

## Part II – Legal Developments on EU Level

This part of the dissertation explores legal developments on a European Union level. In February 2012, the European Commission put in place a High-Level Expert Group (HLEG)<sup>350</sup> with the assignment of considering possible bank structural reforms for the European Union.<sup>351</sup> Eight months later, the Final Report of the HLEG (Liikanen Report)<sup>352</sup> set off the EU's undertaking of implementing a common approach on structural reform. In January 2014, the European Commission adopted its draft regulation<sup>353</sup> after reviewing the proposal, consulting stakeholders and conducting a comprehensive impact assessment.<sup>354</sup> According to the EU's legislative process, the next step following the submission of draft legislation by the European Commission would have been the adoption of a position by the European Parliament.<sup>355</sup> The events in the European Parliament, however, led to the situation that no position was adopted. The Council of the EU

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350 The official title of the expert group is “High Level Expert Group on reforming the structure of the EU banking sector”.

351 HLEG (2012) Liikanen Report, i.

352 The HLEG was chaired by Erkki Liikanen, Governor of the Bank of Finland.

353 *European Commission* (2014) Proposal for a Regulation.

354 *European Commission* (2014) Impact Assessment Part 1, 6–8.

355 The EU's bank structural reform was supposed to take the form of a regulation, as set down in Art. 288 Treaty on the Functioning of the European Union, C 326/47 (TFEU), and thus was exemplary for the general trend of the EU financial market law towards full harmonisation (see *Sester* (2015) *Neue Generation*, 420 et seqq. (describing the impact of the financial crisis on the EU's legislation, leading to a trend towards full harmonization); *Sester* (2018) *EU-Finanzmarktrecht*, 54–56). Art. 114 TFEU stipulates that the European Parliament and the Council of the EU shall adopt legislation concerning the internal market (see Art. 26 TFEU) according to the ordinary legislative procedure which is set down in Art. 289 TFEU: the European Parliament and the Council jointly adopt a regulation based on the proposal of the European Commission. The legislative procedure demands that after a European Commission's proposal, the European Parliament is to adopt a position in a first reading, which it then communicates to the Council of the EU. Depending on the Council of the EU's decision to approve or not approve this position, the legislative procedure continues (in case of a rejection the Council is to adopt its own position and to communicate it to the Parliament). As the European Parliament was not able to adopt its position, the legislative procedure was halted until finally being withdrawn.

made use of the possibility of adopting a general approach.<sup>356</sup> In late 2017, the European Commission made public its decision to withdraw the controversial file as part of its Work Programme 2018 and by that end, the legislative process.<sup>357</sup>

In spite of the withdrawal, research on the developments above continues to be of special importance, as they (i) have strongly influenced the academic and political discourse on structural reforms of banking both internationally and nationally and (ii) have considerably shaped already adopted national legislation. Due to the advanced stage of the legislative process, they will (iii) remain a benchmark for structural reform proposals in the EU and abroad. There is, furthermore, (iv) still the chance that parts of the structural reform file are adopted with other regulatory initiatives.<sup>358</sup> These likely orientate towards the discussed approaches.<sup>359</sup> Alternative options for introducing a union-wide ring-fencing requirement may set the foundation for a possible approximation of the EU's to the Swiss solution.

This part of the dissertation therefore discusses the contentious steps of the legislative process, the events in the European Parliament and the withdrawal by the European Commission, and subsequently explores alternative ways of introducing a union-wide ring-fencing requirement.

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356 The Council of the EU may issue a general approach, which is a political agreement reached by the Council before the European Parliament has adopted its position in the first reading. A general approach serves the goal of accelerating the legislative procedure and facilitating an agreement by informing the European Parliament of the Council's views, which would otherwise take the form of a Council's position. See <http://www.consilium.europa.eu/en/council-eu/decision-making/>; The general approach of the Council is therefore referred to as "negotiating stance", *Council of the EU* (2015) Negotiating Stance.

357 *European Commission* (2017) Commission Work Programme 2018: Annex 4, 2. The European Commission has yet limited its explanation for the withdrawal to the comment that there was "no foreseeable agreement" on the matter and that "the main financial stability rationale" had in the meantime been addressed by other regulatory measures. *European Commission* (2017) Commission Work Programme 2018: Annex 4, 2.

358 This applies for example to the negotiations on the EU intermediate parent undertaking (IPU), which is part of the CRR/II/CRD IV package. For a discussion of the EU IPU, see *Nemeczek/Pitz* (2016) Intermediate EU Parent Undertaking. See also the proposed amendments to CRDV, reflecting a (more stringent) European Commission's proposal, Chapter II.IV.C.b: Legislative options.

359 See e.g. the proposed amendments to CRDV, reflecting the Liikanen recommendations. See Chapter II.IV.C.b: Legislative options.

## I. Liikanen Report

This chapter enlarges on the findings of the HLEG considering structural reform of the EU banking sector. In a first step, these findings shall be presented. Subsequently, their reception by the various stakeholders shall be examined. Then they shall be discussed and put in perspective to the methods of ring-fencing established above.

### A. Mandate and structure

The HLEG's mandate commissioned it to “*consider in depth whether there is a need for structural reform [...] or not and to make any relevant proposals as appropriate, with the objective of establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy and the internal market*”. The HLEG was thereby instructed to take into account structural reform measures already proposed in the United States and the United Kingdom.<sup>360</sup>

The Liikanen Report outlines developments of the EU bank sector before and after the crisis,<sup>361</sup> and analyses the EU bank sector's composition.<sup>362</sup> It subsequently evaluates other regulatory reforms, such as Basel III, EMIR,<sup>363</sup> MiFID II<sup>364</sup> and BRRD. Many of them, however, were still at an early stage at the time of the report. Furthermore, it sums up other structural reform efforts of the time, namely the United States' Volcker Rule and the United Kingdom's Vickers Report.<sup>365</sup> Finally, it assesses the necessity of further reform and then presents its own structural reform proposal.<sup>366</sup>

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360 *European Commission* (2011) Mandate of the HLEG; *HLEG* (2012) Liikanen Report, i; See also *European Commission* (2014) Structural Reform Press Release.

361 See further *HLEG* (2012) Liikanen Report, 3 et seqq.

362 See further *HLEG* (2012) Liikanen Report, 32 et seqq.

363 EMIR's counterpart in Switzerland is the Financial Market Infrastructure Act. See Chapter I.II.C.c: Post-crisis response. On central counterparties and their emergence, see *Brändli* (2011) Zentrale Gegenpartei, 3 et seqq.

364 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, L 173/349 (MiFID II). MiFID II's counterpart in Switzerland is the Bundesgesetz über die Finanzdienstleistungen (Swiss Financial Services Act) which is yet to be adopted. See *Bundesrat* (2015) Gesetzesentwurf Fidleg.

365 See further *HLEG* (2012) Liikanen Report, 67 et seqq.

366 See further *HLEG* (2012) Liikanen Report, 88 et seqq.

The HLEG comes to the conclusion that further reform measures are needed to complement the reforms mentioned above, to further reduce the chance of bank failures, to further raise the chance of bank resolvability and to further avert tax payer bailouts.<sup>367</sup>

## B. Avenue 1

To achieve these goals, the HLEG developed two models of functional separation. Under the term “Avenue 1” the Liikanen Report presents, apart from increased capital requirements on trading activities, the “*separation of banking activities subject to a supervisory evaluation of the credibility of the recovery and resolution plans*”.<sup>368</sup>

### a. Outline

By making the separation conditional on the decision of a supervisory authority, structural separation is linked to the recovery and resolution plans (RRP) mandated by the BRRD. Banks with significant trading activity exceeding a certain threshold would need to prove to supervisors as part of their RRP that they are capable of separating retail banking activities from trading activities in case of distress. They would need to show that trading activities could be wound down without danger to the retail activities. The supervisor would then have to decide whether the RRP is credible. If an RRP is considered not credible, functional separation would come into force: banks would have to reallocate their trading activities into a separate legal entity. This entity would have to be legally, economically and operationally separate, and thus be allowed to fail. The remaining retail entity would be prohibited to engage in trading activities except liquidity management and own hedging.<sup>369</sup>

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367 HLEG (2012) Liikanen Report, 94.

368 HLEG (2012) Liikanen Report, 95–97.

369 HLEG (2012) Liikanen Report, 94–97.

b. Costs and benefits

The Liikanen Report addresses some benefits and potential costs of Avenue 1. In its favour, it argues that an evolutionary approach may be better suited to the continuing weakness of the financial system as discontinuities to the provision of financial services could be avoided. It would further give banks the chance of taking the initiative for structural reform themselves, while allowing supervisors to make the ultimate decision on banks' proposals. As some banks have endured the financial crisis without major problems, Avenue 1 would allow flexible decisions concerning individual banks and would avoid a separation in cases where it is not necessary. Furthermore, it is in line with other regulatory initiatives and is considered by the HLEG to complement them smoothly. The main criticism identified by the Liikanen Report is, apart from questions of the calibration of the capital requirements, that there may be difficulties establishing an even and harmonised implementation.<sup>370</sup>

C. Avenue 2

Under the term “Avenue 2” the Liikanen Report puts forth the model of structural reform that is favoured by the HLEG and which constitutes its final proposal. Similar to the structural reform model mentioned above, Avenue 2 establishes increased capital requirements on trading activities and their functional separation from the rest of the bank. However, unlike Avenue 1, the separation is mandatory and does not involve the decision of a supervisor.<sup>371</sup>

a. Outline

Banks that exceed a certain threshold would have to separate trading activities from the rest of the bank and place them in a legally, economically

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370 HLEG (2012) Liikanen Report, 97. This argument lost weight due to the common supervision and resolution, in particular for G-SIBs. (On the SSM and SRM, see Chapter II.II.A.a: Importance of a harmonized approach). The competence of ECB and SRB likely enhance the harmonised and consistent application of recovery and resolution, free from national biases. See e.g. *Binder* (2014) Resolution Planning, 20.

371 HLEG (2012) Liikanen Report, 97–98.

and operationally separate trading entity. This would be achieved by requirements such as separate capital bases, separate funding, individual responsibility for the compliance with prudential regulatory requirements, separate reporting, independent results and balance sheets, independent management and governance, and the necessity of transacting at arm's length. A holding company structure would be required to combine trading activities and commercial banking activities under the same roof.<sup>372</sup>

#### b. Costs and benefits

Also with respect to Avenue 2, the Liikanen Report addresses costs and benefits. The HLEG argues that the most effective way of tackling complexity, interconnectedness and implicit subsidies for trading activities remains their separation from commercial banking. A separation of balance sheets would also support recovery and resolution procedures by making it easier to get rid of the risky part in case of distress. Overall, bank structures would be more aligned with their activities, which would increase transparency for both the banks themselves and the regulators and would keep different management cultures apart. Once a bank is split up in a trading and a retail entity, further regulation such as activities restrictions would, moreover, be easier to impose. The main points of criticism, as presented by the Liikanen Report, are the apprehension that rules may be eroded over time and that they may not work as intended. Furthermore, the Report notes that the requirement of arm's length transactions between the different entities may be hard to enforce. Important additional arguments against mandatory separation are the difficulty of the task of identifying which activities must be separated and, in particular, the high costs arising by its implementation.<sup>373</sup>

#### c. Final proposal

In the proposal, the HLEG recommends the separation of “*proprietary trading and all assets or derivative positions incurred in the process of market-making*”.<sup>374</sup> These activities must be performed by the separate trading entity

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372 HLEG (2012) Liikanen Report, 98.

373 HLEG (2012) Liikanen Report, 98–99.

374 HLEG (2012) Liikanen Report, 101.

that can be constituted as an investment firm or bank. This entity alone would be allowed to engage in relationships with hedge funds, private equity funds and structured investment vehicles.<sup>375</sup> The Liikanen Report recommends that all other activities be allowed to remain with the rest of the bank, now the retail entity<sup>376</sup>, except if, for instance, RRP's demanded something else. Securities underwriting and certain hedging services would not have to be segregated, but closely monitored by supervisors. The trading entity would further be prohibited from accepting deposits and providing retail payment services, but could engage in all other banking services.<sup>377</sup>

Regarding the scope, the HLEG recommends introducing thresholds to ensure that mandatory separation would only be necessary “*if the activities to be separated amount to a significant share of a bank's business, or if the volume of these activities can be considered significant from the viewpoint of financial stability*”. It endorses a two-stage process: in the first stage, the focus is on banks' assets held for trading and available for sale. If they exceed a relative threshold of 15–25% or an absolute threshold of 100 billion €, those banks would proceed to the second stage. In the second stage, the trading activities that were to be separated are assessed. The HLEG handed it over to the Commission to calibrate an appropriate threshold, which would be a share of the banks' total assets. If activities to be separated exceed the share, all of these activities would need to be separated.<sup>378</sup>

#### D. Results and discussion

The following paragraphs first consider the reception of the HLEG's proposals by the various stakeholders. Subsequently, criticism by both supporters and opponents shall be discussed. Then, the underlying character

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375 “Any loans, loan commitments or unsecured credit exposures to hedge funds (including prime brokerage for hedge funds), SIVs and other such entities of comparable nature, as well as private equity investments, should be assigned to the trading entity”. HLEG (2012) Liikanen Report, 101. This definition implies that secured credit exposures, i.e. fully collateralised transactions are not prohibited for the retail entity. A similar exception exists in Germany, see Chapter III.IV.B.a.1: Excluded activities.

376 The Liikanen Report refers to the retail entity as “deposit bank”. HLEG (2012) Liikanen Report, 101.

377 HLEG (2012) Liikanen Report, 101–102.

378 HLEG (2012) Liikanen Report, v.

shall be explored and the method of RF proposed by the Liikanen Report identified.

