THE SINGLE SUPERVISORY MECHANISM- THE FIRST STEP TOWARDS A BANKING UNION

Sarah Louise Azzopardi

ABSTRACT

This work aims to shed light on the recent developments in financial supervision on a European level and how this has led to greater integration between euro zone member states, creating the impetus towards forming a Banking Union.

KEYWORDS:FINANCIAL SUPERVISION – EUROPEAN LAW – BANKING UNION

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Sarah Louise Azzopardi[1]

1. The Financial Crisis: Introduction

The start of the financial crisis may be traced back to 9 August 2007 when inter-bank trading which forms the foundation of the financial system dwindled, prompting seizure of the financial system.[2] 15 September 2008 is another infamous date in the world of finance. The collapse of Lehman Brothers Holdings marked the start of a financial recession the effects of which have been far-reaching and all-pervasive[3]. However the worst financial crisis since 1929 is not simply the result of the bankruptcy of one company, no matter how successful but it signified a number of underlying issues in financial regulation and crisis management. The causes speculated by analysts are various, including a lax monetary policy spanning a number of years, financial deregulation and global imbalance.[4]

The crisis had serious implications for Europe. In his speech to the commission French Commissioner Barnier held that:

> The crisis highlighted only too clearly the limits and sometimes the failings of our supervision system in Europe. The accumulation of excessive risk was not detected. Surveillance and supervision were not effective in time. When transnational

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[1] Sarah Louise Azzopardi is currently reading for a Doctor of Laws at the Faculty of Laws of the University of Malta. She has recently graduated with a Bachelor of Laws from the University of Malta. This article was part of the 2013 Partnership In Research Programme done in collaboration with the MFSA. The author would like to thank Dr. Fabri for whose help made this research program an invaluable leaning experience, Dr. George Bugeja at Ganado Advocates, legal firm and Mr. Aldo Giordano at the MFSA who kindly took time to answer all queries and whose insights greatly enriched this work and resulted in a better understanding and appreciation for the subject.

[2] Charles A.E. Goodhart, The Regulatory Response to the Financial Crisis (Edward Elgar Publishing Inc. 2009) p.3. In his introduction Prof. Goodhart quaintly equates this sudden collapse to "a heart attack"

[3] <http://www.library.hbs.edu/hc/lehman/history.html> Harvard Business School 'History of Lehman Brothers' accessed on 14 April 2014

[4] Jin Cao, Banking Regulation and the Financial Crisis (Routeledge International Studies in Money and Banking 2012) p. 3

financial institutions faced problems, the coordination between national authorities was far from optimal, and this even though these institutions are more and more numerous.[5]

1.1 Larosière Report- Causes of the crisis

Brussels responded on the 15 February 2009 when the Commission charged the High Level Group on Financial Supervision with the task of analysing the causes of the crisis. Consequently a report[6] was published. This included a number of practical solutions in order to safeguard economic growth in the Member States and ensure that the European Union and in particular the euro- currency retained their economic strength. The report, chaired by former IMF managing partner and Governor of the Bank of France Jacques de Larosière, emphasised that in order to meet the challenges in the financial sector 'action is required at all levels -Global, European and National and in all financial sectors.'[7]Its aims laid out in page 5 of the report are summarised as:

- crafting a new regulatory system which reduces risk and increases transparency
- strengthening financial supervision on a European level and
- improving crisis management and fostering once more an element of trust for investors

The report outlines some of the major causes underlying the financial crises, particularly 'ample liquidity and the related low interest rate conditions'. These conditions then led to high risk trading by market players.[8] However the Larosière Report particularly emphasises the fact that such high risk practices were 'not contained by regulatory or supervisory policy or practice'.[9] In fact Article 13 of the report highlights the fundamental failures in risk assessment both by credit institutions as well as supervisory authorities. Article 25 specifically addresses the failings of national regulatory bodies. They failed to correctly assess the interaction of credit and liquidity and underestimated the minimum capital to be held by credit institutions. In fact it states unequivocally that regulated financial institutions were the worst offenders as regards insufficient liquidity management and risk assessment.

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5 http://ec.europa.eu/commission_2010-2014/barnier/headlines/speeches/2011/01/20110101_ en.htm accessed 5 July 2013

6 De Larosiere Report Brussels, 25 February 2009, <http://ec.europa.eu/internal_market/finances /docs/de_larosiere_report_en.pdf>, accessed 8 July 2013

7 *ibid*.

8 *ibid*. Article 43

9 *ibid*. Article 25

Such behaviour was possible as prior to 2007 and the subsequent bankruptcy of Lehman Brothers, there had been a period of seemingly stable economic growth (see graph below). This may have led to complacency among financial supervisors as very often national regulators did not insist on receiving the information necessary to correctly evaluate risk. In addition national regulatory authorities within the eurozone failed to share such information with their counterparts in other member states.[10]

