Towards a European Banking Union – The European Commission Announces a New Legal Framework for Banking Supervision

On 12 September 2012, the European Commission published two proposals which will pave the way towards a European Banking Union. The proposals aim at strengthening the Economic and Monetary Union (“EMU”) and ultimately, providing some stabilisation in the Eurozone. The Commission proposes a single supervisory mechanism under which the European Central Bank (“ECB”) would have supervisory responsibility for all banks in the Eurozone. This is the first step on the road towards banking union and the ambitious aim is for the new system to come into force on 1 January 2013. Further legislative proposals, including one which will create a single European resolution authority with the ability to intervene, reorganise and wind-up banks in a crisis, are also anticipated. In addition, the Commission is promoting a form of compulsory burden-sharing under which there would be effectively common funds, paid for by the banks themselves, to guarantee deposits and for resolution financing but it appears that opposition from some Member States has derailed the Commission’s legislative plans in this area.

Background

Eurozone leaders announced on 29 June 2012 that, when an effective single supervisory mechanism is established for Eurozone banks, the Eurozone’s emergency rescue fund, the European Stability Mechanism (“ESM”), could be used to recapitalize banks directly. Under existing rules, money from the ESM must be funnelled to banks via loans to national governments, a step that piles more debt on to the government and can thus increase its borrowing costs. Accordingly, the move to permit the ESM to give money directly to banks is intended to break the link between banks and their sovereigns but, as fiscal responsibility is intrinsically linked to supervisory control, it is conditional on common supervision of the Eurozone’s banks.

In response to this and the mandate from EU leaders at the European Council of 28 and 29 June 2012, the European Commission has presented a package of measures that will change the way in which banks in the Eurozone will be supervised. Currently, Member States are responsible for supervision and appoint national regulators. The establishment of the European System of Financial Supervision in 2011 required these regulators to work in tandem with the newly created European Supervisory Authorities (“ESAs”) and gave the ESAs responsibilities which were intended to ensure a more harmonised approach to supervision across the EU but supervision of banks remained the responsibility of national regulators. The current proposals will change that and confer responsibility for the supervision of banks in the Eurozone on a pan-European institution, the ECB. A single supervision mechanism, built around the ECB, is intended to provide a short-term reassurance to markets that the EU is tackling the sovereign debt crisis and, following that, pave the way for banks in the Eurozone to be recapitalised directly by the ESM.

The remaining pillars of the European Banking Union are a single rule book for financial institutions in the single market (a project on which the EU has already begun work), a common system for deposit guarantees and an integrated crisis management framework.

1 See http://ec.europa.eu/internal_market/finances/committees/index_en.htm

The Package of Proposals

The Commission’s package includes:

• a legislative proposal for a Council Regulation to give specific tasks related to financial stability and banking supervision to the ECB applicable to all banks in the Eurozone, with a mechanism for countries outside the Eurozone to join on a voluntary basis;  

• a legislative proposal for a Regulation of the European Parliament and the Council designed to align the existing regulation on the European Banking Authority (“EBA”) to the modified framework for banking supervision; and

• a communication outlining the Commission’s overall vision for banking union, covering the single rulebook and the single supervisory mechanism, as well as the next steps involving a single bank resolution mechanism.

The Proposal relating to the prudential supervision of banks by the ECB

Key provisions in the proposal for a Council Regulation giving the ECB powers relating to the prudential supervision of banks are as follows:

• the proposal is addressed to all 27 Member States in the EU but its provisions apply predominantly to the Eurozone;

• the ECB shall have prudential supervisory responsibility for all banks in the Eurozone (over 6,000);

• this will include Eurozone subsidiaries, but not branches, of banks located outside the Eurozone, such as the UK;

• countries outside the Eurozone can pass national legislation to subject their regulators to the supervision of the ECB;

• the legislation shall come into force from 1 January 2013 and the ECB could commence supervision of all banks on this date but supervision can be phased-in gradually (see Articles 27 and 28);

• from 1 July 2013, the ECB must supervise “the most significant” banks (Article 27(1));

• the proposal encourages the ECB (in Article 27(3)) to commence its supervision of those institutions which have “received or requested public financial assistance” early;

• the proposal creates a twin peak model of supervision with the ECB responsible for prudential regulation and national regulators responsible for conduct regulation;

• the ECB’s supervisory tasks (listed in Article 4(1)) include authorisations and withdrawals of authorisations, ensuring compliance with capital requirements, setting pillar 2 add-ons and imposing capital buffers.

