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MOCOMILA REPORT (April 2014)
European Banking Union

by Rosa M. Lastra, Bernd Krauskopf, Christos Gortsos and René Smits

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Rosa M. Lastra,* Bernd Krauskopf,** Christos Vl. Gortsos,*** René Smits****

May 2014 - Abstract

This paper is part of the Report of the Monetary Committee on the International Law Association (MOCOMILA) presented at the bi-annual meeting of the International Law Association (ILA), which took place on April 7th, 2014, in Washington DC, USA. MOCOMILA is dedicated to the study of legal aspects of money, payments, currency and financial stability.

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A. Introduction

The launch of European Monetary Union (EMU) on 1 January 1999 was not accompanied by a fiscal union and a transfer of supervisory responsibilities from the national to the supranational arena. The asymmetry between a centralized monetary area (for those Member States who adopted the euro - the euro area) and decentralised financial supervision (albeit subject to a substantial amount of common rules) became evident in the aftermath of the great financial crisis; reforms first to federalise and then to centralize supervision found political agreement amongst eurozone Member States.

The concept of a European Banking Union is based upon three pillars: The first pillar is a central and common European Banking Supervision, the Single Supervisory Mechanism (SSM), with the ECB as the institution in charge. The second pillar deals with the restructuring and resolution of financial institutions and contains a unified European Restructuring and Resolution mechanism: the Single Resolution Mechanism (SRM), which should be aligned with the proposed EU Bank Recovery and Resolution Directive (BRRD). The third pillar is common deposit protection.

Underpinning these three pillars is the concept of a common supervisory rule book, laying down uniform terms for the authorisation and withdrawal of credit institutions, for the conduct of micro-prudential supervision over credit institutions, for the resolution of non-viable credit institutions and for the operation of deposit guarantee schemes.1

The banking union will co-exist with the single market in financial services. From an institutional perspective this means that the expanded mandate of the ECB – the entity at the centre of the SSM – will impact upon the work of the European Banking Authority, whose jurisdiction is the EU at large.2

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1 See, notably:

- Directive 2013/36/EU of the European Parliament and of the Council “on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC” (known as CRD IV), which consists of 165 articles, and


B. The rationale for the Banking Union

The crises in Europe (the twin financial and sovereign debt crises) have shown a relationship of interdependence between sovereign nations emitting sovereign debt and financial institutions (banks) purchasing sovereign debt, while relying on restructuring and resolution frameworks, in particular a full bail-out, backed by national budgets. Refinancing failing banks can threaten the solidity of national budgets and rapidly increase national indebtedness, the sustainability of sovereign debt can threaten the stability of banks that hold the sovereign debt. A vicious circle or doomed loop was created in this way during the sovereign debt crisis.

To break this vicious circle between financial institutions and sovereign nations a common European back-stop with the ability to recapitalize banks directly was requested to relieve (some) Member States from the substantial rise of their national indebtedness due to the need to finance the restructuring of their banks. In June 2012 the Euro Area Summit decided that the European Stability Mechanism should get an instrument to recapitalize banks directly (under its current set of instruments, the ESM can only give credit to its Member States which can transfer the credit to their banks).3

To address the risk of moral hazard and the possibility of regulatory forbearance, the Euro area summit also decided to transfer banking supervision to the European level and to build a Banking Union consisting of a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and common deposit protection. A key aim of this Banking Union is to prevent that the financial consequences of improper national supervisory measures could be transferred to the European level and, thereby, to the taxpayers of other Member States. The creation of the Banking Union is the logical consequence of the political intention to create a possibility for the ESM to recapitalize banks in the Euro area directly. In this context, the Euro Area Summit of 29 June 2012 stated: “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 recapitalise banks directly”.4

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3 The statement at the end of the Euro Area Summit of 29 June 2012 was clear: “We affirm that it is imperative to break the vicious circle between banks and sovereigns”. However, banking union is not enough to break this vicious link. We also need to address – as Jens Weidman writing in FT on 1st Oct 2013 suggested – the regulatory treatment of sovereign exposures and end the ‘fiction of risk-free assets’ which receive favourable ratings by credit rating agencies. See, also the Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, 25 September 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”, available at: http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/20120925JointS/name.jsp

