EU ECONOMIC AND FINANCIAL AFFAIRS
SUB-COMMITTEE
Bank Structural Reform
Correspondence with Ministers

The EU Economic and Financial Affairs Sub-Committee have written to the Financial Secretary to the Treasury, and also the Economic Secretary, HM Treasury setting outs its views on Bank Structural Reform, in a chain of correspondence.

Contents
LETT ER FROM THE CHAIRMAN TO THE UK GOVERNMENT, 11 MARCH 2014 2
LETT ER FROM THE UK GOVERNMENT TO THE CHAIRMAN, 4 JUNE 2014 4
LETT ER FROM THE CHAIRMAN TO THE UK GOVERNMENT, 10 JUNE 2014 6
LETT ER FROM THE UK GOVERNMENT TO THE CHAIRMAN, 16 JULY 2014 12
LETT ER FROM THE CHAIRMAN TO THE UK GOVERNMENT, 22 JULY 2014 15
EM 6022/14: Structural reforms of EU credit institutions

Thank you for your Explanatory Memorandum 6022/14, dated 26 February 2014, on the proposal for a Regulation on structural measures improving the resilience of EU credit institutions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 11 March 2014.

We are grateful to you for this useful summary of the proposals. However, it gives rise to a number of questions. You state that, overall, the Government are in favour of the proposal as a means to reduce the implicit taxpayer guarantee which distorts the Single Market. We would be grateful for more details of your view of the proposal. Overall, is the proposal an improvement on or a step backwards from the recommendations of the High Level Expert Group on reforming the structure of the EU banking sector, chaired by Bank of Finland Governor Erkki Liikanen? Does this matter?

You state that the timetable for consideration of this proposal has not been announced and no working groups have been scheduled. This is unsurprising given that the proposal has been adopted so close to the end of the European Parliament’s legislative term. The Chair of the European Parliament Economic and Financial Affairs (ECON) Committee, Sharon Bowles MEP, has reportedly described this timing as an insult. Do you share her concern at the delay in the Commission bringing forward this proposal? Are such structural reforms urgently needed in your view? Do you believe that there is sufficient political momentum to ensure that agreement is reached, or has the moment for such structural reforms now passed? Can you give us any indication of when substantive progress in negotiations will occur? Do you share the view expressed in media reports that agreement is unlikely befor December 2015 at the earliest? You state that you have consulted with UK financial institutions. What is their view of the proposals? What is the position of the Prudential Regulation Authority as the UK’s competent authority?

Turning to the main provisions of the proposal, we note that the regulation seeks to place a ban on proprietary trading by certain categories of credit institution. You state that you will be scrutinising the legislation to ensure that the ban is effective while avoiding unintended consequences such as preventing helpful market making activity. What is your initial assessment of the proposals, including the proposed definition of proprietary trading? Is it possible to disentangle proprietary trading from market making? Do you believe that the narrower definition proposed by the Commission will succeed in making this distinction and in avoiding some of the regulatory difficulties encountered in the US? Or will it be so narrow as to have a negligible effect on the day-to-day activity of most institutions?

The proposal to ban proprietary trading echoes the Volcker model in the USA (albeit more tightly defined), but is at variance with both the Liikanen recommendations and the UK’s reforms as contained in the Banking Reform Act 2013. Are you concerned by the lack of consistency in relation to this vital issue in the US, EU and the UK itself? To what extent does such inconsistency matter? You state that the Banking Reform Act provides for an independent review of the case for a prohibition of proprietary trading in UK law to be undertaken in 2021. Noting the Government Impact Assessment’s statement that the impact on the UK is likely to be limited, how would you summarise the likely impact of the ban on the UK and its credit institutions?

On the structural separation proposals, you appear to support the degree of supervisory discretion proposed. Is this correct? The discretionary model is also at variance with the Liikanen recommendations. Does this matter? Where does the balance lie in terms of the benefits and risks of such a model? Does it raise any issues regarding a consistent approach across the EU, in particular given that responsibility within Banking Union
participants will be split between the ECB and national authorities depending on the size of the institution? How does the proposal compare with the models pursued in other Member States, such as Germany and France? What is their view of the proposal? How will it affect their models and banking institutions? What is the practical impact of such inconsistency of approaches to the question of structural separation across the EU?

In terms of the impact on the UK, you state that the proposal will provide for structural reform of credit institutions throughout the Union “in a slightly different way” to the Banking Reform Act 2013. Aside from those identified above, what would you identify as the most important differences? To what extent are the two models compatible? What will be the impact on credit institutions? Will there be a regulatory burden in needing to comply with two similar but not identical set of rules? We welcome, as you do, the proposed derogation provisions in relation to Chapter III of the regulation. You state that “the Government will be seeking to ensure that this remains the case during the negotiation and that firms are subject to ring-fencing under the Banking Reform Act 2013 will be exempted from the provisions of chapter III of the regulation”. Is there any reason to believe that the derogation provisions are under threat? You state that the Government are committed to ensuring the draft regulation “maintains an appropriate balance between the role of the member state and the role of the Commission”. Can you be more specific about your concerns? Is there any way in which you believe this balance to be inappropriate as currently envisaged? You also state that the Government will work to ensure that the derogation process is transparent and timely enough to prevent uncertainty in the market and that provision is made for Member States to challenge an adverse decision by the Commission. Are the criteria with which national legislation need to comply appropriate? What specific amendments to the regulation would you wish to see to meet your concerns?

In addition to the derogation provisions, the EM states a number of times that the Government will be seeking to secure certain safeguards in the course of negotiations. On fundamental rights compliance, you state that “the UK will be closely scrutinising compliance during negotiations to ensure that interferences with the conduct of business and the exercise of property rights which are permitted by the regulation are proportionate and fair, and that the decision-making powers conferred on competent authorities are consistent with fair-trial rights”. Is there any reason to believe that this will not be the case?

