

# **Crisis-based regulatory intervention: are we at the top of the prudential wave?**

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## A. An overview of the new EU financial framework

1. The new EU framework pertaining to financial regulation, supervision and oversight is a 'child of crisis' and, to be more precise, of two crises: the recent (2007-2009) international financial crisis, and the current fiscal crisis in the euro area, which erupted in 2010.

It addresses most of the causes of these crises by introducing a set of extensive rules aimed at three primary goals:

- enhancement of financial stability,
- enhancement of market efficiency, transparency and integrity, and
- enhancement of consumer protection.

## A. An overview of the new EU financial framework

2. For the most part, regulatory measures in this set were taken over from the international financial reform agenda, mainly the work orchestrated by the Financial Stability Board (FSB) and soft law rules adopted by international fora, such as the Basel Committee on Banking Supervision and IOSCO.

3. It has also established *three pan-European structures* for the micro-prudential supervision and resolution of (at least) systemically important credit institutions and investment firms, within the framework of the European Banking Union (EBU):

- the Single Supervisory Mechanism (SSM),
- the Single Resolution Mechanism (SRM), and
- the Single Resolution Fund (SRF).

## A. An overview of the new EU financial framework

4. The establishment of the SSM, the SRM and the SRF constitute bold institutional novelties. Especially the creation of the SSM is a reform element, that of improved financial supervision, that was not addressed adequately during the first sub-period since 2008.

It should be recalled that **the 2009 de Larosière Report**, which was elaborated in order to identify the causes of the recent (2007-2009) international financial crisis, highlighted weak financial supervision as a major cause. It is worth noting that even this Report **concluded that (contrary to macro-prudential oversight) micro-prudential supervision should not be assigned to the ECB**, a proposal that has been rejected with the establishment of the SSM.

## **B. A broad assessment of the new EU financial framework**

1. The new framework, which applies to all 28 EU Member States, with the exception of the rules on the EBU institutions (SSM, SRM, and SRF) that are confined to euro area Member States, is characterised by the following:

- it is more robust, consistent in principle, and has curtailed the overall risk exposure of the EU financial system,
- its biggest achievements are the establishment of the Single Supervisory Mechanism (SSM) and the adoption of the resolution framework,
- its major – though intended – drawback is the very short period of time within which it was adopted (albeit justified given the circumstances under which it was introduced),

## **B. A broad assessment of the new EU financial framework**

- the legislative process has definitely been improved, enabling the adoption of rules by EU institutions with a more active involvement of supervisory bodies, through the three ‘European Supervisory Authorities’ (EBA, ESMA and EIOPA), which de facto have definitely superior technical knowledge of the subject-matters,
- it transfers considerable powers from Member States to EU institutions and bodies, mainly within the institutional framework set by the Treaties, and
- it imposes substantial compliance costs on financial actors, including a heavy cost of raising more own funds to meet capital adequacy requirements.

## **B. A broad assessment of the new EU financial framework**

2. It is also worth pointing out the following on this new framework:

- it would be premature to judge its resilience under circumstances of new, unforeseeable crises,
- the framework is too recent to be in need of immediate revision, even though developments in the relevant international agenda must be constantly kept under close watch,
- its flexibility enabling it to withstand a new crisis must be assessed both on the basis of the existing legal framework and with regard to its adaptability,
- in the light of differences in regulatory costs between the EU and other international financial centres, the case for enhanced international cooperation and coordination is even stronger in order to avoid regulatory arbitrage, and

## **B. A broad assessment of the new EU financial framework**

3. The main comparative advantages of the new EU financial framework are the following:

- the positive signalling effect of a prompt and mainly decisive regulatory response by European institutions to the causes of the two crises,
- its adoption without an amendment to the TFEU, which would compromise the speed of reform and the flexibility to resort to an Intergovernmental Agreement (on the SRF, even with abstention of two Member States) if the TFEU did not provide the appropriate legal basis,
- its compliance with international financial standards, subject to the constraints arising from the fact that other international financial centres may not have complied with such standards,
- its ‘unbiased approach’, in the sense that new rules have been adopted across the board, applying to all four sectors of the financial system (banking, capital markets, private insurance, and payments).

