House of Lords EU Committee on Economic and Financial Affairs
Inquiry into reform of the EU banking sector

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In June 2012, the European Commission proposed a draft Directive on Recovery and Resolution to empower member states to develop robust resolution regimes for banks, certain investment firms, and financial conglomerates and groups. Later that same month, the European Council of Ministers issued a Decision to create a Euro area Banking Union designed to build a more effective banking supervision regime in the Euro area.[1] The draft legislation creating a Euro area Banking Union was proposed on 12 September 2012 in the form of a Council Regulation[2] conferring bank supervisory powers on the European Central Bank, and another Regulation amending the European Banking Authority's powers regarding its interaction with the ECB in respect of the supervision of credit institutions.[3]

Although the proposals have been praised as necessary regulatory reforms to restore Euro area financial stability and to enhance banking regulation, they raise important institutional issues regarding the effectiveness of EU financial regulation and its implications for UK regulation. The proposals also raise important legal issues regarding the extent and scope of the ECB's competence to supervise banks and financial groups under the EU Treaty. This note will address these issues and argue that the proposals are at odds with each other in certain key areas which may undermine their ultimate effectiveness as regulatory reforms.

Commission's Draft Directive for Bank Recovery and Resolution

During the financial crisis of 2007-09, most EU states did not have effective bank resolution and recovery regimes to ensure an orderly restructuring or winding-up of a failing bank or financial institution. When a number of major European banks began to fail in 2008,

[1] Council, Conclusions, 29 June 2012, EUCO 76/12., p. 3.
[2] Commission, Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, Brussels, 12.9.2012.
[3] Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority)

including Fortis, Dexia and the Royal Bank of Scotland, the absence of an effective resolution and recovery framework led EU Member State authorities to engage in a chaotic scramble to freeze and seize assets located in their jurisdictions in order to pay creditors and depositors of distressed financial institutions in their countries. Moreover, national authorities resorted to *ad hoc* measures to provide state guarantees and inject capital into failing financial institutions.[4] The crisis demonstrated the EU's lack of a clear and predictable legal framework to govern how a distressed financial institution would be reorganized or liquidated in an orderly manner without undermining financial stability. To reduce the likelihood of future bailouts and disorderly restructurings, the European Commission proposed on 6 June 2012 a draft Directive on a Framework for Bank Recovery and Resolution ("BRRF").[5] The BRRF would apply to all EU credit institutions, certain investment firms, financial groups and conglomerates and aims to reduce the risk and impact of financial failures on the financial system.[6]

The BRRF provides new resolution tools and powers for Member State supervisory authorities to ensure that uninterrupted access to deposits and payment transactions is maintained during periods of market stress or when an individual bank or banking group becomes insolvent.[7] Member State authorities would be empowered to sell viable assets of

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[4] According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 were close to €1 trillion or 8% of the EU GDP. In addition, between October 2008 and October 2011, the Commission approved €4.5 trillion (equivalent to 37% of EU GDP) of state aid measures to financial institutions. See http://www.g20.org/images/stories/docs/eng/washington.pdf (last visited 9 August 2012).

[5] Commission 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, COM(2012) 280/3. The draft Directive is also known as the Crisis Management Directive.

[6] The draft Directive was based on an earlier Commission Communication published in 2009 entitled an 'EU Framework for Cross-Border Crisis Management in the Banking Sector', which analysed gaps and weaknesses in the EU legal framework governing bank resolution. See Commission Communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector, COM(2009) 561 final. Later, in December 2010, the Council of Ministers (ECOFIN) adopted conclusions calling for a more comprehensive Union framework to regulate financial markets, including crisis prevention, management and resolution.

[7] The European Commission proposal has incorporated some of the international standards on bank resolution adopted by the Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', (July 2011) (BIS: Basel). See http://www.financialstabilityboard.org/publications/r_111104cc.pdf (last visited 8 August 2012)

the bank and to apportion losses in an equitable and organized manner by requiring, for example, that certain creditors incur losses on their claims against the distressed financial firm. The BRRF is not intended to replace Member State bank insolvency laws and regulations, but rather to enhance and provide minimum powers across the EU for Member State authorities to require banks and financial groups to recapitalize or restructure creditor claims during periods of market stress in order to reduce the likelihood of a bank becoming insolvent and to mitigate the impact of a bank resolution or insolvency on the financial system.[8]

