Bank structural reform: too big to fail, too big to save and too complex to manage, supervise and resolve?

1.1 The case for bank structural reform

Bank structural reform is the result of a global financial crisis which developed in the summer of 2007 and became obvious in the EU in the latter part of 2008. The EU Member States that share an economic and monetary union (‘the Eurozone’) began to appear particularly vulnerable: the Greek sovereign debt crisis became apparent in early 2010 and serious economic problems emerged in Ireland, Portugal, Italy and Spain. Fearing possible defaults, markets began demanding substantially higher interest rates for the bonds of these Member States with Spanish 10-year yields topping 7.5 per cent in the summer of 2012.

A negative feedback loop between banks and their sovereigns began to be seen as the principal cause of the crisis: as banks are the major purchaser of sovereign debt, banking problems can jeopardise the fiscal position and sovereign debt problems can put banks at risk. As a result of this inter-connection, governments intervened to provide State aid to banks that were at risk of failing in an attempt to restore confidence in the financial sector and avoid a systemic crisis. Between 1 October 2008 and 1 October 2013 the European Commission took more than 400 decisions authorising State aid measures to the financial sector. Between 2008 and 2012, the overall volume of aid used for capital support (recapitalisation and asset relief measures) amounted to €591.9 billion. The guarantees and other forms of liquidity supports reached their peak in 2009 with an outstanding amount of €906 billion.

Although the sovereign debt crisis was worst in the Eurozone, as a result both of contagion (which occurred as investors lost faith in other countries within the Eurozone) and the exposure of Eurozone states to each other, EU countries outside the Eurozone were far from immune. Decisions to stabilise their banking sectors cost Germany €64 billion, Ireland €63 billion and Spain €60 billion but the UK spent €82 billion on supporting its banks. The British bank RBS (€46 billion) tops the list of bank recipients, followed by Ireland’s Anglo Irish Bank (€32 billion) and Spain’s Bankia (€22 billion).

It is necessary to look beyond the so-called doom loop, however, to understand why bank structural reform is seen as a panacea. The failure of Northern Rock in September 2007 caused the UK financial regulatory authorities to examine their existing system of supervision and to consider whether changes were needed. The financial crisis in 2008 and 2009 expanded their review. In 2012 the UK government explained that the crisis had revealed the following flaws in the financial system:

“Banks ran risks that they did not understand. Investors did not put sufficient pressure on institutions to manage risk effectively and bought securities that proved to be far from secure. Management oversaw banks that were too complex and intermingled. Non-banks and the shadow banking sector became intertwined in complex ways with the banking system. Regulators, central banks and politicians were not sufficiently robust in

supervising firms, nor were they equipped with effective resolution tools to resolve banks without resorting to huge amounts of capital injections. European taxpayers have provided billions in capital to their banks, and trillions in liquidity support. In short, the crisis, as well as causing a global recession, exposed a range of problems which required action, most crucial of which is the perceived implicit guarantee enjoyed by banks and other financial firms.  

The UK was not alone in identifying these problems and, as a result, a number of jurisdictions started to overhaul bank regulation and supervision: bank structural reform was part of that agenda.

### 1.2 Bank structural reform: the basics

At its core, bank structural reform involves separating retail and commercial banking from wholesale and investment banking. The objective is to protect core banking activities and depositors from the riskier trading activities 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. Bank structural changes are also intended to reduce complexity and so improve the resolvability of banking groups. International regulators are concerned that the failure of the biggest banks would be detrimental to the global financial system and that this very fear means that these banks have an unfair advantage over smaller banks: 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.  

Until 29 January 2014 there were two main approaches to bank structural reform: the US approach espoused by Paul Volcker and the UK approach espoused by John Vickers. The French and German approaches could equally be described as Volcker-lite or Vickers-lite. There are two main differences between the approaches of Volcker and Vickers. The first difference is the US preference for prohibition (or owner separation) as opposed to the EU preference for ring-fencing (or functional separation/subsidiarisation). This difference means that the activities that the US has prohibited cannot be carried out within a banking group at all, whereas the activities on which the EU Member States (the UK, France and Germany) have focused can be carried out within a distinct trading entity, which is separate from the retail and commercial bank entity. The second main difference in the approaches pre-January 2014 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. This contrasts to the UK approach which focuses on a wider range of investment and wholesale banking. By prohibiting deposit-taking entities from ‘dealing in investments as principal’, it requires most of the derivative and trading activity currently carried out by wholesale and investment banks to be carried out by a trading entity wholly separate from the retail bank.
The French and German approaches follow the ring-fencing approach of the UK but, like the US, have a narrower focus; hence their description as both Volcker-lite and Vickers-lite. 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.

On 2 October 2012 the EU high-level expert group chaired by Erkki Liikanen published its report on reforming the structure of the EU banking sector. Following that report, it was expected that the European Commission would introduce a proposal for bank structural reform that followed a ring-fencing approach in requiring legal separation of certain particularly risky financial activities from deposit-taking banks within the banking group. The Liikanen group suggested that in proprietary trading, all assets or derivative positions incurred in the process of market-making (save for some exempt activities), private equity investments and loans, loan commitments or unsecured credit exposures to hedge funds, SIVs and other similar entities of comparable nature be assigned to a separate trading entity.

On 29 January 2014 the European Commission published its long-awaited proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions. 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 and, although the proposal contains provisions which mirror the Vickers ‘ring-fencing’ approach they are not, in direct contradiction to Liikanen’s recommendation, mandatory even for the largest banks. The Commission’s legislative proposal, by including elements of both the US and UK approaches, 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.

At the time of writing, the Council and European Parliament have just begun their internal deliberations on the proposal for EU bank structural reform legislation. Although elements of it are controversial, the logic of bank structural reform has seemingly not been challenged. Accordingly, some form of EU legislation is expected, although the detail is far from clear. The approach taken in this article is, therefore, to identify some of the more controversial elements in the Commission’s legislative proposal and carry out a comparative analysis of it and the existing bank structural reform legislation.

