of the financial products they trade.

It is obvious that financial institutions considered systemically important (SIFIs) take advantage of implicit government guarantees when refinancing on the capital market. Universal banks, however, mostly fund themselves with deposits, which are considered less critical to the system and hence are not backed by public guarantee to the same extent. Ways to internalize such external effects are known and have been taken in the course of recent financial market reforms. They include imposition of stricter capital requirements on SIFIs as well as banks' contributions to national financing arrangements under the BRRD. External effects of deposit guarantee schemes could be internalized by raising risk-adequate contributions. The specific problems associated with the existence of SIFIs in the EU banking sector can thus be dealt with by applying instruments available today or currently under development. Spinning off individual lines of business would neither be necessary, nor would it help solve any of those issues.

The consultation paper also suggests that structural separation reduces complexity, thus simplifying a bank's resolution and preventing an internal crisis from escalating to a systemic level. We consider that reasoning a fallacy. Separating risks by transferring trading exposure onto one entity and credit risk onto another has no bearing on the financial system's aggregate exposure. Even after a separation, a complex and risky transaction remains just that.

Flatly separating individual lines of business on the assumption that they are particularly risky would, therefore, fail to help increase financial stability. Even the reduction of complexity it claims to achieve is an illusion. Reforming the banking sector along the lines proposed would be plausible only if EU legislators knew beforehand that the business units to be spun off were just the ones in which the next financial crisis were to emerge. But who may claim to have that knowledge? Neither is there any evidence to justify the hope that separated investment entities should be unable intrinsically to cause further global financial and economic crises.

So if there is any merit in shifting risk, it will be negligible compared to the potential benefits of directly curbing the exposure ensuing from questionable business models. Reform advocates also seem to be unaware of the cost that restructuring the banking sector would incur on the entire economy.

Another point often made in favour of a structural reform of the entire banking sector is the alleged cross-subsidization in which universal banks supposedly engage by using deposits backed by guarantee schemes as a source of funding. Funding certainly is a business function in which universal banks achieve economies of scope. However, mixed funding from both deposits and the capital market benefits the banking business as a whole. Most universal banks use their asset-liability management to allocate funds to business units. But there is no such practice as subsidization among units. The direct link drawn in the consultation paper between deposits and trading is pure conjecture. It is, in fact, impossible to determine which means fund what business. Balance sheet data is unsuited to retrieving such information.

According to the consultation paper, "structural reforms of the banks that are too-big-to-fail would *directly* address intragroup complexity, intragroup subsidies, and excessive risk-taking incentives", this statement, too, misinterprets the economies of scale and of scope achieved in universal banking. Universal banking is vital for funding Europe's economy. Any structural reform that were to compromise that system would severely harm Europe's business community. There are better ways than restructuring the banking sector to accomplish the objectives specified in the consultation paper, including the urgent TBTF problem. A reform along the lines set out in the paper will fail to solve those issues in the long term. That is why we do not consider it desirable.

What we share, though, is the idea of protecting the real economy, private investors, and taxpayers' money. With those goals in mind, we should discuss the effectiveness of the measures proposed in the paper. Regrettably, the two scenarios outlined, the selection of organizations to be involved, options presented and approaches envisaged for implementation all raise doubts as to their suitability for accomplishing the primary objective. Instead, the network of European financial systems, woven over centuries, adjusted to national needs and preferences, and already extensively regulated, threatens to be made liable collectively for the misconduct of individual organizations that have not even been under regulation before.

We therefore advocate maintaining the universal banking system, and advise against any regulatory action to separate individual lines of business. Not only are universal banks deeply rooted in the economic traditions of continental Europe. They also offer customers a number of advantages such as a broad range of products and services, and help stabilize the financial system by spreading risk and sources of income. If those proven structures are to be modified, changes should be very selective, and proportional to their objectives in scope. Hence reform deliberations should focus on business conducted with unregulated institutional counterparties. It would also be wise to wait for the many and varied regulatory initiatives taken, for example, to advance the banking union project, to take effect, as they will have an indirect influence, at least, on the banking sector's structures as well as on the revision of business models.

Question 2
"Do you consider that an EU proposal in the field of structural reform is needed? What are the possible advantages or drawbacks associated with such reforms? Please substantiate your answer."

