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# **EBF RESPONSE TO FSB CALL FOR INPUT PRECEDING ITS EVALUATION OF THE TOO- BIG-TO-FAIL REFORMS**

## **Key points:**

- ◆ **European G-SIBs have successfully reduced the associated systemic risk in line with the objectives of the FSB's TBTF reforms**
- ◆ **Evolutions may differ for EU and Rest-of-World markets**
- ◆ **Reforms have also generated some unintended consequences which should be addressed, such as fragmentation of financial resources and obstacles to consolidation and to funding of the EU economy**
- ◆ **While EU G-SIBs' systemic risk has materially reduced, risk has shifted to other market participants, which should be the focus of the FSB's work going forward.**

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## EBF position:

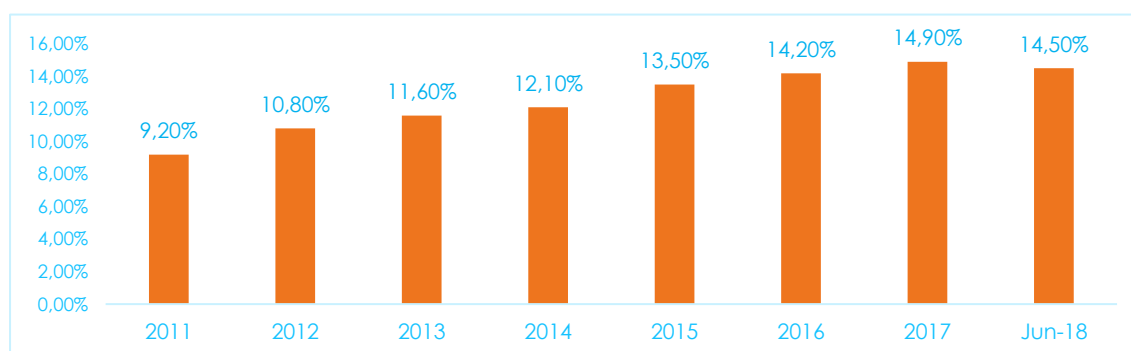
The European Banking Federation (EBF) welcomes the FSB's call for input in preparation of an evaluation of the TBTF reforms.

Please see below our comments to the questions listed by the FSB in its call for input.

### FSB Question 1

**“To what extent are TBTF reforms achieving their objectives as described in the terms of reference? Are they reducing the systemic and moral hazard risks associated with SIBs? Are they enhancing the ability of authorities to resolve systemic banks in an orderly manner and without exposing taxpayers to loss, while maintaining continuity of their economic functions? What evidence can be cited in support of your assessment?”**

**Remark 1:** Over the last years EU banks have greatly increased the capital they maintain in their balance sheets to cover their risks. According to the European Banking Authority data, the capital ratio has evolved from 9.2% to 14.5% (as of June 2018).



Source: EBA Risk Assessment of the European Banking System as of December 2018.

Figure 1

In addition, banks also must meet numerous new prudential requirements (liquidity coverage ratio, net stable funding ratio, leverage ratio, more demanding Pillar 3 framework, new reporting requirement, etc.). Moreover, in Europe this framework is applied to all banks, rather than only to internationally active banks for which it had been designed by the Basel Committee.

**Remark 2:** The market recognizes the lower risk of G-SIBs. We use CDS spreads as a “clean” metric to measure credit risk as assessed by the market, given that, unlike bond yields, they are not impacted by market liquidity and monetary policy rates. The CDS market signals a low credit risk for most G-SIBs, whether US or EU ones, as demonstrated by Figure 2.