In terms of third country equivalence, you note that the impact will be different from the Banking Reform Act in that it applies to all branches and subsidiaries of EU credit institutions wherever they are located. It also applies to EU branches of credit institutions established in third countries. You state that the Government will work to ensure that undue costs are not placed on non-EEA firms establishing branches within the EU, nor on third country branches or subsidiaries of EU banks. How significant are the costs likely to be if the regulation as currently proposed is agreed? What amendments do you wish to see made to reduce such costs? Taking the third country provisions as a whole, are you content with the process by which the Commission will deem whether third country legal frameworks are equivalent? What has been the reaction to the proposal in other major global financial centres?

With regard to the impact on UK institutions, you state that the UK will work to ensure that the role of the ECB under the regulation will not undermine their independence. Is there anything in the regulation as drafted that gives you cause for concern that UK authorities’ independence is under threat?

You note that the extensive use of delegated acts in the proposal will give the EBA an important role and leave much of the detail uncertain. Are you proposing to reduce the use of delegated acts and limit the role of the EBA? If so, which specific changes do you wish to see?

Finally, you state that it is important that the legal basis for the regulation is sound, and that the Government continue to scrutinise whether Article 114 TFEU is an appropriate basis in light of the provisions made in relation to remuneration policies. What is the view of the Commission and other Member States in relation to your concerns? In the event that you conclude that the Article 114 legal base is not appropriate, is there another legal base that you would deem to be acceptable?
We will continue our scrutiny of this important proposal in the weeks to come, and would be grateful for a response to our questions by 8 April 2014. In the meantime we will hold the document under scrutiny.

I am copying this letter to William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Paul Hardy, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Kunal Patel, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.

LETTER FROM THE UK GOVERNMENT TO THE CHAIRMAN, 4 JUNE 2014

Letter from Sajid Javid MP, Financial Secretary, HM Treasury to the Chairman

Structural Reforms of EU credit institutions

Thank you for your letter on 11 March, relating to the Commission proposal on Bank Structural Reform. In my response I have endeavoured to answer as many of your questions as possible, although you will recognise that there is limited clarity on a number of issues at this stage of the negotiation.

The first matter you raise relates to the Liikanen Report, in response to which the Commission presented its proposal on Bank Structural Reform. Many of the policy measures within the Commission proposal are brought forward as a direct consequence of the report’s recommendations; for example the prohibition on proprietary trading and the application of structural separation. You will be aware that some of the report’s other recommendations have been introduced through other pieces of EU legislation which specifically apply ‘bail-in’ measures (the BRRD) and capital requirements (the CRD4 package).

You go on to ask about the timing of the proposal, recognising that some have criticised its lateness in the legislative calendar. The proposal has been released very close to the European Parliament elections and as a result, as you will be aware, the EP has not appointed a rapporteur for this dossier. We would expect the dossier to be allocated after the EP elections. With respect to Council negotiations, the Greek Presidency has signalled their intention for the first working group to take place on 28 April and others will likely follow regularly afterwards. Based on the complexity of the proposal, and the level of Member State interest shown up to this point, we expect the negotiation to be lengthy. The Commission estimates that the negotiation will be concluded in 2015, which the we believe is a realistic timetable as it is quite normal for a financial services dossier of this complexity and importance to take up to two years to be fully agreed between the co-legislators.

In informal consultations, UK banking firms have expressed an interest in this dossier, particularly where it differs from the Banking Reform Act 2013. They are less concerned about the concept of structural separation, but more interested in potential misalignments on scope, overlap of rules between the two frameworks, and the uncertainty created by the number of provisions still to be formed through delegated acts and other forms of level 2 legislation.

On the substance of the dossier, we are confident that it will contribute to European efforts to tackle the implicit taxpayer guarantee that globally systemic banks will receive state aid if they are at risk of failing, by making banks more resolvable and helping to protect depositors. The Government believes this will significantly improve the functioning of the Single Market by helping remove the resulting competitive distortion that allows systemic banks to access cheaper funding and pursue more risky and competitive business strategies than medium sized firms, under the implication that they will be rescued by the taxpayer if they come to need it. This rebalancing of funding costs will represent a fairer pricing of bank funding and more efficient allocation of resources in the economy and help to further reduce market fragmentation in the eurozone, a key concern of many member states.

Moving on to your questions about the substance of proposal, you ask whether its criteria of application are appropriate. Further to the analysis contained in the Explanatory Memorandum and Impact Assessment, the
Government agrees that to ensure proportionate application of the proposal, it is appropriate for there to be criteria based on an institution’s size and activity so that only firms above a given threshold are captured. As the negotiation progresses, we expect to cover in detail what these thresholds should be.

You also ask about the value of supervisory discretion in applying these thresholds. While clear thresholds are appropriate to ensure the proportionate application of the proposal, given its application across a diverse set of national banking sectors in the EU, then supervisory discretion is appropriate. This supervisory assessment will help ensure separation occurs where necessary to support financial stability. This could include requiring separation in exceptional circumstances where banks don’t meet the thresholds based on trading activity, but nonetheless are systemically important in the economies where they operate.

In its own explanatory memorandum, the Commission notes the difficulties in defining proprietary trading and distinguishing it from other activities such as market making. In response to this, the definition of proprietary trading is intentionally drawn narrowly, so as to make the prohibition proportionate and enforceable.

The prohibition of proprietary trading in the proposal is at variance with the UK Banking Reform Act 2013 but it is unlikely to impair legitimate market making services or significantly impact UK banks at currently proposed. In its report on 5 March 2013 the Parliamentary Commission on Banking Standards found that there is little to suggest the practice is widespread in the UK’s main banks. As the definition clearly refers to overt proprietary trading that is undertaken by divisions, desks or individuals, it is not expected at this early stage to be interpreted in a way that could impair the provision of legitimate liquidity services. In addition, I would note that the Commission proposal includes a provision for third country equivalence, which would mitigate the impact of different regulatory approaches.

