Insight: Regulatory

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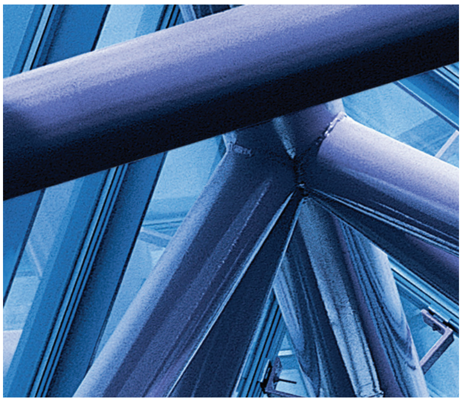
European Commission's proposal on banking structural reform- a Volcker Rule for Europe

On 29 January 2014, the European Commission published a legislative proposal for a Regulation on structural reforms to the EU banking sector (the "Proposed Regulation") (available **here**). The Proposed Regulation advances the recommendations set forth in a report published in October 2012 by the EU High-Level Group on reforming the structure of the EU banking sector chaired by the Governor of the Bank of Finland, Erkki Liikanen (the "Liikanen Report") (available **here**).



In summary, the Proposed Regulation aims at improving the resilience of the EU banking system by requiring banks, in particular banks that are deemed to be "too big to fail", to implement structural reforms. The key structural reforms proposed include: (i) a ban on speculative activities i.e. proprietary trading; and (ii) a requirement to separate certain trading activities, such as market making, from a deposit taking entity if the trading activities of the bank exceed certain thresholds.

The proposed ban on proprietary trading for Europe's largest banks will come into force on a date to be specified (proposed 1 January 2017). The requirement to separate trading activities in banking groups will depend upon an assessment to be carried out by European bank supervisors that is intended to identify the banks to which the separation requirement should apply. It is intended that this assessment should be carried out over an 18-month period following the publication of the Proposed Regulation in its final form (proposed 1 January 2018).

The proposals, particularly with regard to the separation of trading activities, therefore imply a quite long period of development in terms of the negotiation of the Proposed Regulation through the EU legislative process, the development of some key technical standards and the timetable for the phasing in and implementation of the provisions. This would appear to present a risk to the largest European banking groups of 'planning blight' since it may take several years before the precise impact of the Proposed Regulation can be predicted with any certainty.

Key Provisions

Scope

The Proposed Regulation is targeted at banks that are "too big to fail", in particular those with significant trading businesses, whose failure could have a disruptive effect on the financial system and the economy. Under Article 3 of the Proposed Regulation the following EU banks are covered:

(a) EU banks that are deemed to be a global systemically important institution (G-SIIs) under the CRD IV Directive (2013/36/EU).

(b) EU banks that for a period of three consecutive years have (i) total assets amounting to at least €30 billion **and** (ii) trading activities amounting to at least €70 billion or 10 per cent of their total assets.

Article 23 of the Proposed Regulation sets out the following formula for calculating a bank's trading activities:

> **Trading activities** = (Trading Securities Assets + Trading Securities Liabilities + Derivative Assets + Derivative Liabilities)/2

Assets and liabilities of group insurance and reinsurance undertakings and other non-financial undertakings are excluded for the purpose of this calculation. Further guidance on the methodology for calculating the trading activities will be provided by the European Banking Authority (the "**EBA**") at a future date through implementing technical standards.

The European Commission has stated that out of the 8,000 banks operating in the EU, only around 30 would likely be affected by the Proposed Regulation, representing however over 65 per cent of the total banking assets in the EU. It should be noted that the thresholds in the Proposed Regulation are lower than in some of the EU member states' already existing legislation on the separation of certain trading activities such as in Germany.

The Proposed Regulation applies at the EU universal bank consolidated group level, including each EU bank within the group, the ultimate holding parent company and any subsidiaries and branches wherever located. EU branches of banks from outside the EU may also fall within the scope, however, the Proposed Regulation provides for a third country equivalence regime whereby, pursuant to Article 4, foreign subsidiaries of EU banks and EU branches of foreign banks might be exempted if they are subject to equivalent separation rules. The US Volcker Rule, by contrast, applies to the US branches and subsidiaries of EU and other non-US banks with a U.S. banking presence. Application of the Volcker Rule also is not limited by a bank's systemic importance.

