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ΕΥΡΩΠΑΪΚΟ ΚΕΝΤΡΟ ΟΙΚΟΝΟΜΙΚΟΥ ΚΑΙ ΧΡΗΜΑΤΟΟΙΚΟΝΟΜΙΚΟΥ ΔΙΚΑΙΟΥ

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CURRENT DEVELOPMENTS IN EUROPEAN BANKING LAW

by Professor Christos Vl. Gortsos

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Current developments in European Banking Law

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Abstract

The collapse of financial markets in autumn 2008 and the credit crunch that followed can be attributed to multiple, often inter-related, causes, as identified, among others, in the 'de Larosière Report,' published on 25 February 2009, and in particular to the accumulation of excessive risk in the financial system. The financial crisis prompted a broad EU and international effort to develop effective policies to tackle the underlying problems. In fact, almost the entire existing banking regulation is being revised as a response to the recent financial crisis. The objective of this report is to examine the amendments to take place in European banking regulation.

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A. General Overview

The collapse of financial markets in autumn 2008 and the credit crunch that followed can be attributed to multiple, often inter-related, causes, as identified, among others, in the 'de Larosière Report,' published on 25 February 2009, and in particular to the accumulation of excessive risk in the financial system. The financial crisis prompted a broad EU and international effort to develop effective policies to tackle the underlying problems. In fact, almost the entire existing banking regulation is being revised as a response to the recent financial crisis. Taking as a point of reference the European banking regulation currently in force, the following amendments have already taken place or are under preparation:

(a) Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (known as 'CRD') has been amended by Directive 2009/111/EC (known as "CRD II") and Directive 2010/76/EC (known as 'CRD III'), while a proposal for a Directive and a proposal for a Regulation are under preparation in order to transpose in European law the Basel III regulatory framework (known as 'CRD IV' and 'CRR', respectively).

(b) Directive 94/19/EC on deposit-guarantee schemes has already been amended by Directive 2009/14/EC and will also be amended by a proposal for a Directive currently under preparation.

(c) A 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 was adopted by the European Commission on 6 June 2012.

(d) Last-resort lending, in principle without a legislative framework, was widely used during the recent financial crisis by the ECB as part of its 'unconventional monetary measures'. In addition, new elements of last-resort lending were introduced in order to allow the national central banks in certain member states of the Eurosystem (notably Ireland and Greece) to provide also emergency liquidity assistance to commercial banks under their jurisdiction upon the so-called 'Emergency Liquidity Assistance' (the 'ELA').

The objective of this report is to examine the amendments to take place with respect to each element of the 'bank safety net' as it is regulated at the European level. In this respect, the following areas are examined:

- micro-prudential regulation of credit institutions (under B),
- micro-prudential supervision of credit institutions (under C),
- macro-prudential regulation of credit institutions (under D),
- macro-prudential oversight of credit institutions (under E),
- resolution of credit institutions (under F), and
- deposit-guarantee schemes (under G).

It is also worth mentioning that since June 2012 there are discussions on the creation of a 'banking union', which would resort to:

- the establishment of a single European banking supervisory authority (by enhancing the powers of the European Banking Authority),
- a single European resolution authority, and
- a European deposit guarantee scheme.

The implementation of such proposals would require a *total overhaul* of the existing European banking law (including the one under amendment), and induce the introduction of new provisions in all of the legislative acts to be issued by the current agenda. The relevant political decisions are not expected to be taken before September 2012.

B. Micro-prudential regulation of credit institutions

In the proposal for a Regulation ('CRR') there are provisions amending the existing regulatory framework governing the capital adequacy of credit institutions (under 1), and provisions introducing "innovative" elements and additional rules on micro-prudential regulation (under 2).

1. Amendments to the existing rules governing the capital adequacy of credit institutions

1.1 Provisions on credit institutions' minimum regulatory capital

During the recent financial crisis it was found that the quality of capital instruments required to absorb unexpected losses from risks in the trading book and Tier 3 capital instruments were not of sufficiently high quality. Furthermore, the harmonisation in the EU of the definition of capital was insufficient. The main objective of the proposal is to strengthen further the criteria for eligibility of capital instruments and to introduce harmonisation of the adjustments made to accounting equity in order to determine the regulatory capital that it is prudent to recognize for regulatory purposes. The new requirements would be implemented gradually between 2013 and 2015.

1.2 Provisions on coverage against exposure to credit risk

The crisis revealed a number of shortcomings in the current regulatory treatment of counterparty credit risk arising from derivatives, repo, and securities financing activities. Requirements for management and capitalisation of the counterparty credit risk will be strengthened. Risk weights on exposures to financial institutions relative to the non-financial corporate sector will be raised. The proposal for a Regulation would also enhance incentives for clearing over-the-counter instruments through central counterparties.

