



Reforming the structure of the EU banking sector

Consultation paper

This consultation paper outlines the main building blocks of the Commission's follow-up of the report of the High-level Expert Group on reforming the structure of the EU banking sector. It is divided in three parts. The first outlines the problem that bank structural reform could address. The second assesses the necessity of EU action in terms of subsidiarity. The third presents the main options under consideration. Each section is accompanied by questions where the Commission services would welcome the views of stakeholders.

This document focuses on the structural separation recommendation of the Liikanen High-Level Expert Group (HLEG). The other recommendations of the HLEG have been at least partially taken on board in other initiatives such as the Bank Resolution and Recovery Directive (additional separation of activities conditional on the recovery and resolution plan; use of bail-in as a resolution tool) and Capital Requirements Directive/Regulation (corporate governance requirements), or will only become actionable after the completion of ongoing exercises (e.g. Basel Committee's fundamental review of trading book capital requirements).

In light of the problem definition set-out in section 1 and the focus on Too-Big-To-Fail (TBTF) banking groups, it is clear that any regulatory action on bank structural reform would only affect a small subset of the approximately 8,000 banks incorporated in the EU (see section 3.2.1). It would in particular exclude the vast majority of local and regional banks that serve the local economy as well as the banks that focus on customer-related lending. Moreover, any decision to potentially impose separation requirements would not necessarily apply automatically to banks exceeding examination thresholds and may imply some degree of supervisory discretion.

Respondents from relevant banking groups are as a matter of priority requested to provide data to substantiate their assessment of the impact of structural reform by completing the tables in appendix 1 (Excel format). Such data submissions are in particular encouraged from EU banking groups with the highest degree of systemic importance.¹ The tables outline two scenarios for the purpose of informing the assessment of the set of options being considered by the Commission services. For the purposes of quantitative analysis, these scenarios incorporate a number of constraints and assumptions intended to ensure the tractability and comparability of the data, e.g. transition deadlines, geographical scope, etc. These scenarios do not prejudice the policy choice to be made by the European Commission at a later stage.

¹ This is a subset of the set of banks that are consistently captured by the different threshold options outlined in section 3.2 ("Scope of banks")

1. PROBLEM DRIVERS

In the run-up to and during the on-going crisis, some large and complex EU banking groups have faced problems of balance sheet expansion, high leverage, lack of market discipline, lack of bank resolvability, excessive risk-taking, trading and market-based activity, implicit bail-out expectations, competition distortions, and conflicts of interest. Arguably, pre-crisis regulation and supervision have been inadequate. These intertwined problems have a clear link with the way some large banking groups are structured, which makes them too big, too important, too complex, and too interconnected to fail. As a result, such banks benefit from a lower cost of funding, given that bank investors judge that their investments face a limited risk of default. The implicit subsidy arising from the limited default risk is further strengthened by the presence of deposits backed by deposit guarantee schemes.

Furthermore, such banking groups that take deposits subject to government insurance are (i) largely unrestricted in the type of activities they are undertaking, (ii) largely unrestricted in their intra-group legal structure, and (iii) restricted only in a limited way in terms of intra-group connectedness and interconnectedness with other financial institutions. As a result, the lower cost of funding benefits the group as a whole. Accordingly, depositors effectively cross-subsidise other activities. Such activities, e.g. risky trading activities, can accordingly be undertaken on a larger scale than would have been the case if the cost of funding reflected the risk of that particular activity only. Arguably, as a consequence, economic resources are diverted from more socially useful activities such as lending to the real sector of the economy, while banks also tend to accumulate excessive risks. Conversely, it may be argued that cross-subsidisation may also result into market financing of the economy through notably private equity and market making on corporate bonds.

Structural reforms of the banks that are too-big-to-fail would *directly* address intra-group complexity, intra-group subsidies, and excessive risk-taking incentives. Structural reforms may increase the credibility and effectiveness of the recovery and resolution process for large and complex banking groups, thereby lowering the ultimate taxpayer costs. Structural reforms also aim at a broader set of objectives, such as aligning the private incentives of banks with socially useful activities.

Questions

1. *Can structural reform of the largest and most complex banking groups address and alleviate these problems? Please substantiate your answer.*

2. SUBSIDIARITY

An EU-wide approach to bank regulation and international coordination is desirable because of the interconnectedness of economies and the complex cross-border operations of many banks. Some Member States are in the process of developing bank structural reforms.² While these reforms share the same objective, the specific forms differ.

