Client Alert

Latham & Watkins Finance Department

The EU's Banking Union Proposals, Consolidating the European Regulatory Supervision of Credit Institutions

On 12 September 2012 the European Commission adopted legislative proposals, including a draft EU Regulation (the Banking Union Regulation¹), to establish a single supervisory mechanism for banks (SSM) which is to be led by the European Central Bank (ECB). These proposals are accompanied by a 'road map²' setting out how the Commission intends to formally establish a 'banking union'. The concept of a banking union was first proposed in May 2012 as a vital part in restoring confidence in credit institutions and the Euro. On 18 October 2012 the European Council affirmed³ the political commitment to a banking union and provided a deadline of December 2012 for publishing an updated road map to establishing a banking union.

The Banking Union Regulation is currently proposed to be in place by 1 January 2013 with a subsequent phased transfer of various supervisory arrangements in to a SSM proposed to be completed by 1 January 2014.

The Commission's understanding of a 'banking union' is the combination of a single supervisory structure, a single rulebook, common deposit protection and a single bank resolution mechanism. As such, the Banking Union Regulation should be read in conjunction with the EU's proposed <u>Crisis Management Directive</u>. A banking union is also seen as a pre-condition for the possible direct recapitalisation⁴ of credit institutions by the European Stability Mechanism (ESM)⁵ or for direct ECB rather than national central bank provision of emergency liquidity assistance for those credit institutions⁶ that fail to raise capital in the markets. The proposed Banking Union Regulation is, of course, part of the bigger regulatory picture that is continuing to evolve and credit institutions should consider the interrelation with the ESM, the EU Crisis Management Directive, the continued European harmonisation of deposit guarantee schemes and pay-outs to eligible depositors as well as the existing CRD IV proposals.

At this stage it is important to stress that the Banking Union Regulation is only a proposal and subject to change. The proposed timeframe for implementation may also be delayed pending political approval and changes may be made to the scope of supervisory framework or indeed the legal framework necessary to achieve the regulatory outcomes put forward in the proposed Banking Union Regulation. Critics of the Banking Union Regulation have highlighted two important barriers to the efficacy of the proposals, firstly the overambitious timeline and secondly the level of the ECB's competence to undertake effective supervisory engagement of close to 6,000 credit institutions by a

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create."

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January 2013 deadline.

The extent of changes to the Banking Union Regulation between now and its adoption will depend on the level of lobbying by both Member States (the UK in particular) and credit institutions both within the Euro area and those outside wishing to do business in the Euro area. Importantly, whilst the Banking Union Regulation will mainly be applicable in the Euro area, the legislative proposals still require unanimous consent from all 27 EU Member States.

Who will it affect?

The Banking Union Regulation provides that the ECB shall, in accordance with EU law, be granted new and strong powers⁷ including exclusive competency to carry out prudential supervision through its SSM powers of all credit institutions established in the participating Member States⁸. Non-Euro area Member States are able to voluntarily opt-into the SSM. The voluntary opt-in is aimed at encouraging the participation of non-Euro area Member States such as the UK.

Thus, the Commission's proposed changes will mainly affect credit institutions in the Euro area. However, the proposed Regulation also poses a number of issues for credit institutions located in Member States of the European Economic Area (EEA) which are outside the Euro area (non-Euro area credit institutions). The Banking Union Regulation may attempt, or be perceived to, ring-fence some of the Euro area problems, but for those non-Euro area credit institutions such as UK-domiciled banks it causes a number of issues as the UK is the predominant financial market in the EEA and non-Euro area credit institutions will have to decide whether to (A) embrace the Banking Union Regulation and move some operations in to the Euro area, (B) lobby the UK national regulators and government to opt-in to the Banking Union Regulation, or (C) stay out of the Banking Union Regulation and maybe move operations out of the UK. Non-Euro area Member States however cannot afford to ignore or be complacent over the Banking Union Regulation as the Euro area will remain one of the key trading partners for non-Euro area Member States. The Banking Union Regulation proposals also raise important issues about the emergence of a 'multi-speed' EU regulatory and supervisory framework. For Member States that join the banking union, this will mean signing up for 'more and deeper Europe'. Technical questions aside this raises political questions.

Credit institutions in the EEA are currently subject to regulatory supervision by (1) national financial regulatory authorities (FSA, BaFIN, ACP, etc.) on a national and cross-border level and (2) the European Supervisory Authorities¹⁰ such as the European Banking Authority (EBA)¹¹. The Banking Union Regulation does not stop regulation by the relevant national regulators and the EBA, rather, for those credit institutions in the Euro area it imposes an additional layer of prudential regulatory supervision led by the ECB. The Banking Union Regulation premise is that when the financial crisis spread to Europe, banking regulations as well as supervisory engagement, and in particular early intervention powers, were largely fragmented. The Commission has stated that more integrated banking supervision is necessary for the Euro area and by harmonising that power in the ECB it will eliminate conflicting approaches arising at the national level.

