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FOR REGULATION BALANCING STABILITY AND ECONOMIC EFFICIENCY

FÉDÉRATION
BANCAIRE
FRANÇAISE

A REGULATORY REVOLUTION

FOR GREATER FINANCIAL STABILITY

The **REGULATORY FRAMEWORK** put in place in response to the financial crisis includes more than 40 new laws and is now exhaustive.

CAPITAL REQUIREMENTS have led to a significant increase in the amount of capital. French banks have accumulated over 100 billion euros in additional capital.

European **RESOLUTION MECHANISMS** (the BRRD[1] directive, Single Resolution Mechanism and Single Resolution Fund) have been set up to combat the risks created by banks that are «too big to fail». To complete these measures and meet potential difficulties, additional capital buffers have also been put in place. Following the example of TLAC which will be transposed into EU law.

The banks have also markedly strengthened their **INTERNAL CONTROL** and activity safeguarding procedures

All these measures have ensured the **FINANCIAL STABILITY** of the European Union and respond to the deficiencies highlighted by the financial crisis.

A number of new rules have changed banking practices relating to transparency and the design of services (account switching, the right to basic banking services). They have helped restore **CONSUMERS' CONFIDENCE** in banks.

Without going any further – or embarking on a further phase of additional regulation, you need to have the time to **ASSESS THE IMPACT** of the numerous regulations recently adopted, some of which are still in the process of transposition.

(1) Banking Recovery and Resolution Directive - Directive 2014/59/EU of 15 May 2014 creating a framework for the recovery and resolution of credit and investment institutions
(2) Total Loss Absorbing Capacity

FINANCING OF THE ECONOMY

THE INCREASE IN PRUDENTIAL REQUIREMENTS IS A RISK FACTOR

ONE THING IS CERTAIN:

A WORRYING CHANGE IN THE STRUCTURE OF BANK'S BALANCE SHEETS

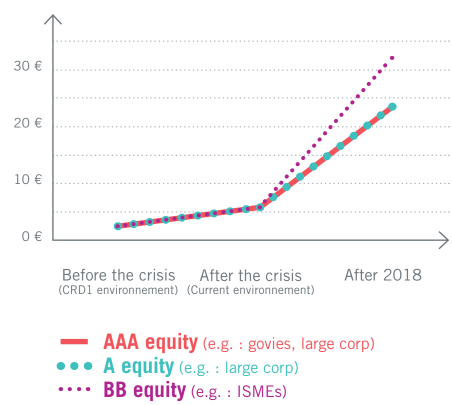
↘ **15.7%**

REDUCTION OF TOTAL ASSETS OF BANKS IN THE EURO AREA COMPARED WITH 2008 .

PENALIZING BOND AND CORPORATE FINANCING

Over the medium/long term (Banking book)

For example, the cost of capital for a bank that holds shares of large companies will be **multiplied by 4** for short term holding. The cost of capital for a bank with regards to holding bonds will be **multiplied by 20**.



The new rules have led to a very marked change in the structure of bank balance sheets that is unfavourable for the financing of the economy:

Deleveraging of European banks' balance sheets

The total amount of bank assets in the euro area was €28.1 trillion at the end of 2014, 15.7% lower than in 2008 and down 4.8% compared with 2012.

/ source: ECB, Report on Financial Structures, October 2015/

This « deleveraging », if it should continue, would lead banks to abandon the funding of certain capital intensive businesses. Already, banks have largely given up capital funding of companies which penalizes the funding ofstart ups.

A reduction in balance sheet maturity

Liquidity and capital ratios have led banks to shorten the maturities of their loans. Long-term infrastructure loans have already been strongly penalised by this move.

An increase in holdings of sovereign debt to meet liquidity requirements

The levels of sovereign debt held by euro area banks is higher than before the financial crisis because of the need to meet LCR[1] and NSFR[2] requirements.

/ source: ECB, Financial Stability Review, May 2015/

Accordingly, the proportion of public debt financing has increased relative to the financing of the real economy.