1.3 The EU’s Volcker Rule

1.3.1 SCOPE

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 deliberately departed from the Volcker rule in a number of areas.

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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 Global-Systemically Important Institutions (‘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 and trading activities of €70 billion or 10 per cent of total assets including:

1. EU banks which are neither parent institutions nor subsidiaries, plus all their branches regardless of their location;
2. EU parent institutions, plus all their subsidiaries and branches regardless of their location, when one of the group entities is an EU bank; and
3. EU branches of non-EU banks.\(^\text{12}\)

The intention appears to be that the assessment of total assets and trading activities is made at each individual entity level, including at branch level in the case of EU branches of non-EU banks,\(^\text{13}\) save in the case of (b) above where it appears that an assessment should be made on a consolidated basis. The proposal contains some detail on how trading activities are to be calculated and the European Banking Authority (‘the EBA’) shall be mandated to draft legislation to set out the exact methodology.\(^\text{14}\)

Bringing EU branches of non-EU banks and non-EU subsidiaries of EU banks within the scope of the EU prohibition is an attempt to create a level playing field in the EU and not give non-EU banking groups or EU banking groups with non-EU entities a competitive advantage. This raises questions of effectiveness and legality. The inclusion of EU branches of non-EU banks is not particularly controversial, especially given that their inclusion cannot be expected to impose the EU prohibition across their banking group but, unless a non-EU banking group is subject to similar provisions to the EU ban on proprietary trading, it is still possible that the EU branch of a non-EU bank could utilise non-EU entities within its group to carry out the activities that are prohibited in the EU. The inclusion of non-EU subsidiaries of EU banks is legally contentious. The UK and the Council Legal Service have questioned the purported extraterritorial application of other recent pieces of EU legislation. In its legal challenge to the remuneration provisions of CRD IV,\(^\text{15}\) the UK has alleged that, 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.\(^\text{16}\) A similar issue is currently being debated in the context of the financial transaction tax (‘FTT’). The UK 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.\(^\text{17}\) Although the Court of the Justice of the EU dismissed the UK’s legal challenge as premature given that a FTT has not yet been adopted, it did not address the merits of the UK’s arguments and the Council Legal Service has given some support to the argument.

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.\(^\text{18}\) 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 and whether it has a reciprocity provision.\(^\text{19}\) It is

\(^{12}\) Ibid., the Proposal, Article 6(1) (which cross-refers to the scope provision in Article 3).
\(^{13}\) 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.
\(^{16}\) Case C-507/13 United Kingdom of Great Britain and Northern Ireland v European Parliament, Council of the European Union.
\(^{17}\) Case C-209/13 United Kingdom of Great Britain and Northern Ireland v Council of the European Union.
\(^{19}\) The reciprocity requirement is that the non-EU jurisdiction recognises the EU legislation in the same way as the EU legislation recognises equivalent non-EU legislation.
questionable whether any jurisdiction has requirements equivalent to both the Volcker-style and ring-fencing provisions in the draft EU legislation. It is expected that the Volcker rule would be regarded as effectively equivalent to the EU provisions on proprietary trading, although there are differences. US legislation does not require ring-fencing to the same extent as the EU proposal, however, and it does not contain a reciprocity provision. It seems unlikely, therefore, that an equivalence decision will benefit any EU branch of a non-EU bank or non-EU subsidiary of an EU bank. Thus the question of scope is a contentious issue which has yet to be resolved: EU banks are concerned that, even with the inclusion of EU branches of non-EU banks, non-EU banks will be at a competitive advantage, especially given the purported inclusion of the non-EU subsidiaries of EU banks.

1.3.2 THE PROPRIETARY TRADING BAN

In drafting its proprietary trading ban, the Commission claims to have learned from the US experience and its approach is, therefore, deliberately different, although it could be argued that the same result has been achieved. Like the US, the EU’s proposed rule prohibits proprietary trading within the banking group within scope but, unlike the US legislation, the EU draft is skeletal and does not permit further clarification in subordinate (or level 2) legislation. The EU proposed legislation has a narrow definition of proprietary trading with limited exemptions. This is in direct contrast to the US legislation which defines proprietary trading widely but includes a number of 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.

Thus the EU proposal defines proprietary trading 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. Trading in EU sovereign debt is expressly permitted in the draft legislation. It is also proposed that entities can trade in cash or defined cash equivalent assets (money market instruments) if they use their own capital as part of their cash management processes.

Many Member States and banking entities have expressed concern at this approach and are lobbying for greater clarity on what activities are within and outside the scope of the prohibition. It could be argued, however, that it is preferable to have a purposive and pragmatic approach as opposed to a rule-based one in which it is necessary to fit activities within tightly-drafted exclusions and exemptions which themselves contain onerous conditions for use. Whilst the EU approach may create greater initial uncertainty and the possibility of regulatory inconsistency, the proposed drafting of the definition does give banks the flexibility and latitude to construct an argument that many of their activities are not for the sole purpose of making a profit for their own account and are connected to actual or anticipated client activity. When advocating for greater clarity, Member States and banking entities should be aware that further prescription may be at the expense of flexibility and may result in an outcome that they do not desire. It may also not result in what the EU seeks to achieve without a cost: safer deposit-taking banks which ensure the continuity of retail and SME business.

