EUROPEAN COMMISSION

MEMO

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

This memo will be updated regularly to reflect latest developments. It is intended to be an information tool: it is not a legal text.

Update 1

INTRODUCTION

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

The ensuing eurozone crisis added an extra dimension. It highlighted the potentially vicious circle between banks and sovereigns. The need for a better governed and deeper economic and monetary union for a single currency to work in the long run became clear. For that circle to be broken, a more robust financial sector is not enough. In particular for countries which share a currency, a deeper more integrated approach is necessary - basically ensuring centralised delivery of the rules for all 28 Member States.

This is why EU Heads of State and Government committed to a banking union in June 2012. The vision was further developed in the European Commission's blueprint for economic and monetary union in November 2012 (MEMO/12/909). Heads of State and Government have agreed the legislative work underpinning the banking union should be completed before the end of this legislature which thus required important milestones to be met before the end of 2013. Thanks to hard work and a spirit of compromise demonstrated by both the European Parliament and the Member States, important milestones were met last December and Europe is well on the way to living up to its commitments.

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

1. A ROBUST FINANCIAL FRAMEWORK FOR THE SINGLE MARKET

When the financial crisis spread to Europe in 2008, we had 27 different regulatory systems for banks in place, largely based on national rules and national rescue measures, although some limited European minimum rules and coordination mechanisms already existed. The pre-crisis framework was not capable of responding to the financial crisis, in particular its systemic nature. There were for example no tools in place to deal with the collapse of large cross-border banks.

Since 2008 the European Commission has tabled around 30 proposals[1] to create piece-by-piece a sounder and more effective financial sector. Better regulated and supervised banks will be stronger, more resilient, and operate to benefit the real economy at large.

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

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

1.1 Measures to secure better supervision of the financial system

Regulation alone is not enough.

Without good supervision, regulation can be worthless.

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

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

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

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

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

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

1.2 A single rulebook for all banks in Europe (8 300 banks)

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

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

1.2.1 The backbone of the single rulebook: Stronger prudential requirements

The package on capital requirements for banks, the so called "CRD IV" (see MEMO/13/690) transposes via a Regulation and a Directive the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework. It entered into force on 16 July 2013.

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

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

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

1.2.2 Agreement on the recast Directive on deposit guarantee schemes

The European Parliament and EU Member States have just reached a provisional agreement on an important text for the protection of the deposits, which completes the single rulebook on crisis management. It should be formally adopted early in 2014.

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

The reform (MEMO/13/1176) ensures faster pay-outs with repayment deadlines, which will be gradually reduced from 20 working days to 7 working days and strengthened financing, notably through a significant level of ex-ante funding of 0,8% of covered deposits to be collected from banks over a 10-year period. A maximum of 30% of the funding can be made up of payment commitments. In case of insufficient ex ante funds, the DGS will collect immediate ex post contributions from the banking sector, and, as a last resort, the DGS will have access to alternative funding arrangements such as loans from public or private third parties. There will also be a voluntary mechanism of mutual borrowing between DGS from different EU countries.

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

1.2.3 Agreement on a framework for bank Recovery and Resolution

Repeated bailouts of banks have created a situation of deep unfairness, increased public debt and imposed a heavy burden on taxpayers.

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

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

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

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

How will the bail-in mechanism work in practice?

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

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

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

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

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

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

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

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

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

The Council and the European Parliament are expected to formally approve the text early in 2014.

1.2.4 Other chapters of the single rulebook

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

The following rules are now in force:

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

Other proposals made and to be hopefully adopted before the end of this legislature:

- Reform of the audit sector (see IP/11/1480) The co-legislators have reached agreement (see MEMO/13/1171) subject to final approval in Spring 2014.
- Reform of the framework for market abuse (see IP/11/1217 and IP/12/846) - the leading committee of the European Parliament for Economic matters gave its support to the proposal for criminal sanctions to tackle the abuse and manipulation of financial markets This agreement is now expected to be confirmed by the European Parliament in plenary in February 2014 (MEMO/14/6)
- Revision of current rules on markets in financial instruments (see IP/11/1219) and investment funds (see IP/10/869). Agreement of Council and European Parliament was reached on 14 January 2014 (see MEMO/14/15)
- Shadow banking including Money Market funds and Securities law (see IP/13/812) (MEMO/13/764): proposal made in September 2013
- Revision of the governance of market benchmarks such as: Libor (see IP/13/841) (MEMO/13/774): proposal made in September 2013

A final proposal will be made on 29 January 2014 to finalise the framework:

- Review of the reform of the structure of the banking sector following the work of the high-level expert group headed by Erkki Liikanen (see IP/12/1048)

2. THE BANKING UNION

2.1 Why a banking union for the euro area?

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

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

Building on the strong regulatory framework common to the 28 members of the Single Market (single rulebook), the European Commission has therefore taken an inclusive approach and proposed a roadmap for the Banking Union with different steps, potentially open to all Member States but in any case for the 18 Member States currently within the euro area and their 6 000 banks.