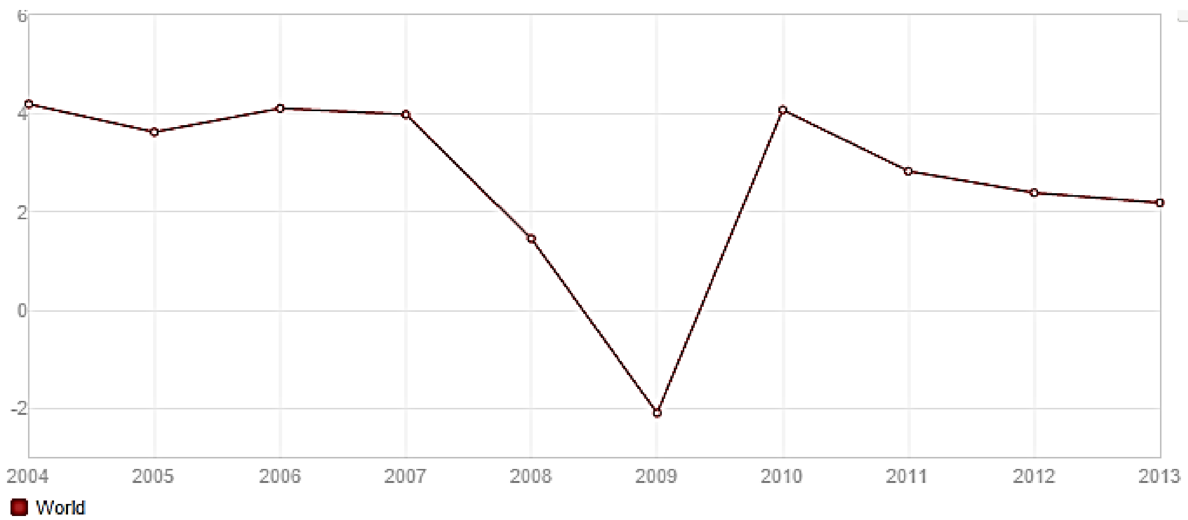

Figure 1 shows the GDP annual growth rate percentage[11]

The period between 1992 to 2006 is further characterised by economic growth, a low rate of inflation (see below) and attractive interest rates- a 'golden age [and] perhaps the very best economic period ever'[12]

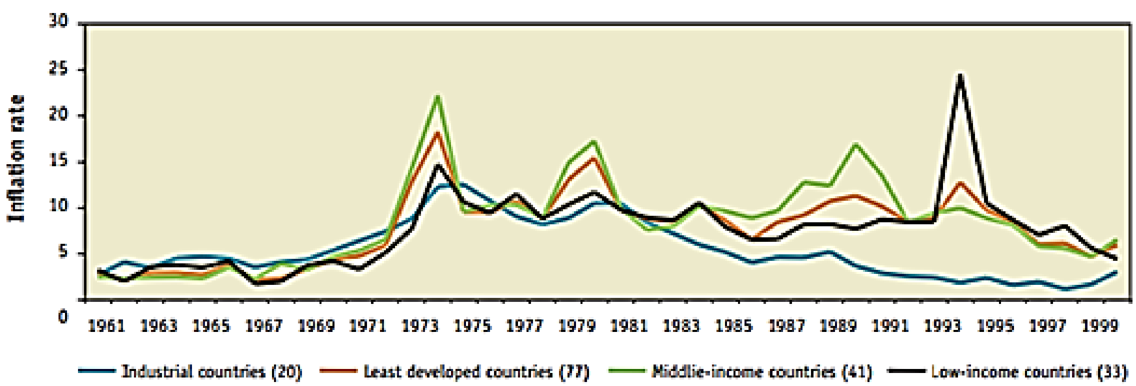

Figure 2 shows rapidly decreasing inflation rates in industrialised countries[13]

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10 *ibid*. Article 28

11 <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries?display=graph> accessed 8 July 2013

12 Charles A.E. Goodhart (n.1)

However this macroeconomic growth, based on very low interest rates and irregular mortgage lending created what is referred to as the subprime mortgage bubble[14]. The actual risk of such a financial policy was smothered by increasing growth and high yields. The rapid decline of the financial sector is a testament to the unsustainability of this economic growth. Financial supervisory authorities failed to correctly assess the precariousness of this type of economic growth. This period was characterised by micro prudential supervision by both Central Banks and financial regulators so that macro-systemic risks were ignored. Low-interest loans were given to borrowers with a low or even non-existent credit, some of whom even had a history of past bankruptcies, with a view simply on short-term high risk lending rather than long-term stability[15]. Financial regulators failed to achieve a consensus as to the seriousness of the problem, perhaps unwilling to take action during a period of seemingly strong financial growth. Any warnings proved to be both too late and too feeble to shield financial institutions from the fallout of the financial crisis.[16]

The de Larosière report articulated the need for a broader supervision to avoid costly bail-outs and to ensure confidence in the financial sector by having the capacity to identify problems at an early stage[17]. Article 51 of the Report justifiably states that global financial services did not prevent or limit the effects of the crisis and propounds that there has to be a more co-operative approach as regards financial services on both a global and particularly, an EU level. However, it recognised the importance of self-regulation in the financial sector where fluctuating market trends require a degree of flexibility which had previously been insufficiently unregulated.[18]

The decreased confidence in the market led to a collapse in the Greek economy, the effects of which rippled throughout the entire euro area destabilising the euro. This displayed the interconnected nature of the euro area and exposed the weakness of the EMU in times of financial stress.[19] This was particularly prevalent in the strong link between sovereign debt which was not sufficiently regulated and the banking sector which led to the public sector

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13 <http://www1.worldbank.org/prem/lessons1990s/chaps/04-Ch04_kl.pdf> accessed on 9 July 2013

14 n.5 p.8

15 Joseph Mangion, Banking Regulation and its Role in the Avoidance of Crises, (Bachelors in Commerce digital dissertation, 2011 University of Malta), p.20 accessed 9 July 2013

16 n.5 Article 29

17 Andrew Formosa, Regulation of the Financial Sector in the Light of the Global Economic Crisis: An EU Perspective, (LL.D thesis digital dissertation, 2010 University of Malta), p.19 accessed on 9 July 2013

