

‘Banking Union’:
Where did we come from?
Where do we stand?
Where might we go?

Lecture

on Thursday 18 April 2013 in Lisbon (P)

by

Professor Dr. René Smits

Jean Monnet Professor of the

Law of the Economic and Monetary Union,

Universiteit van Amsterdam, Amsterdam (NL),

Visiting Professorial Fellow, Centre for Commercial Law Studies.

Queen Mary, University of London, London (GB),

Strategic Legal Counsel, Authority Consumers and Markets, The Hague (NL)

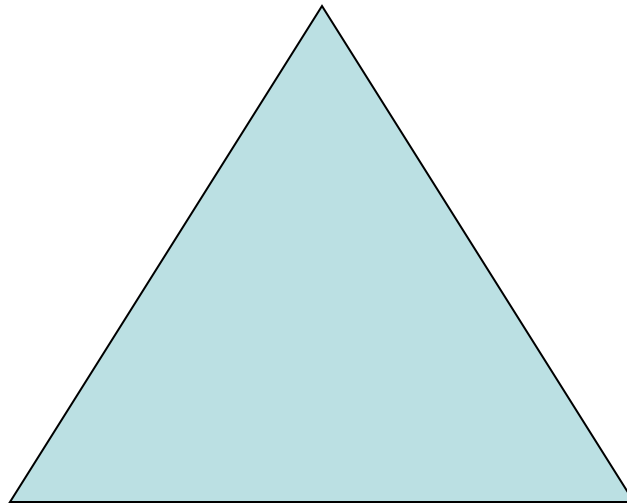
Overview

1. Initial considerations – background
2. DeLarosière innovations: ESFS
3. ‘Banking union’: idea, structure
4. Single Supervisory Mechanism (SSM)
5. Further steps: resolution regime, deposit guarantee system
6. Legal issues
7. Prospects

The trilemma of financial supervision

(Dirk Schoenmaker, 2003, based on Andrew Rose 1996)

Stable financial system



Integrated financial market

National financial supervision

Prudential supervision: State-centered



18-4-2013

(c) René Smits

4

Monetary policy: federal decision-making, national execution



Legal situation

- ❑ Supervisory rules harmonised for “1993” internal market programme
- ❑ Later programmes of harmonisation
- ❑ Largely through directives:
 - National implementation
 - ‘Gold-plating’
 - 27 different sets of prudential rules across EU
- ❑ Art. 4 (2) (a) TFEU: internal market is ‘shared competence’ between Union and Member States

The credit crisis: Despair on the stock exchange



**THE HIGH-LEVEL GROUP
ON FINANCIAL SUPERVISION
IN THE EU**

**Chaired by
Jacques de Larosière**

REPORT

Brussels, 25 February 2009

De Larosière Report

- extensive investigation into causes of crisis
- large number of proposals, predominantly of an institutional nature
- proposal to establish European Systemic Risk Board (ESRB) and European System of Financial Supervisors (EFSF)
- Commission proposals followed-up; legislation adopted late 2010 and in force since early 2011

Some of the De Larosière issues

- **Common bank resolution regime**
 - absence thereof will carve up single market when banks come home to 'die nationally'
 - current rules hardly harmonised, largely confined to conflict-of-law rules and mutual recognition (Reorganisation and Winding-up Directive 2001/24/EC)
 - EU needs its own bank resolution scheme, based on a common exclusive definition of credit institutions
- **Single European rulebook, doing away with national exemptions**
 - urgently needed
 - regulation preferred legal instrument (Basle-III implementation)

Ten legal gaps Europe's regulators must close

René Smits identifies ten key issues that European financial legislators must consider when constructing the post-crisis regulatory framework