Increase in market volatility

Economic surveys (particularly those earned by the BIS) show an increase in volatility on the bond and equity markets, mainly due to the reduction in market making by banks.

Market makers have reduced their activity levels, contributing to a general fall in liquidity on the fixed income markets.

(1) Liquidity Coverage Ratio
(2) Net Stable Funding Ratio

FIVE PRIORITIES

1 ENSURE THAT REGULATION IS CONSISTENT WITH THE FINANCING OF THE ECONOMY AND PRUDENTIAL REGULATION

Banks are required to invest in and finance growth and jobs. And yet, the regulations have imposed leverage ratios on the banks that are set at a level that is inappropriate to an intermediated economy and liquidity ratios that lead to liquidity being neutralised in high quality assets, pushing banks to exit certain businesses (e.g. factoring).

The reforms envisaged by the Basel Committee should not put a greater burden on the constraints. The Basel Committee has undertaken new work on areas such as credit risk, market risk and internal models. Overall, this work should not add to the burden of global prudential requirements, but instead lead to a straightforward reallocation of requirements between the various risks. The role of the Coherence and Calibration Task Force will therefore need to be strengthened in order to ensure that the burden is not increased. The transposition into EU law of the programme envisaged by the Basel Committee should be subject to a cost/benefit analysis on the objectives of financial stability and financing the economy.

Lastly, the adoption of IFRS 9(1) would have a marked impact on the financing of the economy, in particular, by affecting support for SMEs.

2 ENSURE THAT THE SPECIFIC FEATURES OF EUROPEAN FINANCE ARE RECOGNISED IN INTERNATIONAL PRUDENTIAL REGULATIONS

The international regulations adopted in Basel, by the FSB, or in Brussels, do not take account of the specific characteristics of European banking systems and particularly the universal banking model that can accompany companies through bank lending to market funding. These standards are detrimental to the financing of the European economy. The representation of the European Union and the weight of the SSM in international forums are major challenges. Without strengthened European influence in these circles, there is a real danger that the upcoming standards (« Basel IV ») do not really take account of the specific European features.

(1) Standards defining the accounting treatment of financial instruments.

Here are two examples that illustrate this particularly well:

Fixed-rate mortgage loans

The proposals of the Basel Committee aimed at calculating the interest rate risk of a bank portfolio using a Pillar I standardised approach favour banking models in which loans are granted at variable rates, and strongly disadvantage banking models that primarily feature fixed-rate mortgage loans.

Long-term infrastructure financing

The financing of infrastructure is a European issue that requires prudential treatment that does not penalise long term commitments, in order to finance a transition to a low carbon economy.

3 ENSURING THE BANKING UNION SUPPORTS THE FINANCING OF THE ECONOMY

No one is considering the consequences of the implementation of the Single Supervisory Mechanism (SSM) on the financing of the euro area economy.

The fragmented nature of the decision-making centres (European Commission, EBA, ECB, etc.) make the system difficult to manage. The Single Supervisor does not fully consider the risks related to the distortion of competition with other geographic regions or even within the EU in its decisions.

A levelling risk of banking models and attack on the universal banking model

The harmonisation of the supervisory practices of the Single Supervisory Mechanism is legitimate but could lead to a *de facto* harmonisation of national banking systems within the euro area under direct supervision although the economies are not harmonised. There is therefore a risk to the financing of economies.

Penalizing large banks does not permit the funding of large projects

The model favoured by the SSM penalizes, *de facto,* the global systemically important banks (G-SIBs)[1], whose specific characteristics have yet to be recognised. With the move towards implementing CMU under way, there is a risk of the big European banks being excluded from market financing and no longer funding large companies.

