Does Volcker + Vickers = Liikanen?
EU PROPOSAL FOR A REGULATION ON STRUCTURAL MEASURES IMPROVING THE RESILIENCE OF EU CREDIT INSTITUTIONS

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1) On 29 January 2014 the European Commission published a proposal for a regulation of the European Parliament and of the Council “on structural measures improving the resilience of EU credit institutions.” This proposed legislation is the EU’s equivalent of Volcker and Vickers. It was initiated by the Liikanen report published on 2 October 2012 but the legislative proposal departs in a number of ways from the report’s conclusions. There are two significant departures: the legislative proposal contains a Volcker-style prohibition, which also departs from the individual EU Member States’ approach and, although the proposal contains provisions which mirror the Vickers ‘ring-fencing’ approach, they are not, in direct contradiction to Liikanen’s recommendation, mandatory.

Background

2) Post financial crisis, various jurisdictions have started to overhaul bank regulation and supervision. Bank structural reform is part of that agenda and involves separating retail and commercial banking from wholesale and investment banking, as well as outright prohibitions. The objective is to protect core banking activities and depositors from the ‘riskier’ trading activities, which have been deemed as ‘socially less important’, by reducing the risk of contagion spreading from trading activities to traditional retail banking and protecting the deposits of individuals and small businesses in the case of bank failure. In addition, bank structural changes are intended to reduce complexity and so improve the resolvability of banking groups. The EU has been concerned about banks which it terms “too big to fail,” “too big to save” and “too complex to manage, supervise and resolve.” It has been concerned that failure of these banks would be detrimental to the financial system in the EU as a whole. The EU also believes that these banks have an unfair advantage over smaller banks: it believes that the presumption that they would be bailed out rather than be allowed to fail provides an implicit guarantee which impacts their funding costs and leads to moral hazard and excessive risk-taking. These concerns and beliefs have led to a variety of legislative proposals and legislation.

3) Different jurisdictions have taken different approaches to bank structural reform. Reference has already been made to the UK and US legislation but France and Germany have also adopted legislation and the Belgian coalition government reached a political agreement in December 2013 on structural reform of its
banking sector which it aims to finalise before elections in May 2014.8 One of the fundamental differences between the US and the approaches of the individual EU Member States has been the US preference for prohibition (or owner separation) as opposed to the EU Member States’ preference for ring-fencing (or functional separation/subsidiarisation). This difference means that the activities which the US has prohibited cannot be carried out within a banking group at all whereas the activities on which the EU Member States have focused can be carried out within a distinct trading entity which is separate from the retail and commercial bank entity. The EU’s legislative proposal, by including elements of both approaches, blurs this distinction and creates a third approach to bank structural reform which is consistent with neither the US approach nor the approaches of the individual EU Member States.

4) The second significant difference in the approaches taken to date relates to the activities which the different jurisdictions have regulated. Broadly speaking, the US approach has prohibited proprietary trading, sponsoring private equity and hedge funds (known as “covered funds”), investing in covered funds and loans (known as “covered transactions”) to covered funds with which the banking group is involved. Proprietary trading is defined widely but there are a number of helpful exclusions and exemptions which narrow the scope of the prohibition, including a number of exclusions and exemptions to reduce the extraterritorial impact on non-EU banks, although, of course, there are conditions with which compliance is necessary before reliance can be placed on the exclusions and exemptions. There are similar exclusions and exemptions relating to the prohibitions on sponsoring and investing in covered funds and on covered transactions with covered funds. The Volcker rule is examined in detail in our legal reports “Final Regulation Implementing the Volcker Rule”9 and “The Volcker Rule—Application to Securitization Transactions.”10

5) The UK approach (Vickers) focuses on a wider range of investment and wholesale banking. By prohibiting deposit-taking entities from ‘dealing in investments as principal,’11 it requires most of the derivative and trading activity currently carried out by wholesale and investment banks to be carried out by a trading subsidiary separate from the retail bank. The French and German approach follow the ring-fencing approach of the UK but, like the US, have a narrower focus. Their approaches reflect the agreement reached by the two countries to push forward arrangements in the EU for the separation of “speculative activities” from deposit-related and customer-orientated activities. Thus the French legislation provides that proprietary trading and unsecured financing to alternative investment funds (“AIFs”) above a certain threshold (the “speculative activities”) must be carried out by a trading subsidiary separate from the retail banking entity. Similarly, the German legislation specifies certain high-risk activities (above a certain threshold in terms of overall trading activity), including proprietary trading, credit and guarantee business with certain AIFS (or equivalent funds which are high-leveraged or engaged in short selling) and certain forms of trading in one’s own name with the exception of market-making that must be ring-fenced and transferred to a separate trading entity.

6) Finally and amongst those jurisdictions that have chosen the ring-fencing approach, there is some difference in the strength of the ring-fence or the degree of functional separation required. The UK requires the ring-fenced body (“RFB”) to be legally, economically and operationally independent, to interact with the rest of the banking group on an arm’s length basis and to have its own capital and liquidity resources. The Prudential Regulation Authority (“PRA”) will make additional rules to ensure the integrity of the ring-fence and the independence of the RFB.
The German legislation requires the RFB to be legally, economically and operationally independent, to interact with the rest of the banking group on an arm’s length basis and to have its own capital and liquidity resources, but does not give any guidance on how this should be achieved or should interact with German corporate law.

