EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 19 April 2013

on protection from risks and separation of banking businesses

(CON/2013/28)

Introduction and legal basis

On 25 February 2013, the European Central Bank (ECB) received a request from the German Federal Ministry of Finance for an opinion on a draft law on protection from risks and on the planning of recovery and resolution of credit institutions and financial groups (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft law relates to the Deutsche Bundesbank and contains rules applicable to banks which materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 The draft law contains rules on the following: (a) recovery plans to be prepared by credit institutions (CIs), and resolution powers, including the drawing up of resolution plans, for the Federal Financial Supervisory Authority (BaFin), (b) the separation of areas of risk within CIs, and (c) requirements for governing bodies of CIs to safeguard sound risk management, including administrative and criminal sanctions. It supplements the Law on restructuring and the Law on reorganisation of credit institutions[2].

1.2 With respect to recovery and resolution plans and the BaFin's powers in this regard, the draft law aims to require systemically relevant CIs and financial groups to plan recovery measures in advance of a crisis. Such CIs and financial groups must provide for various possible courses of action that could be taken in order to stabilise and improve the economic situation of the CI or group in question, thereby securing its ability to survive, without needing to have recourse to public

1 OJ L 189, 3.7.1998, p. 42.

2 With regard to these laws, the ECB adopted opinion CON/2010/83. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

stabilisation measures. Further, the draft law empowers the BaFin to establish an organisationally separate resolution unit within the BaFin itself. Such unit will draw up resolution plans in cooperation with the Bundesbank and the BaFin's supervisory departments.

1.3 The draft law prohibits specific speculative transactions such as proprietary trading and transactions with hedge funds and alternative investment funds (highly leveraged institutions) in order to separate the areas of risk of CIs or groups with a high level of overall trading activities or where such trading activities account for a relatively large proportion of a CI's or the group's balance-sheet total[3]. The draft law contains exceptions for transactions carried out in the form of services for others. Further, the BaFin has the power to prohibit (a) market making activities within the meaning of Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps[4], and (b) other transactions entailing a comparable level of risk, if such transactions might endanger the solvency of the CI. CIs and financial groups may continue to engage in the above transactions if these have been transferred to a financial trading institution which is economically and legally separate. Such financial trading institution: (a) must be licensed under the Law on banking to carry out the types of transactions in question, (b) will be subject to the supervisory regime under that Law, (c) must be able to refinance itself independently, and (d) must fulfil information requirements vis-à-vis BaFin. The financial trading institution is not permitted to provide payment services.

1.4 In addition, the draft law requires Managing Directors of CIs to safeguard risk management. Compliance therewith will be monitored by the BaFin. The BaFin is also competent to issue instructions. Non-compliance with such instructions may result in administrative fines of up to EUR 200 000 and prosecution under criminal law[5] if, as a consequence, the assets of a company in the financial sector, and thereby financial stability, are endangered.

2. Instruments for recovery and resolution planning

2.1 The ECB welcomes the draft law as it strengthens the tools and procedures available to the national authorities for planning the recovery and resolution of CIs. In line with the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions[6] and the European Commission's proposal for a Directive on the recovery and resolution of credit

3 The draft law considers this to be fulfilled if items in the trading book or available for sale within the meaning of Article 1 of the Annex to Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, or items arising from these transactions allocated to the trading stocks and liquidity reserve exceed the value of EUR 100 billion or twenty per cent of the total balance sheet of the CI or group. The twenty per cent value only applies if the balance-sheet of the CI or group reached a minimum of EUR 90 billion on the date of closing of accounts in the preceding three financial years.