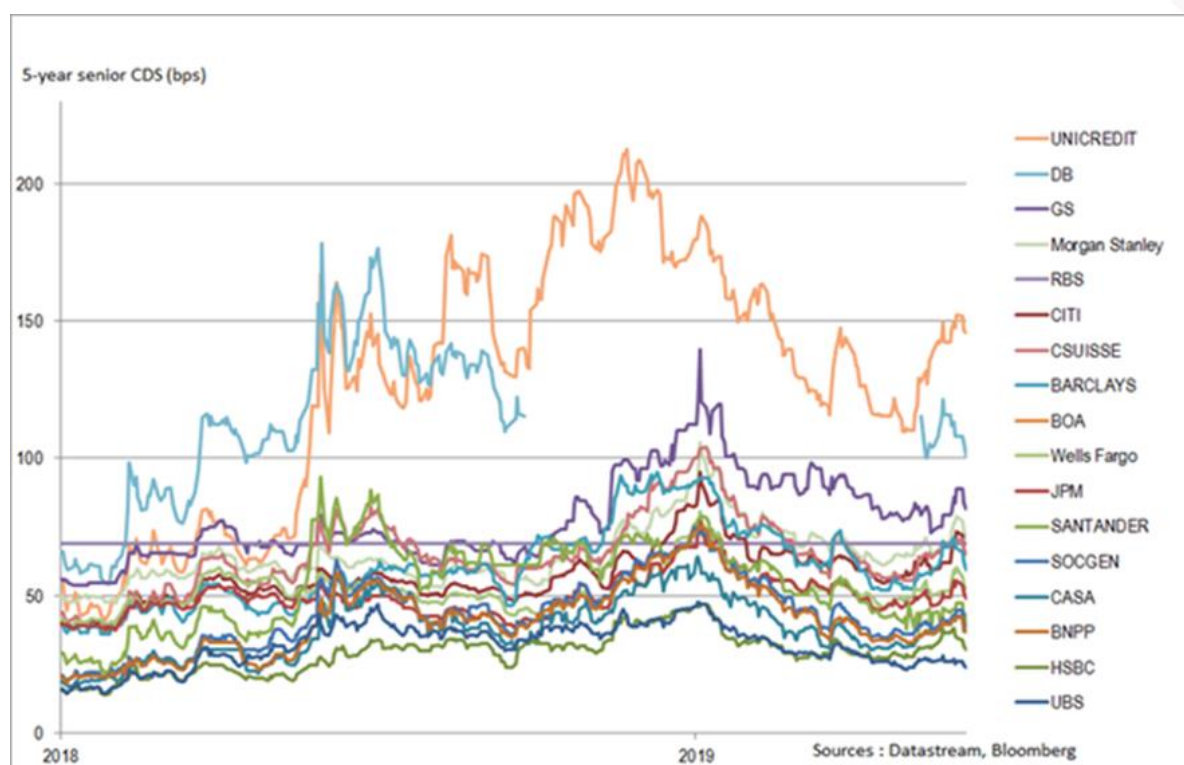


Figure 2  
[Banks are listed in decreasing order on the basis of the most recent 5yr senior CDS level]

Also, while the one Italian G-SIB's CDS spread is higher than its peers', this spread is significantly below Italian sovereign CDS, suggesting that the sovereign/bank nexus has been reduced (see also remark 5).

As a side comment, observers often refer to the Price-to-Book ratio as a signal of market confidence. This is not relevant. Indeed, the Price-to-Book does not reflect the probability of failure of a listed company, but the risk seen from an equity investor point of view. In any case, the level of the Price-to-Book ratio is related to the gap between the cost of equity and the return to equity. From the shareholder point of view, the risk is associated to uncertainty in expected returns. It should be no surprise that – given persisting regulatory uncertainty, persisting low rates impacting Net Interest Margin, and low growth affecting business development opportunities – EU banks exhibit a lower Price-to-Book ratio compared to US G-SIBs

**Remark 3:** European G-SIBs have successfully reduced the associated systemic risk in line with the objectives of the FSB TBTF reforms.

Looking at the G-SIB score as a proxy for systemic footprint (and despite the shortcomings linked to the fact that the G-SIB score is a relative score, and that it may be subject to exchange rate effects), we observe that EU G-SIBs have on average succeeded in reducing their scoring, as shown in Figure 3 and 4 over the period 2013-2017 (NB: BCBS source for the worldwide comparison).

In comparison for US G-SIBs, the G-SIB scoring is quite flat (slightly decreasing) on average over 2013-2016 due to mixed evolutions across these banks (see below) and across indicators. Asian G-SIBs are even growing strongly.