18 n.5 p.16

19 'The future of economic governance in the EU' European Union Committee House of Lords Volume 1 Report published 24 March 2011

carrying the burden of the banking crisis. This enforced the need for greater regulation of bank behaviour in order to prevent a similar destabilisation of the banking sector, particularly since fiscal policy is left up to the discretion of member states with the result that mismanagement in one member state, most notably Greece, affects the entire euro zone.[20] In fact, the total debt of banks located in the six countries most severely affected by the crisis amounted to €9.4 trillion with a combined government debt of €3.5 trillion.[21]

1.2 Development of Legislation – Working towards Single Supervisory Mechanism

Following the de Larosière report a slew of Commission reports, Council meetings and Parliamentary debates ensued as the European Union's complex legislative system swung into action in order to limit as much as possible the fallout from the economic crisis. In a Commission report entitled 'Driving European Recovery'[22] the Commission agreed with the findings of the de Larosière report and approved its recommendation to create a European supervisory framework to assess and control high-risk transactions before they can have an impact. Another important objective is to 'provide legislative proposals where national regulation is insufficient'. This report was then approved by the Council[23]. These aims were further elucidated in another Commission proposal which specified that the European Systemic Risk Council would be responsible for macro-economic supervision and analysing potential threats. This Council then forms part of the European System of Financial Supervisors (ESFS) which includes another three supervisory authorities and the Joint Committee of the European Supervisory Authorities[24]. The ESFS must then work in collaboration with national financial authorities to carry out both macro and micro-economic supervision[25]

The reports emphasised the need to demarcate between national and European regulation and suggests that the crisis was due to lax national supervision. However it is worth noting that the crisis was triggered by failure to assess risks on a macroeconomic level. Hence, this

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20 *ibid*.

21 Hans Werner-Sinn and Harold Hau, 'Eurozone banking union is deeply flawed', Financial Times, 28 January 2013

22 Commission Communication for the Spring European Council 'Driving European Recovery' COM(2009) 114, 4 March 2009

23 Council of the European Union 10862/09 'Agreed Council decisions on Strengthening EU Financial Supervision' 10 June 2009

24 Council Regulation 1092/2010, on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (2010), Article 1

25 Commission Communication on 'European Financial Supervision' COM (2009) 252, 27 May 2009

failure cannot be placed solely at the door of national regulatory bodies. Lack of foresight was also present in the European supranational institutions[26]

2. A new supervisory framework: the European System of Financial Supervision (ESFS)

The de Larosière report emphasised the need for financial supervision to become more coordinated through convergence between member states on technical rules and an effective mechanism to ensure consistent application of these rules.[27] This new supervisory framework is based on two main pillars namely the European Systemic Risk Board (ESRB) and three supervisory authorities.

2.1 EuropeanSystemic Risk Board[28]

The European Systemic Risk Board (ESRB) was set up as 'an independent macro-prudential body covering all financial sectors'[29]. Its main objective is to identify and prevent risks to financial stability. The ESRB may issue systemic risk warnings but it has no binding legal powers. The members of the General Board include the President and Vice-President of the European Central Bank (ECB) and the Governors of national central banks.[30] This is recognition of the fact that central banks should have a leading role in macro-prudential supervision and in the maintenance of financial stability.[31] It further strengthens the link between national and supranational authorities as the latter does not have the specialised knowledge of the financial situation of a member state and must work in tandem with the national central bank in order to give effective recommendations.

2.2 Supervisory Authorities: the European Banking Authority

The supervisory authorities are specialised in different areas of the financial sector. These are:

- Regulation 1093/2010 establishing a European Banking Authority

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26 Adair Turner 'The financial crisis and the future of financial regulation' The Economist's Inaugural City Lecture 21 January 2009

27 <http://europa.eu/rapid/press-release_MEMO-09-404_en.htm> accessed 15 July 2013

28 Regulation 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board

29 n.14 p.3

30 n.21 Article 6

31 n.18 p.6

- Regulation 1094/2010 establishing a European Insurance and Occupational Pensions Authority
- Regulation 1095/2010 establishing a European Securities and Markets Authority

For the purposes of this article, the European Banking Authority (EBA) is of particular relevance.

The EBA came into force on 1 January 2011 and is located in London. Its role is to 'maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector', as well as to aid in the establishment of a single consistent rulebook for financial institutions across the EU.[32] This Single European Rulebook would create a harmonised set of rules to be adopted by all financial institutions to establish a 'more resilient, transparent and efficient banking sector'. The need for a single rulebook was felt after the financial crisis exposed the interconnected relationship among member states and to ensure that firms and investors do not exploit loopholes due to diverging and inconsistent regulations.[33]

The EBA's aims are further expounded in Directive 1093/2010 which lays down the legal framework within which the Authority is to function. It establishes that the EBA shall safeguard the stability and integrity of the financial sector by inter alia, ensuring a consistent level of regulation and supervisory coordination particularly as regards risk and promoting competition and consumer protection. [34] In order to accomplish this, the Authority provides opinions and issues guidelines and recommendations as to supervisory standards to be implemented by EU institutions[35].

3. The Single Supervisory Mechanism

The changes in financial supervision across the euro zone were not solely restricted to the creation of the European Banking Authority and the above-mentioned ESFS. It was still felt that a more integrated approach to financial supervision was needed, particularly in the euro area where negative developments in one member state impact the stability of the

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32 http://www.eba.europa.eu/aboutus;jsessionid=6087E6F5B30DB75C5C818A8B41C513DF accessed 5 August 2013

33 <http://www.eba.europa.eu/regulation-and-policy/single-rulebook> accessed 5 August 2013

34 Directive 1093/2010, of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC para. 11

35 n.20 Article 8

currency as a whole. This was particularly emphasised in the Euro Area Summit[36] held on 29 June 2012 which called for urgent action to be taken, with a decision being taken by the Eurogroup by 9 July 2012. It held that the European Financial Stability Facility (EFSF) which was created during Ecofin committee meetings would be responsible for providing financial assistance until replaced by the European Stability Mechanism which came into force on 27 September 2012. This prompted the European Commission to present a proposal for a Single Supervisory Mechanism (SSM).

