BANKING STRUCTURAL REFORM

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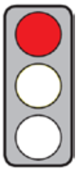
KEY ISSUES

Objective of the Regulation: The Regulation prohibits "proprietary trading" by larger banks and permits the banking regulators to prohibit "trading activities" so that the trading concerned is only carried out by companies which are separate from the bank.

Affected parties: Banks, investment funds, regulatory authorities, other financial market participants.



Pro: –

Contra: (1) Bans on proprietary trading and trading activities require sufficient justification which has not been forthcoming either from arguments based on economic theory or from practical experience.

(2) The large number of vague definitions and the broad scope given to the Commission and the regulatory authorities to clarify them, creates legal uncertainty.

(3) The blanket ban on proprietary trading and on investments in alternative investment funds is in breach of the freedom to conduct a business.

(4) The power of the Commission to exempt banks in certain Member States from individual parts of the Regulation is incompatible with the EU's internal market competency.

CONTENT

Title

Regulation COM(2014) 43 of 29 January 2014 on **structural measures improving the resilience of EU credit institutions**

Brief Summary

- **Objectives and definitions**
  – By way of the Regulation, the Commission wants (Art. 1)
    - to prevent banks from taking excessive risks and
    - to reduce the interconnectedness of the financial sector in order to avoid systemic risks.
  – The Commission proposes the following "structural measures" (Art. 2):
    - a ban on "proprietary trading" for certain banks and
    - authorisation for the banking regulatory authorities to prohibit certain banks from carrying out "trading activities", so that the trading concerned can only be carried out by legally separate companies.
  – "Proprietary trading" is trading by banks with financial instruments or commodities using their own or borrowed capital - by way of "desks, units, divisions or individual traders" who are "specifically dedicated" to such trading - for the "sole purpose" of making a profit (Art. 5 No. 4)
    - without any connection to "actual or anticipated" client activity or
    - for the purpose of hedging the bank's risk resulting from "actual or anticipated" client activity.
  – "Trading activities" are not defined but include at least (Art. 9 (1) in conjunction with Art. 5 Nos. 12-15)
    - market making; a bank's commitment to ensure market liquidity by regularly posting two-way quotes for financial instruments, at which the bank is prepared to buy or sell, whilst exclusively fulfilling client orders and without the bank being exposed to any "material market risk";
    - investment in securitisation, i.e. investing in claims which are bundled and converted into tradeable securities;
    - trade in derivatives – i.e. trade in financial contracts whose value is derived from base values such as share prices, commodity prices or exchange rates.
  – "Trading activities" does not include, inter alia, deposit business or lending (Art. 8 (1)).
- **Scope**
  – The Regulation applies to
    - any "global systemically important" banks established in the EU, including all subsidiaries and branches worldwide (Art. 3 (1) (a)), and to
    - other companies (Art. 3 (1) (b))
      - that for a period of three consecutive years have total assets amounting at least to EUR 30 billion and
      - that pursue trading activities in each of the three years which amount at least to EUR 70 billion or 10% of their total assets.

      This may be:
      - banks established in the EU (including all subsidiaries and branches worldwide),
      - non-banks established in the EU (including all subsidiaries and branches worldwide), which are parents of a group of companies which has a bank established in the EU,
      - EU branches of banks from non-EU countries.

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– The Regulation does not apply to (Art. 4 (1), in conjunction with Art. 27 (1))
  - subsidiaries of EU banks in a non-EU state and
  - EU branches of non-EU banks,
  if the non-EU country is recognised as having equivalent rules.

► **Ban on proprietary trading**
The banks affected by the Regulation cannot engage in proprietary trading (Art. 6 (1) (a)).
Proprietary trading is still allowed where it is
– with financial instruments issued by the EU or the Member States (Art. 6 (2) (a)),
– for the purpose of "liquidity management" and with cash or liquid short-term investments such as shares in money-market funds (Art. 6 (2) (b)).

► **Ban on investments in alternative investment funds (AIFs)**
– Banks are not permitted, with their own capital or borrowed money, for the purpose of making a profit and for their own account, to acquire or retain shares in open-ended, leveraged alternative investment funds (AIFs) (Art. 6 (1) (b)). These include, in particular, hedge or real estate funds.
– Banks may, however, acquire and retain shares in closed-ended and unleveraged AIFs, in venture capital funds (EuVECA), social entrepreneurship funds (EuSEF) and European long term investment funds (ELTIFs) (Art. 6 (3)).

