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A comprehensive EU response to the financial crisis: a strong financial framework for Europe and a banking union for the eurozone

INTRODUCTION

The financial crisis highlighted the need for better regulation and supervision of the financial sector. It is the reason why the European Commission has since 2010 proposed nearly 30 sets of rules to ensure all financial actors, products and markets are appropriately regulated and efficiently supervised. These rules are the basic framework for all 28 Member States of the EU and underpin a properly functioning single market for financial services.

The ensuing eurozone crisis added an extra dimension, highlighting the need for a better governed and deeper economic and monetary union for a single currency to work in the long run. In 2011, the crisis took a new turn with the eurozone debt crisis: it highlighted the potentially vicious circle between banks and sovereigns.

For that circle to be broken, a more robust financial sector is not enough. In particular for countries which share a currency, a deeper more integrated approach is necessary - basically ensuring centralised delivery of the rules for all 28 Member States.

This is why EU Heads of State and Government committed to a banking union in June 2012. The vision was further developed in the European Commission's blueprint for economic and monetary union in November 2012 (MEMO/12/909).

This memo sets out what has been done to create a robust financial framework for all 28 Member States and what is being done on top of that in the banking union specifically for countries which share the euro, although the banking union is also open to all non-euro EU Member States who want to join. This memo does not deal with efforts to improve the wider governance of the eurozone (this is dealt with here: MEMO/13/318)

1. A ROBUST FINANCIAL FRAMEWORK FOR THE SINGLE MARKET

When the financial crisis spread to Europe in 2008, we had 27 different regulatory systems for banks in place, largely based on national rules and national rescue measures, although some limited European minimum rules and coordination mechanisms already existed. The pre-crisis framework was incapable of responding to the financial crisis, in particular its systemic nature. There were for example no tools in place to deal with the collapse of large cross-border banks.

Since 2008 the European Commission has tabled around 30 proposals to create piece-by-piece a sounder and more effective financial sector. Better regulated and supervised banks will be stronger, more resilient, and operate to benefit the real economy at large, as well as ensuring that taxpayers don't have to foot the bill for banks' mistakes.

The robust financial framework being created is for all 28 Member States and both preserves and strengthens the single market. It also corresponds to the EU's implementation of its G20 commitments on financial regulation.

1.1 Measures to secure better supervision of the financial system

Regulation alone is not enough.

Without good supervision, regulation can be worthless.

That is why we have revamped the supervision of the financial sector at EU level, improving both coordination between national supervisors and enhancing EU-wide supervision to deal with risks and issues with cross-border effects. Both supervision levels are complementary and essential for the sake of financial stability in Europe.

Three European supervisory authorities (ESAs) were established on 1 January 2011 to introduce a supervisory architecture (MEMO/10/434):

- the European Banking Authority (EBA), which deals with bank supervision, including the supervision of the recapitalisation of banks
- the European Securities and Markets Authority (ESMA), which deals with the supervision of capital markets and carries out direct supervision with regard to credit rating agencies and trade repositories
- and the European Insurance and Occupational Pensions Authority (EIOPA), which deals with insurance supervision.

The 28 national supervisors are represented in all three supervising authorities. Their role is to contribute to the development of a single rulebook for financial regulation in Europe, solve cross-border problems, prevent the build-up of risks, and help restore confidence.

A European Systemic Risk Board (ESRB) was established to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial system as a whole ("macro-prudential supervision"). To this end, the ESRB provides an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks.

1.2 A single rulebook for all banks in Europe

The European Council of June 2009 unanimously recommended establishing a single rulebook applicable to all financial institutions in the single market.

The rulebook is a corpus of legislative texts covering all financial actors and products: banks have to comply with one single set of rules across the single market. This is crucial to ensure that there are no loopholes and good regulation everywhere in order to guarantee a level playing field for banks and a real single market for financial services.

1.2.1 The backbone of the single rulebook: Stronger prudential requirements

The package on capital requirements for banks, the so called "CRD IV" (see MEMO/13/272), which transposes via a Regulation and a Directive the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework, was published in the EU Official Journal on 27 June, 2013.

The new rules which will apply from 1 January 2014 tackle some of the vulnerabilities shown by the banking institutions during the crisis, namely the insufficient level of capital, both in quantity and in quality, resulting in the need for unprecedented support from national authorities. The timely implementation of the Basel III agreement features among the commitments taken by the EU in the G20.

The new framework sets stronger prudential requirements for banks, requiring them to keep sufficient capital reserves and liquidity. This new framework will make EU banks more solid and will strengthen their capacity to adequately manage the risks linked to their activities, and absorb any losses they may incur in doing business.

Furthermore, these new rules will strengthen the requirements with regard to corporate governance arrangements and processes of banks. For example, a number of requirements are introduced in relation to diversity within management, in particular as regards gender balance. In addition, in order to tackle excessive risk-taking, the framework imposes tough rules on bonuses.