The result was a European Commission proposal for a Council regulation 'conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions'[37]. It held that the SSM would be 'one of the key elements' of the Banking Union which would have 'a direct oversight of banks' and would carry out supervision and enforce rules for all credit institutions in the euro zone member states regardless of their size. This objective is ambitious when one considers that the euro zone comprises 17 member states and that Malta, the smallest member state, has 26 registered credit institutions alone[38]. The size of banks varies greatly and subsequently so does the risk that they pose to systemic stability. It is estimated that the largest 150 banks account for about 80 percent of banking system assets in the euro area.[39]

There are clear logistical difficulties in the aim to supervise all credit institutions and questions have been raised as to how the ECB will supervise over 6,000 banks in the euro zone. It is estimated that about 800 personnel will be needed to staff the SSM[40]. The time frame for setting up this supranational supervisory authority is also highly ambitious. The Commission proposal states that the regulation to set up an effective SSM would enter into force on 1 January 2013, allowing the ECB to supervise banks which have received or requested State aid and the largest financial institutions coming under its supervision as of 1 July 2013. All other banks will form part of the SSM's supervisory scope by 1 January 2014 at the latest[41]. In fact in the Council regulation which accepted the Commission's proposal, the deadline for the ECB to assume its new responsibilities is 1st March 2014 or

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36 http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf, accessed on 9 August 2013

37 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, 12 September 2012

38 http://www.mfsa.com.mt/pages/licenceholders.aspx

39 A Banking Union for the Euro Area' IMF staff discussion report February 2013

40 Eva Kuehnen, 'Single bank watchdog becomes mammoth project for ECB'(26th May 2013) Reuters UK <http://uk.reuters.com/article/2013/05/26/uk-ecb-bankssupervisionidUKBRE 94P04420130526>, accessed 23 July 2013

41 N.19 p.8

12 months after the entry into force of the regulation. This second deadline takes into account the EU's legislative process whereby a Council regulation requires the approval of the European Parliament. After a series of compromises, this approval was given on 19 March 2013.[42]

As often happens, the envisaged deadlines proved to be too ambitious. This is not surprising considering that the SSM constitutes a complete overhaul in financial supervision across the eurozone. In reality, the ECB will assume its new 'key competencies in the field of banking supervision' as from 4th November 2014.[43] The challenges faced by the ECB to deal with the increased workload are dealt with in a laudable manner in a report drawn up by the European Court of Auditors. This report praises the speed with which the Commission responded to financial pressures, however it criticises the 'tight deadlines for the EBA, brief public consultation' and the lack of proper impact assessment.[44]

The Council regulation provides that although larger banks pose the biggest threat to financial stability, smaller banks must still be directly supervised by the ECB. In fact, the ECB will have a direct supervisory role over all the banks in euro zone member states.[45] This was affirmed by a report issued by the ECB which stated that the inclusion of all banks would promote 'a level playing field among banks and prevent segmentation'.[46]

The ECB will be the ultimate supervisory authority for all banks in the eurozone 'regardless of their size'.[47] However, a compromise emerged between the need for strict regulation and a realistic assessment of the risk smaller banks pose, and the adequacy of national supervision for lower-risk banks. The ECB will have direct oversight powers for the most significant banks, with total assets exceeding € 30 billion or 20 per cent of domestic GDP as well as those having requested financial assistance from the EFSF. The ECB recently issued a list of significant entities which satisfy these criteria and will fall under direct ECB

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42 <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/136846.pdf>, accessed 6 June 2013

43 'Countdown to November: European supervision ready for lift-off' ECB press release, speech by Sabine Lautenschläger, Member of the Executive Board of the ECB, Frankfurt am Main, 3 September 2014

44 'European banking supervision taking shape - EBA and its changing context' European Court of Auditors, 2014 p.23

45 Council Regulation 1024/2013 'conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions' 15 October 2013 para. 15

46 (CON/2012/96) ' Opinion of the ECB on a proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions' 27 November 2012

47 'A Single Supervisory Mechanism for eurozone banks' Freshfield Bruckhaus Deringer briefing, 12 September 2012

supervision.[48] In total, the ECB will directly supervise 120 significant credit institutions, constituting almost 85% of total banking assets in the euro area[49] In Malta, three banks were deemed to be 'significant' on the grounds that their total assets exceeded 20% of GDP. These are Bank of Valletta plc, Deutsche Bank (Malta) Ltd. and HSBC Malta plc.