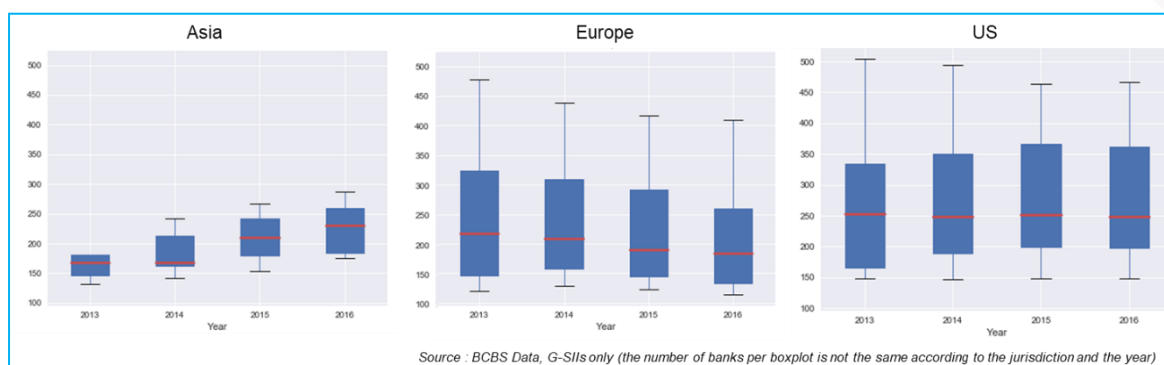


Figure 3

### Change in Banks' G-SII Scores, 2013-17 (basis points)

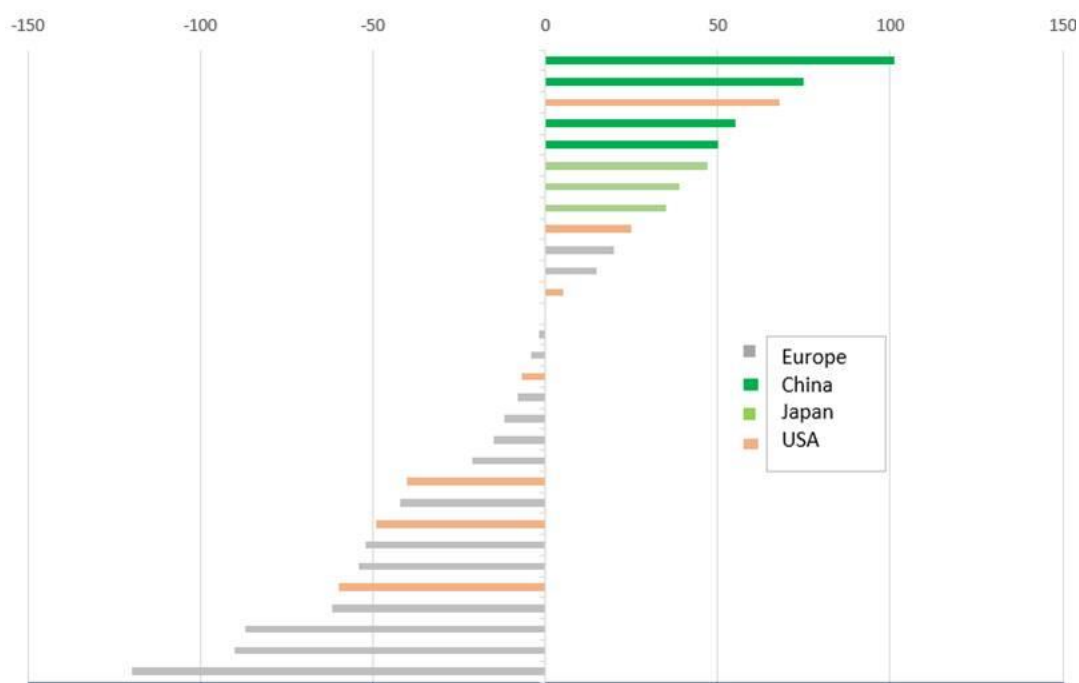


Figure 4, Source BCBS

**Remark 4:** In order to go one step further, and to by-pass the shortcomings of the relative G-SIB scoring, it can be useful to look at the underlying G-SIB indicators in absolute terms. This analysis shows that EU G-SIBs have significantly reduced, in absolute terms, the value of their indicators considered by the International Standard Setters as the relevant contributors to systemic risk. This observation is in line with the expected result of reducing systemic risk through the reduction of their risk profile, of the externalities they pose and the limitation of the impact of a failure. This decrease of EU G-SIB scores can be decomposed by indicator and shows a reduced complexity of those G-SIBs, as shown by Figure 5.