BSR[2] and the Financial Transaction Tax will increase the difficulties

This would be more likely to happen if the FTT and structural reform of the banks are implemented

4 ENSURE CONSISTENCY WITH THE CAPITAL MARKETS UNION

The development of the financial markets is necessary to create alternative financing to bank loans. That is the whole point of the capital markets. Such market development requires regulated intermediaries that provide liquidity. It is therefore necessary to study the impact of the existing and forthcoming regulations on market liquidity, and consequently, the volatility created.

5 SIMPLIFY CUSTOMER RELATIONSHIPS

Regulation has gone too far in many areas. This has ended up by having a negative impact on the marketing of products, slowing down sales or in some cases preventing them. The situation has become highly complex, including for the consumers that were supposed to be protected by obligations that in some cases were inappropriate.

The accumulation of regulation has increased costs, ultimately impacting on consumers, who have seen services disappearing if they were unprofitable, or otherwise becoming more expensive.

It is urgent to carry out an assessment of the real impact on consumers to better meet their needs, to ensure that they are adequately protected and comply with the principle of proportionality.

(1) Global Systemically Important Bank
(2) Banking Structural Reform

DEFEND THE UNIVERSAL BANKING MODEL

PRESERVE THE MARKET-MAKING MODEL AND FINANCIAL STABILITY

Market making is vital for the financing of the economy and efficient market operation. Market makers provide liquidity and enable market participants to build and unwind positions easily without excessive price volatility, ensuring the credit quality of the issuer and allowing investors to raise funds under good conditions.

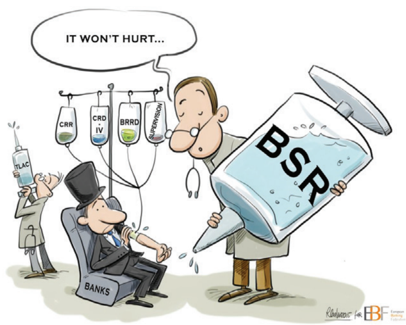
SET UP A EUROPEAN LIQUIDITY OBSERVATORY AND A MARKET PANEL FOR SUPERVISORS

It would therefore be beneficial to set up a European liquidity observatory under the European Commission, involving market professionals. Similarly, it is important for supervisors to assess the impact of their decisions on the markets.

PRESERVE REPO TRANSACTIONS AND SECURITIES FINANCING TRANSACTIONS

STABILISE THE REGULATORY AND PRUDENTIAL ENVIRONMENT TO REDUCE UNCERTAINTY FOR BANKS AND INVESTORS

WITHDRAW THE BSR PROPOSAL, IN ORDER TO PROTECT MARKET-MAKING ACTIVITIES AND MARKET LIQUIDITY.



OUR METHODOLOGICAL RECOMMENDATIONS

UPDATE THE METHODOLOGICAL APPROACH

The need for more precise calibration of the content and frequency of consultations

The need for more comprehensive ex-ante impact studies particularly on the level playing field and taking the universal banking model into account

These impact studies should address the issue of the «level playing field» with other jurisdictions, notably the United States.

The need for a transaction-by-transaction cross-functional approach

Concerning market activities, there is an interaction between the various prudential provisions that increase the cost in the euro area of obtaining financing on the capital markets for companies and the cost of investing for investors.

An impact study of all of the regulation (transaction by transaction) should cover the following activities and instruments:

- Market-making;
- Repo transactions;
- Secondary bond market;
- Derivatives markets.

A summary and global approach to reporting requirements

In addition, a degree of proportionality for small banks should be taken into account, particularly in the area of reporting (reduced frequency and less detailed reports). A simpler regime reflecting the «too small to comply» maxim would be more appropriate.

The FBF would like to contribute to this work.

CLARIFY THE ROLE OF EACH INSTITUTION

To improve their coordination and limit the risk of overbidding and undercutting of legislation particular emphasis should be placed on clarifying the role of each institution that takes part in the European regulatory and legislative process

ANALYSE THE NOTION OF THE "EUROPEAN CONSUMER"

The notion of European customer justifies a large number of European texts whereas to date none of these has been subject to a proven economic or sociological analysis. A detailed independent analysis is required.

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