With respect to the compatibility of the Commission proposal with the Banking Reform Act, the derogation will allow firms to implement the UK measures without having to implement the proposed EU rules too. This removes the risk of a duplicated compliance burden. The approach taken to structural reform by the Commission proposal is slightly different to the UK measures, with separation being based on the size of trading activities instead of deposit taking. In addition under UK ring-fencing larger corporate depositors and high net worth individuals will be permitted to bank outside the ring-fence whereas the commission proposal does not contain similar provisions (although the UK policy can continue for firms that are granted a derogation). However, the outcomes of ring-fencing and the Commission proposal are broadly similar, with the deposit taking institution separated from the trading institution.

The French and German structural reform measures are considered further away from the Commission proposal than the UK reforms, as they focus on the separation of proprietary trading activities alone. Those countries will need to consider the implications of this divergence as the negotiations progress.

You also ask about the position of the derogation provision in negotiations and its functioning. The derogation has drawn some criticism from some Member States because of a misconception that it would allow for a weaker standard to be adopted and that this may raise the possibility of regulatory arbitrage. Other Member States have raised concerns that the derogation undermines the principles of using a regulation instead of a directive to harmonise rules across the EU. The derogation allows some Member States the flexibility to maintain their own legal frameworks after the regulation takes effect, even though regulations are meant to achieve a very high level of harmonization by directly entering national legislation and replacing previous rules covering the subject. The Government is proactively defending the derogation in EU discussions and widely seeking to correct misconceptions by making it clear the provisions are there to allow those Member State who have already begun implementing stricter structural reform measures to continue to do so.

As the derogation only applies to firms subject to separation, and not the proprietary trading ban, in our view the opportunities for regulatory arbitrage are minimal. On the means by which the derogation is granted, we agree it is appropriate that the decision is made on the basis of equivalence. It is very important that the process for agreeing the derogation is clear and strikes an appropriate balance between the role of the Commission and the applicant Member State.
With respect to safeguards, and in particular fundamental rights compliance, we believe that these are important issues that deserve close scrutiny in all EU negotiations. The Government considers that the proposals as published are compatible with fundamental rights, and will scrutinise any proposals to amend them to ensure that this continues to be the case. There is no reason to think that there will be serious problems in this area.

You also raise questions about the 3rd country and extra-territorial impact of the proposals. This is an area where the proposal would benefit from further development and clarification, which I expect to occur as part of negotiations. With much of the detail still to be discussed, and working groups yet to begin, much is uncertain about the size of the costs emerging as a result of the impact on 3rd countries and the functioning of the Commission’s equivalence regime. However, at this early stage we can see advantages to the equivalence provision in relation to the prohibition on proprietary trading. As the US Volcker Rule also has extra-territorial impact on the EU, and is strongly expected to fully cover the provisions of the prohibition proposed by the Commission, the proposed 3rd country equivalence regime will help lower compliance costs for firms by requiring them only to be bound one of the two prohibitions and reporting requirements.

On the role of the home supervisor (the supervisor of the Group Parent) in the proposal and its implications for the independence of UK supervisors, we are conscious that the proposed role for home Competent Authorities, including the European Central Bank, represents a departure from the conventional allocation of supervisory tasks to home and host supervisors in relation to banking groups and group entities. The conventional allocation of tasks is recognised in the BRRD and the CRD4 package, so the Government expects the issue of home and host supervisors to be addressed at a technical level. It will work to ensure that the role of home supervisors, including the ECB in this regulation does not undermine the role of host supervisors. In addition, we currently consider that because of Article 139(2) TFEU (as further reflected in Protocol 4 on the Statute of the European System of Central Banks and of the European Central Bank) the ECB does not have a legal mandate to perform any supervisory or other tasks in relation to banks established in states that are not participating in the Euro. Regarding whether article 114 is an appropriate legal base for the provision regarding remuneration (article 7 of the regulation), the views of other Member States on the legal basis or the desirability of including such clauses are not yet known. It is arguable that the more appropriate legal base is Article 115 TFEU. Alternatively, if the remuneration provisions represent an incursion into the sphere of social policy the appropriate legal base may be Article 153 TFEU; or, if no other treaty basis is available, Article 352. However, given the different procedures associated with these alternative bases there would likely be significant resistance to this position.

I hope this response provides some clarity on the issues you raise in your letter. You will also be aware that my officials are providing private evidence and will be able to expand on the matters you have raised.

LETTER FROM THE CHAIRMAN TO THE UK GOVERNMENT, 10 JUNE 2014

Letter from the Chairman to the Andrea Leadsom MP, Economic Secretary, HM Treasury

EM 6022/14: Structural reforms of EU credit institutions

Thank you for the letter from the former Financial Secretary to the Treasury, dated 4 April 2014, on EM 6022/14, the Commission’s proposal for a Regulation on structural measures improving the resilience of EU credit institutions, and for your letter, dated 1 June 2014, on JHA issues pertaining to the proposal. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered these documents at its meeting on 10 June 2014. In doing so we took account of evidence heard on the proposal on 8 April 2014 from Martin Spolc, Deputy Head of Unit, Banks and Financial Conglomerates II, DG Internal Market, European Commission, and on 6 May 2014 from Sir Win Bischoff, former Chairman, Lloyds Banking Group, Dominic Morris, Director, Group Public Affairs, Lloyds Banking Group, and Anthony Browne, Chief Executive, British Bankers Association (BBA). We set out the evidence heard, and our own views and questions, under a number of headings below.

The rationale behind the proposal
Martin Spolc described the proposal as the “final cog in the wheel to complete the regulatory overhaul of the EU banking system”. He said that the proposal was justified on the grounds that the size and complexity of a small number of the largest and most complex institutions remained a concern: “these banks remain too big to fail, too costly to save and too complex to resolve”, which meant that they “enjoyed special privilege” in the form of an implicit public subsidy: “they believe, and there is a perception, that if these banks get into difficulties the Governments will step in to bail them out rather than let them fail.” This in turn leads to “moral hazard, excessive risk-taking and weaker market discipline.” Martin Spolc stressed the Commission’s view that risky trading activity had shifted some banks’ focus from customer-oriented service, and that such activity should not benefit from implicit government support.