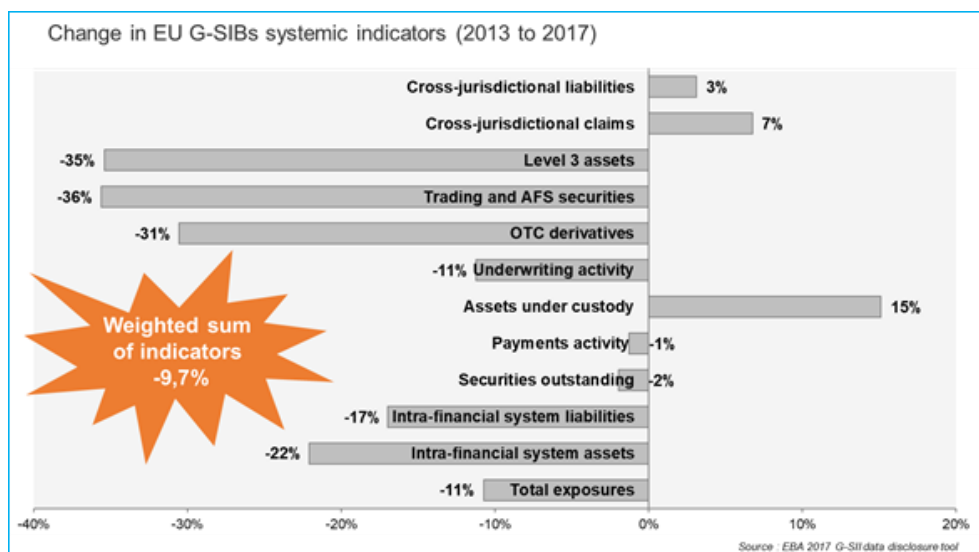


Figure 5

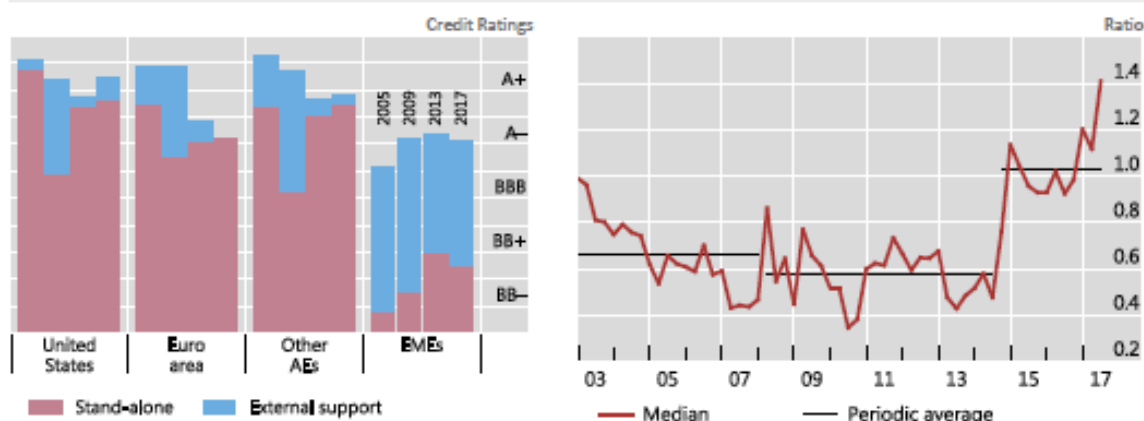
**Remark 5:** With regard to Moral Hazard and the reassessment of government support – and hence the exposure of taxpayers – we point to the FSB’s own analysis of credit ratings (Figure 6).

### Reduced market perception of government support for systemic banks

### Graph 11

Credit support ratings have dropped in some countries since the peak of the crisis

The difference in credit default swap (CDS) spreads of junior and senior bonds for G-SIBs has increased recently



Left panel: Decomposition of bank credit ratings into stand-alone rating (red) and ratings uplift from external support (blue). Asset-weighted averages. Based on a sample of about 50 large banks, using Fitch ratings. Source: [2018 BIS Annual Economic Report](#).

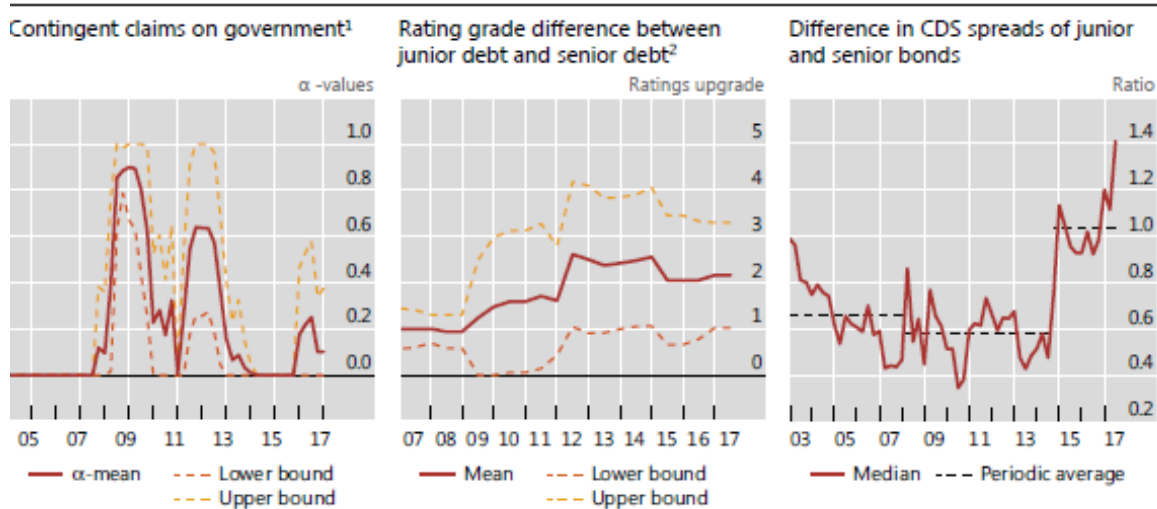
Right panel: CGFS Papers no. 60, [Structural changes in banking after the crisis, 2018](#), Graph 19.

Figure 6

**Remark 6:** The establishment of resolution regimes has been beneficial. This is shown by the comparative evolution of G-SIBs’ junior and senior bank debt rating and junior/senior CDS spreads (e.g. as referred to in <https://www.bis.org/publ/cgfs60.pdf>, page 44, also Figure 7). Such differentiation clearly indicates that debt investors understand that bail-in may indeed be triggered in case of stress, and that they no longer rely on sovereign bail-outs. Further data analysis based on differentiation by geography would also be useful and could be considered by the FSB in its upcoming evaluation.