The BRRF attempts to improve the conditions for the establishment and functioning of the EU internal market by proposing minimum harmonizing legislation that delegates authority to the European Banking Authority (EBA) to draft and propose technical implementing standards for Member States to adopt for their resolution regimes.[9] These tasks conferred on the EBA are closely linked to the subject matter of the BRRF, which is to promote more harmonized Member State resolution practices that will reduce barriers to the internal market. The BRRF's scope of application extends widely to include all credit institutions, investment firms subject to capital requirements of at least €730,000, any financial institution engaged in a wide range of financial services which is a subsidiary of a credit institution and which is subject to consolidated supervision at the level of the parent company.[10] The BRRF's coverage runs parallel with the Capital Requirements Directive,[11] which harmonizes capital, liquidity, and governance arrangements for financial institutions and banking groups. The CRD is a maximum harmonization directive, the requirements of

[8] See BRRF, Recital 1provides 'adequate tools to prevent the insolvency of credit institutions or, when insolvency occurs, to minimise negative repercussions by preserving systemically important functions of the failing institution'.
[9] The legal basis for BRRF is Article 114 of the Lisbon Treaty (TFEU) which provides for the establishment of EU bodies and institutions that are vested with responsibilities for contributing to the harmonization of laws and facilitating their uniform implementation by Member States.
[10] BRRF, Article 1. A €730k firm is defined as such under Article 9 of Directive 2006/49/EC (the Recast Capital Adequacy Directive).
[11] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, [2010] OJ C 293/1; and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions, [2009] OJ L 94/97.

which Member States may not depart from except in specified circumstances, whereas the BRRF is a minimum harmonization directive based mainly on general principles, recommendations and minimum powers for resolution authorities. Member states are afforded discretion to design a recovery and resolution regime that fits their own economic circumstances and domestic legal frameworks. Member State authorities will be required to implement most requirements of the BRRF by 1 January 2015, whilst the Directive's more controversial bail-in requirements discussed below must be implemented by 1 January 2018.

Each Member State is required to designate a resolution authority to exercise powers under the BRRF.[12] States are free to decide whether or not the resolution authority will be a separate authority or combined institutionally with the bank supervisor, central bank or some other authority. However, where supervisory and resolution authorities are located within the same institutional structure, the BRRF requires that functional separation and independence between the authorities be demonstrated and there must be safeguards against conflicts of interests.

Each financial institution, covered investment firm and parent entity subject to consolidated supervision will be required to prepare a recovery plan as a condition for authorization.[13] Article 4 prescribes the information to be included in the firm's recovery plan, including its business strategy, organisational structure, expected funding sources, and risk management. The Directive also requires that the EBA and Commission adopt technical implementation standards on the minimum content to be provided by institutions in their recovery plans.[14] Article 5 requires institutions to submit their recovery plans for approval to the resolution authority. In reviewing the proposed recovery plan, the resolution authority must consider whether the plan can restore the firm's viability and financial soundness in

[12] Article 3 BRRF.
[13] Article 5 BRRF.
[14] European Banking Authority, *EBA Discussion Paper on a template for recovery plans*, 15 May 2012 (EBA/DP/2012/2) (containing draft template with information to be provided in recovery plan).

difficult market circumstances without having adverse impact on the financial system. Authorities have the power to require firms to adopt any measure which the authority believes is necessary to overcome potential impediments or deficiencies in the implementation of the firm's plan.

The resolution authority will be required to develop resolution plans for each financial institution that is not part of a group and for each group subject to consolidated supervision.[15] Unlike the recovery plans which are prepared by the regulated entity or group, the resolution plans are prepared by the resolution authority in consultation with the regulated entity or group. Resolution plans are required to show how crucial payment functions and business lines can be separated economically and legally so as to ensure continuity of the bank's services to depositors and other customers. The plan must also provide an assessment of the institution's resolvability and a list of measures to address or remove impediments to resolvability. A feasibility assessment of alternative resolution strategies and how they could be financed without the assumption of extraordinary public support must be included, along with an analysis of the impact of the plan on other institutions within the group. [16]

The EBA will propose guidelines and technical standards seeking to promote supervisory convergence in the development of resolution plans and in proposing scenarios to be used for testing the robustness of resolution plans. The BRRF envisages that the resolution plans should be able to respond to a range of market developments including idiosyncratic risks and market-wide stress scenarios. The BRRF contains a number of other important provisions that will be briefly mentioned. Articles 31-64 authorize Member State authorities to apply resolution tools against financial institutions and groups when they do not satisfy prudential standards, or when certain early intervention trigger points are reached. For example, the authority can compel the institution to sell a business, or an institution can have all or part of its assets transferred to a 'bridge institution', usually state-owned. The authority

