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European Union Banking Reform Update

By the end of this year, the European Commission will present its legislative proposals for EU banking structural reform. Once the proposals are implemented, EU banks will have to separate their "investment" business from "retail" business. The degree and nature of the required separation is still to be determined.

The European Commission's proposals will come on top of a number of other international developments in this area.

Some EU countries[1] already have begun implementing their own individual national approaches to bank restructuring. For example, the U.K. has begun implementing the Vickers Report, which sets out a number of bank structure separation recommendations. The U.K. Financial Services (Banking Reform) Bill is expected to become law by February 2014 with all relevant secondary legislation to be in place by May 2015 and final implementation by 2019.

In the U.S., there is no requirement that would require such separation for U.S. banks, although a proposed Federal Reserve rule would require non-U.S. banks operating in the U.S. to place their businesses that operate outside of the U.S. branch of the bank under a single U.S. holding company. This will require significant modification of many EU banks' U.S. businesses. The Volcker Rule's requirement that banks cease short-term proprietary trading contains no requirement that banks restructure their businesses.

The recent announcement by one global bank that it would ring fence its domestic banking business from other operations, subject to regulatory review and approval, may prove to be a model for other institutions contemplating similar requirements.

Michel Barnier, the European Internal Market and Services commissioner, is reported this week to have suggested that the European-level proposals may go further than certain national laws. Globally active banks will, therefore, need to determine what impact the Commission's proposals will have on their current plans and will need to identify the differences between the various EU and non-EU approaches, where relevant, in the U.S., Switzerland and Asia. Regulator-validated separation plans are likely to help mitigate the increase in regulatory capital requirements that major banks are dealing with. A harmonised approach in the EU may be welcomed, but there is a concern that major differences in approach from those in non-EU jurisdictions may emerge.

Given their imminence this alert sets out the background to the forthcoming European Commission legislative proposals.

The Liikanen Report

In October 2012, a high-level expert group chaired by Erkki Liikanen, governor of the Bank of Finland, published its recommendations on EU banking reform (the "Liikanen Report").

1 The U.K., Germany, France, Belgium and the Netherlands are in various stages of preparing such laws.

The group took into account the U.S. Volcker Rule and the U.K. Vickers Report when considering measures to:

- reduce the risk of the banking system as a whole;
- reduce the risks posed by individual firms to the financial system;
- reduce moral hazard;
- promote competition; and
- maintain the integrity of the internal market.

The Liikanen report made five main recommendations:

- **Mandatory Separation**: Proprietary trading and other significant trading activities reaching specified thresholds should be transferred to a separate legal entity. Both parts of a banking group should maintain separate ring-fenced capital, have separate funding and meet stand-alone prudential requirements. However, smaller banks would not be subject to the separation requirement;
- **Recovery and Resolution, Further Separation**: Banks should be required to draw up and maintain effective and realistic recovery and resolution plans, as proposed in the Recovery and Resolution Directive. National regulators should be allowed to require further separation of the "retail" bank if, following assessment of the plan, they consider it necessary to ensure the bank's resolvability;
- **Bail-in**: Banks should build up a sufficiently large layer of clearly defined "bail-inable" debt;
- **Capital Requirements:** More consistent treatment of risk in internal models and more robust risk weights should be applied to determine minimum capital requirements. The treatment of real estate lending should be reconsidered and maximum loan-to-value (and/or loan-to-income) ratios should be included in the instruments available for micro- and macro-prudential supervision; and
- **Governance**: Measures should be introduced to strengthen boards and management, promote the risk management function, restrict compensation, improve risk disclosure and strengthen regulatory sanctions.

European Commission consultation

In May 2013, the European Commission published a consultation paper on the Liikanen Report's structural separation recommendations.

The Commission considered how much discretion should be given to national regulators in determining whether the relevant thresholds requiring separation have been reached. For example, should the EU supervisor have discretion (subject to complying with EU technical standards)? Should their role be limited to evaluating whether the bank's scope is correct? Or, should they not have any discretion?

The Commission proposed three potential separation options:

- "Narrow" trading entity and "broad" deposit bank with a view to separating proprietary trading;

- "Medium" trading entity and "medium" deposit bank: separate proprietary trading and market making; or
- "Broad" trading entity and "narrow" deposit bank: separate all wholesale and investment banking activities. The trading entity, therefore, would engage in activities including the underwriting of securities, derivatives transactions and origination of securities, in addition to the activities mentioned above.

The Commission considered the strength of the separation and proposed three options:

- Functional separation with economic and governance links restricted according to current rules;
- Functional separation with tighter restrictions on economic and governance links; and
- Ownership separation, in which banking groups would not be allowed to engage in certain activities. They would accordingly have to divest any such activities that they currently engage in.

Other EU banking reform initiatives

There are a number of other EU banking reforms that are distinct from the Commission's policy proposals on banking structure:

- The EU is implementing the Basel III accord through the CRD IV process. Formal implementation of the enhanced capital and liquidity standards will take place between January 2014 and January 2019;
- The EU also is implementing a banking union in the Eurozone and in other EU countries that have not adopted the Euro that wish to opt in.[2] Banking union will see the European Central Bank take the leading supervisory role in the banking union, with input from EU national banking regulators. Banking union is expected to begin in November 2014;
- Banking union also requires a method of resolving banks which are failing. EU lawmakers are currently debating the terms and scope of the resolution framework, which is expected to be in place by 1 January 2015.

2 The U.K., Sweden and the Czech Republic have indicated that they will not join the EU banking union.