Prohibition on proprietary trading

Article 6 of the Proposed Regulation sets out a ban on proprietary trading for banks and entities within the same group that meet the size metrics in Article 3. Proprietary trading is defined as using capital or borrowed funds to take positions in financial instruments and commodities for the sole purpose of making a profit for the bank's own account, and without any connection to actual or anticipated client activity or for hedging such activity. The proposed ban applies to actual or anticipated client activity through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making, including through web based trading platforms.

In contrast to the final rule to implement the **US Volcker Rule**, this definition is quite narrow which may create a risk of circumvention. The Proposed Regulation definition, on the other hand, does not limit proprietary trading subject to the prohibition to trading for "short-term" profit or resale as does the Volcker Rule final rule, and, apparently, includes within the proposed ban positions in spot commodities which are outside of the scope of the Volcker Rule prohibition. Limited exceptions are available for trading in EU government bonds and also dedicated structures for buying and selling money market instruments for the purpose of cash management. The Proposed Regulation indicates that this exclusion may be expanded to include debt issued by non-EU sovereigns that are assigned a 0% risk weight and which meet other criteria to be specified in technical standards. In order to prevent circumvention of the prohibition by banks, the prohibition extends to investing in or holding shares in hedge funds, or entities that engage in proprietary trading or sponsor hedge funds. However, this additional restriction does not apply to unleveraged and closed-ended funds, such as private equity, venture capital and social entrepreneurship funds.

The European Commission's rationale for this prohibition is to prevent the re-emergence of proprietary trading which, in the Commission's opinion, was significant prior to the crisis.

Rules on remuneration

In order to aid compliance with the above prohibition, banks are required to ensure that their remuneration policies do not, directly or indirectly, encourage or reward the carrying out by any staff member of proprietary trading. The Volcker Rule final rule similarly does not permit compensation arrangements designed to reward or incentivise prohibited proprietary trading. Furthermore, Article 11(2) requires banks to ensure that their remuneration policies prevent any residual or hidden proprietary trading and that they reflect the legitimate hedging objectives of the bank as a whole.

Potential separation of trading activities

The Proposed Regulation also makes provision for a wider, more general, review of trading activities of so called core-banks and banking groups (that contain a core-bank) that fall within the size metrics in Article 3. A "core-bank" is a bank that accepts deposits that are covered by the EU mandated deposit guarantee scheme.

Because the definition of prohibited proprietary trading is relatively narrow, the European Commission intends that the other trading activities of banks within Article 3 should be reviewed to guard against the risk that such activities may be circumventing the ban on proprietary trading.

The Proposed Regulation contains a list of activities that are not to be considered as 'trading activities" (for example deposit taking, lending, financing of commercial financing, providing payment services and money broking). The duty to review trading activities is said to apply "in particular" to market making, investments in and acting as a sponsor for securitisations and trading in derivatives (other than for the purpose of managing its capital, liquidity and funding) or in the provision of risk management services for customers. Rather than require separation of trading activities outside of the proprietary trading ban, the Volcker Rule sets permissible limits for a bank's continued conduct of those activities because banking law and the Glass Steagall Act already require separation of many of these lines of business.

Importantly the Proposed Regulation makes provision for technical standards to be developed that will specify metrics and limits above which particular kinds of trading activity are to be considered significant. These standards will also specify which types of securitisation should not be considered to pose a threat to the financial stability of the core bank or to the European financial system. These technical standards will be key in establishing the impact of the trading activity separation requirement and the extent to which it will apply to banking groups.

If a competent authority concludes that the bank's trading activities and the related risks exceed the proposed thresholds and meet certain conditions linked to the metrics in Article 9(2) then it **must** require the bank to separate its high risk trading activities, unless the bank can demonstrate that the trading activities do not endanger the financial stability of the EU. Furthermore, a competent authority has discretion under Article 10(2) to require separation where it believes that the bank's trading activities pose a threat to the bank's stability or to the financial system of the EU, even where the thresholds have not been exceeded nor the conditions met.

Separation plan and separate group entities

The decision of a competent authority to separate a core-bank's high risk trading activities triggers the requirement for the bank to submit a separation plan to its competent authority for approval. The competent authority may require revisions to be made to the plan or it may adopt its own plan if the bank fails to do so within the required timeframe. The separation plan must set out the specification of assets and activities to be separated, details on how the rules on separate group entities will be applied and a timeline for the separation.