² Structural reforms are currently being pursued in some Member States and third countries: the United States (the Volcker Rule prohibiting banks from engaging in proprietary trading that takes place within a context of existing structural separation); the United Kingdom (ring-fencing the retail bank operations of large UK banks); France and Germany (some banks have to transfer their proprietary

Any lack of coordination at EU level carries the risk that higher regulatory requirements apply to banks in some Member States but not in others and that undesirable geographic arbitrage might unintentionally be encouraged. Without an EU-wide approach banks will be forced to adapt their structure and operation along national boundaries, thereby making them even more complex and increasing fragmentation. Such a development may also have the effect of limiting the effectiveness of the Single Supervisory Mechanism and a future Single Resolution Mechanism – which may undermine the creation of an effective banking union.

Therefore, an EU-wide approach to regulation would (i) avoid the costs for banking groups of diverging national bank structural reform proposals; (ii) avoid potential inconsistencies of national reforms; and, (iii) safeguard the EU internal market in financial services. *Questions*

2. *Do you consider that an EU proposal in the field of structural reform is needed? What are the possible advantages or drawbacks associated with such reforms? Please substantiate your answer.*

3. POLICY OPTIONS

This section outlines the policy options that are being considered in the impact assessment.

3.1. The baseline

The default option for the impact assessment is to take no policy action as regards structural bank reform at the EU level. This represents the baseline against which the incremental impact of structural bank reform options will be evaluated. The “no policy action” option would notably reflect the structural bank reforms being pursued by Member States, as well as third countries. The assessment would notably aim to assess the complementarity of structural reform with relevant reforms at European level that have recently been adopted, are in the process of being negotiated, or where proposals will be put forward shortly.³

3.2. Spectrum of structural reform options

Structurally separating banks requires decisions on (i) which banks should be subject to separation (ii) the scope of activities to be separated; (iii) the strength of separation.

trading activities to a separate legal entity). In addition, structural reforms are at an earlier stage of consideration in Belgium and the Netherlands. At the international level, institutions like the IMF and the OECD have recently called for a broad and global debate on bank business models.

³ This would notably include measures to strengthen banks' solvency and resolvability; measures to better guarantee deposits; measures to improve transparency and address the risks of derivatives. It would also take into account the proposals related to Banking Union, i.e. the Single Supervisory Mechanism and the Single Resolution Mechanism.

3.2.1. *Scope of banks potentially subject to separation (De minimis exemptions)*

The Commission services have undertaken work with the aim of reviewing the thresholds suggested by the HLEG and address some of the concern highlighted by some respondents to the public consultation held by the Commission upon receiving the report. That work is focusing in particular on how to define trading activity, estimating the institutional implications of different thresholds, and benchmarking the results against other readily available metrics (for further information, see annex).

The Commission services have assessed a number of options for defining trading activity in order to determine the scope of the institutions subject to a separation requirement. Due to the absence of publicly available data for banks' specific business lines, this analysis has been done on the basis of publicly available accounting (balance sheet) data from commercial providers. The analysed options are:

1. Using the HLEG definition (Assets held for trading and available for sale);
2. A more narrow definition that excludes available for sale assets as mostly composed of securities held for liquidity purposes;
3. A definition focused on the gross volume of trading activity, which is likely to focus on proprietary traders and market-makers;
4. A definition focused on net volumes, which is likely to only capture those institutions that have a higher share of unbalanced risk trading (proprietary traders).

For each of the last three options, absolute and relative thresholds have been assessed. Depending on the option chosen, about 30-35 banks are selected. Even though the selected banks represent less than 20% of the sample, their assets account between 50% and 75% of the assets in the sample, and by and large between 40% and 60% of EU banking assets. A set of 20 banks are selected under all definitions and they represent 50% of the sample in terms of total assets.

Questions

3. *Which of the four definitions is the best indicator to identify systemically risky trading activities? If none of the above, please propose an alternative indicator.*

3.2.2. *Supervisory discretion for separation*

The HLEG report recommends a two step-process in which the supervisor determines the need for separation based on a threshold to be calibrated by the Commission. Several options can be envisaged:

- **ex post separation subject to constrained discretion by the supervisor:** under this approach, the activities to be separated and the form such a separation would take would be stipulated in EU legislation, but leave the actual separation decision would be left to the supervisor. In order to avoid regulatory forbearance, the Commission could adopt technical standards/guidelines providing criteria for when the activities

are significant based on proposals from the European Banking Authority (EBA) based on criteria and minima set-out in EU legislation.

- **Ex ante separation subject to evaluation by the supervisor:** in order to address the prolonged legal uncertainty resulting from the first option, a second approach could be that the banks above the examination threshold would in principle be subject to separation. There would still be discretion by the supervisor in order to determine whether the institutional scope is correct. This could foresee the possibility for the supervisor to exempt banks from separation, as well as the possibility to subject additional banks to separation, both subject to clear criteria and limits set out in EU legislation;
- **Ex ante separation:** use the examination thresholds as separation thresholds. For example, this is the approach chosen in draft legislation proposed in an EU Member State, which has translated the examination thresholds into an immediately applicable separation threshold. In other words, all banks with significant overall trading activities would have to separate a sub-set of those.