2. "Innovative" elements

2.1 Leverage ratio

In order to limit an excessive build-up of leverage on credit institutions' and investment firms' balance sheets and thus help contain the cyclicality of lending, the Commission proposes to introduce a non-risk based leverage ratio (namely, assets and off-balance sheet items of banks are not risk-weighted as in the case of capital adequacy requirements). The leverage ratio will be introduced as an instrument for the supervisory review of institutions. Its impact will be monitored with a view to migrating it to a binding pillar one measure in 2018.

2.2 Liquidity ratios

Existing liquidity risk management practices were shown by the crisis to be inadequate in fully grasping risks linked to originate-to-distribute securitization, use of complex financial instruments and reliance on wholesale funding with short term maturity instruments. This contributed to a demise of several financial institutions and strongly undermined the financial health of many others, threatening the financial stability and necessitating public support.

To improve short-term resilience of the liquidity risk profile of financial institutions, a Liquidity Coverage Ratio ('LCR') will be introduced after an observation and review period in 2015. LCR would require institutions to match net liquidity outflows during a 30 day period with a buffer of "high quality" liquid assets.

After an observation and review period in 2018, a Net Stable Funding Ratio ('NSFR') will also be introduced in order to address funding problems arising from asset-liability maturity mismatches. The NSFR would require institutions to maintain a sound funding structure over one year in an extended firm-specific stress scenario such as a significant decline in its profitability or solvency.

C. Micro-prudential supervision of credit institutions

The basic rule, i.e., the exercise of supervision by the competent *national* authorities, remains the same as well as the coordination and the exchange of the necessary information between competent authorities of the Member States in case of cross-border activities of one credit institution. The *novum* in this area is the establishment on 23 September 2009 of the European Banking Authority (the 'EBA'), the European Insurance and Occupational Pensions Authority (the 'EIOPA'), and the European Securities and Markets Authority (the 'ESMA'), as the successors of the Lamfalussy Committees and the new powers and tasks conferred to them.

The EBA is a part of the newly-established European System of Financial Supervisors (the 'ESFS'), which started operating on 1 January 2011. The ESFS is the result of the legislative adoption of the proposals of the 'de Larosière Report' and its legal basis are 4 Regulations of the European Parliament and of the Council and one Regulation of the Council. The EBA, being the successor of the CEBS and a component of the ESFS, has a clearly more important role in ensuring the stability of the European banking system than that of its predecessor, the CEBS, extending beyond the area of micro-prudential supervision, especially during crisis situations. It has been conferred with extensive tasks and broader powers.

Meanwhile, the EBA has also been endowed with tasks and powers on the field of protecting financial services consumers, although it has not become a, literally, European supervisory authority of the banking system in the European Union. The Chairman of MOCOMILA, Sir William Blair, is the first President of the Joint Board of Appeal in respect of certain decisions of the EBA and the two other European Supervisory Authorities. A further appeal lies to the European Court of Justice.

D. Macro-prudential regulation of credit institutions

The term 'financial macro-prudential policies' (of which macro-prudential regulations are a part) refers to the set of policies (mainly of a prudential nature) adopted and implemented to limit the financial system's exposure to systemic risk, ensuing from factors that do not concern individual financial services providers or individual markets and structures of the financial system, but are more general in character. *A systemic risk is defined as the risk of a malfunction in the supply of financial services (and/or failure to supply), due to the weakening of a sector or of the entire financial system, potentially leading to serious negative consequences in the real sector of the economy.*

The relevant rules of the CRD IV, under preparation, are introduced for the first time and they are addressing exclusively the time dimension of systemic risk. In this context, credit institutions are called to create a "capital conservation buffer" in times of economic growth (under 1), and a "countercyclical buffer" in times of excessive credit expansion (under 2). Both buffers are meant to attenuate the risk of pro-cyclicality and the risk of excessive leverage by building strong "forward-looking provisions" and covering against excessive cyclicality of the minimum capital requirements of credit institutions.

1. Capital conservation buffer

According to the CRD IV, the Capital Conservation Buffer amounts to 2.5% of risk weighted assets, applies at all times, and has to be met with capital of the highest quality. It is aimed at ensuring institutions' capacity to absorb losses in stressed periods that may span a number of years. Credit institutions would be expected to build up such capital in good economic times.