#### a. Reception by stakeholders

The Liikanen Report has overall received rather positive responses from the press and the world of politics.<sup>379</sup> On March 6<sup>th</sup> 2013, the College of Commissioners discussed the need for structural reform and in particular the findings of the Liikanen Report. President Barroso noted “*broad consensus in favour of an approach at European level*”.<sup>380</sup> The European Parliament also welcomed the findings of the Liikanen Report, considering it a “*sound and welcome basis for structural reform*”<sup>381</sup> and almost unanimously<sup>382</sup> adopted a resolution welcoming the European Commission’s “*intention to bring forward a directive for structural reform of the EU banking sector*” in its Committee on Economic and Monetary Affairs.<sup>383</sup>

Although the Liikanen Report has been greeted by some as a “*step forward for EU banks*”<sup>384</sup> and “*a good second best*”<sup>385</sup> to a Glass-Steagall-oriented separation, it has also been criticised by both supporters and opponents of bank separation.

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379 See ZEW (2013) Trennbanken, 23–24. See also Wolf, Liikanen is at least a step forward for EU banks, *Financial Times* (October 4, 2012); *The Economist*, The Liikanen Review: Into the ring (October 6, 2012); Krahnen (2013) Rettung durch Regulierung?, 179 (pointing out that the banking industry predominantly rejected the recommendations of the Liikanen Report).

380 See *European Commission* (2013) Meeting of the Commission, 17–20. See also *European Commission* (2014) Impact Assessment Part 1, 6. Other commentators considered the European Commission’s response not as positive, e.g. *The Economist*, The Liikanen Review: Into the Ring, (October 6, 2012) (noting “*a cool reception from the European Commission, which says it wants to reflect on how they fit with its other regulatory proposals*”).

381 *European Parliament* (2013) Report on Structural Reform, 14.

382 The final vote of the committee resulted in 36 votes of consent, 3 dissenting votes and 4 abstained from voting. *European Parliament* (2013) Report on Structural Reform, 15.

383 *European Parliament* (2013) Report on Structural Reform, 8.

384 Wolf, Liikanen is at least a step forward for EU banks, *Financial Times* (October 4, 2012).

385 *Financial Times*, EU sets out vision for safer banking: Liikanen report on structural reforms is a promising start (October 3, 2012).



b. Criticism of the Liikanen Report

One of the main points of critique by supporters is the height of the threshold. For some commentators it has been set too high, missing in its scope a number of systemically important banks. Furthermore, as the European Commission is to specify the threshold, they argue that there is too much room left for banks to exercise pressure and thus to water it down.<sup>386</sup>

In addition, there is doubt about the permission for the retail entity to engage in hedging services for non-banking clients and securities underwriting, as they “*naturally belong to the ‘casino’ rather than the ‘deposit’ arm of a bank*”.<sup>387</sup> In this context, *Vickers* points out certain inconsistencies of the Liikanen Report, namely that securities underwriting in particular “*by its nature creates large exposures*”. These exposures are far higher than the ones of market making and regular derivatives trading, which are prohibited for the retail entity. He also notes that although relationships with hedge funds, private equity funds and structured investment vehicles are limited to the trading entity, the retail entity could still engage in a number of worrisome relationships with other kinds of financial institutions or non-European entities.<sup>388</sup>

Opponents, on the other hand, claim that costs for bank clients such as corporate bond issuers would increase. Furthermore, they argue that European banks would face a competitive disadvantage against banks from the United States, where structural reform is considered to be less stringent.<sup>389</sup> In relation to the threshold, they identify a different problem, namely that banks may be confronted with the incentive to retain trading activities beneath the thresholds, while engaging in riskier trades to keep up the ex-

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386 See *Wolf*, Liikanen is at least a step forward for EU banks, *Financial Times* (October 4, 2012); See *Financial Times*, EU sets out vision for safer banking: Liikanen report on structural reforms is a promising start (October 3, 2012).

387 *Financial Times*, EU sets out vision for safer banking: Liikanen report on structural reforms is a promising start (October 3, 2012). See also *Wolf*, Liikanen is at least a step forward for EU banks, *Financial Times* (October 4, 2012). In the UK, such transactions face limitations, see Chapter III.IV.A.b: Non-ring-fenced bodies.

388 *Vickers* (2012) Banking Reform, 19. See in this regard the prohibitions for certain transactions set down by the UK regime, Chapter III.IV.A.b: Non-ring-fenced bodies.

389 *Jenkins/Barker*, Big banks face hardest hit from ringfencing, *Financial Times* (October 2, 2012). See also *European Commission* (2012) Replies to the Consultation, 3.

pected return. They further identify uncertainties regarding the evaluation of the recovery and resolution plans of Avenue 1.<sup>390</sup> Other points of criticism are that the consistency of the different structural reforms in other countries (U.S. and UK) may not be ensured and that there is a lack of clarity regarding the implementation (for example with regard to the measurement of the thresholds).<sup>391</sup>

In the author's opinion, it could further be criticised that the Liikanen Report lacks explanation in some of its key points. Recollecting the HLEG's mandate, which included "*paying particular attention*" to other structural reforms, notably the Volcker Rule and the Vickers Report,<sup>392</sup> the HLEG's observations concerning them are of a rather basic form: first, the Liikanen Report provides merely an outline of both regulatory approaches. Only with regard to the Volcker Rule does it describe some concerns expressed by respondents during the consultation process.<sup>393</sup> Furthermore, there is no reflection on why the HLEG decided against those approaches, and where it detects the benefits that make its own proposal superior.<sup>394</sup>

Similarly, it can be criticised that the HLEG provides two avenues and rationale for each of them, but does not offer a substantial reasoning on why it considered Avenue 2 to be superior. A further explanation balancing the two avenues would have been desirable, making the HLEG's choice more transparent.

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390 See ZEW (2013) Trennbanken, 22–23 (pointing out uncertainties regarding the supervisory competence and noting that the HLEG stresses the need of a single supervisory authority). With the adoption of the Single Supervisory Mechanism, this fundament has been set. See Chapter II.II.A.a: Importance of a harmonized approach.

391 *European Commission* (2012) Replies to the Consultation, 3. This has been addressed by the European Commission (see Chapter II.II.E.e: Exemption for the United Kingdom) and the Council of the EU (see Chapter II.III.E.c: Exemption for the United Kingdom) in their proposals.

392 *European Commission* (2011) Mandate of the HLEG.

393 See HLEG (2012) Liikanen Report, 84.

394 More detailed considerations would likely have contributed better to a well-founded discussion of structural reforms. They would likely have prevented the European Commission from recommending measures the Liikanen commission did not consider worth pursuing, in particular the prohibition of proprietary trading. Enlightening in this regard is *Krahnen/Kemmerer* (2013) Gesprächsreihe Strukturreformen, 7, 18 (clarifying intentions of the Liikanen commission's recommendations).

c. Characterisation and method of ring-fencing

The Liikanen Report is clearly inspired by the Vickers Report's ring-fencing model and subsequent legal developments in the United Kingdom.<sup>395</sup> However, the Liikanen Report proposes a separation that works the other way around, namely a separation of risky activities from the rest of the bank. Since the separation is only relative – risky activities can still be performed from an independent trading entity, the Liikanen Report recommends the *containment method* of ring-fencing.<sup>396</sup>

In the author's opinion, the HLEG deserves acknowledgement for pioneering this form of ring-fencing, which presents a different approach than the one chosen by the ICB while maintaining many of its benefits. Particularly, it shows consideration for the universal banking model, as it does not propose a total ban on certain activities. Given the experiences with the Volcker Rule, it further seems sensible not to differentiate between proprietary trading and market making. Delimiting both activities has proven to be a considerable challenge.<sup>397</sup>

Although the European Commission did not fully pick up its recommendations, the Liikanen Report has had a course-setting impact on structural reform efforts on a national level, shaping ring-fencing laws across Europe.<sup>398</sup>

## II. Commission Draft Regulation

This chapter explores the European Commission's draft regulation,<sup>399</sup> which was adopted following the Liikanen proposal at the end of January

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395 On similarities and differences see e.g. *Vickers* (2012) Banking Reform, 19 et seq.

396 The Liikanen Report forces affected banks to separate activities which are considered risky. The separated trading entity is prohibited from providing desired activities such as deposit taking. This typically characterises the *containment method* of ring-fencing. See Chapter I.VI: Different Methods of Ring-Fencing.

397 See Chapter I.IV.D.a: Digression: The Volcker Rule. *Krahnen* describes the separation of market making as the “*potentially most important detail*” of the Liikanen Report. Own translation from German original, see *Krahnen* (2013) *Retung durch Regulierung?*, 174.

398 Germany and France in particular adopted legislation on the basis of the Liikanen Report. See *Lehmann* (2014) Ring-Fencing, 8–9; *Hardie/Macartney* (2016) EU Ring-Fencing, 512–513; Chapter III.II.C: Germany.

399 *European Commission* (2014) Proposal for a Regulation.

2014. As it provided the basis for the negotiations of the European Parliament and the Council of the European Union, it shall be presented in greater detail. To avoid redundancies, a critical evaluation shall be performed synchronously to its presentation. This chapter will, after an introduction, examine the draft regulation with a view to its key elements, namely its scope, the separation of proprietary trading and of other trading activities, and the bundle of provisions governing the strength of the separation. Concludingly, its underlying character and possible implications shall be analysed, its reception and criticism by the various stakeholders shall be discussed, and the method of ring-fencing decided on by the European Commission shall be identified.

## A. Introduction

### a. Importance of a harmonized approach

As several Member States had already implemented or were in the process of implementing their own structural reform,<sup>400</sup> the European Commission found a need for a harmonized European Union approach.<sup>401</sup> This was in particular to avoid regulatory arbitrage<sup>402</sup> and to make sure that banks could be supervised through the Single Supervisory Mechanism

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400 This includes Germany, France, the United Kingdom and Belgium. See e.g. *De Vogelaere* (2016) Bank Structure Reforms; *Binder* (2014) To ring-fence or not, and how?, 29 et seqq.

401 *European Commission* (2014) Proposal for a Regulation, 5.

402 The EU fundamental freedoms can facilitate regulatory arbitrage concerning national regulation: the freedom to provide services allows banks to offer financial services across the European Union. The freedom of establishment allows them to establish both subsidiaries – legally independent entities subject to the regulation of the Member State they are established in, and branches – legally dependent units of a bank subject to the regulation of the Member State their parent bank is established in, in every Member State. National legislation only applies to banks and subsidiaries that are established in the specific country. Branches of banks from other Member States are not covered. Therefore, there may be inconsistencies in a certain market when banks established in the Member State and subsidiaries, which are both covered by national regulation, compete against branches of banks established in other Member States, which are not covered by national regulation. Banks may be tempted to relocate and offer their services through a local branch to avoid regulation or move certain activities to Member States with more lenient legislation. *European Commission* (2014) Impact Assessment Part 1, 22–23.

(SSM)<sup>403</sup> on a consistent basis. Furthermore, the European Commission argued that the effectiveness of the Single Resolution Mechanism (SRM)<sup>404</sup> would make a harmonized approach necessary.<sup>405</sup>

Although a number of other EU financial sector reforms had already been launched and were at an advanced stage at the time of the adoption, the European Commission considered its draft regulation “*a critical part of the Union response to tackling the TBTF dilemma*”,<sup>406</sup> “*complement(ing) the overarching reforms already undertaken*”.<sup>407</sup>

This highlights how important the European Commission considered an EU-wide structural reform and is particularly interesting when compared to later messages reflecting the development towards a watered-down version,<sup>408</sup> ultimately even the withdrawal of the draft regulation.<sup>409</sup> At the time, the European Commission set a tone that has since been exerting pressure on law-making institutions, including, in particular, the European Commission itself. With the withdrawal and the brief explanation, the high hopes for structural reform have turned into a considerable loss of image and credibility for the European Union.

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403 The SSM constitutes the first pillar of the European Banking Union. It consists of national authorities of the euro area, national authorities of non-euro Member States that have chosen to participate in the SSM, and of the European Central Bank. It is in charge of the prudential supervision of all credit institutions in the participating Member States. If credit institutions fulfil certain criteria and thresholds, they are considered ‘significant’ and are thus supervised directly by the ECB (*European Central Bank* (2014) Banking Supervision, 4–5, 10–11). This direct supervision by the ECB applies to Europe’s biggest banks and as of April 1, 2017 includes 124 significant entities (*European Central Bank* (2017) List of supervised entities). The ECB’s direct supervision can be seen as part of a general trend of the EU towards full harmonisation, which can also be observed with regard to its legislation. See *Sester* (2015) *Neue Generation*, 420 et seqq.; *Sester* (2018) *EU-Finanzmarktrecht*, 54–56.

404 The SRM constitutes the second pillar of the European Banking Union. It aims at improving the management of a bank resolution through a Single Resolution Board (SRB) and a Single Resolution Fund (SRF). *European Commission* (2015) *Banking Union*, 2; On the functioning of the SRM, see e.g. *European Commission* (2015) *Single Resolution Mechanism*.

405 *European Commission* (2014) *Impact Assessment Part 1*, 22–25.

406 *European Commission* (2014) *Proposal for a Regulation*, 2.

407 *European Commission* (2014) *Structural Reform Press Release*.

b. Structure

The European Commission adopted its draft regulation after conducting two public stakeholder consultations and entering into discussion with Member States. Furthermore, an extensive impact assessment<sup>410</sup> was conducted and repeatedly revised.<sup>411</sup>

The draft regulation consists of three major elements that are to establish a common structural reform in Europe: firstly, as the European Commission targets only large banks, it establishes criteria and thresholds to identify the banks subject to the regulation. Secondly, the draft regulation stipulates a prohibition on proprietary trading. Thirdly, it mandates a potential separation of certain trading activities. This last element entails a great many other provisions governing the implementation and the upholding of the separation.<sup>412</sup>

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408 E.g. *European Commission* (2015) Speaking Notes of Commissioner Hill (in which Commissioner Hill speaks about the draft regulation on the occasion of the adoption of the Council of the EU's negotiating stance, saying "*I know this has not been a straightforward proposal, in some Member States in particular. The proposal was never aimed – although some thought it was – at calling into question the important role that universal banks play in supporting the financing of the wider economy. The text has changed substantially since the Commission's original proposal. [...] However, overall, we believe today's text is a reasonable and pragmatic compromise which forms a solid basis for future trilogues.*"); *European Commission* (2017) Commission Work Programme 2018: Annex 4 (in which the European Commission claims that "*the main financial stability rationale of the proposal has in the meantime been addressed by other regulatory measures in the banking sector and most notably the entry into force of the Banking Union's supervisory and resolution arms*").

