Regulatory Watch

Madrid, February 12, 2014
Economic Analysis

Regulation & Public Policies

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European Commission's proposal on structural reforms

On January 29th, the European Commission (EC) released its proposal on structural reform that would impose new constraints on the structure of European banks. The proposal aims at ensuring the harmonization between the divergent national initiatives in Europe. However, the EC goes beyond many of the European national legislations and opts for a mix solution that establishes both (i) a prohibition of proprietary trading such as the US Volcker Rule and (ii) a mechanism to require the separation of trading activities including market making such as the UK Banking Reform. This note provides a description of the proposal, a comparison with the other undertaken initiatives and an assessment.

Executive Summary

- **The proposal is twofold and imposes both:** (i) prohibition of proprietary trading and investments in hedge funds, and (ii) potential separation of trading activities.
- **The EC reform is stricter than the majority of national initiatives since it affects market making** (France, Germany and US). The EC proposal goes even beyond the recommendations of the High Level Expert Group established by the EC itself which recommended a separation of proprietary trading and market making but no prohibition of trading activities. Only the UK proposal is stricter.
- **The scope of banks that will be subject to the reform is wide.** All the European Global Systemically Financial Banks (G-SIBs) and the entities with significant trading activities, i.e. around ***29 European banks***, will be subject to both ***(i) the ban on proprietary trading***; and ***(ii)*** an ***annual examination of their trading activities*** that could trigger the separation of trading activities. Metrics and thresholds will be defined later on by delegated acts.
- **Separation mechanism.**
  - Entities that exceed the thresholds for a certain number of metrics will have to create two homogeneous sub-groups ***(i) the core credit institution*** including mainly the retail activities; and ***(ii) the trading entity*** that includes the activities related to market-making, risky securitization and complex derivatives. Both entities will have to be organized as stand-alone subsidiaries that are independent in legal, economic, governance and operational terms. The ***bank is provided with the opportunity to demonstrate***, to the satisfaction of the competent authority, that the separation is not justified.
  - Even if the entity does not breach the thresholds, the competent authority can require separation of a particular trading activity if it considers that there is a threat for financial stability.
- **Assessment.**
  - ***There is a need for harmonization*** of structural reforms at the European level, given the proliferation of national initiatives. In that vein, the EC's proposal is welcomed.
  - ***The prohibition of proprietary trading could help to achieve the objectives*** of structural regulation without being detrimental for the real economy.
  - ***It is important to minimize the unintended consequences of the separation***, specifically on traditional banking: (i) Market-making should be preserved; (ii) need to avoid excessive concentration of trading activities in fewer entities by ensuring an adequate calibration of the scope of banks, (iii) metrics and thresholds to determine the scope of banks must be clarified.
  - ***The EC's proposal will mainly affect large investment banks***.
  - ***Structural reforms should avoid penalizing the universal banking model***.
  - ***On the positive side:*** (i) the opportunity provided to banks to demonstrate that separation is not justified and (ii) the exemption for foreign stand-alone subsidiaries with MPE resolution strategy.

