MANAGEMENT BOARD BANKING

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Michel Barnier
Commissioner for the Internal Market and Services
European Commission, BERL 10/038
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Dear Commissioner,

With great interest ING has taken notice of the report by the High-level Expert Group on reforming the structure of the EU banking sector (hereafter: “the Group”) that was published on 2 October 2012. The report contains a solid analysis of the recent financial crisis and the underlying weaknesses that were at the root of it. The Group was asked to assess whether, in addition to the regulatory reforms that have already been initiated to address these weaknesses, other structural reforms are needed. Similar initiatives are under way in other jurisdictions around the world, including in some Member States. By establishing the Group in February 2012, Commissioner Barnier underlined the need for a coordinated approach in Europe. Restrictions to the activities of banks, or legislation regarding their (legal) structure by definition have an impact on their international competitive position and a fragmented approach within Europe would be detrimental to the functioning of the internal market.

The Group acknowledges that a broad array of regulatory initiatives has been launched since the crisis started, aimed at removing the risk of recurrence. Running regulatory reforms under way include the drive for stronger capital requirements embodied in CRD IV, the Fundamental Trading Book Review by the Basel Committee, the proposed Bank Recovery and Resolution Directive and the Banking Union proposals further strengthening the role of the supervisors. Banks are putting a lot of effort and resources in working on and preparing for the implementation of these measures. ING subscribes to the need to make the institutions more resilient and the system as a whole more stable and supports the great majority of these measures. As we have expressed before, however, ING does have a concern regarding the accumulation of different measures, their combined impact and the timing of their implementation.

The Group’s conclusion is that in addition to all the measures that are already being prepared or have been implemented, it may be necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within a banking group. In

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addition the Group has made a number of other recommendations regarding bail-in instruments, capital requirements and governance and control. ING supports some of these recommendations, but disagrees with others. ING therefore welcomes the opportunity to share its views on what it believes are the key issues in the report of the Group, with the Commission.

Mandatory separation banks into deposit bank and a trading entity
ING believes in the strength of the universal banking model, combining retail and wholesale banking activities. The universal banking model brings major benefits in terms of group risk diversification, capital and liquidity management, consumer choice and fulfilling the needs of long-term client banking relationships. Commercial banking activities within ING provide key support in terms of debt capital markets, hedging, cash management, trade finance and project finance, which helps serving the growing demand for integrated services, from corporates and SME's. The synergies that are achieved by combining this wide range of services within the universal bank would be lost if part of these activities would be separated, and even when a strong ring-fence would be put in place. ING is of the opinion, that legally separating the activities that are not permitted in the deposit bank into a trading bank is detrimental to the ability of banks to serve their customers.

The effectiveness of EU banks to serve customers will be hit hard by a separation of activities. EU companies will increasingly turn to non-EU parties if they cannot get a full range of services from European banks. Excessive dependence on foreign banks involves a risk to the financing of EU businesses as well as to employment and growth. It is important that banks can continue to meet the credit needs of households and businesses; this is certainly the case in the current, difficult economic conditions.

Making retail and investment banking activities ring-fence-ready is preferable above separation since the supposed advantages of far-reaching types of ring-fencing/separation do not outweigh the disadvantages from the loss of commercial synergy and diversification benefits. The Group does recognize the importance of the universal banking model, but deems it necessary to separate trading activities in case these amount to a significant share of a bank´s business. ING underlines that a balanced diversification of sources of revenues and of funding represents a key stability factor. If banks would be forced to split the banking and trading activities they would run the risk not being able to attract sufficient funding for these activities.

Only the very large trading houses would be able to continue to attract sufficient funding for their trading activities due to their strong established franchise and track record. This will inevitably lead to a further concentration, an increased systemic risk and loss of EU competitiveness vis-à-vis other countries. On balance, ING doubts whether separation really leads to increased stability and, in ING's opinion, the perceived benefits of separation certainly do not outweigh the costs of the loss of the synergies mentioned above.

