**EUROPEAN COMMISSION**

**MEMO**

Brussels, 28 March 2014

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

***This memo is updated to reflect latest developments. It is an information tool; not a legal text.***

*Update 2*

## 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 eurozone crisis highlighted the potentially vicious circle between banks and sovereign debt. The need for a better governed and deeper economic and monetary union for a single currency to work in the long run became clear. 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). Heads of State and Government have agreed the legislative work underpinning the banking union should be completed before the end of this legislature. Thanks to hard work and a spirit of compromise demonstrated by both the European Parliament and the Member States, important milestones were met last December and in the first quarter 2014 and Europe is living up to its commitments.

This Memo sets out what has been done so far to create a robust financial framework for all 28 Member States and where we stand in building the banking union. The banking union is specifically for countries which share the euro, although it is also open to all non-euro EU Member States who want to join.

Spokespersons' Service
Service des Porte-parole

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# 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 not capable 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[1] 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.

This framework will also ensure that taxpayers do not have to foot the bill for banks' mistakes. And it will underpin financial stability in Europe which is a pre-condition for a sustainable recovery. Indeed, banks need to resume their normal function: to start lending again to the real economy, to households and Small and Medium-size Enterprises (SMEs) in particular.

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.

[1] http://ec.europa.eu/internal_market/publications/docs/financial-reform-for-growth_en.pdf

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 European Systemic Risk Board 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 (8 300 banks)

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 body 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 is good regulation everywhere, without loopholes, in order to guarantee a level playing field for banks and a real integrated 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 (Capital Requirements Directive IV)" (see MEMO/13/690) implements 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. It entered into force on 16 July 2013.

The new rules which 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 Agreement on the recast Directive on Deposit Guarantee Scheme (DGS)

The European Parliament is due to confirm at the April plenary agreement on an important text for the protection of deposits, which completes the single rulebook on crisis management.

It ensures bank deposits in all Member States will continue to be guaranteed up to €100 000 per depositor per bank if a bank fails. From a financial stability perspective, this guarantee prevents depositors from making excessive withdrawals from their banks, thereby preventing severe economic consequences.

The reform (MEMO/13/1176) would ensure faster pay-outs with repayment deadlines, which would be gradually reduced from 20 working days to 7 working days and strengthened financing, notably through a significant level of ex-ante funding of 0.8% of covered deposits to be collected from banks over a 10-year period. A maximum of 30% of the funding could be made up of payment commitments. In case of insufficient ex ante funds, the Deposit Guarantee Scheme would collect immediate ex post contributions from the banking sector, and, as a last resort, the Deposit Guarantee Scheme would have access to alternative funding arrangements such as loans from public or private third parties. There would also be a voluntary mechanism of mutual borrowing between Deposit Guarantee Scheme from different EU countries.

The new Directive would also improve depositor information to ensure that depositors are aware of the key aspects of protection of their deposits by Deposit Guarantee Scheme. For example, when depositing money at a bank, depositors would be obliged to countersign a standardised information sheet containing all relevant information about the coverage of the deposit by the responsible Deposit Guarantee Scheme. Banks would be obliged to inform their depositors about Deposit Guarantee Scheme protection of their deposits on the statements of account.

### 1.2.3 Agreement on Bank Recovery and Resolution Directive (BRRD)

Repeated bailouts of banks have created a situation of deep unfairness, increased public debt and imposed a heavy burden on taxpayers. (Between October 2008 and 31 December 2012, European countries have mobilised €591.9 billion – 4.6% of EU 2012 GDP- in public capital support to their banks). See IP/13/1301.

To ensure that the taxpayer will not have to bail out banks repeatedly, the European Commission proposed a common framework of rules and powers (see IP/12/570 and MEMO/12/416) in June 2012 to help EU countries intervene to manage banks in difficulty.

The European Parliament and the Member States reached agreement on this framework on 11 December 2013, subject to technical finalisation and formal approval by both institutions (MEMO/13/1140).