The Proposal relating to the EBA

This proposal makes some amendments to the regulation establishing the EBA, the ESA responsible for the banking sector. These changes are essential not just to preserve the role of the EBA but also to accommodate it within the modified framework of banking supervision. In particular, they reflect the particular status of the ECB as an EU institution and amend the voting modalities in the EBA to ensure that the Eurozone does not unduly influence the decisions of the EBA which are intended to reflect the interest of the EU as a whole.

---


Decisions in the EBA are taken mainly by the Board of Supervisors, which includes one representative from a regulator in each Member State. Decisions are taken by simple majority (and thus the Eurozone currently has a majority) or qualified majority voting (the rules of which are specified in the Treaty on the Functioning of the EU (the “Treaty”). The Eurozone does not currently have a qualified majority but will do so under new voting procedures to be introduced in stages in 2014 and 2017.

The proposal recognises that the EBA cannot impose decisions on the ECB and so amends Article 18 and 19 of the EBA regulation which permits the EBA, in specified circumstances, to impose decisions on national regulators in the case of an emergency (as declared by the Council) or as part of a binding mediation process in the case of a dispute between national regulators. The EBA retains these powers over national regulators but is not given them in respect of the ECB: instead the ECB must comply with the EBA decision or explain why it has not done so. The proposal provides, however, that if the ECB does not comply with the EBA decision, the EBA can impose its decision on the individual institution which is the subject of the ECB’s underlying supervisory decision, as it can over national regulators when they do not comply with an EBA decision directed to them.

Article 41 of the EBA regulation is amended to create an independent panel consisting of the Chairperson of the EBA Board of Supervisors and 2 other members of the Board of Supervisors (one from the countries outside the Eurozone) to decide on decisions referred to EBA under the binding mediation process (Article 19 EBA) and in cases where a regulator is thought to be in breach of union law (Article 17 EBA). The original provision established an internal panel consisting of the Chairperson of the Board of Supervisors and any 2 other members of the Board of Supervisors to consider cases of binding mediation referred to it.

An amendment to Article 44 of the EBA regulation provides that a decision of the panel is to be adopted unless rejected by a simple majority of the Board of Supervisors including 3 votes from the Eurozone and 3 votes from the countries outside the Eurozone.

Other Measures

The Commission’s Communication accompanying the proposals envisages the creation of a single resolution authority for countries within the banking union. Somewhat unexpectedly, it does not promise a future proposal for a single resolution fund or a single deposit guarantee scheme but cross-refers to proposals already being negotiated – the recast of the deposit guarantee schemes directive6 and the recovery and resolution directive7 - and asks the EU institutions to reconsider these proposals in light of the proposal on common supervision by the end of the year. Proposals on a common fiscal backstop are likely to be even more politically controversial than the proposal on common supervision as they are regarded as amounting to compulsory burden sharing, something about which Germany, in particular, will be reticent. On the basis of the current proposal, however, the ESM could have the possibility to recapitalise banks directly from 1 January 2013.