Do you agree with this analysis of the problem? Is the Commission’s proposal the right way to seek to address it, or is there a case for a simpler model of separation between commercial and investment banking? Overall, is the Commission’s proposal an improvement, or a step back, from the Liikanen proposals? Do you agree with Martin Spolc that this is the final cog in the wheel to complete the regulatory overhaul of the EU banking system? Or does more need to be done?

Which institutions?

Martin Spolc told us that a “too big to fail” bank is defined as one whose failure would have systemic implications, but that such a judgment should not only be based on an institution’s size, but should also take account of the riskiness of its trading activity. Nevertheless, the proposal was likely to capture “only a very small number of the largest and most complex banks”, perhaps 30 to 35 in total. Individual Member States would be able to impose structural measures on small banks not captured by the proposal. Is this the right approach to ensure that all systemically-important banks are included within the proposal’s scope? Given that only a limited number of institutions will be affected, is there a case for a uniform approach to smaller institutions?

A regulation or a directive?

Martin Spolc told us that the Commission had opted to propose a regulation rather than a directive because of the importance of a single rulebook for systemically important banks with significant cross-border activity. In terms of the regulatory burden, he noted that it would be easier for a bank if the rules were applied consistently across the EU. A regulation was also proposed to make it easier for the rules to be applied in the context of Banking Union, since the ECB would only be required to implement one set of rules rather than numerous national laws.

Anthony Browne thought it an unusual piece of legislation as a regulation with derogation and discretion for national authorities. However, he said that the Commission had to adopt a more flexible approach because of the work that had already been undertaken by different Member States.

Would there have been any advantages for the proposal to have been brought forward in the form of a directive? Does it set any kind of (unhelpful) precedent, in particular given the suggestion that a regulation was adopted to suit the demands of the ECB in its role as single supervisor within Banking Union? What are the likely future implications of such a preference for regulations for non-participants in Banking Union/ non-members of the Eurozone, such as the UK?

The ban on proprietary trading

Martin Spolc said that the Commission recognised the difficulty of disentangling proprietary trading from market-making, which is why it proposed a narrow definition of “trading that is carried out with the exclusive
purpose of making a profit for the bank itself without any actual close relationship with the customer”. In the Commission’s view, “proprietary trading activities not linked to clients’ activity should simply not be permissible.” Martin Spolc acknowledged that the Commission’s analysis suggested that proprietary trading represented only a limited part of banks’ activities and revenues, meaning that any ban would be unlikely to lead to significant costs. Nevertheless there were social benefits of banning proprietary trading, including “reducing systemic risks, complexity, interconnectivity and conflicts of interest.”

Dominic Morris referred to the practical difficulty that banks had found of separating market-making activities from proprietary trading, “because there is a point in the day when you are actually holding it on your books”. He said that 1300 pages of the Dodd-Frank regulations sought to deal with this practical interface, “and it would be a nightmare for the regulators to police”. Anthony Browne noted that the US ban on proprietary trading under the Volcker rule had proved more complicated than Paul Volcker initially anticipated: “the trouble is that the more you try to define it, the more complex it is. A lot of activities – such as market making and other forms of client facilitation and so on, which are entirely normal and laudable activities of banks – tend to look very similar to proprietary trading.”

Anthony Browne acknowledged that the Commission’s proposals seemed simpler than the Volcker regulation: “Ultimately, it boils down to intent: if the sole intent of a transaction is to make money on behalf of a bank rather than to facilitate a client, then you could define that as proprietary trading, but it is quite difficult to judge transactions not by the transaction is but by the intent of the transaction. You could have two transactions that are basically identical except one has a different intention from the other; one would be banned because the intent is different from the other”.

Sir Win Bischoff was concerned about the proposed ban on proprietary trading, and suggested that the impact of a ban would be greater than many, including the UK Government, had suggested. On the likelihood of the proprietary trading provisions being amended, Sir Win Bischoff expected that “common sense will prevail”, and that a narrow definition would be adopted to allow market making to continue in some form, so as to provide both liquidity and financing.

On the other hand, Anthony Browne asserted that proprietary trading was not a huge part of the business model of UK banks, and was not a high level concern for the BBA’s members, who either did not get involved with proprietary trading or found it to be a totally marginal activity. What would concern them would be an attempt to “Volckerise” the narrow definition, resulting in “all the banks’ activities, such as market making, suddenly [having] to be processed through this lens … There would be a huge cost to that. There would obviously be burdens on the way they operate. They might have to stop doing something that basically no one has a problem with”. In his view, proprietary trading was not so dangerous that it needed to be banned in any case. He argued that 4% of total losses in relation to the global financial crisis were down to proprietary trading. In his view it was preferable to separate proprietary trading activity rather than ban it completely.

Is the Commission’s proposed definition likely to prove effective at banning the trading activity it seeks to target, or could it have any unintended consequences? Or is it so narrowly drawn as to be unlikely to have any practical effect? How will it be enforced, and how can it be ensured that the distinction between such activity and legitimate market-making activity is retained? Do you perceive any dangers in seeking to ban proprietary trading, even on the basis of such a narrow definition? How would you respond to the Commission’s argument that a ban would bring “social benefits”, even if the financial implications are limited? Do you anticipate attempts to broaden the definition of proprietary trading during the negotiating process? If so, what steps are you taking to ensure that any negative effect on the day-to-day activity of UK institutions, for instance in legitimate market-making activity, is minimised? How can the effect of a ban be effectively monitored in the years ahead? What lessons can be learned from the US experience? In light of such experience, are you concerned at the lack of international consistency in the approach to proprietary trading?
**Structural separation**

On the proposals for structural separation, Martin Spolc noted that the Commission came to the conclusion that, rather than basing a separation decision on size as the Liikanen Group had proposed, “it would be better and more nuanced to base the separation decision on criteria … such as leverage, complexity, profitability, associated market and counterparty credit risk and interconnectedness.” He also stressed the importance of providing a “limited and carefully framed degree of supervisory discretion … to judge the riskiness of certain trading activities on a case-by-case basis”, so that a supervisor could choose to separate certain activities that it judged to pose systemic risk even if the criteria were not exceeded. Alternatively a supervisor could decide not to impose structural separation “if the supervisor was convinced by the arguments put forward by the banks that the trading activities do not cause systemic or financial stability risks”. The supervisor would have to consult the EBA in such cases, and, if it was decided not to enforce separation, the supervisor would have to disclose its decision.