► **Ban on trading activities and the ability to separate them**
– **Ban on specific trading activities**
  - The regulatory authorities, and therefore also the ECB, assess the trading activities of banks which accept deposits protected by deposit guarantee schemes ("core banks") (Art. 9 (1)).
  - The assessment is carried out using parameters laid down in the Regulation, particularly size, amount of leverage and profitability of the trading activities (Art. 9 (2)).
    - The EBA specifies in technical regulatory standards how to measure and apply the parameters (Art. 9 (4)).
    - The Commission specifies in delegated acts the limits of the parameters which may justify a ban on trading activities (Art. 10 (5)).
  - The regulatory authorities must ban trading activities where (Art. 10 (1) and (3))
    - the Commission's conditions have been met and
    - they therefore see a threat to the stability of the core bank or to the EU financial system.
  - They can ban trading activities where the Commission's conditions have not been met but they see a threat to the stability of the core bank or to the EU financial system (Art. 10 (2) and (3).
  - Where a regulatory authority bans a core bank from carrying out certain trading activities, the bank may issue a response to this within two months. The authority will adopt a final decision within a further two months which is reviewed after five years. (Art. 10 (3) and (4))
– **Trading activities which are still permitted**
  - Core banks which are banned by the regulatory authorities from carrying out trading activities are still allowed to trade with specific financial instruments (Art. 11 (1), Art. 12 (1)):
    - They are allowed to manage their capital, liquidity and funding by using interest rate derivatives, foreign exchange derivatives and credit derivatives, which are eligible for clearing, provided their use mitigates the bank's position risks.
    - They can, under certain circumstances, sell interest rate derivatives, foreign exchange derivatives, credit derivatives, emission allowances derivatives and commodity derivatives, which are eligible for clearing, to non-financial companies, closed-ended and unleveraged AIFs, EuVECAs, EuSEFs, ELTIFs, UCITS investment funds and insurance companies.
  - The Commission can extend the list of financial instruments by way of delegated acts (Art. 11 (3) and Art. 12 (2)).
– **Transfer of prohibited trading activities to trading entities**
  - A core bank which belongs to a group is permitted to transfer trading activities, which have been prohibited by the regulatory authorities, to a "trading entity".
  - The trading entity may be part of the same group but must be "legally, economically and operationally separate" from the core bank. The core bank cannot generally hold shares in the trading entity or voting rights in it. (Art. 13 (1) and (5))
  - The parent of the core bank must ensure that, in the event of the insolvency of the trading entity, the core bank can continue its activities (Art. 13 (4)).
  - Core bank and trading entity must each comply with the capital requirements [Regulation (EU) No. 575/2013, see cep**PolicyBrief**, and Directive 2013/36/EU, see cep**PolicyBrief**] (Art. 13 (11)).
– **National exceptions**
  - The Commission may exempt a bank, which takes deposits from individuals and small and medium-sized enterprises (SMEs), from the prohibitions under the Regulation relating to trading activities.
  - The conditions for this are that the relevant Member State (Art. 21 (1))
    - has already adopted national legislation, prior to 29 January 2014, on structural measures which "complies" with the EU prohibitions relating to trading activities and
    - has applied for an exemption.

- **Entry into force**
  The provisions (Art. 36)
  – prohibiting trading activities, allowing activities to be still permitted and those providing for national exeptions take effect when the Regulation comes into force;
  – on the separation of trading activities, take effect 36 months after publication of the Regulation;
  – prohibiting proprietary trading and AIF investments, take effect 18 months after publication.

Statement on Subsidiarity by the Commission

According to the Commission, inconsistent national legislation increases the risk of distortions in the movement of capital and investment decisions.

Policy Context

In 2011, Internal Market Commissioner Barnier commissioned a group of experts chaired by Erkki Liikanen to develop proposals for structural reform of the banking sector. In its final report in 2012, it called for the separation of proprietary trading and other high-risk trading activities into separate legal entities for certain banks. In the EU, Germany, United Kingdom, France and Belgium have already adopted similar measures, and the US adopted the "Volcker Rule".

