CEPS COMMENTARY
Thinking ahead for Europe

A European Glass-Steagall to preserve the single market

Karel Lannoo

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The European Commission faces a delicate balancing act with the proposal it unveiled on January 29th, aimed at implementing the recommendations of the Liikanen High-level Expert Group formed in February 2012 to examine possible reforms to the structure of the EU's banking sector. The proposed regulation must meet the dual challenge of preserving the single market and at the same time accommodating existing EU measures covering resolution and trading activities. Given the changes in the composition of the incoming European Parliament and the European Commission and the public's fatigue with post-crisis measures, the fate of the proposal is uncertain – but still, it is on the table.

The proposal will apply to banks with total assets exceeding €30 billion and with trading activities exceeding €70 billion or 10% of total assets. National competent authorities will apply metrics setting thresholds in terms of relative size, leverage, complexity, profitability, associated market risk, as well as interconnectedness from which to mandate, where warranted, separation between the core credit institution and the trading entity. Both would have to be legally, economically and operationally separated, and would issue their own debt on an individual or sub-consolidated basis. The entities could only be consolidated at group level. The European Banking Authority (EBA) is tasked with developing draft regulatory technical standards to specify how the metrics will be defined and applied. The metrics were not part of the Liikanen report, published in October 2012, which only set absolute size thresholds.

The Commission proposal comes late in the crisis. It follows about four years after the comparable Volcker proposals were unveiled in the US, and more than three years after Commissioner Michel Barnier announced the creation of the expert group chaired by Erkki Liikanen, Governor of the Bank of Finland and former European Commissioner. In the meantime, the member states have not waited for the EU to take action and have adopted national measures on their own. The most well known are the Vickers proposals in the UK covering retail ring-fencing; France and Germany adopted timid national rules on separation, followed most recently by Belgium. The surprising element of these national measures is that none of them provoked any protest from the European Commission that the task can be better dealt with at EU level, and could hinder the free provision of services. The proposal by the Belgian government to separate banking, for example, does not make any sense on 'subsidiarity' grounds. It will only apply to two mid-sized banks that have Belgium as their home country.

Karel Lannoo is Chief Executive Officer and Senior Research Fellow at CEPS.

From this perspective, the Commission's separation proposal faces tough challenges, as suggested by the statement issued by Ministers Schauble and Moscovici following the meeting of the Franco-German Finance Council just two days before the proposal was released, insisting that national acts on the subject had to be respected. For banks that were subject to national primary legislation adopted before 29 January 2014, the Commission proposal foresees a derogation for the separation, but under very tight conditions (Art. 21). They require a clear separation of the risk-taking activities of the bank from the deposit-taking activities, not only legally, but also in the decision-making structure and risk management. For a bank to receive a derogation, its member state must send a request to the Commission, accompanied by a positive opinion issued by the competent authority supervising the credit institution. This may be a difficult test for French and German institutions to pass, but it will be easier for the UK, as the intention is principally to safeguard the deposit-taking, although it must be a separate entity. And for states that have a tighter system in place, such as Belgium, the proposal may be difficult since it comes in the form of a regulation, and hence the national legislation will need to be adapted. For third countries, an equivalence test will apply, but it is doubtful whether the US would ever pass the test as the Volcker rule does not mandate legal separation.

Two broader questions remain: Why this proposal now, with the move towards the Single Supervisory Mechanism (SSM) and the finalisation of the resolution framework underway? And is the evidence in support of separation sufficiently strong? Given the national legislation in place throughout the EU, the danger is not imaginary that the final text will be watered down substantially, above all the conditions attached to the derogation spelled out in Art. 21, and more powers will be left to the member states. The same applies for the authority that will decide on separation, which in the draft is 'the competent authority', meaning the European Central Bank for the SSM, but this may well become the member state in the negotiations, as happened in many places in the capital requirements Directive (CRDIV). Hence, the end result could diminish the single market, despite the best of intentions, and present the ECB with a hell of a job to perform.

In response to the second question, the jury is still out on the merits of separating commercial from investment banking. Our own research indicates that universal retail banks are less fragile than narrow banks. Tail risks hit focused and investment banks the hardest; hence splitting up the banking system renders it more fragile.[1] Moreover, several pieces of legislation have been adopted since the beginning of the crisis to strengthen supervision and increase capital requirements, also for securitisation and trading activities (initially in CRDII and III, later consolidated in CRDIV). Most importantly, structural separation in banking is an old-fashioned, rules-based approach for what should be, under the capital add-ons of Basel III and its Pillar II, a matter of supervisory discretion.

[1] See Rym Ayadi, Emrah Arbak and Willem Pieter De Groen (2012), *Regulation of European Banks and Business Models: Towards a new paradigm?*, CEPS Paperback, CEPS; Brussels.