## **B. A broad assessment of the new EU financial framework**

4. On the other hand, its main comparative costs are the following:

- as a result of the rapid adoption and implementation of several legal acts simultaneously, an enormous compliance burden imposed on financial actors,
- in more detail, a need for credit institutions to raise significant amounts of new capital within a relatively short period of time, and meet the new liquidity requirements imposed on them, leading some to reconsider their business model, and
- the fact that the achievement of its three primary goals may compromise, at least in the short run, the positive contribution of the financial system (and in particular of its banking sector) to the real sector of the economy, in terms of both borrowing costs and available credit.

## **B. A broad assessment of the new EU financial framework**

5. An inconsistency problem arises only to the extent that all legal acts of the new EU financial framework contain national discretions to be used:

- by all of the 28 Member States, when transposing EU Directives into their national legislation, and
- by their supervisory, resolution or other designated authorities according to specific provisions of Directives and Regulations.

It is then up to the EBA, the ESMA and the EIOPA to ensure that EU financial law is implemented in a uniform manner across all Member States through its technical standards and its soft law instruments.

## **B. A broad assessment of the new EU financial framework**

6. The use of the term ‘over-regulation’ is not inappropriate in this context. EU financial law (mainly administrative in nature, if viewed from the perspective of national law) currently covers almost every single aspect of financial activity:

- More regulation, however, does not linearly lead to higher levels of financial stability, market efficiency, and consumer protection.
- Effective supervision and enforcement are conditions sine qua non towards that end. These have to be ensured by the ECB (within the SSM), the national competent supervisory authorities in the fields of banking (again within the SSM), capital markets and insurance, as well as, to the extent they are competent for this, by the EBA the ESMA and the EIOPA.

## **B. A broad assessment of the new EU financial framework**

7. To the extent that the EU financial framework extensively regulates and thus restrains financial activity (maybe to the limits of a market economy) in order to ensure the achievement of its primary goals, it can be argued that the overall risk exposure of the EU financial system is curtailed. Nevertheless, it would be premature to judge its resilience under circumstances of new, unforeseeable crises due to:

- stress arising from inside the system (which is the main focus of the new framework),
- persistently negative developments in the real sector of the EU economy (which would strongly affect all sectors of the financial system),
- a generalised sovereign debt crisis (thus far averted),
- the negative spill-over effects of geopolitical developments in the region (an aspect which until recently was not taken into account), or
- inappropriate fiscal and/or monetary policies (very improbable, but still one of the main causes, in the author's view, of the recent (2007-2009) international financial crisis, at least in some cases).

## C. The way ahead

### 1. General overview

The political decisions made on the above-mentioned three main pillars (building blocks) of the EBU were bold, and, with the exception of the establishment of a single deposit guarantee scheme, the relevant legislative work was completed by mid-2014. Nevertheless, the **full Europeanisation of the 'bank safety net'** requires, in the author's opinion, three (3) further elements, which are either pending or have not yet been discussed (see below 2-4).

The EBU is also the driving force behind the very recent discussions pertaining to the creation of a **European Capital Markets Union**, part of which is already the new resolution regime (SRM, SRF and BRRD), which applies equally to credit institutions and investment firms.

## C. The way ahead

### 2. Direct recapitalisation of credit institutions by the European Stability Mechanism

The first issue is whether the recapitalisation of credit institutions faced with insolvency (albeit viable according to the evaluation of supervisory authorities) could be assigned directly to the European Stability Mechanism (the ‘ESM’), thus curbing the public debt of Member States in which such credit institutions are incorporated. Under the applicable regime, the ESM may provide financial assistance to euro area Member States for the purpose of bank recapitalisation, **albeit indirectly**.

- a loan is provided by the ESM to the Government of the requesting euro area Member State under a ‘Financial Institution Recapitalisation Facility’, and
- the funds are earmarked for the recapitalisation of one or more ailing credit institutions. However, such assistance increases the country’s public debt.

## C. The way ahead

### 2. Direct recapitalisation of credit institutions by the European Stability Mechanism (cont.)

On 10 June 2014, the euro area Member States reached a preliminary agreement on a new instrument, the **ESM 'Direct Recapitalisation Instrument'** (the 'DRI'). The DRI will enter into operation, when the necessary national procedures have been completed and the ESM Board of Governors takes a unanimous decision to its creation. It will be available mainly to systemically relevant credit institutions that are unable to:

- meet the capital requirements established by the ECB in its capacity as single supervisor within the SSM, and
- obtain sufficient capital from private sources, if a bail-in would not be sufficient to meet the anticipated capital shortfall.

