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Commissioner Michel Barnier
European Commission
Directorate-General Internal Market and Services
B-1049 Brussels
Belgium

Dear Commissioner Barnier,

CFA Institute appreciates the opportunity to respond to the consultation by the High-level Expert Group on possible reforms to the structure of the EU banking sector.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

Though CFA Institute does not fall under the categories listed in the consultation (banks, corporate customers, retail customers), we have responded to those questions that are relevant to our members and that concern the integrity of capital markets.

Summary

In our view, further work needs to be done to strengthen the stability and efficiency of the banking system in the EU. With regard to systemic risk mitigation, we recommend improving the governance structure and composition of the ESRB over time to increase its independence. Additionally, investors, financial institutions, and other stakeholders would benefit from greater transparency about the objectives, rules, policy tools, and decision-making processes surrounding the conduct of macroprudential policy.

Regarding the structural reform proposals to date in the United States and United Kingdom, we support the goals of eliminating unfair competitive advantages, alleviating moral hazard and protecting taxpayers. In our view, trading activities by financial institutions that also carry insured deposits on their balance sheets should instead be confined to a separately capitalised, nonbank dealer subsidiary of the bank's holding company.

Specific Comments

Q: To what extent are the current and ongoing regulatory reforms sufficient to ensure a stable and efficient banking system and avoid systemic crises?

In our view, the current efforts fall short.

At the microprudential level, the broad framework of the Basel III accord (implemented through the Capital Requirements Directive IV), based on strengthened loss absorbency capacity through enhanced equity capital requirements, and various ratios for leverage and liquidity, is welcome and much needed. However, as we have noted in the subsequent question, the framework remains deficient with regards to the risk weightings applied to asset classes.

At the macroprudential level, the current framework requires improvements if systemic crises are to be avoided. At the EU level, the European Systemic Risk Board (ESRB), tasked with conducting analysis on emerging systemic risks and providing advice and risk warnings, is weakened by the lack of independent members on its board. ESRB members are comprised only from existing regulatory institutions and prudential authorities, supported by the secretariat of the European Central Bank. This lack of independence raises the risk of "group think". Moreover, it could present a conflict of interest if national regulatory decisions taken by board members at their respective authorities are incompatible with the collective view and/or policy advice of the ESRB. Accordingly, we recommend improving the governance structure and composition of systemic risk committees over time.

An important aspect of the macroprudential policy framework is the need to establish a set of rules to govern the conduct of policy. The transmission mechanism of macroprudential policy will not function effectively if the policy framework is not predicated on a clear set of rules and targets around which decisions are based. Such a rules-based approach helps to anchor expectations and therefore strengthens the link between policy goals and outcomes, enabling policymaking to remain optimal over time. Although the conduct of macroprudential policy is still in its formative stages, investors, financial institutions, and other stakeholders would benefit from greater transparency about the objectives, rules, policy tools, and decision-making processes of the ESRB and other systemic risk committees in national jurisdictions.

Finally, progress to date on the frameworks surrounding the winding down of failing financial institutions has been limited. Consequently, the "too big to fail" problem remains a risk.

Q: Which structural reforms would improve the safety and efficiency of the banking system in the EU in the near term? In the long term?

In the near term, acceleration of the development of orderly resolution plans would improve the safety of the banking system, particularly because the Basel III requirements are not yet fully implemented and hence the banking sector remains under-capitalised and vulnerable to systemic shocks.

In the long term, reform of the risk weightings applied to asset classes is necessary. A weakness of Basel III is that it applies risk weights to different asset classes regardless of the magnitude of their concentrations within individual institutions or across the entire financial system. Moreover, the risk weights allow certain sovereign bonds to carry a zero per cent weighting, even though, as recent experience shows, such bonds are not always risk-free. A zero per cent risk weighting merely enhances systemic risk as it encourages banks to hold more sovereign debt, thereby increasing leverage and their exposure to the fiscal position of the sovereign issuer. By compounding the linkage between the financial health of governments and the financial health of banks, the risk of negative spill-over effects on the real economy is potentially amplified.