[15] Articles 9-12 BRRF.
[16] Article 10 BRRF.

can also engage in asset separation by transferring viable assets to third party purchasers, thus allowing non-viable assets to be wound down in the original institution or in a bridge bank. Authorities will also be encouraged to use bail-in measures that allow institutions to recapitalize themselves whilst in distress by imposing losses on priority creditors and other unsecured creditors according to their ranking only after shareholders' interests have been extinguished. Depositor claims will be treated *pari passu* with priority unsecured creditors.[17]

The BRRF proposes harmonized principles and enumerates a set of resolution tools that encourage Member State authorities to intervene in the institution's risk management and strategy, but Member States are free to adopt divergent approaches in deciding whether and when to use these tools. Although the EBA will publish guidelines on how and when Member State authorities should use resolution tools, Member States will have ultimate discretion to decide whether or not to adopt these tools in their legal and regulatory frameworks. This may create incentives for states to adopt light touch approaches to resolution practice and potentially lead to regulatory arbitrage within the Union. The Commission recognizes this by stating expressly that the draft Directive provides a minimum harmonization framework that is meant to allow Member States to experiment with different resolution approaches and to use their discretion in the exercise of resolution powers. Nevertheless, more legal certainty should be provided that establishes clearly that the resolution tools supersede existing domestic law and related EU law. It is not enough to provide a harmonized set of principles and a proposed resolution framework to be applied in a discretionary manner by Member States. An effective EU resolution regime must consist of precise legal powers for Member State authorities to impose specific corrective measures on weak and failing financial institutions and groups at the early intervention stage before insolvency.

[17] This conflicts with the UK Independent Commission on Banking (Vickers' Commission) proposals which would give retail deposit creditors a priority over the banks priority unsecured bondholders.

The UK approach to resolution

The UK Banking Act 2009 provides a state of the art regime for resolution of deposit-taking banks and building societies. As mentioned above, the BRRF draws considerably on the principles and practices set forth in the UK's special resolution regime. The Banking Act's special resolution regime creates a special resolution authority (SRA) within the Bank of England that can decide how to resolve a bank or building society which has not complied with applicable prudential regulatory requirements. The SRA can exercise stabilization powers to transfer property and shares from a failing bank to a state-owned bridge bank or private bank, or place the bank into temporary public ownership with the consent of the Treasury. Although the exercise of these resolution powers can substantially interfere with shareholder rights and other property rights, these powers have the objective of striking a balance between the legitimate rights of bank shareholders, creditors and depositors while preventing a failing bank from causing a systemic crisis.

The UK SRR has been criticised on the grounds that it does not provide an adequate resolution framework for large or too-big-to-fail banks.[18] Indeed, the operational complexity, jurisdictional issues, and political sensitivity of resolving a large cross-border bank require a more robust transnational approach. The UK Banking Bill attempts to address some of these weaknesses by adopting the proposals of the Independent Commission on Banking (ICB), namely, to ring-fence by subsidiarisation a UK retail bank's operations from the rest of the banking group (including separation from investment banking); to impose higher loss-absorbing capital requirements on UK retail bank subsidiaries; and to grant creditor preference to insured deposits with the retail subsidiary.

[18] In a recent report, the International Monetary Fund concluded that certain features of the UK SRR – particularly property transfer arrangements to the private sector – could be used to resolve other types of financial firms.

Another gap in the UK resolution regime is that it does not cover investment banks, insurance firms, financial groups and conglomerates. Although the Financial Services Act 2010 provides powers to support recovery and resolution planning, it does not require UK retail deposit-taking institutions or other UK financial firms to have recovery plans, nor does it subject insurance and investment firms and financial conglomerates (excluding a bank subsidiary) to the resolution regime. The BRRF would address this by requiring member states to extend their special resolution regimes to certain investment banks, insurance firms and financial conglomerates and groups. In July 2012, the UK Treasury issued a consultation that addressed whether or not the UK SRR should go beyond the minimum harmonisation requirements of the BRRF and to extend the recovery and resolution framework to potentially systemic financial infrastructure, such as clearing houses, payment systems, and securities settlement institutions.[19]

Commission's proposed Banking Union and Single Supervisory Mechanism (SSM)

The Heads of State decision[20] on 28 June 2012 to establish a European Banking Union aims to strengthen EU economic and financial governance by providing the ECB with supervisory powers over banks operating in the Euro Area. The Commission proposed on 12 September 2012 two Regulations that would, respectively, create a Single Supervisory Mechanism (SSM)[21] giving the ECB ultimate authority to supervise banks based in the euro area and enabling the European Banking Authority to interact with the ECB in adopting and implementing an EU banking regulatory code.[22] The Commission's proposals for the ECB to exercise competence to supervise credit institutions in the Euro area through the SSM

[19] The Treasury's consultation suggests that the UK special resolution regime should extend to insurance and investment services firms, and financial conglomerates and groups.

