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Suggested answers to further **Questions to Commissioner-designate for Financial Stability, Financial Services and Capital Markets Union, Mr. Jonathan Hill**

Brussels, 3 October 2014

1. What is your vision of a well-regulated and integrated Capital Markets Union? How do you define the concept, what are its features and what are in your opinion the three most important elements to achieve a Capital Markets Union?

The priority of a Capital Markets Union should be to promote financing channels with short intermediation chains, in particular those that do not require asset transformation, in order to avoid creating additional systemic concerns.

End-users (corporations of all sizes, institutional and retail investors) should be at the centre of the action plan, not intermediaries. Lessons should be drawn from previous attempts at integrating the EU capital markets. For example, MiFID 1 did reduce trading costs but the benefits were not passed on to end-users. Furthermore, MiFID 1 focused exclusively on secondary market liquidity, with little impact on primary market issuance – thus missing the main objective.

We stress that an excessive focus on improving the Capital Markets Union could take attention away from the important post-crisis regulatory agenda which is far from completed (TBTF/bank structure, securitization, shadow banking).

To read Finance Watch's assessment of EU 2009-2014 legislative work on banking, "Too-big-to-fail in the EU" which includes recommendations on how to improve the five main regulations affecting TBTF, visit http://www.finance-watch.org/our-work/publications/912

2. What are the main barriers to creating a Capital Markets Union? What specifically needs to be done for these barriers to be removed? Which ones will you be giving priority and why?

The fragmentation in financial markets which the industry blames for the lack of growth and job creation is actually fuelled by loopholes and exemptions in financial regulation inserted under industry pressure, creating barriers and home biases, for instance through the calculation of risk weights. Only a harmonised European legislative framework can properly address this issue.

We support other initiatives currently being discussed, such as harmonising the framework for covered bonds and deepening bond and stock markets.

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3. If securitisation is to be revived, please outline your view of how it can be made safe and how it will lead to growth and jobs.

The current lack of growth and job creation is linked to a range of factors, of which SME credit access is only one. If SME credit is the focus, then reviving traditional relationship banking should be a priority.

Revising "good" securitization as a standalone measure might be considered as a way to support this policy through the creation of additional high quality collateral, but should be part of a broader range of measures and come with suitable safety measures.

4. What legislation can be adapted or introduced to support the further development and diversification of capital markets? How would this lead to SME's gaining better access to long term funding via capital markets?

SMEs are rightfully considered as the motor for growth and jobs in the current economic climate.

Capital Markets could do more to finance SMEs, particularly in continental Europe, and we welcome initiatives to increase access to seed capital and facilitate private equity listing on stock exchanges. As importantly, we also need to improve SME access to bank credit where needed.

However, more fundamentally we should question the case for changing the "European" model and promoting capital market financing. The crisis did not show that we need more capital markets because traditional banks were too risky. The crisis showed that investment banks were too risky and that we need more traditional, relationship-based banking. Traditional banks proved more resilient, create less systemic risks and are more focussed on lending to households and non-financial corporations. Local banks have better insight into the companies that they finance than financial markets, and their funding tends to come at lower cost and better quality to SMEs.

See Finance Watch's Policy Brief "Structural reform to refocus banks on the real economy", http://www.finance-watch.org/our-work/publications/898-fw-policy-brief-august-2014

5. What recommendations would you suggest with regards to digital currencies like bitcoin?

Part of the popularity of digital currencies can be attributed to the lack of trust in the financial sector following the financial crisis. Digital curries allow citizens to rely less on financial intermediaries such as platforms, payment services and banks.

We should acknowledge certain benefits that are contributed to the digital currencies such as financial inclusion, speed of transaction, certainty of payments received and potential lower transaction costs. Regulation in the area of consumer protection, tax evasion, and money laundering should be adapted to reflect this new reality.

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6. What is your opinion on high frequency trading in general and its compatibility with the need to stimulate long term financing?

Most long-term financing is done by large financial institutions such as insurers and pension funds with buy-and-hold strategies and matching long-term commitments. Other institutions need to rely on maturity transformation to make their long-term investments more liquid.

The surge of high frequency traders induced by competition among trading venues (MiFID 1) led to a change in business models of “liquidity providers”. In a nutshell, traditional market makers were pushed out of the market. While HFT does provide for smaller spreads, this comes at the huge cost of focusing exclusively on highly liquid instruments (which in fact by definition do not need intermediaries to be traded). The useful market making that long term financing requires (in SME stocks, illiquid sovereign bonds, etc.) is not provided by HFT traders. At best, HFT does not contribute at all to long term financing.