**We agree with you that, given the proposal’s application across a diverse set of national banking sectors in the EU, some degree of supervisory discretion is appropriate. Are you content that sufficient safeguards are in place in the proposal as drafted to ensure that this power is not used in an inappropriate fashion?**

**The impact on the UK and the derogation provisions**

Martin Spolc stressed that the Commission proposals were compatible with the UK Banking Reform Act, and shared the same objective of protecting core deposit-taking and lending from trading activities. As a result, he thought the costs of applying both sets of rules to one banking group would be limited. Nevertheless he acknowledged the difference between the two, including the Commission’s proposal to ban proprietary trading, the “conceptual difference” between the UK approach in separating retail activity from trading activity and the Commission’s proposal to separate trading activity from deposit-taking activity (although they led to the same outcome of separating retail and trading activity), and the territorial scope. On the latter issue, Martin Spolc observed that the Commission proposed a broader scope because it wanted to avoid regulatory arbitrage and the possibility of banks circumventing the rules by shifting some of their trading activity outside the EU to third countries.

Martin Spolc justified the proposed derogation provisions on the grounds that it was logical for the Commission to scrutinise existing laws and to judge whether they achieve equal or greater results than the Commission’s proposals. He added that banks subject to UK law obtaining the derogation would not be affected by the EU regulation. However, subsidiaries of the UK banking groups that carried out important activities in the EU or outside the UK that would not be captured by the UK law would be captured by the EU law.

Anthony Browne stressed that “it is very important that these European proposals do not make it impossible for the UK and for the UK banks to implement” the Banking Reform Act, and “that meant they had to have national derogation, because I cannot see any other way around it.” Yet other countries viewed the derogation provisions as being designed specifically for the UK “because we were first out of the traps” with domestic legislation.

Anthony Browne agreed that the EU legislation’s extraterritoriality was a major difference from the UK approach: “it affects the global operations of EU banks and, indeed, to some extent, the operations of global banks operating within the EU, both of which are untouched by the Financial Services (Banking Reform) Act.” He also noted that “if you are a UK-headquartered bank, your global operations are potentially affected by the Commission proposals in a way that they are not by the Financial Services (Banking Reform) Act proposals. A lot of non-EU banks’ or non-EEA banks’ operations in the UK could potentially be affected by this legislation as well.” He noted that the Commission proposal was deliberately designed to capture the entire global operations of EU-headquartered banks, so long as they fit certain criteria. By contrast, the UK legislation was deliberately designed not to have such an extraterritorial effect in order to make sure that London’s
competitiveness as a global financial centre, nor the competitiveness of UK-headquartered banks, were not impaired.

You state that the derogation provisions remove the risk of a duplicated compliance burden. However, we would be grateful for your view of the likely impact of the proposal on a UK-headquartered group, as well as a UK-headquartered institution, and how the derogation would apply in each case. For instance, what will be the impact on the global activity of a UK-headquartered group? What will be the impact on the activity of subsidiaries of a UK-based group operating outside the UK? What will be the impact on the UK activity of EU banks headquartered in other Member States? Given the limited extraterritorial effect of the UK Banking Reform Act, is it fair to state that UK-based banks will be at a competitive advantage compared to those based in other Member States? Given the interconnection between the financial sector in the UK, the EU and globally, and given the cross-border nature of banking activity, what assessment have you made of the overall economic impact of the Commission’s proposals on the UK? What is the view of the PRA on the proposals as the UK’s competent authority? Can you provide any more detail about the concerns set out in your EM that the draft regulation “maintains an appropriate balance between the role of the member state and the role of the Commission”?

France and Germany

Martin Spolc noted that the Commission proposal went further than the French and German model in proposing to ban, rather than separate, proprietary trading, and in seeking to capture a broader scope of trading activities, such as complex securitisations, “that might be risky and might not be related only to activities such as lending to hedge funds”. While it was too early to state precisely what the impact of the reforms would be, he said that the Commission’s proposal, as it stood, would have a significant impact on the French and German banking sectors.

Sir Win Bischoff noted a push against the proposal by France and Germany, who would either wish, through derogation, not to be a part of the regulation “or would wish to persuade the Commission to do something that is closer, perhaps, to Liikanen, which allows some sort of trading to take place inside either the ring-fenced entity or the non-ring-fenced entity.” In his view, the French and German approach to proprietary trading was workable, whereas the Commission’s proposals were more problematic for financial institutions. Yet “if they do not find a way in Europe to have a united view of how banking structure should be carried forward, that is not a good thing for Europe.”

Anthony Browne said that in France and Germany, banks, government and regulators alike were “incredibly hostile” to the proposals: “There is an awful lot of anger about it. I have certainly been party to some really quite hostile exchanges between French and German banks and Commission officials on it.” He found it difficult to see how the proposal could survive in its current form without the support of the French and German Governments.

What assessment would you make of the reaction in France and Germany to the Commission’s proposal? Do you recognise the description of their reaction as “incredibly hostile”? Do you agree with our witnesses that the chances of the Commission’s proposal being agreed as it stands are therefore slim? What amendments do you anticipate France and Germany seeking to make? For instance, do you anticipate any amendments to the derogation provisions?

