Client Alert

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Separation Anxiety: Structural Reform of EU Credit Institutions

The march towards structural reform of the EU banking sector has taken another step forward, as the EU Commission's (the "Commission") legislative proposals (the "Proposals") for a Regulation implementing certain recommendations of the Liikanen Report (see further below) were published on 29 January 2014[1]. Following hot on the heels of regulatory progress in respect of structural reforms at the EU member state level (including in France, Germany and the UK[2]) and globally (most notably in the US with the recent final text of the Volcker Rule being issued in December 2013), the Proposals are aimed at implementing structural changes that are designed to improve the resilience of the banking system and minimise the risk of public funds being utilised to bail-out financial institutions.

Background

On 2 October 2012, the European Commission's high-level expert group, chaired by Erkki Liikanen, published its final report (the "Liikanen Report") making recommendations on the need for structural reforms to the EU banking sector. The Liikanen Report reached a number of conclusions, amongst them the recommendation that a deposit bank's proprietary trading activities (and other significant trading) should be segregated and operated by a separate legal entity, to the extent that such activities amount to a significant share of the bank's business (determined by a threshold test).

This separation recommendation was further explored by the Commission in its May 2013 consultation paper, setting out the building blocks for proposed structural reform[3]. In particular, fundamental questions were raised regarding: 1) which banks should be subject to separation, 2) which activities should be separated, and 3) how strong should any resulting separation be?

The Commission's Proposals attempt to tackle these issues by blending an outright ban on proprietary trading for larger EU banking groups (akin to the Volcker Rule in the US but with more limited scope) with the potential additional ring-fencing of other existing trading activities. The outcome will undoubtedly result in further regulatory complications for the EU banking sector. The principal features of the proposals are explored further below.

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[1] http://ec.europa.eu/internal_market/bank/docs/structural-reform/140129_proposal_en.pdf.

[2] The UK's Financial Services (Banking Reform) Act 2013 (the "Banking Reform Act"), which provides the UK treasury and Prudential Regulation Authority (PRA) with powers to implement the recommendations of the Vickers Report, received Royal Assent on 18 December 2013.

[3] http://ec.europa.eu/internal_market/consultations/2013/banking-structural-reform/docs/consultation-document_en.pdf.

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Scope

The scope of the Proposals is somewhat complex and is intended to apply across the global corporate groups of EU banks which meet certain criteria and exceed designated thresholds. Frequently Asked Questions published by the Commission alongside the proposals suggest that the current proposal would be likely to apply to around 30 banks. This is considerably more limited than the Volcker Rule, which applies to all insured depository institutions and bank holding companies in the US, as well as foreign banks treated as bank holding companies.

Specifically, the rules apply to EU credit institutions and their parents, including branches and subsidiaries irrespective of where they are located, in each case when identified as a global systemically important institution (G-SII)[4]. It will also apply to (a) credit institutions established in the EU that are neither parent undertakings nor subsidiaries (including their branches wherever they are located), (b) EU parent companies, (including their branches and subsidiaries wherever they are located) and (c) EU branches of credit institutions established in third countries, in each case where, for a period of 3 consecutive years, such entities have total assets of at least €30bn and total trading activities of at least €70bn (or 10% of its total assets). In relation to EU branches of non-EU entities, it appears that the calculation of total assets and trading activities is by reference to the branch only and not the entire legal entity.

The Proposals make clear, however, that (1) EU branches of credit institutions established in third countries and (2) subsidiaries of EU parents established in third-countries, will not be subject to the regulations to the extent that there is a legal framework governing any such institution that is deemed to be equivalent. Given that a number of the in-scope entities are likely to be branches of US banks, this means that they will potentially be exempt as a result of being subject to the Volcker Rule and other provisions of the Dodd-Frank Act. Nevertheless, the territorial scope of the Proposals is significant and has been designed with the intention of preventing activities being transferred outside of the EU in order to circumvent the intended reforms.