4 OJ L 86, 24.3.2012, p. 1.

5 A maximum fine on conviction of EUR 10.8 million or a term of imprisonment of up to five years.

6 Available at FSB's website at www.financialatabilityboard.org.

institutions and investment firms dated 6 June 2012 (hereinafter the 'BRRD')[7], recovery and resolution plans are a key element of preparation for possible crisis scenarios and for taking swift and effective remedial action. The ECB notes that the draft law restricts the requirement to draw up recovery and resolution plans to those institutions which are assessed as 'potentially systemic'. The ECB is of the view that it is possible to extend this requirement to all CIs, which would have the merit that all CIs would benefit from a clear plan of remedial action to be taken in the event of emerging difficulties and clarity would be provided regarding their resolvability. The existence of such plans for all CIs would also address potential concerns as regards ensuring a level playing field. The ECB understands that the consulting authority may have concerns relating to the proportionality of placing such requirements on CIs which are not systemically important. In this respect, it is important to rigorously assess why no potential threat to the system is expected to derive from an institution's failure, thus thoroughly demonstrating why recovery and resolution planning is deemed dispensable.

2.2 The draft law empowers the BaFin to assess the recovery and resolution plans and to address eventual shortcomings. The ECB, in line with its general stance[8], welcomes the proposed provisions involving Deutsche Bundesbank in such assessments while it considers that certain clarifications should be introduced in this respect. It should be clarified that assessments of recovery plans are conducted by the BaFin in agreement with the Deutsche Bundesbank[9] acting in its capacity as a competent authority performing on-going monitoring of banks[10]. Furthermore, it should be clarified that consultation and information sharing with the Deutsche Bundesbank to which BaFin is obliged in connection with its assessments of resolution plans[11] aims at utilising Deutsche Bundesbank's expertise in the areas of banking supervision and financial stability and that this task is not part of the Deutsche Bundesbank's competence to perform on-going monitoring of banks.

2.3 The organisationally separate resolution unit created within the BaFin will ensure functional separation and independence vis-à-vis the BaFin's supervisory tasks. The ECB welcomes that this resolution unit will be responsible for drawing up the resolution plans and conducting a resolvability assessment. For the practical functioning of any resolution, it will be important that the resolution authority has clear ownership of the resolution planning and, in addition, has the power to address impediments to the resolvability, as is the case in the draft law. In particular, the power to reduce the complexity of an institution or group by changing its legal or operational

7 Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM (2012) 280 final.

8 Opinion CON/2010/83, paragraph 4.2, Opinion CON/2010/7, paragraph 2.1.1, Opinion CON/2007/33, paragraph 2.1.

9 See Article 47b(2) of the Law on banking, inserted by Article 1(6) of the draft law.

10 See Section 7 of the Law on banking.

11 See Article 47e(1),(2) and (5), Article 47f(6) and Article 47g(1) of the Law on banking inserted by Article 1(6) of the draft law.

structure is a key tool for achieving resolvability, in line with the FSB Key Attributes and the BRRD.

2.4 The ECB understands that the draft law ensures mutual support and the free exchange of information between the supervisory authority, the new resolution unit, and the Deutsche Bundesbank[12]. Such close cooperation and information exchange will be vitally important for effective supervision as well as resolution[13].

2.5 The ECB notes that the draft law includes aspects of the recovery and resolution planning provided for in the BRRD. In this context, the ECB understands that the legislator will review the draft law once the BRRD is adopted, in order to ensure full consistency with developments at Union level. In this respect, the ECB also refers to the Recommendations of the European Banking Authority (EBA) on the development of recovery plans (EBA/REC/2013/02) dated 23 January 2013, and to the recent consultation initiated by the EBA on proposed technical standards in this respect[14].

3. Measures relating to the structure of CIs and groups

3.1 This draft law arises in conjunction with the Report of the European Commission's High-level Expert Group of 2 October 2012 on reforming the structure of the EU banking sector (hereinafter the 'Liikanen report')[15]. The Commission will prepare a comprehensive impact assessment of its recommendations in the course of 2013 and will make corresponding legislative proposals as appropriate, to ensure a consistent Union framework. Given that these measures primarily address internationally active CIs, the ECB considers coordination and consistency to be important at Union level in order to avoid regulatory arbitrage and ensure a level playing field. The ECB also notes that, unlike the Liikanen report, the draft law does not provide for the mandatory separation of market making activities. Further, trading assets originated to hedge underlying exposures to clients or used for asset-liability management purposes are permitted within the deposit-taking entity. The draft law further provides for mandatory separation of proprietary trading, high-frequency trading, and credit and guarantee business with highly-leveraged institutions on a secured and unsecured basis, including the prime brokerage business, from the deposit-taking institution (above the thresholds set out in footnote 3 above).