For references and further explanation, please consult the HFT page on the Finance Watch website: http://www.finance-watch.org/hot-topics/blog/278

7. The Chair of the European Banking Authority indicated that certain banks might not pass the on-going stress tests. Should this happen, what action would you take?

If any capital shortfall is revealed by the ECB’s comprehensive assessment, the deadlines for covering the shortfall are set at a maximum of nine months. It means that banks might still be searching for solutions to meet the targeted capital ratios when the new resolution framework enters into force.

Hence, the Commission’s task should be to cooperate closely with the Single Resolution Board and also to ensure the smooth enacting of the resolution framework. The new tools have to be implemented on time in a coherent and consistent manner.

If recapitalization with public funds is needed and exemptions to the resolution regime are invoked (in the case of a precautionary recapitalization), we need to make sure that the exemptions comply with the resolution framework and State Aid framework.

For references and further explanation, please read our forthcoming policy brief on State Aid (draft version available on request).

9. Taking into account the previous commitments of the Commission, are you in favour of a Single EU Deposit Guarantee Scheme? Will you make a legislative proposal to that effect, and if so when?

A single DGS would provide an external loss absorption mechanism, independent of the solvency of the relevant member state and therefore contribute to the objectives of the Banking Union.

The role of any DGS is to prevent bank runs. To be credible, the Single DGS needs immediate and unconditional access to the funds and the fund should be big enough to reimburse all depositors up to the guaranteed amount.

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If the European Commission chooses to issue a legislative proposal, it should aim to restore public confidence in deposit guarantees, assure that the appropriate guarantees are in place and that a credible fiscal backstop is established.

11. How do you intend to deal with discrepancies between EU and other important jurisdictions, notably USA? Which approach do you intend to take on third-country equivalence decisions? How do you plan to involve the European Parliament in third-country related matters?

Discrepancies on the details of legislation in the EU and other jurisdictions are unavoidable due to differences in the legislative framework and processes. Bilateral and multilateral dialogues (FMRD, BCBS, IOSCO, G20) are the most appropriate platforms to address the consequences of these discrepancies. However, jurisdictions including the EU and the United States have the duty and the right to protect their citizens and taxpayers even if this leads to suboptimal outcomes for some, including extraterritorial application of rules. The use of one-size-fits-all instruments like TTIP to remedy minor discrepancies is inappropriate, given the significant role of the financial industry in our society.

The European Parliament as a co-legislator should be involved in certain key equivalence decisions, as these are often not technical endorsements but political assessments (which should not be delegated to the Commission).

12. Will you keep the European Parliament fully informed about the work being done in international bodies such as the FSB, Basel Committee, the IASB, and guarantee that unnecessary and unadapted rules for the EU financial sector are being avoided?

The Commission (and member state authorities) are often directly or indirectly involved in the work of these international bodies and should be able to fully inform the Parliament of their work. Furthermore, these bodies issue guidelines and frameworks, not prescriptive specific rules. It is thus unlikely that "unnecessary and unadapted rules for the EU financial sector" are imposed by these international bodies.

15. You agreed that the problem of "too-big-to-fail" banks is important and persists. Can you outline how you intend to address it through legislation currently on the table and, potentially, new initiatives? Can you outline what a healthy European banking system looks like?

A healthy European banking system is focused on financing the real economy and not on finance-by-finance-for finance activities. The real economy needs traditional relationship-oriented banking, which helps the client survive turbulence rather than being the cause of turbulence.

What the real economy does not need are vulnerable banks which threaten financial stability with increased systemic risk. It is therefore essential to implement the bank structure reform and transform TBTF banks into much safer deposit taking institutions and smaller investment banks. Structural reform is one of the major initiatives that can deal with the system's fragility caused by expanded trading and overreliance on wholesale funding.

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Another initiative could be the introduction of a binding leverage ratio and addressing systemic risks arising from securities financing transactions (which could be built on the current SFT transparency proposal).

For references and further explanation, please read our report on Europe's Banking Trilemma (http://www.finance-watch.org/our-work/publications/687-europe-banking-trilemma) and our policy brief Structural reform to refocus banks on the real economy (http://www.finance-watch.org/our-work/publications/898-fw-policy-brief-august-2014).