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21 Ibid., the Proposal, Article 5(q).
22 Ibid., the Proposal, Article 6(2).
23 Section 13 BHCA broadly prohibits any banking entity from engaging in proprietary trading. Section 13(a) of the Final Regulation defines ‘proprietary trading’ as ‘engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.’ The US regulators rejected many of the requests in comment letters that the proposed definitions of ‘proprietary trading’, ‘trading account’, and ‘financial instrument’ be narrowed, taking the view that these concerns are best addressed in the context of the exclusions and exemptions from proprietary trading. Accordingly, section 13(d) of the Final Regulation expressly excludes a number of activities from the definition of proprietary trading, those being repurchase and reverse repurchase transactions; securities lending and borrowing; liquidity management; clearing organisation transactions; clearing activities; trading as agent, broker or custodian; trading in satisfaction of delivery obligations; trading on behalf of employee benefit plans and debt collection activities. Sections 14–16 of the Final Regulation permit certain specifically defined trading activities subject to detailed conditions and compliance obligations. These exempt trading activities are market-making, underwriting, risk-mitigating hedging activities, trading activities conducted by foreign banking entities solely outside the United States, trading in US and foreign government obligations, trading on behalf of customers and trading by regulated insurance companies.
24 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 per cent risk weighting under the Capital Requirements Regulation.
1.3.3 THE PROHIBITION ON INVESTMENT IN FUNDS

The EU Commission has expressed a desire to regulate banking entities’ investment in hedge funds and to ensure that those entities subject to the prohibition on proprietary trading are not able to use other entities to circumvent the ban.25 Thus the proposal 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 if the sole purpose of the banks’ activity is to make a profit for its own account.26 Unleveraged and closed-ended AIFs established in the EU or, if not established in the EU, marketed in the EU (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.27

The provision as currently drafted has a far wider application than the Commission seemingly envisages. It would bring within its scope 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 but there are real concerns that if the proposal is adopted it will prevent the provision of seed capital and the co-investment (or ‘skin in the game’) which many investors demand.

Although this second prohibition again appears to have been modelled on Volcker,28 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. 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.

1.4 Ring-fencing

The provisions on ring-fencing are perhaps the most controversial aspect of the EU’s proposal on bank structural reform both because they are regarded as too UK-centric and because they are said to threaten the continental universal banking model. In brief, the EU proposal29 mandates national regulators to review the trading activities of each individual deposit-taking bank (termed core credit institution)30 in the EU and decide whether those activities create a threat to the financial stability of the core credit institution itself or to the EU financial system as a whole. If so, the national regulator must prohibit the core credit institution from carrying out the

27 Ibid., Article 6(c).
28 The Volcker Rule prohibits any ‘banking entity’ from sponsoring ‘covered funds’; acquiring or retaining an ownership interest in ‘covered funds’ unless an exemption is available; and places limitations on lending and other financial relationships (known as ‘covered transactions’) with covered funds for which the banking group acts as sponsor, investment manager or investment adviser. The definition of a ‘covered fund’ includes any issuer of securities that either engages primarily in the business of investing or trading in securities or invests 40 percent or more of its total assets in ‘investment securities’ under the 1940 Act and would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company 1940 Act (section 10(b)(1)). Under section 10(c) of the Final Regulation provides 14 exclusions from the definition of covered fund.
30 The drafting of Chapter III of the EU legislative proposal (which contains the provisions on ring-fencing) is currently ambiguous. It is not clear whether all core credit institutions are within the scope of the ring-fencing provisions or just the larger banks that are subject to the ban on proprietary trading. It is also not clear whether the national regulator’s ring-fencing decision may be limited to the core credit institution or whether it can extend to all members of a group which contains a core credit institution. 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 non-EU banks.
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.

One of the aspects of the EU Commission’s proposal which has attracted the most comment is the possibility that individual banks, in Member States which had equivalent national legislation in place as of 29 January 2014, are eligible to apply for a derogation from the EU ring-fencing provisions. Many consider this a gift to the UK whose legislation on bank structural reform is closest to that envisaged by the EU Commission but it is by no means certain that the UK’s legislation will be regarded as equivalent to the EU legislation and, if it were, it does not necessarily follow that all UK banks would benefit from a derogation.

In order to be eligible for a derogation from the ring-fencing provisions, the provisions of the national legislation referring to the legal, economic and governance separation of deposit-taking entities must have an equivalent effect to the EU legislation. In essence, the national legislation must ensure legal separation between the deposit-taking entity and the trading entity. It must also ensure that the deposit-taking entity takes decisions independently of other group entities; has a management body independent of other group entities and the deposit-taking entity itself; is subject to capital and liquidity requirements in its own right; and enters into contracts with the trading entity on a third party basis.31

The approach taken in this section, therefore, is to compare the EU Commission’s proposal on ring-fencing with the approach taken in the UK with some reference to the French and German approach.

The draft legislation provides that the Commission may grant a derogation to an individual bank at the request of a Member State that had primary legislation having equivalent effect in place on 29 January 2014. This would mean that only France, Germany and UK are eligible to apply for derogation. Belgium adopted primary legislation on 25 April 201432 but, on the basis of the current draft, Belgian banks would not be eligible to apply for a derogation. This is one of the legally and politically contentious aspects to the derogation criticised by the Council Legal Service.

The Council Legal Service has raised a valid legal argument that a regulation (which is of general application, binding in its entirety and directly applicable in all Member States) should not contain derogations, exemptions, waivers or options. This argument is strengthened when, as in the proposal under discussion, the legal base for that regulation is Article 114 of the Treaty on the Functioning of the EU (‘TFEU’) which allows the Parliament and the Council to adopt ‘measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States’, which have as their object the establishment and functioning of the internal market. It is legally possible to have a derogation or option provided that the EU legislation contains objective criteria for its application but some elements of the proposed derogation would still remain incompatible with a regulation adopted under Article 114 TFEU. The cut-off date of 29 January 2014, the fact that the derogation would not apply to all banks in a Member State and the proposal that the Commission rule on whether a derogation is permissible, are all problematic if the proposed legal form and legal basis are retained. If the possibility of a derogation is to remain, a more sound option would be to replace the proposed regulation with a directive which, as it would be binding only as to the result to be achieved, could accommodate pre-existing non-conflicting national legislation. The replacement of the regulation with a directive, however, would require the Commission to withdraw the original proposal and this does not seem likely at the time of writing.