409 *European Commission* (2017) Commission Work Programme 2018: Annex 4, 2. The limited explanation for the withdrawal provides a sharp contrast to the comprehensive work done on the file.

410 The impact assessment explains why the European Commission chose to adopt the draft regulation in its present form. Among other things, it considers existing structural reform, including legislation in Germany, France, the United States and the United Kingdom in detail and weighs them against each other. By doing that, it compensates for the lack of evaluation of the Liikanen Report, criticised in Chapter II.I.D.B: Criticism of the Liikanen Report. *European Commission* (2014) Impact Assessment Part 1, 34 et seq.; *European Commission* (2014) Impact Assessment Part 2, Annex A1.

411 *European Commission* (2014) Proposal for a Regulation, 3–4.

412 *European Commission* (2014) Proposal for a Regulation, 7–8.

## B. Scope of the draft regulation

The first elements of the draft regulation are the criteria and thresholds that identify the banks that are subject to its provisions. Art. 3 stipulates that the draft regulation applies to European banks that are identified as global systemically important institutions (GSIIs). It further applies to banks exceeding two thresholds for three consecutive years: the first threshold is fulfilled if a bank's total assets exceed 30 billion €. <sup>413</sup> The second threshold is fulfilled if a bank's total trading assets and liabilities <sup>414</sup> exceed 70 billion € or 10 percent of its total assets. <sup>415</sup>

In contrast to the Liikanen Report, <sup>416</sup> the draft regulation exempts all banks with total assets of less than 30 billion €. This general exemption allows for such banks to have a more trading-oriented business model. Even if trading assets and liabilities constitute a high percentage of such a bank's total assets, neither the prohibition of proprietary trading nor the conditional separation of trading activities apply.

The draft regulation casts a wide net <sup>417</sup> as it applies to Union credit institutions and their EU parents, their subsidiaries and branches, including in third countries. It further applies to EU branches and EU subsidiaries of banks established in third countries. <sup>418</sup>

## C. Separation of proprietary trading

### a. Prohibitions

The prohibition on proprietary trading is set down in Art. 6 in the second chapter of the draft regulation. <sup>419</sup> For the definition of proprietary trading,

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413 The threshold of 30 billion € also constitutes the threshold for the ECB supervision. See Chapter II.II.A.a: Importance of a harmonized approach.

414 Art. 22 and 23 of the draft regulation comprise rules on the calculation. Assets and liabilities of insurance and reinsurance undertakings and other non-financial undertakings are not included in the calculation. The EBA is called upon to draft implementing technical standards. See *European Commission* (2014) Proposal for a Regulation, Art. 22, 23.

415 *European Commission* (2014) Proposal for a Regulation, 7, Art. 3.

416 See Chapter II.I.C.c: Final proposal.

417 There are, however, possible exemptions set down in Art. 4; See *European Commission* (2014) Proposal for a Regulation, Art. 4.

418 *European Commission* (2014) Proposal for a Regulation, 7, Art. 3.

419 *European Commission* (2014) Proposal for a Regulation, Art. 6(1)(a).

it refers to Art. 5(4), which specifies proprietary trading as “*using own capital or borrowed money to take positions in any type of transaction to purchase [or] sell [...] any financial instrument or commodities for the sole purpose of making 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 [...] client activity, through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making [...]*”.<sup>420</sup>

To avert banks from bypassing the proprietary trading prohibition, they are also forbidden from engaging in certain relations with alternative investment funds,<sup>421</sup> in particular hedge funds and other entities engaging in proprietary trading.<sup>422</sup> In contrast to the Liikanen report however, there is no prohibition for loans or guarantee business with alternative investment funds.<sup>423</sup>

There are exemptions for trading in government bonds and cash management processes.<sup>424</sup>

## b. Discussion

It is remarkable that the European Commission chose to include a prohibition on proprietary trading – something that was not recommended by the Liikanen Report – and that it chose a very narrow definition,<sup>425</sup> especially compared to the U.S. Volcker Rule, which stipulates a much broader pro-

420 *European Commission* (2014) Proposal for a Regulation, Art. 5(4).

421 For a definition of „alternative investment funds“, the draft regulation refers to Art. 4(1)(a) Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010. Alternative investment funds include hedge funds, private equity funds, commodity funds, real estate funds and infrastructure funds. *European Commission* (2009) Alternative Investment Fund Managers, 2. However, Art. 6(3) of the draft regulation stipulates far reaching exemptions to unleveraged and closed-ended funds, mainly private equity, venture capital and social entrepreneurship funds, because of their relevance for financing the real economy. *European Commission* (2014) Proposal for a Regulation, 8.

422 *European Commission* (2014) Proposal for a Regulation, Art. 6(1)(b). This provision is clearly orientated towards the Volcker Rule’s prohibition on the relations with certain funds, see Chapter I.IV.D.a: Digression: The Volcker Rule.

423 See Chapter II.I.C.c: Final proposal; for the German Ring-fencing Act, see Chapter III.IV.B.a.1: Excluded activities.

424 *European Commission* (2014) Proposal for a Regulation, Art. 6(1)(a) and (b).

425 See *European Commission* (2014) Proposal for a Regulation, 8.



hibition.<sup>426</sup> As shown above, the draft regulation only prohibits trading on own account through sections of a bank that are “*specifically dedicated*” to such an activity. E contrario, all proprietary trading happening in other, not-specifically dedicated elements of a bank is not covered by the general prohibition.

This leads to the situation that the proposed prohibition per se would only have a limited force over bank’s business models of today, not only because of the very narrow scope,<sup>427</sup> but also because banks cut back on dedicated proprietary trading operations after the crisis.<sup>428</sup>

The European Commission itself finds this prohibition in its impact assessment to be of “*limited effectiveness*”. Nevertheless, it claims that the separation of additional trading activities would improve the effectiveness, as the supervisor would have the possibility to require the separation of further activities.<sup>429</sup>

The Commission chose this approach for practical reasons, namely because it acknowledges the difficulty of distinguishing between proprietary trading from other permitted activities such as treasury management or market making. It points out that a broad definition of proprietary trading would most likely have the undesired effects of identifying activities that should not have been identified and not identifying activities that should have been identified. A choice for a narrow definition therefore had its reason in the feasibility.<sup>430</sup>

For the advantage of the European Commission, it is to note that the proprietary trading prohibition may, in contrast to the reception of the Volcker Rule, be indeed less criticised for being “*frustratingly vague*”<sup>431</sup> and remains rather clear in its scope. By avoiding a too broad definition, regu-

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426 Chapter I.IV.D.a: Digression: The Volcker Rule; see also *Armour et al.* (2016) Financial Regulation, 524.

427 *Barker*, Banking groups push Brussels to ditch overhaul of big lenders, Financial Times (November 23, 2014).

428 This has also been acknowledged by the European Commission. However, it argues that the current cut back is far from a guarantee that proprietary trading will not increase again in the future. *European Commission* (2014) Impact Assessment Part 1, 45; *European Commission* (2014) Impact Assessment Part 3, 56, 248. See also *PwC* (2014) AFME: Bank Structural Reform Study, 7 (noting that “[a]lmost 90% of banks studied announced reductions in proprietary trading activities since the financial crisis, with over half exiting these businesses”).

429 See *European Commission* (2014) Impact Assessment Part 1, 62–63.

430 See *European Commission* (2014) Impact Assessment Part 1, 60–61; see also *Armour et al.* (2016) Financial Regulation, 524.

431 *Dombalagian* (2013) Proprietary Trading, 403.

lators are spared the difficult and possibly unreasonable unravelling of prohibited proprietary trading and permitted activities, in particular market making.<sup>432</sup> Whether this provision may achieve the desired effect or may be considered a farce, only application in practice would show.

#### D. The conditional separation of trading activities

The second major element of the European Commission's proposal for structural reform is the potential separation of certain trading activities. It is stipulated in the third chapter of the draft regulation.<sup>433</sup>

##### a. Trading activities

Art. 8 specifies activities that are not part of the trading activities and can therefore under no circumstances be separated. These include retail activities such as deposit-taking, retail lending and retail payment services. All other activities<sup>434</sup> are considered trading activities.<sup>435</sup>

This negative definition of trading activities comprises a large variety of activities. It grants the competent authority the competence to review a significant part of a bank's operations and thus contributes to the strong position of the authority.

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432 See Chapter I.II.B: Proprietary trading and market making.

433 *European Commission* (2014) Proposal for a Regulation, Chapter III.

434 There is an exemption for the buying and selling of European Union government bonds from the potential separation in Art. 8(2), that goes hand in hand with the exemption from the prohibition on proprietary trading stipulated in Art. 6(2). These exemptions are set down to “prevent possible negative consequences in these crucial markets” (*European Commission* (2014) Proposal for a Regulation, 8). It is beyond the scope of this dissertation to criticise these provisions. It should, however, be pointed out that comparable provisions existed already in the Glass-Steagall Act (See Chapter I.IV.C.a: Digression: The Glass-Steagall Act) and that they can also be found in the Volcker Rule. See Chapter I.IV.D.a: Digression: The Volcker Rule.

435 *European Commission* (2014) Proposal for a Regulation, Art. 8(1).

b. Review of trading activities

The draft regulation then tasks the competent authority with the review of these activities and highlights among them market making, investing in and acting as a sponsor for securitisation and trading in derivatives,<sup>436</sup> as these are activities particularly prone to risks. The competent authority – for systemically important banks included in the SSM, this would be the European Central Bank –<sup>437</sup> shall therefore use a number of metrics, including relative size of trading assets, leverage of trading assets, relative complexity of trading derivatives, relative profitability of trading income and the interconnectedness to assess the activities with regard to a separation. The measurement of these metrics shall be specified by the EBA,<sup>438</sup> and adopted by the European Commission as a delegated act.<sup>439</sup> There are, however, exemptions for risk management and the provision of risk management services to customers.<sup>440</sup>

The competence to separate market making is especially very controversial. It is a significant increase in scope and thus in strictness compared to approaches adopted in European Member States, namely Germany and France, after the Liikanen Report.<sup>441</sup>

c. Separation procedure

Art. 10 empowers the competent authority to separate trading activities by requiring the core credit institution, i.e. the deposit-taking entity,<sup>442</sup> to stop providing them. This decision can be made after a procedure stipulat-

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436 Investing in and acting as a sponsor for securitisation and trading in derivatives are activities that have especially contributed to the financial crisis (*European Commission* (2014) Proposal for a Regulation, 9). Market making is one of the activities that are especially close to proprietary trading and therefore difficult to distinguish. See *European Commission* (2014) Impact Assessment Part 1, 60.

437 See Chapter II.II.A.a: Importance of a harmonized approach.

438 *European Commission* (2014) Proposal for a Regulation, Art. 9(1), 9(2), 9(4).

439 *European Commission* (2014) Proposal for a Regulation, Art. 10(6).

440 *European Commission* (2014) Proposal for a Regulation, Art. 11–12.

441 *Barker*, EU bank reforms set out to reduce complexity and curb speculation, *Financial Times* (January 29, 2014). See also *Hardie/Macartney* (2016) EU Ring-Fencing, 504 et seqq. (discussing the question why France and Germany chose to pursue much softer ring-fencing laws); Chapter III.IV.B.a: Non-ring-fenced body.

442 See *European Commission* (2014) Proposal for a Regulation, Art. 5(16).

ed by the draft regulation: first, the review by the authority, described above, must reveal that the metrics are fulfilled, and the authority must “*deem [...] that there is a threat to the financial stability of the core credit institution or the Union financial system as a whole*”.<sup>443</sup> In a second step, the authority notifies the affected bank. Thirdly, the bank then has the chance to demonstrate that the reasons leading to the authority’s conclusion are not justified. Fourthly, the authority decides whether or not it accepts the demonstration of the bank. Fifthly, the authority states the reasons for its decision and publicly discloses it.<sup>444</sup>

If the review by the authority reveals that the metrics are not fulfilled, it can still initiate the procedure leading to the separation of a particular activity if it considers the activity to “*pose[] a threat to the financial stability of the core credit institution or the Union financial system as a whole*”.<sup>445</sup>

This provision is particularly notable as it allows the competent authority to engage a separation even if the metrics are not fulfilled. That means that an authority may also order a separation if it concludes that the financial stability is at risk and takes into account the rather imprecise objectives<sup>446</sup> of the draft regulation. This provision, therefore, provides the authority with wide discretion.

The authority’s decision to separate a bank is, therefore, an ultima ratio, applied only if the authority doubts the bank’s ability to manage its risk properly. *Krahnen/Noth/Schüwer* point out that the authority thereby has significant discretion in its decision-making, as the conditions for its intervention refer to financial stability in very general terms.<sup>447</sup>

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443 *European Commission* (2014) Proposal for a Regulation, Art. 10(1).

444 *European Commission* (2014) Proposal for a Regulation, Art. 10(3).

445 *European Commission* (2014) Proposal for a Regulation, Art. 10(2); see also the detailed explanation of the draft regulation, *European Commission* (2014) Proposal for a Regulation, 9. However, the wording of the draft regulation itself is somewhat obscure, as Art. 10(2) allows the competent authority to “*start the procedure leading to a decision as referred to in the third subparagraph of paragraph 3 [of Art. 10]*”, whereas the procedure leading to such a decision is stipulated in the second subparagraph. *European Commission* (2014) Proposal for a Regulation, Art. 10(2).

446 These objectives include, for example, the reduction of excessive risk-taking, the removal of conflict of interest, the reduction of interconnectedness, the facilitation of an orderly resolution and recovery. *European Commission* (2014) Proposal for a Regulation, Art. 1.

447 *Krahnen/Noth/Schüwer* (2016) Structural Reforms, 15.

## E. Rules following a separation

Art. 13 of the draft regulation stipulates that the trading entity has to be “*legally, economically and operationally separate [...] from the core credit institution*”,<sup>448</sup> but may remain in the same banking group. This provision gives rise to a number of questions and is in need of further determination. The following articles set down rules governing the strength of separation between the deposit-taking entity and the trading entity.