A. European Commission's Proposal

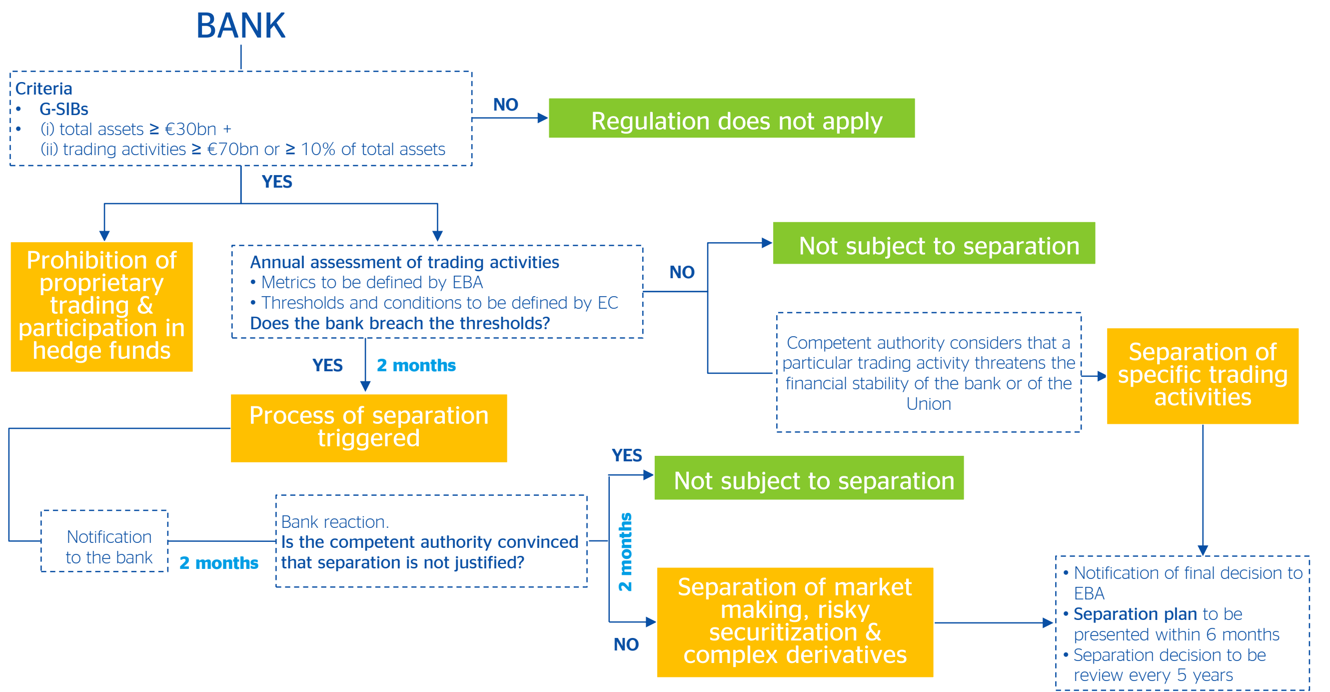
1. Background

- **In Europe, there is a proliferation of divergent national initiatives.** Although all the European initiatives (i.e. UK, Germany, France, and Belgium) opted for the same approach i.e. separation of risky activities into a stand-alone subsidiary, the design of the ring-fencing strongly varies across countries.
- **In October 2012, the High-level Expert Group** on reforming the structure of the EU banking sector (HLEG, chaired by Erkki Liikanen), established by the EC in order to examine possible reforms to the structure of the European banking sector, recommended the European authorities imposing a separation of certain trading activities to those banking groups that are significantly active in these operations.

2. Philosophy

- **Goal.** The aim of this initiative is to mitigate systemic risk by improving *resolvability*. The underlying objective of the EC proposal is to ensure *harmonization* between the divergent national initiatives in Europe.
- **Main idea.** The European Commission opted for a *twofold proposal*: (i) prohibition of activities + (ii) separation of activities.

Chart 1
Separation/Prohibition decision making process*



* Competent authority (ECB under the SSM) must consult EBA before taking any decision
Source: BBVA Research

3. Scope

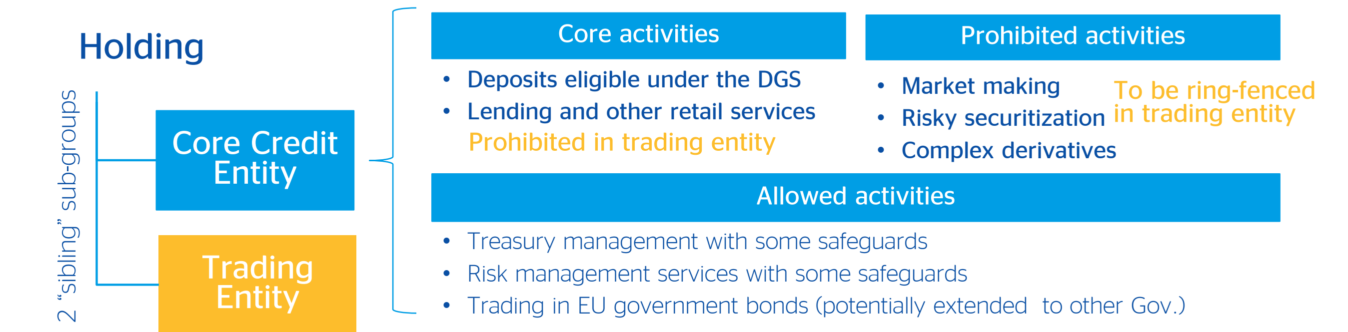
- **Which banks will be subject to the reform?**
  - European Global Systemically Financial Banks (G-SIBs)
  - Those banks that breach the following thresholds during 3 consecutive years: (i) total assets ≥ € 30 bn + (ii) trading activities ≥ € 70 bn or ≥ 10% of total assets.
  - Currently, ***29 European banks*** would be subject to the reform
- **Territorial scope.** The reform would apply to European branches and subsidiaries of foreign banks and to foreign branches and subsidiaries of European banks.
- **Exemptions**
  - The Commission may exempt from this regulation, through the adoption of derogation, foreign subsidiaries of European banks and European branches of foreign banks if they are subject to ***equivalent separation rules*.**
  - Supervisors could also exempt from the separation requirement foreign ***subsidiaries*** of European groups with ***autonomous geographic decentralised structure*** pursuing a "Multiple Point of Entry" resolution strategy.