ING manages risks based on a firm wide risk appetite framework taking into account all risks (credit risk, interest rate risk, fx risk, etcetera). The share of trading activities in INGs overall risk profile is very limited. A very large part of the activities booked in the trading book is actually directly linked to hedging the markets risks resulting from the commercial activities of the bank and putting the excess cash position of the bank at work. In case of a forced split of the trading activities from the rest of the bank this would no longer be possible within one bank, also due to the large exposure rules. By taking a more holistic view, it shows that this development does not really lead to disentanglement; the separated trading entities of banks will now be much more exposed to the risks of other banks.This means that in the event of a systemic crisis it may actually be more difficult to isolate problems and prevent contagion.

Separation conditional on RRP
ING agrees that all banks should have credible recovery plans to make them more resilient to idiosyncratic or systemic shocks. In addition banks should be resolvable, meaning that it should be possible that their failure is managed in an orderly way, without recourse to tax payers and contagion to other institutions. In addition, in case banks providing services to retail customers fail, the operational continuity of key transaction services should be ensured. ING acknowledges that excessive complexity of transactions or structure as well as the size of risk positions may hinder effective resolution. It is for that reason exactly, that in the Commission's proposals for Recovery and Resolution, certain powers are conferred to the resolution authority to address or remove impediments to the resolvability of an institution.

In particular, Article 14, paragraph 4, of the Directive identifies a number of measures that the resolution authority may impose where necessary and proportionate to reduce or remove impediments to resolution. This paragraph includes the possibility for the resolution authority to require changes to the legal or operating structure of the institution. It also contains a number of less far reaching measures such as requiring the institution to draw up service agreements to cover the provision of critical economic functions or services, requiring the institution to limit its maximum individual or aggregate exposures or requiring the institution to limit of cease specific existing or proposed activities.

By (only) pointing at the possibility of legal separation, the Group creates the risk that resolution authorities skip the less far reaching and more proportionate measures and resort to the ultimate and far more damaging measure of legal separation. ING therefore recommends that any impediments to resolvability are addressed along the lines of the better balanced provisions of the Directive.

Bail-in instruments
ING agrees with the Liikanen recommendations that bail-in debt should be issued via a new and separate asset class inserted in the Basel III requirements. Including all senior unsecured funding in the bail-in-able debt category, would put pressure on the availability and pricing of this category of debt and would hamper banks in complying with the liquidity requirements that are part of CRD IV. Similar to the Lower Tier –instrument it is important that for this

new liability class rules are in place and trigger points for non-viability are defined. EBA should thereby ensure a harmonised approach between countries and institutions. ING concurs with Liikanen that RWA should be a key determining factor instead of the total balance sheet. Finally, it should not just be common equity as that can replace a minimum amount of bail-in debt as it is stated in the Liikanen report, but in fact it should be possible that any form of regulatory capital can be used, albeit AT1 or LT2. This is also the position taken in the draft Crisis Management Directive.

ING does not support the recommendation that bail-in instruments should not be held inside the banking sector by restricting them to non-bank investors such as insurance companies and investment funds. To establish a new market for this kind of instruments can only be successful if banks are able to provide some kind of liquidity. Banks should not hold these securities in significant size, but capping exposure or putting the right risk weights in place should help to manage this.

Capital Requirements on Trading Assets and Real Estate related instruments
The Group refers to the trading capital requirements that may suffer from modeling risks and measurement errors. Specifically mentioned are: tail risks and systemic risks (impact on market liquidity of failure of major players). On top of that operational risks related to trading activities are mentioned. It is however not clear which definition of trading book capital requirements is used as a starting point. It should be noted that as a result of the introduction of Stressed VaR and IRC, the capital requirement for INGs trading activities has increased already more than fourfold.