As pointed out in answering the previous question, European legislation presently in effect or under way covers all the subjects addressed by the consultation paper. Markets have been re-regulated, international supervision restructured. Intervention includes regulatory action aimed at improving capital and liquidity structures, the resolution of banks, collateralization of assets, and the rating of institutional counterparties – see Basel 2,5 and III provisions in CRD III and IV, legislation on the supervision of credit rating agencies, the BRRD, the European Market Infrastructure Regulation (EMIR), provisions on securitization in CRD II and III, as well as current consultations on securities legislation. We consider those measures conducive to increasing financial market stability and, in particular, to protecting customer assets in the event of a crisis. Hence we suggest waiting for them to take effect rather than hasting to introduce additional structural reforms that would run parallel. Such reforms are more likely to confuse market participants, put EU banks at a disadvantage versus external competitors, and stimulate risk concentration rather than reduce exposure. In any case, it would be wise to conduct a thorough analysis of the potential interplay between current and planned regulatory action before pushing ahead.

Against this background, we fail to see any need for a structural reform initiative such as the Commission's. The fact that some member states have been quick to amend their regulatory laws does nothing to strengthen the reasoning in favour of EU-wide legislation. As we see it, financial stability will increase only if identified risks are addressed selectively, taking into account their cumulative impact. A structural reform of the entire banking sector is the solution to a problem that does not even exist. Mandatory recovery and resolution planning as initiated on the European level, and already under way in Germany commends itself as a more refined and hence sounder strategy than separating individual lines of business. It would also be more responsive to the differences between banks and banking systems among the member states. In addition, capital buffers as provided for in CRD IV, including capital conservation and countercyclical buffers adding up to five percent of Common Equity Tier 1 plus up to three systemic buffers, substantially increase the resilience of financial institutions against present and future crises. Rather than redesigning or prohibiting an organization's structure indiscriminately upon its crossing any prudential threshold, as stated in answering question 1 above, the recovery and resolution scheme lets supervisors assess case by case whether any structural barriers to the organization's continuity can be removed within the structures in each member state.

Considering the differences between the structural reforms imposed by Britain, France and Germany on their respective financial sectors, we would like to know how the Commission is going to achieve harmonization without compromising the member states' home-grown banking systems. Any solution that were to accommodate whatever national legislators demand just for harmony's sake would be bound to fail as, for example, integrated cooperation within Germany's Savings Banks Finance Group or the Cooperative Financial Network (each comprising local institutions mostly engaged in retail banking, as well as central institutions specializing in capital market business and large-scale funding) is incompatible with Britain's regulatory approach of ring-fencing closely circumscribed parts of retail banking. Similar concerns apply to the business model of the country's traditional private banking houses. Therefore, we remain highly sceptical of a structural reform of the EU banking sector as outlined in the consultation paper based on the Liikanen report. In our eyes, the obvious dismissal of the default option mentioned in the paper is one if its major shortcomings.

At the stakeholder meeting on 17 May 2013, another reason given in favour of the Commission's initiative was that it would help cut back the increase in regulatory complexity resulting from recent EU legislation such as CRD IV. Should financial market rules passed over the last few years really have risen to a level of complexity unmanageable by supervisors, it would, indeed, be wise to amend such provisions. But the idea that simplification could be achieved implicitly by splitting banks is, as we see it, a fallacy. Especially when banks are separated functionally, supervision could become even more complex than it is today.

If the Commission decides to continue pursuing its plans to separate or prohibit certain banking activities despite the serious objections raised above, it should take care to do so in a manner that ensures the continuity of reforms tailored to national banking structures.

Question 3
"Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator."

Both the current and previous crises were grounded in prolonged periods of excessive lending, and the ensuing proliferation of risk. A main driver of the financial crisis that began in 2007 has been a commitment made by political leaders in the Unites States to make home loans available even to those citizens whose economic standing would not allow them to service the debt.

We would also like to point to the mismatch between intervention thresholds and the scope of business to be separated in all four of the options presented. In practice, financial institutions which may have crossed a threshold but merely have a minor business volume to spin off, would be at a competitive disadvantage next to those that remain on the safe side.

