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BANKING STRUCTURAL REFORM

European Commission withdraws Banking Structural Reform proposal

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On January 2014, the European Commission released its proposal on structural measures to improve the resilience of EU credit institutions (the so-called banking structural reform), which would have imposed new constraints on the structure of European Banks. The proposal aimed at harmonising the different initiatives that had grown in Europe in the previous years. The main reason for the withdrawal is the lack of progress in the negotiation of the file after the Council agreed its position back in 2015. The Commission also recognises that the objectives pursued by the proposed rule have already been achieved by other regulations.

In 2011, the European Commission created a High-Level Expert Group (HLEG) to analyse potential structural measures for the EU banking system that could reduce the probability and impact of failures. In 2012 a report was released with a series of recommendations (the Liikanen report). The European Banking Structural Reform was presented in January 2014, amid the proliferation of several national initiatives in the European Union (France, Germany, Belgium or the Netherlands) and with the objective of harmonising them. Moreover, during the design and negotiation of the proposal in the EU, other major initiatives were taking shape, such as the Vickers rule in the United Kingdom (which imposes a strict separation between retail and the rest of activities of the bank) or the Volcker's rule in the United States (which prohibits banking entities to engage in proprietary trading activities and in other activities with hedge and private equity funds).

A look back to the proposal

The European proposal was based on the HLEG report, but evolved into a final text with the following key features:

- **A twofold proposal**: it included both: i) a prohibition of proprietary trading and investment in hedge funds and ii) a potential separation of trading activities.

- **Wide scope**: all the European Global Systemically Banks (G-SIBs) and entities with significant trading activities would have been subject to the rule.

- **Potential separation**: It would only have applied to banks under the scope of the regulation and meeting certain thresholds. Affected entities would have had to divide their activities into two different parts: i) the core credit institution, which would retain all the retail activities and a ii) trading entity, grouping activities related to market-making, risky securitisation and complex derivatives.

During the negotiation process, the main issues discussed in the Council and the Parliament were:

- **The Council's agreed text** included significant changes to the original proposal. It was based on a two-tier approach, classifying banks depending on the volume of trading activities, and defining measures to apply only for entities in the tier 2 (those with trading activities over EUR 100bn). Flexibility was a key feature of this proposal, including a toolkit available for supervisors in which separation of trading activities was not the only option, but one of the measures in that toolkit. Moreover, the proposed prohibition of proprietary trading in the original proposal was softened by a potential separation of the activity. Allocation in Tier 1 did not require any action, while allocation in Tier 2 could trigger the adoption of measures after an assessment had been performed.

- **The Parliament's work on the proposal** maintained the prohibition of the proprietary trading. Together with this retained prohibition, the Parliament was working on a three step approach, by which entities meeting certain thresholds would be subject to an assessment that could end up in the separation of the entity. The last step included increased disclosure and reporting requirements. The Parliament failed to reach an agreement, being the main issue of discussion flexibility versus a more automatic approach.

Reasons for the withdrawal

After the Commission presented the proposal on January 2014, negotiations started both in the Council and in the Parliament. After a tough negotiation process, the Council reached an agreement on its internal position on June 2015, with significant modifications on the original proposal. Not the same happened with the Parliament which failed to agree a common position on the text. Now, after 2 years of the agreement in the Council, and without further developments on the issue, the Commission has decided to withdraw the proposal. Specifically, the Commission states as main reasons for this withdrawal, the lack of progress and foreseeable agreement on the file. Moreover, the Commission also recognises that the *main objectives of the proposed regulation have already been addressed by other regulatory measures in the banking sector, most notably with the entry into force of the Banking Union's supervisory and resolution arms*.

BBVA Research assessment

- **The withdrawal of the proposal is reasonable and timely**. During the last 9 years, authorities have already adopted panoply of measures that share the objectives of improving the resolution of entities and controlling systemic risk. In this sense, in Europe a whole new institutional architecture has been successfully launched in a record time and the key structure of the Banking Union has been put in place with the creation of a new Single Supervisory Mechanism (SSM) in the European Central Bank (ECB), and a Single Resolution Mechanism (SRM) in charge of the recovery and resolution tasks that cover a large part of the project's objectives on structural reforms.

- **Certainty is welcomed**. 4 years after the launching of the proposal, and 2 years after the latest developments, we welcome the Commission clarifying the withdrawal of the file. With two major legislative proposals being negotiated (at a European level, the review of the CRR / CRD IV and at a global level, the finalisation of the Basel III framework), it is welcomed to have more certainty about the final framework applying to banks.

- Finally, **this regulation could have posed negative consequences on other major projects in the European Union, such as the Capital Markets Union and the Banking Union**. The proposed separation of activities, such as market making activities, would have resulted in higher operational costs that could have ended up affecting market's functioning. Both projects, the Banking Union and Capital Market union are a key for the future of the Economic and Monetary Union of Europe (EMU) whose essence is to underpin financial integration in the Eurozone through the centralisation of powers into supranational authorities and the introduction of risk sharing mechanisms among banks in case of crises.

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