## C. The way ahead

### 3. The ECB as lender of last resort

Another issue not discussed officially as yet is the prospect of the ECB becoming a single lender of last resort in the euro area for solvent credit institutions with temporary liquidity shortage. Currently, and due to the lack of a solid legal basis for the ECB, this function is considered to be a task for the national central banks - members of the Eurosystem. Indeed, ‘**Emergency Liquidity Assistance**’ (the ‘**ELA**’) is provided, according to the Governing Council of the ECB:

- by the national central banks of the Member States whose currency is the euro,
- to individual solvent credit institutions facing temporary liquidity problems, and
- against collateral not eligible for the ECB’s monetary policy operations.

## C. The way ahead

### 3. The ECB as lender of last resort (cont.)

The Governing Council of the ECB is allowed to prohibit this, if it is deemed in conflict with the objectives and tasks of the ECB, according to [Article 14.4 of the Statute](#).

During the current euro area fiscal crisis, the ELA has been activated with regard to several Irish, Greek and Cypriot credit institutions, and also, as recently as in August 2014, a Portuguese credit institution.

## C. The way ahead

### 4. Winding-up of credit institutions

Credit institutions' winding-up proceedings in the EU fall within Member State competence. Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001, which governs both the reorganisation and the winding-up of credit institutions, did not even provide for a minimum harmonisation of national reorganisation measures and winding-up proceedings.

The Directive mainly introduced the principle of mutual recognition, according to which (as applied to winding-up proceedings) the administrative or judicial authorities of the home Member State, which are responsible for winding-up, are solely competent to decide on the opening of winding-up proceedings concerning a credit institution, including its branches established in other Member States

## C. The way ahead

### 4. Winding-up of credit institutions (cont.)

The discussions on the creation of the EBU did not touch upon the prospect of changing this regime. Accordingly:

- credit institutions' winding-up proceedings will remain national, at least in the foreseeable future,
- also activating the repayment procedure of national deposit guarantee schemes (upon, however, a decision for the withdrawal of an authorisation taken by the ECB), since, in the vast majority of cases, the repayment procedure of deposit guarantee schemes is being activated by the decision to wind-up a credit institution.

**TABLE 1****The key legal sources of the three main pillars the European Banking Union**

	<b>Prudential supervision and regulation of credit institutions</b>	<b>Resolution of non-viable credit institutions</b>	<b>Deposit guarantee schemes</b>
European 'Single Mechanisms'	Single Supervisory Mechanism: <ul style="list-style-type: none"> <li>• Council Regulation (EU) 1024/2013 ('SSM Regulation')</li> <li>• ECB Regulation (EU) 468/2014 ('SSM Framework Regulation')</li> <li>• other ECB legal acts</li> </ul>	Single Resolution Mechanism and Fund: <ul style="list-style-type: none"> <li>• Regulation (EU) 806/2014 of the European Parliament and of the Council ('SRM Regulation'), and Commission delegated and implementing acts</li> <li>• Intergovernmental Agreement (2014)</li> </ul>	No initiatives as yet
Harmonisation of substantive rules ('single rulebook')	<ul style="list-style-type: none"> <li>• Regulation (EU) 575/2013 of the European Parliament and of the Council (CRR), and Commission delegated and implementing acts</li> <li>• Directive 2013/36/EU of the European Parliament and of the Council (CRD IV), and Commission delegated and implementing acts</li> </ul>	<ul style="list-style-type: none"> <li>• Directive 2014/59/EU of the European Parliament and of the Council (BRRD), and Commission delegated and implementing acts</li> </ul>	<ul style="list-style-type: none"> <li>• Directive 2014/49/EU of the European Parliament and of the Council (DGSD), and a Commission delegated act</li> </ul>

**TABLE 2****Addressees of and date by which the main provisions of the key legal sources pertaining to the European Banking Union are applicable****A. Authorisation - prudential supervision - prudential regulation**