That said, we welcome that several approaches to identifying the institutions to be separated have been put up for discussion, although most of them take into account nothing else but balance sheet ratios, which we deem highly problematic. Hence we see the consultation process as an opportunity to develop indicators that more genuinely reflect their business context, thus supporting more effectively the core objective of supervision, that is, curbing risky and speculative trading funded by client money.

Opinion of the German Banking Industry Committee: Consultation Paper on Reforming the Structure of the EU Banking Sector

Indicators of systemically risky trading should refer to the problem drivers identified in chapter 1 of the consultation paper. The primary goal is, we understand, to prevent institutions from using funds acquired through regulated deposit-taking, lending or securities operations to cross-subsidize trading with shadow banks, or to funding such players. Indicators relating to the market are difficult to define given that unrated, unregulated players conduct their business both within and outside the regular banking system. That is why we suggest looking at the interfaces between regular and shadow banks. Regular banks' trading activities with shadow players can be captured by classifying counterparties. We would welcome a classification rule based on a definition of shadow banks referring to counterparties. That rule would apply to funding transactions conducted with hedge funds, unregulated SPVs or market players, off-balance-sheet ventures, high-frequency traders and the like. As regulated institutions can clearly distinguish the business they conduct with counterparties operating outside the regular banking system, the volume of such transactions can be quantified with accuracy.

Furthermore, thresholds based on balance-sheet ratios would be difficult to interpret as they follow an accounting and business administration terminology out of tune with a separate banking system. First point in question is whether balance-sheet-based thresholds for assessing entities included in a group's consolidated financial statement shall apply both to individual and to group accounts levels. Looking at the group level when deciding whether or not a bank's activities must be separated seems problematic. Difficulty will arise when a cumulative metric of a line of business represented by several institutions indicates separation, while some of them have, in fact, complied with the threshold.

In our opinion, indiscriminate risk classification pursuant to IFRS categories is inadequate. The very fact that not all banks balance their accounts pursuant to IFRS raises doubts as to the suitability of those classes. Focusing evaluation on business objectives seems more reasonable.

We also think that using „available for sale" (AFS) positions as an additional basis for assessing the need to spin off risky business would be inappropriate. Definition 1 must be interpreted in the light of the AFS category laid down in IAS 39. That class comprises mostly long-term assets that need to be held for regulatory liquidity management. It would be beyond comprehension if compliance with prudential liquidity requirements were to become a valid reason for enforcing the structural separation of universal banks. This point has been highlighted as critical in the consultation paper itself. Besides that, neither definition 2 nor 3 adequately reflect that both the "held for trading" category specified in IAS 39 and definition 3 itself expressly refer to assets and liabilities that help balance risks.

Among the four definitions presented in the consultation paper, we only see the fourth as adequate because it bases evaluation on a consolidated net position, thus factoring in effects of liabilities. Since derivatives are often purchased to hedge securities risks, it would make sense to depart from definition 4 and net those assets and liabilities.

Just as inappropriate for managing risk is the exclusive valuation of assets at market prices. The positive market values of derivatives implicit in definition 2 refer to reporting them as gross pursuant to IFRS. Positive market values are booked as assets, negative values as liabilities. There is no recognition of any risk-compensating effects between those gross assets and liabilities. Whenever a derivative transaction with a client has been hedged completely with a counterposition on the capital market, equivalent amounts are booked under assets and liabilities. Since one of the two transactions always has a positive market value, the other a negative one, market values add up to zero. Besides, market prices of derivatives reported in gross terms swing with market parameters such as interest rates. Due to the historically low interest rates owed to the crisis, market values of interest rate derivatives reported both as assets and as liabilities are extremely high although the holder's exposure remains unchanged.

Since derivatives are often purchased to hedge securities risks, it would make sense to depart from option 4 and net those assets and liabilities. Market prices of derivatives reported as assets, as implied in definition 2, will reveal neither any open risk position nor systematic trading. Their amounts have just as little to do with the derivative portfolio's real exposure because they swing with volatile market parameters. Nor will grossing up receivables and payables from derivatives, respectively, as suggested by definition 3, deliver a more meaningful result as it boosts the effects referred to above by changing parallel the market values reported as assets and liabilities of closed positions. Therefore, definition 3 is just as ill-suited to spotting open risk positions in derivative trading. Netting the two transactions, which always results in zero in the case of a perfect hedge, is the only method to show that market value volatility is neutral in terms of risk, as exemplified by a position comprising a derivative sold to a client, and a capital market hedge. Suitability for detecting risk or trading within the derivatives portfolio hence is another reason for us to believe that, among the four definitions presented in the consultation paper, only the last one will do since it accounts for the effects of liabilities by basing assessment on a consolidated net position.