The use of a minimum harmonising directive as opposed to a regulation could satisfy the competing demands of the UK on one hand and France and Germany on the other. It is recognised that the French and German ring-fencing legislation is significantly less ambitious and onerous than the EU proposal. Accordingly, it is not expected that, on the basis of the current proposal, French and German banks will be able to apply for a derogation. The EU proposal is thus seen as a significant threat to the universal banking model under which banks in France and Germany are traditionally established and a watering down of the ring-fencing provisions could be the price that France and Germany demand for their support in Council. On the other hand, the UK’s bank structural reform agenda is well-advanced and the UK government would resist any EU legislation that would require it to dismantle its carefully crafted regime. Reconciling the demands of France, Germany and the UK will not be easy.


32 The Law of 25 April 2014 on the status and supervision of credit institutions.
The differences between the EU approach and that of the individual Member States, including the UK, becomes apparent when an analysis is made of the conditions which a Member State must satisfy in order for its banks to obtain a derogation. As explained above, in order for a derogation to be obtained the aim of the national legislation, its material scope and its provisions referring to the legal, economic and governance separation of deposit-taking entities must have an equivalent effect to the EU legislation. It is relatively easy to satisfy the first criterion. The aim of all forms of bank structural reform legislation is much the same: to prevent the failure of large, complex and interconnected financial entities and thus to prevent systemic risk and protect depositors. The disparities begin to appear when consideration is given to scope, the effect of the ring-fence and the strength of the ring-fence.

1.4.1 SCOPE OF THE EU PROPOSAL

The scope of the EU rules on ring-fencing is unclear in the Commission’s proposal. It could be the intention that the ring-fencing provisions apply only to the largest banks, as with the prohibition on proprietary trading, but the initial draft indicates a much wider scope. On the basis of the original drafting, it appears that the EU rules are 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 recast Deposit Guarantee Schemes Directive contains an option for Member States to cover additional SME pension schemes and smaller public authorities. Member States may also provide that deposits may be released in accordance with national law only to pay off a loan on private immovable property, whether made by the credit institution or another institution holding the deposit are excluded from repayment by a deposit guarantee scheme. Thus the definition of eligible deposits may differ between Member States with the result that the scope of the ring-fencing provisions is set differently in Member States. There is, however, still a wide definition of deposit which is used to bring banks within the scope of the ring-fencing provisions. In protecting all deposits held by individuals and small, medium and large businesses, the EU draft approach appears to protect a wider range of deposits and to target a wider group of banks than the UK and, arguably, the German and French legislation. The narrower scope of the domestic legislation is explained in the following sections on the scope of the UK, German and French ring-fences.

The ring-fencing provisions have the same territorial scope as the Volcker-style prohibitions: they are intended to apply to an EU parent, and all its branches and subsidiaries regardless of their location, of a core credit institution, as well as to an EU branch of a non-EU bank. 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, but this article has already posited that it is unlikely that any jurisdiction will be able to benefit from an equivalence decision. 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 is, therefore, available to those banking groups that have multiple point-of-entry resolution strategies. There is not a similar exemption for EU branches of non-EU banks nor in relation to the prohibitions on proprietary trading and investment in AIFs.

34 Ibid., the recast DGSD, Article 5(2).
35 Ibid., Article 5(3).
36 There is seemingly no requirement for the branch or the non-EU bank to fall within the definition of a core credit institution. 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 core credit institution) if they were established in the EU as a subsidiary.
Although the scope of the EU ring-fencing provisions is wide, the discretionary nature of the ring-fencing provisions is a significant departure from the Liikanen Report and differs from the domestic legislation of the UK, France and Germany. The EU proposal mandates national regulators to assess the trading activities of core credit institutions. 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 a power 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).

The national regulator must carry out its assessment of individual core credit institutions at least yearly and must use prescribed metrics when doing so. These metrics are:

1. relative size and leverage of trading assets;
2. relative levels of counterparty credit risk and market risk;
3. relative complexity of trading derivatives;
4. relative profitability of trading income;
5. interconnectedness; and
6. credit and liquidity risk arising from commitments and guarantees provided by the core credit institution.

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 will set out the conditions that trigger the exercise of the national regulator's power to separate. It is not clear how these metrics, particularly those relating to the relative size and leverage of trading assets, relate to the calculation of the trading activities necessary to determine which banks fall within the scope of the ring-fencing provisions. The Commission will also draft legislation specifying certain types of securitisations which are not considered a threat to the financial stability of the core credit institution or the EU as a whole.

It is essential that the Commission sets the limits and conditions at the correct level as these will determine the parameters of ring-fencing. It is also important that the proposal contains metrics which accurately measure the risks associated with trading activities and takes into account risk mitigation techniques. The proposal does not currently have regard to risk mitigation techniques such as netting, offsetting, diversification and portfolio compression nor prudent risk management and hedging techniques.

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 core credit institution or the financial system of the EU is deemed to exist and the regulator must commence the process whereby the core credit institution 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 core credit institution, which is given two months to comment. Unless the core credit institution demonstrates that the conclusions are not justified, the national regulator shall prohibit the core credit institution from carrying out the specified trading activities.

38 Ibid., Article 8(1).
39 Ibid., Article 8(2).
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 core credit institution 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 core credit institution concerned. This could lead to inconsistencies of approach across different jurisdictions and even across banking groups. It also gives the regulator(s) enforcing the EU ring-fence more discretion than the regulators enforcing the UK, French and German ring-fences.