Questions

4. *Which of the approaches outlines above is the most appropriate? Are there any alternative approaches? Please substantiate your answer.*

3.2.3. Activities to be separated

The banking activities undertaken by large EU banking groups range from retail and commercial banking (RCB) activities to wholesale and investment banking (WIB) activities. Examples of RCB activities include e.g. insured deposit taking, lending to households and SMEs, and the provision of payment system services. Examples of WIB include e.g. underwriting, market making and proprietary trading.

The rationale for separation of activities is to insulate certain bank activities that are particularly risky from those that are critically important for the real economy so as to protect depositors from potentially risky but socially less important activities.

In the national structural reform efforts to date, the separation has been applied at different “locations” between and within the range of RCB and WIB activities. Accordingly, options to separate banking activities end up between, at one end of the spectrum, a narrow trading entity (TE) and a correspondingly broad deposit bank (DB) and, at the other end, a broad TE and a correspondingly narrow DB. In the first case, relatively few activities are being separated from the entity funded by guaranteed deposits, and it accordingly remains relatively free to provide a broad set of activities. In the latter case, the reverse applies.

The Commission services are accordingly considering three stylised options for the set of activities that need to be separated. More specifically:

- **“Narrow” trading entity and “broad” deposit bank:** A first polar case is the case in which only relatively few trading activities that need to be separated from a broad DB, namely those types of trading where traders are speculating on markets using the bank’s capital and borrowed money, for no purpose other than to make a profit and

without any connection to trading on behalf of customers. Such activities would include proprietary trading⁴, and the setting up of dedicated units in order to do so. Although precise estimates are not publicly available, the importance of the activities considered above, relative to total assets or total income, does not seem significant according to preliminary data provided by banks and bank associations. The deposit-taking entity hence remains relatively unrestricted and allowed to perform a broad set of retail and investment banking activities;

- **“Medium” trading entity and “medium” deposit bank:** While proprietary trading and market making⁵ can be distinguished in theory, it is difficult to delineate the two in practice. Accordingly, a second option is to add market making to the above set of activities that need to be separated from the DB. This can be motivated from a risk point of view, as market makers need to mobilise large trading volumes and also hold significant stocks of inventory, which in principle exposes the bank to counterparty risk, and to some extent, market risk. Even so, market makers provide an important function by enabling buyers to meet sellers, which is particularly important in less liquid markets; or
- **“Broad” trading entity and “narrow” deposit bank:** at the other end of the spectrum, all wholesale and investment banking activities would need to be separated. TEs would accordingly engage in activities including underwriting of securities, derivatives transactions, origination of securities, in addition to the ones in the above options.

A particular issue arises as regards the deposit bank's ability to *directly* provide clients with certain **risk management services**. Under one scenario, the deposit bank would not be able to provide such services directly, as they would be transferred to the trading entity given the associated risk.⁶ In another scenario, it could be allowed to directly offer some risk management products. This right could be more or less curtailed (e.g. limiting type of derivative products to be used, providing for position risk limits...).

Questions

5. *What are the costs and benefits of separating market-making and/or underwriting activities? Could some of these activities be included in, or exempt from, a separation requirement? If so, which and on what basis?*
6. *Should deposit banks be allowed to directly provide risk management services to clients? If so, should any (which) additional safeguards/limits be considered?*

⁴ Proprietary trading is the purchase and sale of financial instruments for own account with the intent to profit from the difference between the price paid when entering the trade and the sale price in the market at a later stage.

⁵ In general terms, market making is the purchase and sale of financial instruments for own account at prices defined by the financial institution, on the basis of a commitment to provide market liquidity on a regular and on-going basis. Consequently, this activity provides "immediacy" to clients and investors by facilitating their requests quickly and, arguably, in a cost-effective way for them.

⁶ However, the deposit-taking entity could still offer risk management products on an agency basis (e.g. similar to how the banking arm of a financial conglomerates currently offer the products of the insurance arm).

3.2.4. *Strength of separation*

When determining the strength of separation, a starting point is to consider three broad forms: (i) accounting separation; (ii) functional separation (i.e. subsidiarisation); and (iii) ownership separation (i.e. prohibition of certain business lines). These forms of separation are not mutually exclusive. For example, functional separation presupposes a degree of accounting separation and can also coexist with prohibition (ownership separation) of certain activities.