On the other hand, national supervisors will retain direct powers over the other banks. According to the list issued by the ECB, in Malta the national supervisory authority (MFSA) will have the responsibility of sixteen other banks not deemed to be significant. The ECB will verify the correct application of common supervisory powers by national authorities and will also be allowed to exercise powers on less significant banks so as to ensure the consistent application of high supervisory standards. The European and national level will be jointly responsible, within the SSM, for the implementation of the common supervisory policy and will be subject to a duty of cooperation and an obligation to exchange information.[50]

Finally, on 15 October 2013, the Council established the Single Supervisory Mechanism as ‘the first “pillar” of Europe’s Banking Union’.[51] In its press release, the Council confirmed and approved the amended Council Regulation[52] charging the ECB with the responsibility of the functioning of the SSM. It specified that the ECB will assume its supervision of eurozone banks within twelve months after publication of the legislation ‘in close cooperation with national supervisory authorities’.[53] The SSM provides for a centralised financial supervision across the eurozone and represents ‘the most momentous step towards unification of the Eurozone area’ since the establishment of the euro currency.[54]

3.1 Sharing of competence: the national and supranational dichotomy

The Council Regulation outlining the structure and scope of the Single Supervisory Mechanism emphasises the integrated approach to be taken to financial supervision, with the ECB working alongside national supervisors and the EBA promoting the stability of the financial system. The ECB is the competent authority to authorise credit institutions and

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48 'The list of significant supervised entities and the list of less significant institutions', European Central Bank, 4th September 2014

49 https://www.ecb.europa.eu/ssm/list/html/index.en.html

50 <http://eprints.lse.ac.uk/49338/1/blogs.lse.ac.ukthe_December_2012_agreement_on_EU_bank_supervision_is_a_good_first_step_towards_an_effective_banking_.pdf>, accessed 12 July 2013

51 ‘Council approves single supervisory mechanism for banking’ Council of the EU press release 15 October 2013

52 n.39

53 n.45 p.1

54 Banking and Financial Institutions newsletter, Ganado Advocates, Issue no.3 February 2014 p.5

also has the power to withdraw such authorisation.[55] However, Article 15 of the Regulation states that the ECB may carry out this task upon a proposal by the competent national authority such as the MFSA which assesses compliance with national law. Furthermore, the ECB will be responsible to carry out an assessment of a prospective investor wishing to acquire a significant share in a credit institution. It shall also ensure that banks maintain an adequate level of capital (Articles 16 and 17 respectively). These measures act as safeguards against high-risk investment and help to ensure that credit institutions can weather troublesome economic times. In addition, in order to further safeguard against a similar banking crisis, the ECB shall also ensure that banks hold sufficient liquid assets and internal capital to withstand a downturn in world markets, and that additional capital buffers are respected to absorb any losses during periods of financial stress. Such measure are carried out by national authorities but only after the ECB has been duly notified.[56] All these measures shall be within the exclusive competence of the ECB in the case of the significant banks in the Eurozone. In the case of less significant entities the national supervisory authority shall be responsible for carrying out these tasks. However the authorisation of banks and the authorisation of changes in qualifying shareholdings in banks are within the exclusive domain of the ECB, regardless of the institution in question.[57]

In order to perform such tasks the ECB will have the power to conduct investigations and impose fines on credit institutions for some types of regulatory breaches. In addition, it has the power to carry out early intervention measures.[58] Article 21 of the Regulation states that the ECB has the responsibility to intervene at an early stage in cases where a financial institution's viability is deteriorating. However, such intervention must be coordinated with the national authorities.

The demarcation between national and supranational competence is one which the Regulation aims to achieve, as it seeks to increase the supervisory role of the ECB while still ensuring that national authorities are not side-lined by a larger institution. This dichotomy lies at the heart of EU integration. As markets become more closely intertwined and the common currency requires a more integrated approach, the question persists as to whether greater integration means a derogation of state sovereignty as decisions are increasingly being taken by institutions which may not perhaps, have a complete understanding of the requirements of the local financial sector. In fact Article 22 states that

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[55] n.24 Article 14

[56] n.24 Article 18

[57] A Single Supervisory Mechanism for Eurozone banks' Freshfield Bruckhaus Deringer briefing, 12 September 2012

[58] *ibid*.

‘[s]upervisory tasks not conferred on the ECB should remain with national authorities’. While this seems like a generous compromise it must be noted that the scope of these national supervisory tasks are limited when compared to the increased responsibilities of the ECB. Such tasks include consumer protection and prevention of money laundering as well as supervision of third-country credit institutions. On a conciliatory note however, Article 28 recognises that national supervisors have a ‘long-established expertise within their...organisational and cultural specificities’ and holds national supervisors responsible to assist the ECB in the day to day verifications and supervisory activities necessary to prepare and implement ECB acts such as on-site evaluations and sharing sanctioning powers.

In addition to the supranational/national supervisors dichotomy there is also the ESFS, including the EBA, which also has a contributory supervisory role over credit institutions. It is a justified observation that the solution from Brussels to the financial crisis was to create a more complex system of boards and regulatory authorities where the demarcation of competence is somewhat obscure.[59] This raises questions as to how efficient such a system would prove to be in practice as the adage ‘too many cooks spoil the broth’ springs to mind. The effectiveness of coordination between these institutions, particularly as regards data exchange, is largely dependent on clearly defined objectives, which is why there has been a plethora of legislative proposals and consultations with various bodies. [60] However, due to the closely integrated financial system uniting member states in a single market, it is unwise for member states to deviate too widely from a single set of standardised regulations, particularly since member states may fail to take into consideration the consequences of their courses of action on other member states. This is exemplified by Icelandic banks which operated branches in the EU by means of mutual recognition arrangements.[61] However, with the aid of a technologically sophisticated data management and exchange system, the challenges presented by this large network of information exchange across member states and centralised agencies are not insurmountable.[62]

National supervisory authorities must notify and meet the approval of the ECB in Frankfurt for instance, to issue a licence for a credit institution. Such a process is lengthy, particularly when one considers the sheer amount of data to be processed and compiled from 27

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59 Alexandria Carr ‘Banking Union: Story of the Emperor’s New Clothes?’, Butterworths Journal of International Banking and Financial Law, February 2013 p.4

60 Iris H-Y Chiu, ‘Macroprudential supervision: critically examining the developments in the UK, EU and internationally’, Law and Financial Markets Review Volume 6/Issue 3, 1 sMay 2012 p.8