16. The IMF is warning about an uncontrolled rise of shadow banking activities. You stated a need to be vigilant of the risks such activities entail but also to distinguish economically useful activities of this kind from others. Can you outline how you propose to detect these activities, assess their utility and ensure the application of the principle of "same risks, same rules"? In this regard, what is your opinion about the key provisions regarding the Commission legislative proposal on Money Market Funds?

In terms of legislative action, we need to address the systemic risks of securities financing beyond reporting as foreseen in the SFT proposal. Furthermore, we need to avoid the build-up of new shadow banking activities by refraining from softening the prudential treatment of anything other than the most basic securitisation.

The proposed Regulation on Money Market Funds aims to improve financial stability as well as investor protection.

From the perspective of consumer protection, it is essential that the final legislation includes strong product rules defining eligible assets, a ban on short selling and securities lending, and restricted use of derivatives. The Commission correctly highlights that MMFs are not deposits and that their assets are subject to price fluctuations. A mandatory cash buffer helps indirectly to reinforce this message.

The financial stability impact of the proposal should be further improved. The definition of eligible assets still allows securitized products without detailed rules on their structure, which create additional risks such as an indirect exposure to leverage. External support must also be restricted to reduce interconnectedness. Parent bank sponsoring proved an unreliable model in the crisis.

For more information, please see our response to the shadow banking consultation: http://www.finance-watch.org/our-work/publications/211-shadow-banking-consultation

19. You committed yourself to the principle of proportionality. Can you outline measures and proposals you want to put forward in order to ensure that small and low complexity financial actors will not be pushed out of the market because of regulatory burden?

Regulation should be proportional taking into consideration the nature, complexity and scale of activities. A balance needs to be achieved to make sure that inappropriate and burdensome regulatory requirements do not disadvantage certain market players.

It is important to sustain diversity and competitiveness of various business models. It should be noted that in banking the burden of regulatory compliance generally decreases with size.

However this does not necessary mean that smaller institutions should be completely exempt from prudential rules.

Any proposal to exempt certain business models from applying rules based on the proportionality principle should be based on evidence and assessment of the potential impact.

22. Could you provide us with a specific figure/estimate on the size of the implicit funding subsidy for Too Big to Fail Banks by taxpayers in the EU and how you envisage removing that subsidy by means of banking regulation?

According to the Commission's estimates the implicit subsidy enjoyed by a sample of 112 EU banks (covering 60-70% of the total bank assets in the EU) over the period 2011-2013 is in the range of EUR 72-95 billion in 2011 and EUR 59-82 billion in 2012. In relative terms, this amounts to 0.5% to 0.8 % of annual EU GDP and between one-third and one-half of the banks' profits. See http://ec.europa.eu/internal_market/finances/docs/general/20140515-erfra-working-document_en.pdf

It should be noted that the value of the implicit subsidy increases sharply in a financial crisis.

The most important policy option for removing the implicit subsidy is through structural reform in combination with a credible resolution framework (including in particular a credible bail-in tool for the most complex banks). Without changes to bank business models the resolution framework might not be credible. This is because of the amounts of losses to be potentially absorbed, banks' interconnectedness, and exclusions from the scope of bail-in. Therefore, structural reform should be the EU's top priority.

For references and further explanation, please read our report on Europe's Banking Trilemma (http://www.finance-watch.org/our-work/publications/687-europe-banking-trilemma)
and our policy brief Structural reform to refocus banks on the real economy (http://www.finance-watch.org/our-work/publications/898-fw-policy-brief-august-2014).

23. In relation to the Commission proposal on Benchmarks, there is significant pressure to extend or increase the number of definitions of benchmarks. Do you take the view that it is appropriate to have different supervisory rules for different benchmarks, depending on their importance, which could give rise to regulatory arbitrage, or do you think it is better to have a simple supervisory rule that applies to all benchmarks?

The Commission proposal actually has a very wide scope, and calls to reduce this scope should be resisted. We support the Commission's reasoning that any indices "involving discretion should be subject to regulatory measures". It is not the impact of the benchmark that matters, but the risk of manipulation that is linked to a conflict of interest. If needed, proportionality should be introduced with a *de minimis* exception, rather than through a prescriptive approach defining relevant and "irrelevant" benchmarks at Level 1 or at Level 2.