As a priority the SSM is currently set to apply to all the credit institutions that have received or requested public funding, followed in July 2013 by all banks of 'major systemic importance' ahead of complete coverage of all credit institutions by the completion of the transition period in January 2014. Further communications during the course of December 2012 may change this timeline.

The Banking Union Regulation not only grants new supervisory powers to the ECB, it also makes a number of amendments to the existing powers of the ECB so as to amend its decision-making powers and to ensure its governance remains balanced with its role as a central bank. The grant of new supervisory powers means that

specific national supervisory tasks will be reallocated from the national regulatory authorities within the Euro area to the ECB as competent authority. This shift from the national to the European level is being proposed to strengthen the resilience of the European financial system and systemic risk monitoring¹². It is also aimed at reducing regulatory arbitrage within the EU.

Accordingly, the ECB will, if the Banking Union Regulation enters into force in its current form, become tasked with authorising credit institutions, assessing acquisition and disposals of holdings in credit institutions, prudential regulatory supervision including powers to set leverage and liquidity requirements or otherwise monitor capital buffers and Pillar 2 capital in line with the EU Capital Requirements Directive, carrying out supervisory stress tests in addition to the EBA's and national financial regulator's stress tests. The ECB will also be responsible for supervising financial conglomerates, supervising certain governance requirements, monitoring and administering the resolution and recovery plan powers under the EU Crisis Management Directive.

The Banking Union Regulation will continue to apply to existing home/host supervisory arrangements, but to the extent that the ECB has taken over supervisory tasks it will carry out the functions of the home and host authority for all participating Member States. For example, where previously an Italian Bank with an Austrian established branch established under the passporting rights of the Banking Consolidation Directive (the Banking Directive)¹³ would have previously dealt with both the Italian competent authorities as the home state regulator and the Austrian competent authorities as the host state regulator, that bank will under the Banking Union Regulation interact with the ECB as home and host state regulator in connection with all of the activities where the ECB has jurisdiction. Certain supervisory powers outside of the ECB's jurisdiction would still fall to the relevant competent authorities in their roles as home and host state regulators.

The Banking Union Regulation also confers the ECB with certain investigatory powers which are typically exercised by national regulators. These wide-ranging investigatory powers include the power to request all necessary information, to conduct all necessary investigations of the credit institution and persons as well as to carry out on-site inspections. The ECB shall also have the power to impose sanctions and fines which may be in addition to and/or in excess to those imposed by national regulators. By comparison, these proposals are significantly far wider reaching than the EBA's existing powers. The same is also true in respect of the ECB's proposed power to impose pecuniary sanctions on a relevant credit institution directly.

The other European Banking Regulators: The EBA and the national regulators

Within its restricted supervisory functions, the EBA shall remain an European supervisory authority with responsibility across all 27 EU Member States, albeit the EBA's role in respect of Euro area credit institutions shall be a complementary one to that of the ECB. The EBA will continue to be tasked with creating a 'single rulebook' as well as the coordination of national financial regulatory authorities. Politically, and perhaps culturally, the Banking Union Regulation shifts the power of banking regulatory oversight away from the EBA, historically a regulatory forum based in London, to the ECB, historically a central bank tasked with monetary policy and with limited regulatory supervisory responsibility based in Frankfurt.

As highlighted above the Banking Union Regulation proposes that the relevant national supervisory authorities would continue to be responsible for day-to-day regulatory supervision as all tasks <u>not</u> conferred on the ECB will remain with the national regulators. The Banking Union Regulation prompts national regulators to be integrated into the framework of the ECB's new powers and support the ECB in exercising those powers. As also indicated, the ECB and the national

regulators will share powers in dealing with supervision and enforcement of credit institutions. Crucially, the Banking Union Regulation provides that national competent authorities shall follow the ECB's instructions. As a result the ECB is more than just a coordinator of national supervisors but has a real power to override national regulators. This may lead to tensions with a number of the more sophisticated financial regulatory authorities and relevant Member States as there is no dispute mechanism or mediation mechanics as is the case under the EBA's role as a coordinating body of European financial regulators. The exact framework of interaction and apportionment of regulatory supervisory arrangements between ECB and national regulators as well as between ECB and EBA is likely to evolve as the SSM takes shape and the ECB increases its level of competence.