4. Prohibition of activities

- **Prohibited activities**
  - ***Proprietary trading in financial instruments and commodities*** according to the following narrow definition: activities specifically dedicated to taking positions for making a profit for own account, without any connection to client activity or hedging the entity's risk.
  - Investments and participations **in *hedge funds***
  - Investments and participations in entities that undertake previous activities
- **Exemptions**
  - Transactions on ***money market instruments*** with cash management purposes
  - Trading in **EU *Member States' government bonds*.** This exemption could be extended to other Governments by the EC though delegated acts.
  - ***Unleveraged and close-ended funds*,** inter alia private equity, venture capital and social entrepreneurship funds.
- **Mechanism**
  - Management body gets responsibility for ensuring compliance.
  - Sanctions. The competent authority will be provided with powers to impose sanctions in case of breach of the prohibition: inter alia withdrawal of functions, temporary/permanent bans, and pecuniary penalty.

5. Separation of activities

Chart 2
Design of ring-fencing



Source: BBVA Research

- Mechanism
  - *Ex-post assessment by competent authorities.* The competent authority, i.e. the European Central Bank for participating countries in the Single Supervisory Mechanism, must assess the trading activities of banks entering the scope of the regulation, specifically market making, risky securitization and complex derivatives. This analysis must be based on certain metrics that indicate the size, leverage, complexity, profitability, market risk and interconnectedness of trading activities and will be developed by EBA and adopted through delegated act by the EC.
  - *Required separation.* The competent authority must require separation if a certain number of metrics exceed certain thresholds (the conditions and the thresholds to trigger the separation process will be defined by the EC). However, the ***bank is provided with a two months reaction period*** during which it benefits from the opportunity to demonstrate, to the satisfaction of the competent authority, that the separation is not justified.
  - *Potential separation.* Even if the entity does not breach the thresholds, the competent authority can require separation of a particular trading activity if it considers that this threatens the financial stability of the bank or of the European Union.
- Core activities that cannot be undertaken in the trading entity
  - *Deposits* that are eligible under the Deposit Guarantee Scheme (DGS)
  - Payment services with some exceptions
- Activities to be ring-fenced, prohibited in the core credit entity
  - *Market making*
  - *Risky securitization.* The European Commission is empowered to specify which type of securitisation is not considered to pose a threat to financial stability
  - *Trading in derivatives* other than those that are specifically allowed for the purpose of prudent risk management.
- Trading activities allowed in the core credit entity
  - *Prudent management of own risks*: interest rate, foreign exchange and credit derivatives eligible for central counterparty clearing. Safeguard: the bank must demonstrate that the hedging activity reduces its own risks.
  - *Provision of risk management services to customers:* interest rate, foreign exchange, credit, emission allowance and commodity derivatives eligible for central counterparty clearing. Safeguard: the own funds requirements for position risk related to the derivative does not exceed a certain proportion of its total risk capital requirement (to be determined by EC later on).
- Strict functional separation. If subject to separation, the banking group will have to create two homogeneous functional subgroups on a sub-consolidated basis constituted on the one side (i) by the core credit institution and on the other side (ii) the trading entities. Both sub-

groups will have to be organized through stand-alone subsidiaries and therefore be independent in legal, economic, governance and operational terms.

- **Large exposures' limits.** In addition, limits on both intra and extra group exposures are established.
  - ***Intra-group limits*** for aggregate deposit entities to any other entity: 25% of own eligible capital.
  - ***Extra-group limits*** in terms of own eligible capital for deposit entities both on individual and aggregate basis (i) to any individual financial entity: 25%; and (ii) to the whole financial sector: 200%.

6. Calendar

- **Adoption by EU Council and Parliament: June 2015**
- EBA technical standards on metrics to trigger separation: around July 2015
- Adoption of required delegated acts for key provisions by EC: 1 January 2016
- Release of first annual list of covered and derogated banks: 1 July 2016
- **Ban on proprietary trading takes effect: 1 January 2017**
- **Separation of trading activities from credit entity takes effect: 1 July 2018**
- First review of regulation: 1 January 2020

7. Shadow Banking

The EC also addresses the risks posed by the potential shift of trading activities into the shadow banking sector as a consequence of the imposition of new constraints on banks' business model. The EC therefore released a proposal to improve the transparency of securities financing transactions. The proposal increases the transparency of certain transactions outside the regulated banking sector and prevents banks from translating parts of their activities to the less-regulated shadow banking sector. It establishes three main areas for increasing transparency: (i) securities financing transactions including registration and supervision of trade repositories (ii) investor and (iii) rehypothecation.