61 Pierre Schammo, ‘EU Day-to Day Supervision or Intervention-based Supervision: Which Way Forward for the European System of Financial Supervision?’, Oxford Jounral of Legal Studies Vol.32 No.4, 21 March 2012

62 n.32 p.9

different states. Lengthy, bureaucratic and administrative procedures waste time and hinder business. For this reason, the Regulation lays down time limits within which national supervisors as well as the ECB must take decisions. For instance Article 4a(1) lays down that should the ECB object to the level of capital buffers kept by a bank in a member state it must notify the member state in writing within five working days. However, the euro zone crisis amply proved that the EMU cannot work unless there is a consistent application of a single fiscal policy in the euro zone. The uncoordinated practices across the different member states cannot subsist when cross-border markets are so closely interconnected. Thus the Single Supervisory Mechanism aims to avoid bank malpractice in any member state and subsequently prevent or at least, curb any repercussions throughout the EU. In addition the Banking Union takes a wider view of the European financial sector and allows the euro area to adopt a clear and unified front in a crisis.[63]

4. The Banking Union: The Move towards Greater Integration

The Single Supervisory Mechanism was an important step towards integration in the financial sector, transferring decision-making power to the ECB. However it was only one step towards achieving a greater economic and monetary union within the EU. A European Banking Union was also required in order to restore credibility and stability to the euro banking system and to break the vicious cycle between banks and sovereign states.[64] The structure of the Banking Union was outlined in a report[65] issued by the President of the European Council Herman van Rompuy and is based on three pillars namely: integrated supervision by means of the Single Supervisory Mechanism, the Bank Resolution and Recovery Directive and the Deposit Guarantee Scheme.

The Banking Union plays an integral role in the euro zone. It reduces the fragmentation of European banking markets, providing a more integrated approach to banking. Such an integrated system of banking creates a higher standard of enforcement, removes national distortions and mitigates risk which compromises systemic stability.[66] This stability is required in the euro zone area and is aimed at strengthening and protecting the future of the currency.

However the euro zone comprises 17 out of 27 EU member states and those which do not use the single currency are not included in the Banking Union. This poses a problem as

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63 n.13 p. 22

64 'European Banking Union: Key issues and challenges' European Union Committee House of Lords Report published 12 December 2012 (HL Paper 88)

65 'Towards a Genuine Economic and Monetary Union', Report by President of the European Council Herman Van Rompuy, 26 June 2012

66 'A Banking Union for the Euro Area' IMF staff discussion report February 2013

non-euro member states such as the UK may choose not to adopt proposals issued by the Union. This has raised fears of marginalisation of non-euro member states.[67] Such non-euro member states may join the union on a voluntary basis under a close cooperation arrangement.

4.1 Bank Recovery and Resolution Directive (BRRD)

The financial crisis also prompted the need for a better response to bank resolution and recovery. Consequently, the Commission issued a proposal establishing a framework for the recovery and resolution of credit institutions and investment firms, known as the Bank Recovery and Resolution Directive (BRRD) [68] This is crucial when one considers that banks also have a social impact, as when banks fail the effects are far-reaching and the burden of resolving such failures usually falls on the tax-payers.[69] Furthermore, the extent of the interdependency between institutions creates a greater possibility of systemic crises, as problems in one bank can affect the system as a whole. Therefore bank failures have to be appropriately managed to prevent this spill-over effect.[70]

When a financial institution fails it is subject to insolvency proceedings which vary according to the member state in which it is situated. The Commission proposal postulates that these proceedings do not adequately contain disruptions to overall financial stability nor do they provide adequate protection for investors[71]. The proposed directive would give member states the responsibility of choosing a resolution authority, which must be a public administrative authority such as a Central Bank or financial services supervisor, which would work according to technical standards set by the EBA.[72]

The proposal issued on 12 June 2012 includes the conclusions of an Impact Assessment which lays down the importance of a Banking Union to promote financial stability by reducing systemic risk, protecting investors and minimising the burden on tax payers. The work undertaken by the Commission mirrors that taken on an international level by the Financial Stability Board which issued a regime for effective bank resolution approved and

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67 n.44 p.13

68 Commission Proposal for a Directive of the European Parliament and the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM (2012) 280/3

69 'Reducing the moral hazard posed by systemically important financial institutions' Financial Stability Board 2010

70 *ibid*. p.4

71 *ibid*. p.5

72 *ibid*. p.47 Article 3

adopted by the G20.[73] Similar to the Commission proposal the objective of this resolution regime is to protect vital economic functions of financial institutions without exposing taxpayers to loss, as shareholders and creditors instead absorb losses according to a hierarchy of claims rather than relying on State bail-outs[74] There are three main stages in bank resolution: preparation and prevention, early intervention and resolution.

4.2 Preparation and prevention

Under Article 4 of the Commission proposal for the BRRD the competent resolution authority is charged with ensuring that adequate recovery plans are maintained in accordance with EBA technical standards[75], as well as implementing a group recovery plan for parent institutions to ensure the coordination of contingency measures[76]. Similarly it must also provide a resolution plan as well as a group resolution plan which include a description of the time frame required for the implementation of such a plan, the value of core assets of the institution and how resolution measures can be financed as little as possible by public funds.[77] The measures outlined in the resolution plan should only be implemented if and when the institution is likely to fail and no other solution may be found to restore its viability in a timely manner.[78]

4.3 Early intervention measures

If an institution does not or is not likely to meet the requirements of the European regulations for credit institutions[79] the resolution authority may then put in place the measures set out in the recovery plan and it may require the managers and shareholders to convene for the adoption of decisions. It may also remove and replace board members and managing directors in accordance with EBA standards.[80] In addition, in the proposed directive Article 24 also empowers the resolution authority to appoint a special manager to

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73 'The Key Attributes of Effective Resolution Regimes for Financial Institutions' Financial Stability Board October 2011

74 COM (2012) 280/3 p.5

75 *ibid*. p.50 Article 5

76 *ibid*. Article 7

77 *ibid*. Article 9 and 11

78 *ibid*. p. 11

79 Regulations are laid out in Directive 2006/48EC

80 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 and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 COM (2012) 280/3 p.66 Article 23

prevent further deterioration of a financial institution. His duty is to take all measures necessary to restore the proper functioning and prudent management of the institution.