It should also be noted that the ability of competent authorities to review a bank's trading activities with a view to possible ring-fencing (see "*Separation of Certain Trading Activities*" below) shall only apply to (a) "core credit institutions"[5] established in the EU that are neither parent undertakings nor subsidiaries (including their branches wherever they are located), (b) EU parent companies, (including their branches and subsidiaries wherever they are located, where one of the entities is a core credit institution established in the EU) and (c) EU branches of credit institutions established in third-countries.

Prohibition on Proprietary Trading

Subject to certain limited exceptions (see below), entities that are in-scope (described above) will no longer be entitled to engage in proprietary trading. Such activities involve an entity using its own capital or borrowed money to purchase, sell or otherwise take positions in financial instruments or commodities, for the "sole purpose" of making a profit for its own account. The test, it seems, is therefore quite a narrow one (and more narrow than the definition of proprietary trading under the Volcker Rule), since any activity that is connected to actual or anticipated client activity (such as hedging activities) would appear to fall outside the "sole purpose" test and not be subject to the restrictions. Further, the activities captured are only those which are entered into through the use of desks, units, divisions or individual traders that are "*specifically dedicated to such position taking and profit making*". This would appear to exclude proprietary trading that takes place through desks or units that are not solely dedicated to that activity.

Entities subject to the Regulation, will also be prevented from using their own capital or borrowed money to acquire or retain units or shares in alternative investment funds ("AIFs"), invest in derivatives, certificates, indices or instruments linked to AIFs, or to hold any units or shares in other entities that engage in proprietary trading or

[4] In accordance with Directive 2013/36/EU (also known as CRD-IV).
[5] I.e., those banks which, at a minimum, take deposits that are eligible under the EU's Deposit Guarantee Scheme.

acquire shares or units in AIFs, in each case, where the sole purpose of the transaction is to make a profit for the account of the relevant entity. This requirement is intended to prevent banks from circumventing the prohibition, by setting up or investing in hedge funds that conduct proprietary trading activities on their behalf.

The restrictions are ameliorated, however, by a number of exceptions. These include an allowance being made for the trading of EU sovereign debt, as well as debt issued by multilateral development banks or other international organisations. In addition, the prohibition will not apply where an entity used its own capital as part of its cash management process in connection with holding, purchasing or selling cash or other cash equivalent assets.

Separation of Certain Trading Activities

The second limb of the Commission's Proposals, provide competent authorities with the ability to review the trading activities of an in-scope bank (these might include, for example, market making, investment or sponsorship of securitisation or the trading of certain derivatives other than for hedging purposes) and, following consultation with the European Banking Authority ("EBA"), separate[6] any activity where its trading activities as a whole exceed a particular set of defined metrics, and is therefore considered to pose a threat to the financial stability of the core credit institution or the EU financial system as a whole. Even where the defined metrics are not exceeded, a competent authority can still demand such a separation of any particular trading activity (other than derivatives trading) if it concludes that such activity poses such a threat. These metrics have not yet been calibrated in accordance with supervisory data although, once determined by the European Commission[7], they will have reference to, for example, factors such as the relative size and leverage of trading assets, complexity of trading derivatives and profitability of trading income.

Trading activities that are potentially caught by the ring-fencing requirement are extremely broad in nature and must be determined on a negative basis by reference to a list of activities that are expressly excluded. Amongst the proposed exclusions, is the taking of deposits under the EU Deposit Guarantee Scheme, the provision of various forms of lending and consumer credit, payment services and administration of securities or custody services. Any activity outside these excluded activities would appear to be potentially subject to a ring-fencing requirement.

The Proposals do, however, provide an opportunity for banks to demonstrate that any activities which have been designated for ring-fencing, do not pose a danger to the stability of the EU. If they are able to do so to the satisfaction of their competent authority, the ring-fencing requirement may be removed. Competent authorities are required to make public their conclusions and analysis.