Both market liquidity of trading assets and tail risks are explicitly covered in the Fundamental Trading Book Review. The concept of Expected Shortfall (ES) is introduced to replace the current VaR methodology for calculating trading book capital requirements. ES is known for better capturing tail risks. The issue of market liquidity is also addressed in the Fundamental Trading Book Review. ING supports these developments, although there are still some practical issues to be solved on topics such as back testing or how to exactly determine the liquidity horizon for trading exposures. First estimations show however that the capital requirement under ES is in line with the requirement under the current methodology. This implies that the underestimation of risks under the current model is probably less than anticipated. Back testing has evidenced that during the crisis; ING had no occurrences where the consolidated P&L of the trading activities breached the consolidated VaR (i.e. ING observed no ‘outliers’).

Two alternatives are proposed by The Group to further increase trading book capital requirements: the introduction of a robust floor in the trading risk RWA or a non-risk based capital buffer for all trading book assets. ING is not in favor of both approaches. We believe a risk-based model gives the best incentives in the day-to-day management of our trading activities. A non-risk based floor could give wrong incentives and provides opportunities for arbitraging by maximizing risk taking towards the floor. In our opinion, banks can better have risk-based capitals, based on solid models closely monitored and approved by the competent regulator.

Furthermore, ING is of the opinion that operational risks related to trading activities are already sufficiently captured via the operational risk capital models. Increasing market risk capital for operational risk will not contribute to improved transparency.

In addition, ING questions whether the impact of a further increase in capital requirements will result in reaching the Group's objectives. Higher capital requirements for trading activities – in combination with increases in capital requirements for other activities and the limited availability of capital - could result in a market with less active market participants. The few market participants that can continue to play an active role in the financial markets will take over the market shares of the smaller participants that are forced to discontinue their operations. ING fears that the dominance of a few big players in the market will result in less liquid markets, increased prices and more importantly, increased systemic risk.

Summarizing, ING does not support the Group's recommendations to further improve the robustness of the trading book capital requirements. Moreover, ING concludes that these recommendations by the Group are based on perceived weaknesses in the current approach that in ING's view have not been substantiated. ING therefore recommends that the following topics are included in the upcoming impact assessment by the Commission:

- The expected impact of the Fundamental Trading Book Review in terms of required capital and market behavior.
- The impact of Basel 2.5 on market behavior (to what extent have increased capital requirements caused market participants to reduce their trading activities?)
- The expected impact on market behavior in case additional capital requirements are imposed on top of the ones that have already been implemented.

As to the perceived low RWAs and low historical loss data compared to recent losses on real-estate portfolios, INGs actual write-offs on real-estate lending are much lower than provisions. This shows that at this stage of the crisis, losses on real-estate based lending are adequately provisioned. ING is in favour of maintaining a risk based approach in the modelling of RWA as this provides the best incentives for banks and for the economy as a whole. The risk-based RWAs are already complemented by an overall leverage ratio that acts as a backstop to RWA, therefore ING does not share the view that there is a need for an additional floor in RWA.

ING is in favour of implementing effective macro-prudential tools in order to prohibit excessive lending. However, this is more complex than it seems at first sight. Taking the example of LTV caps, it is very important to determine who is the borrower and what is the term of the underlying rental contract. For example: an LTV cap is not really relevant for a 50-year real-estate based loan to a government, while it is very important for a 3-year loan to a lower rated corporate. This means that implementing LTV/LTI caps should be done while taking into account market and national characteristics. If not, these metrics will be too harsh and will hamper economic growth too much.

We would like to emphasize that a review of RWA for real-estate based lending has already been initiated by BIS and EBA and that ING is cooperating in this review. These reviews are being coordinated by the Dutch Central Bank who have stated that they wish to await the outcome and analysis before making any changes to existing RWA requirements. ING is very much in favour of awaiting the outcomes of this review before implementing additional regulation via other bodies. It is important that coordination exists in the framework of capital requirements.

Corporate Governance Reforms
The Group’s proposal to strengthen governance in a number of ways is based on the analysis that as a result of increased complexity, size and scope internal control and external risk monitoring have become more complex. ING subscribes this analysis, but is of the opinion that the broad range of regulatory initiatives already developed to target reforms in corporate governance are not clearly taken into consideration by the Group.

Best regards,

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Vice Chairman ING Bank