<b>Legal act</b>	<b>Addressees</b>	<b>Date of start of application</b>
Regulation (EU) No 1024/2013 ('SSM Regulation')	19+ Member States	4 November 2014
ECB 'SSM Framework Regulation'	19+ Member States	15 May 2014
Regulation 575/2013 ('CRR')	28 Member States	1 January 2014
Directive 2013/36/EU ('CRD IV')	28 Member States	1 January 2014

**B. Recovery and resolution**

Regulation (EU) No 806/2014 ('SRM Regulation')	19+ Member States	1 January 2016
Intergovernmental Agreement on the 'SRF'	19+ Member States	1 January 2016 ( <i>upon ratification by Contracting Parties</i> )
Directive 2014/59/EU ('BRRD')	28 Member States	1 January 2015

**C. Deposit guarantee**

Directive 2014/49/EU on deposit guarantee schemes	28 Member States	4 July 2015
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**TABLE 3****Procedure for the adoption of legal acts which constitute the sources of European financial law**

	<b>Level 1 (*): legally binding acts</b>	<b>Level 2 (*): legally binding acts</b>		<b>Level 3 (*): non-legally binding acts (soft law)</b>
<b>Type of legal act</b>	Legislative acts falling within the Authorities' scope of action (Article 289 TFEU)	Regulatory technical standards by means of delegated acts (Article 290 TFEU)	Implementing technical standards by means of implementing acts (Article 291 TFEU)	Guidelines and recommendations (Regulations establishing the Authorities)
<b>Body issuing the legal act</b>	European Parliament and Council (with the ordinary legislative procedure)	European Commission	European Commission	<b>EBA/ESMA/EIOPA</b> (according to the scope of action)
<b>Assistance to the issuing of a legal act</b>	EBC/ESC/EIOPC (**) (as advisory committees) <b>EBA/ESMA/EIOPA</b> (as opinion-giving bodies)	<b>EBA/ESMA/EIOPA</b> (elaborating draft technical standards)	<b>EBA/ESMA/EIOPA</b> (elaborating draft technical standards) EBC/ESC/EIOPC (as regulatory committees) (***)	

(\*) Reference to these “three levels” depicts the wording that was used (without any explicit legal basis) in the Lamfalussy Report

(\*\*) European Banking Committee, European Securities Committee, European Insurance and Occupational Pensions Committee

(\*\*\*) According to the comitology procedure (Regulation (EU) No 182/2011).

**TABLE 4**

**European banking law before and after the European Banking Union:  
Elements of continuity and change**

**A. Prudential requirements**

<b>Financial policy instruments</b>	<b>Institutions/rules</b>	
	<b>Until 31 December 2013</b>	<b>By 2014 (gradually) (italics denote change or new element)</b>
1. Authorisation and micro-prudential supervision of credit institutions	<ul style="list-style-type: none"> <li>National supervisory authorities</li> <li>Minimum harmonisation of rules (Directive 2006/48/EC)</li> </ul>	<ul style="list-style-type: none"> <li>Single Supervisory Mechanism ('SSM Regulation') (for euro area +)</li> <li>National supervisory authorities (for Member States with a derogation)</li> <li>Single rulebook ('CRD IV') (for all Member States)</li> </ul>
2. Micro- and macro-prudential regulation of credit institutions	Minimum harmonisation of rules (Directives 2006/48/EC and 2006/49/EC)	<i>Single rulebook ('CRR' and 'CRD IV') (for all Member States)</i>
3. Evaluation of recovery plans	–	<ul style="list-style-type: none"> <li><i>Single Supervisory Mechanism ('SSM Regulation') (for euro area +)</i></li> <li><i>National supervisory authorities (for Member States with a derogation)</i></li> <li><i>Single rulebook ('BRRD')</i></li> </ul>
4. Resolution planning	–	<ul style="list-style-type: none"> <li><i>Single Resolution Mechanism ('SRM Regulation') (for euro area +)</i></li> <li><i>National resolution authorities (for Member States with a derogation)</i></li> <li><i>Single rulebook ('BRRD')</i></li> </ul>
5. Macro-prudential oversight of the financial system	European Systemic Risk Board	European Systemic Risk Board

**TABLE 4 (cont.)**  
**European banking law before and after the European Banking Union:**  
**Elements of continuity and change**