Liikanen...But Not As We Knew It

7) At the same time as individual jurisdictions were considering bank structural reform to deal with the issues summarised at paragraph 2 above, the EU was considering action, believing that inconsistent national legislation increases the possibility of distortions of capital movements and investment decisions, serves to make the structure and operation of cross-border banks more complex and increases fragmentation. In February 2012, the Commission established a High-level Expert Group to examine possible reforms to the structure of the EU’s banking sector, appointing Erkki Liikanen, Governor of the Bank of Finland and a former member of the European Commission, as the chairman. The Group presented its final report to the Commission on 2 October 2012, the Commission examined the possible reform options and their implications and, on 29 January 2014, it adopted a proposal for a regulation on structural measures improving the resilience of EU credit institutions plus a proposal on transparency of securities financing transactions aimed at increasing transparency in the shadow banking sector. This note focuses on the former proposal.

8) The UK government had considered adding a Volcker-style prohibition to the Vickers ring-fence established in the Banking Reform Act 2013 but rejected it because of concerns that defining proprietary trading as opposed to activities such as market-making was too problematic, the “technical challenges” that the US was experiencing in implementation and the fear that it would distract regulatory attention from the ring-fence. The EU, however, clearly did not share these concerns as their proposal departs from the approach taken by individual EU Member States and contains a Volcker-style prohibition, as well as provisions on ring-fencing. The main points of note are set out in the table below.

The main provisions of the EU proposal:

Scope

a) It is proposed that the Volcker-style rule will apply to:
   i) EU G-SIs (and all their branches and subsidiaries regardless of their location); and
   ii) banks that for three years have total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.

b) The proposal does not make ring-fencing mandatory but requires national regulators to consider the possibility in relation to each individual deposit-taking bank (termed “core credit institution”) depending upon its risk profile. There is a wide definition of core credit institution.

c) The EU proposal intends to have extraterritorial effect and apply to non-EU subsidiaries of EU banks, as well as effectively to non-EU banking groups with EU branches, unless the Commission deems the relevant non-EU jurisdiction equivalent to the EU regime but, although the stated intention is to create a level playing field in the EU, these provisions raise questions of legality and enforcement. National regulators may exempt a non-EU subsidiary of an EU bank from the ring-fencing requirements of the EU proposal in the absence of an equivalence decision if the relevant national regulator is satisfied that the subsidiary’s resolution strategy has no adverse effect on the financial stability of the
Member State(s) where the parent and other group entities are established. There is no such additional exemption for EU branches of non-EU banks or in respect of the Volcker-style prohibition.

The Rules

d) The EU Volcker-style rule prohibits proprietary trading (which is said to be narrowly defined), investments in AIFs save for closed-ended and unleveraged AIFs and investments in other entities which themselves engage in proprietary trading or investment in AIFs. This rule is considered in more detail at paragraphs 9–19 below.

e) Unlike Liikanen, the EU proposal does not make separation of trading activities from retail and commercial banking mandatory. Instead it provides that national regulators must consider separation of trading activities (which is very widely defined to include almost all activities save those related to retail and commercial banking) from retail and commercial banking depending on the risk each individual core credit institution presents. The assessment of risk will be carried out on the basis of metrics set out in further legislation drafted by the European Banking Authority (“EBA”) and the Commission. Where the risk levels are exceeded and the national regulator determines that there is a threat to financial stability then the national regulator must impose a ring-fence on that particular bank, unless the bank can demonstrate that the regulator’s conclusions are not justified. These provisions are considered in more detail at paragraphs 20–39 below.

Individual Member State Derogations

f) The Commission may grant individual deposit-taking banks within Member States (not individual Member States) a derogation from the ring-fencing requirements set out in the proposal where national legislation is equivalent to the EU legislation. At the time of writing, it appears that only the UK legislation is likely to meet the requirements of equivalence but that may depend on secondary legislation, which the UK has yet to adopt, which will provide the technical detail of the Vickers rule.

Timing

9) The introduction of a prohibition on proprietary trading, investment in AIFs and certain other entities is a major departure from the Liikanen recommendations. As noted above, none of the EU Member States which have introduced legislation to address bank structural reforms have adopted a Volcker-style prohibition. Although the US legislation is clearly the influence behind the provisions, the Commission has not taken exactly the same approach as Volcker.

Scope

10) The first thing to note is that, unlike the US rule, the EU Volcker-style rule is not intended to apply to all deposit-taking institutions. It is intended to apply to around 30 of the largest banks in the EU, those being:

a) EU G-SIIs (and all their branches and subsidiaries regardless of their location); and

b) banks that for 3 consecutive years have had total assets of at least 30 billion euro and trading assets of 70 billion euro or 10% of total assets.

The rule is intended to apply to the following entities within category (b):

i) EU banks which are neither parent institutions nor subsidiaries, plus all their branches regardless of their location;

ii) EU parent institutions, plus all their subsidiaries and branches regardless of
their location, when one of the group entities is an EU bank; and

iii) EU branches of non-EU banks.