The new rules, which should enter into force on 1st January 2015, would provide authorities with the means to intervene decisively both before problems occur (for instance by ensuring that all banks have recovery and resolution plans in place) and early on in the process if they do (for instance the power to appoint a temporary administrator in a bank for a limited period to deal with problems). If, despite these preventive measures, the financial situation of a bank would deteriorate beyond repair, the new law would ensure through a "bail-in" mechanism that shareholders and creditors of the banks would have to pay their share of the costs.

If additional resources were needed, these would be taken from the national, prefunded resolution fund that each Member State would have to establish and build up so it reached a level of 1% of covered deposits within 10 years. All banks would have to pay in to these funds but contributions would be higher for banks which took more risks.

**How will the bail-in mechanism work in practice?**

The mechanism would stabilise a failing institution so that it could 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, would avoid the disruption to the financial system that would be caused by stopping or interrupting its critical services, and would give the authorities time to reorganise it or wind down parts of its business in an orderly manner. This is what is called bail-in.

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

Deposits under € 100 000 would never be touched: they are entirely protected at all times.

Deposits of natural persons and SMEs above € 100 000 1) would benefit from preferential treatment ("depositor preference") ensuring that they did not suffer any loss before other unsecured creditors (so they are at the very bottom of the bail-in hierarchy) and 2) Member States could choose to use certain flexibility to exclude them fully.

In order to preserve the recovery prospects of a bank and general economic stability, bail-in would apply at least until 8% of a bank's total assets have been eaten away. In most cases this would see shareholders and many bondholders wiped out. After this threshold, the resolution authority might grant the bank use of the resolution fund, accessing funds up to a maximum of 5% of that bank's assets.

The agreed text supports a regime which, to the furthest extent possible, places the responsibility of covering bank losses on private investors in banks and the banking sector as a whole.

In some cases, in particular in the context of a systemic crisis, it may be necessary to depart from that principle and allow for the use of public funds to finance bank resolution. There is the necessary flexibility in the agreed text to do that.

For instance, recourse to government stabilisation tools would be possible after the 8% bail-in and subject to prior assessment by the Commission of whether the economic disturbance and potential threat to the functioning of the Single Market justify it. In this case the 5% ceiling could be dis-applied and public funds could replace the resolution fund directly. In any case, the use of the resolution fund remains subject to State aid control.

However, the flexibility is appropriately framed and does not detract from the need for banks to develop sufficient capacity to allocate losses to their shareholders and creditors. This would apply in all circumstances. Indeed, the granting of any rescue aid in systemic crises would only come after the required bail-in and would remain subject to EU State Aid rules.

The Council and the European Parliament are expected to formally adopt the text shortly.

### 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[2] 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) and (IP/12/1417)
- 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)

Rules fully adopted at this stage:

- Reform of the framework for market abuse (see IP/11/1217 and IP/12/846) (MEMO/14/77)

Other proposals due to be adopted before the end of April:

- Reform of the audit sector (see IP/11/1480): the Council and European Parliament have reached agreement (see MEMO/13/1171) subject to final approval in Spring 2014.
- European Parliament approved the Commission's proposal for a Directive on criminal sanctions for market abuse in February
- Revision of current rules on markets in financial instruments (see IP/11/1219) and investment funds (see IP/10/869). Agreement of Council and European Parliament was reached in trilogue on 14 January 2014 and Council confirmed it in February. The new regulation and directive should be formally approved by the Parliament in April. (see MEMO/14/15)

Other proposals made more recently:

- Shadow banking including Money Market funds and Securities law (see IP/13/812) (MEMO/13/764): proposal made in September 2013
- Revision of the governance of market benchmarks such as Libor (see IP/13/841) (MEMO/13/774): proposal made in September 2013
- Review of the reform of the structure of the banking sector following the work of the high-level expert group headed by Erkki Liikanen (see IP/14/85) and (MEMO/14/63)

[2] See footnote 1

# 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 sovereign debt 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 and their 6 000 banks.