Legislative Procedure

29 January 2014	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Internal Market
Leading Committee of the EP:	Economic and Monetary Affairs
Leading Federal Ministry:	Federal Ministry of Finance
Leading Committee of the BT:	Finance
Decision-making mode in the Council:	Qualified majority (Adoption by a majority of the Member States and with 260 of 352 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (Ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The planned **"structural measures"** – the prohibition of proprietary trading and trading activities – **represent radical intervention in the freedom** of banks **to conduct business;** they therefore require strong **justification** which **has not been forthcoming either from arguments based on economic theory or from practical experience.**
Structural measures may mean that implicit government guarantees against risky trading activities by banks become superfluous. They thus contribute to these activities being priced according to the risk and prevent the misallocation of resources. This may also reduce distortions of competition in favour of "systemically important" banks. However, the structural measures also involve risks and costs. These include, in particular, a reduced diversification of risk and losses due to smaller economies of scale. Experience gained in the financial crisis is mixed. The insolvency of pure investment banks as well as traditional banking activities like lending can impact on financial stability, as was shown by the Lehmann Brothers crash and by the bursting of the property bubbles in Spain and Ireland. Ultimately it is unclear, therefore, whether the planned structural measures are an efficient way of making the financial system more stable and of preventing systemic crises.
From 2015, **the Bank Resolution Directive** (Directive 2014/59/EU, see cep**PolicyBrief**) **will already provide the resolution authorities with broad powers to intervene in banking structures.** In individual cases, the authorities can prohibit a bank from carrying out certain activities if they see that there is a risk to the bank's resolvability. **Additional measures are not currently justified.**
The Regulation creates substantial legal uncertainty and thus restricts innovation and competition to find the best business model. **The large number of vague definitions** – such as what "trading activities" are and which parameters to use –, **and the broad scope given to the Commission and the regulatory authorities**, (i.e. also the ECB) **to clarify them, gives rise to problems.**
This situation is serious in three respects. Firstly, there are varying legal consequences depending on the classification of the activity. Proprietary trading is subject to a blanket ban whereas other trading activities are only potentially prohibited and can be separated. Proprietary trading and market-making, in particular, are

often difficult to distinguish from one another. Secondly, there is a risk that, as a result of this uncertainty, banks will be over-cautious and, in case of doubt, refrain from economically desirable activities. Thirdly, there is also a risk of political opportunism. Since the decisions of the Commission and the regulatory authorities can have a considerable impact on the competitiveness of the financial sector of individual Member States, extraneous arguments are likely to find their way into the deliberations.

The exemption of government loans from the ban on proprietary trading suggests that – unlike private loans – these are not subject to any significant risk of failure. It thus leads to a misallocation of resources, **creates distortions of competition and promotes cluster risks.**

The ban on the acquisition of shares in open-ended AIFs that finance their investments by borrowing ("leverage"), is too general. Not every investment by a bank in leveraged funds is high risk per se since these AIFs can also effect low-risk investments which keeps the repercussions for the bank within bounds in the event that the investments fail. **Rather than focussing** solely **on leveraged financing, the legislation should be based** to a greater extent **on the risk profile of the AIF.**

Although the Regulation provides that EU-wide parameters play a role in banning trading activities, the regulatory authorities retain wide discretionary powers. The level of harmonisation - and therefore distortions of competition - will thus depend on the conduct of the regulatory authorities. The ability for individual Member States to exclude banks from the Regulation, intensifies the problem. In addition, it is unclear how to interpret the requirement that analogous national rules "comply" with the Regulation.

Legal Assessment

Legislative Competency

The Regulation is correctly based on the internal market competence (Art. 114 TFEU). It improves the internal market's functioning by easing the making use of the fundamental freedoms. **The power of the Commission to exempt banks in certain Member States from individual parts of the Regulation is incompatible with the EU's internal market competency**. Granting exemptions would undo some of the improvements related to the making use of the fundamental freedoms, hence fragmenting the internal market.

Subsidiarity and Proportionality with Respect to Member States

Unproblematic.

Compatibility with EU law in other Respects

The blanket ban on proprietary trading and on investment in AIFs is in breach of the freedom to conduct a business. [Art. 16 EU-Charter of Fundamental Rights (CFREU)]. It is unnecessary and therefore constitutes an unjustified intervention: The Regulation aims to prevent banks from being able to take excessive risks and to avoid systemic risks in the financial sector. Separating off high-risk trading activities seems milder but is as effective as a complete ban and is justified if it is necessary to prevent systemic risks to the financial sector.

The ban on investing in AIFs includes the blanket obligation to sell any shares held in these funds. This obligation is in breach of the right to own property (Art. 17 CFR). An order to sell would only be justified in individual cases provided it was necessary in order to avoid systemic risks to the financial sector.

Impact on German Law

The German structural measures for the banking sector stipulate higher thresholds than the Regulation (€ 90 billion rather than € 30 billion) (Section 2 (2) German Banking Act (KWG)). Also, banned transactions only have to be transferred to a financial trading institute (Section 25 (1) et seq. KWG). Market making is not a banned transaction (Section 3 (2), sentence 2, No. 3 KWG). It is not yet clear whether the German structural measures will permit a national exception to the Regulation for German banks.

Conclusion

Bans on proprietary trading and certain trading activities require sufficient justification. This has not been forthcoming either from arguments based on economic theory or from practical experience. The large number of vague definitions and the broad scope given to the Commission and the regulatory authorities to clarify them, creates legal uncertainty. The blanket ban on proprietary trading and on investment in AIFs is in breach of the freedom to conduct a business. The power of the Commission to exempt banks in certain Member States from individual parts of the Regulation is incompatible with the EU's internal market competency.