The intention appears to be that the assessment of total assets and trading assets is made at each individual entity level, including at branch level, rather than that an assessment should be made on a consolidated basis. It appears that the presence of an EU bank within a group could bring entities whose assets would not otherwise have to be assessed within the scope of the EU prohibition. The proposal contains some detail on how trading activities are to be calculated and the EBA shall be mandated to draft legislation to set out the exact methodology.

11) The EU prohibition will not apply to non-EU subsidiaries of EU banks and to EU branches of non-EU banks if the Commission deems the relevant non-EU jurisdiction equivalent to the EU regime. In considering equivalence, however, the Commission will look at whether the non-EU jurisdiction has requirements equivalent to both the Volcker-style and ring-fencing provisions. It is questionable whether any jurisdiction has requirements equivalent to both these provisions in the draft EU legislation. Like the Volcker rule, the effect of the EU rule is to prevent the prohibited activities being carried out within the banking group in its entirety. Thus bringing EU branches of non-EU banks within the scope of the EU prohibition is an attempt to bring the entire non-EU banking group within scope, unless it has equivalent legislation which is not currently likely. Whereas the objective is sensible—to create a level playing field in the EU and not give non-EU banking groups a competitive advantage—this raises questions and could precipitate a clash with the US, particularly if the EU rule imposes additional or different prohibitions to the Volcker rule.

12) Without an equivalent decision, the draft EU legislation provides that its Volcker-style prohibition will apply to non-EU subsidiaries of EU banks and effectively to non-EU banking groups that have an EU branch, within scope, but such purported extraterritorial application raises questions as to its legality and enforcement. In order for the prohibition to be effective, it, like the US Volcker prohibition, must apply throughout the whole banking group. How this will be applied to banking groups headquartered outside the EU and, arguably, subsidiaries established outside the EU is far from clear, particularly if there are significant differences with Volcker. It is also worth noting that the UK and the Council Legal Services have questioned the purported extraterritorial application of other recent pieces of EU legislation. In its legal challenge to the remuneration provisions of CRD IV, the UK has alleged, to the extent that the cap on bankers’ bonuses is required to be applied to employees of institutions outside the EU, it infringes Article 3(5) of the Treaty on European Union and the principle of territoriality found in customary international law. A similar issue is currently being debated in the context of the financial transaction tax. The UK has issued proceedings arguing the decision permitting the adoption of the tax by a subset of the EU is unlawful because it authorises the adoption of an FTT with extraterritorial effects for which there is no justification in customary international law and the Council Legal Services has supported this argument. Thus the question of extraterritorial application is likely to be a contentious issue in the context of this dossier also.

The Prohibitions: Proprietary Trading

13) Chapter II of the proposal prohibits the largest banks and entities within their group from carrying out the following:

a) proprietary trading, which is defined as using own capital or borrowed money to purchase, sell or otherwise acquire or dispose of a financial instrument or commodity “for the sole purpose of making a profit for own account, and without any
connection to actual or anticipated client activity or for the purpose of hedging the entity’s risk as a result of actual or anticipated client activity” through specifically dedicated desks, units, divisions or individual traders;

b) with their own capital or borrowed money and for the sole purpose of making a profit for own account:

i) acquiring or retaining units or shares in AIFs;

ii) investing in financial instruments the performance of which is linked to shares or units in AIFs; and

iii) holding any units or shares in an entity that engages in proprietary trading or acquires units or shares in AIFs.

There are some very limited exemptions to both the prohibitions at (a) and (b) above.

14) The Commission has indicated that it has learned from the US experience of implementing the Volcker rule. Rather than adopting a wide definition of proprietary trading with a number of specific exclusions and exemptions, it claims to have opted for a narrow definition with limited exclusions. Careful analysis will be required to assess both whether the definition is as narrow as the Commission claims and whether the EU approach achieves the same result as the more detailed Volcker rule.

15) The narrow definition of proprietary trading is intended to satisfy France and Germany who were concerned to ensure that market-making was not restricted. It appears that both underwriting market making and it would fall out with the definition of proprietary trading as it will be argued that they are connected to client activity and does not have the sole purpose of making a profit for the bank. Trading in EU sovereign debt is expressly permitted. Entities can also trade in cash or defined cash equivalent assets (money market instruments) if they use their own capital as part of their cash management processes but concerns have been expressed that it does not seem that securities transactions for the purpose of liquidity management and riskless principal transactions will be permitted. Hedging for own purposes is permitted but only as set out in the definition of proprietary trading and so is limited to hedging as a result of actual or anticipated client activity.

16) The differences in approach between the US and EU rules are marked. The US approach is more sophisticated and consists of detailed and lengthy rules setting out exclusions and exemptions individually tailored to specific activities and situations, as well as the conditions with which there needs to be compliance in order to rely on the exclusions and exemptions. Setting out so much detail has been both challenging and time-consuming. It has also led to some unforeseen, and perhaps unintended, consequences. The EU approach is the diametric opposite: it consists of about a page and a half of relevant rules. Interestingly, there is no provision in the draft for significant level 2 legislation to add further detail to the high-level prohibitions set out in the proposal.