Alternatively to our suggestion that indicators of systemically risky trading should follow a definition of shadow banks referring to counterparties, we favour indicators that reflect a bank's net volumes of proprietary trading. However, as stated above, that would include all trading and associated cash flows both into regulated and into unregulated Markets. That is why we recommend taking this approach one step further by confining mandatory separation of such business as corresponds to the above definition of shadow banking in terms of counterparties.

The key element of definition 4 is its reference to net trading volumes. Banks are required to hedge credit and underwriting risks with derivatives. They also hedge clients' positions as well as their own dealings with clients. As a result, they accumulate considerable gross derivative positions, which may be netted, though, on the balance sheet under certain conditions. Looking at gross volumes would fail to distinguish institutions that avoid risk and hedge their transactions from those that take large open positions. Hence it seems more reasonable to base threshold calculation on net positions. Option 4 points in the right direction. Even better than simply adding up net volumes of securities and derivatives, as implied in that option, would be factoring in the "algebraic signs" of instruments kept in the trading book given that securities and derivatives often serve to hedge each other.

A welcome side effect of drawing on net positions for assessment would be that market volatility alone could not push an institution beyond a threshold, as may happen when looking at gross volumes, which ignores the compensatory effect of hedging positions on the liability side. Focusing on net exposures also counters risk by posing an incentive to close positions.

Not to forget: Since separation severely encroaches on owners' fundamental rights, crossing an absolute or relative threshold once should not suffice to trigger the suspension or separation of business deemed risky. After all, the transgression may have external causes. Hence it stands to reason to base assessment on an average of several fiscal years. As market volatility also has an impact, it seems questionable whether there is any point in measuring threshold compliance as at a particular date.

Separation causes considerable effort even when just a small portion of the business may have to be spun off. To ensure that the effort remains in proportion with the value of the portfolio in question, legislation should include a de minimis rule, or a possibility to ask national supervisors to concede an exception while noncompliance remains within de minimis limits.

Finally, a transition deadline should be granted. As an institution's influence on the value of assets relevant to threshold compliance is limited, banks would be hard-pressed to meet and anticipate separation requirements at short notice.

Question 4
"Which of the approaches outlined above is the most appropriate? Are there any alternative approaches? Please substantiate your answer."

Both *ex-post separation subject to constrained discretion* and *ex-ante separation subject to evaluation* concede supervisors the flexibility they need to allow for national, institutional or group specifics such as operating as a financial services network. Lack of such discretion would boil down to mandatory standardization disregarding business diversity. The two approaches also protect institutions hovering around intervention thresholds from undesired cliff effects.

The third proposal, referred to as *ex-ante separation*, however, does not admit of any discretion whatsoever, economically sensible though the latter may be. Following that approach, national supervisors would be unable, for example, to make concessions to banks that were going to downsize or phase out the business they are required to spin off anyway. Institutions concerned would have to set up separate legal entities to conduct such auxiliary business at considerable expense. Hence that approach should be dropped.

Please also note that it is impossible to conduct a sound analysis of the impact of either ex-ante or ex-post separation without knowing the technical standards or guidelines envisaged in the consultation paper, nor the criteria underlying the powers conferred on banking supervisors.

Regardless of whether separation is to take place ex ante or ex post, we think that any legislation proposed by the Commission must provide for a materiality or de minimis threshold as suggested in the Liikanen report. That would oblige national supervisors to review the proportionality of any legal requirement to spin off assets for transgression of regulatory thresholds based on balance-sheet ratios. Supervisory discretion is necessary on a national level for two reasons: First, it helps avoid having to take uneconomic measures in cases where the extent of noncompliant business has been negligible. Second, it protects institutions hovering around thresholds from undesired effects. Otherwise, supervisors' administrative burden would soar, while compliance would become economically prohibitive. In other words, having to separate business units as soon the intervention threshold has been exceeded by one euro would be counterproductive. This stance is implied, though not stated expressly, in the description of the second approach.