Q: What are your views on the structural reform proposals to date (e.g. US Volcker Rule, UK ICB proposal)? What would be the implications of these proposals on your institution and the financial system as a whole?

The Volcker Rule proposal in the United States prohibits insured depository institutions from engaging in proprietary trading, with certain exemptions, and prohibits these institutions from having certain relationships with hedge funds and private equity funds.

CFA Institute supports the goal of the Volcker Rule to ensure that insured depository financial institutions do not take advantage of guaranteed deposits to fund proprietary trading. Typically, banks that have insured customer deposits on their balance sheets carry an implicit subsidy which reduces their cost of funds. Therefore, a bank with insured deposits that engages in proprietary trading benefits from a cost of capital that is disproportionately low relative to the riskiness of its trading activities.

Consequently, permitting such banks to engage in proprietary trading creates moral hazard by encouraging risk-taking under the recognition that the firms and their creditors could retain all gains from their risky trading endeavours while a taxpayer backstop would insulate them against losses. Second, this type of taxpayer backstop has given, and would continue to give, such institutions an unfair competitive advantage over trading firms that don't use insured deposits to fund their operations. For these two reasons, CFA Institute supports the goal of the Volcker Rule.

However, we believe that from a practical standpoint, the regulatory structure proposed to implement the Volcker Rule suffers from certain drawbacks. Most obviously, it could be very difficult for a regulator to differentiate between legitimate market-making activities (a client service) and prohibited proprietary trading. In relatively less liquid trading markets, in particular the fixed-income markets, distinguishing between proprietary trading and market making is difficult at best.

Unlike equity markets, banks play a significant role in bond markets, using their balance sheets to make markets and provide liquidity. The sheer number of debt securities, the large sizes in which they trade, and, away from government bonds, the relative infrequency of transactions and low secondary market liquidity all necessitate a supply of dealer inventory to facilitate trades.

For example, in the corporate bond market, investors do not benefit from a ready supply of buyers and sellers as is the case in large-cap equity markets. Under these circumstances, dealers cannot count on immediately finding buyers for securities purchased from selling customers as part of their market-making efforts. Nor can they count on finding securities that their clients may wish to purchase in the secondary market. Instead, dealers must act as principals and use their own capital to acquire such securities from selling customers and hold the securities in inventory until they locate investors interested in buying. The length of time for which securities may be held in inventory varies. Therefore, there is a risk that banks may withdraw from market making activities if such inventory positions are deemed to constitute proprietary trading positions under certain conditions. In turn, a withdrawal from market making activities would negatively impact liquidity and increase costs for investors. These costs would be borne by, among others, collective investment funds and pension funds invested in fixed income securities.

Accordingly, while we support the Volcker Rule, it may not be the most effective tool to achieve its goal. In our view, to the extent that trading activities (market making) do occur within a bank holding company or similar institutional structure, those activities should be confined to a separately capitalised, nonbank dealer subsidiary of the bank's holding company. This, together with effective regulation and monitoring that controls how funds move between the depository and the holding company, in our view, has the potential to alleviate many of the concerns that the Volcker Rule seeks to address.

In the same context, we support the principle thrust of the recommendations of the U.K. Independent Commission on Banking (ICB). The ICB calls for ring-fencing the "utility" element of universal banks (retail deposits, commercial loans, etc.) from riskier investment banking activities. The ring-fenced subsidiary—subjected to higher capital requirements and deposit insurance—would be protected in the event of insolvency of the investment banking operation, such that the investment bank would be allowed to fail without imperilling the core utility operations of the bank. This type of structure is likely to alleviate moral hazard and protect taxpayers in the event of a failure of the investment bank owing to (for example) proprietary trading losses.

Conclusion

We appreciate the opportunity to express our views to the High-level Expert Group on possible structural reforms to the EU banking sector. Please do not hesitate to contact us should you seek further elaboration on any of the points raised.

Yours faithfully,

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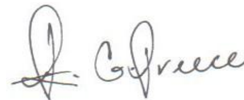

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