1.2.2 Strengthening deposit guarantee schemes

A second strand of a more robust financial sector is ensuring bank deposits in all Member States are guaranteed up to €100 000 per depositor per bank if a bank fails. From a financial stability perspective, this guarantee prevents depositors from making brutal withdrawals from their banks, thereby preventing severe economic consequences.

In July 2010, the Commission proposed to strengthen existing rules in this area (IP/10/918). While the €100 000 guarantee remains appropriate, the reform would ensure faster pay-outs (reduction of pay-out delay from the current 20 working days to 7 calendar days) and strengthened financing, notably through ex-ante funding of deposit guarantee schemes (target level of at least 1.5% of eligible deposits to be reached over 10 years).

The negotiations on this proposal are on-going. The European Council has made clear that the co-legislators (Council and Parliament) should agree on both proposals as a matter of priority.

1.2.3 Common Recovery and Resolution tools

The Commission's proposal on recovery and resolution tools for banks in crisis of 6 June 2012 (see IP/12/570 and MEMO/12/416) implements the European Union's commitment as part of the G20 to review our bank resolution and restructuring regimes in light of the crisis to allow for an orderly wind-down of large complex cross-border banks which have been considered "too big to fail".

To ensure that the taxpayer does not have to end up bailing out banks, the EU has proposed a common framework of rules and powers to help EU countries intervene to manage banks in difficulty. These should enter into force in 2015. Repeated bailouts of banks have created a situation of deep unfairness, increased public debt and imposed a heavy burden on taxpayers.

This EU-wide resolution framework for the managed resolution of banks and investment firms will give national resolution authorities all the tools to prevent crises from emerging in the first place (for instance by ensuring that all banks have recovery and resolution plans in place), and address them early on in the process if they do (for instance the power to appoint a special manager in a bank for a limited period to deal with problems). And, if the financial situation deteriorates beyond repair, national authorities in all Member States will have a common toolkit and roadmap to manage the failure of banks in an orderly fashion, with a "bail-in" mechanism to call on shareholders and creditors when attributing losses of failed banks.

How will the bail-in mechanism work in practice?

The mechanism would stabilise a failing institution so that it can continue to provide essential services, without the need for bail-out by public funds. Recapitalisation through the write-down of liabilities and/or their conversion to equity would allow the institution to continue as a going concern, avoid the disruption to the financial system that would be caused by stopping or interrupting its critical services, and give the authorities time to reorganise it or wind down parts of its business in an orderly manner.

In short: if a bank needs to resort to bail-in, authorities will first bail-in all shareholders and will then follow a pre-determined order. Shareholders and other creditors who invest in bank capital (such as holders of convertible bonds and junior bonds) will bear losses first.

Deposits under € 100 000 will be entirely protected and the deposit guarantee scheme will make a contribution equivalent to the amount it would have born if the institution had been liquidated.

The proposal also foresees the creation of national resolution funds paid for by banks in order to support bail-in and other resolution tools for restructuring and closing down of banks.

The ultimate aim of the proposal is to make sure that the financial sector pays for its own failings, rather than having to call on taxpayers' money. If a national resolution fund would not have sufficient resources to pay for a restructuring, the proposal asks Member States to impose an extra levy on its banking sector, before calling on the option to borrow from national resolution funds of other EU Member States.

Negotiations on this proposal are now in their final stages and an agreement should be reached in the autumn between the Council and the European Parliament.

1.2.4 Other chapters of the single rulebook

To complement the key pillars of the single rule book set out above, the Commission has tabled legislation on other aspects to make the financial sector as a whole more robust.

The following rules are now in force:

- Stricter rules on hedge funds (see MEMO/10/572)
- Stricter rules on short selling and credit default swaps (see MEMO/11/713)
- A comprehensive set of rule for derivatives (see MEMO/12/232)
- A framework for reliable high quality credit ratings (see MEMO/13/571).

Proposals have also been made, and are still being negotiated on:

- Reform of the audit sector (see IP/11/1480)
- Reform of the framework for market abuse (see IP/11/1217 and IP/12/846)
- Revision of current rules on markets in financial instruments (see IP/11/1219) and investment funds (see IP/10/869).

Further proposals will be made shortly to finalise the framework:

- Review of the reform of the structure of the banking sector though the work of the high-level expert group headed by Erkki Liikanen (see IP/12/1048);
- Shadow banking including Money Market funds and Securities law (see IP/12/253)
- Revision of the governance of market benchmarks such as Libor (see IP/12/939).

2. THE BANKING UNION

2.1 Why a banking union for the euro area?

Uncoordinated national responses to the failure of banks have reinforced the link between banks and sovereigns and led to a worrying fragmentation of the Single Market in lending and funding. This fragmentation is particularly damaging within the euro area, where monetary policy transmission is impaired and the ring-fencing of funding impedes efficient lending to the real economy and thus growth.

Swift progress towards a Banking Union, comprising single centralised mechanisms for the supervision and restructuring of banks, is indispensable to ensure financial stability and growth in the euro area.