International consistency and third country equivalence

Martin Spolc stressed the Commission’s commitment to international consistency and convergence, noting that it was in contact with all major jurisdictions to ensure that any possible overlaps in application or inconsistencies were minimised. He said that the third country equivalence regime would make it possible for
third-country banks operating via branches in the EU, or subsidiaries of the EU banks operating overseas, to be exempted from the regulation. This was designed to reduce compliance costs for banks that undertook cross-border activity.

Sir Win Bischoff noted that some European banks, including Deutsche Bank, BNP, Santander, Barclays and HSBC, were sizeable global operators: “For the regulated, who have to deal with regulation or this kind of structural separation in a number of countries, it is going to be quite difficult. … The extraterritoriality of it is a real difficulty.” Across the financial sector more generally, he stressed how difficult it was to apply global standards: “there may be convergence, but it is going to be increasingly difficult. … There is not going to be that much commonality all that soon”. In his view, it would have been preferable to have a single set of rules across the EU, if not globally.

Anthony Browne agreed: “If you started at the beginning of this process and said, ‘Do we need national legislation in the UK, France, Germany and Belgium and also European legislation on top of that? Is that an ideal framework?’, you would be hard-pushed to find anyone, including many of the authors, to say that would be the case.” He added that part of the reasons why different countries had come up with slightly different answers was because of the complexity of banks. The idea of a level playing field in Europe was a good idea in principle, but the Commission needed to reflect the fact that a lot of activity had already been undertaken in individual countries, notably the UK. Nevertheless, BBA members wanted as much international consistency in legislation as possible: “The more differences there are, the more compliance costs there are and the more difficult it is to do business – and, also, the more scope it creates for regulatory arbitrage”.

Notwithstanding the reforms being implemented as a result of the UK Banking Reform Act, do you agree with our witnesses that it would have been preferable, in principle, to reach agreement on a common set of rules across the EU, if not globally? Given where we find ourselves, what can be done at this stage to ensure that there is as much international legislative consistency as possible, thereby minimising compliance costs and the risk of regulatory arbitrage? What has been the reaction in other major global financial centres to the proposal?

Home/host responsibilities

In terms of the division of home and host responsibilities, Martin Spolc acknowledged that the proposal gave responsibility to the lead (i.e. home) supervisor. He expected the issue to be prominent in the negotiation process, but at this stage the Commission’s judgment was that “a decision on the structural measures is so important that the lead supervisor should have the final say”.

We would be grateful for a full explanation of the Government’s concerns about the division of home and host responsibilities. What would be the practical impact of the Commission’s proposal, as drafted? Are you concerned at the shift in responsibility to the home authority? Does this set an unhelpful precedent?

Delegated powers and securitisation

In his evidence before us, Martin Spolc highlighted a number of issues that he anticipated would be dealt with through delegated powers. This included the definition of thresholds for certain criteria on which a decision about structural separation would be based, decisions on whether certain trading activities would be separated, the EBA’s role in developing regulatory and implementing technical standards, decisions on third country equivalence and defining good and bad securitisation. On the latter issue, Martin Spolc said that the proposal was the first time that EU legislation had attempted to separate and distinguish between good and bad securitisation. The Commission recognised that good securitisation might be good for long-term financing and providing support to the real economy, whereas some securitisation would be complex and could prove to be toxic.
In light of the concerns expressed in your EM about the scope of such delegated powers, how would you respond to Martin Spolc's evidence? Are these appropriate measures to be set out in delegated acts? Is it possible to distinguish between good and bad securitisation and, if so, what should be the basis of such a judgment?

The progress of negotiations

Notwithstanding the complexity of these issues, Martin Spolc told us that there was no reason why political agreement should not be reached before the end of 2015. He said that while Member States had expressed some concerns, discussions at the informal ECOFIN in April had been “very positive. There was broad endorsement of the objectives of the proposal and the Ministers also decided to start technical discussions on this proposal after Easter.”

Do you share Martin Spolc’s optimism about the prospects for agreement? Is his description of negotiations thus far a fair one? What update can you give us on subsequent discussions, and the timetable for progress over the coming months?

JHA opt-in

We also note the Government’s assertion in your letter of 1 June 2014 that the UK’s JHA opt-in protocol is triggered in relation to this proposal. As you know, the Committee’s consistent position is that the opt-in is engaged only if the proposal cites a Treaty base within Title V TFEU. Given that the deadline to notify the Commission of the UK’s decision was 19 May, we regret that this was not brought to the Committee’s attention until now. Whilst we are grateful for your apology for the delay, we note that this is the second time in a matter of weeks that a JHA opt-in issue has been identified at a late stage. On 31 March 2014, the then Economic Secretary to the Treasury, Nicky Morgan MP, wrote to us in a similar vein in relation to EM 17949/13: Proposal for a Directive on the Union Legal Framework for Customs Infringements and Sanctions. What steps are you taking to improve the Government’s internal processes to ensure that JHA issues are identified and brought to the Committee’s attention at an early stage?

Conclusion

We appreciate that some of these questions are difficult to answer at this early stage in negotiations. However, we would be grateful for a full response to as many of these questions as is possible at this stage, by 10 July 2014. We will continue our examination of these important proposals as negotiations progress in the coming months. In the meantime we will continue to hold the document under scrutiny.

I am copying this letter to William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Arnold Ridout, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.

LETTER FROM THE UK GOVERNMENT TO THE CHAIRMAN, 16 JULY 2014

Letter from Andrea Leadsom MP, Economic Secretary, HM Treasury to the Chairman

EM 6022/14: Structural reforms of EU credit institutions

Thank you for your letter of 10 June relating to the Commission proposal on structural reforms of EU credit institutions and to the evidence given to the Sub-Committee at its meeting of 10 June 2014. Whilst I have
endeavoured to answer as many of your questions as possible, we are still in the early stages of negotiations on this complex dossier and as such some issues still remain unclear and will need to be returned to in the future.