1.4.2 SCOPE OF THE UK LEGISLATION

The UK’s primary legislation focuses on a ring-fenced body which is defined as ‘a UK institution which carries out one or more core activities’. The only core activity set out in the primary legislation is deposit-taking. The primary legislation also sets out the core services associated with the core activity of accepting deposits: these are the core services which the new core activity was created to protect. The core services associated with accepting deposits are facilities for accepting deposits or other payments into an account, facilities for withdrawing money, making payments from accounts and overdraft facilities. The primary legislation exempts building societies from the definition of ring-fenced bodies but the secondary legislation exempts further entities and provides that accepting some deposits does not amount to a core activity as those deposits are not ‘core deposits’. It exempts two main classes of institutions: non-bank institutions such as insurers, co-operatives and community benefit societies, which would otherwise be captured by the definition of ‘ring-fenced body’ in the primary legislation because they accept deposits; and banking groups which hold less than £25 billion in core deposits. The secondary legislation also provides that the deposits of organisations with a turnover greater than £6.5 million, more than 50 employees or a balance-sheet total greater than £3.26 million, and individuals with more than £250,000 worth of financial assets will not be core deposits provided they comply with a self-certification regime, allowing high net worth individuals and large organisations to make an active choice to bank outside the ring-fence. Deposits of other financial institutions and qualifying members of the same group as a UK deposit-taker are also excluded from the definition of core deposits.

The rationale behind the exemptions for depositors is that sophisticated investors, both natural and legal persons, should be able to make an active choice to deposit outside the ring-fence because they are able to tolerate a temporary interruption in access to their accounts. The de minimis exemption is intended to avoid imposing disproportionate costs of ring-fencing requirements on small banks, which could impede their ability to compete and grow, thus deterring new banks from entering the market. The exemption for non-bank institutions reflects the fact that the UK ring-fence has been designed to address problems specific to banks and banking services. These exemptions are not envisaged in the EU proposal and their effect is to narrow the scope of the UK ring-fence.

Thus, although the scope provisions in the UK primary legislation and the EU proposal appear similar, when consideration is given to the UK’s proposed secondary legislation, disparities begin to emerge. The UK ring-fence will have a narrower scope than the currently proposed EU ring-fence: there are different tests for both the banks in scope and the deposits in scope. Accordingly, it is anticipated that only the five largest banks in the UK will be within the scope of the Vickers ring-fence.

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40 Op. cit., Section 142A(1) FSMA.
41 Ibid., Section 142B(2).
42 Ibid., Section 142C (2).
43 Ibid., Section 142A(2)(a).
45 Ibid., Article 2(2) defines a ‘core deposit’ as a deposit held with a UK deposit-taker in an EEA account except as set out.
46 Ibid., Article 11(0)(a) and (b).
47 Ibid., Article 11(0)(a) and Articles 12–13.
49 Ibid., Articles 2(2)(d), 9–10.
50 Ibid., Article 2(2)(a).
51 Ibid., Articles 2(2)(c) and 8.
The geographical scope of the EU proposal and the UK legislation is also different: the UK legislation does not have the same extraterritorial effect as the EU proposal, although the UK secondary legislation does impose restrictions on the entities which a bank within the Vickers ring-fence can establish outside the European Economic Area (‘EEA’).52

1.4.3 SCOPE OF THE FRENCH LEGISLATION

The French legislation53 applies to all credit institutions, financial companies and mixed financial holding companies but only where certain thresholds are exceeded. At the time of writing, these thresholds have yet to be determined but it is expected that the five largest French banking groups will be within scope. The French legislation will apply to French banking groups globally on a consolidated basis but there is no indication that it will apply to French branches (as opposed to subsidiaries) of foreign banking groups.

1.4.4 SCOPE OF THE GERMAN LEGISLATION

Prima facie the German legislation54 appears to have a wide scope: it captures deposit-taking financial institutions (Einlagenkreditinstitute)/credit institutions within the scope of the Capital Requirements Regulation55 and all entities within a group56 which contains a deposit-taking institution but a threshold must then be exceeded to bring the solo entity or group within scope. The threshold can be exceeded in either of the following ways:

the trading activities57 of the entity or group exceed €100 billion; or

the entity or group’s balance sheet total in the last three business years was at least €90 billion and trading activities account for at least 20 per cent of such total.

1.4.5 EFFECT OF AN EU RING-FENCING DECISION

The EU draft legislation provides that once a decision to ring-fence any trading activity has been made by a national regulator, further provisions are triggered which mean that any core credit institution 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 risk58 or to provide risk management services to customers as set out in the proposal.59 These provisions seem to render a national regulator’s decision to ring-fence only certain trading activities nugatory.

The proposal provides that a core credit institution that has been subject to a ring-fencing decision by a national regulator may use only credit, foreign exchange (‘FX’) and interest rate derivatives60 which are eligible for clearing to hedge its overall balance sheet risk. This seems to link the derivatives that a ring-fenced core credit institution can use or sell to the European Securities and Markets Authority’s (“ESMA’s”) decision under EMIR61 on which classes of derivatives are subject to the clearing obligation. Given that ESMA’s decision cannot be anticipated and that it is still far from clear that the clearing obligation will apply to any FX derivatives, this cross-reference appears peculiar. The core credit institution must also demonstrate to the national regulator that such hedging demonstrably reduces or significantly mitigates specific identifiable risks of its individual or aggregated positions. The wording mirrors that found in the Volcker rule and does not, per se, prohibit portfolio hedging.

55 Op. cit., CRR.
56 The term ‘group’ is defined by reference to the Capital Requirements Regulation.
59 Ibid., Article 12.
60 The Commission may adopt secondary legislation adding to these classes of derivatives, including those that are not cleared.
A core credit institution 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.

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 core credit institution subject to a ring-fencing decision. This would mean that those core credit institutions could not engage in market-making, underwriting, securitisation activities and trading in derivatives other than those set out in the proposal and explained above. As a result, irrespective of the decision taken by the national regulator who may decide to separate only certain trading activities, the effect of the current drafting is to prevent the core credit institution 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 ring-fenced body 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. The EU legislation does not, however, contain the same exemptions envisaged by the UK draft legislation.

As with all ring-fencing approaches, the draft EU legislation does not prohibit trading activities being carried out within the banking group. Under the EU proposal, the separated trading activities may be carried out by a separate trading entity under the conditions explained below.