B. Assessment

1. Comparison of initiatives

- **Two main different perspectives to approach structural reforms:** (i) imposing prohibition of activities or (ii) separation. The US authorities opted for the first option. On the contrary, in Europe, the trend turns towards the option of separation of risky trading activities from traditional banking. The "philosophy" of structural regulation is therefore deeply inconsistent between the two leading forces of the international scene.

Chart 3
Simplistic comparison of structural initiatives[1]

	Separation of activities (Softer → Stricter)				MIX of Volcker & HLEG	Prohibition of activities
	Germany	**France**	**Europe** HLEG	**UK** Vickers	**Europe** COM Proposal	**US** Volcker
Idea	Ring fencing of **investment** activities			Ring fencing of **retail** activities	**Prohibition** of **prop trading, investments in hedge funds** **Ring-fencing** of **trading** activities	Prohibition of **prop trading** activities , investments in hedge and private equity funds
To be excluded from retail entity	**Prop trading**, high frequency trading (HFT), unsecured lending to hedge & private equity funds	**Prop trading**	**Market making, Prop trading,** hedge & private equity funds	**Most of the investment activities** (likely exception for few derivatives)	Market making, risky securitization & complex derivatives	
Which entities? Threshold	If **activities to be excluded (i)** > € 100bn, or **(ii)** > 20% of total assets if total assets > € 90bn	**TBD** on activities subject to separation	**2 steps: (i)** if assets for trading and available for sale > 15-25% of total assets or > € 100bn in absolute value, banks go to 2nd stage; **(ii)** TBD on trading **activities subject to separation**	Nearly the **whole** banking sector	2 Steps: **1.** G- SIBs and banks with (i) total assets ≥ €30bn + (ii) trading activities ≥ €70bn or 10% of total assets **2.** Assessment of trading activities according to metrics & thresholds TBD (EBA/COM)	**Subject to prohibition & assessment of trading activities** **Subject to separation**
Specificities	Allow **market making in retail entity**	Allow **market making in retail entity** Totally prohibits HFT	Allows **derivatives and hedging** for client purposes in retail entity	**Additional loss absorbency** for retail entity.		

Source: BBVA Research

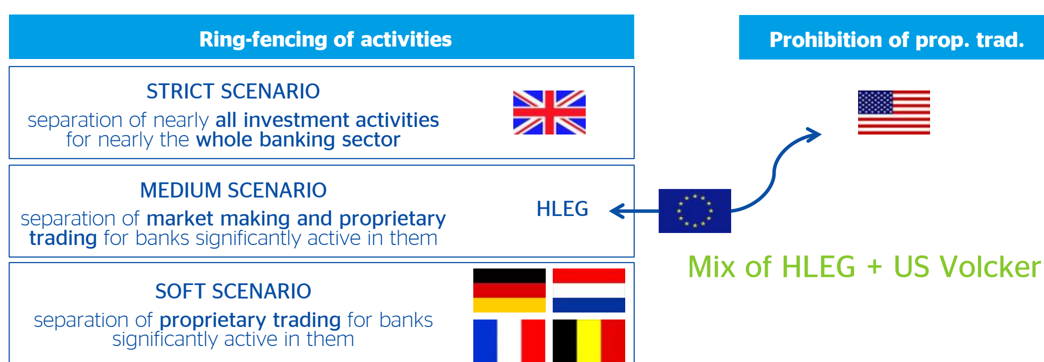
- In December 2013, the **US authorities adopted the Volcker Rule** which prohibits proprietary trading and investments in hedge and private equity funds. The Rule will be fully implemented in July 2015.
- **In Europe, there is a proliferation of divergent national initiatives**. Although all the European initiatives opted for the same approach i.e. functional separation of risky activities into a stand-alone subsidiary, the design of the ring-fencing strongly varies across countries:
  - ***The most stringent reform is the one adopted in the United Kingdom*** that opted for the separation of nearly all investment activities for nearly the whole banking sector. Structural regulation in UK has been divided in two legislative processes: **(i) the *primary legislation*** that only defines the philosophy of the reform received Royal Assent in December 2013; and **(ii) the *secondary legislation*** that defines the key details of the reform (inter alia activities to be ring-fenced, intensity of separation, etc.) is still under negotiations, agreement is expected to be reached in 2014. ***Banks will have to apply the ring-fencing requirement from 2019.***
  - ***At the other side of the spectrum of initiatives are the French and German proposals*** which opted for a soft design of ring-fencing: separation is limited to proprietary trading and only applies to those banking groups that are very active in these operations. The

1: The purpose of this comparative table is to provide a simplistic overview of the different initiatives. Therefore, some technical details of the different approaches have been omitted, inter alia differences in intensity of separation, exemptions, etc.