C. The Single Supervisory Mechanism and the single rulebook on banking regulation

1. The Single Supervisory Mechanism

1.1 Legal basis

The SSM was based on Article 127 (6) TFEU which states that the Council, acting by means of regulations, may unanimously confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings. On the basis of this provision the SSM Regulation, namely Regulation (EU) No 1024/2013 ‘conferring specific tasks on the European Central Bank concerning policies relating to the (micro-) prudential supervision of credit institutions’ was adopted on 15 October 2013. On 3 November 2013 the SSM-Regulation entered into force. According to Article 33 (2) the ECB shall assume the tasks conferred on it by this SSM regulation on 4 November 2014.

1.2 Asset quality review and stress tests

Before the actual start of the first stage of the Banking Union (i.e., before November 2014), it is necessary to determine and assess existing legacy assets in the balance sheets of the financial institutions subject to the SSM to avoid that hidden legacy assets undermine the credibility and reputation of the ECB’s supervisory work. The Member States are responsible and liable for the risks in the balance sheets of their financial institutions that have arisen under the supervision of their national authorities. Therefore, these risks must be borne and financed (if necessary) by the respective Member States and their national restructuring and resolution institutions, e.g. their national resolution funds.

The ECB – in collaboration with the national competent authorities – will perform a Comprehensive Assessment of the credit institutions that will be directly supervised by the ECB, consisting of three components:

(i) a ‘Supervisory Risk Assessment’ to review, quantitatively and qualitatively, key risks, including liquidity, leverage and funding;

(ii) an ‘Asset Quality Review’ to enhance the transparency of bank exposures by reviewing the quality of banks’ assets, including the adequacy of asset and collateral valuation and related provisions;

(iii) a stress test to examine the resilience of banks’ balance sheet to stress scenarios. This exercise will be performed in collaboration with the European Banking Authority.

1.3 Content of the SSM Regulation

The SSM-Regulation confers specific tasks related to the prudent supervision of financial institutions on the ECB.

The ECB will directly supervise “significant” institutions and indirectly the other “less significant” institutions. In principle, a financial institution is considered “significant” if it belongs to the three major credit institutions in its Member State or if its balance sheet total exceeds either 20% of the GDP of its Member State, or 30 billion Euros.\(^5\) The day to day supervision of other institutions will remain in the competence of the national supervisors. However, the ECB has the power to take over the

\(^5\) Article 6 (4) SSM-Regulation.
surveillance of any bank in individual cases. The ECB is responsible for the entry into the market of any credit institution\textsuperscript{6} and for the authorisation of holdings in authorised credit institutions\textsuperscript{7}. The ECB is mandated to organise coherent supervision of the entire banking system by these NSAs and itself.\textsuperscript{8}

While all Euro area Member States are legally required to take part in the SSM, non-Euro area Member States may participate voluntarily by agreeing a “close cooperation” with the ECB.\textsuperscript{9}

The supervisory tasks conferred on the ECB shall primarily be planned and executed by a new internal body called Supervisory Board. The Supervisory Board is composed of its Chair and Vice Chair, four representatives of the ECB who may not be charged with any tasks directly linked to the monetary policy tasks of the ECB, and one representative of the national authority competent for the supervision of credit institutions in each participating Member State.\textsuperscript{10} Decisions of the Supervisory Board shall be taken by a simple majority of its members and each member shall have one vote.\textsuperscript{11}

The Supervisory Board shall carry out preparatory works regarding supervisory tasks conferred on the ECB and propose complete draft decisions to the Governing Council of the ECB.\textsuperscript{12} These decisions are adopted by the Governing Council as the decision-making body of the ECB. A draft decision of the Supervisory Board shall be deemed adopted unless the Governing Council objects within a certain period.\textsuperscript{13} According to this “non-objection procedure” the Governing Council can adopt or object a draft decision of the Supervisory Board (“take it or leave it”). In case of an objection by the Governing Council, the matter can be referred to a Mediation Panel. However, the non-objection procedure has to be interpreted narrowly. It should only be applied for decisions (with addressees) in the supervisory process and sanction procedure, thus respecting, the Governing Council’s ultimate decision making competence which cannot be restricted by secondary EU law.