### a. Activities restrictions

The deposit-taking entity is naturally no longer allowed to perform the trading activities separated by the decision of the competent authority.<sup>449</sup> The draft regulation further stipulates a prohibition for the trading entity to engage in the activities of deposit-taking and payment services.<sup>450</sup>

### b. Subgroups

In case of separation, two subgroups have to be established which contain either only deposit-taking entities or only trading entities.<sup>451</sup> Both subgroups have to comply with prudential requirements of the CRR concerning own funds, capital requirements, large exposures, liquidity, leverage and disclosure on an individual basis.<sup>452</sup> They are further subject to large

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448 *European Commission* (2014) Proposal for a Regulation, Art. 13(1).

449 There are, however, exceptions, as the deposit-taking entity may continue to carry out certain trading activities: permitted are trading activities “*to the extent that the purpose is limited to only prudently managing its capital, liquidity and funding*”, i.e. for managing its own risk. Several safeguards, such as a limitation to certain derivatives, a specified remuneration policy and a duty to demonstrate that it is indeed hedging, shall prevent proprietary trading (*European Commission* (2014) Proposal for a Regulation, 9, Art. 11); Furthermore, the deposit-taking entity is allowed to provide certain risk management services to non-financial, non-banking clients. It is thereby limited regarding the potential customers, with regard to the potential financial instruments it may use, and with regard to the risks it may address. *European Commission* (2014) Proposal for a Regulation, 9–10, Art. 12.

450 *European Commission* (2014) Proposal for a Regulation, Art. 20.

451 *European Commission* (2014) Proposal for a Regulation, Art. 13(3).

452 *European Commission* (2014) Proposal for a Regulation, 10, Art. 13(11)–(13).

exposure limits<sup>453</sup> on both intra- and extra-group exposures, contributing significantly to the economic separation.<sup>454</sup> In addition, both subgroups are each to issue their own debt.<sup>455</sup>

These provisions increase the distance between deposit-taking entities and trading entities, and serve the goal of making the former more resistant to dangers of the latter (for example by limiting their exposure to each other). They also enforce that trading entities can be excluded from implicit subsidies of the deposit-taking entities. Furthermore, the provision that both subgroups would need to comply with the CRR's capital standards traps capital and would significantly shrink<sup>456</sup> the activities of the trading entity.

### c. Exercise of power

A deposit-taking entity is not allowed to hold voting rights or capital instruments in a trading entity.<sup>457</sup> They may enter into contractual relations, but only on arm's length basis, i.e. they "*shall be as favourable to the core credit institution as are comparable contracts and transactions with [...] entities not belonging to the same sub-group*".<sup>458</sup>

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453 Large exposure limits aim at preventing institutions from suffering disproportionately large losses following the failure of an individual client or a group of connected clients. See *European Banking Authority*, Large exposures and structural measures, <https://www.eba.europa.eu/regulation-and-policy/large-exposure-s>.

454 *European Commission* (2014) Proposal for a Regulation, 10, Art. 14, 15.

455 *European Commission* (2014) Proposal for a Regulation, Art. 13(6).

456 See for an example of how far-reaching the effects of the need to comply with capital standards on an individual basis on the scale of trading activities can be (*Blundell-Wignall/Atkinson/Roulet* (2013) Bank Business Models, 78–80). *PwC* conducted a study for the bank interest group *AFME* in which it came to the same conclusion. However, in contrast to *Blundell-Wignall/Atkinson/Roulet*, it considers its findings detrimental to the public good: if trading entities face higher funding and capital costs, banks would not be able to offer market making services at today's conditions. This, in turn would reduce the number of market makers and liquidity in the market, which would then lead to higher costs for corporate borrowers in the corporate bond markets. See *PwC* (2014) Bank Structural Reforms, 51 et seqq.

457 *European Commission* (2014) Proposal for a Regulation, Art. 13(5).

458 *European Commission* (2014) Proposal for a Regulation, Art. 13(7).

Furthermore, the management body<sup>459</sup> of the deposit-taking entity and the trading entity shall not be composed of the same persons, but shall each consist of a majority of persons not engaged in the managing body of the other entity. No member of the management body, apart from the parent undertaking's risk management officer, shall occupy an executive function in both entities.<sup>460</sup> In addition, the management bodies of all entities of the group just mentioned, including the parent, are under the obligation to “*uphold the objectives of the separation*”.<sup>461</sup>

#### d. Designation

The separation of the two entities is further emphasized by a provision stipulating that the character of each entity has to be reflected in its designation, so that “*the public can easily identify which entity is a trading entity and which entity is a core credit institution*”.<sup>462</sup>

This provision is especially interesting. It shows that the independency of the two entities shall also be emphasized in their appearance before the public. The effect of such a designation should not be underestimated.

#### e. Exemption for the United Kingdom

Art. 21 allows for a derogation of the third chapter of the draft regulation, i.e. the separation of trading activities. A credit institution that takes deposits can be excluded from the provisions concerning separation if it is “*subject to national primary legislation adopted before 29 January 2014*” and if

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459 The term “management body” is defined in Art. 3(1)(7) of the CRDIV Directive (Directive 2013/36/EU). It refers to “*an institution's body or bodies, [...] which are empowered to set the institution's strategy, objectives and overall direction, and which oversee and monitor management decision-making, and include the persons who effectively direct the business of the institution*”. European Commission (2014) Impact Assessment Part 3, 99 Fn 98.

460 European Commission (2014) Proposal for a Regulation, Art. 13(8).

461 European Commission (2014) Proposal for a Regulation, Art. 13(9). This provision resembles the prohibitions on the sharing of personnel of the Glass Steagall Act (see Chapter I.IV.C.a: Digression: The Glass-Steagall Act). The management body, particularly executive functions, has significant influence on the conduct of an entity. Conflicts of interest can be avoided only through a truly independent management body.

462 European Commission (2014) Proposal for a Regulation, Art. 13(10).

several criteria are met. The European Commission decides on the request of the Member State.<sup>463</sup> For third countries, Art. 27 stipulates that the European Commission may regard their legal situation as equivalent to the requirements of the draft regulation.<sup>464</sup>

## F. Results and discussion

The following paragraphs characterise the draft regulation with regard to other structural reforms, in particular the proposal of the Liikanen Report. Subsequently the implications of its adoption as proposed by the European Commission, shall be assessed. In a third step it shall be explored how the draft regulation has been perceived by stakeholders. Concludingly, the method of ring-fencing chosen by the Commission shall be identified.

### a. Characterisation

In summary, it can be found that the European Commission decided against the main proposal (Avenue 2) of the Liikanen Report: in contrast to the HLEG's recommendations, the draft regulation does not stipulate a mandatory separation of trading activities: the Commission chose to empower the competent authority to decide about it. This may be understood as a watered-down approach that is more lenient than the Liikanen proposal;<sup>465</sup> it may, however, also be understood as a more flexible approach that allows for a tailor-made assessment of each bank subject to the regulation.

With regard to proprietary trading and relations with certain funds, the draft regulation stipulates an *activities ban* for the whole banking group. It thereby strikes out in a new direction orientating towards the United States' Volcker Rule. As pointed out above, the draft regulation, however,

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463 *European Commission* (2014) Proposal for a Regulation, Art. 21. This provision is tailored to the UK ring-fencing regime (other Member States that had at the time implemented structural reforms, e.g. Germany, are not within its scope). It addresses the risk that banks in the UK could be affected by both national and transnational bank structural reform and thus required to split into three parts. See e.g. *Haynes* (2015) Banking Reform, 122–133.

464 *European Commission* (2014) Proposal for a Regulation, Art. 27.

465 See e.g. *Barker*, EU bank reforms set out to reduce complexity and curb speculation, *Financial Times* (January 29, 2014); *Jenkins*, Ringfencing will make it harder to wind up failing banks, *The Financial Times* (January 29, 2014).



differs from it by prohibiting proprietary trading only in specifically dedicated units of the bank, i.e. it does not attempt to define proprietary trading functionally.

Considering that the potential separation of trading activities is subject to the competent authority's decision, the European Commission decided to follow the Liikanen Report's Avenue 1. As *Krahnen/Noth/Schüwer* put it, the draft regulation therefore “combines the logic of Liikanen's Avenue 1 [...] with the Volcker Rule”.<sup>466</sup>

## b. Implications

The European Commission's decision to create a more enforcement-based approach, conforming to Liikanen Avenue 1, may lead to a similar result as the mandatory separation proposed by the HLEG in Avenue 2: *Krahnen* emphasizes that one should not be fooled by the limited reach of the draft regulation, separating only proprietary trading, “At second sight [...] [the draft regulation] may prove to be more effective than many believe today”, as the competent authority may end up exercising a lot of influence on the structure of banks through its risk assessment. Although the risk assessment is not specified in the draft regulation, he expects the competent authority to have a lot of discretion in its decision-making. As part of the risk assessment, the competent authority would require banks to prepare effective recovery and resolution plans.<sup>467</sup>

Because transparency and planning security is of utmost importance to both the competent authority and banks themselves, banks may therefore implement structures that almost achieve factual separation of trading activities themselves, even if it has not been demanded from them by the competent authority. Therefore, in case of an implementation of the draft regulation it may be possible that “there will be a factual separation in the self-interest of financial institutions, rather than a forced one”.<sup>468</sup>

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466 *Krahnen/Noth/Schüwer* (2016) Structural Reforms, 15.

467 See *Krahnen* (2014) Structural Reform, 2 (“The fencing of trading business from other banking activities may play a crucial role in signalling stability and resolvability vis-à-vis the supervisor”).

468 *Krahnen* (2014) Structural Reform, 2. This form of separation has a lot in common with the Swiss approach. See Chapter III.IV.C: Switzerland.

c. Reception and criticism

The draft regulation was welcomed with mixed emotions by stakeholders. Germany and France expressed their concern that its measures are too stringent and therefore might hurt the economy and lead to a relocation of activities to the shadow banking sector.<sup>469</sup> The United Kingdom also took an opposing stance against the draft.<sup>470</sup>

The fact that the European Commission adopted the draft regulation shortly before the European Parliament breaks for election, thus at a very inconvenient time in the EU legislative calendar, was criticised heavily by Members of Parliament.<sup>471</sup> Furthermore, the draft regulation is not supported by all Members of Parliament and was criticised by some to be a “purely symbolic political act”.<sup>472</sup>

Representatives of the industry warned that the draft regulation could prove disruptive and damaging to both banks and the economy.<sup>473</sup> Furthermore, they criticised that the draft regulation was inconsistent with the European Commission’s aim to ensure the flow of credit to the real economy, supporting the Capital Market Union (in particular because of the looming separation of market making), and to abstain from excess EU interventions. Banks were said to have become much safer, making further reform unnecessary. Moreover, data from the European Commission’s impact assessment was considered outdated and it was pointed out that in some Member States, national structural reform legislation had already been implemented.<sup>474</sup> The *Association for Financial Markets in Europe*

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469 *Barker*, EU bank reforms set out to reduce complexity and curb speculation, Financial Times (January 29, 2014).

470 *Barker*, EU’s Hill considers shelving bank structural reforms, Financial Times (December 4, 2014).

471 *Barker*, EU bank reforms set out to reduce complexity and curb speculation, Financial Times (January 29, 2014).

472 *Barker*, Europe set to ease reform on bank splits, Financial Times (January 5, 2014).

473 *Barker*, EU bank reforms set out to reduce complexity and curb speculation, Financial Times (January 29, 2014).

474 *Barker*, Banking groups push Brussels to ditch overhaul of big lenders, Financial Times (November 23, 2014). See *British Bankers’ Association/Federation Bancaire Française*, Letter to Frans Timmermans, First Vice President Better Regulation, Interinstitutional Relations, the Rule of Law and Charter of Fundamental Rights, (November 13, 2014), <http://www.fbf.fr/fr/files/9R6M5Q/Letter-EU-Structural-Reform-Better-Regulation.pdf>.

(AFME),<sup>475</sup> one of the most active lobbying groups concerning the EU's structural reform, commissioned PwC to conduct an extensive study on the consequences of an implementation of the draft regulation. The study's findings<sup>476</sup> supported the interest group's claims mentioned above.<sup>477</sup> Furthermore, it was argued that the draft regulation would lead to significant disadvantage for European banks' competition, in particular with regard to U.S. banks, and would harm Europe's "economic sovereignty".<sup>478</sup>

Opponent interest groups such as *Finance Watch*,<sup>479</sup> on the other hand, contested most of these arguments and argued that separation would, on the contrary to bank interest group claims, lead to numerous benefits, such as cheaper funding and a better functioning Capital Markets Union.<sup>480</sup>

The draft regulation was further hit by a change of personnel in the European Commission, with *Jonathan Hill*<sup>481</sup> succeeding *Michael Barnier* as Commissioner responsible for Financial Stability, Financial Services and Capital Markets Union. *Jonathan Hill* was called upon by banks to recon-

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475 <http://www.afme.eu>.

476 Among other things, the study found that the draft regulation would entail significant costs for companies interested in borrowing, and would have a detrimental effect on economic growth and jobs in the EU. It would further reduce the number of viable capital market banks, decrease market liquidity and would increase end-user costs. Furthermore, it found that implicit subsidies that were "once considerable" are now "statistically insignificant" and concluded, that "while costs [...] are clearly substantial", "it is much harder to quantify incremental benefits". PwC (2014) Bank Structural Reforms, 1–3.

477 PwC (2014) Bank Structural Reforms, 1–3.

478 See opinion by Frédéric Oudéa, CEO of Société Générale and president of the European Banking Federation, *Oudéa*, Europe needs homegrown bulge bracket banks, *Financial Times* (October 11, 2015). As a response, *Finance Watch* noted they "[understood] concerns among big banks about competitiveness, but Europe's need for sustainable prosperity must come first". Big banks should "recognise financial stability as a prerequisite for sustainable growth and job creation in the rest of the economy". See opinion by *Christophe Nijdam*, Secretary General of *Finance Watch*, *Nijdam*, Need for sustainable prosperity comes first, *Financial Times* (October 15, 2015).