French and German reforms have been published in their respective Official Journal in summer 2013 and ***will be fully implemented by summer 2015.***

- Other countries are taking the way toward structural regulation such as Belgium and the Netherlands that will probably follow the French and German examples.
- In 2011, the EC established in 2011 a ***High-level Expert Group*** in order to examine possible reforms to the structure of the EU's banking sector (HLEG). The group of experts chaired by Erkki Liikanen examined two possible alternatives: (i) immediate functional separation of significant trading activities; and (ii) separation of trading activities subject to a supervisory evaluation of the credibility of the recovery and resolution plans. The HLEG finally released its non-binding recommendation in October 2012 and proposed to adopt the first solution that consist in a ring-fencing of proprietary trading and market-making activities applied to those banks that are significantly active in these operations.

Chart 4
Overview of national initiatives



Source: BBVA Research

- The EC proposal is a **mix of (i) the US Volcker Rule** (prohibition of proprietary trading) **and (ii) the recommendation of the HLEG** (separation affecting market making).
  - ***Only the UK reform is stricter*** than the EC proposal, since the Vickers reform would imply a strict functional separation of nearly all investment activities applied to nearly the whole banking sector.
  - ***The EC goes beyond the recommendations of the HLEG.*** Indeed, in addition to the separation of certain trading activities, the proposal imposes a prohibition of proprietary trading and investments on hedge funds while the HLEG only recommended a ring-fencing of these activities. Moreover, the separation of activities is stricter than the HLEG's one since it affects a wider scope of activities including trading in many derivatives and risky securitization. It also seems that the EC proposal would be applied to a wider scope of banks.
  - ***The proposal is stricter than the US Volcker Rule*** since, in addition to the prohibition of proprietary trading, it imposes a potential separation of other trading activities. However, the prohibition proposed by the EC is lighter than the US reform in other aspects since it would not affect exposures to private equity funds.
  - ***The EC goes beyond the French and German proposals.*** Indeed, France and Germany impose a functional separation that only affects proprietary trading. The EC is stricter (i) regarding to the intensity of the reform applied to proprietary trading, i.e. ownership separation; and (ii) regarding the scope of activities subject to the ring-fencing, i.e. by extending it to market making.

2. Assessment of the EC proposal

- **There is a need for harmonization of structural reforms at the European level, given the proliferation of national initiatives** which could exacerbate regulatory uncertainty, increase the fragmentation of the financial markets, complicate cross-border activities, and dampen the effectiveness of supervision.

- **In that vein, the EC's proposal is welcomed since it is a necessary condition to create a level-playing field** for all banking entities operating in the EU.
- **The first piece of the proposal, i.e. prohibition of proprietary trading and investments in hedge funds, could help to achieve the objectives of structural regulation** without being detrimental to the role of the financial sector for the real economy.
- **It is important to minimize the unintended consequences of the separation, specifically on traditional banking.**
  - ***Market-making should be preserved***. Indeed, these activities are fundamental for the proper functioning of the financial markets.
  - ***The scope of banks subject to the separation must be well calibrated.*** Indeed, certain banks that are predominantly retail could *divest from their trading activities****, which would foster concentration of highly risky trading activities in fewer entities and exacerbate systemic risk.***
  - ***The key elements (metrics and thresholds) to determine the scope of banks subject to separation must be clarified.*** Regulatory uncertainty on business models could compromise the credibility of key regulatory pieces such as the Asset Quality Review exercise and the whole Banking Union project.
- **The EC's proposal will mainly affect large investment banks.**
- ***Structural reforms should avoid penalizing the universal banking model.*** Indeed, this model was not a driver during the financial crisis and has proven to raise many benefits for the economy as a whole.

On the positive side

- ***The opportunity provided to banks to demonstrate that separation is not justified*** would avoid automatically applying too burdensome structural constraints on banks that are anyway resolvable.
- ***The exemption of foreign stand-alone subsidiaries*** of EU banks from the scope of entities subject to the reform is an improvement in the understanding of the variety of business models by the regulators. The features of the "multiple point of entry" (MPE) resolution strategy justify the exemption of those foreign subsidiaries from European structural constraints and leave them under the responsibility of the host supervisor.

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