### Market perception of government support for G-SIBs

Graph 19



<sup>1</sup> Alpha values are the fraction of bank losses that might become contingent government liabilities. A value of 1 implies full government support of bank debt. <sup>2</sup> Moody's credit ratings. Lower and upper bound are one standard deviation from the mean.

Sources: Bloomberg; Moody's Investors Service.

Figure 7

**Remark 7:** The EBF agrees with the FSB’s previously expressed view that funding in resolution provided by authorities, or in form of another kind of public backstop for example by central banks, is a key element of effective resolution regimes.

We agree that the resolution framework should include a credible and unlimited public tool in charge of providing liquidity when an entity under a resolution process needs liquidity to deliver its critical functions, such as included in the frameworks in the US, Canada and the UK.

We strongly believe that banks should not be their own backstop, which would be a source of systemic risk.

**Remark 8:** The EBF encourages the FSB to assess overall capital and eligible liability requirements against stress test capital shortfalls and against the losses incurred during the financial crisis.

The below figures show that US and EU banks are resilient to supervisory stress test losses (Figure 8, respectively DFAST, EBA ST).

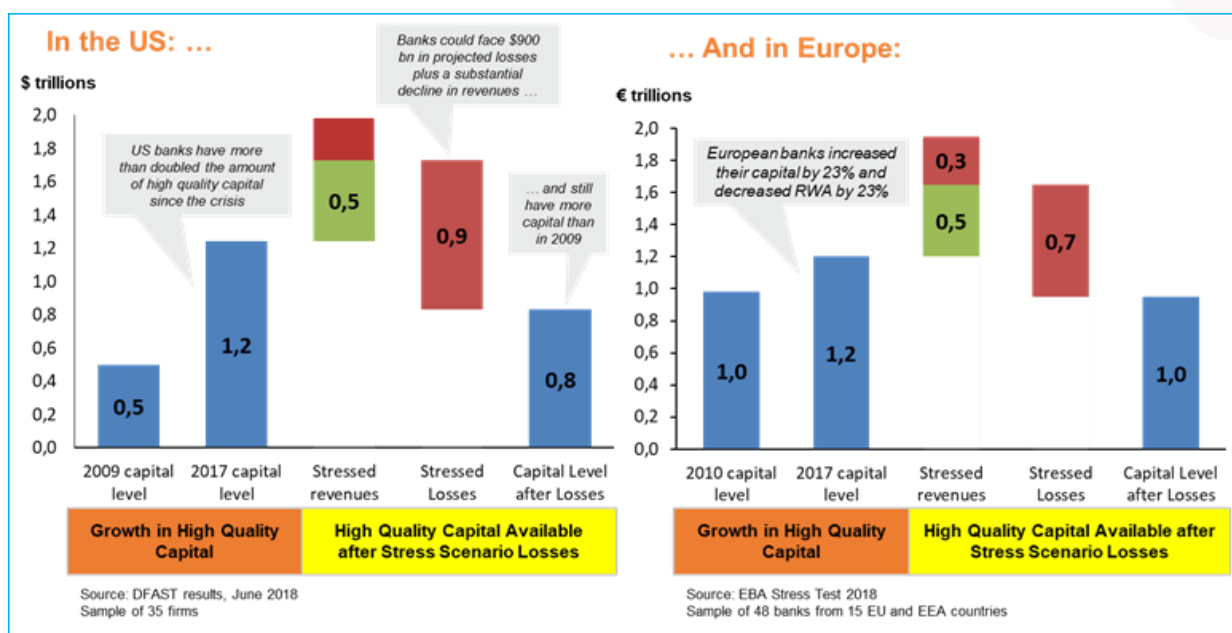


Figure 8

### FSB Question 2

“Which types of TBTF policies (e.g. higher loss absorbency, more intensive supervision, resolution and resolvability, other) have had an impact on SIBs and how? What evidence can be cited in support of your assessment?”

It is not possible to disentangle the impact of every single reform on the de-risking of G-SIBs. It is the combination of reforms that has reached the goal.