Once the plan has been approved, the next step requires the bank to transfer the trading activities identified by its competent authorities to a separate legal entity (a "**trading entity**"). This step is required if the bank wants the activities in question to remain within the same banking group. Restrictions will apply to the legal, economic, governance and operational links between the trading entity and the rest of the group in order to ensure that the separation is real and effective. In addition, pursuant to Article 20, trading entities are prohibited from carrying out certain core activities, including taking deposits eligible for protection under deposit guarantee schemes and providing associated retail payment services.

The Proposed Regulation will allow trading activities to be carried on with a group that contains a core-bank provided there is legal, economic and operational separation between the trading entity and the core-bank. The general rule is that the core-bank cannot hold capital instruments or voting rights in the trading entity. The trading entity and core bank must meet European capital and liquidity rules on a sub-consolidated basis.

The degree of separation required by the Proposed Regulation is not absolute. A core-bank and trading entity may transact with each other provided the terms of the transaction are as favorable to the core-bank as comparable third party contracts. The so-called "Super 23A" provisions of the Volcker Rule prohibit credit and other transactions between a bank and any private equity or hedge fund for which the bank acts as a manager, adviser or sponsor. Some limited commonality between the management boards of the bank and trading activity is permissible under the Proposed Regulation. The name of the trading entity and core bank must be such as to indicate which is the bank and trading entity. The Proposed Regulation does not appear to rule out both the core-bank and trading entity enjoying funding provided by a common parent that may raise market debt.

Derogation

Article 21 provides a possible derogation from the trading activities separation requirements in Chapter III of the Regulation where a bank is subject to national primary legislation adopted before 29 January 2014 if the national legislation (a) aims at preventing financial stress or failure and systemic risk; (b) prevents credit institutions taking eligible deposits from dealing in investments as principal and holding trading assets (subject to certain permissible exclusions); (c) as necessary, provides for the effective separation between the deposit taking institution and other group entities that deal as principal in investments or which hold trading assets. The ring –fence between the deposit-taking and other group trading entities must meet the same criteria of effective economic, legal and operational separation as required under the Proposed Regulation.

At this stage it is not possible to say with certainty whether any existing national primary legislation will or will not meet the criteria that would enable the European Commission to take a decision to allow a Member State to derogate from the trading separation requirements in Chapter III of the Proposed Regulation. However, there must be some possibility that the UK national provisions contained in the Financial Services (Banking Reform) Act 2013 (the "**2013 Act**") will qualify for such a derogation. The 2013 Act is primary legislation that, subject to certain exclusions, prohibits a so called "ring-fenced" body from carrying on dealing and trading activities and such a body must be effectively separated from other group entities that carry on such activities. A ring-fenced body is a bank that carries on the core activity of deposit-taking and that provides typical retail banking facilities. The UK legislation is likely to define a "ring-fenced" body as excluding banks that have eligible deposits of less than £25bn.

UK banks that hold less than £25bn in eligible deposits and which do not meet the criteria in Article 3 of the Proposed Regulation (not designated as a Global Systemically Important Institution and with total assets less than €30bn and trading activities less than €70bn) would not fall within the scope of either the European or UK banking structural requirements.

Lead supervisor

The typical profile of a bank likely to fall within the scope of Proposed Regulation is a bank which operates in several different countries through branches and subsidiaries and which is therefore subject to supervision by several different authorities. The Proposed Regulation seeks to ensure that structural reforms are implemented in an effective and efficient way. It aims to achieve this goal by granting authority to a lead supervisor to make final structural separation decisions for the consolidated group.

Implementation timeline

The European Commission has outlined the following principal dates for the implementation of the key provisions of the Proposed Regulation:

- **June 2015**: European Parliament and European Council adopts final text of the Regulation.
- **1 January 2016**: European Commission adopts the required delegated acts for implementation of key provisions.
- **1 July 2016**: publication of the list of covered and derogated banks and on a yearly basis thereafter.
- **1 January 2017**: prohibition on proprietary trading comes into force.
- **1 July 2018**: provisions in relation to the potential separation of trading activities become effective from this date.

Although the proposal takes over many elements of the Liikanen Report, the Proposed Regulation is still controversial among policy makers in several respects. Under the expected timeline it is foreseen that the final text will only be adopted after the European election in May 2014, which may increase the probability of amendments during the legislative procedure.

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