479 <http://www.finance-watch.org/home>.

480 See *Lallemand*, Bank Reforms will help lift Europe's struggling economy, *Financial Times* (November 26, 2014).

481 *Jonathan Hill* was European Commissioner from 2014 to 2016 (*European Commission*, Jonathan Hill, [http://ec.europa.eu/commission/2014-2019/hill\\_en](http://ec.europa.eu/commission/2014-2019/hill_en)). He resigned in the aftermath of Brexit. *Rankin*, UK's European Commissioner quits in wake of Brexit vote, *The Guardian* (June 25, 2016).

sider the draft regulation, which took form under his predecessor.<sup>482</sup> Indeed, *Hill* already considered a withdrawal in November 2014 but decided to await future developments.<sup>483</sup>

d. Method of ring-fencing

Considering the question which method of ring-fencing the draft regulation represents, one comes to the conclusion that the European Commission decided for the *containment method*, because it chose to separate risky activities from the rest of the bank. It is, however, enforcement-based: similarly to the Liikanen Report – although dependent on an authority’s decision –, the draft regulation stipulates in its third chapter that trading activities can be separated and assigned to a trading entity. In particular Art. 13 to Art. 17, presented above, enable the trading entity to be legally, economically and operationally separate. All other activities can be performed by the now ring-fenced entity. Art. 20 of the draft regulation stipulates a prohibition on desired activities for the trading entity, thereby completing the model.

However, the European Commission further proposed a prohibition on proprietary trading in the second chapter of the draft regulation, which took the form of an outright ban. The mandatory segregation of designated proprietary trading from the banking group as a whole qualifies as an *activities ban* of full separation.

In conclusion, it can be noted that the European Commission’s proposal is characterised by an enforcement-based *containment method* of ring-fencing in combination with an *activities ban* concerning proprietary trading.

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482 *Barker*, Banking groups push Brussels to ditch overhaul of big lenders, Financial Times (November 23, 2014).

483 *Barker*, EU’s Hill considers shelving bank structural reforms, Financial Times (December 4, 2014); See, in particular, *Hill*, Letter to Frans Timmermans, (November 18, 2014) [http://www.eunews.it/wp-content/uploads/2014/12/Letter-to-VP-Timmermans\\_Hill.pdf](http://www.eunews.it/wp-content/uploads/2014/12/Letter-to-VP-Timmermans_Hill.pdf).

### III. Council of the European Union Negotiating Stance

This chapter addresses the negotiating stance of the Council of the European Union.<sup>484</sup> It presents and assesses its main modifications of the European Commission's draft regulation. In conclusion, the results shall be summed up and the concept of RF chosen by the representatives of the European Member States shall be identified.

#### A. Introduction

On June 19th 2015, the Council of the European Union adopted its negotiating stance on the EU bank structural reform. It is based on draft regulation of the European Commission and provides the foundation for the negotiations with the European Parliament. If the European Parliament had adopted its position, negotiations would have commenced.<sup>485</sup> As the European Parliament did not reach agreement on its own position, the negotiating stance of the Council remains the most recent step in the almost tragic story of the European Union bank structural reform.

The Council claims to “*aim[] at strengthening financial stability by protecting the deposit-taking business of the largest and most complex EU banks from potentially risky trading activities*”.<sup>486</sup> Identically to the draft regulation, the negotiating stance acknowledges the still pending too-big-to-fail problem of “*a limited subset of the largest and most complex Union banking groups*”, which requires structural reform as a complement to the ongoing banking regulatory reform agenda.<sup>487</sup> However, the negotiating stance comprises a number of important modifications to the draft regulation, leading to a much softer proposal.

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484 For better readability and in line with the Council's own terminology, this dissertation refers to the general approach as “negotiating stance” (see *Council of the EU* (2015) Restructuring Risky Banks Press Release). As explained above, a general approach is a position of the Council, already adopted during the first reading. It will serve as the Council Presidency's negotiating mandate in the negotiations with the European Parliament on the final version of the regulation *Council of the EU*, Structural reform of EU banking sector: improving the resilience of credit institutions, <http://www.consilium.europa.eu/en/policies/banking-structural-reform/>.

485 *Council of the EU* (2015) Restructuring Risky Banks Press Release.

486 *Council of the EU* (2015) ECOFIN Council Meeting, 4.

487 *Council of the EU* (2015) Negotiating Stance, 4; *European Commission* (2014) Proposal for a Regulation, 14.

## B. Scope

The negotiating stance identifies entities that are to be covered by its provisions and subsequently allocates them into two tiers. While the scope remains unchanged regarding the Commission's draft regulation,<sup>488</sup> the introduction of tiers is a new feature.

### a. Tiers

The negotiating stance's tiers are based on the size of an entity's trading activities and on the presence of excessive risks: if an entity's trading activities<sup>489</sup> have exceeded 100 billion € over the last three years, it is automatically included into Tier 2.<sup>490</sup> This provision is aimed at banks with especially large trading activities. Entities with smaller trading activities can be included into Tier 2 if an assessment reveals the presence of excessive risks.<sup>491</sup> All other entities are included into Tier 1.<sup>492</sup>

The allocation of banks into different tiers correlates with different efforts of supervision: an entity included into Tier 2 has to comply with a broader assessment of its trading activities and stricter reporting requirements.<sup>493</sup>

### b. Negative scope

Furthermore, the negative scope, which stipulates exemptions from the proposed regulation, was changed by the Council by adding exemptions to the draft regulation.

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488 Although the wording of the scope has changed compared to the draft regulation, there are no significant changes concerning the scope. In particular, the thresholds and the link to the qualification of being a G-SII has stayed exactly the same. See *Council of the EU* (2015) Negotiating Stance, Art. 3; *European Commission* (2014) Proposal for a Regulation, Art. 3.

489 The calculation of the trading activities follows the provisions of the European Commission's draft regulation. See *European Commission* (2014) Proposal for a Regulation, Art. 23; *Council of the EU* (2015) Negotiating Stance, Art. 3b.

490 *Council of the EU* (2015) Negotiating Stance, Art. 4a(2).

491 See *Council of the EU* (2015) Negotiating Stance, Art. 8(4).

492 *Council of the EU* (2015) Negotiating Stance, Art. 4a(3).

493 See *Council of the EU* (2015) Negotiating Stance, Art. 6b, 8a.

Art. 4(1)(d) and (e) set forth exemptions both for groups with at least one credit institution established or authorised in the European Union as well as for credit institutions that are neither a parent undertaking nor a subsidiary, if they fulfil at least one of two conditions: if they either hold total eligible deposits of less than three per cent of their total assets or if their total eligible retail deposits amount to less than 35 billion euros.<sup>494</sup>

This provision is aimed at banks that only engage in deposit-taking to a limited extent, either in relation to their balance sheets or in total numbers. This arguably refers to big investment banks that do not engage in retail banking,<sup>495</sup> presumably in particular to non-EU investment banks operating from the UK.<sup>496</sup>

## C. Separation of proprietary trading

### a. Mandatory separation

One of the most important changes is the handling of proprietary trading.<sup>497</sup> In contrast to the draft regulation, proprietary trading is not prohibited by the negotiating stance. Instead of a total ban from the banking group as a whole, proprietary trading can be performed in a trading entity that is legally, economically and operationally separate from core credit institutions.<sup>498</sup> This is effected by the Council opting in Art. 6 for a mandatory separation from the core credit institution,<sup>499</sup> i.e. the deposit-taking entity.

Regarding the prohibition of relations with certain funds, the negotiating stance emphasizes that it only covers funds employing leverage on a substantial basis.<sup>500</sup> Similarly to proprietary trading, they can, however, be

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494 *Council of the EU* (2015) Negotiating Stance, Art. 4(1)(d), 4(1)(e).

495 *BBVA Research* (2015) Financial Regulation Outlook, 5.

496 *Barker*, EU finance ministers back drive to tackle ‘too big to fail’ banks, *Financial Times* (June 19, 2015).

497 However, the perception of its quality remains unchanged, as the negotiating stance states that it has “*limited or no added value for the public good and [...] [is] inherently risky*”. *Council of the EU* (2015) Negotiating Stance, 9.

498 *Council of the EU* (2015) Negotiating Stance, 9.

499 *Council of the EU* (2015) Negotiating Stance, Art. 6(1)(a).

500 *Council of the EU* (2015) Negotiating Stance, Art. 6(1)(b) (referring for a definition of “substantial basis” to Art. 111 of the Commission Delegated Regulation (EU) No. 231/2013, which uses the term, if exposure of a fund exceeds three times its net asset value).

conducted in a trading entity. Furthermore, the fully collateralized loans and guarantee business is not prohibited.<sup>501</sup>

b. Three-step procedure

This separation is enforced in a three-step procedure: first, core credit institutions are prohibited from performing proprietary trading and from certain relations with funds. Second, several activities close to proprietary trading are exempted. It is clarified in the process that they do not constitute proprietary trading. Third, to make sure the core credit institution does not engage in proprietary trading, a procedure to identify the activity and require the core credit institution to cease it, is created.

1. First step: prohibition of proprietary trading

As described above, the first step is the mandatory separation of proprietary trading, which is achieved by a prohibition for core credit institutions to perform it.<sup>502</sup> Regarding its definition, the negotiating stance only slightly changes the wording of the draft regulation; however, it omits an important part: the European Commission limited its prohibition of proprietary trading to sections of a bank which are specifically dedicated to perform such activities.<sup>503</sup> This limitation was dropped by the Council, leading to a much broader definition of proprietary trading,<sup>504</sup> which

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501 See *Council of the EU* (2015) Negotiating Stance, Art. 6(1)(b)(iv). A similar exemption was introduced in Germany by BaFin. See Chapter III.IV.B.a.1: Excluded activities.

502 “A core credit institution shall not: (a) engage in proprietary trading”. *Council of the EU* (2015) Negotiating Stance, Art. 6(1)(a).

503 “[...] through the use of desks, units, divisions or individual traders specifically dedicated to such position taking and profit making, [...]” *European Commission* (2014) Proposal for a Regulation, Art. 5(4). See also Chapter II.II.C: Separation of proprietary trading.

504 Proprietary trading is, therefore, defined as “using own capital or borrowed money to enter into any type of transaction to purchase, sell or otherwise acquire or dispose of any financial instrument or commodities 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 result of actual or anticipated client activity”. *Council of the EU* (2015) Negotiating Stance, Art. 5(4). Apart from the omission described above, only a minor change in the wording can be found.



again leads to a much broader prohibition. Relations with certain funds are also prohibited for the core credit institution.<sup>505</sup>

## 2. Second step: exemptions

The negotiating stance then explicitly stipulates several activities that are not to be considered proprietary trading, including the provision of funding, hedging, investment services to clients, market making and the buying and selling of financial instruments acquired for long term investment purposes.<sup>506</sup>

These activities, in particular market making, are difficult to distinguish from proprietary trading.<sup>507</sup> By broadening the scope of the definition, the problem arises that proprietary trading is very hard to distinguish from the other trading activities.<sup>508</sup>

## 3. Third step: identification procedure

As a result, core credit institutions have to provide “*detailed reporting*” on these activities “*to demonstrate that they do not constitute proprietary trading*”. Competent authorities have to perform an assessment and order the credit institution to “*cease carrying out these activities*” if they turn out to indeed constitute proprietary trading.<sup>509</sup>

The reporting requirements and the assessment concerning the possible performance of proprietary trading are stipulated in Art. 6b and Art. 8 of the negotiating stance. Core credit institutions have the duty to at least annually make information on the activities mentioned above available to

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505 *Council of the EU* (2015) Negotiating Stance, Art. 6(1)(b)(iv).

506 *Council of the EU* (2015) Negotiating Stance, Art. 6(2). These exemptions are very similar to the ones of the German Ring-fencing Act. See Chapter III.IV.B.a.2: Exceptions.

507 See Chapter I.II.B: Proprietary trading and market making.

508 The negotiating stance acknowledges this problem and aims to tackle it with enhanced reporting. See *Council of the EU* (2015) Negotiating Stance, 10 (“*It is difficult to distinguish proprietary trading from other trading activities, especially market making. To overcome this difficulty and to dissuade core credit institutions from engaging in proprietary trading, core credit institutions should provide detailed reporting [...]*”). Similar problems arise concerning the Volcker Rule’s proprietary trading prohibition. See Chapter I.IV.D.a: Digression: The Volcker Rule.

509 *Council of the EU* (2015) Negotiating Stance, 10.

the competent authority. This information includes qualitative information and quantitative information. As mentioned above, Tier 2 core credit institutions have stricter reporting requirements. If the competent authority finds the core credit institution to engage in proprietary trading, it can require it to cease that activity.<sup>510</sup>

### c. Results

The negotiating stance, on the one hand, mitigates the separation of proprietary trading proposed by the European Commission by allowing it to be performed in a separate entity. On the other hand, it decides against the European Commission's limited scope of proprietary trading, thereby broadening the scope of proprietary trading that has to be separated.

The broadened scope combined with the exemptions for trading activities, including market making, imports the problems of delimitation discussed in the context of the Volcker Rule: comprehensive and complex reporting.<sup>511</sup> If authorities want to ensure this separation takes place, they have to identify it first. The burden of identifying it is therefore placed on the regulators: the draft regulation spared authorities the task of identifying it by addressing units specifically dedicated to proprietary trading. The negotiating stance tasks them with the elaborate obligation of finding it and differentiating it from other activities.

The negotiating stance recommends a separation very similar to the one adopted in Germany and France.<sup>512</sup> As it combines the scope of the Volcker Rule with a more lenient form of separation, it can be considered “*Volcker-lite*”.<sup>513</sup>

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510 *Council of the EU* (2015) Negotiating Stance, Art. 6b, 8.

511 See Chapter I.IV.D.a: Digression: The Volcker Rule. See also *Krahnen/Kemmerer* (2013) Gesprächsreihe Strukturreformen 15–16 (explicitly warning that such a system was deliberately not recommended by the Liikanen Commission).