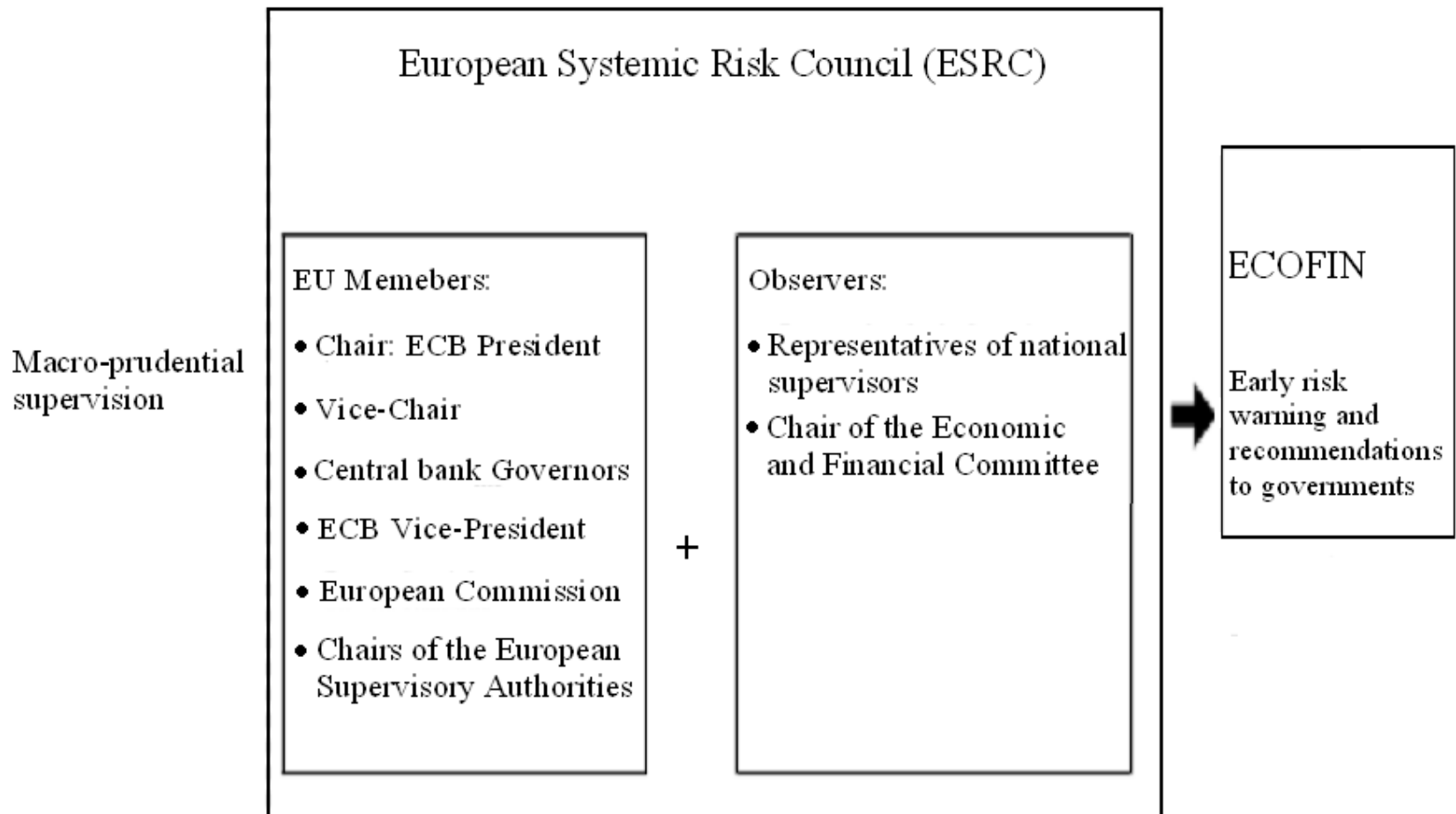


Central Banking
Volume 20, Number 4

Ten legal gaps Europe's regulators must close (nos. 1-8)

- 1) A single rule book
- 2) Divergent definitions of credit institutions
- 3) Jurisdictional delimitation (extra-territorial effect of supervisory action, application of national measures, such as naked short-selling ban)
- 4) Divergent supervisory regimes (different 'tool boxes')
- 5) Differing resolution regimes
- 6) Duplicative reporting regimes
- 7) Information collection (sufficient and timely at ESA level?)
- 8) Cooperation between home and host supervisors
(based on MoUs beyond public domain and unworkable in practice)

