The European System of Financial Supervision after the Banking Union

Overview

The European Supervisory Authorities (‘ESAs’) are the European Banking Authority (‘EBA’), the European Securities & Markets Authority (‘ESMA’) and the European Insurance & Occupational Pensions Authority (‘EIOPA’), which were all established in January 2011.

The ESAs are independent, EU-funded bodies of experts from EU member states (the ‘Member States’) who advise on new financial legislation, promote supervisory convergence, and generally exercise an EU-level ‘system management’ role as distinct from day-to-day supervision.

The Single Supervisory Mechanism (‘SSM’) is the first element of the Eurozone Banking Union proposed in mid-2012. The core of the SSM is the European Central Bank (‘ECB’), which will exercise direct day-to-day prudential supervision over larger Eurozone banks, while also retaining ultimate responsibility for the prudential regulation of other Eurozone banks, which will take place in practice by national supervisors as before.

The SSM proposals made clear that the ECB was intended to replace national supervisors for certain activities, but not to encroach on the remit of the EBA (see above). However concerns have been raised over how far this will work in practice.

Diagram
The European System of Financial Supervision ('ESFS'), 2011

History and scope

The rules and institutions that make up the ESFS apply to all Member States.

Following the 2008 credit crunch and subsequent events, including the contagion arising from the collapse of several Icelandic banks, serious criticisms were levelled at the existing EU financial services regulatory regime.

The original proposals for the ESFS were adopted by the European Commission on 23 September 2009, as the "more Europe" option for replacing the previous system. These proposals were then agreed by the European Parliament and Council of the EU following twelve months of intense negotiation, and the new supervisory structure came into being on 1 January 2011.

The main elements of the new structure were the creation of three European Supervisory Authorities ('ESAs') and the European Systemic Risk Board ('ESRB').

The European Supervisory Authorities ('ESAs')

The cornerstone of the ESFS are the three ESAs:

- the European Banking Authority ('EBA')
- the European Securities and Markets Authority ('ESMA'); and
- the European Insurance and Occupational Pensions Authority ('EIOPA').

These replace the previous ‘level 3 committees’ – CEBS, CESR and CEIOPS – which had been made up of representatives from national supervisors. The ESAs were intended to be more powerful and also more independent; both from the European Commission and from the Member States. It was recognised that financial supervision is an extremely technical area requiring an EU-level body with a high level of expertise.

Like the level 3 committees before them, the ESAs' main role is to ensure the consistent application of rules by national competent authorities across the EU as well as to work with the European Commission to prepare detailed secondary legislation for the implementation of financial services Regulations and Directives.

The ESFS gave the ESAs a greater role than the level 3 committees had, however this role is still characterized by the implementation of rules and regulation introduced by the European Commission, the European Parliament and the Council of the EU. Under the five-stage ‘Lamfalussy Process’ for financial services legislation (in its current, post-ESFS form), the roles can be described as follows:

- the European Commission, the European Parliament and the Council of the EU agree high-level primary legislation (level 1);
- the European Commission, with the help of the ESAs, prepares implementing secondary legislation (level 2);
- the ESAs then prepare detailed ‘implementing technical standards’ and ‘regulatory technical standards’ – secondary legislation filling in the fine detail of the level 1 primary legislation – which must then be adopted by the European Commission (level 2.5);
- the ESAs prepare guidance for and with national competent authorities, with the aim of co-ordinating cross-EU consistency in the application of the new laws (level 3); and
- finally, national competent authorities are charged with actually enforcing the new laws in Member States.

New and additional powers and responsibilities for the ESAs include:

- exclusive supervision of Credit Rating Agencies;
- co-ordinating cross-border supervision of groups by multiple national competent authorities, including colleges of supervisors;
- generally promoting supervisory co-operation and co-ordination across Member States;
- conducting EU-wide risk assessments and stress testing;
- analysing the economics of financial markets to better understand market structure and market failures;
emergency powers enabling the ESAs to demand national competent authorities take specific remedial actions, including temporary restrictions on financial products or activities;

- raising standards of supervision across Member States through issuing guidelines and instructions, both to national competent authorities and also to individual financial institutions;

- working to establish a single rulebook and a single supervisory handbook across the EU (see below); and

- involvement in international discussions with regulators outside the EU.

The work of the ESAs has been described as 'system management', to distinguish it from the day-to-day, on-the-ground supervisory activities of Member States’ national competent authorities (which will now include the ECB: see below).

The European Systemic Risk Board (‘ESRB’)

The ESRB is concerned with high-level macro-prudential oversight of the EU financial system, monitoring and predicting future risks to financial stability. It is a forum for co-ordination and discussion without any formal powers, save making recommendations to countries and ESAs – although if it makes a recommendation, the addressee will need to explain any non-compliance.

Single rulebook and single supervisory handbook

Beyond the new ESFS regulatory regime described above, there was also a renewed emphasis on harmonising both regulatory rules (the single rulebook) and also the application of rules by national competent authorities (the single supervisory handbook) across the EU. The ESAs are involved with both.

The ‘single rulebook’ approach also informs the process for new EU financial services legislation, which will:

- involve more Regulations (which have direct effect in Member States) and fewer Directives (which need to be implemented by national legislatures);

- tend towards ‘maximum harmonisation’; i.e. allowing Member States less discretion to ‘gold-plate’ the rules;

- make use of ‘framework’-style primary legislation, with the detail being reserved to secondary legislation;

- delegate more power to the European Commission to fill in the key details via secondary legislation; and

- set more detailed standards at EU level.