17) It could be said that the EU has taken a more pragmatic approach, opting for a principle-based, as opposed to the US rule-based, approach. It could be argued that a vast range of activities which could otherwise fall under the heading of ‘proprietary trading,’ including securities transactions for the purpose of liquidity management, riskless principal transactions and hedging activities, are ultimately connected to actual or anticipated client activity, even if indirectly. The lack of specified exemptions and exclusions in the EU rule could be said to create uncertainty and the possibility of regulatory arbitrage, as much will depend on individual national regulator’s interpretation of the provisions, and to require individual consideration of each bank’s different activities but it does give banks a degree of latitude and flexibility by not setting out a finite set of permitted activities. This lack of certainty
may make it difficult to draw exact comparisons with the Volcker rule in the abstract and in the absence of some indication as to how broadly—or narrowly—the national regulators will enforce the EU prohibitions.

**The Prohibitions: Investment in AIFs and Other Specified Entities**

18) In order to prevent evasion of the prohibition on proprietary trading, the proposal also provides that banks subject to the prohibition are prohibited from using their own capital or borrowed money to invest in or hold shares in AIFs (or certificates/derivatives linked to such shares) or entities that themselves engage in proprietary trading or invest in AIFs. The sole purpose of the banks’ activity must be to make a profit for their own account: this provision may give some additional flexibility. Unleveraged and closed-ended AIFs established in the EU or, if not established in the EU, marketed in the EU (arguably mainly private equity funds), venture capital funds, social entrepreneurship funds and the proposed European Long-Term Investment Funds are exempted from this prohibition as they are regarded as supporting the financing of the real economy. The Commission has stated that this provision is targeted at hedge funds but, as drafted, it has a far wider application as it would capture all leveraged and open-ended AIFs (plus AIFs which are unleveraged but not closed-ended) which could include, for example, a real estate fund, a fine art or wine fund, a retail investment fund or an investment company which is established or marketed in the EU.

Banks to which these EU prohibitions apply will be able to continue providing banking/custody services to the AIFs within the scope of the prohibition.

19) Although the second prohibition again appears to have been mirrored on Volcker, there are disparities. The potential exemption of private equity funds from the prohibition is in direct contrast to the Volcker rule which prohibits investment in private equity and hedge funds. There is no equivalent in the EU rule to the Volcker prohibition on covered transactions with covered funds with which the banking group has other relationships. Further, the EU legislation does not, unlike earlier drafts and the Volcker rule, prohibit the sponsorship of AIFs. On the other hand, the limited exclusions as opposed to the myriad US exclusions and exemptions, means that this investment prohibition appears to go further than the Volcker rule in certain respects. In addition, and in a broader fashion than the Volcker rule, the EU rule has an indirect effect: it prohibits investment in any entity that itself engages in proprietary trading or invests in AIFs. This provision is exceptionally wide and its practical effect is questionable: it is not clear whether the Commission expects banks to carry out extensive due diligence of all entities into which they have already invested or into which they are considering investing. These disparities will be of particular concern to those banks—for example, EU branches and subsidiaries of US banks and US branches and subsidiaries of EU banks but also other third-country banks with a presence in both the EU and US—which are likely to have to comply with both Volcker and the EU prohibitions.

**The Ring-Fencing Provisions**

20) The discretionary nature of the ring-fencing provisions is another departure from the Liikanen Report. Chapter III of the proposal only mandates national regulators to review the trading activities of each individual deposit-taking bank (termed “core credit institution”) in the EU and decide whether those activities create a threat to the financial stability of the core credit institution (“CCI”) itself or to the EU financial system as a whole. If so, the national regulator must prohibit the CCI from carrying out the specific risky trading activities, unless that institution convinces the regulator that such a decision is not justified. Such a decision would not prevent the identified trading activities
being carried out elsewhere within the banking group.

Scope

21) A significant difference between the EU rules on ring-fencing and the UK legislation is that the EU rules are generally intended to apply to all banks that take deposits eligible under the Deposit Guarantee Scheme as provided for in the Deposit Guarantee Schemes Directive. This includes all deposits held by individuals and small, medium and large businesses but not financial institutions and public authorities. The UK approach has been to apply its ring-fencing legislation to deposit-taking banks but it intends to exempt the deposits of specified types of depositors in secondary legislation, as well as provide for a de minimis exemption. The draft secondary legislation provides that deposits of high net worth individuals who have chosen to deposit outside the ring-fence, deposits of large organisations and deposits of other financial institutions are not ‘core deposits.’ The EU approach is, therefore, to protect a wider range of deposits than the UK which may cause a problem when the UK seeks to apply for a derogation—see paragraphs 35–39 below.

22) As with the Volcker-style prohibitions, these provisions have extraterritorial effect. In the same way as set out at paragraph 10 above, they are intended to apply to an EU parent, and all its branches and subsidiaries regardless of their location, of a CCI, as well as to an EU branch of a non-EU bank. Thus the same issues as described in paragraphs 11 and 12 above apply. Non-EU subsidiaries of EU banks and EU branches of non-EU banks will be exempt from the ring-fencing provisions if the Commission has made an equivalence decision regarding the non-EU jurisdiction: we have already commented (at paragraph 11 above) on the likelihood of an equivalence decision given that it demands equivalence as to Chapter II (the EU Volcker-style prohibition) and Chapter III (the ring-fencing provisions). There is an additional option, however, for non-EU subsidiaries of EU banks: a national regulator may exempt the subsidiary if it is satisfied that there is a group-level resolution strategy agreed between the EU group level resolution authority and the third country authority and that strategy for the subsidiary does not have an adverse effect on the financial stability of the Member State(s) where the EU parent and other group entities are established. This exemption, therefore, necessitates the cooperation of the relevant EU resolution authority, although it does not make clear which authority ought to make the discretionary decision as to the effectiveness of the resolution strategy.