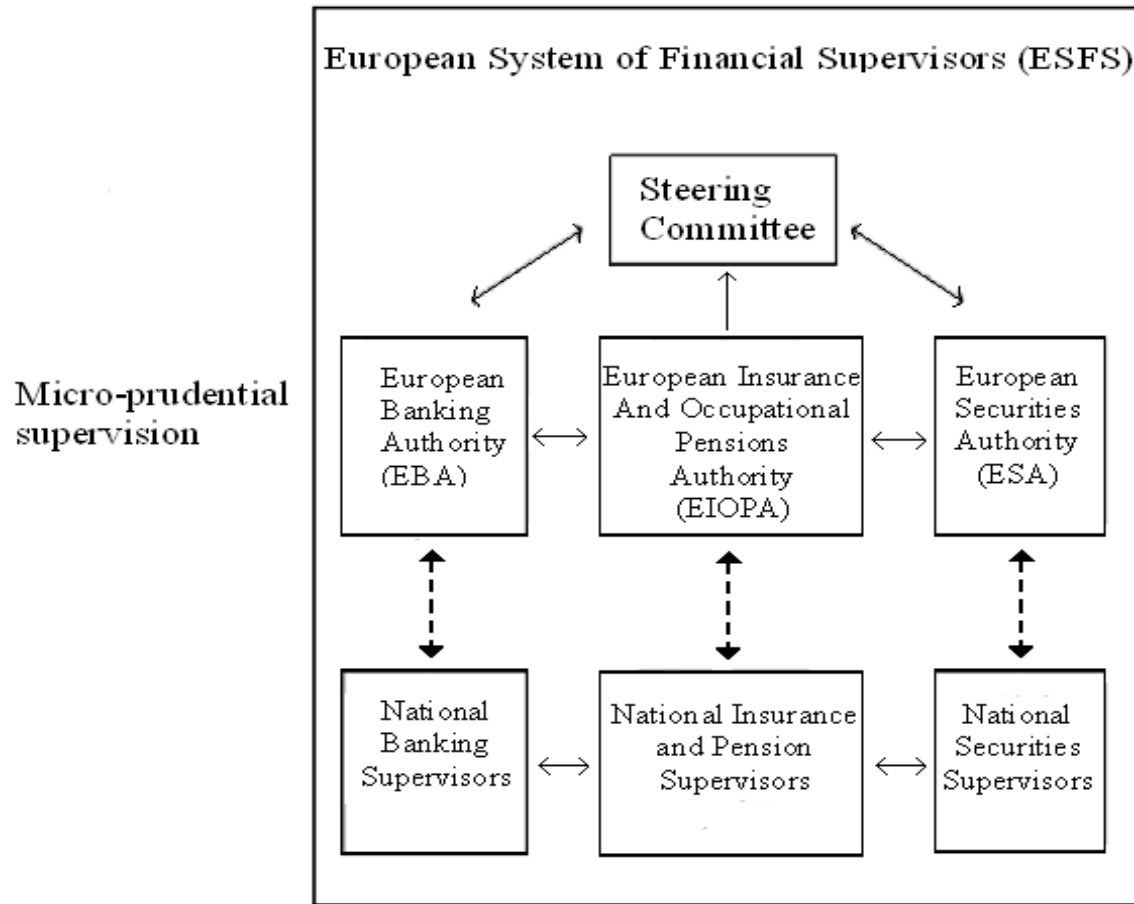
European Systemic Risk Council



Criticism

- Body of 27 + 27 (rotating) + 7 members not conducive to efficient decision-making on advisory functions, let alone agreeing actions
- Reporting to another unwieldy body (Ecofin)
- No EU competences to act for the single market or the euro area yet: absence thereof is the problem
- The 'act or explain' mechanism for addressees of recommendations of the ESRB insufficient for effective harmonization of policies across Europe
- Plus: national focus and lack of communications will not be remedied by formation of yet another 'club'

European System of Financial Supervisors



Legal issues at inception

- Article 114 TFEU as a legal basis
- *Meroni* doctrine [Case C -9/56 and 10/56, *Meroni v High Authority* [1957/1958] ECR 133]: discretionary powers for a new 'institution' not permitted
- Way around: Commission's role in application of direct powers for ESAs
- ...sufficiently effective federal supervision?

Standards without policy choices?