## 2.2 The pillars of the banking union

### 2.2.1 Creation of the single supervisory mechanism (SSM)

On 4 November 2013, about one year after the Commission had proposed to set up a single banking supervision mechanism in the euro area (see IP/12/953), the Single Supervisory Mechanism Regulation entered into force. This mechanism will be fully operational in November 2014.

In the meantime, the European Central Bank is actively preparing to take up its new role of supervisor. The ECB is currently carrying out a comprehensive assessment of all banks which will be under its direct supervision and the balance sheets of those banks. In parallel it is recruiting high quality supervisory staff and building up a new supervisory structure that integrates national supervisors before it commences its activities. Danièle Nouy has been appointed as first Chair of the Single Supervisory Mechanism board (MEMO/13/1155).

It is important to recall that Europe's banks are in a much better place today than they were two years ago. They have raised substantial amounts of capital on the markets, so that levels of capital for big European banks are now equivalent to American banks. Main features of the Single Supervisory Mechanism (SSM):

- It confers new supervision powers on the ECB for the banks of the euro area: the authorisation of all banks in Europe and the coherent and consistent application of the single rulebook in the euro area, the direct supervision of banks significant banks, including all banks having assets of more than €30 billion or constituting at least 20% of their home country's GDP (around 130 banks), the monitoring of the supervision exerted by national supervisors on less significant banks. 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 ECB shall ensure the coherent and consistent application of the single rulebook in the euro area.
- The Single Supervisory Mechanism is open to all non-euro area Member States.
- The governance structure of the ECB will consist of a separate Supervisory Board supported by a steering committee, the ECB Governing Council with the right to object to Supervisory Decisions from the Board, and a mediation panel. Clear

separation between the ECB's monetary tasks and supervisory tasks is fully ensured.

The reinforced regulatory and supervisory framework of the Single Supervisory Mechanism 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.

More information:

http://www.ecb.europa.eu/ssm/html/index.en.html

### 2.2.2 Agreement on the Single Resolution Mechanism (SRM)

That is why the European Commission proposed a single resolution mechanism to complement the Single Supervisory Mechanism in July 2013 (see IP/13/674 and MEMO/13/675). It would 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 thanks to a Single Resolution Board and common resolution financing arrangements including a Single Resolution Fund.

The Single Resolution Mechanism (SRM) would 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 much more efficient than a network of national resolution authorities and avoid risks of contagion.

European Parliament and Council reached agreement in trilogue on 20 March (STATEMENT/14/77).

The Single Resolution Mechanism would be governed by two texts: a Single Resolution Mechanism regulation covering the main aspects of the mechanism and an intergovernmental agreement (IGA) related to some specific aspects of the Single Resolution Fund (SRF).

**Key elements of the trilogue agreement:**

The Single Resolution Mechanism would apply to all banks supervised by the Single Supervisory Mechanism. The Board would prepare resolution plans and directly resolve all banks directly supervised by the ECB and for cross-border banks. Member States outside the euro zone which join the Single Supervisory Mechanism will also join the Single Resolution Mechanism.

A strong architecture…

- Swift and decisive centralised decision-making would be built around a strong Single Resolution Board (the 'Board') and would involve permanent members as well as the Commission, the Council, the ECB and the national resolution authorities. In most cases, when a bank needs to be resolved in the euro area or established in a Member State participating in the Banking Union, the ECB would notify the case to the Board, the Commission, and the relevant national resolution authorities. The Board could meet in two configurations. In its plenary session, the Board would take all decisions of a general nature and in its executive session, it would take decisions in respect of individual entities or banking groups where the use of the Single Resolution Fund remains below a €5 billion threshold.

…backed by EU-level funding arrangements:

- To ensure the availability of medium-term funding support to enable the bank to continue operating while it is being restructured, the Single Resolution Mechanism regulation establishes a Single Resolution Fund to which all the banks in the participating Member States would contribute. The Fund has a target level of about 1% of covered deposits of the banking union's banks over a 8 year period (this would amount to circa €55 billion). During this transitional period, the Single Fund would comprise national compartment, the resources of which would be progressively mutualised over a period of 8 years, starting with 40% of these resources in the first year. The transfer of national funds towards the Single Fund and the activation of the mutualisation of the national compartments would be provided for in an inter-governmental agreement established among the participating Member States in the Single Resolution Mechanism.