3.2 First, the ECB sees merit in mandatory separation of proprietary trading and other high-risk non-client related activities as it would, *inter alia*, further protect depositors from exposure to losses from such high risk activities, reduce complexity and enhance resolvability. However, the ECB

12 See in particular Article 47 c (2) and 47 e (1) of the draft law.

13 See also point 3.1 of Opinion CON/2012/99 of 29 November 2012 on a proposal for a directive establishing a framework for recovery and resolution of credit institutions and investment firms, OJ C 39, 12.2.2013, p. 1.

14 European Banking Authority, Consultation Paper: Draft Regulatory Technical Standards On the content of recovery plans under the draft directive establishing a framework for the recovery and resolution of credit institutions and investment firms, of 11 March 2013, EBA/CP/2013/01.

15 Available on the European Commission's website at: http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

notes that, under the draft law, market making will still be permitted in the deposit-taking entity, though it would be subject to discretionary intervention by the BaFin if risk stemming from such activities was deemed to be too high. As regards the BaFin's power to prohibit 'other transactions entailing a comparable level of risk'[16], the ECB, while welcoming such power which aims to avoid possible circumventions of the draft law, recommends qualifying this power. This should be done by including, preferably in the law itself, the conditions ensuring compliance with the principles of legal certainty[17] and level playing field or by inserting the requirement that the BaFin (1) specifically lists the types of prohibited transactions and (2) justifies this prohibition with evidence indicating the material similarity of the economic nature of such transactions with the transactions prohibited under the draft law. As regards the scope of mandatory separation, consistency should be ensured at Union level and the ECB encourages the German authorities to contribute to harmonisation in this respect.

3.3 Second, as regards high-frequency trading, as previously highlighted by the ECB[18], the ECB supports the Commission's proposal to introduce organisational safeguards for trading venues, such as circuit breakers, minimum tick sizes and maximum ratios of unexecuted orders, in line with international recommendations. Further, all entities engaged in algorithmic trading on a professional basis should be deemed to come within the definition of investment firms and be subject to supervision and monitoring of their activities by competent authorities. In addition, the ECB supports granting competent authorities the power to temporarily prohibit or restrict certain types of financial activity or practices with a view to addressing threats to the orderly functioning of financial markets or to the stability of the whole financial system or part thereof.

3.4 Finally, the ECB notes that the draft law applies to CIs whose trading plus available-for-sale assets exceed EUR 100 billion or 20 % of total assets. The latter is subject to a EUR 90 billion *de minimis* threshold of total assets. The ECB understands that these thresholds are broadly in line with the proposals under the Liikanen report and are based on accounting concepts for the classification of financial instruments, such as available-for-sale assets. The recognition and measurement of financial instruments under International Financial Reporting Standards, or alternatively, the German Commercial Code[19], should not be the only basis for separation as it may provide sufficient discretion for CIs to e.g. restructure financial transactions and use the scope provided by accounting rules to circumvent separation rules. The ECB recommends to the German authorities

16 See new paragraph 3 added in section 3 of the the Law on banking by Article 2(3)(b) of the draft law.

17 See Section 54 of the Law on banking pursuant to which breaching the prohibition is subject to criminal sanction.

18 See paragraph 10.1 of Opinion CON/2012/21 of 22 March 2012 on (i) a proposal for a directive on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council, (ii) a proposal for a regulation on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories, (iii) a proposal for a directive on criminal sanctions for insider dealing and market manipulation and (iv) a proposal for a regulation on insider dealing and market manipulation (market abuse), OJ C 175, 19.6.2012, p. 11.

19 See Article 2, no. 3 (b) of the draft law, amending Section 3 (2) no. 2 of the Law on banking, referring to Section 340e of the Commercial Code.

inserting in the draft law provisions that will counteract potential circumvention of separation rules in that they will grant relevant powers to BaFin or other competent bodies.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 19 April 2013.

[signed]

The Vice-President of the ECB

Vítor CONSTÂNCIO