- Recital 62 of preamble to draft Directive implementing Basle-III:

“(…) to entrust EBA with the elaboration of draft regulatory and technical standards which do not involve policy choices, for submission to the Commission”

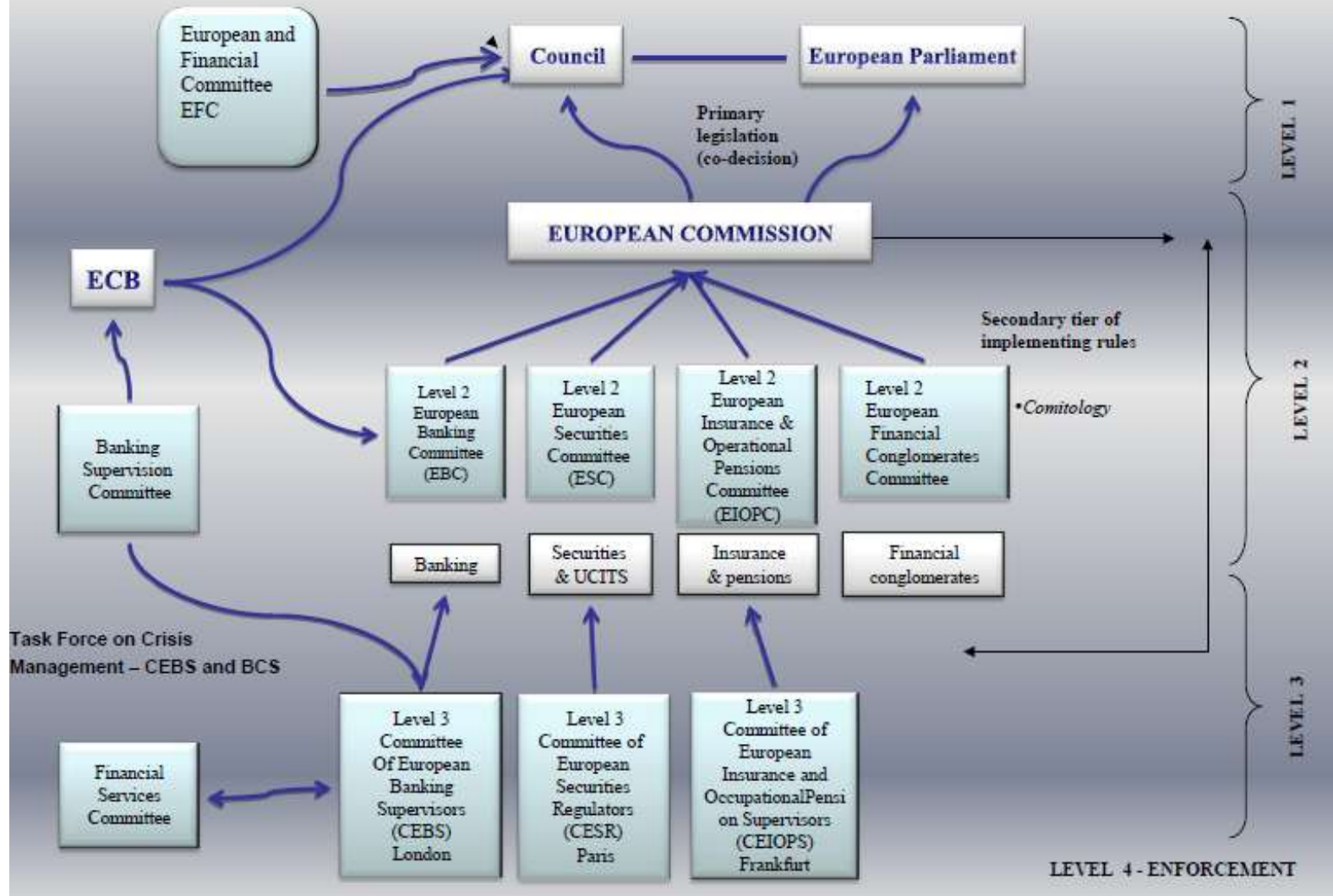
- Articles 10 and 15 Regulation 1093/2010 (EBA):
“no strategic decisions or policy choices”