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 core credit institution. The proposal contains provisions to achieve this level of separation including the following:

1. a group which contains core credit institutions and trading entities shall be structured so that on a sub-consolidated basis two distinct sub-groups are created, only one of which contains core credit institutions;
2. only certain core credit institutions may hold capital instruments or voting rights in a trading entity (essentially, core credit institutions in groups that qualify as mutuals, cooperatives, saving institutions or similar) and only with the consent of the national regulator;
3. core credit institutions and trading entities shall issue their own debt, provided this is consistent with the group’s resolution strategy;
4. contracts between core credit institutions and trading entities shall be agreed on a third party basis;
5. requirements regarding members of the management bodies of both types of entities;
6. the names of core credit institutions and trading entities shall make clear whether they are core credit institutions or trading entities;
7. limits on the intra-group exposure a core credit institution has to any entity outside its sub-group; and
8. limits on the extra-group exposure a core credit institution can have to financial entities

The effect of the provision summarised at (2) above is that a core credit institution cannot be the top company in a banking group. Arguably, the effect of the provision summarised at (1) above and the requirement for legal, economic and operational separation is that a trading entity cannot be a top company either. If the effect of the EU proposal is to require a holding company to top all banking group structures, significant and costly structural reorganisation would be necessary in many banking groups. The requirement that the national regulator approve

The separation plan will mean that structural decisions such as this will be carefully scrutinised and this creates another possibility of regulatory inconsistency. Although the ECB will assume its full supervisory tasks from 4 November 2014, and will thus be the relevant prudential regulator for Eurozone banks 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 on-going day-to-day supervision of ‘significant supervised’ banks. As a result, the possibility of inconsistent national approaches must remain.

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.

1.4.6 THE EFFECT OF THE UK RING-FENCE

There is no regulatory discretion as regards the imposition of the Vickers ring-fence. The UK primary and secondary legislation will define the parameters of the ring-fence. It has already been explained that the UK primary legislation defines both the ring-fenced bodies and the core activity of accepting deposits. It has also been explained that secondary legislation specifies which institutions are excluded from the definition of a ring-fenced body and which deposits do not amount to core deposits so that they can be held outside the ring-fence. Legislation also sets out the activities in which ring-fenced bodies cannot engage.

The primary legislation provides that the regulated activity of dealing in investments as principal is an ‘excluded activity’ and may not be carried out by ring-fenced bodies except in circumstances specified by Her Majesty's Treasury. The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 contains additional excluded activities. It provides that dealing in commodities (e.g. precious metals, oil, agricultural products) is an excluded activity: this is intended to insulate ring-fenced bodies against swings in global commodity prices. In addition, a ring-fenced body is prohibited from using services provided through an inter-bank payment system unless the ring-fenced body is a direct participant or using services indirectly through an intermediary; from having a branch or a subsidiary (other than a non-financial services subsidiary) outside the European Economic Area; and from having exposures to financial institutions.

The Order also, however, creates exceptions to excluded activities. Thus ring-fenced bodies will be permitted to deal in investments as principal for the purpose of reducing exposure to specified risks; to acquire investments in exchange for a loan write-off; to acquire debentures issued by itself, its parent or one of its subsidiaries or from an issuer where the issuer structures its borrowing accordingly; to acquire shares in subsidiaries or companies in which it has a participating interest; and to use investments as security. Ring-fenced bodies may also trade where the other party to the transaction is a structured finance vehicle sponsored by the ring-fenced body itself; trade with central banks (so that they are not prevented from accessing central bank liquidity); and sell a narrow range of simple derivatives to their customers, such as interest rate swaps and simple FX options, as well as swaptions (to allow them to provide the basic risk-management services used by business customers) subject to conditions. There are also a number of exemptions from the prohibition on exposures to other financial institutions, including exposures that arise in relation to transactions entered into by ring-fenced bodies for risk-management purposes, intra-group transactions and payments exposures; exposures that arise in relation to trade finance; exposures that arise in a ring-fenced body's own sponsored structured finance

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63 Ibid., Article 20.
65 Op.cit, FSMA, Article 142D(2).
67 Ibid., Article 13.
68 Ibid., Article 20.
69 Ibid., Article 14.
70 Ibid., Article 6.
71 Ibid., Article 7.
72 Ibid., Article 8.
73 Ibid., Article 10.
74 Ibid., Articles 9, 11 and 12.
75 Ibid., Article 14.
76 Ibid., Article 15.
vehicle;\textsuperscript{77} exposures that arise for the purpose of conduit lending to a ring-fenced body's own special purpose vehicle ('SPV') or a SPV of an entity which is not a financial institution;\textsuperscript{79} exposures that arise in the course of repurchase agreements ('repos');\textsuperscript{79} or exposures that are ancillary to the provision of core services by the ring-fenced body.\textsuperscript{80}

Thus, although the UK primary legislation prohibits a ring-fenced body from carrying out almost any of the derivative and trading activity currently being carried out by wholesale and investment banks and the draft secondary legislation adds to the list of prohibited activities, there are wide ranging exemptions which are intended to ensure ring-fenced bodies are able to continue to provide banking and financial services to their core household and business client group in a cost effective manner.

The UK legislation does not prohibit the excluded activities being carried out by another entity (an investment bank) in the banking group. Initially, the ring-fenced body and the bank conducting the investment business may have common ownership or one may be the subsidiary of the other. There are a number of circumstances in which an individual ring-fence can be 'electrified' by the regulator, so that the ownership of a particular retail bank and investment bank are fully separated.\textsuperscript{81} These are essentially where the regulator is satisfied that the non-electrified ring-fence fails to achieve the aims of the legislation: the ring-fenced body is adversely affected by the acts or omissions of other group members; the ring-fenced-body is not sufficiently independent of the rest of the group; in the event of the insolvency of one or more group members, the ring-fenced body would be unable to carry on its core activities; or the conduct of the ring-fenced body or another member of its group is having, or is likely to have, an adverse effect on the objectives of the regulators. In these circumstances and under certain conditions, the regulator has the power to direct the parent company of a banking group to divest itself of specified subsidiaries (either the ring-fenced bank or any other group companies) or to require any regulated company within a banking group to dispose of specified assets and/or parts of its business. There are a number of procedural safeguards, including the right for the ring-fenced body to make written and oral representations and the need for the consent of HM Treasury, with which compliance is necessary before the regulator can exercise its group restructuring powers.