The lightest degree of intervention is **accounting separation**. This would require an integrated financial services group to make publicly available separate reports for its different business units. However, accounting separation would not affect economic incentives faced by banks. For example, it would not impose any restrictions on intra-group legal and economic links. It therefore appears unlikely to be sufficient to curtail potential intra-group transfers of the implicit subsidies enjoyed by systemically important banks. Accordingly, it would not appear to contribute to addressing those/the problem of too-big-to-fail;

A second degree of intervention is **functional separation** whereby banking groups continue to provide a universal set of banking services within one group but some of these activities would need to be provided by separate "functional" subsidiaries. Links between the banking group and the functionally separate legal entity(-ies) would nevertheless remain, and choices need to be made as regards the degree of legal, economic, governance and operational independence of the separated entity(-ies). More specifically:

- As regards **legal separation**, any future legislative measures could be limited to requiring the setting-up of a separate legal entity, effectively a subsidiary, to which the activities outlined above were to be separated for banks that fall under the institutional scope of the regulation. A stronger degree of legal separation by governing also the ownership links between this new entity and the rest of the group could also be considered;
- As regards **economic separation**, each separate legal entity within the banking group could be required to respect the CRD/CRR requirements related to capital, liquidity, leverage, and large exposures on an individual basis or, potentially, sub-consolidated basis. Further rules could be considered for the relations between the separated entities and other group entities;
- As regards **governance separation**, consideration could be given to the degree of independence of the boards of the separated entities, as well as whether or not the separated entities should in all cases have risk management structures as foreseen by the CRD for significant institutions;
- As regards **operational separation**, consideration could be given to the degree to which infrastructure related to payment systems and IT and data could be shared among group entities, or whether it would also need to be separated.

The third and strongest degree of structural intervention is **ownership separation** where the ownership of assets supporting different activities would be fully separated. Accordingly, those services would have to be provided by different firms with different owners that have no affiliations. This is the approach followed by the Volcker Rule and was also the approach followed by the 1933 Glass-Steagall Act.

For the purposes of this consultation, the Commission services would welcome comments about the following three stylised options based on functional and ownership separation. Notably, two forms of functional separation are considered, reflecting different degrees of in particular legal and economic separation. More specifically:

- **Functional separation with economic and governance links restricted according to current rules:** in terms of legal separation, this option would require a separate legal entity. In terms of economic separation, it would restrict itself to the economic and governance requirements that currently result from this degree of legal separation. That entity should be subject to the CRD/CRR prudential requirements in terms of capital, liquidity, leverage and large exposures on an individual basis. This would result in a degree of economic and governance separation, depending on whether these requirements would be waived or not;
- **Functional separation with tighter restrictions on economic and governance links:** in order to more effectively address intra-group funding subsidies, this option would require a more significant degree of functional separation in legal and/or economic terms. In terms of legal separation, it includes rules on ownership links between separated entities within the group. This would provide for a stricter degree of economic separation (e.g. separate funding). Irrespectively, this includes stricter economic separation in its own right, notably by considering rules on intra-group relations (e.g. requirements that intra-group transactions be on third party, commercial terms; ensuring that current large exposure restrictions are not waived and possibly apply stricter requirements; providing limits on intra-group guarantees (deposit-taking entity would not support trading entity); and, stipulating a higher degree of governance separation (e.g. limits on cross-use of board directors within the group); or
- **Ownership separation:** under this option, banking groups would not be allowed to engage in certain activities. They would accordingly have to divest any such activities that they currently engage in.

Questions

7. *As regards the legal dimension of functional separation, what are the costs and benefits of regulating intra-group ownership structures?*
8. *What are the relevant economic links and associated risks between intra-group entities?*
9. *As regards full ownership separation, what are the associated costs and benefits?*

3.3. Options to be considered

On the basis of the above, the following set of preliminary and illustrative combinations of different degrees of activity scope restrictions and separation degrees could be subject to further assessment in terms of costs and benefits. These are not mutually exclusive.

Naturally, some may not need to be assessed in full, e.g. those whose effectiveness and efficiency indicates that the option is ineffective and/or that the associated costs are disproportionately high in comparison to the benefits.

Table 1: overview of options

Activities \ strength	Functional separation 1 <i>Current requirements</i>	Functional separation 2 <i>Stricter requirements</i>	Ownership separation <i>Ownership separation</i>
Narrow Trading Entity/ Broad Deposit Bank <i>E.g. Proprietary trading + exposures to VC/PE/HF (PT)</i>	Option A [≈ FR, DE baseline]	Option B [≈ US swaps push-out]	Option C [≈ US Volcker]
Medium Trading Entity/ Medium Deposit Bank <i>e.g. PT + market-making (MM)</i>	Option D [≈ FR, DE if wider separation activated]	Option E [≈ HLEG]	Option F
Broad Trading Entity/ Narrow Deposit Bank <i>E.g. all investment banking activities</i>	Option G	Option H [≈ US BHC; ≈ UK]	Option I

Questions

10. *Does the above matrix capture a sufficiently broad range of structural reform options?*
11. *Which option best addresses the problems identified? Please substantiate your answer.*