Changes to the EBA's role are in the proposed 're-cast EBA Regulation¹¹' which is set to be adopted concurrently with the Banking Union Regulation. The re-cast EBA Regulation will amend the existing management arrangements of the EBA so to include at least two members from non-Euro area Member States as well as to amend to the voting structure to ensure the ECB does not have a dominant position in the EBA's decision making process. Unlike the ECB, the EBA will not be granted powers to override the decisions of national regulators but will instead retain the existing dispute resolution mechanism.

ECB — new governance arrangements

The ECB, in its supervisory role, will be directly accountable to the European Parliament and to the Council as well as the Eurogroup¹⁵. The ECB shall be required to provide regular reports on its supervisory activity to those bodies. The ECB recognises it will need to separate its monetary policy from its supervisory tasks and build up competence in a manner that is independent from 'undue influence by national competent authorities and market participants'. The supervisory role of the ECB shall be led by a 'Supervisory Board'.

The European Council in conjunction with the Parliament and the ECB's executive board shall also be responsible for selecting ECB members of the Supervisory Board. The Supervisory Board shall be comprised of four representatives of the ECB and one representative from the national authority designated as the competent authority for the supervision of credit institutions in each Euro area Member State. The ECB will have a separate budget for supervisory tasks which shall be financed by directly charging fees to the supervised institutions. Those fees are likely to be in addition to existing fees due on a national basis.

Authorisation and home/host state issues

Any application for an authorisation to establish or act as a credit institution in a Euro area Member State shall be made with the relevant national regulator in accordance with national legislation. If the credit institution complies with all conditions of authorisation the national competent authority shall submit a decision to approve the authorisation to the ECB, who in turn will assess whether the credit institution has met all requirements of EU law. If the ECB determines that it has, it shall grant authorisation to that credit institution. The ECB may withdraw authorisation from a credit institution on its own initiative or pursuant to a proposal from a national competent authority of the Member State where the credit institution is established.

Where a credit institution uses its passporting rights under the Banking Directive (branch and services basis) between participating Member States or from a non-participating Member State passporting into a participating Member State the ECB will assume the role of national competent authorities. The ECB's proposed powers mean that the ECB will become the competent supervisor rather than the relevant national regulators. The proposed powers also would apply where for example

a credit institution in the UK is passporting into France and such a scenario will continue to be regulated under the existing home/host state regulatory framework.

The ECB would also become the competent authority for the approval of any change of control for credit institutions and certain financial conglomerates including those headquartered outside of the EU.

How does the proposed Regulation affect Member States that are not in the Euro area?

The Banking Union Regulation does not directly apply to credit institutions in non-participating Member States save where a credit institution is exercising its passport rights into a participating Member State. Such an example would include a UK-domiciled credit institution using its Banking Directive 'passport' to provide services on a cross-border services or branch basis into France for example.

Nevertheless the Banking Union Regulation creates a concept of a 'close cooperation' agreement established between the ECB and the national competent authorities outside the Eurozone, such as the UK's financial regulatory authorities. Where such a close cooperation agreement exists the ECB may address guidelines or direct requests to the national competent authority of the non-participating Member State. A key pre-requisite to a close cooperation agreement is that the Member State concerned has adopted national legal acts to ensure that its national competent authority will be obliged to adopt any measure in relation to credit institutions requested by the ECB. This may prove controversial to those Member States considering whether to opt-into the Banking Union Regulation.

Equally for certain credit institutions operating outside of the Euro area but inside the EEA, the Banking Union Regulation envisions that the ECB will exert a degree of influence over the existing college of supervisors that currently have and would continue to retain supervisory responsibility over a credit institution passporting between non-Euro area Member States. Take for example the situation where the UK credit institution has come under the scope of the ECB supervision through exercise of its passporting rights, by say passporting into France and assume that the same institution were to exercise its Banking Directive passporting rights into a non-Euro area Member State such as Hungary. The existing college of supervisors between the UK and Hungary may also need to accept ECB direction in this wholly non-Euro area scenario in as much that the credit institution could be seen to pose a threat to the ECB's objectives and/or the Hungarian operation causes an inability for the ECB to effectively supervise the UK credit institution under its supervisory jurisdiction. These practical consequences may change the way credit institutions are structured, with parts that are exclusively subject to ECB supervision and parts that are structured to remain outside the scope of ECB supervision. The same is true in respect of structuring economic activity that could constitute MiFID activity rather than activity regulated under the Banking Directive or Baniking Union Regulation.