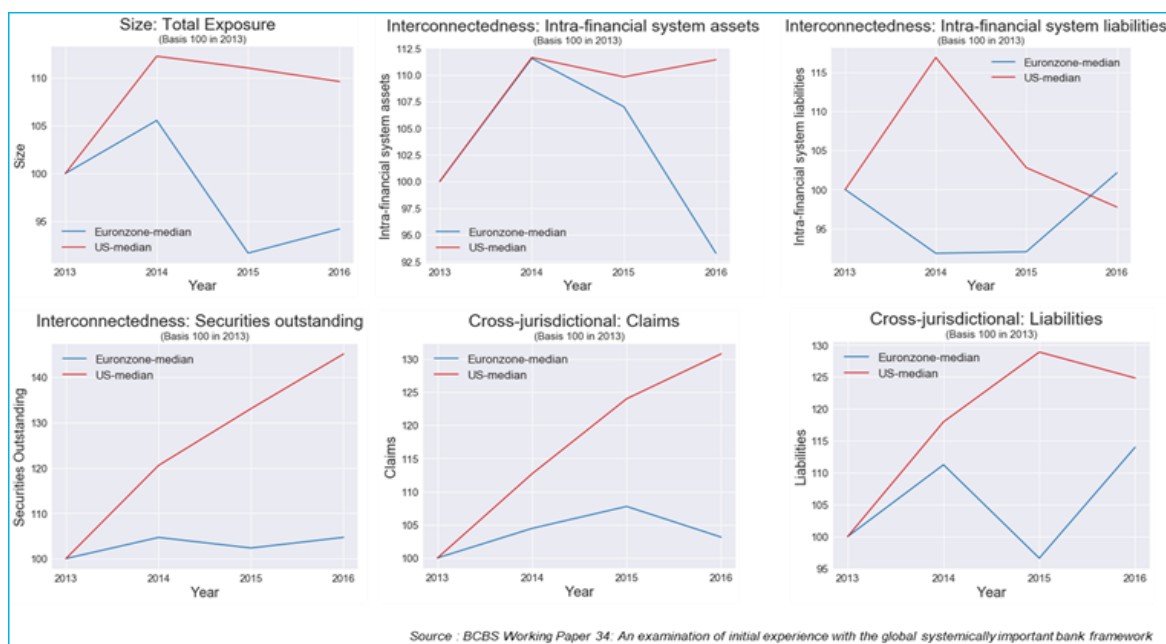
### FSB Question 3

“Is there any evidence that the effects of these reforms differ by type of bank (e.g. global vs domestic SIBs)? If so, what might explain these differences?”

**Remark 1:** We observe significant differences in the impact of the TBTF reforms on banks in the EU and the US. The following data from the BCBS (Figure 9 and 10) show the key diverging developments:

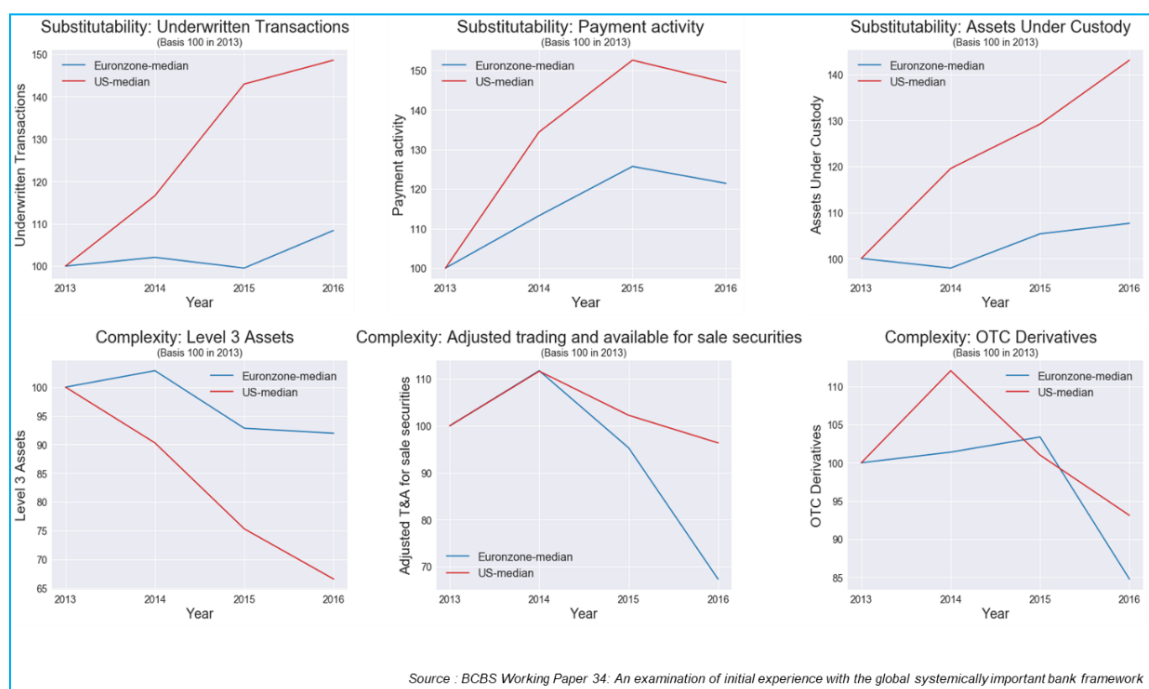
While EU G-SIBs have made tremendous efforts to decrease their SII scoring, their US peers have continued to grow on most indicators. However, this is not really reflected in the G-SIBs’ buffer of the latter, probably due to differences in US G-SIB methodologies (e.g. the level 3 assets criterion which has decreased the most is more weighted in the US than in the FSB method, cap on assets under custody, substitutability criteria replaced by short term wholesale funding...).