If separation does occur, the Proposals go on to put in place a number of economic, legal, governance and operational controls between a separated trading entity and the rest of its group. These are proposed to include, for example, a requirement that the core or deposit taking entity would not be able to own capital instruments or voting rights in the separated traded entity.

Compatibility with Other Legislation

As mentioned above, the Commission's Proposals follow in the wake of a number of other existing structural reforms both inside and outside the EU. In the UK, for example, the Financial Services (Banking Reform) Act 2013 provides powers to the UK Treasury and regulators that are in many ways similar to those provided to competent authorities under the Proposals. It also provides for a full ring-fence of retail banking activities, which goes much further than the Proposals, although would not appear to be incompatible with it. Although there was significant debate in relation to proprietary trading in the UK in the development of the Banking Reform Act, there is currently no prohibition on proprietary trading by entities outside of the ring-fence (entities within the

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[6] The Proposals refer to a legal, economic and operational separation.
[7] In accordance with Article 9(4) of the Proposals, the EBA will be empowered to develop draft regulatory technical standards specifying how the metrics will be measured and the European Commission has the power to make legislation adopting such standards.

ring-fence are significantly curtailed in the activities they can undertake, which amounts to an effective prohibition on proprietary trading). The Banking Reform Act also requires UK regulators to carry out an assessment (and prepare a report) of the case for and against a ban on proprietary trading.

Regardless of the rules of individual member states, the Commission does not intend that banks should have to follow two sets of ring-fencing rules. Article 21 of the Proposals provides for a potential derogation from the separation requirements, in circumstances where banks are already covered by member state legislation that has an equivalent effect to the proposals[8]. Similarly, Article 27 provides for possible further derogations in circumstances where third-country structural reforms are deemed to be equivalent. It remains to be seen, however, the extent to which such derogations will be applied by the Commission.

Implementation

The prohibition on proprietary trading is expected to become effective on 1 January 2017, with the separation of trading activities to become effective on 1 July 2018. Such proposed timing may be ambitious, however, when considered in the light of the time taken for other EU regulatory reforms (including EMIR, CRD IV and MiFID) to go through the legislative process. Timing is further complicated by the fact that there will be elections to the European Parliament in May 2014 and the current EU Commission's term of office expires in October 2014. It seems unlikely that agreement will be reached on the draft Regulation until after the election of the new EU Parliament and appointment of the new EU Commission. The proposed timetable is therefore uncertain.

Reaction to Proposals and Impact

Early reports on the views of commentators across Europe suggest that initial reactions to the Proposals have been mixed. In France and Germany, concern has been raised that the measures are a step too far (in particular, the inclusion of certain types of market-making as an activity that could potentially be subject to separation) and are unnecessary in the light of domestic reforms that have already taken place in those countries. To the contrary, others believe that the failure of the Proposals to bifurcate the banks into retail and wholesale units, waters down the effect of the legislation, which does not go far enough to curb the 'too big to fail' threat. Similarly, comparisons with the Volcker Rule highlight that the prohibition on proprietary trading is not as broad as the US requirements and it may be that policy makers ultimately end up pushing for something more stringent.

The interaction of any finalised EU legislation resulting from the Proposals and the Volcker Rule is likely to be a key area of focus. Many, if not all, of the EU banks that would come within the scope of the Proposals are likely to be regarded as Foreign Banking Organisations ("FBOs") under the Volcker Rule by virtue of owning US banks or operating branches or agencies in the US. The Volcker Rule exempts FBOs and their affiliates from the Volcker proprietary trading ban, to the extent that the activity is conducted solely outside the US (known as the SOTUS exemption). Depending on where the Proposals eventually come out, EU banks will need to decide whether to structure operations such that their US operations are subject to Volcker and the rest of the group is subject to the EU version of the proprietary trading prohibition, or such that the whole group is compliant with both regimes.

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[8] The equivalent domestic legislation must have been adopted by 29 January 2014.

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