The regulatory framework for credit institutions established outside the EU but who wish to operate in an EU Member State will remain much unchanged and remain subject to the relevant national competent authorities. For a number of non-EU credit institutions based in the EU, in particular in London, parts of their ordinary course of business may be conducted through a local branch of say a US-domiciled and US-regulated entity which may or may not be directly regulated by a national competent authority in the EU and other parts of its business may be conducted through a stand-alone subsidiary regulated by a national competent authority (such as the FSA) which in turn may have exercised passporting rights to outsource part of its activity by either servicing or providing regulated activities from or into a Euro area Member State. Equally much of traditional 'investment banking' activity may be undertaken by institutions which are MiFID investment firms and thus (in theory) outside the current scope of the SSM.

Other more practical questions have begun to emerge in relation to the proposed Banking Union Regulation and interaction with non-Euro area credit institutions. One such question is whether a non-Euro area credit institution which were to become subject to ECB supervision could permit that credit institution to also request access to ECB liquidity or term funding? Under current arrangements access to ECB funding is only permitted for certain eligible credit institutions in the Euro area. It also remains unclear how the ECB would supervise credit institutions that may be conducting business pursuant to their, or their affiliates', MiFID passporting rights as opposed to their roles as credit institutions. The Banking Union Regulation does not (yet) have an anti-avoidance provision although it is expected that the ECB, like many sophisticated national regulators, will adopt the approach will look at substance rather than form.

Summary

The adoption of a Banking Union Regulation, even in a form that differs from the current proposal, is likely to have a profound impact on European banking beyond the benefits of supervisory centralisation and harmonisation that the Banking Union Regulation seeks to create. Ultimately, the Banking Union Regulation will likely create two regulatory blocs — one within the banking union and one outside the banking union. Relevant credit institutions will need to assess their business model and the impact and costs of their regulatory engagement, and may as a result modify their presence in various financial centres and conduct their cross-border business on a different basis. Finally, any successful introduction of a Banking Union Regulation will require a substantial build-up of competence within the ECB in order that it can exercise effectively such broad supervisory powers, and will require resolution of various substantive and procedural issues regarding the interaction between the ECB and other supervisory bodies both supervisory within and outside the EU.

Endnotes

- http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-511_en.pdf
- ² http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf
- ³ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/132986.pdf
- ⁴ Although the scope of recapitalisations and any retrospective application, i.e. to cover 'legacy cash needs' such as Spanish or Irish banks, is an area that is not yet clear and likely to be subject to much debate. Although the ECB provides normal and emergency liquidity assistance the latter is still provided by national central banks at the ECB's direction. The ESM provides support as well.
- 5 The now permanent 'bailout fund' which succeeded the European Financial Stability Facility on 27 September 2012.
- ⁶ Credit Institution in the Banking Union Regulation is a credit institution within the meaning of Directive 2006/48/EC otherwise known as the Banking Consolidation Directive. The definition therein means an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.
- ⁷ The Treaty on the Functioning of the European Union permits the granting of supervisory powers to the ECB.
- A participating Member State is defined in the Banking Union Regulation as a Member State whose currency is the Euro, but could include those Member States outside the Euro area who opt-in. The non-Euro area Member States of the EU are (currently) the UK, Bulgaria, Czech Republic, Denmark, Hungary, Latvia, Lithuania, Poland, Romania and Sweden. Norway, Iceland and Liechtenstein are non-Euro area EEA States which will be within scope of the Banking Union Regulation but outside the SSM i.e. the existing national regulators will have to decide whether to follow the ECB's decisions under an SSM or retain certain national divergences.
- ⁹ The Commission estimates that this is approximately 6,000 in the Euro area. Whether the SSM will apply to the 6,000 credit institutions from the start or whether this will be subject to an additional transition, perhaps extended, period will be open to debate. The Banking Union Regulation proposed

that the first wave of credit institutions to be subject to the SSM will be during 2Q 2013

- ¹⁰ Including the European Systemic Risk Board, the European Securities and Markets Authority and the European Insurance and Occupational Pension Authority.
- ¹¹ The former Committee of European Banking Supervisors established under Regulation (EU) No 1093/2010 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF and part of the European Supervisory Authorities.
- ¹² A task that was already granted to the ECB through the creation of the European Systemic Risk Board by Regulation 1092/2010.
- ¹³ Directive 2006/48/ EC, as amended, http://eur-lex.europa.eu/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF
- 14 http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-512_en.pdf
- ¹⁵ A term used to describe the informal gathering of the Finance Ministers of the EU Member States who belong to the Euro area, the Commissioner of Economic and Monetary Affairs and the President of the European Central Bank.

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