512 For example, as pointed out above, with regard to the prohibition and exemptions. For the German and French national ring-fencing legislation, see *Lehmann* (2014) Ring-Fencing, 8–9; *De Vogelaere* (2016) Bank Structure Reforms, 72–76; see also Chapter III.IV.B.a: Non-ring-fenced body.

513 *Vickers* uses this term to describe German and French national ring-fencing legislation. See *Vickers* (2016) Banking Reform Presentation, 22.

#### D. The conditional separation of trading activities

The conditional separation of trading activities is linked to the allocation of entities into the different tiers. Core credit institutions that are included into Tier 2 (trading assets of over 100 billion € or excessive risks according to an assessment) are subject to an assessment to identify excessive risk in their trading activities.<sup>514</sup>

##### a. Assessment of other trading activities

In this assessment, the competent authority has to evaluate the information provided by the Tier 2 core credit institution in accordance with Art. 6b, which includes both qualitative information<sup>515</sup> and quantitative information<sup>516</sup>. The EBA is ordered to issue guidelines to specify a methodology for assessing the level of risk.<sup>517</sup>

If the assessment reveals highly risky trading activities or conditions facilitating them, the competent authority has to “*carry out due diligence to verify whether those trading activities are excessively risky*”. If it turns out that the risks are indeed excessive, the competent authority has to make a decision as set down in Art. 10.<sup>518</sup>

Art. 10 stipulates the power of a competent authority to impose certain measures on a Tier 2 core credit institution. These measures include, apart from other prudential measures,<sup>519</sup> an increase of the core credit institu-

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514 *Council of the EU* (2015) Negotiating Stance, Art. 8a.

515 Qualitative information that needs to be provided to the competent authority at least annually includes, *inter alia*, a description of the governance structure of the trading activities, a description of mandates, activities, strategies and procedures of each trading unit, and a description of internal control measures. See *Council of the EU* (2015) Negotiating Stance, Art. 6b(2).

516 Quantitative information that needs to be provided to the competent authority quarterly includes, *inter alia*, daily profit and loss and quarterly transaction volumes. See *Council of the EU* (2015) Negotiating Stance, Art. 6b(3).

517 *Council of the EU* (2015) Negotiating Stance, Art. 8a.

518 *Council of the EU* (2015) Negotiating Stance, Art. 8a(4).

519 These prudential measures are set down in Art. 104 of the CRDIV Directive (Directive 2013/36/EU) and include, for example, requiring an institution to present a plan to restore compliance and set a deadline for it, requiring the reduction of the risk inherent in the activities, products and systems of an institution, or requiring an institution to use net profits to strengthen own funds.

tion's own fund requirements, and the separation of the trading activities.<sup>520</sup>

## b. Results

Conclusively, it can be said that the competent authority reviews trading activities of Tier 2 banks. If it finds them to be of high risk, it has to make absolutely sure they are excessively risky. If they indeed turn out to be excessively risky, the authority may choose separation of the many remedies provided by the negotiating stance.

However, there is number of newly introduced backstops that keep the competent authority from making decisions that might be too far-reaching. If, for example, the competent authority finds during its assessment that market making activities carry high risks, it shall “*consider the importance of those activities for the well-functioning of the financial system or real economy [...] and weigh the additional benefits of a separation against other measures that may be taken to reduce the risks of the core institution*”.<sup>521</sup>

During the assessment, the competent authority shall furthermore take into account a number of principles,<sup>522</sup> which include that “*decision[s] shall be proportionate to the aim pursued and appropriate as regards the need for, and the choice of any measures [...]*”, “*the need to balance the interests of the various Member States involved [...]*”.<sup>523</sup> Art. 10, which empowers the competent authority to impose separation, also calls the competent authority to take “*appropriate action*”, which shall be “*proportionate to the risk identified*”.<sup>524</sup>

This emphasis on proportionality pervades the entire negotiating stance.<sup>525</sup> It is complemented by a strong call for the compliance with fun-

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520 Council of the EU (2015) Negotiating Stance, Art. 10.

521 Council of the EU (2015) Negotiating Stance, Art. 8a(4).

522 Council of the EU (2015) Negotiating Stance, Art. 8a(4). Art. 8a(4) refers for the principles, obviously by mistake, to Art. 26(6), which does not constitute any principles. Only a reference to Art. 26(7) makes sense, as this provision sets forth principles for decision-making.

523 Council of the EU (2015) Negotiating Stance, Art. 26(7).

524 Council of the EU (2015) Negotiating Stance, Art. 10.

525 “*Following the assessment, where the competent authority concludes that excessive risk exists [...], it should impose an effective and proportionate measures to address that risk. The proportionality principle should apply [...]*”. Council of the EU (2015) Negotiating Stance, 15.

damental rights and fundamental freedoms<sup>526</sup> as well as the regular confirmation that trading activities are “*generally beneficial to the real economy and the public good*”.<sup>527</sup> It can be assumed that the unlikely case of an implementation of the negotiating stance in this form would lead to a very reluctant enforcement of separation.

## E. Rules following a separation

Considering the rules following a separation, the Council decided for comparatively minor changes. Trading entities still must be legally, economically and operationally separate from core credit institutions.<sup>528</sup>

The requirements for separated entities to issue their own debt, engage with each other at arm’s length, maintain separated management bodies, individually comply with capital requirements of the CRR and to carry distinct designations also remain unchanged.<sup>529</sup>

### a. Corporate structure

The council, however, added the provision that groups may choose the appropriate legal corporate structure for their operations. The requirement to create subgroups, as set down by the draft regulation, should “*not necessarily result in a requirement to adopt a holding structure or other specific corporate legal structures*”. After a separation, core credit institutions and trading entities should still be able to be parent undertakings of both trading entities and core credit institutions.<sup>530</sup> This explains why the Council also decided

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526 See *Council of the EU* (2015) Negotiating Stance, 26, stressing that the application of the negotiating stance has to be in accordance with, *inter alia*, the freedom to conduct business, the rights of shareholders, the right to property, the right to a fair trial.

527 See, for instance, *Council of the EU* (2015) Negotiating Stance, 10. See also *Council of the EU* (2015) Negotiating Stance, 13 (describing trading activities as “*often related to client activity*” and emphasizing the “*potentially useful nature of such activities*”).

528 *Council of the EU* (2015) Negotiating Stance, Art. 13(1); *European Commission* (2014) Proposal for a Regulation, Art. 13(1).

529 See *Council of the EU* (2015) Negotiating Stance, Art. 13.

530 *Council of the EU* (2015) Negotiating Stance, 16, Art. 13(4).

to skip the prohibition of holding capital instruments or voting rights in a trading entity for core credit institutions.<sup>531</sup>

b. Activity-restrictions

A further change was made to the activity-restrictions for trading entities. Whereas the draft regulation prohibits them from taking deposits in general,<sup>532</sup> the negotiating stance only prohibits them from taking “retail deposits”, i.e. deposits held by natural persons and micro, small and medium sized enterprises. It thereby allows trading entities to accept non-retail deposits eligible for deposit insurance.<sup>533</sup> Trading entities can therefore fund themselves with deposits from e.g. institutional investors.<sup>534</sup>

c. Exemption for the United Kingdom

Concerning the legal situation in the United Kingdom, the controversial exemption of Art. 21 of the draft regulation was amended: the negotiating stance stipulates in Art. 5a that a separation of trading activities can be either achieved by the measures set down in its provisions, or by “*the requirement [...] that core retail banking activities [...] are located in a legally, economically and operationally separate entity*”. It thereby essentially describes the United Kingdom’s structural reform model.<sup>535</sup>

The provision is formulated in a way that opens up the alternative for every Member State. Essentially, however, it constitutes a “*rare UK derogation from [an] EU regulation*”.<sup>536</sup> Interestingly, the negotiating stance, as requested by French negotiators, emphasizes that “*the way chosen is due to the*

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531 Cf. *European Commission* (2014) Proposal for a Regulation, Art. 13(5).

532 See *European Commission* (2014) Proposal for a Regulation, Art. 20.

533 *Council of the EU* (2015) Negotiating Stance, 17, Art. 5(18), Art. 5(19), Art. 20.

534 A similar exception can be found in the German Ring-fencing Act. See Chapter III.IV.B.b.2: Other activity restrictions for the financial trading institution.

535 See *Council of the EU* (2015) Negotiating Stance, Art. 5a.

536 *Barker*, EU finance ministers back drive to tackle ‘too big to fail’ banks, *Financial Times* (June 19, 2015) (This article also cites *George Osborne*, former UK chancellor saying: “*What we have had to come up with is a regulation which is rather unusual in design and basically allows the European Central Bank to have a single resolution, while allowing the UK to take a different and tougher course*”).

*special circumstances of the regulation. It is in no way a precedent for future financial services regulation”.*<sup>537</sup>

## F. Results and discussion

### a. Negotiating manifest

Because of the events in the European Parliament depicted in the next chapter, the Council’s negotiating stance remains the latest step in the European Union’s failed Bank Structural Reform file. Evaluating its provisions, one has to note that they constitute a negotiating manifest for negotiations with the European Parliament rather than a final legal text. However, in the author’s opinion, its provisions are already indicative of the following developments of the EU’s bank structural reform, namely the withdrawal by the European Commission.

### b. Watered down

The negotiating stance is characterised by a systematic watering down of previous legislative proposals.<sup>538</sup> While the draft regulation has already been criticised by proponents of tougher structural reform for not taking up the path of mandatory separation of trading activities recommended by

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537 *Council of the EU* (2015) Negotiating Stance, 7. See *Barker*, EU finance ministers back drive to tackle ‘too big to fail’ banks, *Financial Times* (June 19, 2015). See for an insight into French banks’ interest group work *Federation Bancaire Francaise* (2015) Bank Structural Reform.

538 This is noted by the media, (see e.g. *Barker*, EU finance ministers back drive to tackle ‘too big to fail’ banks, *Financial Times* (June 19, 2015)), but is also indicated by leading actors: Commissioner *Hill* described the content as “a reasonable and pragmatic compromise”, which changes a proposal that “has not been [] straightforward”. *European Commission* (2015) Speaking Notes of Commissioner Hill. See also *Hogan*, Bank Ring-Fencing Edges Closer in Europe: Finance Ministers have agreed on their version of ring-fencing heaping pressure on MEPs to complete their discussions, (June 28, 2015) <https://home.kpmg.com/xx/en/home/insights/2015/06/bank-ring-fencing-edges-closer.html> (noting that, although the negotiating stance is seen as watered down, it would still place considerable requirements on banks).

the Liikanen Report,<sup>539</sup> the negotiating stance reduces the importance of the separation measure considerably.

This is in particular because, with regard to trading activities that are found to be excessively risky, separation is only one of several possible remedies. As discussed above, several backstops ensure that a separation becomes highly unlikely. The grandly announced bank structural reform is therefore reduced to only one alternative, notably a very unlikely one.<sup>540</sup>

Furthermore, the number of affected banks was decreased dramatically. Only banks allocated to Tier 2, i.e. banking groups with trading assets of over 100 billion € or excessive risks according to an assessment, are subject to the potential separation of trading activities.<sup>541</sup>

Regarding proprietary trading the Council decided, on the one hand, to follow the problematic direction towards the Volcker Rule set by the draft regulation and assimilate it even more by adopting a similarly broad definition. On the other hand, it decided against a full separation in the form of the *activities ban* for the whole banking group.

### c. Method of ring-fencing

The Council's negotiating stance proposes a mandatory *containment method* of ring-fencing for proprietary trading and relations with certain funds. It thus decided against the *activities ban* of full separation proposed by the European Commission.

Regarding other trading activities, a subset of banks are subject to an authority's decision, drawing from a number of measures, of which the *containment method* of ring-fencing constitutes one. Regarding the other trading activities, it is thus enforcement-based.

### d. Influence of Germany and France

*Hardie/Macartney* emphasize that the powerful Member States Germany and France were already advocating for lighter ring-fencing requirements

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539 See Chapter I.II.F: Results and discussion.

540 See Chapter I.III.D: The conditional separation of trading activities.

541 See Chapter II.III.D: The conditional separation of trading activities.



during the Liikanen process and later on during negotiations with the European Commission.<sup>542</sup>

Looking at the ring-fencing model set out by the Council in the negotiating stance, one finds that it orientates clearly towards the national ring-fencing legislation adopted in the two countries. In particular with regard to the handling of proprietary trading, the negotiating stance is inspired by national legislation of Member States.<sup>543</sup> The far-reaching exemptions for hedging, investment services to clients, market making and the buying and selling of financial instruments acquired for long term investment purposes<sup>544</sup> also reflect adopted ring-fencing legislation of the Member States.<sup>545</sup> As it combines, similarly to Germany and France, the scope of the Volcker Rule with a more lenient form of separation, it can be considered “*Volcker-lite*”.<sup>546</sup>

It is indeed comprehensible that the two countries did not manage to achieve their domestic interests with regard to the Liikanen Commission or the European Commission, as these two bodies are to act independently from interests of the Member States. However, it is not surprising that the position of the Council, which constitutes the institution on a European Union level that represents interests of the Member States, much more reflects their interests and national legislation.

#### IV. Withdrawal of the File and Alternatives

##### A. European Parliament

At the end of January 2014, the draft regulation of the European Commission was passed on to the European Parliament,<sup>547</sup> where the Committee

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542 *Hardie/Macartney* (2016) EU Ring-Fencing, 513. See also *Götz/Krahnen/Tröger* (2017) Liikanen-Bericht, 208 (noting disputes in the Council of the EU due to the different impacts of concrete rules on Member States according to the respective design of the rules).

543 For the German and French national ring-fencing legislation, see *Lehmann* (2014) Ring-Fencing, 8–9; *De Vogelaere* (2016) Bank Structure Reforms, 72–76; see also Chapter III.IV.B.a.1: Excluded activities.

544 *Council of the EU* (2015) Negotiating Stance, Art. 6(2).

545 For the German exceptions, see Chapter III.IV.B.a.2: Exceptions.

546 *Vickers* uses this term to describe German and French national ring-fencing legislation. See *Vickers* (2016) Banking Reform Presentation, 22.