[20] Council, Conclusions, 29 June 2012, EUCO 76/12., p. 3.

[21] Commission, Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, Brussels, 12.9.2012.

[22] Commission, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority)

represent a dramatic institutional restructuring of EU banking supervision which will have important implications for the practice of financial regulation in all EU states. Indeed, the proposed Banking Union in the Euro area is designed to sever the link between banking fragility and over-indebted sovereign debtors by authorising the European Stability Mechanism (the Eurozone's bailout fund) to recapitalise ailing Euro area banks on the condition that these banks are subject to ECB supervision and strict conditionality.

Euro Area banking union envisions a maximum harmonisation regime for banking supervision in which the ECB will ensure that Euro area banks are supervised according to the requirements of Union law, while the BRRF (as discussed above) provides a minimum harmonisation regime for EU member state resolution authorities to develop robust bank recovery and resolution regimes. It is not clear yet how the Commission will coordinate the banking union proposal with the BRRF. It is imperative that these proposals work together and complement one another in achieving the objectives of enhanced Euro area bank supervision along with effective recovery and resolution programmes for EU banks and investment service firms.

The ECB's supervisory powers would be phased-in over a period beginning from 1 January 2013 with the creation of a Single Supervisory Mechanism (SSM) to oversee banks that have accepted direct capital support from the European Stability Mechanism and 1 July 2013 when the ECB gains supervisory oversight of the most significant credit institutions and financial holding companies[23] until 1 January 2014 when the ECB shall carry out supervisory tasks for the estimated 6000 credit institutions in the Euro area.[24] The regulation provides that the ECB shall establish a SSM that will be primarily responsible for licensing, monitoring and enforcing prudential regulations against banks based in the Euro area.[25] The ECB will also be

[23] Commission, Proposal for a Council Regulation conferring specific tasks on the European Central Bank, COM(2012) 511 final, Brussels, Art 27 (1).
[24] Art 27 (2).
[25] Art 4 (1)-(4).

empowered to approve bank recovery plans and asset transfers between affiliates within banking groups or mixed financial conglomerates.[26]

But the Regulation does not prescribe any powers for the ECB to resolve a distressed banking or financial institution. Resolution remains the sole responsibility of member state authorities. In some EU states, including Germany, France and Italy, resolution powers are exercised by the banking supervision agencies, while in the UK and other EU states the resolution authority is institutionally separate from the bank supervisor but the discharge of their responsibilities is coordinated by statute.[27] Under the BRRF, resolution funds and their financing are the responsibility of member states. For Euro area states, however, it is envisaged that the BRRF could be amended to allow the ECB to be involved in providing liquidity support to banks and financial groups subject to a resolution procedure and in administering a Euro Area resolution fund.

The proposals to give the ECB authority to act as the primary supervisor of banks in the euro area confronts two important obstacles: 1) institutional, and 2) legal.

Institutional. In an era where global financial policymakers have accepted the importance of macro-prudential regulation and the coherent exercise of supervisory practices extending from licensing to resolution, it is striking that the draft Regulation creating the SSM only provides ex ante prudential supervisory powers for the ECB, without any mention of resolution powers. Indeed, the notion of prudential supervision has evolved substantially since the global financial crisis began in 2007 to take on a more macro-prudential perspective that includes both *ex ante* prudential regulatory rules involving capital adequacy, liquidity buffers, fit and proper and leverage limits, and *ex-post* crisis management practices involving

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[26] Art 4 (1)(k).

[27] See Financial Services and Markets Act 2000, s 7. Section 7 sets out the two main conditions that trigger the special resolution regime (SRR): (i) the bank is failing or is likely to fail, and has failed to satisfy the threshold conditions for permission to carry on regulated activities set out in the Financial Services and Markets Act 2000 section 41; and (ii) it is not reasonably likely that without the stabilisation powers the bank can take action to satisfy the threshold conditions.. See also Threshold Conditions (Banking Act 2009) Instrument 2009. For a description of what is covered by the threshold conditions and how they are applied, see the FSA Handbook, available at http://fsahandbook.info/FSA/html/handbook/COND/2.

prompt corrective action and recovery and resolution plans. Most regulators now agree that effective regulation requires a seamless process from crisis prevention through crisis management.

