REGERINGSKANSLIET

Ministry of Finance

Financial Markets and Institutions

Dnr: 2013/2606

FINANSINSPEKTIONEN

Swedish Financial Supervisory Authority

Dnr: 13-7188

RIKSGÄLDEN

Swedish National Debt Office

Dnr: 2013/1290

European Commission
DG Internal Market and Services

Swedish Authorities' response to the Commission's consultation paper "Reforming the structure of the EU banking sector"

The Swedish Ministry of Finance, the Swedish Financial Supervisory Authority (Finansinspektionen) and the Swedish National Debt Office (Riksgälden) – referred below to as *the authorities* – welcome the opportunity to comment on the Commissions consultation paper "*Reforming the structure of the EU banking sector*", developing the Commissions view on the High Level Group (HLEG) report presented to the Commission in October 2012. If a question or topic has not been commented or answered it should not be taken to constitute our approval or dismissal.

The authorities wish to underline the importance that, if the Commission were to proceed with a proposal on structural reform, it should be flexible and adjustable to changes in market conditions, bank product development, changes in valuation methods, and future changes to regulation. The authorities believe that a mandatory structural separation will most likely impede on the possibility for non-financial companies to secure financing and liquidity and will thus have unintended negative effects on the real economy. These effects are likely to differ between financial market segments as well as individual Member States. It is therefore crucial to first assess the impact of all new and planned regulations, before initiating any process towards mandatory structural separation.

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

The authorities believe that the HLEG-report provides a useful and balanced analysis of the financial crisis and its origins. However, neither the Commission consultation paper nor the HLEG-report provides a sufficient justification for structural reforms separating wholesale and

investment banking (WIB) operations from the more traditional retail and commercial banking (RCB). Experiences from the present crisis, as well as from Sweden's history, show that severe financial crises rarely originate from WIB activities. Hence, we believe that justification for a mandatory structural separation of universal banks is lacking in the papers.

Several recommendations in the HLEG report have already been addressed by other initiatives such as the Capital Requirements Directive/Regulation (CRD/CRR) and the Bank Resolution and Recovery Directive (BRRD). A combination of actively working with higher and, when deemed appropriate, targeted sectoral capital requirements, as well as recovery and resolution strategies should entrust national authorities with sufficient discretionary ability to manage financial stability, and if deemed appropriate, structurally separate or dismantle activities.

Further, higher capital requirements combined with the new resolution regime is likely to have significant impact on banks' management. Therefore, the authorities are of the opinion that the discussion on mandatory separation should be put on hold until we can observe and evaluate the implications and effects of current and forthcoming legislation packages.

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.*

Many European companies and sovereigns are highly dependent on the trading capacity and strong balance sheets of universal banks, especially concerning services such as primary and secondary bond markets as well as hedging of credit, interest rate and currency risks. These are socially important functions. Hence, structural reforms that constrain the provision of these services (functions) can have negative effects on the real economy. Therefore the Commission needs to consider the MS national economic characteristics and fully evaluate the impact on the real economy before considering any compulsory structural reforms.

This applies especially to small economies (with small currency areas), as these economies are dependent on certain financial services provided by universal banks to maintain efficient and transparent markets. Such financial services include market making and hedging activities. An EU regulation that stipulates a mandatory separation of universal banks will impose substantial restriction on banks' business models. The *de facto*

heterogeneity of the structure of financial markets in Member States raise questions about the appropriateness and conformity with the subsidiarity principle of a uniformly imposed separations model.

Another concern is the scope for regulatory arbitrage. One aspect is the risk of separated activities gradually moving out of supervisory and regulatory reach. This potential development could in fact increase the build-up of systemic risk. The other aspect is the lack of global harmonisation, since mandatory separation would at least affect large internationally active banks.

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.*

As noted above, the authorities believe that legislation should not differentiate based on bank size or business model, but would rather see a risk based approach. The authorities believe that current financial reporting standards do not offer a clear picture of actual risk taking in banks' trading activities. Hence, using accounting based thresholds, as suggested, would risk portraying a skewed picture of a bank's risk profile and discriminate against size since smaller banks under the proposed thresholds may still take excessive risk with guaranteed deposits.

4. *Which of the approaches outlines above is the most appropriate? Are there any alternative approaches? Please substantiate your answer.*

If separation were to be imposed, the authorities would primarily favour an ex-post separation subject to discretion by the national supervisory authority. Under this approach, the activities to be separated and the form of such a separation would be stipulated in EU legislation but leave the actual separation decision to the national supervisor. This would create a situation where separation is adaptable to national conditions and the decision on which products and services are to be separated or banned completely could be more well-balanced. An ex-ante model will be based on assumptions of general character, which risks capturing other businesses or institutions than those conducting trading activities with a high degree of risk taking.

If additional measures are to be adopted, the authorities believe that economic incentives are superior to mandatory separation, as this should lead to a gradual conditioning. A combination of higher and possibly targeted sector capital requirements as well as prudential regulation should therefore be considered as a more appropriate measure. Such a

structure can be applied to more risky business models and not discriminate against size.

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?*

Neither the consultation paper, nor the HLEG-report shows that banks' involvement in market making and underwriting activities has led to financial instability in the past or currently threatens financial stability in Europe. On the contrary, bank failures have more often involved traditional bank lending, not least to real-estate segments. Conversely, it could be argued that a universal bank with a broader combination of both WIB and RCB services is generally more resilient to financial shocks.

Significant trading losses are fundamentally related to failures of risk management, internal control and governance. Hence, limiting trading losses cannot be considered a strong argument for structural separation. Bank specific idiosyncratic risks are best dealt with by proper internal control processes and risk based supervisory practices.

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

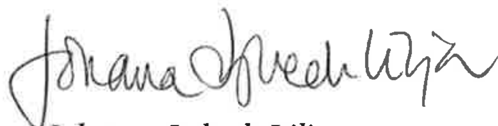
We consider risk management services as basic banking products. For instance sovereigns, financial companies (such as insurance companies) and manufacturing companies need access to adequate risk management products in order to properly manage financial and business risk, utilise market based competitive advantages and secure efficient access to capital markets. These are socially important functions.

Moreover, the key issue with regard to financial stability is not whether a bank provides a particular service to clients, but how it manages the risks that these services may entail. Fundamentally, banks are *intermediaries* helping clients to handle savings and risks of various kinds. This implies, for example, that if a bank has two customers with offsetting hedging needs, it can help both without incurring risk. Consequently, banks fail not because they take on risks, but because they fail to manage the risks inherent in their activities in a prudent manner.

Structural separation thus focuses on issues that are – at most – secondary to the objective of financial stability. On the other hand, they may be of crucial importance for securing access to risk management services to the non-financial sectors of the economy, including the public sector.

Stockholm, 2 July 2013

Finansdepartementet (Ministry of Finance)



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