Article 114 TFEU

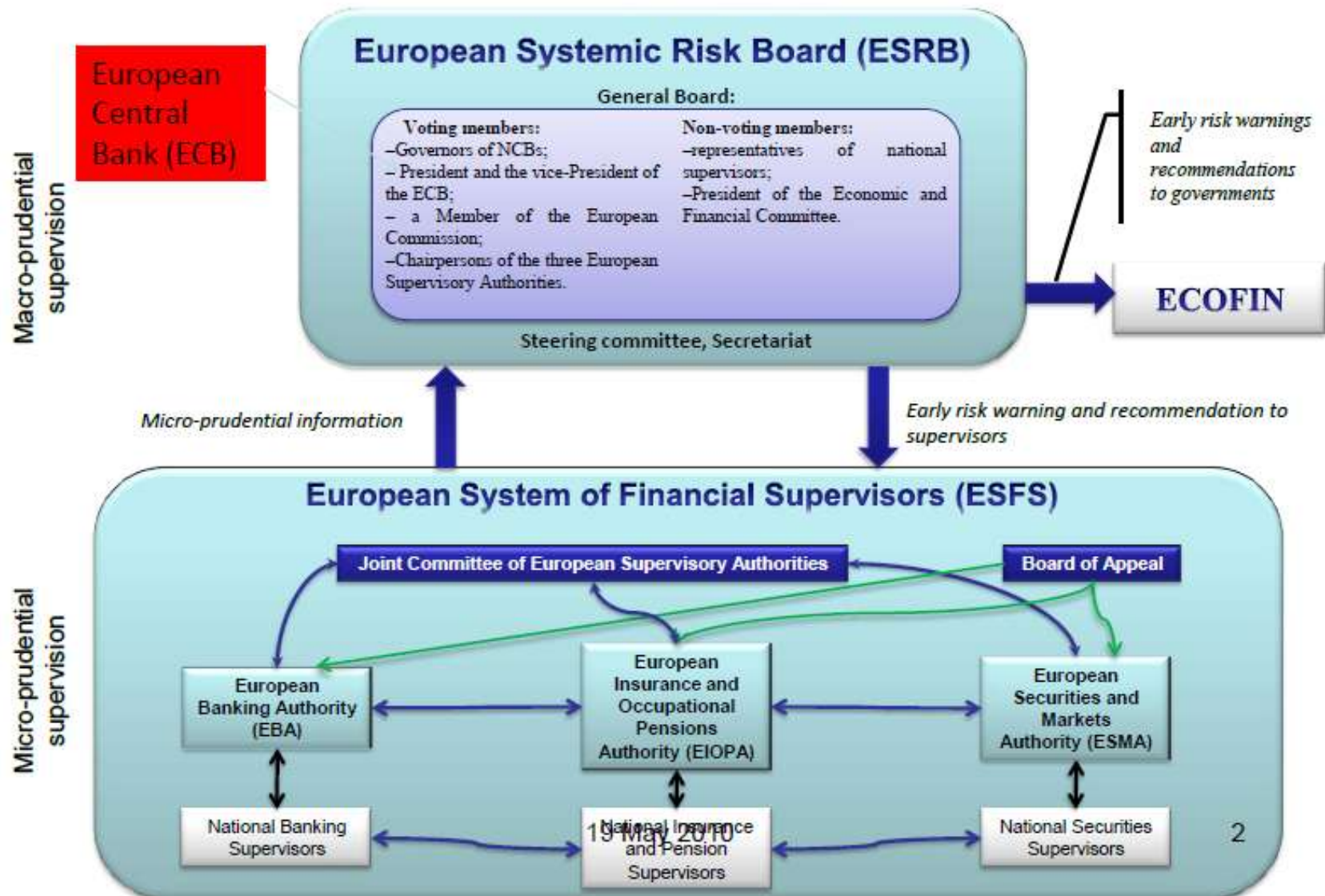
Article 114 (ex Article 95 TEC)

1. Save where otherwise provided in the Treaties, the following provisions shall apply for the achievement of the objectives set out in Article 26 [internal market completion clause, rs]. The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.