The Potential Ring-Fencing of Certain Trading Activities

23) National regulators appear to be given a significant degree of discretion in Chapter III. This does raise the issue of inconsistent approaches but the discretion conferred on regulators is not as wide as it initially appears. National regulators are required to assess the trading activities of CCIs. A wide definition of “trading activities” is given so that it essentially means all activities other than taking deposits eligible for deposit insurance, lending, retail payment services and a number of other retail and commercial banking activities. Trading in EU sovereign debt is exempt from the obligation to review (and thus the power to separate) and the Commission has the same power as described in footnote 15 to adopt further secondary legislation to exempt trading in the sovereign debt of third countries. The regulators are directed to give specific attention to market-making (as it is closely related to proprietary trading), investing and sponsoring securitisations and trading in derivatives other than those that are specifically permitted for the purpose of prudent risk management (as the Commission believes that these latter activities played a key role during the financial crisis).
24) The national regulator must carry out its assessment of individual CCIs at least yearly and must use prescribed metrics when doing so. These metrics are:

a) relative size and leverage of trading assets;
b) relative levels of counterparty credit risk and market risk;
c) relative complexity of trading derivatives;
d) relative profitability of trading income;
e) interconnectedness; and
f) credit and liquidity risk arising from commitments and guarantees provided by the CCI.

The EBA will draft secondary legislation specifying how the metrics should be measured, giving further detail of the metrics and setting out a methodology for consistent measurement and application of the metrics. The Commission will also specify a limit for each metric above which the risk level of the relevant trading activity is deemed “individually significant” and set out the conditions which will trigger the exercise of the national regulator’s power to separate. Indeed, even where the limits and conditions are not exceeded, the national regulator may commence to consider such a prohibition if its assessment leads it to conclude that any trading activity, save trading in those derivatives that are specifically permitted for the purpose of prudent risk management, poses the threat outlined above. The regulator must consult with the EBA and communicate its conclusions to the relevant CCI, which is given two months to comment. Unless the CCI demonstrates that the conclusions are not justified, the national regulator shall prohibit the CCI from carrying out the specified trading activities.

25) When the national regulator has carried out its assessment and concludes that the limits and conditions set out in the secondary legislation have been surpassed, a threat to the financial stability of the CCI or the financial system of the EU is deemed to exist and the regulator must commence the process whereby the CCI would be prohibited from carrying out the trading activities in respect of which the limits and conditions have been exceeded. Indeed, even where the limits and conditions are not exceeded, the national regulator may commence to consider such a prohibition if its assessment leads it to conclude that any trading activity, save trading in those derivatives that are specifically permitted for the purpose of prudent risk management, poses the threat outlined above. The regulator must consult with the EBA and communicate its conclusions to the relevant CCI, which is given two months to comment. Unless the CCI demonstrates that the conclusions are not justified, the national regulator shall prohibit the CCI from carrying out the specified trading activities.

26) The drafting of the provisions gives the national regulators little discretion to do other than make a decision to ring-fence the relevant trading activities away from the CCI when the limits and conditions set out in the secondary legislation are surpassed. The regulators do, however, appear to have considerable discretion as to whether they are satisfied by the representations of the CCI concerned. This could lead to further inconsistencies of approach across different jurisdictions and even across banking groups. Once a decision to ring-fence any trading activity has been made by a national regulator, however, further provisions are triggered which mean that any CCI which has been subject to a ring-fencing decision, regardless of which or how many trading activities are ring-fenced or the extent to which the limits and conditions have been exceeded, can only use or sell derivatives to manage its own risk or to provide risk management services to customers as set out in the proposal. These provisions seem to
render a national regulator’s decision to ring-fence only certain trading activities nugatory.

27) The proposal provides that a CCI that has been subject to a ring-fencing decision by a national regulator may use only credit, FX and interest rate derivatives which are eligible for clearing to hedge its overall balance sheet risk. This seems to link the derivatives that a ring-fenced CCI can use or sell to ESMA’s decision under EMIR on which class of derivatives are subject to the clearing obligation. Given that ESMA’s decision cannot be anticipated and that it is not clear that the clearing obligation will apply to any FX derivatives, this cross-reference appears peculiar. The CCI must also demonstrate to the national regulator that such hedging demonstrably reduces or significantly mitigates specific identifiable risks of its individual or aggregated positions. This wording mirrors the wording found in the Volcker rule and does not per se prohibit portfolio hedging.

28) A CCI that has been subject to a ring-fencing decision is permitted to use a slightly wider range of derivatives when selling them to clients for their risk management purposes. It can use credit, FX, interest rate and commodities (including emissions allowances) derivatives (but again only those eligible for clearing) provided that the sole purpose of the sale is to hedge credit, FX, interest rate or commodity risk and subject to caps on the resulting position risk which the Commission will set out in further secondary legislation. There are also restrictions on the range of types of ‘real economy’ clients that could benefit from such risk management services.