\textbf{1.4 Assessment of the SSM Regulation}

The decision-making structures of the ECB were designed primarily for monetary policy. This poses challenges with regard to the actual conduct of supervision by the ECB. Supervision, lest us forget is by definition resource and personnel intensive, very litigious, prone to reputational damage and, generally, a ‘thankless task’ in which failures are magnified and successes are often hidden. The conferral of supervisory responsibilities onto the ECB also poses challenges for its cherished independence. After all, the central bank’s independence is of a different kind than the regular ‘supervisory independence’ that characterizes the exercise of prudential supervision. The need to resist what is referred to as ‘regulatory capture’, a phenomenon that should

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\textsuperscript{6} Article 14 SSM-Regulation in conjunction with Articles 4 (1) (c) and 6 (4).

\textsuperscript{7} Article 15 SSM-Regulation in conjunction with Articles 4 (1) (c) and 6 (4).

\textsuperscript{8} Articles 6 (1), (2), (3), (5), (7) SSM-Regulation.

\textsuperscript{9} Article 7 SSM-Regulation.

\textsuperscript{10} Where the competent authority is not a central bank, the member of the Supervisory Board may decide to bring a representative from the Member State’s central bank.

\textsuperscript{11} Article 26 (6) SSM-Regulation.

\textsuperscript{12} Article 26 (8) SSM-Regulation.

\textsuperscript{13} Article 26 (8) SSM-Regulation.
be labeled ‘supervisory capture, i.e. the measure of influence over supervisory decisions by the supervised, is one element that distinguishes the two.

The creation of ‘Chinese walls’ within the ECB, in order to ensure the effective separation of its monetary responsibilities from its supervisory tasks is a key challenge for the ECB. The possibility of conflict is recognised in Article 25 of the SSM Regulation which foresees the establishment of a ‘mediation panel’.

Furthermore, every transfer of a new task to the ECB raises concerns about democratic legitimacy. These issues have been addressed in arrangements between the ECB and the Council\(^\text{14}\) on the one hand, and the European Parliament,\(^\text{15}\) on the other. These arrangements provide for extensive reporting and accountability mechanisms.

The coexistence between the SSM and the Single Market is a further challenge for the effectiveness of both realities (banking union and single market). Though it is stated in the SSM Regulation that the inclusion of the ‘single supervisory mechanism’ in the European System of Financial Supervision (ESFS) will not affect the current tasks of the European Banking Authority, this remains to be tested.

2. The single rulebook on banking regulation

On 26 June 2013, the following acts were published in the Official Journal of the European Union:

- Regulation (EU) No 575/2013 of the European Parliament and of the Council “on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012” (known as CRR), which consists of 521 articles\(^\text{16}\) and
- Directive 2013/36/EU of the European Parliament and of the Council “on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC” (known as CRD IV), which consists of 165 articles\(^\text{17}\).

Both texts have transposed into EU law the regulatory framework of the Basel Committee on Banking Supervision (known as ‘Basel III’). Regulation 575/2013 and Directive 2013/36/EU collectively set the framework which governs access to activity, the supervisory framework and the rules on prudential regulatory intervention in the operation of credit institutions and investment firms.

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\(^{15}\) Interinstitutional Agreement between the European Parliament and the European Central Bank on the practical modalities of the exercise of democratic accountability and oversight over the exercise of the tasks conferred on the ECB within the framework of the Single Supervisory Mechanism, Official Journal of the EU, No. L 320/1, 30 November 2013.

\(^{16}\) EE L 176, 27.6.2013, pp. 1-337.