EUROPEAN FINANCIAL ARCHITECTURE: CURRENT DESIGN (BY ROSA LASTRA)



NEW EUROPEAN FINANCIAL ARCHITECTURE (BY ROSA LASTRA)



Acknowledgement: previous two slides borrowed from:

Professor Rosa Maria Lastra

LLB, MA (Valladolid), LLM (Harvard), PhD (Madrid)

Professor of International Financial and Monetary Law,
Queen Mary, University of London



EBA powers – 1 (Art. 8 (2) Reg. 1093/2010)

- developing draft **technical standards**
- issuing **guidelines** and **recommendations**
- taking **individual decisions** addressed to **competent authorities** in the specific cases referred to in Art. 18 (3) + 19 (3)
- taking **individual decisions** addressed to **financial institutions** in three specific cases: Art. 17 (6), 18 (4) and 19 (4)
- issuing opinions to EP, Council, Commission
- collecting information

EBA powers – 2

(Art. 8 (2)-(4) Reg. 1093/2010)

- temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union
- issue warnings
- establish Committee on financial innovation

Euro Area Summit Statement, 29 June 2012

“We affirm that it is imperative to **break the vicious circle between banks and sovereigns**. The Commission will present Proposals on the basis of Article 127(6) for a **single supervisory mechanism** shortly. (...) When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the **ESM could**, following a regular decision, **have the possibility to recapitalize banks** directly.”

Bernd Krauskopf
MOCOMILA Lima
4-5 April 2013
Seite 24

Euro Area Summit Statement, 29 June 2012 (Background 1)

- Sovereign debt crisis revealed the interdependence between sovereigns emitting debt and banks purchasing their nation's debt while at the same time relying on a restructuring framework backed by the same sovereign.
- As particularly Ireland in the EU (and Iceland outside) have shown, refinancing failing banks can threaten the solidity of national budgets and rapidly increase national indebtedness, even challenging debt sustainability.
- As long as banking supervision remains a national responsibility and under national control, liability towards stabilizing the financial market has to remain a task for the national budget as well.
- As recapitalization of struggling banks in some European markets through the national budget would threaten the debt sustainability of the respective Member State, shifting banking supervision to the European level was re-considered.

Bernd Krauskopf
MOCOMILA Lima
4-5 April 2013
Seite 25

Euro Area Summit Statement, 29 June 2012 (Background 2)

- Responsibility and liability need to go hand in hand.
 - Direct bank recapitalization through the ESM requires banking supervision to be transferred to the European level.
 - As a matter of this principle, recapitalization through the ESM should not be an option for the realization of risks having accrued under national supervisory regimes.
- Problem: Legislative basis in the TFEU
 - Art. 114 TFEU (internal market harmonization, chosen for ESFS) might have been option to establish independent authority (outside ECB)
 - **Political determination by the Euro Summit for Art. 127.6 TFEU**
 - “specific tasks” vs. integral banking supervision
 - delimitation between EBA’s and ECB’s responsibilities
 - need to closely monitor implementation to safeguard ECB’s primary mandate

Acknowledgement:

previous two slides borrowed from:



Bernd Krauskopf is General Counsel of the Deutsche Bundesbank since 2000, deputy chairman of its steering committee for European affairs and member of the Legal Committee of the European System of Central Banks. In these functions, he also advises the president as member of the Governing Council

of the ECB. He has contributed in various positions to monetary union between the former two German states in 1990 and was involved in the preparation of the European Monetary Union on behalf of the Bundesbank and the German government in various functions on a national and European level since 1993. He earned his law degree from Justus-Liebig-Universität, Gießen in 1979 after studies of law, economics and politics and has published various articles in particular on monetary and central bank law.

European Commission
Berlaymont building
Brussels, August 2012
© 2012 Joey Mathis



18-4-2013

(c) René Smits

28

Towards a genuine EMU (1)

Van Rompuy's ideas (June, October 2012)

- Gradually developing a fiscal capacity for EMU
 - to facilitate adjustments to State-specific shocks by providing for some degree of absorption at central level ...
 - ... and, beyond shock-absorption function: to facilitate structural reforms in MS
 - establishment of a Treasury function with clearly defined fiscal responsibilities
 - pooling of some short term sovereign funding instruments (T-bills) on a limited and conditional basis to be examined

Towards a genuine EMU (2)

Van Rompuy's ideas (June, October 2012)

□ Economic policy pursuit

- 'careful balance' between 'need to maintain policy autonomy and adjustment capacity' and enforceability of measures to prevent build-up of imbalances and facilitate price & cost adjustment
- greater visibility, authority and impact of agreed legislation
- institutional quality, labour market and business climate: cross-EU weaknesses and sizeable differences between MS > completion of single market
- individual arrangements of a contractual nature MS/ EU institutions on reforms promoting growth and jobs / financial support from EU
- ex ante coordination of major economic policy reform plans with significant spillover effects on euro area

Towards a genuine EMU (3)

Van Rompuy's ideas (June, October 2012)

- ❑ SSM
- ❑ Strengthening macro-prudential policy
- ❑ Democratic legitimacy and accountability:
 - 'strengthened role of EU institutions commensurate involvement of the European Parliament ('EP')
 - increased cooperation between national parliaments/EP
 - a debate in EP and national parliaments on recommendations adopted in European Semester.

