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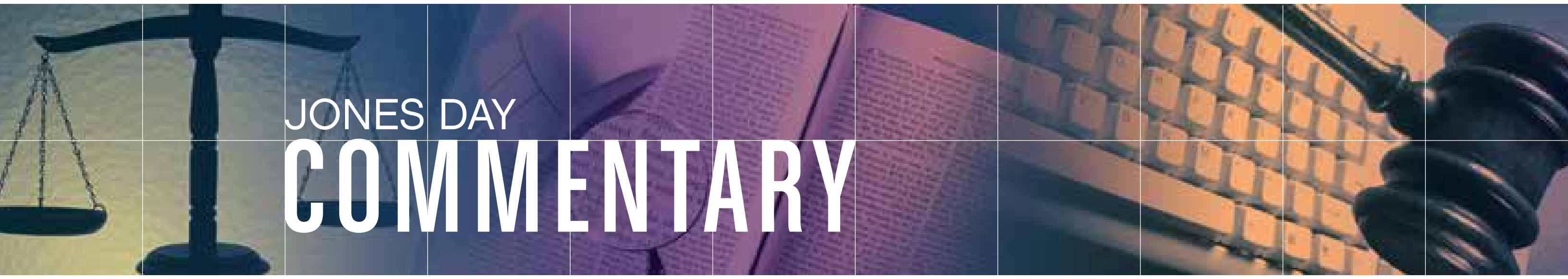

THE EUROPEAN PROPOSAL FOR STRUCTURAL REORGANIZATION OF CREDIT INSTITUTIONS: WILL IT MAKE EUROPEAN BANKS SAFER?

On January 29, the European Commission released a regulation proposal on structural measures to improve the resilience of European Union ("EU") credit institutions (the "Proposal"). Coming after the report prepared by the High Level Expert Group chaired by Herkki Liikanen and presented in October 2012, this proposal essentially aims at putting in place a safer and more resilient legal framework based on the main idea that core banking activities financing the economy should be separated from financial activities considered as risky. It is also an answer to various legislative initiatives from certain EU jurisdictions (in particular France, Germany, and the United Kingdom) that were not presenting a harmonized legal framework.

The Liikanen report suggested that the safety of the banking system should rely on the separation of core banking activities (mainly deposits and means of payment) from proprietary trading within banking entities, therefore not requiring a complete separation out of the banking group. This approach has been implemented in France and Germany, where the proprietary trading activities are to be segregated, whereas the UK has favored the ring-fenced approach (where the segregation relates to the core banking activities). However, if some similarities may be found with the French or German national approaches, the Proposal reveals a difference as to the preservation of the universal banking.

PROHIBITION OF PROPRIETARY TRADING WITH FEW EXCEPTIONS

As suggested in the Liikanen report, the Proposal prohibits credit institutions that qualify as global systemically important institutions or having a balance sheet and proprietary trading activities crossing certain thresholds determined in the Proposal, from carrying on any proprietary trading. This rule would also be applicable to EU branches of non-EU credit institutions crossing such thresholds. This prohibition also extends to investments with an institution's own capital (or borrowed money) in opened ended or leveraged alternative investment vehicles.

Where France proposed a rather comprehensive list of activities derogating to the proprietary trading prohibition (such as provision of investment services to clients, clearing, market making, hedging risks of the group, investment operations of the group, etc.), the Proposal considers as exceptions to this rule only (i) proprietary trading having a connection with actual or anticipated client activity (including hedging an institution's own risks deriving from client risks), (ii) proprietary trading on EU governmental instruments, or (iii) investment in monetary assets in cash management processes. It is difficult to anticipate how the "connection test" will be met, but to ensure that the universal banking model is preserved, it will be significantly important for that test to be comprehensively conducted.

This mandatory split is also accompanied with a financial separation so that on a group-level basis, there are two different sub-consolidated groups (one with the credit institutions and the other with the trading entities). Trading entities are supposed to be financed independently from the other sub-consolidated group, and the insolvency of the trading entity should have no impact on the other sub-consolidated group. Any arrangement between the credit institution and the trading entity shall be as favorable to the credit institutions as if such arrangement were entered into with an entity not belonging to the same sub-consolidated group.

It is to be noted that a Member State may require one or several credit institutions within its jurisdiction to be exempted from complying with separation obligations if it had adopted legislation before January 29 that meets certain requirements deemed to be equivalent to those stated in the Proposal.

From a capital requirement perspective, any exposure of the credit institution to an entity pertaining to the other sub-group may not exceed 25 percent of the core eligible capital of that credit institution. In addition, the credit institution may not incur an exposure against a financial entity (considered on an individual or sub-consolidated group basis) exceeding 25 percent of its eligible capital and 200 percent of its eligible capital in total exposure against financial entities (considered on an individual or sub-consolidated group basis).

From these general principles, one may consider the Proposal as reflecting the principle of separation of proprietary trading as implemented in France or Germany. However, the extent to which this principle will be applied may shape a more drastic separation than expected by the financial community. The differences will essentially result from the definition and scope of proprietary trading activities to be separated and the restriction on other trading activities that may be ordered by national authorities.

RESTRICTION ON TRADING ACTIVITIES

In addition to the prohibition mentioned above relating to proprietary trading, and as opposed to some current legislations (such as in France), the Proposal also envisages to separate, under certain conditions, trading activities for third account from banking activities. The latter requires the assessment by national authorities within 18 months from publication of the future regulation of trading activities. These trading activities are widely defined as any activity other than deposits, lending, leasing, issue or management of payment means, and custody of securities. The review will assess trading activities from the qualitative and quantitative perspective described in the Proposal (and to be refined in EU secondary legislation). On the basis of such assessment, and after having received the comments from the credit institution, the national authority may order the latter to stop or transfer certain trading activities, and this transfer is to be documented within a separation plan submitted for approval to such authority.

In respect in particular of market making (considered under the Proposal as a trading activity and not as proprietary trading, although acknowledging that the difference is minor), such activity may remain within the scope of credit institution activities, but it is subject to an evaluation to be conducted by national authorities since this activity, as well as the sponsoring of investment vehicles or trading on derivatives, is considered to present a greater risk to imply hidden proprietary trading.

SAFER BANKS? THE QUESTION REMAINS

This overview of the Proposal shows that the EU Commission has broadly followed the same approach as in France or Germany for proprietary trading: prohibition as a matter of principle with some exceptions. However, an additional focus is directed toward trading activities that may be restricted pursuant to a supervisory assessment. Hence, the key elements to consider the extent of the separation depend on (i) the characterization of the proprietary trading activities considered as connected to actual or anticipated client activity and (ii) the metrics determined by secondary legislation and used by national authorities to order, on a case-by-case basis, the stoppage or transfer of certain trading activities including market making. Will these rules make EU banks safer? The question remains.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

John C. Ahern
London
+44.20.7039.5176
jahern@jonesday.com

Philippe Goutay
Paris
+33.1.56.59.46.58
pgoutay@jonesday.com