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Regulation Flash

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Economic Analysis

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Banking Structural Reform: Council gives green light to its agreed position

After months of negotiations, today the Council has reached an agreement on its position on Banking Structural Reform. This position includes important changes on the original Commission's proposal. It softens the proposal by introducing the mandatory separation of proprietary trading instead of the prohibition, in line with several national legislations already in place. It incorporates a more flexible and risk-based approach establishing a menu of options for competent authorities to take on trading activities. Separation is no longer the only measure to be adopted, but an additional one in the toolkit of the authorities. The approval of the Council position is only the first step in the European legislative process. Only if the European Parliament reaches and agreement, trilogues will begin in order to adopt the new legislation.

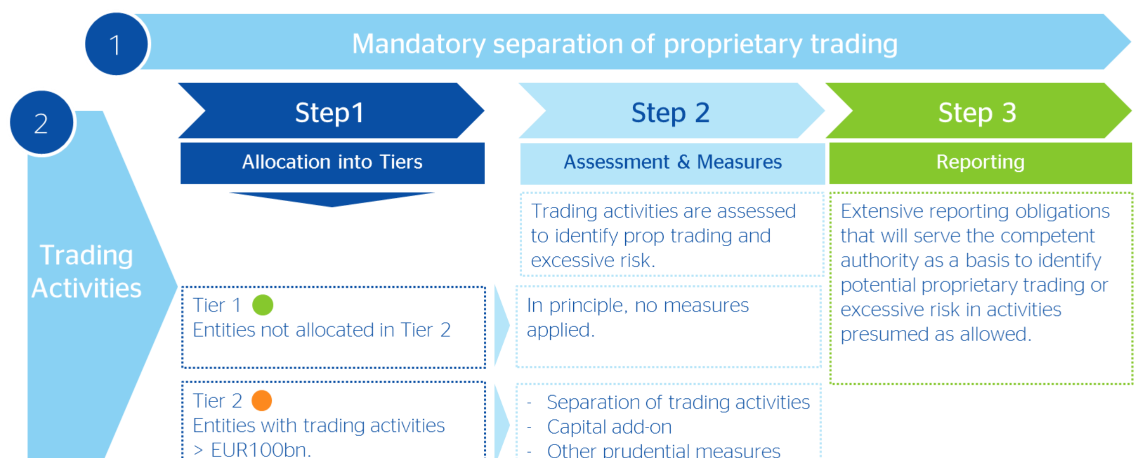
Main aspects of Council's position

- **Goal:** This Regulation is aimed at preventing that potential losses coming from the trading activities may affect the retail bank activity, and ultimately the Deposit Guarantee Scheme which in turn should protect covered deposits. It intends to reduce excessive risk taking as a result of trading activities.
- **Scope:** This regulation will apply to entities that: (i) have been identified as a global systemically important institution or (ii) over the last three years have total assets amounting to at least EUR 30 billion and trading activities amounting to at least EUR 70 billion or 10% of its total assets.
- **The entities exempted from this Regulation have widened:** The Regulation would not apply to: (i) branches and subsidiaries in the Union of credit institutions established in third countries when they are subject to a legal framework deemed equivalent, (ii) public entities, (iii) a group containing a credit institution in the Union or even a single entity where total eligible deposits amount to less than 3% of its total assets or EUR35bn (arguably in reference to genuine big investment banks).
- **Proprietary trading is no longer prohibited, but separated from the Core Credit Institution**. As opposed to the straightforward prohibition set in the Commission's proposal, released in January 2014 and supported by Parliament, under the Council's position, an assessment is developed in order to identify proprietary trading and require its separation from the Core Credit Institution. This assessment shall be conducted in the context of the supervisory review and evaluation process (SREP) and shall be carried out at least every year.
- **Allocation of entities into two Tiers: the amount of trading activities is the key.** Tier 1 does not require any action while tier 2 triggers the adoption of measures. Entities will be allocated to Tier 2 when their trading activities over the last three years exceed EUR100bn. Those entities not allocated to Tier 2 will be allocated to Tier 1. A stricter supervisory approach is developed for those entities in Tier 2, with a wider assessment of their trading activities and stricter reporting requirements. Under this approach, 14 banks would be allocated to Tier 2.
- **Trading activities will also be subject to a risk assessment. Discretionality has been granted for competent authorities to choose from the supervisory toolkit the**

preferred measure to adopt in order to address excessive risk in trading activities. Separation of those activities is just one of the options but not necessarily the only one to adopt.

- **For those entities in Tier 2, an assessment of their trading activities will be conducted in order to determine if they carry an excessive risk**. Competent authorities are empowered to adopt several measures to address that excessive risk. These measures are: (i) separation of those trading activities, (ii) a capital add-on and (iii) other prudential measures in accordance with CRD IV. Recital 26 suggests that measures in accordance to CRD IV are complementary to the two first options and not to be used on its own. Trading activities' assessment shall be conducted drawing from the SREP.
- **Chapter II and III of the original proposal are merged in a single chapter. The resulting new Chapter II now deals with proprietary trading and other trading activities.** Main issues covered in this chapter are: (i) mandatory separation of proprietary trading, (ii) reporting requirements, (iii) assessment of proprietary trading and excessive risk of trading activities and (iv) measures to reduce excessive risk in trading activities,
- **Trades with Member States' sovereign bonds have been excluded**. The chapter II will not apply to financial instruments issued by Member States' central governments. Nevertheless, a review clause has also been introduced in order to review this exemption if there is any review of the regulatory treatment of sovereign exposures either at International or European level.
- **Council's position includes an exemption for UK banks already applying their national legislation**. This is achieved through a two-option framework by which Member States can decide to replace chapter II of the Regulation by national regulation meeting certain conditions, or on the contrary, apply the whole European Regulation. This framework has been long discussed as it may represent a negative precedent regarding single market.

Figure 1: Council's position



Source: BBVA Research

State of play in Parliament

- **The Parliament rejected the report on the vote of May 26th**, meaning that no agreement has been reached so far within Parliament.
- **The main cause for rejection has been discretionality to apply separation of activities.** The existence of a regulatory toolkit with separation nearly as last measure to be applied. Against this increased discretionality Hokmark had introduced much higher reporting requirements (Venetian Window).
- **Parliament will resume negotiations in September.** Only if Parliament reaches and agreement, trilogues between European Parliament, Council and Commission will begin in order to reach a final text. This will be done under the Luxembourg Presidency.

Figure 2: Banking Structural Reform timeline

Source: BBVA Research

Assessment

- **The Council position improves the original proposal released by the Commission. However, there are still ground to doubt whether this is a needed reform**. Most of the powers provided to the authorities under this legislation are already available either under the new Bank Recovery and Resolution Directive (BRRD) or other regulatory measures already adopted to address the too big to fail problem. Of course, riskier activity needs higher capital and more supervision, but the authorities already have these tools.
- **The effect of this Regulation** in market making operations and market's liquidity is under the spotlight. Many fears that as a result of it, many banks may withdraw from certain market activities, thus resulting in a reduction of liquidity in the markets, Moreover, the universal bank model will be negatively affected by the proposed reform.
- **It is not clear to what extent this regulation is compatible** with another Commission's priority,that is the Capital Market Union, which is aimed at ensuring enough financing to the real economy in Europe.
- **The approval of the Council position is only the first step in the European legislative process.** Given the divergences between Council's and European Parliament's positions, there is huge uncertainty about the final outcome and final design of the Regulation. It is still to be seen if both institution are able to reach an agreement on the file.

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