European Council Conclusions, 13-14 December 2012

„Towards a Genuine European Monetary Union“

Stage 1 (End 2012-2013): Ensuring fiscal sustainability and breaking the link between banks and sovereigns

- Single Supervisory Mechanism (SSM)
 - Then, possibility of direct bank recapitalization through the ESM
- Harmonization of national resolution and deposit guarantee frameworks until June 2013
- Capital Requirements Regulation and Directive (CRR/CRDIV) until June 2013

Stage 2 (2013-2014): Completing the integrated financial framework and promoting sound structural policies

- Common resolution authority
- Appropriate backstop mechanism

Stage 3 (post 2014): Improving the resilience of EMU through the creation of a shock-absorbing function at the central level

Bernd Krauskopf
MOCOMILA Lima
4-5 April 2013
Seite 32

'Single Supervisory Mechanism'

- SSM term for ECB assuming operational tasks in prudential supervision, together with national competent and designated institutions, a first step towards 'banking union' *
- Micro-prudential supervision next to macro-prudential supervision (ESRB)
- Link with recently renewed EU-wide supervisory landscape: EBA, ESMA, EIOPA (+ ESRB = ESFS)
- Recovery and Resolution at EU level (via ESM?) } *
- Deposit Insurance at EU level } *
- Single rulebook } * From preamble CRRIV (16 April 2013): *For reasons of legal certainty and because of the need for a level playing field within the Union, a single set of regulations for all market participants is a key element for the functioning of the internal market.*

Different types of supervision

investor protection ('conduct of business')

supervision, focusing on conduct-of-business rules and disclosure of information

micro-prudential supervision, geared towards the safety and soundness of individual financial-services providers in the interest of depositors and other creditors

macro-prudential supervision, geared towards avoidance and containment of systemic risk and, therefore, interested in macroeconomic and financial market developments and market infrastructures

Some legal issues on SSM

- Independence of ECB – accountability
- Role of Governing Council vis-à-vis Supervisory Board
- ECB supervision of banks partly based on national law
- **Legal traps facing the ECB**

The European Central Bank is set to gain supervisory powers over the continent's banks via the single supervisory mechanism. René Smits explains the practical issues linked with the banking union

Central Banking Journal | 12 Dec 2012

- mandatory information exchange among supervisors constituting SSM
- application of national law by ECB
- review of supervisory decisions: national courts/ECJ // who decided actually?
- (limitation of) supervisory liability
- role in home and host State responsibilities ('European passport')
- EU-wide system of 'legal separation' (Vickers Report [UK])

Article 1: Objectives

- Safety and soundness of credit institutions
- Stability of the financial system in EU & each Member State
- “full regard and duty of care” to unity & integrity of internal market (equal treatment, avoiding regulatory arbitrage)
- ‘limited supervisory regulation [supervision] only’: CIs, not CCPs
- No discrimination clause (against ECB in case by UK on clearing house establishment rules)
- Micro- or macro-prudential control not conferred to ECB?
MS competent!

Article 4: tasks conferred on ECB

- a. Authorisation and withdrawal of authorisation
- b. Home [host] State powers for outbound [inward] branching or provision of services ins/outs (NB non-participating MS = euro <outs> minus those with 'close cooperation' with ECB)
- c. Assessment of qualifying holdings in credit institutions
- d. Compliance with capital, solvency, liquidity, leverage, reporting and disclosure by credit institutions
- e. Governance of credit institutions, fit & proper tests, remuneration, risk management and internal control
- f. Supervisory review and stress tests > specific additional own funds requirements
- g. Consolidated supervision (holding companies)
- h. Supplementary supervision (financial conglomerates)
- i. Recovery and early intervention but not resolution powers