2. Countercyclical conservation buffer

According to the CRD IV, the Countercyclical Capital Buffer is set by national authorities for loans provided to natural and legal persons within their Member State, it can be set between 0% and 2.5% of risk weighted assets, and has to be met by capital of the highest quality likewise. This buffer will be required during periods of excessive credit growth and released in a downturn.

E. Macro-prudential oversight of credit institutions

The European Systemic Risk Board (the 'ESRB') is a part of the newly-established ESFS, which started operating on 1 January 2011. The ESRB is responsible for the macro-prudential oversight of the European financial system in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress.

For this purpose, the ESRB is carrying out the following, *inter alia*, tasks:

- determining and/or collecting and analysing all the relevant and necessary information,
- identifying and prioritising systemic risks,
- issuing warnings where such systemic risks are deemed to be significant and, where appropriate, make those warnings public,
- issuing recommendations for remedial action in response to the risks identified and, where appropriate, making those recommendations public,
- cooperating closely with all the other parties to the ESFS; and, in particular, in collaboration with the ESAs, developing a common set of quantitative and qualitative indicators to identify and measure systemic risk, and
- coordinating its actions with those of international financial organisations, particularly the IMF and the FSB as well as the relevant bodies in third countries on matters related to macro-prudential oversight.

F. Resolution of credit institutions

According to the proposal for a Directive establishing a framework for the recovery and resolution of credit institutions, submitted in June 2012, the aim is to provide national competent authorities *"with the tools to intervene sufficiently early and quickly in an unsound or failing credit institution so as to ensure the continuity of the credit institution's essential financial and economic functions, while minimizing the impact of an institution's failure on the financial system and ensuring that shareholders and creditors bear appropriate losses"*.

As a first step towards that end, the Commission is developing a legislative proposal for a harmonized regime for crisis prevention and bank recovery, which includes a common set of resolution tools and reinforcement of cooperation between national authorities. The framework of the Commission comprises three (3) classes of measures: preparatory and preventative measures (under a), early supervisory intervention (under b), and resolution tools and powers (under c).

(a) Preparatory and preventative measures are designed to increase the possibility that developing problems will be identified at an early stage, include reinforced micro-prudential supervision by competent authorities, asset transferability, the conduct of recovery and resolution plans ("living wills") setting out the measures a credit institution or group would take under different scenarios to address liquidity problems, raise capital or reduce risk, and preventative powers of authorities (indicatively, amendments to business operations and operational structures).

(b) Early supervisory intervention measures are designed to address developing problems at the entity and group level at an early stage, prevent them from aggravating and secure recovery, include in particular:

- expanded supervisory powers (indicatively, clear powers to require the replacement of managers or directors),
- implementation of recovery plans in case an institution is failing to meet the solvency and liquidity requirements under the provisions of the European financial law in force, and
- the supervisory power to appoint a special manager to take over the management, or assist the existing management of an institution.

(c) Resolution tools require the adoption of appropriate financial insolvency laws in order to ensure that "failing" financial institutions can be resolved in a way that minimizes risk of contagion and ensures continuity of essential financial services. The resolution tools include a 'sale of business', a 'bridge bank', an 'asset separation', and a 'bail-in' tool.

G. Deposit Guarantee Schemes (DGS)

The main amendments to the existing framework Directive 94/19/EC as amended by Directive 2009/14/EC are the following:

(a) The coverage level will be set at of EUR 100,000 (Directive 2009/14/EC) at maximum.

(b) Payout: the DGS must act to repay depositors within one week (from 20 working days according to Directive 2009/14/EC).

(c) *DGS financing and borrowing between DGS:* according to the proposal for a Directive, DGSs' available financial means should be proportionate to their potential liabilities. The financing of DGSs will be based on the following subsequent steps:

- *First*, in order to ensure sufficient funding, DGSs must have 1.5% of eligible deposits on hand after a transition period of 10 years.
- *Second*, credit institutions must pay extraordinary (ex-post) contributions of up to 0.5% of eligible deposits if necessary.
- *Third*, a mutual borrowing facility allows a DGS in need to borrow from all other DGSs in the EU, which, altogether, must lend to the DGS a maximum of 0.5% of its eligible deposits in need.
- As a *fourth* and last line of defense against taxpayers' involvement, DGSs must have in place alternative funding arrangements, recalling that those arrangements must comply with the monetary financing prohibition laid down in article 123 TFEU.

(d) *Risk-based contributions to DGSs:* Contributions from credit institutions to DGSs must be calculated according to their risk profiles in a harmonised way. The proposed indicators cover the key risk classes commonly used to evaluate the financial soundness of credit institutions (capital adequacy, asset quality, profitability and liquidity).

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