Building on the strong regulatory framework common to the 28 members of the Single Market (single rulebook), the European Commission has therefore taken an inclusive approach and proposed a roadmap for the Banking Union with different steps, potentially open to all Member States but in any case for the 18 Member States currently within the euro area.

2.2 The agreement on a single supervisory mechanism

On 12 September 2012, the Commission proposed a single banking supervision mechanism in the euro area (see IP/12/953). It is expected to be fully operational in late 2014.

Main features of the Single Supervisory Mechanism (SSM):

- It confers new supervision powers on the ECB for the banks of the euro area: the coherent and consistent application of the single rulebook in the euro area, the direct supervision of banks having assets of more than €30 billion or constituting at least 20% of their home country's GDP, the monitoring of the supervision exerted by national supervisors on less significant banks. That said, the ECB may at any moment decide to directly supervise one or more of these credit institutions to ensure consistent application of high supervisory standards.
- The SSM is open to all non-euro area Member States.
- For cross-border banks active both within and outside Member States participating in the SSM, existing home/host supervisor coordination procedures will continue to exist as they do today.

- Finally the EBA will remain a key player of the single market, ensuring consistency in the application of a single rulebook to all banks within the EU by the single supervisory mechanism and all national supervisors outside of the SSM.

2.3 Towards a fully-fledged banking union

The reinforced regulatory and supervisory framework of the SSM and enhanced prudential requirements will bolster the safety of banks. However, the risk of a bank experiencing a severe liquidity or solvency problem can never be totally excluded. In the Banking Union bank supervision and resolution need to be exercised by the same level of authority and be backed by adequate funding arrangements. Otherwise tensions between the supervisor (ECB) and national resolution authorities may emerge over how to deal with ailing banks, while market expectations about Member States' ability to deal with bank failure nationally could continue, reinforcing feedback loops between sovereigns and banks and fragmentation and competitive distortions across the Single Market. Swift and decisive action at the central level, backed by EU-level funding arrangements, are also needed to avoid nationally conducted bank resolution from having disproportionate impacts on the real economy, and in order to curb uncertainty and prevent bank runs and contagion to other parts of the euro area.

2.3.1 Single Resolution Mechanism

That is why the European Commission has proposed a single resolution mechanism to complement the SSM (see IP/13/674 and MEMO/13/675). It will basically apply the substantive rules of the draft Bank Recovery and Resolution Directive (see 1.2.3 above) in a coherent and centralised way ensuring consistent decisions for the resolution of banks, and common resolution financing arrangements.

The Single Resolution Mechanism (SRM) will ensure that – not withstanding stronger supervision - if a bank subject to the Single Supervisory Mechanism faces serious difficulties, its resolution can be managed efficiently. In case of cross-border failures, it would be more efficient than a network of national resolution authorities and avoid risks of contagion.

The SRM will take over when ECB, as the supervisor, would flag a bank, which needs to be resolved in the euro area or established in a Member State participating in the Banking Union.

In terms of timing, the SRM should be agreed by co-legislators before the end of the mandate of the current Parliament in Spring 2014.

As the SRM is corollary to the SSM, Member States outside the euro zone and joining the SSM will also join the SRM.

2.3.2 Will the banking union include a supranational Deposit Guarantee Scheme?

It is not envisaged to equip the banking union with a single supranational DGS at this stage. The priority is to reach an agreement on a common network of national deposit guarantee schemes. The proposal on DGS once agreed will ensure that every Member State has a deposit guarantee fund which is properly funded, *ex ante*.

2.3.3 EU financial backstops and bank recapitalisation

Once a robust financial framework is operational, including stronger prudential requirements and the ability to resolve banks in an orderly fashion including bail-in, the Commission's estimate is that needs for further recapitalisation will be very rare. If we look at the past, no bank which faced problems since 2008 in the European Union - apart from one exception - would have needed extra recapitalisation (from public funding) if it had held CRD IV levels of capital and been subject to bail-in.

However, it is always possible that injections of public money might be necessary.

That is why at the euro area summit on 29 June 2012, it was proposed that once an effective supervisory mechanism involving the ECB was established for banks in the euro area, the future European Stability Mechanism (ESM) could have the possibility to recapitalise banks directly. This will further contribute to breaking the vicious circle between banks and sovereigns, as the ESM loans would not add to the debt burden of countries facing intense market pressure. The Eurogroup agreed on the main features of ESM direct bank recapitalisation on 20 June, which will be reflected in the operational framework of the instrument.

To reflect the close correlation between two important parts of the new EU financial framework (most importantly the Bank Recovery and Resolution Directive and the Deposit Guarantee Scheme Directive), on which the banking union is based, the Eurogroup agreed that the operational framework will be finalised as soon as these proposals are adopted by the European Parliament.

The ECB should start exercising full supervision one year after the entry into force of the SSM regulation. However, from the entry into force of the SSM Regulation, and upon unanimous request by the ESM, the ECB may immediately take over direct supervision of a credit institution as a precondition for direct recapitalisation from the ESM, following a decision addressed to the national entities and the national supervisory authority concerned.