Source : BCBS Working Paper 34: An examination of initial experience with the global systemically important bank framework

Figure 9



Source : BCBS Working Paper 34: An examination of initial experience with the global systemically important bank framework

Figure 10

**Remark 2:** We observe that Eurozone G-SIBs' share in total local banking assets is much lower than for US G-SIBs. This signals a lower concentration in EU/Eurozone banking markets (see Figure 11). Such lower concentration can also be seen as a lower degree of systemicity.



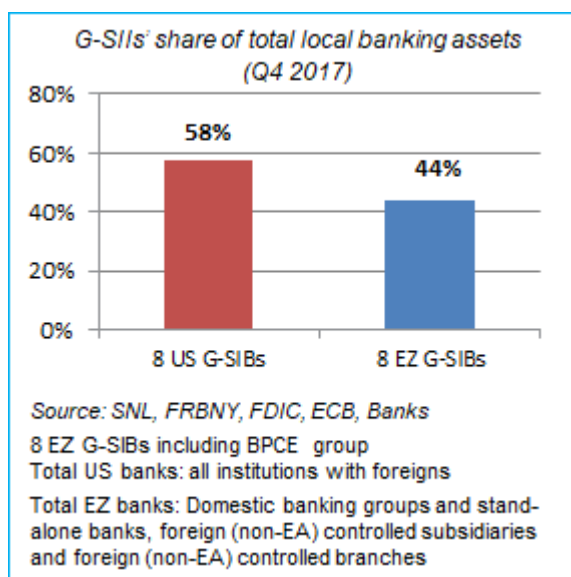


Figure 11

#### FSB Question 4

**“What have been the broader effects of these reforms on financial system resilience and structure, the functioning of financial markets, global financial integration, or the cost and availability of financing? What evidence can be cited in support of your assessment?”**

**Remark 1:** The increased cooperation between countries, with the goal of fostering a common supervisory framework especially for TBTF credit institutions as well as a common resolution framework, have increased the capacity to address risks and to protect depositors, consumers and tax-payers. All this is essential for financial stability.

Having said that, we note our concern that there are a growing number of instances where national authorities or policy makers are introducing additional supervisory expectations intended to protect their own jurisdiction, for example by ring-fencing. Such additional supervisory expectations are drivers of market fragmentation and undermine the international cooperation of the last decade as well as the post-crisis international agreements reached by G20 standard setting bodies. We are concerned that the rise of widespread ring-fencing, where jurisdictions require dedicated pools of local capital and liquidity, will not only dampen the progress of the G20/TBTF policies, but may even harm economic resilience and financial stability. Moreover, we note that ring-fencing policies are much more costly as a whole for many stakeholders than a harmonized international regulatory framework which provides flexibility to deploy capital and liquidity resources where needed.

**Remark 2:** Reforms related to resolution have had knock-on negative effects on financial integration. The FSB’s TLAC Term Sheet took account of the needs of host jurisdictions by creating the requirement for internal TLAC, at 75% to 90% of the external requirement,

for material entities within a group. However, the reality of implementation has not respected the balance envisaged by the FSB.

Within SPE groups and within MPE groups (for entities within the resolution group), jurisdictions have placed the internal requirements at 90% or more, and have extended the scope beyond material entities.

In a similar vein, MPE groups can be penalised where intra-group TLAC exposures exist, giving rise to 100% deductions.

Such attitudes dent the strength and resilience that comes from the diversified nature of large banking groups in terms of geography and of business lines, whether they be SPE or MPE. We advocate for an alternative regulatory treatment which a) takes into account the aforementioned resilience and diversification and b) allows for taking into account at individual entity or resolution group level the solidity that comes from their association with other entities or resolution groups.

**Remark 3:** The increase in capital ratios in Europe has had a negative impact on the financing of EU economy as the CET 1 ratio increase was driven to a large extent by significant balance sheet risk deleveraging.

While EU banks' total asset volume has been relatively stable since 2014-end, their business has been more and more geared towards less risky assets in order to meet the increasingly stringent capital and liquidity requirements, thereby contributing to strengthen the resilience of the financial system. This flight to quality (HQLA buffer, lending to low-risk creditors, etc.) translates into a lower risk density, which explains the decrease in RWAs shown in Figure 11 (right-hand side).



Source: EBA Risk Dashboard<sup>1</sup>

Figure 11: Evolution of EBA sample banks assets and RWAs since 2014

<sup>1</sup> This risk dashboard is based on a sample of risk indicators from 190 European banks (unconsolidated number of banks, including 36 subsidiaries)

**FSB Question 5: Have there been any material unintended consequences from the implementation of these reforms to date? What evidence is available to substantiate this?**

**Remark 1:** Despite a massive increase in capital and liquidity buffers, commercial banks can be viewed by the market as being vulnerable, not because they have too little capital, but because they are close to elevated regulatory capital minima (i.e. minimum capital requirements have increased and are met but the margin for manoeuvre above the requirements has decreased).

