Commissioner Barnier recently announced proposals for structural reform of Europe’s banks, writes Simon Lewis. Coming on top of Banking Union and other financial legislation, the latest proposals conflict with broader regulatory objectives and are likely to reduce the supply and increase the cost of finance for business, while hitting job creation and economic growth in Europe.

The central proposal is a ban on proprietary trading activities and a requirement for the legal separation of other trading activities, including market-making for banks’ corporate customers, where certain still-to-be-defined criteria are met.

Market-making is when a bank sells and buys securities in order to provide liquidity to its clients. By doing this, the bank reduces transaction costs and facilitates trading. Without market-making, we expect that yields on corporate bonds will climb and bid/offer spreads will increase to reflect higher funding and capital costs. These will have to be borne by the newly separated trading entities, with a knock-on effect on funding costs for companies.

**Sovereigns excluded**

EU sovereigns are excluded from these ring-fencing requirements – which means in practice that governments will continue to enjoy the benefits of deep and liquid financial markets, while other public and private sector issuers will face shallower and more expensive markets.

The proposed rules apply to EU credit institutions wherever they operate. They will also capture branches and subsidiaries in the EU of banks established in third countries. In practice, therefore, most big banks operating in Europe’s wholesale financial markets will be affected – and their corporate customers.

**Global context**

To understand why the proposed measure is damaging, it helps to put it in the context of other structural measures in France, Germany, the UK and the US. The latest measure is a hybrid of Vickers in the UK and Volcker in the US, with a resulting lack of clarity and coherence.

The main focus in Volcker is on proprietary trading. Barnier’s proposals go much further in requiring the separation of other trading activities, including market-making, where certain, as yet undefined, conditions are met. So although the definition of proprietary trading is narrower than in the Volcker rule, there is potential for the separation of a much broader range of activities.

Vickers approaches the issue from the opposite end -- by separating out retail banking. It imposes ring-fencing, but not full separation, although the UK government has powers to enforce this as a last resort. The latest proposals from M. Barnier appear to contain a derogation for the UK that could be
interpreted as ensuring that UK banks are not caught twice. However, Vickers does not ban proprietary trading outright and therefore British banks may end up being subject to further limits on activities outside the retail ring-fence.

Meanwhile, Germany and France are not happy that the UK has a potential derogation, while their own measures risk being overridden. Separation in these two countries targets proprietary trading and other high-risk activities such as business with hedge funds. Market making is not automatically separated as it likely to be under the Commission’s proposals.

**Proprietary trading ban timetable**

In theory, banks will have to comply with the proprietary trading ban from 1 January 2017, and the provisions on separation of trading activities from credit institutions will become effective on 1 July, 2018. However, this timetable is unrealistic -- not least because of forthcoming elections for the European Parliament and new leadership at the Commission. The issue is already stirring up heated debate in the run-up to the elections. For example, the Green Party believes M. Barnier’s swansong does not go far enough, while German and French governments are likely to make their own reservations increasingly vocal.

In summary, the threat to market-making will make it harder for European companies to raise money from capital markets – an “own goal” in policy terms when banks’ balance sheets are shrinking and capital requirements becoming more stringent. Moreover, the proposals conflict with other legislation that is being put in place to make Europe’s banks robust and fit for purpose. For example, the whole point of the new European Bank Resolution Law, as well as the new Banking Union, is to ensure that failing banks do not damage the economy.

We are currently briefing policy-makers on the implications and economic impact of this ill-advised proposal; we need regulations that promote viable and competitive financial markets in Europe, rather than harm them.

*Simon Lewis is CEO of the Association for Financial Markets in Europe*

**Association for Financial Markets in Europe**

London office:
St Michael’s House
1 George Yard
London EC3V 9DH
Tel: +44 (0)20 7743 9300