Question 5
"What are the costs and benefits of separating market-making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?"

The relevance of the banking sector to the real economy goes far beyond lending, taking deposits and facilitating payments. Export-oriented, predominantly medium-sized economies that heavily rely on banks for funding, such as Germany, need more advanced services like underwriting, market making for initial public offerings, or derivatives for hedging purposes. Market making is also important for placing covered bonds in Germany. Furthermore, core banking services include asset management and private banking. Let us keep in mind as well that banks need to spread their risk, so rather than transforming all their deposits into credits, they should invest in long-term securities, too, by engaging in strategic proprietary trading. To meet all those needs, institutions must be allowed to operate on capital markets, and to hedge the risks they are expected to take on.

The consultation paper stylizes three options by which to split a bank's business. Each option entails different costs and possibly far-reaching consequences on business models as well as on the foundations of financial markets. The choice that prevails may trigger massive interference with home-grown structures. Extensive interpretation will spur such interventionism. Starting from these general considerations, let us proceed to look at the three options more closely.

Even if trading entities to be set up were highly specialized, competitive advantages such as economies of scale would lead to a concentration of trading in the hands of few players, which runs counter to the purpose of regulation.

We are sceptical about trading entities along the lines of the second option, which bundles proprietary business with market making, and separates both from deposit banking. We see it crucial for deposit banks to remain in a position to make markets with as little restriction as possible. This service is vital for securities trading to function as it provides sufficient liquidity largely independently of market conditions, thus securing clients access. Without it, reliable buying and selling prices would be unavailable, and markets would become dysfunctional. A major beneficiary is the real economy as it depends on efficient capital markets for raising equity and managing price risks. Germany's recently passed *law on shielding against risks, and on planning recovery and resolution of financial institutions and groups*, better known as separate banking act, recognizes the importance of market making by refraining from making separation mandatory upon crossing any intervention threshold. Instead, the law empowers supervisors to impose spinoff of market making on a case-by-case basis under conditions such as imminent insolvency due to such business.

We are no less sceptical of broad trading entities, which would be separate investment banks just as in a separate banking system. As functional separation has been a driver of previous crises, it should not be promoted by EU legislation. For our fundamental concerns about that system, which are backed by numerous studies, please see our answer to question 1 above. A separate banking system as such does nothing to reduce risk. This point of view is shared, among others, by the IMF in its analysis of financial stability in Europe, conducted under its Financial Sector Assessment Program (FSAP), as published on 15 March 2013.

Any bank performing important functions in both customer-driven and interbank business due to its size and integration into the financial market can do so only by maintaining key capabilities such as hedging their own transactions, or serving institutions that cannot access markets as readily. Market access is also among the vital services provided by central institutions to associates in a banking services network (*Verbund*).

Moreover, trading conducted by a universal bank's client-driven investment unit is closely interlinked with its customer-facing branches. Trading units always provide their services, among them market making, stockpiling of securities to stabilize prices and to satisfy client demand, as well as underwriting (that is, purchasing a portion of a client's IPO at a guaranteed price for own account to resell to investors later), in support of customer-driven business. Only when bundled with customer care and consultancy into a comprehensive service package, can such trading satisfy clients' needs. This practice serves the economy as a whole, as multi-level customer relations help overcome information asymmetry, and put the right price tag on risk. Mandatory separation of the trading business specified above from customer care, including capital market sales, corporate and key account management, would make it very difficult for banks to provide capital market services to (corporate) clients.

Hedging exposure associated with customer-driven business is an integral part of efficient risk management in the banking industry. This practice must be exempt from any future separation requirement. Otherwise, banks' risk-adjusted balance sheets will be compromised, resulting in substantial charges and instability.

Transactions for liquidity and risk management purposes must also remain allowed to deposit banks. Else efficient bank and risk management would hardly be possible.