29) The intention behind these provisions is not entirely clear but the drafting provides that using derivatives for their own risk management purposes and selling derivatives to clients for their risk management purposes are the only trading activities that can be carried out by a CCI subject to a ring-fencing decision. Article 11(1) provides that “A core credit institution that has been subject to a [ring-fencing] decision...may carry out trading activities to the extent that the purpose is limited to only prudently managing its capital, liquidity and funding.” The following article, which provides for the provision of risk management services to clients, is arguably inconsistent with the word “only” in Article 11(1) but it does appear that CCIs which have been subject to a ring-fencing decision cannot engage in any other trading activities save those specifically set out in Articles 11 and 12. For the avoidance of doubt, this would mean that those CCIs could not engage in market-making, underwriting, securitisation activities and trading in derivatives other than those set out in Articles 11 and 12 of the proposal. As a result, irrespective of the decision taken by the national regulator who may decide to separate only certain trading activities, the effect of Article 11(1) is to prevent the CCI subject to the ring-fencing decision from carrying out any trading activity other than the use of certain derivatives for the specified risk management purposes. This restriction is consistent with the UK approach to ring-fencing, which prohibits the RFB from dealing in investments as principal which means that it cannot engage in market-making, underwriting and most of the derivative and trading activity currently being carried out by wholesale and investment banks.

30) The synergies with the UK legislation become even more apparent when consideration is given to the UK draft legislation published for consultation in July 2013 that permits RFBs to deal in derivatives to hedge their own balance sheet risks and to sell simple derivatives as risk management products to customers subject to safeguards. It ought to be noted, however, that the UK draft legislation includes additional exemptions from the excluded activity of dealing in investments as principal: these permit own asset securitisation and acquiring and selling shares in companies through debt-equity swaps. The EU draft legislation does not currently go so far.
31) France and Germany have not taken the same approach as the UK, however, but have focussed more specifically on prohibiting their RFBs from proprietary trading, trading for their own accounts in certain circumstances and lending to certain AIFs. The German law also provides for a number of exceptions, including hedging and market making.

Rules on Ring-Fencing

32) Unlike the Volcker-style prohibition, the effect of a ring-fencing decision does not prevent the trading activities that have been separated being carried out elsewhere in the banking group. Under the EU proposal, the separated trading activities may be carried out by a trading entity which is legally, economically and operationally separate from the CCI. The proposal contains provisions to achieve this level of separation including the following:

a) a group which contains CCIs and trading entities shall be structured so that on a sub-consolidated basis two distinct sub-groups are created, only one of which contains CCIs;

b) CCIs may only hold capital instruments or voting rights in a trading entity in prescribed circumstances and with the consent of the national regulator;

c) CCIs and trading entities shall issue their own debt, provided this is consistent with the group’s resolution strategy;

d) contracts between CCIs and trading entities shall be agreed on a third party basis;

e) requirements regarding members of the management bodies of both types of entities;

f) the names of CCIs and trading entities shall make clear whether they are CCIs or trading entities;

g) limits on the intra-group exposure a CCI has to any entity outside its sub-group; and

h) limits on the extra-group exposure a CCI can have to financial entities.

The proposal also provides that the trading entity may not carry out certain activities, those being taking deposits eligible for protection under deposit guarantee schemes and providing retail payment services as defined in the Payment Services Directive. It appears that, if an EU branch of a non-EU banking group is within the scope of the EU legislation, these provisions are intended to apply to the non-EU banking group.

33) When a CCI has been subject to a ring-fencing decision, or an entity has decided to separate trading activities on its own initiative, it or its EU parent must submit a separation plan to the national regulator within six months of the ring-fencing decision or at the start of the national regulator’s assessment period. The national regulator has six months to approve the plan or require changes to be made. If a separation plan is not submitted, the national regulator shall adopt its own plan.

34) When consideration is given to the existing EU domestic legislation, the UK requirements on ring-fencing are most consistent with these provisions. The Banking Reform Act 2013 is a framework piece of legislation which sets out the key political choices which will give effect to Vickers but much of the technical detail will be found in subsequent secondary legislation and regulatory rules. Thus the Act requires the PRA to make rules governing the degree of separation between the RFB and the rest of the group, including rules to limit the shares and voting powers a RFB may have in another company, to ensure independence of decision-making in the RFB, to ensure the RFB does not rely on the provision of capital and liquidity resources of other members of the group, to restrict payments the RFB may make to other group members and to enter contracts with other members of the group on an arm’s length basis. In addition, the UK government has published draft legislation which prohibits RFBs having exposures to certain financial institutions.
35) The EU proposal provides for the possibility of the Commission granting a derogation from the ring-fencing provisions at the request of a Member State which had in place on 29 January 2014 primary legislation which fulfils the criteria set out on the proposal. This means that only the UK, France and Germany would qualify for the derogation as they are the only EU Member States which have already adopted legislation. The Belgian coalition government has, however, committed to finalising its legislation on bank structural reform before the elections in May 2014 and other Member States may want an opportunity to introduce their own legislation. The Commission’s choice of cut-off date may, therefore, be challenged.