The Prudential Regulation Authority ('PRA') is mandated to make ring-fencing rules to ensure the integrity of the ring-fence and the independence of the ring-fenced body,\textsuperscript{82} but, at the time of writing, draft rules have yet to be published. The UK legislation requires that the rules ensure that the ring-fenced body is legally, economically and operationally independent so that its core activities are not adversely affected by the acts or omissions of other group members and it can, as far as reasonably practicable, continue to carry on such core activities in the event of the insolvency of one or more group members. Thus the mandate requires the PRA to make rules at least to ensure that the ring-fenced body must enter contracts with other members of the group on an arm's length basis; to restrict payments the ring-fenced body may make to other group members; to require the disclosure to the regulator of intra-group transactions; to ensure the independence of decision-making in the ring-fenced body; to ensure the ring-fenced body acts in accordance with a specified remuneration policy and human resources policy; and to ensure the ring-fenced body has arrangements to identify, monitor and manage risk. Although a conclusion cannot be reached until the detail of the UK rules is published, there appears little difference between the strength of the proposed EU ring-fence and the Vickers ring-fence.

The French and German legislation have a more narrow focus than the UK legislation and draft EU legislation. As most French and German banks are traditionally set up under a universal banking model, they regard a mandatory full separation of trading activities from retail banking activities as inconsistent with this model and the cost of full functional separation as disproportionate.

\textsuperscript{77} Ibid., Article 16.
\textsuperscript{78} Ibid., Article 17.
\textsuperscript{79} Ibid., Article 18.
\textsuperscript{80} Ibid., Article 19.
\textsuperscript{81} Ibid., Section 142H.
1.4.7 THE EFFECT OF THE FRENCH RING-FENCE

In essence, the French legislation amends existing banking legislation so as to require credit institutions, financial companies and mixed financial holding companies exceeding specified thresholds (yet to be determined, as explained above) to transfer certain trading activities to specialised trading subsidiaries. The targeted activities are trading in financial instruments carried out by credit institutions for their own account and unsecured transactions with leveraged AIFs, but in each case only to the extent that the activities exceed certain thresholds to be defined under secondary legislation.

There are a number of exceptions to the prohibition on proprietary trading including the provision of investment services to clients; clearing financial instruments; sound and prudent management of the cash of the banking group; intra-group financial or investment transactions; and hedging of the risks of the credit institution or its banking group (excluding the trading subsidiary) provided that the hedging results from the entity’s credit and market activities and the financial instruments used for the purpose of hedging have an economic link with the risk to be hedged. The main exception is, however, market-making which is permitted provided that the market-making activities remain below thresholds to be determined and assessed on a case-by-case basis depending on: (i) the net income of the relevant institution; and (ii) other indicators showing that the institution has a continuing and minimal presence on the financial markets: the thresholds and criteria will be defined in secondary legislation.

There is also an exception to the prohibition on unsecured transactions with leveraged AIFs. Transactions secured by a security benefitting the institution and which is found to be acceptable will be permitted: the criteria for the relevant security (in terms of liquidity and enforceability) will be defined in secondary legislation and assessed on a discretionary basis by the French banking regulator.

Neither the French nor German legislation contains the same granularity as the EU proposal or the anticipated UK rules. The French legislation prescribes what the trading entity can and cannot do. It must be subject to specific licensing from the French banking regulator. It must be able to be distinguished from its banking group and it cannot carry out any high frequency trading activities nor enter into OTC derivatives transactions on agricultural commodities. The trading entity must not be consolidated from a prudential perspective with its banking group.

1.4.8 THE EFFECT OF THE GERMAN RING-FENCE

The German legislation targets proprietary trading in financial instruments; trading for own account as a participant of an organised market or multilateral trading facility using high frequency trading; credit and guarantee business with hedge funds and other highly leveraged AIFs; and high-frequency trading. As with the French legislation, market-making is excluded from the prohibition but so is hedging of the risks of the entity or group which arise because of their exposure to client transactions, except for AIFs or their management companies; risk management in relation to interest rate, currency, liquidity or credit risks of the entity, group or those credit institutions and financial service providers that belong to the same institutional protection scheme within the meaning of Article 113 of the Capital Requirements Regulation; and transactions for the sale and purchase of long-term participations and transactions that are not entered into for the purpose of making profits by the short-term use of actual or expected differences between sale and purchase prices or a variation of market prices or interest rates.

If the threshold to which reference was made in the section above entitled Scope of the German Legislation is exceeded, the entity or group in scope of the German legislation must make a risk analysis of the business within six months and either terminate the prohibited business or transfer it to a separate financial trading entity. Even if the thresholds are not exceeded, the German regulator may prohibit credit institutions or entities within the scope of the Capital Requirements Regulation from carrying out the prohibited activities or other transactions in financial instruments which have a comparable risk profile, if these activities could jeopardise the solvency of the credit institution or entity.

83 Further conditions will be set out in secondary legislation.
The German trading entity is subject to specific licensing from the German banking regulator and subject to stricter supervision and stricter organisational requirements than banks generally. It is prohibited from carrying out certain banking activities including e-money business and payment system services. The German legislation requires the trading entity 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 and tax law.

1.5 Conclusion

The banking reform agenda is still in its infancy, although the US is ahead of its European counterparts. The Volcker rule conformance period is scheduled to terminate on 21 July 2015: the key requirement for all banking entities during the conformance period is to continue making good faith efforts to be in a position to comply with the Volcker rule by the end of the conformance period.