Under the proposed Regulation, however, the ECB would not be authorised to engage in crisis management, nor would it be permitted to resolve a too-big-to-fail bank, or to use public funds to finance a bank bail-out. The ECB's ultimate effectiveness, therefore, under these proposals can be called into question. Is it really realistic to create the ECB with *ex ante* responsibilities for micro- and macro-prudential supervision while not having the authority to resolve, bail-out, nationalise or unwind a large cross-border bank or to engage other types of financial rescues? The necessary link between crisis prevention and crisis management is ignored in these proposals and without an adequate recognition of the ECB's role in bank resolution the proposed Regulations are destined to fail to achieve their objective of controlling systemic risk and enhancing macro-prudential regulation in the Euro area.

Furthermore, ECB officials have signalled that they are willing to play a role in supervising large Eurozone banks. In June 2012, ECB Vice President Vitor Constancio supported the proposal for the ECB to be the bank supervisor. He claimed ECB had expertise and infrastructure to conduct supervision. However for the ECB to take on the supervision objective might bring it into conflict with ECB's main objective of price stability. According to this view, the ECB might be tempted to lower interest rates or to loosen conditions for bank access to liquidity in order to stabilise the banking sector but which might conflict with its price stability objective. However, Mario Draghi in early July 2012 set forth conditions that he argues are necessary to make the plan work and protect ECB's reputation. He said that supervision and monetary policy must be 'rigorously separated'. He also said national supervisors should play a significant role in any Eurozone supervisory plan.

The second obstacle is *legal*. Article 127 (6) of the EU Treaty (TFEU) provides that

> The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

Under EU law, European institutions have legal competence to exercise powers that are specifically conferred. Under the Treaty, the ECB does not have conferred power to exercise supervision over credit institutions unless it is provided by unanimous consent of EU states. The Commission's proposed Regulation relies on Article 127 (6) as a treaty basis to confer bank supervisory powers on the ECB. According to the language of Article 127 (6), however, the ECB can only have supervisory powers conferred on it 'concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.' This means it can only have bank supervisory powers conferred on it under this provision, not resolution powers, nor other supervisory powers over insurance firms and probably not for financial holding companies and conglomerates as well. The restrictive language of Article 127 (6) is presumably why the Commission's proposed Regulation was designed specifically for banks and credit institutions and did not include wider powers, such as resolution.

In addition, the lack of ECB legal competence to engage in bank resolution under the Regulation means that the ECB would have no power to order member state resolution authorities to take a bank into resolution. Moreover, the ECB itself could not exercise resolution powers, such as nationalising the assets of a Euro area bank, nor transferring the assets of a distressed bank to a private purchaser, nor transferring a distressed bank's assets to a bridge bank. The ECB could not even order competent resolution authorities in Euro area states to perform these resolution functions. This legal obstacle obstructs the ability of the ECB to perform effective banking supervision and supports the view that the ECB should not be granted banking supervisory powers unless the Treaty is amended to provide it expressly with enlarged powers to operate a bank resolution regime.

Summing up

An effective EU banking regime must consist of the following: effective prudential regulation and supervision to reduce systemic risk, deposit guarantee schemes to reduce the likelihood of a bank run, liquidity assistance from central banks to solvent banks experiencing temporary funding problems, and an effective resolution regime to mitigate the social costs of bank failure. The European Commission's proposed Directive on a Bank Recovery and Resolution Framework is an important step toward building a more effective cross-border EU regulatory regime. The BRRF proposal recognizes the important link between crisis prevention and crisis management and therefore supports other important regulatory reforms designed to stabilize the European financial system.

Much of the BRRF is modelled on the UK special resolution regime. However, it would require the UK to expand the scope of its resolution regime to include investment banks, insurance firms and financial groups. But the BRRF is a minimum harmonisation regime, meaning that it does not restrict the UK from expanding its resolution regime to cover other areas of regulatory concern, such as systemically important financial market infrastructure, or from providing greater protections to certain stakeholders, such as depositors.

The ECB is expected to have authority to ensure compliance with European banking rules, such as capital adequacy. The Commission's proposal however does not address how the ECB's vast new supervisory powers will interact with member state resolution powers, nor does it address the legal question of whether it can do so under the Treaty. These outstanding issues suggest that continued work on a European Banking Union is needed in order to design a more effective institutional framework that can achieve regulatory objectives while overcoming outstanding legal issues.