It is worth noting that Malta already had similar regulations for preventing the deterioration of financial institutions in cases where they failed to comply with regulations or had insufficient funds to make good their obligations and liabilities. Article 29 of the Banking Act[81] specifies that in such circumstances, the competent authority must consult with the Central Bank and may require the credit institution to take any steps it deems necessary to rectify the situation. The national regulatory authority may also appoint a competent person to manage the proper conduct of its business and functions and this direction must be complied with. All facilities must be provided in order to enable such appointed person to carry out their duties. The Banking Act however correlates its provisions with those set by the European Union by means of Article 4A[82], which requires the local authority to converge its practices with the supervisory regulations set by the European Banking Supervisors.

4.4 Resolution

This third stage applies only when the resolution authority deems that the institution is failing and there is no prospect that any alternative action may prevent this failure[83]. In this case, the resolution authority must comply with the principles outlined in the BRRD which aims to prioritise creditors in case a financial institution fails so that they do not bear the brunt of this failure. Thus shareholders bear losses before creditors. The resolution tools include selling off all or specified assets without the consent of shareholders (the sale of business tool) or transferring them to a bridge institution[84], thereby dividing the institution under resolution by transferring assets and functions to public authorities or to an asset-management vehicle, which may be the resolution authority itself. Such authority or vehicle then appoints managers to maximise the value of assets.

A more innovative resolution tool is the bail-in technique. In this case, rather than losses being revealed after assets have been sold or transferred, an ex-ante judgement of the expected losses is made and following a hierarchy of creditors, the various layers of debt

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81 Laws of Malta Cap. 371

82 Added by Act II.2011.5

83 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 and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 COM (2012) 280/3 p.71 Article 27

84 *ibid*. Article 32 and 34 respectively

are assessed until losses are covered.[85] This technique is to be used to reorganise the capital structure of banks so that they may resume functionality and may only be used if there is a reasonable prospect that it will restore the institution's viability.[86]

4.5 The Single Resolution Mechanism

The Single Resolution Mechanism (SRM) was envisaged as a complement to the Single Supervisory Mechanism (SSM). Following the establishment of the SSM, it became apparent that mere supervision would not be enough to curb the effects of an economic crisis. The SRM would correct the 'misalignment' between Union supervision of banks and divergent national practices as regards bank resolution.[87] Its aim is to 'govern the resolution of banks and coordinate in particular the application of resolution tools to banks within the banking union.'[88] The harmonisation of resolution rules and practices across member states is fundamental in ensuring a competitive playing field within financial services as well as to increase stability and reduce fragmentation within the internal market. By its very nature, the internal market connects member states and their banking systems inextricably to each other and all banks have a large percentage of foreign assets. The SRM therefore, increases integration within the internal market and reduces spill-over effects from bank failure[89]. The SSM and the SRM therefore provide a two-step approach to ensuring financial stability and a harmonised approach to economic recovery: the SSM supervises credit institutions, but should a bank fail notwithstanding this supervision and the safeguards imposed by the SSM, the SRM would ensure that bank resolution is carried out effectively. This was described by Commission President José Manuel Barroso as the step which 'completes our banking union'. [90]

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85 'Resolution and future of finance' Paul Tucker speech at INSOL World Conference, the Hague, 20 May 2013

86 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 and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 COM (2012) 280/3 Article 37

87 Council Regulation (EU) of 15 July 2014 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010

88 Communication from the Commission to the European Parliament and the Council, 'A Roadmap towards a Banking Union', COM(2012) 510, 12 September 2012

89 n.86 para. 12

90 Commission statement, 'European Parliament and Council back Commission's proposal for a Single Resolution Mechanism: a major step towards completing the banking union' 20 March 2014

The Commission proposal[91] emphasises that the Single Resolution Mechanism must be able to take legally sound and effective decisions as quickly as possible in times of crisis so as to contribute to minimising the costs of resolution. The entire raison d'être of the SRM is to ensure that should a bank fail in spite of all the measures put in place by the SSM, the backlash is as minimal as possible. Efficiency therefore is key not only to 'enhance the credibility of the SRM as a responsive tool' but more importantly, to preserve any viable assets which would otherwise lose value during a lengthy resolution process.[92]

In light of this important principle, the SRM regulatory framework envisages the creation of a Single Regulatory Board which will be the centralised power responsible for the effective functioning of the SRM.[93] In addition, it shall have exclusive competence for drawing up and implementing resolution plans and exercising resolution powers. These measures shall be the exclusive competence of the Board in cases of banks deemed to be significant. Similar to the division of competence in the implementation of the SSM, the SRM also applies the criteria established by the ECB for exclusive Union competence[94]. National resolution authorities will be responsible for carrying out resolution measures (including drafting resolution plans, early intervention measures and implementing resolution tools) for all credit institutions which are not listed as significant under ECB criteria.[95]The correlation between the SSM and the SRM is thus further made apparent by their division of national and supranational competence. The SRM also requires 'close cooperation with national resolution authorities'[96] and exchange of information is vital in order to bridge the gap between national authorities and the centralised Resolution Board which has wide investigatory powers.[97]