The UK, French and German primary legislation has been adopted but all three jurisdictions rely on secondary legislation to provide the detail behind the key policy choices set out in the primary legislation. The UK’s primary legislation is not yet in force but is expected to come into effect on 1 January 2019. The coming into force of the secondary legislation is staged: the provisions setting the parameters of the ring-fence will come into force on 1 January 2015 but the operative provisions setting out the obligations placed on banks come into force on the same date as the primary legislation. The French legislation was enacted on 26 July 2013 and is already in force. It requires the transfer of the relevant activities to have taken place by 1 July 2015: entities within scope were required to identify the activities that are to be transferred by 1 July 2014. The German legislation was also adopted in the summer of 2013 and will enter into force on 1 July 2015.

The Commission has set a timetable for the EU’s proposal on bank structural reform. Agreement on a final version of the legislation is not expected before June 2015 and, on this basis, the Commission’s 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. The EU is, however, a long way from agreement. The proposal must be adopted by the European Parliament and Council under the ordinary legislative procedure. Under this procedure the Council and the Parliament (as the co-legislature) are placed on an equal footing. 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 trilogues 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.

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. There are legal and political concerns about the derogation, but it seems unlikely that the Council will approve a version of the Commission’s proposal that does not go some way to appeasing the French and Germans. The primacy of EU law means that national legislation, which is inconsistent with EU law, must give way and the consequence of shared competence in financial services legislation means that Member States may exercise their competence only in so far as the EU has not exercised, or has decided not to exercise, its own competence.

Thus the consequence of a derogation for which only UK banks are eligible is that the French and German legislation must be repealed. Equally, the deletion of any derogation, option, waiver or exemption would mean that the UK legislation must be repealed. Either consequence seems unlikely. Yet there are problems with the derogation beyond the fact that only UK banks appear eligible to apply for it. The arbitrary cut-off period, the apparent 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 and the Commission vesting in itself the discretion to decide whether or not to grant the derogation, appear neither justifiable nor legally sound.
It appears likely, therefore, that the Council at least will make significant changes to the Commission’s proposal and there is a strong possibility that changes to appease the French and Germans will also preserve the Vickers ring-fence. The result of such a compromise, if accepted by the Parliament and Commission, would be the existence of numerous approaches to bank structural reform in the EU plus an additional approach in the US. The possibility of duplicative and conflicting requirements will be a concern for banks which are cross-border active 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 such a result would address the problem that the Commission itself identified of inconsistent national legislation. The different approaches could themselves 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 the legislation that the EU and Member States have already adopted in order to improve the resilience of banks and reduce the probability and impact of bank failure? What does the EU proposal add to the measures already in place which include banking union (the single supervisory mechanism\(^8\)) and the single resolution mechanism,\(^9\) new prudential requirements (the CRR/CRD IV),\(^10\) the EU legislation on bank recovery and resolution (BRRD),\(^11\) measures to better guarantee deposits (the recast DGSD), measures to improve the transparency and address the risks of derivatives (EMIR)\(^12\) and domestic bank structural reforms? What is the EU proposal really seeking to achieve and, given the need for compromise before any legislation will be adopted, are its goals attainable?

A parallel debate exists as regards which approach best achieves the commonly agreed primary aim of bank structural reform: the separation of retail banking services and taxpayers from the risks of wholesale and investment banking. The US and the UK legislature have accepted that any form of bank separation ‘involves a balance between the costs associated with losing synergies and the benefits of improving financial stability through separation’\(^13\). Failure to strike this balance would jeopardise the primary aim of structural reform or have too great an impact on the cost of retail and SME banking and bank lending, thereby having a detrimental impact on capital generation and the real economy. The need to strike such a balance explains the approach taken in the US and the UK: both approaches permit banking entities/ring-fenced bodies to continue to provide client-oriented financial services in an efficient manner, although they differ in their opinion of what services can be provided.

Ownership separation, as prescribed by the Volcker rule, is the most intrusive form of structural reform, but prima facie would appear best to meet the aim of structural reform. It could be argued that ownership separation best reduces both conflicts of interest and the risk of contagion spreading from the trading activities to traditional retail banking; but, if the requirement is only to separate a limited set of trading activities then the efficacy of even the most extreme form of separation is reduced. By permitting underwriting, market-making and asset management to remain on the banks’ balance sheets (albeit under strict conditions designed to manage and limit the risks associated with those services) for example, does the Volcker rule wholly isolate retail banking and taxpayers from the risks of trading activities?


\(^{90}\) Independent Commission on Banking, Final Report Recommendations (September 2011), p. 41.
In such circumstances, it could equally (and perhaps more persuasively) be argued that a less intensive form of separation, such as the functional subsidiarisation required by ring-fencing, which separates a broader range of activities (as is required in the UK and is advocated by the EU Commission), better protects depositors and taxpayers whilst also achieving the aims of reducing complexity and improving the resolvability of banks. The cost of such a broad focus could outweigh its benefits unless a proportionate approach is taken: thus, the UK secondary legislation seeks to ensure that the appropriate banks and deposits are within the ring-fence, that ring-fenced bodies can be organised in an orderly and effective way and that essential client services can still be provided efficiently.

The EU proposal attempts to strike a balance between these two approaches to structural reform but both aspects of its proposal are controversial, as explained above. It is, as has already been noted, far from clear what approach to bank structural reform any eventual EU legislation will adopt but there is a strong possibility that, in order to obtain the agreement of all Member States, the EU approach to bank structural reform will be less intensive, and thus have less chance of achieving its aim, than the US and UK approaches.

Thus it appears likely that the US and UK approaches to bank structural reform will remain the outliers. The argument as to which approach best strikes the balance between the costs and benefits of separating retail from wholesale and investment banking is unlikely to be resolved in the foreseeable future; however, this argument will be academic for the cross-border banks which will have to reconcile the different approaches and the global investment vehicles which may well have to consider different options for re-structuring in order to continue to secure bank investment.

Alexandria Carr
Of Counsel (Employed Barrister)
Direct Line: +44 (0)20 3130 3398
Mobile: +44 (0) 7957 761016
Email: acarr@mayerbrown.com