Impact on banks

The regulation regarding the ECB provides that, by 1 January 2014, the ECB will be responsible for the prudential supervision of all banks in the Eurozone. This will include Eurozone subsidiaries, but not branches, of banks located outside the Eurozone, whether elsewhere in the EU or in the US, for example. Countries outside the Eurozone, such as Sweden or the UK, may pass domestic legislation to subject their regulators to supervision by the ECB but those countries will be questioning whether such an arrangement gives legal or supervisory certainty given that the ECB powers under the Treaty do not extend to them and so any agreement to bind themselves to ECB decisions can only be, as the proposal seems to recognise, voluntary. Countries outside the Eurozone and their banks may question whether even such an agreement would permit the ECB to exercise powers that the Treaty explicitly does not give it. Indeed, the fact that the countries outside the Eurozone cannot take part in the decision-making body of the ECB,

7 See http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm
constitutional difficulties with a blanket fettering of the discretion of their regulators, the need to pass domestic legislation and their inability to benefit from the ESM means that such countries will be considering carefully whether they want to participate in common supervision.

For those banks which will be supervised by the ECB, the proposal, as it stands, creates a potentially confusing system of supervision by both the ECB and national regulators. In one respect, this is inevitable as the Treaty provides that only tasks relating to prudential supervision may be conferred on the ECB which means that the national regulators must retain responsibility for conduct supervision. This is in effect the twin-peaks model that the UK will adopt on the establishment of the Prudential Regulation Authority and Financial Conduct Authority in 2013: it essentially differentiates between how banks manage the risk on their balance sheets and how they conduct their business. There are inherent difficulties in making such a split – some issues can be seen as both prudential and conduct, for example – but there is an even greater risk of confusion when there is also a split between what the ECB will do and what national regulators will do in prudential supervision. The transitional provisions require the ECB to act by instructing national regulators for a limited period but the proposal also provides for an indefinite dual regime: the ECB can only act through the regulators of the countries outside the Eurozone; national regulators are required to assist the ECB and to retain responsibility for those tasks not conferred on the ECB; there is also a dual sanctioning regime with both the ECB and national regulators applying pecuniary sanctions.

The proposal does not include a legal mechanism to challenge the merits of a decision of the ECB. As the proposal now stands, the only challenge mechanism for a bank affected by an ECB decision refusing or withdrawing an authorisation, for example, is an appeal before the European Court of Justice on a question of law, as set out in the Treaty. This process was originally set up because of Treaty provisions which protect the independence of the ECB. Accordingly, ECB decisions were to be appealed to the European Court of Justice and only on questions of law not of fact and merit. This does not seem appropriate for appeals in relation to day-to-day decisions on banking supervision.

The ECB governance structure suggested by the proposal includes a new supervisory body, including national regulators, to plan and execute the tasks conferred on the ECB but this does not appear to be consistent with the ECB Statute. The Statute specifies the bodies to which the Governing Council, the ultimate decision-making body of the ECB, may delegate tasks: these bodies include national central banks but do not include national regulators. Any amendment to this Statute require Treaty change. Whereas the Governing Council will clearly not have the capability and capacity to take all supervisory decisions in respect of around 6,000 banks in a timely manner, its role, as set out in the Treaty, has to be respected or amended. It is also this Statute which states that countries outside the Eurozone do not have a seat on the Governing Council, the body which the proposal makes clear must have oversight of and responsibility for the supervisory tasks conferred on the ECB.

Of additional concern to all countries having dealings with the Eurozone will be whether the creation of the ECB as a ‘super supervisor’ will change the existing relationships between national regulators. Will there be equality of arms between the ECB and the national regulators of banks outside the banking union, for example? Where the ECB is the supervisor of all institutions in a group (ie the home and host supervisor), how will the interests of the differing institutions and the different countries in which they are located be represented? A college wholly within the Eurozone would appear meaningless and a college where the ECB represents the vast majority of institutions would appear skewed in favour of the Eurozone.