**B. Crisis prevention**

<b>Financial policy instruments</b>	<b>Institutions/rules</b>	
	<b>Until 31 December 2013</b>	<b>By 2014 (gradually)</b> <i>(italics denote change or new element)</i>
1. Adoption of ‘alternative measures’ within the framework of recovery plan evaluation	-	<ul style="list-style-type: none"> <li>• Single Supervisory Mechanism (‘SSM Regulation’) (for euro area +)</li> <li>• National supervisory authorities (for Member States with a derogation)</li> <li>• Single rulebook (‘BRRD’)</li> </ul>
2. Repair or removal of impediments to resolvability	-	<ul style="list-style-type: none"> <li>• <i>Single Resolution Mechanism (‘SRM Regulation’) (for euro area +)</i></li> <li>• <i>National resolution authorities (for Member States with a derogation)</i></li> <li>• <i>Single rulebook (‘BRRD’)</i></li> </ul>
3. Early intervention - special administrator	-	<ul style="list-style-type: none"> <li>• <i>Single Supervisory Mechanism (‘SSM Regulation’) (for euro area +)</i></li> <li>• <i>National supervisory authorities (for Member States with a derogation)</i></li> <li>• <i>Single rulebook (‘BRRD’)</i></li> </ul>
4. Write-down and conversion (without bail-in)	-	<ul style="list-style-type: none"> <li>• <i>Single Resolution Mechanism (‘SRM Regulation’) (for euro area +)</i></li> <li>• <i>National resolution authorities (for Member States with a derogation)</i></li> <li>• <i>Single rulebook (‘BRRD’)</i></li> </ul>

**TABLE 4 (cont.)**  
**European banking law before and after the European Banking Union:**  
**Elements of continuity and change**

**C. Crisis management**

<b>Financial policy instruments</b>	<b>Institutions/rules</b>	
	<b>Until 31 December 2013</b>	<b>By 2014 (gradually)</b> <i>(italics denote change or new element)</i>
1. Reorganisation of credit institutions	<ul style="list-style-type: none"> <li>• National authorities (Directive 2001/24/EC)</li> <li>• No harmonisation of rules</li> </ul>	<ul style="list-style-type: none"> <li>• National authorities (Directive 2001/24/EC)</li> <li>• No harmonisation of rules</li> </ul>
2. Winding-up of credit institutions	<ul style="list-style-type: none"> <li>• National authorities (Directive 2001/24/EC)</li> <li>• No harmonisation of rules</li> </ul>	<ul style="list-style-type: none"> <li>• National authorities (Directive 2001/24/EC)</li> <li>• No harmonisation of rules</li> </ul>
3. Deposit guarantee schemes	<ul style="list-style-type: none"> <li>• National schemes</li> <li>• Minimum harmonisation of rules (Directive 94/19/EC)</li> </ul>	<ul style="list-style-type: none"> <li>• National schemes</li> <li>• <i>Single rulebook (Directive 2014/49/EU) (for all Member States)</i></li> </ul>
4. Resolution of credit institutions	-	<ul style="list-style-type: none"> <li>• <i>Single Resolution Mechanism ('SRM Regulation') (for euro area +)</i></li> <li>• <i>National resolution authorities (for Member States with a derogation)</i></li> <li>• <i>Single Resolution Fund (Intergovernmental Agreement) (for euro area +)</i></li> <li>• <i>Single rulebook ('BRRD') (for all Member States)</i></li> </ul>

**TABLE 4 (cont.)**  
**European banking law before and after the European Banking Union:**  
**Elements of continuity and change**

**C. Crisis management**

<b>Financial policy instruments</b>	<b>Institutions/rules</b>	
	<b>Until 31 December 2013</b>	<b>By 2014 (gradually)</b> <i>(italics denote change or new element)</i>
5. Provision of state subsidies to systemically important credit institutions	<ul style="list-style-type: none"> <li>• Member States</li> <li>• Indirectly the ESM</li> </ul>	<ul style="list-style-type: none"> <li>• Member States</li> <li>• Indirectly the ESM</li> <li>• <i>Potentially directly the ESM ('DRI')</i></li> </ul>
6. Last resort lending to solvent but illiquid credit institutions	National central banks (Emergency Liquidity Assistance (ELA) in the euro area)	National central banks (Emergency Liquidity Assistance (ELA) in the euro area)