36) The EU proposal provides that, in order to qualify for a derogation, the aim of the domestic legislation, its material scope and provisions referring to the legal, economic and governance separation of deposit-taking entities must have an equivalent effect to the provisions of the draft EU legislation. For reasons set out above, it appears that the UK legislation is most likely to satisfy these requirements but, also as pointed out above, not all of the UK’s draft secondary legislation is consistent with the EU provisions. In addition to the exemptions mentioned at paragraph 30 above which permit RFBs to engage in their own asset securitisation and to acquire and sell shares in companies through debt-equity swaps, the UK’s draft legislation also provides for a de minimis threshold below which institutions will be exempted from ring-fencing and exemptions which will permit the deposits of larger organisations and high net worth individuals to be held outside the ring-fence. It is not clear whether these exemptions would prevent the UK’s legislation meeting the criteria necessary for a derogation. There is thus a risk that the UK will have to change its draft secondary legislation if it wishes to benefit from the derogation.

37) Even within France and Germany, it is considered that the French and German domestic legislation is less likely than the UK’s legislation to qualify for the derogation as the scope of the French and German ring-fencing provisions is less extensive than the EU proposal. The French banking market is already expressing concern at the possibility that UK banks may be the only banks which benefit from a derogation.

38) There are two other points of controversy as regards the derogation. First, it appears the intention of the Commission that, despite the fact that a Member State must apply for it, any derogation should be granted on an individual deposit-taking bank basis, not on a jurisdictional basis. Article 21(1) provides that a derogation may be granted “to a credit institution taking deposits from individuals and SMEs that are subject to national primary legislation adopted before 29 January 2014 when the national legislation complies with the” requirements set out within the Article.

Article 21(2) envisages a derogation being withdrawn from a bank after the Commission has decided that the national legislation is not incompatible because that legislation no longer applies to a particular credit institution. Taking the UK’s legislation as an example and supposing that the exemptions referred to in the above paragraph are maintained, it is not clear whether a deposit-taking bank which takes advantage of the proposed de minimis exemption, for example, would be regarded as “subject to national primary legislation” so as to qualify for the derogation. It would be argued, of course, that such a bank is subject to the Banking Reform Act and is merely relying upon an exemption granted in accordance with it but, if that argument is valid, it is not clear why it would be necessary for derogations to be granted on an individual bank basis and not to all banks within a jurisdiction which has adopted national legislation having equivalent
effect: the provision for a derogation on an individual bank basis presupposes that different decisions can be reached in respect of different banks within the same jurisdiction. Subsequent drafting does suggest that a Member State can apply for derogations in respect of a number of deposit-taking banks at the same time and that one single derogation would be granted. Further, if domestic legislation is to be regarded as equivalent to the EU legislation, it would seem inconsistent for a decision to be reached that it is only equivalent for certain banks but the drafting and intent requires clarification to ensure certainty.

39) The second point of controversy is that the draft EU legislation gives the Commission a discretion to decide whether or not to grant the derogation. It is for the Commission to decide whether the domestic legislation is compatible with the EU legislation and it also appears that the Commission is required to consider the potential impact of a derogation on the financial stability of the EU and the functioning of the internal market. Conferring such a discretion on the Commission will raise political and legal questions concerning whether and how the Commission can be given such a power.

40) The effect of the provision on derogations is that an EU cross-border banking group with a number of CCIs in different Member States (or potentially a number of CCIs in the same Member State) could obtain a derogation for some of those CCIs but could still be required to develop a separation plan that applies across its group if a derogation is not granted to all its CCIs.

What Happens Next?

41) The proposal must be adopted by the European Parliament and Council under the ordinary legislative procedure. Under this procedure, the Council and the Parliament are placed on an equal footing as the co-legislature. Both institutions will consider the Commission’s proposed text and reach an internal agreement as to a version that they can accept. Once they have reached this agreement, they and the Commission enter a process known as trialogues in an attempt to reach an agreed text for adoption as legislation. The agreed text must be adopted by a qualified majority of the Council and a simple majority of the Parliament.

42) The process for adopting EU legislation is thus both complex and lengthy. France, Germany and Italy have already made clear their objection to the proposal as a whole and the UK is likely to be concerned both at the Volcker-style prohibition it contains and the process necessary to obtain a derogation from the ring-fencing provisions. Given these concerns, significant amendments to the proposal, in Council at least, are to be expected. It is less clear how the new Parliament will view the proposal.

43) Agreement on a final version of the legislation is not expected before June 2015 and, on this basis, the Commission’s proposed timetable would see the prohibition on proprietary trading applying from 1 January 2017 and the provisions on separation of the trading activity applying from 1 July 2018. This timetable is not dissimilar to that which is expected to apply in the UK but is significantly behind the Volcker timetable: the Volcker conformance period ends on 21 July 2015 and banking entities must make good faith efforts to be in compliance by that date.

44) When considering the operational changes required by Volcker, Vickers, the French law on the separation and regulation of banking activities and the Trennungsgesetz, it would be prudent to bear in mind the likelihood of additional EU requirements, although there is as yet no certainty as to exactly what those requirements may be. In addition, banks which expect to be within the scope of the EU’s proposal should commence lobbying their own governments, the Commission and, after
elections, the new European Parliament if, as appears likely, they are concerned by the EU proposal.