Impact on non-Eurozone countries

It seems likely that the conferral of supervisory tasks on the ECB will be used as a justification for the even greater use of directly applicable regulations in EU financial services legislation as this will enable the adoption of legislation which does not allow for national discretions or options. Given that the proposals currently being negotiated on bank capital
requirements (CRD IV / CRR)\(^8\) still contain around 60 national discretions, some of which countries like the UK argued were necessary to ensure the proper implementation of international obligations (such as Basel III), this is significant. Such a development would appear to lead to rule-based - as opposed to judgement-based - supervision and there will be questions as to whether this model of supervision is most effective: for example, many Pillar 2 decisions require considerable discretionary judgement rather than the application of heavily codified or rigid rules.

An ECB rulebook which is used in the 17 Eurozone Member States may end up being adopted throughout the entire EU as an EU-wide measure through sheer weight of numbers. In this way, EU countries outside the Eurozone may find the supervisory model used by the ECB being applied to them in any event as the majority of EU financial services legislation is adopted via qualified majority voting and the Eurozone will have a qualified majority when the new rules on voting are adopted.

**Role of the EBA**

The proposed amendments to the EBA regulation are also designed to ensure that the Eurozone cannot dominate the making of EBA decisions but the countries outside the Eurozone might query whether they go far enough. The EBA regulation originally provided that a panel decision on binding mediation had to be approved by a simple majority of regulators and could be rejected by a blocking minority. It will thus be harder, especially for the smaller group of countries outside the Eurozone, to reject a decision of the panel. In addition, there are no changes made to the decision-making process under which the EBA proposes level 2 legislation: this remains a qualified majority decision.

**Outlook**

Not all Member States agree that all banks in the Eurozone ought to be subject to common supervision. Germany, in particular, has been vocal in arguing that only the largest and most systemically important banks ought to be supervised by the ECB. It has also queried whether the ECB has the capability and capacity to supervise so many banks.

The proposal needs to be politically acceptable as it must be adopted by all 27 Member States not just the Eurozone. Negotiations between the Member States will almost certainly result in significant amendments being made to the proposal before it is eventually adopted by the Council. The timetable of adoption of the necessary legislation by the end of the year is ambitious and a number of Member States, led by Germany, have already argued that it is unrealistic. The German finance minister, Wolfgang Schäuble, has stated that there is no possibility of the ESM being able to recapitalise banks directly by 1 January 2013: he has argued that common supervision is a necessary but insufficient condition for such a move. On the other hand, France leads a bloc of Member States which support the ambitious but, they say, necessary timetable. After an informal meeting of EU finance ministers on 15 September, the Swedish finance minister, Anders Borg stated that there will be “a very tough autumn with a lot of very hard negotiations ahead” but the focus is still on EU leaders adopting the plan for banking union at the formal December summit meeting on 13 – 14 December 2012.

---

It remains to be seen whether it will be possible to agree a framework for common supervision that is credible, legally robust and provides for effective supervision as well as being politically acceptable within such a tight timescale. It would seem that common supervision ought to be accompanied by common fiscal backstops but it is by no means certain that these, even more contentious aspects of banking union, will be agreed. It is significant that the Commission has not published the expected details of proposals for a single guarantee scheme, single resolution fund and a single resolution authority: this highlights the political obstacles that may stand in the way of full banking union and thus a genuine economic and monetary union.

The EU is limited in what it can achieve without Treaty change. This may explain the shortcomings in the current proposals. If it wishes to develop a credible solution to the crisis in the Eurozone, establish a long-term framework for effective supervision which is legally robust and deal with the concerns of Member States, it needs to address the question of Treaty change at the same time.

If you have any questions about any of the issues raised in this update, please contact:

Alexandria Carr  
Of Counsel (Employed Barrister), London  
T: +44 20 3130 3398  
E: acarr@mayerbrown.com

Mark Compton  
Partner, London  
T: +44 20 3130 3388  
E: mcompton@mayerbrown.com

Dr. Salomé Cisnal de Ugarte  
Counsel, Brussels  
T: +32 2 551 5981  
E: scisnaldeugarte@mayerbrown.com

Dr. Jörg Wulfken  
Partner, Frankfurt  
T: +49 69 79 41 2951  
E: jwulfken@mayerbrown.com