Therefore, the national and supranational dichotomy is once again at the forefront in trying to ensure a balance between the integrity of the internal market and national sovereignty. National resolution authorities are given the power to regulate the resolution of non-significant banks however this in no way constitutes a carte blanche to carry out resolution procedures unilaterally without any EU interference. National resolution authorities must

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91 Commission Proposal for a regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council COM(2013) 520

92 *ibid*. Article 2

93 n.86 Article 7

94 Council Regulation (EU) No 1024/2014 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions Article 6

95 vide p.5; n.47

96 n.86 Article 31

97 *ibid*. Article 35

abide by the guidelines and instructions issued by the Board (in accordance with BBRD guidelines) and submit to any request for information or investigation. Failure to do so may result in fines and sanctions.[98] While this may seem to be excessively intrusive it is important to keep in mind that it is in the best interests of member states that an independent centralised authority monitors and oversees bank resolution. Bank failure is not contained in one member state but has a ripple effect, not only due to negative market perceptions which may inhibit investment but because banks are so interconnected by means of investments and subsidiaries that it is impossible to contain the repercussions of bank failure to a single member state. The very composition of the Single Resolution Board is a testament to the solidarity which is being forged in financial services throughout the eurozone to create the Banking Union. Article 43 of the SRM Regulation specifies that the Board shall include a member from each participating Member State 'representing their national resolution authorities'. This bridges the gap between the EU and national authorities; it shifts away from the perception that a supranational body is imposing upon national authorities how to perform their function to create a more conciliatory dynamic.

In addition, the SRM also puts into place a Single Resolution Fund whose primary objective is not to absorb losses but to ensure financial stability. The rationale behind this is logical. Banks are required to pool their contributions into a fund so that taxpayers would not be required to fund bank failures.[99] This further serves the vital purpose of strengthening the Banking Union by severing the tie between sovereigns and the banking sector. [100]

4.6 Deposit Guarantee Scheme

The final pillar in the Banking Union is the Deposit Guarantee Scheme which became part of European Union law through Directive 94/19/EC on 30 May 1994. This scheme creates a hierarchy of claims whereby preferred creditors are insured up to €100,000 on their deposits should a credit institution fail. Such payment is to be made within seven days. [101] Malta's Banking Act[102] also includes a similar provision whereby the Minister on the advice of the competent authority may make regulations to protect depositors in case of bank failure including minimum and maximum levels of compensation. A recent directive[103] regarding Deposit Guarantee Schemes now requires every credit institution to form part of

98 *ibid*. Article 38

99 'Commission proposes Single Resolution Mechanism for the Banking Union', Commission press release 10 July 2013

100 *ibid*. para. 19

101 <http://ec.europa.eu/internal_market/bank/guarantee/proposal_en.pdf> accessed on 16 April 2014

102 n.48 Article 28A

103 Directive of the European Parliament and the Council 2014/49/EU of 16 April 2014 on deposit guarantee schemes (recast)

a Deposit Guarantee Scheme and lays down common rules regarding issues such as coverage level and repayment processes.

5. Conclusion

The Single Supervisory Mechanism encapsulated within the Banking Union has ushered in a new era in European integration and the development of the EMU. On the face of it, the transfer of decision-making power to the ECB which now has both a fiscal and monetary policy, might seem to constitute a breach of the subsidiarity principle. However, it is important to note that national supervisory authorities have been placed at the forefront of the new supervisory framework, and while their discretion has been severely cut back, the recent crisis has proved that in order for the EMU to function effectively there has to be co-ordination between member states, particularly those in the euro zone. The ECB in Frankfurt cannot perform detailed analyses of every bank in every member state. Therefore it must rely on the reports, analysis and specialised opinions generated by the national supervisors. The serious repercussions which the financial crisis has generated throughout the euro zone have been traced back to many causes, but most analysts agree that the effects could have been greatly mitigated had there been stricter control over the interpretation and application of European standards in member states, particularly as regards sovereign debt. In a closely interwoven block such as the European Union and in particular, the euro zone, solidarity is easy to achieve when times are good and markets are on the rise but in times of crises the Euro group is only as stable as its weakest member state. This crisis has provided the impetus needed to address the remaining lacunae in the EMU and provide greater security for the future of the EU and its currency.

Only time will tell whether or not such measures are sufficient to prevent another economic downturn. However what is certain is that eurozone member states will be much better prepared to intervene at the early stages of economic downturn and at least curb, if not entirely prevent, a similar crisis. If one looks at the state of the EMU before the recent legislation in response to the economic crisis it is evident that the solidarity between member states was incomplete. Freedom of capital comes at a cost. Member states were more than willing to strengthen financial ties with each other to reap greater profits. However safeguards against market collapse were inadequate and almost inexistent. Therefore the recent steps towards creating a genuine concerted approach to finance across member states and creating the Baking Union were long overdue. The mechanisms in place can be justly criticised as complicating matters by centralising supervisory and response powers which require delicate co-ordination between supranational and national authorities. Indeed, the demarcation of competences may well prove to be problematic. However, this is the case in every area of EU legislation, not just financial law. Once states accept to be part of the EMU, they cannot insist on unilateral control of financial services when it is abundantly clear that any failing in this sector will have significant impacts in other member states. Thus a centralised authority is needed to ensure that the strength of the EMU is not compromised by national interests. This ensures sustainable long-term growth across member states which lies at the very heart of what the EMU seeks to achieve.