45) As currently drafted, the EU proposal is not consistent with any of the existing domestic legislation on bank structural reform, in the EU or in the US. The possibility of duplicative and conflicting requirements will be a concern for banks which are active cross-border as it raises the question whether a single banking model can be designed that complies with the legislative requirements in all relevant jurisdictions. If a single model is not possible, the cost of banking, and thus bank lending, could be increased and this will impact on the real economy and EU’s economic recovery. The EU’s legislative proposal could, therefore, adversely affect the very people who it is designed to protect. It is also hard to see how the EU’s proposal addresses the problem that the Commission itself identified of inconsistent national legislation. The EU legislation could itself increase the possibility of distortions of capital movements and investment decisions, make the structure and operation of cross-border banks more complex and increase fragmentation. In these circumstances, the necessity for this legislation may well be questioned: is EU legislation for bank structural reform necessary and proportionate in addition to banking union, CRD IV, the soon-to-be-adopted bank recovery and resolution directive and the domestic legislation already in place?

Endnotes

1 Admitted to the Hauts de Seine Bar, François-Régis Gonon is a partner in the Banking & Finance practice of the Paris office. David Sahr advises domestic and foreign financial institutions on establishing and expanding their operations in the United States as well as on related regulatory, enforcement and compliance matters. Andreas Lange is a partner in the Frankfurt office of Mayer Brown’s Banking & Finance practice. Mark Compton is a partner in the Financial Services Regulatory & Enforcement practice of the London office advising a wide range of clients, including banks, insurers, proprietary traders, brokers, and funds on all aspects of UK and EU financial services legislation. Charles-Albert Helleputte focuses his practice on the corporate and tax aspects of restructuring transactions and structured finance arrangements.


6 French law no. 2013-672 of 26 July 2013 on the separation and regulation of banking activities.

7 Trennkassengesetz (German Bank Separation Law) which is included in Article 2 of the Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen (Law concerning Separation of Risks and Restructuring and Winding-Up of Credit Institutions and Financial Groups), BGBl. 2013 I Nr. 47, 3090. The law was announced on 7 August 2013 and Article 2 entered into force on 31 January 2014, although most of the rules in Article 2 are not applicable until 1 July 2015.

8 The text is not yet available but was approved in second reading on 14 February 2014 by the Belgian Federal Government.

9 See here http://www.mayerbrown.com/files/Publication/f9312f88-0e01-40f8-b14b-46379c2b118d/Presentation/PublicationAttachment/ddaf0395-d75d-4456-b143-6a026db6be71/Final-Regulation-Implementing-the-Volcker-Rule.pdf.

10 See here http://www.mayerbrown.com/files/Publication/b2ff45ce-4252-45b4-8bc0-899c2914b6a8/Presentation/PublicationAttachment/9b7da366-47a5-4ada-8dfb-05c7f0893a0f/UPDATE-VolckerRule-Application_131219.pdf.

11 Dealing in investments as principal includes buying, selling, subscribing for or underwriting securities or contractually based investments.

12 As a strict matter of law, a branch does not have a legal identity separate to its parent but, although the drafting is not wholly clear, it does not appear to be the intention that branch assets are consolidated with those of its parent.

13 The Fourth Capital Requirement Directive which consists of a directive (2013/36/EU) and a regulation (575/2013).


15 Case C-209/13 United Kingdom of Great Britain and Northern Ireland v Council of the European Union.

16 The Commission may adopt further secondary legislation to exempt trading in the sovereign debt of third countries which
have equivalent supervisory and regulatory requirements, exposures to which have 0% risk weighting under the Capital Requirements Regulation.

17 The drafting of Chapter III is currently ambiguous. Whereas the majority of Articles in Chapter III (for example, Articles 10(2), 10 (3), 11 and 12) refer to the subject of a ring-fencing decision being the EU core credit institution, Article 9(1) currently mandates the national regulator to assess the trading activities of a far wider group of entities, including the EU parent and all branches and subsidiaries in a group which contains a core credit institution, as well as EU branches of all credit institutions established in third countries.

18 Directive 94/19/EC.

19 There is no requirement for the branch or the non-EU bank to fall within the definition of a CCI. Thus it appears that EU branches of a non-EU bank may be within the scope of this provision when they would not be (because they would not fall within the definition of a CCI) if they were established in the EU as a subsidiary.

20 Although the ECB will assume its full supervisory tasks from 4 November 2014 and would thus be the relevant prudential regulator for the purposes of this proposal, national regulators will be responsible for the direct supervision of “less significant” banks and will assist the ECB in the ongoing day-to-day supervision of “significant supervised” banks. As a result, the possibility of inconsistent national approaches must remain.

21 The Commission may adopt secondary legislation adding to these classes of derivatives, including those that are not clea

22 Directive 2007/64/EC.

23 The draft Order provides that banks whose ‘core deposits’ do not exceed £25 billion will not be RFBs. It also provides that deposits of high net worth individuals who have chosen to deposit outside the ring-fence, deposits of large organisations and deposits of other financial institutions are not core deposits.