Money-market instruments needed for liquidity management, such as repo transactions or securities lending, should also by exempt from mandatory separation. Providing collateralized liquidity to the real economy and to other banks that way is a component of the transmission mechanism of monetary policy. Complicating liquidity management by requiring parts of interbank liquidity transfer to be spun off poses a major risk to the stability of the financial sector, to providing liquidity to smaller institutions without direct market access, and to Europe' entire business community. Banks operating regionally or nationally would be unable to comply with that requirement. Consequently, the interbank money market would concentrate. So when the next crisis occurs, its impact would probably be harder given the accumulation of risk in the hands of few major players. In the end, provision of liquidity to the real economy would become insecure, less flexible and possibly more expensive.

To clarify the discussion as to whether to spin off business conducted with venture capitalists, private equity or hedge funds, we would like to stress that the bank exposes itself to those counterparties directly. Exposure to such funds may be in the form of direct equity shares, prefunding equity commitments, or direct funding.

In its FAQ template from 11 July 2013, the Commission provides further guidance as to how *exposure to venture capital, private equity and hedge funds* is to be understood. As stated on page 7 therein, the term "should be interpreted as covering any debt or equity investment (including through loans or the purchase of units/shares) in different types of alternative investment funds. In other words, any relation with vehicles for private equity and venture capital activities and with hedge funds should be included". For numerous reasons, which would have to be discussed separately, that definition seems too general and, thereby, too inclusive. Furthermore, it mixes types of business whose risk profiles and social benefits vary greatly. In that respect, the concept of *exposure to venture capital, private equity and hedge funds* deserves further discussion.

Any impact assessment must include capital and operating expenditure, which would be substantial given the links among business units. Those expenses are prohibitive of some of the separation scenarios considered. In rough terms, they include:

One-Time Costs
- legal and organizational expenses: start-up costs, selection and appointment of management and supervisory boards, service-level agreements
- technical and procedural costs: project staff, additional IT hard- and software, office furniture and equipment, auditing charges
- capitalization: expenses incurred for provision of equity
- transfer of liabilities as approved by investors

Subsequent Costs
- loss of present and future earnings from business no longer possible
- higher funding spreads
- additional risk provisioning expenditure: tendency to conduct riskier business to offset more expensive funding
- compensation of know-how drain, possibly revision of business model

Though incomplete, the above list reveals the difficulty of calculating the cost of separation. It also shows that total cost to be shared by trading and deposit entities will rise considerably.

Given the business needs to be met by deposit banks as described above, it would be desirable to focus any further considerations on a vision of a structural reform that preserves the universal banking model, requiring merely the riskiest operations to be spun off, pursuant to option 1 (*narrow trading entity and broad deposit bank*). That approach is reflected in Germany's recent separate banking act, among others. If the Commission decides to continue promoting a separate banking system despite our reserve about it, option 1 seems to be the way to go. It would preserve the universal banking model, enabling the provision of a broad range of financial services to export-oriented businesses.

Question 6
"Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?"

As to the first half of the question, the answer is, yes, definitely. In present-day banking, commercial and investment operations are inseparable both from the client's and an institutional point of view. Medium-sized businesses, in particular, turn to their banks not only for loans but also for capital market expertise. In a separate banking system, customers would have to purchase capital market products separately from an independent investment bank. That, in turn, requires special knowledge and experience. As most German midmarket businesses are at the smaller end of the size spectrum, they lack that expertise. They depend on one-stop consultancy on both loan and capital market products. In particular, that applies to the price efficiency of such products and services.

In a joint statement from 15 January 2013, the Confederation of German Employer Organisations (BDA), the Federation of German Industries (BDI), the Association of German Chambers of Commerce and Industry (DIHK), the German Confederation of Skilled Crafts (ZDH) as well as all associations of the country's banking industry therefore advocate maintaining the universal banking system.[1] They emphasize that hedging and financing tools, which are usually associated with investment banking, also form an integral part of financial services for companies. By the same token, they warn that the introduction of a separate banking system would increase the cost of hedging risk, and restrict the supply of such financial services at the expense of the international competitiveness of German businesses. Besides, provision of such services would concentrate in the hands of few investment banks, which we fail to see as an objective for EU legislators to pursue.

Question 7
"As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?"

As the consultation paper remains rather vague on how intragroup ownership structures are to be regulated, it is difficult to furnish robust qualitative and quantitative analyses. There is hardly any reliable data available beyond the institutional level on the potential cost or benefit of regulating those structures.