Article 4 (3): law ECB is to apply

- EU law
- (in case of directives): national legislation transposing directives
- (in case of regulations allowing Member State options) national legislation exercising options
- ECB to adopt guidelines, recommendations, and to take decisions
- ECB subject to EBA's regulatory & implementing technical standards and to EBA Supervisory Handbook
- ECB to adopt regulations “only to extent necessary to organise or specify tasks” after public consultation

Article 4 a: macro-prudential tasks

- (1) National competent or designated authorities shall impose additional capital buffers addressing systemic risk – prior consultation of ECB: ‘comply [with ECB] or explain rule’
- (2) ECB may impose higher capital buffers requirements to counter systemic risk

Article 5: cooperation in SSM

- (1) SSM = ECB + national competent authorities – ECB responsible for effective and consistent functioning SSM
- (2) Duty of cooperation in good faith – obligation to exchange information – direct access of ECB to CI – national competent authorities provide ECB with all necessary information
- (3) National competent authorities assist ECB in preparing and implementing acts, subject to ECB instructions
- (4) Division of labour: ECB supervises systemically significant CIs // national competent authorities supervise other CIs, with ECB only responsible for market access, and ECB guiding them through regulations, guidelines, general instructions and ECB able to exercise direct supervision, e.g. when financial assistance has been *indirectly* received from EFS or ESM, and information on performance of supervision by national authorities to be given to ECB

Systemically relevant CIs

Article 4 (4)

- Assets > € 30 bn., or
- Ratio of assets to GDP MS > 20% (unless assets < € 5bn.), or
- National competent authority considers CI systemically relevant domestically, or
- ECB considers CI systemically relevant when participating in >1 MS, or
- Financial assistance directly from EFSF or ESM, plus
- ECB directly supervises three most significant CIs in each MS, unless justified by particular circumstances

Institutional issues

- Article 16: independence of ECB and national competent authorities
- Article 17: accountability towards EP [including closed doors confidential discussions: detailed agreement ECB-EP], Council
- Article 17aa: national parliaments
- Article 18: separation from monetary function // Chinese walls // Governing Council strictly separated meetings and agendas
- Article 19: Supervisory Board (Chair, Vice Chair, four ECB representatives, one representative for each national competent authority) – simple majority (still....) but when adopting regulations: QMV as in Article 16(40 TEU and Article 3 Protocol No. 36 on transitional provisions – ECB voting weight equal to median of voting rights of others // Supervisory Board prepares complete draft decisions for Governing Council – deemed adopted unless GC objects within 10 working days

ECB's new headquarters
at the *Grossmarkthalle*
in Frankfurt am Main
Architect: Martin Elsaesser
Completed: 1928
1941-1945: Collecting point
for deportation of Jewish
population
1997: Holocaust Memorial
Architect of new premises:
Coop Himmelb(l)au



R&R regime seven principles:

- o put **prevention and preparation** first: planning and preventive measures prepare authorities and firms for resolution
- o provide **credible resolution tools**: authorities should have resolution options that minimise the risk of contagion and ensure continuity of essential financial services
- o enable **fast and decisive action**: well-defined powers and processes, eliminating legal uncertainty
- o **reduce moral hazard**: appropriate allocation of losses to shareholders and creditors should protect public funds
- o contribute to **smooth resolution of cross-border groups** with minimum disruption of the internal market
- o ensure **legal certainty**: appropriate safeguards for third parties, limited interference with property rights
- o **limiting distortions of competition**: minimise distortions of the level playing field, ensure that State aid is compatible with Treaty rules and the internal market



From: Commission Communication *An EU Framework for Crisis Management in the Financial Sector*, October 2010 (COM(2010) 579 final)

Challenges ahead - 1

- Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, 25.09.2012:
“the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities”
(http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/20120925JointS/name.jsp)
- ‘Ratification’ of EU legal acts in Germany, Denmark, Austria (shifting of competences to EU level requires parliamentary approval) – German federal elections
- Weighted voting in Supervisory Board ECB
- Role of non-euro area supervisory authorities

Challenges ahead - 2

Berlin demands treaty change for bank reforms

FT 14 April 2013 by Alex Barker in Brussels

Germany laid down a big barrier on the fast track to European banking union, insisting a revision of EU treaties is necessary to create a single authority to wind up banks, even if it took several years to accomplish.



Jean Monnet

« L'Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises »

« Les hommes n'acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise. »