The first issue you raise in your letter concerns the justification for the proposal. The Government agrees that some globally systemic banks benefit financially from perceived implicit taxpayer guarantees that they will receive financial aid from governments if they are at risk of failing. The Government therefore believes that structural reforms rolled out across the EU could help to level the playing field across the Single Market in this regard. Structural reform measures specifically aim to address the issue of banks which are “too big to fail” by making them more resolvable and protecting depositors. These are complementary to other EU regulations such as the Capital Requirements Directive IV and the Bank Resolution and Recovery Directive which also aim to tackle the issue of implicit taxpayer guarantees. The proposal is therefore welcome. Overall, the Government believes this proposal is generally in line with its own structural reforms. Relative to the Liikanen proposal, the degree of supervisory discretion is positive. However, there remain areas where we believe the proposals could be improved, such as third country provisions and the powers of home and host authorities.

The Government believes that the application of the proposal is in line with addressing “too big to fail” as it aims to capture banks that are large and complex. Nevertheless, smaller institutions can also prove to be systemic and this often depends on the banking sector in which such institutions operate. Given the diversity of banking sectors across Europe, we consider the proposal adequately addresses this issue by allowing Member States to ring-fence such institutions where necessary to support financial stability. The Liikanen proposal did not provide such supervisory discretion and the Government believes that the Commission proposal in this respect is helpful. Rather than being unlimited, this supervisory discretion will be applied within a common framework set out in the regulation. The Government will however scrutinise this closely to make sure that this is properly calibrated.

You also raise the question of whether or not there would have been any advantages for the proposal to have been brought forward in the form of a directive. The Government’s priority is to ensure that the proposal provides sufficient flexibility to be compatible with implementation of the Banking Reform Act. The Commission proposal does provide for some supervisory discretion as well as a derogation provision and the Government will be seeking to maintain these elements during the course of negotiations.

Moving on to your questions regarding proprietary trading, the Commission’s definition is intentionally narrow so as to minimise unintended consequences and also to ensure that the prohibition is enforceable. As you are aware, the Volcker Rule in the USA also proposed a ban on proprietary trading but with a much broader definition. Private sector analysis of this found that, among other negative consequences, the ban impaired market liquidity trading, reduced access to credit and increased bank fees for consumers and businesses. These are important factors to consider when assessing the Commission proposal. As currently drafted, the Government does not believe that the ban will entail widespread unintended consequences as the Parliamentary Commission on Banking Standards found in its report of 5 March 2013 that there is little to suggest that proprietary trading is commonplace among the UK’s main banks. It is not yet clear at this stage whether or not there will be concrete attempts to broaden the definition of proprietary trading. The Government will however be scrutinising this area of the dossier to ensure that the ban is effective and that useful market-making is not hindered.

The question of whether or not the ban would bring about ‘social benefits’ is an interesting one. The Financial Services (Banking Reform) Act 2013 (“the Banking Reform Act”) provides for an independent review of the case for a proprietary trading ban in the UK to be undertaken in 2021 which may be able to shed more light on this issue. With regard to international consistency in this area, the proposal does include a provision for third country equivalence which would reduce the potential for duplication and excessive compliance costs.

You also raise questions surrounding the impact on the UK and the derogation provisions. The current drafting leaves some room for uncertainty on how the regulation would apply in this respect. Our initial reading is that, given that the UK Banking Reform Act only applies to banks established in the UK and EU branches of UK banks, EU subsidiaries of UK banks would be subject to the Commission’s proposals and the derogation would
not apply. The impact on UK subsidiaries of banks headquartered in other EU Member States on the other hand is slightly more complex. The derogation will only apply to UK subsidiaries which are subject to the Banking Reform Act. However, given that this Act only applies to ring-fenced bodies, and that only banks which hold more than £25 billion retail and SME deposits or are members of groups holding more than £25 of such deposits, not all UK subsidiaries will be subject to the Banking Reform Act. Such subsidiaries will not qualify for the derogation and the regulation would therefore apply. The Government will scrutinise closely where this is the case and will work to ensure that any additional requirements are proportionate and effective.

Regarding the extra-territorial impact on third countries, the proposal gives power to the consolidating supervisor to apply structural measures to all group entities – regardless of where they are located. The current drafting of these provisions is unclear and the Government will clarify this as the negotiations progress. However, our understanding is that the Commission intend for this to apply only to subsidiaries which hold deposits that are covered by the UK’s Financial Services Compensation Scheme. Furthermore, the Government would like to make it clear that the purpose of a derogation is not to secure a competitive advantage for UK banks vis a vis other Member States but rather to maintain the robust structural reform measures that we have put in place for reasons of financial stability. Regarding the position of the PRA, I understand that they have provided evidence to the Committee on a previous occasion and we are working closely with their officials to ensure that UK priorities for this dossier are aligned.

You also asked for more detail on the question of the appropriate balance between the member state and the Commission. As set out in the EM, the Government is committed to ensuring the draft regulation maintains an appropriate balance between the role of the member state and the role of the Commission. This means that we will be looking carefully at the regulation as it is negotiated to ensure that the Commission is not given a greater role than is justified and that the Council and/or the Member States have an appropriate role provided for in the legislation. In particular, we will seek to ensure that any Commission role in the granting of a derogation is proportionate and that the process is timely and designed to minimise market uncertainty. We will have to judge this on a case by case basis as negotiations continue. We will keep the Committee updated in the event that any issues arise.

The Government considers that the economic impact of the proposal on the UK will be minimal given that the major UK banks will be exempted from the measures as they are covered by the Banking Reform Act. Furthermore, bank structural reform will help to stabilise the European Economic Area, to which UK firms have a large exposure, and it is likely that UK firms will benefit from this added stability. However, there is a possibility that some firms which are not currently covered by the Banking Reform Act may be covered by these new requirements. We estimate the one-off transitional costs for these firms to be between £50m and £500m. The Government will also want to ensure that the third country provisions do not place undue costs on non-EEA firms, or on third-country subsidiaries and branches of EU banks and we will scrutinise these elements of the proposal closely.