Besides, reducing assessment of the legal dimension of separation to a cost-benefit analysis falls short. The consultation paper fails to address the complex legal issues involved. It remains unclear, in particular, whether transnational business matters affected by functional or ownership separation can be resolved with legal certainty. For example, the portfolio to be spun off or transferred may be booked in several business units of a group, such as domestic and foreign branches or subsidiaries. In cases like that, transferring inventory items among units subject to different jurisdictions could prove difficult, even impossible, as well as economically prohibitive as it might incur additional cost such as taxation. Hence alternative ways of transferring exposure, such as cash subparticipation or guarantee, must be provided for.

In terms of cost, tax implications of separation also deserve attention. In German tax law, for example, the separation of a bank's trading business would be tantamount to a sales transaction, entailing disclosure and taxation of any hidden domestic or foreign reserves. If the Commission decides to pursue structural separation further, it should initiate EU-wide harmonization of the assessment of the steps and measures involved in terms of tax law, too. Since separation constitutes a regulatory intervention that encroaches on owners' entrepreneurial freedom, legislators must ensure its tax neutrality.

If intragroup loans were to be treated as lending to third parties, they would become subject to general capital requirements and large exposure restrictions. The EU large exposure regime, for example, limits lending per borrower to a quarter of eligible own funds. However, we see the free flow of capital and liquidity within a banking group not only as vital but also as imperative since such transactions are an integral part of intragroup risk management. Any restriction would collide with the hitherto preferred

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[1] Joint declaration of the umbrella organizations of Germany's business community on maintaining universal banking: http://germanbanks.bankenverband.de/press-room/press-releases/universal-banks-strengthen-financial-market-stability-and-ensure-business-finance

model of centralized, standardized liquidity and capital management on the group level, and inevitably increase the cost of funding entities that do not benefit from centralized intragroup liquidity resources.

This might also impair measures taken by central banks to alleviate liquidity crunches. If, in such an event, the entity concerned could neither turn to the ECB directly for funding nor receive all the funds it needs from within the group, it may run into a liquidity crunch itself despite a sufficiency of liquidity on the group level.

The GBIC prefers functional to ownership separation because the former would allow Germany's proven universal banking model to persist while ensuring transparency of the links between deposit-taking and trading entities. It would also empower national supervisors to impose regulatory standards at their discretion.

To provide trading entities with access to sufficient funding, the degree of integration among the lines of business within the group to be restructured would have to be considered. The fact that cross-subsidization, be it in the shape of guarantees issued by the holding company on behalf of the trading entity, or of direct funding via the deposit-taking entity, is to be avoided, calls the sustainability of the trading entity's business model into question after a separation. Not so if the trading entity were a subsidiary of the deposit-taking entity, which could defuse the former's rating and funding problem.

Question 8
"What are the relevant economic links and associated risks between intra-group entities?"

Links among intragroup entities, be they business units controlled by a holding company or associates of a banking services network, vary with business models. The closer those economic ties, the higher the mutual exposure to contagion effects, for example. And yet it is precisely that interconnection which enables a portfolio approach to managing risk both in economic and in risk-weighted terms. Strict separation of units previously integrated in a holding structure would thwart such advantages.

So far, EU regulatory policy has promoted a centralized and standardized approach to capital and liquidity management. Thus many banking groups have unified their internal funding, mobilizing efficiency reserves by presenting one face to the capital market. By raising liquidity centrally and distributing it as needed, they ensure their business units' ability to satisfy local demand for financial services.

Since intragroup transactions are exposed to counterparty risk just as any loan, they are subject to the same capital requirements and large exposure restrictions. However, if they meet strict requirements like those stipulated in article 113, paragraphs 6 or 7 of the CRR, a number of privileges become applicable. As those exceptions make sense and are justified, they should not be abandoned lightly.

