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Sajid Javid MP
Financial Secretary
HM Treasury
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11 March 2014

Dear Sajid,

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 before 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? We note that the regulation will apply to credit institutions identified as being of global systemic importance under Article

131 of the CRDIV Directive and to credit institutions with total assets of at least €30 billion and trading activities amounting to at least €70 billion or 10 per cent of their total assets. Are such criteria sufficiently comprehensive to ensure that the stability of the EU financial system is protected?

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.

The Lord Boswell
Chairman of the European Union Committee