You also raise questions concerning international consistency and third country equivalence. The UK financial sector is a very global and interconnected one and it makes sense to ensure that financial regulation in different jurisdictions is compatible. Setting minimum standards at international fora such as the FSB and the G20 is key to ensuring international legislative consistency and this practice should continue. Nevertheless, the UK economy has a large exposure to its financial sector and so the need for consistency should not prevent the UK from introducing a strict regulatory regime where this is deemed necessary for financial stability.

With respect to delegated powers, the proposal includes a large number of delegated acts which create uncertainty and enhance the role of the EBA. The Government will be scrutinising these elements of the proposal closely in order to ensure a sufficient amount of certainty as well as supervisory discretion for competent authorities. The Government agrees that certain characteristics can be used to indicate ‘good’ securitisations, and we welcome efforts from the Bank of England, and others, to develop a ‘qualifying’ designation for securitisation. Furthermore, the draft Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 permits ring-fenced banks to engage in securitisation subject to safeguards. This is however an instance where the Commission’s power needs to be closely scrutinised and the Government will consider this carefully.
You also ask about the implications of the division between home and host responsibilities. The approach for dealing with the division of supervisory tasks between home and host supervisors is established in both the CRD4 package and the Bank Recovery and Resolution Directive. More specifically, the role of the home authority under the CRD4 package is principally to apply capital requirements at the level of the group undertaking; it does not have any direct supervisory powers vis-à-vis subsidiaries located in other Member States. The proposal on structural reform however diverges from this approach by giving decisions regarding structural separation to the consolidated supervisor of the group. There is little scope for the host authority, or for the home authority of a subsidiary of a group which is not the consolidated supervisor, to influence the decision on separation. The Government believes that it is for the Financial Conduct Authority and the Bank of England to regulate banks established in the UK. However, the limited role envisaged for authorities other than the consolidated supervisor could undermine UK authorities’ supervisory powers with regard to subsidiaries and branches of parent undertakings established in other Member States. The Government will look to improve the text so as to ensure that UK authorities retain supervisory powers over UK banks.

Regarding the progress of negotiations, the third working group took place on 2 July and the Italian Presidency has scheduled a further working group on 17 July. Whilst there is general agreement in the Council surrounding the objectives of the proposal, there are divergent views among Member States as to how these can be achieved and this may take some time to resolve. Furthermore, the European Parliament elections have delayed the appointment of a rapporteur and no internal negotiations or debates have yet taken place. We therefore expect negotiations on this dossier to be lengthy and to conclude around the end of 2015, which is not out of the ordinary for a file of this size and complexity.

Finally, the Government takes very seriously the concerns you express on matters of JHA process and is focused on ensuring we meet our scrutiny commitments to Parliament. As I also noted in my recent letter on the Shadow Banking and the Securities Financing Transactions proposal, this Department and the Government as a whole are taking steps to address this. To ensure the opt-in is identified at an early stage, the Home Office and Ministry of Justice have recently reissued guidance across Whitehall on the opt-in protocol. In addition, specific training on the application of the opt-in, especially in relation to identifying JHA content and understanding the process for asserting the opt-in is being provided to Departments.

As referenced earlier, this is an extensive proposal that will be negotiated over the course of at least the next year and as the dossier progresses I look forward to a continued dialogue with the Committee.

I am copying this letter to Sir William Cash MP, Chairman of the House of Commons European Scrutiny Committee; Sarah Davies, Clerk to the Commons Committee; Chris Johnson, Clerk to the Lords Committee; Stuart Stoner, Clerk to Lords Sub-Committee A; Les Saunders, Cabinet Office; Hannah Cooke and Thomas Kenny, HM Treasury.

LETTER FROM THE CHAIRMAN TO THE UK GOVERNMENT, 22 JULY 2014

Letter from the Chairman to Andrea Leadsom MP, Economic Secretary, HM Treasury

EM 6022/14: Structural reforms of EU credit institutions

Thank you for your letter, dated 16 July 2014, on EM 6022/14: Structural Reforms of EU Credit Institutions. The House of Lords European Union Sub-Committee on Economic and Financial Affairs considered this document at its meeting on 22 July 2014.

We are grateful to you for this thoughtful response to our 10 June 2014 letter. We are particularly grateful for your helpful clarification in terms of the application of the derogation provision and the issue of home/host
responsibilities. The outcome on both these aspects of the regulation evidently remains highly uncertain, and we would therefore be grateful for updates as these issues are discussed further.

We accept that negotiations are still at an early stage and that many issues, these included, therefore remain unclear. Having said that, there are a number of questions in our letter which you have not addressed which are points of principle and information rather than being dependent on the progress of negotiations. These include:

- Whether this is the final cog in the wheel of the regulatory overhaul of the EU banking system, or whether further reform will be necessary;
- Whether the use of a regulation rather than a directive sets any kind of unhelpful precedent;
- What are the implications of a preference for regulations for non-members of the eurozone such as the UK;
- The reaction in other major global financial centres to the proposal.

Such questions are highly relevant to our new inquiry, launched on 16 July 2014, reviewing the EU financial regulatory framework. As such we would be grateful for a more detailed response to these specific points.

We welcome your promise to keep the Committee updated in the event that any issues arise in relation to discussion of the derogation provision. However you do not mention an extremely significant recent development, namely media reports of a leaked Council Legal Service Opinion questioning the legality of the derogation provision. What are the implications of the Council Legal Service Opinion? What steps are being taken to address the concerns that it has raised? Is it inevitable that the derogation provision will need to be amended? Do you remain confident that the derogation provision can be retained, and if so, in what form?

We would be grateful for a response to these questions, as well as an update on negotiations including the 17 July Working Group, by 2 September 2014. In the meantime we will continue to hold the document under scrutiny.

I am copying this letter to Sir William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Arnold Ridout, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.