By looking somewhat more closely at an organizational structure typical of Germany's banking sector, the *Verbund* (banking services network), we now illustrate that it would be inadequate to confine analysis to groups when considering structural reform. In a networking structure such as the *Verbund* systems comprised by Germany's savings banks and cooperative banks, respectively, a central institution provides money and capital market access to associated local institutions. Since the latter, in general, do not have direct transactional access to capital markets, the central institution conducts business relevant to them either directly or indirectly on their behalf. That business, in turn, entails interbank transactions: As a rule, deposits taken by local institutions, and funds provided to them, enter the central institution's liquidity management, which invests any surplus or raises liquidity as needed on the interbank market. Absent any reference to the special links between central and local institutions operating as a *Verbund* from the consultation paper, we fear that an EU bill as outlined therein will implicitly classify business conducted within such networks, and central institutions' hedging thereof, as well as the intergroup transactions mentioned herein above, as proprietary business subject to mandatory separation. The proven division of labour among the associates of those networks would thus become legally impossible. To avoid that, regulatory deliberations on structural reforms must give due consideration to transactions that serve, above all, the management of liquidity, interest, currency and credit risk in banking services networks.

Question 9
"As regards full ownership separation, what are the associated costs and benefits?"

Reducing assessment of ownership separation to a cost-benefit analysis falls short. As full separation seriously encroaches on owners' fundamental rights, constitutional aspects must be taken into account. Given the severity of the encroachment, it should be reserved as means of last resort. To deal with the TBTF problem, mandatory recovery and resolution planning, as well as regulatory enforcement of an institution's or a group's resolvability, pose a milder, at least equally effective and, hence, preferable alternative. In terms of constitutional law, full ownership separation would, therefore, be unreasonable.

Once again, we feel compelled to stress that Europe's universal banking model has proven its worth. Strict ownership separation, in contrast, as introduced by the Glass-Steagall Act, turns out a toothless tiger. What better example than Lehman Brothers to prove that ownership separation can give rise to investment banks that endanger financial market stability?

If the Commission decides to continue pursuing its plans to separate or prohibit certain lines of business in spite of all that, the GBIC shall advocate functional separation pursuant to the first option presented in the consultation paper, that is, *with economic and governance links restricted according to current rules*. Three key points lead us to argue the case for it rather than for the second option, referred to as *functional separation with tighter restrictions on economic and governance links*:

- Curtailing any transaction among trading and deposit-taking entities is incompatible with maintaining the universal banking model.
- Even if restriction of links between deposit-taking and trading entities is confined to current rules, those ties will be more transparent, making resolution easier.
- National legislators should be able to impose regulatory standards at their discretion, tailoring them to deposit-taking and trading entities, respectively, as necessary.

Question 10
"Does the above matrix capture a sufficiently broad range of structural reform options?"

The consultation paper includes a matrix of options selected and outlined by the Commission. While questions 1 and 2 address the fundamental analysis of the necessity and benefits of an EU bill on separation, questions 10 and 11 regrettably omit that aspect. After all, doing without any model of mandatory separation is referred to as „baseline“ in the paper. Hence there are two options missing in the matrix: first, dropping the project of an EU-wide structural reform of the banking industry, and second, minimum harmonization on the European level to be complemented by member states at their discretion. Also missing is any further reference to alternative intervention paths such as EU crisis management, or recovery and resolution planning, as outlined in our answer to question 2 herein above.

Question 11
“Which option best addresses the problems identified? Please substantiate your answer.”

Analysis of the potential (macro-) economic impact of full ownership separation has been insufficient. In our opinion, that degree of separation is likely to carry new risks for the stability of the financial sector. Hence we doubt its appropriateness and are concerned about undesired side effects.

Among the functional separation options included in the matrix, and beyond our own recommendation of either minimum harmonization or intervention in terms of crisis management, we prefer variant A, which more or less sticks to a baseline drawn by measures taken in France and Germany. However, while we deem variant A more suitable than any other functional separation option presented in the consultation paper, we maintain our reserve about intervention thresholds based on balance sheet ratios, and about the classification of relevant business.

To make an informed decision, the Commission asks respondents to submit additional data. The associations represented in the GBIC are not in a position to comply with that request. Besides, the Commission’s inquiry is extremely challenging. Financial institutions will be hard-pressed to come up with scenarios for separating individual lines of business by 2017. To make matters worse, they reject those scenarios, which makes it unlikely that a substantial number of Germany’s financial institutions will deliver the data requested. The GBIC deeply regrets that the Commission declines to evaluate a broader range of alternatives, including but not limited to the default option. The lack of a clear definition of investment banking as referred to in scenario 2, in particular, makes assessment even more difficult, and needlessly heightens the threat to the operability of Europe’s capital market.