\(^{17}\) EE L 176, 27.6.2013, pp. 338-436.
D. The Single Resolution Mechanism and the single rulebook on the resolution of credit institutions

1. The Single Resolution Mechanism

1.1 General aspects

The establishment of a Single Resolution Mechanism is a logical complement to the creation of the SSM. The SRM shall ensure that financial institutions (banks) can be resolved in times of crisis according to common rules and pre-established procedures. A resolution fund is foreseen as a common financial back-stop; the need to revert to taxpayers’ money in a financial crisis should be reduced to a minimum in order to break the vicious circle between financial institutions and sovereigns.

On 10 July 2013, the Commission presented a proposal for a Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund. Taking into account the disputes among the Member States concerning this draft regulation, the Council reached a compromise (political agreement with the European Parliament) on 18 December 2013 which includes arrangements for the transfer of national contributions to the Single Resolution Fund and their progressive mutualisation over a 10-year transitional phase. The proposed SRM regulation is expected to enter into force on 1 January 2015 and the bail-in and resolution functions shall apply from 1 January 2016.

1.2 Legal Basis of the Proposed SRM Regulation

Article 114 of the Treaty on the Functioning of the European Union (TFEU) is the legal basis for the proposed SRM Regulation. Article 114 allows the EU to adopt measures for the approximation of national provisions laid down by law, regulation or administrative action aiming at the establishment and functioning of the Internal Market of the European Union. This legal basis is controversial and has been criticised as insufficient (given that it deals with the needs of the internal market), with some arguing that a treaty revision is needed.

According to the Meroni doctrine of the European Court of Justice, EU law currently prohibits the delegation of discretionary powers to bodies that are not established in the European Treaties. New bodies with discretionary powers can only be established by the Member States by a transfer of competences in the way of a Treaty Amendment but not by normal secondary legislation. Therefore, the Meroni doctrine requires a basis in primary law for authorities with discretionary powers. Article 114 TFEU in principle does not provide for such basis. Although the establishment of the three European Supervisory Authorities was also based on Article 114 TFEU it has to be noted that the establishment of a SRM including a Single Resolution Fund is substantially different from the ESAs. While the core decision-making competences remain at the national level in the case of the ESAs, with regard

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19 Compare ECJ, case 9/56, Meroni.
20 The three agencies within the European Systems of Financial Supervision are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). The ESRB forms also part of the ESFS.
to the Single Resolution Mechanism, the core decision-making competences are transferred to the European level, to European “authorities”.

Bearing in mind these legal limitations, the proposed SRM regulation creates a Mechanism instead of a new authority (with a Single Resolution Board), but results in a complex decision-making mechanism, [which has already been criticized by some as inefficient].

1.3 The content of the proposed SRM Regulation

The SRM shall supplement the Bank Recovery and Resolution Directive (BRRD). The BRRD is expected to be adopted shortly and as all EU legislative instruments it has to be implemented in all EU Member States. The BRRD aims to give the national competent authorities common resolution tools for financial institutions in the EU. The jurisdictional domain of such BRRD is the EU/single market.

Developing the BRRD further the SRM shall not only harmonize the national legal frameworks on the restructuring and resolution of financial institutions but establish a Single Resolution Board and a Single Resolution Fund for all credit institutions subject to the supervision of the SSM. Therefore, the SRM shall replicate the instruments and competences provided for by the BRRD at the European level.

Although the SRM-Regulation shall apply in principle to all EU Member States its scope covers only institutions from the Member States participating in the SSM. However, the SRM shall not be limited to the “significant” institutions which are directly supervised by the ECB. Also “less significant” institutions shall fall under the scope of the SRM.

Resolution decisions will be taken on the European level. According to the political agreement reached on 18 December 2013, a Single Resolution Board with broad powers concerning bank resolution shall be established. The Single Resolution Board shall adopt resolution schemes and determine the application of resolution tools and the use of the single resolution fund on its own initiative or if it is notified by the ECB that a bank is failing or likely to fail. The Single Resolution Board shall refer its decisions to the European Commission. If the European Commission does not object such a decision within 24 hours of their adoption the decision will enter into force. In the case of an objection by the European Commission the Council has the final decision right.