The Council has just confirmed agreement with the compromise text and the European Parliament is due to approve it by the end of April. Implementing rules would specify the details of the contribution of the banks to the Single Resolution Fund.

The Single Resolution Mechanism would enter into force on 1 January 2015, whereas bail-in and resolution functions would apply from 1 January 2016, as specified under the Bank Recovery and Resolution Directive.

Useful information is also available from the Eurogroup website:

http://www.eurozone.europa.eu/euro-area/topics/towards-a-banking-union/

## 2.3 Other issues

### 2.3.1 Bank recapitalisation and EU backstops

Once a robust financial framework is operational, including stronger prudential requirements and the ability to resolve banks in an orderly fashion including a bail-in under the Bank Recovery and Resolution Directive rules, the Commission considers that further emergency recapitalisations will be needed very rarely. If we look at the past, no bank which faced problems since 2008 in the European Union - apart from a handful of exceptions - would have needed extra recapitalisation from public funding if it had held Capital Requirements Directive IV levels of capital and been subject to bail-in as set out in Bank Recovery and Resolution Directive.

Nevertheless, 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 European Stability Mechanism (ESM) could have the possibility to recapitalise banks directly. The Eurogroup agreed on the main features of European Stability Mechanism direct bank recapitalisation on 20 June 2013, which will be reflected in the operational framework of the instrument.

It has been agreed that the maximum exposure of the European Stability Mechanism for direct bank recapitalisations will be fixed at €60 billion.

The ECB will start exercising full supervision as from November 2014. However, from the entry into force of the Single Supervisory Mechanism Regulation, and upon unanimous request by the European Stability Mechanism, the ECB may immediately take over direct supervision of a credit institution as a precondition for direct recapitalisation from the European Stability Mechanism, following a decision addressed to the national entities and the national supervisory authority concerned.

### 2.3.2 What happens if capital shortfalls are identified in the coming months?

A comprehensive exercise of assessments and stress-tests is being carried out by the ECB and European Banking Authority before Single Supervisory Mechanism is fully operational.

In case capital shortfalls are identified for banks of the banking union, the Council clarified[3] on 15 November 2013 the order of the backstops. In a first instance, banks should raise capital in the market or raise capital from other private sources. Should this not be sufficient, public money could be engaged at national level in line with State aid rules and if needed, through the provision of a public backstop. In the first instance, national frameworks will be activated. In the second instance, if national backstops are not sufficient, instruments at the European level may be used, including the European Stability Mechanism.

Finally, discussions are ongoing to explore how equivalent support mechanisms can be established for non-euro area members willing to join the banking union.

The European Commission has adapted its temporary state aid rules for assessing public support to financial institutions during the crisis. A European Commission's Communication sets out the up-dated EU crisis rules for state aid to banks during the crisis from 1st August 2013.

The main changes include namely strengthened burden-sharing: banks are required to work out a sound plan for their restructuring or orderly winding down before they can receive recapitalisations or asset protection measures. Moreover, in case of capital shortfalls, bank owners and junior creditors are now required to contribute as a first resort, before banks can ask for public funding. The rules will be revised as necessary. In particular, they may need to be adjusted in light of the evolution of the EU regulatory framework for banking.

See IP/13/672 and MEMO/13/886

### 2.3.3 Will the banking union include a supranational Deposit Guarantee Scheme?

It is not envisaged to equip the banking union with a single supranational Deposit Guarantee Scheme at this stage. The compromise text on the Directive on Deposit Guarantee Scheme (see section 1.2.2) would ensure that every Member State has a deposit guarantee fund which is properly funded, *ex ante*. The text also opens the way to a voluntary mechanism of mutual borrowing between the Deposit Guarantee Schemes from different EU countries. This is the only form of mutualisation foreseen at this stage.

[3] See Council statement http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/139613.pdf