This leads to drawbacks, such as a reduced ability to generate P&L for a given level of capital (which also explains the low Price-to-Book ratio for EU G-SIBs and why cost of equity does not go down). Also, banks can reach quite quickly the MDA, which creates the risk of missing, for example, coupon payments on AT1 instruments.

This is the case specifically in the EU, as the capital buffers and Pillar 2 are not explicitly “usable”. In the US, the minimum requirement (including minimum exit point of stress tests) remains at the same 4.5%, so US banks, with a similar CET1 ratio, can show a much larger “loss absorption capacity” than EU banks, given that buffers and Pillar 2 have been implemented as “buffer requirements”. A clarification at international level that buffers are designed to be available to absorb losses during stress as well as in stress tests, would be very welcome to address this major level playing field issue.

**Remark 2:** We also observe an increasing complexity of regulations and divergence in the regulatory regimes of various bodies. Together with a divergence in the focus of regulatory regimes on different parts of the market, this has also led to conflicting rules and hence to market fragmentation.

**FSB Question 6**

**“Are there other issues relating to the effects of TBTF reforms that are not covered in the questions above and on which you would like to provide your views? Please substantiate your comments with evidence”**

**Remark 1:** An outstanding challenge is to find a relevant reference point for the No-Creditor-Worse-Off (NCWO) assessment. It will in most cases be very difficult to determine which factors lead to the specific outcome of the resolution procedure and to explain how a different outcome could have been achieved if the bank had been subject to normal insolvency proceedings instead.

It is necessary to design a more calibrated and realistic NCWO framework by analyzing more carefully the losses in liquidation as opposed to the mechanistic approach followed nowadays which consists in considering ineligible pari-passu liabilities if excluded liabilities represent more than 10% of that class of liabilities.

**Remark 2:** The alignment between both regimes (resolution and liquidation) is key to reducing risks during a resolution process (mainly litigation risks). In Europe, asymmetries between the resolution regimes and national insolvency frameworks are one of the areas where further progress is needed. For example, the conditions to determine that a bank

is 'failing or likely to fail' are not necessarily aligned to the criteria for liquidation at national level. This can create serious problems when dealing with an insolvent entity. We encourage the FSB to perform an evaluation on this issue and provide recommendations to avoid problems in the future.

**Remark 3:** The experience gained with some resolution cases in Europe shows that there is a need for a general special regime in the case where a bank in resolution is acquired and in order to facilitate the integration of the bank in the new group in the most efficient way. Clarifications on the legal liabilities would be key for future resolution events.

The integration and management of a resolved bank is a complex process and the regulatory steps and requirements need to be streamlined. Authorities should evaluate the possibility of a special committee with the different agencies, or speed track for regulatory processes/approvals.

**Remark 4:** While the rest of the memo addresses the extent to which the TBTF risk has been addressed in the EU banking sector, the risk itself has not disappeared. Instead it has shifted toward other types of institutions. In the case of CCPs, these market institutions now concentrate considerable systemic risk despite a limited capital base. Continuing to address the probability of failure and the resolvability of a CCP should remain high on the FSB's agenda. Clearly, the options to manage this new risk should not be to send back this tail risk to the banking sector.

Similarly, asset managers are financing an increasing share of the economy. While their business model is very different, given that the risk is borne by the end-investor, the size of some players growing in a type of "winner-takes-all" framework, and the risk of herd behaviour in upward cycles as in downward cycles, combined with lower market making capability at investment banks, results in increasing episodes of volatility. In addition, the capacity of financial stability authorities to understand "who owns the risk" is decreasing as the proportion of assets held outside the banking sector grows. At a minimum, reporting/disclosure requirements allowing financial sector-wide analysis should be implemented urgently. An example of such "myopia" is the current concern over leveraged loans, which translates into heightened scrutiny of banks, although banks own only a small fraction of those assets on balance-sheet.

Finally, Bigtechs with a strong customer base are entering into new banking services. Here consideration should be given to the risk they pose as they have the potential to become mainstream. In this sense, we support the intention declared by G20 Leaders in Osaka to address the unintended negative effects of non-bank financing, including through regulatory and supervisory cooperation. Therefore we encourage the FSB to analyze the need for stricter oversight by supervisors, capital requirements or periodic stress testing.

**For more information:**

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**About the EBF**

The European Banking Federation is the voice of the European banking sector, bringing together 32 national banking associations in Europe that together represent a significant majority of all banking assets in Europe, with 3,500 banks - large and small, wholesale and retail, local and international - while employing approximately two million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that reliably handle more than 400 million payment transactions per day. Launched in 1960, the EBF is committed to a single market for financial services in the European Union and to supporting policies that foster economic growth.

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