547 *EUR-Lex*, Procedure 2014/0020/COD, [http://eur-lex.europa.eu/procedure/DE/2014\\_20](http://eur-lex.europa.eu/procedure/DE/2014_20).

for Economic and Monetary Affairs (ECON) became responsible for the file. *Gunnar Hökmark*, a member of parliament of the centre right European People's Party, was appointed rapporteur.<sup>548</sup> *Hökmark* himself left no doubt that the European Commission's draft regulation was in his opinion the wrong way to go and prominently argued against a separation of trading activities.<sup>549</sup>

While in 2013 the Liikanen Report was welcomed by ECON as "*sound and welcome basis for structural reform*",<sup>550</sup> the European Commission's draft regulation became a highly controversial matter: particularly between centre left and centre right parties, the views diverged considerably and no agreement could be reached.<sup>551</sup>

One of the most controversial issues was whether or not a separation should to be mandatory or in the discretion of the regulator. Centre right parties rejected the idea of automatically splitting up a bank once a threshold is exceeded. Centre left parties, in contrast, demanded such a requirement to avoid, the risk of an in their opinion lenient approach of regulators.<sup>552</sup>

Another highly discussed issue was whether separation could be avoided in the case of increased capital requirements for banks. Opponents of the draft regulation pushed for a risk-based approach instead of structural measures.<sup>553</sup>

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548 *European Parliament*, 2014/0020(COD), [http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2014/0020\(OLP\)](http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2014/0020(OLP)).

549 This is reflected, e.g. in the rapporteur's explanatory statement, in which he argues that "*there is nothing telling us that trading is more risky than lending, rather the opposite. [...] Trading in covered bonds or options in transparent markets is often more secure than lending to shopping galleries or office centres*". See *European Parliament Committee on Economic and Monetary Affairs* (2013) Draft Report, 54.

550 *European Parliament* (2013) Report on Structural Reform, 14.

551 See *Jones*, Stand-off traps EU's 'too big to fail' bank reform in limbo, Reuters (October 26, 2016); *European Parliament*, Banking Structural Reform, (February 20, 2018), <http://www.europarl.europa.eu/legislative-train/theme-deeper-and-fairer-internal-market-with-a-strengthened-industrial-base-financial-services/file-banking-structural-reform>. See also *Götz/Krahnen/Tröger* (2017) Liikanen-Bericht, 208 (noting disputes in the European Parliament due to the different impacts of concrete rules on Member States according to the respective design of the rules).

552 See *Jones*, Stand-off traps EU's 'too big to fail' bank reform in limbo, Reuters (October 26, 2016).

553 *European Parliament*, Banking Structural Reform, (February 20, 2018), <http://www.europarl.europa.eu/legislative-train/theme-deeper-and-fairer-internal-market-with-a-strengthened-industrial-base-financial-services/file-banking-structural-reform>.

In May 2015, the draft report was rejected by ECON, with only one vote difference,<sup>554</sup> for being too lenient.<sup>555</sup> Since then, the positions hardened on both sides.<sup>556</sup> In September 2016, Commission Vice-President *Dombrovski* tried to kick-start the bill without success.<sup>557</sup>

The fact that the European Parliament was not able to reach a position is remarkable: as the draft report was rejected by ECON, the European Parliament had to restart its negotiations, something that has not occurred on any other major financial reform package.<sup>558</sup>

What is also interesting is that the draft report was rejected by the center left parties for being too lenient.<sup>559</sup> Proponents of a strict functional separation were in the awkward position of either accepting the changes proposed by opponents, which mitigated the draft regulation considerably or rejecting the draft report as a whole.

## B. Withdrawal

In late 2017, the European Commission made public its decision to withdraw the controversial file as part of its Work Programme 2018 and by that end the legislative process. It has limited its explanation for the withdrawal to the comment that there was “*no foreseeable agreement*” on the matter and that “*the main financial stability rationale*” had in the meantime been addressed by other regulatory measures, “*most notably the entry into force of the Banking Union's supervisory and resolution arms*”.<sup>560</sup>

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554 *European Parliament Committee on Economic and Monetary Affairs* (2015) Minutes: Meeting of 26 May 2015, 3 (The result of the vote was 29 in favour and 30 against the draft report).

555 See further *Moshinski*, EU Bank-Structure Rules Falter with Parliament Divided, Bloomberg (May 26, 2015).

556 *Gunnar Hökmark* for instance noted: “*I think there will be a stalemate for quite some time*” and “[e]ither the socialists accept our offer or we will still be where we are”. *Jones*, Stand-off traps EU's 'too big to fail' bank reform in limbo, Reuters (October 26, 2016).

557 *Weber*, EU Bank-Breakup Push Still ‘Locked’ After Dombrovskis Effort, Bloomberg (October 25, 2016).

558 *Hogan*, Bank Ring Fencing Edges Closer in Europe, KPMG Insights, (June 28, 2015), <https://home.kpmg.com/xx/en/home/insights/2015/06/bank-ring-fencing-edges-closer.html>.

559 See *Moshinski*, EU Bank-Structure Rules Falter with Parliament Divided, Bloomberg (May 26, 2015).

560 *European Commission* (2017) Commission Work Programme 2018: Annex 4, 2.

The reception of the decision has been as divided as the positions in the ECON: while rapporteur *Hökmark* applauded the Commission,<sup>561</sup> shadow rapporteur *von Weizsäcker* of the S&D emphasized that the withdrawal “marks an unfortunate turning point in the European agenda on regulating large banks”.<sup>562</sup>

The withdrawal of the file by the European Commission is remarkable. In the author’s opinion, it can be criticised for two reasons: firstly, the medium chosen by the European Commission to inform the public, does not seem to be fitting. To announce the withdrawal of “a critical part of the Union response to tackling the TBTF dilemma”<sup>563</sup> over the Work Programme 2018 seems inappropriate. One would think that the intention to withdraw a major EU reform project would merit a press release.

Secondly, there seems to be insufficient reasoning of the intention to withdraw. While it is likely true that there is “no foreseeable agreement” – the file has indeed “not progressed since 2015” – the argumentation that the main financial stability rationale has “in the meantime been addressed by other regulatory measures in the banking sector” requires substantiation. That it is addressed “most notably [by] the entry into force of the Banking Union’s supervisory and resolution arms”<sup>564</sup> is also questionable. The EU’s bank structural reform has since the Liikanen Report been designed to complement these initiatives.<sup>565</sup> A more detailed explanation would have been desirable.

The withdrawal of the file can rightly be considered a “long-sought victory for the banking industry”, as affected banks and interest groups have lobbied

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561 “As a rapporteur, I welcome the decision. I achieved a majority with me against the core of the original proposal [...] It was my firm belief that splitting up universal banks by separating retail from trade, investment and market making, would create instability and hinder investments and a more dynamic banking sector. [...] The original proposal wouldn’t have strengthened the European banking sector, but rather made it less resilient in times of crisis.” *Hökmark*, Commission withdraws proposal on Banking Structural Reform (BSR), (October 24, 2017), <http://hokmark.eu/commission-withdraws-proposal-on-banking-structural-reform-bsr/>.

562 *Helin-Villes*, The withdrawal of the Bank Structural Reform file marks an unfortunate turning point in the European agenda on regulating large banks, say S&Ds, (October 25, 2017), <http://www.socialistsanddemocrats.eu/newsroom/wit-hdrawal-bank-structural-reform-file-marks-unfortunate-turning-point-european-agenda>.

563 *European Commission* (2014) Proposal for a Regulation, 2.

564 *European Commission* (2017) Commission Work Programme 2018: Annex 4, 2.

565 The Liikanen Report, for instance, discusses extensively the at the time proposed recovery and resolution plans (*HLEG* (2012) Liikanen Report, 81–83) and the Banking Union and Single Supervisory Mechanism (*HLEG* (2012) Liikanen Report, 80–81).

hard against its adoption.<sup>566</sup> As discussed with regard to the negotiating stance,<sup>567</sup> it also reflects the interests of Member States that advocated for lighter structural reform rules.

In summary, it can be stated that the winds seem to have turned in Brussels. Both in the Council of the EU and the European Parliament, the necessary support for stringent structural reform measures could not be gathered. While in the UK and Switzerland, the largest banks are already in the process of implementing far-reaching structural changes,<sup>568</sup> a common European Union approach has not been realizable.

### C. Alternatives

Due to the withdrawal of the file by the European Commission, alternative ways of imposing a ring-fence are expected to become more important. The following paragraphs will set out the expected starting position in the EU institutions and subsequently discuss legislative options for reintroducing a structural reform bill. Finally, they will explore the possibility of introducing bank structural reform through existing provisions.

#### a. Starting position

Considering the close vote in the European Parliament to reject the draft position,<sup>569</sup> the reaction of the political groups<sup>570</sup> and the number of seats

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566 *Brush/Glover*, Banks Win as EU Scraps Proposal to Split Off Trading Units, Bloomberg (October 25, 2017). *Christian Stiefmueller*, Senior Policy Analyst at Finance Watch, commentated this rather dramatically: “*The demise of the bill is as regrettable as it was – by now – predictable. The fact that not even Vice-President Dombrovskis’ intervention one year ago succeeded in reviving the effort is testimony to the iron grip the financial industry’s lobby still exerts on governments and legislators.*” See *Finance Watch*, Too-big-to-regulate: The EU’s bank structural reform proposal failed, (October 25, 2017), <http://www.finance-watch.org/press/press-releases/1468>.

567 See Chapter II.III.F: Results and discussion.

568 See Part III: Legal Comparative Analysis.

569 *European Parliament Committee on Economic and Monetary Affairs* (2015) Minutes: Meeting of 26 May 2015, 3 (The result of the vote was 29 in favour and 30 against the draft report).

570 See *Helin-Villes*, The withdrawal of the Bank Structural Reform file marks an unfortunate turning point in the European agenda on regulating large banks,

by political group,<sup>571</sup> it can be assumed that there is still considerable support for a structural reform of banking in the European Parliament.<sup>572</sup>

As discussed in the context of the European Council's negotiating stance, the Member States, notably France and Germany, do not seem to be interested in a stringent union-wide bank structural reform at the moment.<sup>573</sup> It is hard to tell the position of the European Commission in its current form. The withdrawal and especially its reasoning suggest, however, that it does not see the need for another attempt to revive the project.<sup>574</sup>

## b. Legislative options

The first option would be a legislative proposal by the European Commission based on the regular legislative process of the European Union.<sup>575</sup> Due to the position of the European Commission discussed above, this option can currently be regarded as improbable.

The second option would be a request by the European Parliament to the European Commission to submit an appropriate legislative proposal. The treaties set down the possibility for the European Parliament to adopt such a request with a majority of Members of Parliament. The adoption of such a request would be conceivable, however it is questionable whether it could gather enough momentum to achieve a majority vote. In addition, the European Commission is not bound to submit a proposal following the request.<sup>576</sup>

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say S&Ds, (October 25, 2017), <http://www.socialistsanddemocrats.eu/newsroom/withdrawal-bank-structural-reform-file-marks-unfortunate-turning-point-european-agenda>.

571 *European Parliament*, Seats by Political Group, <http://www.europarl.europa.eu/meps/en/hemicycle.html>.

572 This is also indicated by contributions of Members of Parliament in other matters, in which they stress the importance of reviving the bank structural reform project. See e.g. *Marco Valli* of the EFDD, in a debate on March 1st 2018 on the annual report on the banking union. *European Parliament*, 2017/2072(INI), <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+CRE+20180301+ITEM-002+DOC+XML+V0//EN&language=EN>.

573 See Chapter II.III.F: Results and discussion.

574 See *European Commission* (2017) *Commission Work Programme 2018*: Annex 4, 2; see also Chapter II.IV.B: Withdrawal.

575 Art. 294 TFEU.

576 See Art. 224 TFEU.

The third option would be that the proponents of structural reform in the European Parliament attempt to slip parts of their agenda into the negotiations of other legislative initiatives. Suitable for such actions at the moment is in particular the CRR/CRDV package.<sup>577</sup> This option can currently be considered as the most probable.

Indeed, in February 2018, Members of Parliament proposed as an amendment to CRDV an additional chapter on bank structural reform: it features a prohibition of proprietary trading and relations with certain funds. Deposit-taking entities are allowed only to engage in deposit-taking, lending, payment services and certain activities necessary for hedging. Other trading activities are to be separated into a trading entity, which may remain part of the banking group based on the decision of regulators.<sup>578</sup> This proposal reflects the European Commission's draft regulation's recommendations but is more stringent: it picks up elements of the *activities ban* of full separation (however, with a wider scope than the draft regulation and a reverse burden of proof). Regarding other trading activities, it constitutes an enforcement-based *containment method* of ring-fencing.

While the chances of the proposal to make it through the legislative process are rather small,<sup>579</sup> it demonstrates that proponents of ring-fencing have not yet given up on the project. Elements of the EU's bank structural reform will likely appear in connection with banking regulation packages for a long time.

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577 *European Commission*, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, COM(2016) 850 final; *European Commission*, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, COM(2016) 854 final.

578 *European Parliament Committee on Economic and Monetary Affairs* (2018) Amendments CRDV, 81–89.

579 The distribution of votes likely has not materially changed in the European Parliament. The coming election in 2019 will, however, create a new situation that can not yet be predicted.

## c. Existing regimes

With the withdrawal of the bank structural reform, other, already existing, ways of imposing a ring-fence are likely to become more important in the discourse. Certain provisions of the BRRD and the SRMR are considered by some as potential gateways for union-wide ring-fencing,<sup>580</sup> and may approximate the EU's solution to the Swiss'.