The national resolution authorities shall be responsible for executing the decisions of the SRM. However, the Single Resolution Board has the power to address decisions to the national resolution authorities for the execution at the national level in accordance with the proposed SRM Regulation. The Board shall also monitor the execution by the national resolution authorities of its decisions at the national level and can directly address decisions to banks, if a national resolution authority does not comply with its decision.

The financing of resolution measures shall be carried out through the Single Resolution Fund. This Fund shall be financed through contributions by the financial institutions which are subject to the SRM. The target size of the Fund should be at least 1% of covered deposits in the banking system of the participating Member States. During the ten-year initial build up period of the Fund, the contributions of the financial institutions shall be raised at the national level and flow into "national compartments" of the Single Resolution Fund, which shall be used only for the resolution of banks in the respective Member State. This means that during the buildup period the Single Resolution Fund consists of national compartments. These national compartments shall be gradually merged. While the cost of resolving banks would mainly come from the
‘national compartments’ during the first years this national share would gradually decrease as the contribution from other countries’ compartments increases.

To guarantee the budgetary sovereignty of the Member States, neither the Commission, nor the Council nor the Single Resolution Board shall have the power to require Member States to provide extraordinary public financial support to the Single Resolution Fund. However, as the Fund may not have enough financial means at the beginning of its functioning, it has to be ensured that the national budgets of the Member States are not used to finance resolution measures. Thus, the Council also agreed on the design of a backstop to the Single Resolution Fund. During the build-up period of the Fund, bridge financing will be available from national sources, backed by bank levies, or from the European Stability Mechanism, in accordance with agreed procedures. Lending between the national compartments of the Fund shall also be possible. In addition, a common backstop shall be developed during the buildup period. This backstop shall become fully operational at the latest after 10 years. Political agreement has been reached to establish this fund on the basis of a separate, intergovernmental treaty instead of on secondary legislation based on the TFEU. Concerns about the legality of this latter method led the Member States to opt for this alternative route, which finds opposition in the European Parliament.

2. The single rulebook on the resolution of credit institutions

Concurrently, on 18 December 2013 the European Parliament and the EcoFin Council reached political agreement on the adoption of a Directive that had been on the table for a long time, the provisions of which will harmonise rules governing, inter alia, the resolution of non-viable credit institutions (and certain investment firms). It is worth pointing out that it is the first time that harmonisation rules will be implemented at EU level in this field, as opposed to the fields of prudential supervision and prudential regulatory intervention in the operation of credit institutions and bank deposit guarantees, for which a regulatory framework has been in place (for a long time).


E. Deposit protection

Although a common European deposit protection fund shall not be established for the time being, there are discussions concerning the harmonization of the national deposit protection regimes and a commitment of the national deposit protection funds to grant credits among each other if one fund has not enough financial means in a crisis. The prospect of establishing a European deposit guarantee scheme, as the third main component of a ‘European Banking Union’, is discussed in terms of principles and “high-level politics”, i.e. no specific regulatory proposals have been tabled by the European Commission. In this sense, this field is currently characterised by inaction.

Nonetheless, it should be pointed out that a Directive of the European Parliament and of the Council, repealing Directive 94/19/EC of the same EU institutions (as applicable, already amended to raise the level of deposit protection\(^\text{23}\)) regarding deposit guarantee schemes, is expected to be adopted in 2014. This Directive will further harmonise rules governing national deposit guarantee schemes, with a view to strengthening the single banking market (particularly as regards swift payout if a scheme’s intervention is triggered). The European Parliament and the Council reached political agreement on this proposal on 17 December 2013.

F. Conclusion

The establishment of the Banking Union is intended to break the vicious circle between the sovereign debt crisis and the banking crisis. In this context, the establishment of the SSM and the creation of the SRM can be seen as a first positive step to break this link between sovereigns and banks. It remains to be seen which effects the SSM and the SRM will have in practice. The jury is out.

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