2.2 Creation of the single supervisory mechanism

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

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

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

Main features of the Single Supervisory Mechanism (SSM):

- It confers new supervision powers on the ECB for the banks of the euro area: the authorisation of all banks in Europe and the coherent and consistent application of the single rulebook in the euro area, the direct supervision of banks significant banks, including all banks having assets of more than €30 billion or constituting at least 20% of their home country's GDP (around 130 banks), the monitoring of the supervision exerted by national supervisors on less significant banks The ECB may at any moment decide to directly supervise one or more of these credit institutions to ensure consistent application of high supervisory standards.
- The ECB shall ensure the coherent and consistent application of the Single rulebook in the euro area.
- The SSM is open to all non-euro area Member States.
- The governance structure of the ECB will consist of a separate Supervisory Board supported by a steering committee, the ECB governing Council with the right to object to Supervisory Decisions from the Board, and a mediation panel. Clear separation between the ECB's monetary tasks and supervisory tasks is fully ensured.

2.3 Towards a fully-fledged banking union

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

2.3.1 Single Resolution Mechanism

That is why the European Commission proposed a single resolution mechanism to complement the SSM in July 2013 (see IP/13/674 and MEMO/13/675). It will basically apply the substantive rules of the draft Bank Recovery and Resolution Directive (see 1.2.3 above) in a coherent and centralised way ensuring consistent decisions for the resolution of banks thanks to a Single Resolution Board and common resolution financing arrangements including a Single Resolution Fund.

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

The SRM will take over when a bank needs to be resolved in the euro area or established in a Member State participating in the Banking Union, notably at the initiative of the ECB.

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

The European Parliament ECON Committee adopted its report on 17 December and Member States reached a political agreement on 18 December (see Commissioner Barnier's statement for more information on the general approach reached by the Council MEMO/13/1186). Trilogues have now started with a view to reach a compromise before the end of the mandate of the current Parliament in Spring 2014.

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

It is not envisaged to equip the banking union with a single supranational DGS at this stage. The proposal on DGS now agreed will ensure that every Member State has a deposit guarantee fund which is properly funded, *ex ante*. The text also opens the way to a voluntary mechanism of mutual borrowing between the DGSs from different EU countries. This is the only form of mutualisation foreseen at this stage.

2.3.3 Bank recapitalisation and EU backstops

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

Nevertheless, the euro area summit on 29 June 2012, it was proposed that once an effective supervisory mechanism involving the ECB was established for banks in the euro area, the future European Stability Mechanism (ESM) could have the possibility to recapitalise banks directly. The Eurogroup agreed on the main features of ESM direct bank recapitalisation on 20 June 2013, which will be reflected in the operational framework of the instrument.

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

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

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

A comprehensive exercise of assessments and stress-tests is being carried out by the ECB and EBA before SSM is fully operational.

In case capital shortfalls are identified for banks of the banking union, the Council clarified[2] on 15 November 2013 the order of the backstops. In a first instance, banks should raise capital in the market or raise capital from other private source. Should this not be sufficient, public money could be engaged at national level in line with State aid rules and if needed, through the provision of public backstop. In the first instance, national frameworks will be activated. In the second instance, if national backstops are not sufficient, instruments at the European level may be used, including the ESM.

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

> The European Commission has adapted its temporary state aid rules for assessing public support to financial institutions during the crisis. A EC Communication sets out the up-dated EU crisis rules for state aid to banks during the crisis from 1st August 2013.
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> The main changes include namely strengthened burden-sharing: banks are required to work out a sound plan for their restructuring or orderly winding down before they can receive recapitalisations or asset protection measures. Moreover, in case of capital shortfalls, bank owners and junior creditors are now required to contribute as a first resort, before banks can ask for public funding. The rules will be revised as necessary. In particular, they may need to be adjusted in light of the evolution of the EU regulatory framework for banking.
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> See IP/13/672 and MEMO/13/886

2.3.5 What about backstops once the banking union is in place?

There will also need to be backstops in place once the SSM and the SRM are fully operational as a last resort. The Council and the Eurogroup published a statement in this respect on 19 December 2013.[3]

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

[3] http://www.eurozone.europa.eu/media/502738/20131218-SRM-backstop-statement.pdf