## 1. BRRD

*Binder* underscores that the BRRD's concept of recovery and resolution planning exceeds mere planning. It could be used "*in a way that drastically interferes with the institution[s'] business portfolio, financial and organisational structure, including group structures*".<sup>581</sup>

Central provision regarding the organisation of banks are the "*powers to address or remove impediments to resolvability*" stipulated in Art. 17(5) BRRD. The provision sets down considerable powers for regulators to influence the organisational structure of a banking group, in case the resolvability assessment has found substantive impediments: the resolution authority is empowered, *inter alia*, to require the institution to cease certain activities, to divest assets and to conduct changes to legal or operational structures.<sup>582</sup> As *Kern* notes, "*this could [indeed] involve changes to the legal, operational, and financial structure of institutions or the group itself and their business activities*".<sup>583</sup> The resolution authority is not limited to measures listed in Art. 17(5) BRRD, as the list is to be understood as non-exhaustive.<sup>584</sup>

Far-reaching structural changes can certainly not be ordered out of the blue. The BRRD sets down processes that leads to such a decision. The res-

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580 In particular Art. 17 BRRD and Art 10 SRMR are considered such gateways. See e.g. *Alexander* (2015) Universal Model Banking, 496; *Binder* (2014) Resolution Planning, 16 (noting with regard to the BRRD that "[o]n the basis of their powers given under this part of the Directive, authorities could go a long way towards implementing fully-fledged structural reforms of banking in the relevant jurisdictions, even without a more specific formal mandate to do so"). See also *Binder* (2015) Gleichung, 165 (noting that a segregation of commercial and investment banking may be introduced via these provisions).

581 *Binder* (2014) Resolution Planning, 16.

582 Art. 17(5) BRRD.

583 *Alexander* (2015) Universal Model Banking, 496.

584 *EBA* (2014) Guidelines Impediments Resolvability, 6.



olution authority's measures in particular have to meet a proportionality test.<sup>585</sup> While this test is only “*vaguely defined*”,<sup>586</sup> a decision to require a bank to remove impediments for resolvability is subject to the right of appeal.<sup>587</sup> The EBA clarified that “*depending on the individual case, certain measures may be less intrusive than others*”. Resolution authorities should therefore “*assess which measure is the least intrusive for removing the firm-specific impediment*”.<sup>588</sup>

## 2. SRMR

Another provision that provides regulators with similarly broad powers to influence the organisation of banking groups is Art. 10(11) SRMR. It can be regarded as “*equivalent*” to Art. 17(5) BRRD.<sup>589</sup> If the SRB determines that there are “*substantive impediments*” to the resolvability, it may instruct national resolution authorities to take measures that include far-reaching structural interventions.<sup>590</sup>

Similar to the BRRD, the instruction to take certain measures requires a process.<sup>591</sup> In addition to balancing the effect of the measures on with cer-

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585 Once a resolvability assessment finds “*substantive*” impediments to resolvability, a resolution authority informs the institute (Art. 17(1) BRRD). Within four months, the institute may propose possible measures to “*address or remove*” these impediments. The resolution authority then assesses whether this is the case (Art. 17(3) BRRD). If not, the resolution authority may require the institute to conduct the measures discussed above (including structural measures). It has to demonstrate how the measures proposed by the institution “*would not be able to remove the impediments to resolvability*” and how its own measures “*are proportionate in removing them*”. It has to take into account “*effect of the measures on the business of the institution, its stability and its ability to contribute to the economy*” (Art. 17(4) BRRD).

586 Binder (2014) Resolution Planning, 21.

587 Art. 17(6) BRRD.

588 EBA (2014) Guidelines Impediments Resolvability, 6.

589 Alexander (2015) Universal Model Banking, 498. The framework of the recovery and resolution planning of the SSMR and SRMR “*do not deviate substantially from the relevant procedures and substantive requirements of the BRRD*”. Binder (2014) Resolution Planning, 19.

590 See Art. 10(7)-(10) SRMR.

591 This process is set down in Art. 10(7)-(10) SRMR: If the SRB finds “*substantive impediments to the resolvability*”, it first prepares a report to inform the bank about its findings. It should recommend “*any proportionate and targeted measures*” that are “*necessary or appropriate*” to remove them (Art. 10(7) SRMR).

tain costs,<sup>592</sup> the SRB must take into account “*the need to avoid any impact on the institution or the group concerned which would go beyond what is necessary to remove the impediment to resolvability or would be disproportionate*”<sup>593</sup> – a provision that does not have a counterpart in the BRRD. Decisions by the SRB based on Art. 10(10) SRMR, can be appealed at the Appeal Panel.<sup>594</sup> Its decisions can be appealed at the ECJ.<sup>595</sup>

### 3. Results

The argument that the EU’s bank structural reform legislation is unnecessary because “*tools for structural change already explicitly exist*” has been put forward by industry groups during the legislative process.<sup>596</sup> Indeed, there are important tools for structural change that can be used to influence banks’ structure. However, whether they will be used to establish credible ring-fencing is in the author’s opinion questionable.

The idea of implementing bank structural reform via authorities’ decisions within the framework of recovery and resolution planning is not new: it is clearly set out in Avenue 1 of the Liikanen Report<sup>597</sup> and the European Commission’s draft regulation.<sup>598</sup> The Swiss emergency plan and resolvability assessment are also enforcement-based and set within the framework of recovery and resolution.<sup>599</sup> The main argument against Avenue 1, the poten-

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Within four months, the bank shall propose possible measures “*to address or remove*” the impediments. If they “*do not effectively reduce or remove the impediments*”, the SRB makes a decision. Similar to the BRRD, the SRB has to demonstrate that the measures proposed by the bank are not able to remove the impediments and that its own measures are “*proportionate in removing them*” (Art. 10(10) SRMR). In the assessment of impediments, the SRB is furthermore dependent on information provided by the bank itself and the national resolution authority. See Schoenmaker (2016) Euro-Area Banks, 10.

592 *Inter alia*, the effect of the measure on the “*business of the institution, [...], its ability to contribute to the economy, on the internal market for financial services*”. Art. 10(10) SRMR.

593 Art. 10(10) SRMR.

594 Art. 85 SRMR.

595 Art. 86 SRMR.

596 See e.g. PwC (2014) Bank Structural Reforms, 3.

597 See Chapter II.I.B: Avenue 1.

598 See Chapter II.II.D: The conditional separation of trading activities.

599 See Chapter III.IV.D.c.2: Method of ring-fencing; Chapter III.V.D.b.5: Switzerland as a role model for the EU?.

tial lack of a harmonised and consistent application,<sup>600</sup> lost weight due to the common supervision and resolution, in particular for G-SIBs.<sup>601</sup> However, in contrast to the Liikanen Report and the draft regulation, the existing provisions of the BRRD and the SRMR exhibit the effort of intervening with the structure of banking groups only as little as possible.

In the author's opinion, the obstacles for comprehensively implementing ring-fencing or other bank structural reforms via the existing provisions of the BRRD and the SRMR should not be underestimated: one thing that pervades preparatory documents of ring-fencing initiatives around the world is that it is hard to quantify the benefits and costs of ring-fencing. Similar problems are likely to arise with impediments of resolvability. It can therefore be assumed that (i) a clear assessment of the proportionality as it is stipulated by both the BRRD and the SRMR is hard to obtain with regard to establishing a fully realized ring-fence. The (ii) obligation only to apply the least intrusive measure, which is set out by the EBA for the BRRD and in Art. 10(10) SRMR is also a considerable constraint. As the (iii) list of measures in both legal sources is non-exhaustive, it can moreover be assumed that other measures, such as capital increases, will play an important role.

The considerations above should not be understood as criticism of the powers of regulators to impose structural requirements to enhance the resolvability. They merely question whether full ring-fencing such as the Liikanen recommendations can be established through the existent provisions.

While with the provisions of the BRRD and the SRMR potential gateways for ring-fencing were created, it remains to be seen how far authorities are willing or able to go with regard to structural requirements. Critics even call into question whether authorities will exercise their powers to ensure “*at the very least*” resolvability<sup>602</sup> – effectively separating commercial banking and investment banking activities seems to be a long shot from this.

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600 See Chapter II.I.B: Avenue 1.

601 The competence of ECB and SRB likely enhance the harmonised and consistent application of recovery and resolution, free from national biases. See e.g. *Binder* (2014) *Resolution Planning*, 20.

602 “*In practice, however, it remains to be seen if any of these new powers are exercised, let alone enforced, in the face of relentless resistance by the industry and rapidly declining political support.*” *Finance Watch*, Too-big-to-regulate: The EU's bank structural reform proposal failed, (October 25, 2017), <http://www.finance-watch.org/press/press-releases/1468>.

It can therefore be concluded that an enforcement-based implementation of ring-fencing, as defined for the purpose of this dissertation,<sup>603</sup> via the resolvability assessment would ideally require an additional legal basis that justifies far-reaching intervention with banking groups' organisation.<sup>604</sup>

## V. Results and Outlook

The second part of the dissertation discussed the European Union's bank structural reform initiative addressing the question what the current developments concerning ring-fencing on a EU level are and in what direction it is expected to evolve. The following paragraphs reiterate selected findings and provide a short outlook.

The Liikanen Report is evidently inspired by the Vickers Report and subsequent legal developments in the UK. However, it proposes the separation of risky activities with the possibility of providing them in a trading entity, thereby recommending the *containment method* of ring-fencing. The Liikanen Report considered a separation based on an authority's decision (Avenue 1), but ultimately decided for a mandatory separation (Avenue 2).

The European Commission draft regulation deviates from the Liikanen Report in that it does not stipulate a mandatory separation, but one based on an authority's decision. In addition, it orientates towards the U.S. Volcker Rule, albeit applying a much narrower scope for the prohibition of proprietary trading. It therefore "*combines the logic of Liikanen's Avenue 1 [...] with the Volcker Rule*".<sup>605</sup> In spite of the decision for an enforcement-based approach, the effect of a bank structural reform in the form of the European Commission's draft regulation would likely be material.<sup>606</sup> The European Commission thus decided for an enforcement-based *containment method* of ring-fencing. It complemented this with another structural reform, namely with a variant of the *activities ban* of full separation regarding proprietary trading.

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603 See Chapter I.VII.C.c: Establishing a definition.

604 Such a basis could also include thresholds for larger banks, and a clearer specification of requirements that collectively aim at ensuring the independence of the separated entities (thereby constituting a fence). See Chapter II.I.B: Avenue 1.

605 *Krahnen/Noth/Schüwer* (2016) Structural Reforms, 15.

606 See *Krahnen* (2014) Structural Reform, 2.

After the publication of the draft regulation, the battle for and against a structural reform of banking in the European Union reached its peak so far, with interest groups and Member States making their case for and against it.

The Council's negotiating stance remains the latest step of the legislative process. As a negotiating manifest for dialogues with the European Parliament, it is characterised by a systematic watering down of the European Commission's draft regulation. This is most obvious regarding trading activities that are not proprietary trading: only a subset of banks (the riskiest ones and the ones with the largest trading operations) are subject to a potential separation. This separation, however, is only one of many possible measures and becomes highly unlikely due to a number of backstops inserted in the legal text.

The Council's negotiating stance proposes a mixture between a mandatory *containment method* of ring-fencing for proprietary trading and an enforcement-based *containment method* for other trading activities. In particular with regard to proprietary trading, the negotiating stance follows closely national ring-fencing legislation in Germany and France. As it combines the limited scope of the Volcker Rule with a more lenient form of separation, it can be considered "*Volcker-lite*".<sup>607</sup>

Due to the events in the European Parliament and the withdrawal of the file by the European Commission, alternative ways of imposing a ring-fence in the European Union are expected to become more important. Assessing legislative options, taking into account the starting positions in the institutions of the European Union, it was found that the most probable way of adopting ring-fencing legislation in the European Parliament was via other regulatory reform packages. Indeed, Members of Parliament have already proposed amendments to CRDV, effectively slipping bank structural reform elements into the negotiations.

Among existing regimes, provisions on impediments of resolvability in particular can be considered potential gateways for imposing union-wide ring-fencing. Such an enforcement-based approach would approximate the EU solution to the Swiss. However, in the author's opinion, the provisions of the BRRD and SRMR lack the determination to be used to introduce fully realized ring-fencing; they both prominently reiterate the need for proportionality and comprise a number of obstacles for the introduction of comprehensive structural reform. In particular when taking into ac-

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607 *Vickers* uses this term to describe German and French national ring-fencing legislation. See *Vickers* (2016) Banking Reform Presentation, 22.

count the particularities of the EU banking sector,<sup>608</sup> their suitability for introducing comprehensive and solid ring-fencing can be questioned. To ensure an effective and legally dependable enforcement-based implementation of ring-fencing, in the author's opinion, an additional legal basis such as the one proposed by Liikanen's Avenue 1 would be desirable.

The European Union's bank structural reform project has an almost tragic character: embarking in 2012 with the formation of the Liikanen commission, there were high hopes for a union-wide ring-fencing regime. Structural reform was generally seen as a "*a critical part of the Union response to tackling the TBTF dilemma*".<sup>609</sup> Since then, however, the file has lost support in all European Union institutions. This is particularly visible in the European Parliament, where the Liikanen Report was at the time almost unanimously welcomed as a "*sound and welcome basis for structural reform*",<sup>610</sup> and where two years later no agreement could be reached on the file; something that has not happened in any other major financial reform package.<sup>611</sup> With the announced withdrawal by the European Commission, the legislative process of the bank structural reform ends.

However, the idea of union-wide bank structural reform was planted deep, and it can be reasonably assumed that it will continue to emerge in negotiations on other banking regulations. Furthermore, existing regimes such as provisions of the BRRD and SRMR may be used to establish a union-wide ring-fencing regime based on authorities' demands. Other soft factors such as the potential ECB presidency of *Erkki Liikanen* might also breathe new life into this controversial project.<sup>612</sup>

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608 See the considerations on Switzerland as a role model for the enforcement-based introduction of ring-fencing in Chapter III.V.D.b.5: Switzerland as a role model for the EU?.

609 *European Commission* (2014) Proposal for a Regulation, 2.

610 *European Parliament* (2013) Report on Structural Reform, 14.

611 See *Hogan*, Bank Ring Fencing Edges Closer in Europe, KPMG Insights, (June 28, 2015), <https://home.kpmg.com/xx/en/home/insights/2015/06/bank-ring-fencing-edges-closer.html>.

612 See *Jones*, European Central Bank's marathon man moves to front of the pack, *Financial Times* (April 3, 2018).