The Single Supervisory Mechanism, 2012-present

History and scope

The Single Supervisory Mechanism (‘SSM’) will apply to all credit institutions in every Eurozone Member State, as well as any non-Eurozone Member States that request to join the SSM.

At the Euro-area summit on 28-29 June 2012, EU leaders met to discuss the economic problems engulfing the Eurozone. One recurring feature of this had been the vicious cycle where national governments were obliged to recapitalise ailing banks, only to then find themselves struggling to obtain financing from the markets except at ever increasing bond yields.

Two suggestions that were often made were either to allow the European Stability Mechanism\(^1\) (‘ESM’) to recapitalise Eurozone banks directly (i.e. without individual Member States having to assume liability for the bailouts); and/or to set up a common deposit guarantee scheme across the Eurozone (which would, in practice, need a financial backstop, which would probably be the ESM). The common thread through all these suggestions, and similar options such as issuing common debt, was the pooling of liability for individual banks or countries across all Eurozone Member States; however all proposed solutions had run into political difficulties.

On 26 June 2012, shortly before the Euro-area summit, the Presidents of the European Council, European Commission, Eurogroup and ECB jointly published the report ‘Towards a Genuine Economic and Monetary Union’. This was “not meant to be a final blueprint” but rather “identifies the building blocks and suggests a working method”.

\(^1\) A body empowered to approve bail-outs of up to EUR 500 billion.
The building blocks were

- an "integrated financial framework", consisting of a "single European banking supervision system"\(^2\), and a "European deposit insurance scheme" and "European resolution scheme [...] under a common resolution authority";
- an "integrated budgetary framework" (which might in the "medium term" include "the issuance of common debt");
- an "integrated economic policy framework"; and
- "democratic legitimacy".

It was originally proposed that the integrated financial framework cover all Member States, both Eurozone and non-Eurozone - although the latter seems to have been quietly dropped. At the time, the report was criticised for being an insufficiently concrete response to an urgent situation.

It was followed on 12 September 2012 by legislative proposals from the European Commission for a Regulation putting the ECB in charge of prudential regulation for all Eurozone banks, another Regulation on slightly adjusting EBA voting procedures to provide safeguards for non-Eurozone Member States (collectively, the ‘Regulations’) and a ‘Roadmap towards a Banking Union’ (these are discussed in detail below).

The European Commission proposed "to have the [single supervisory mechanism] in place by 1 January 2013" -a term which was not met.

The final vote of the European Parliament on adopting the Regulations did not take place until 12 September 2013.

These were published in the Official Journal on 29 October 2013, and will come into force on 3 November 2014 (although the ECB may also begin to carry out some of its tasks prior to that date). The ECB will also have to publish detailed operational arrangements for the implementation of the Regulations.

**The Single Supervisory Mechanism (‘SSM’)**

As noted above, the apparent motive for the SSM (and the Banking Union as a whole) was to obtain political consent to the use of the ESM as a backstop.

The official objectives of the SSM are to promote the safety and soundness of credit institutions (e.g. banks) and the stability of the financial system, “with due regard” for the integrity of the single market.

Due to the legal basis for the change, the ECB will not have “overall responsibility” for supervision; rather, it will just have the “ultimate responsibility” for “specific supervisory tasks” concerning the prudential regulation of banks. These include:

- granting and withdrawing authorisation for credit institutions;
- assessing qualifying holdings;
- ensuring compliance with prudential requirements (i.e. capital and liquidity);
- “supplementary” supervision of conglomerates on a group-wide basis (although the prudential supervision of e.g. an insurance undertaking which is part of a group will not be carried out by the ECB);
- taking “early intervention measures” when a bank breaches capital requirements;
- exercising other macroprudential powers, such as setting additional capital buffers for firms; and
- co-ordinating and expressing a “common position” of participating Member States (the ‘SSM Participants’) to the EBA.

The ECB will become the competent authority for each SSM Participant, and for each of the tasks above, with all the powers that entails. The ECB will also get additional investigatory powers akin to those of the national regulators.

\(^2\) The concept of an EU ‘Insurance Union’, analogous to the proposed Banking Union, was expressly rejected by EU insurance supervisors according to reports in November 2013 (see below).
Any supervisory task that is not expressly given to the ECB will remain with the national regulators - most importantly, consumer protection issues. Also, the EBA will retain the same role and powers as before (see below).

Technically, for the tasks listed above, the ECB has direct oversight over all 6,000+ Eurozone banks; in practice, according to Commissioner Barnier’s statement of 19 March 2013, the ECB will directly supervise banks:

- with assets more than EUR 30 billion;
- with assets constituting at least 20% of their home country’s GDP;
- which have requested or received bail-outs from the EFSF or ESM; and/or
- which the ECB decides, in its discretion, to place under direct supervision for any other reason.

All other banks will be supervised on a day-to-day basis by national regulators following ECB instructions and implementing ECB acts. There will be a high degree of integration between the ECB and the national regulators.

How it all fits together

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<th>Scope: institutions covered</th>
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<td>DGS Directive to apply across entire EU; suggested pooling of DGS for Eurozone only (but see below)</td>
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The EBA under the new system

The aim of the SSM is to provide a common, high-level of prudential supervision across the Eurozone, by moving the supervision of banks to the European level. This sits somewhat uneasily with the role of the EBA in promoting common supervisory standards across the European Union as a whole (i.e. the single supervisory handbook).

Nevertheless, the European Commission stated explicitly that the EBA’s present role will be preserved and it will “retain existing powers and tasks”: the ECB “will carry out supervisory tasks which are currently carried out by national supervisors in the Euro area, not by the EBA.” In particular, no powers will be transferred from the EBA to the ECB.

Whether this will work in practice, or whether the ECB will suffer mission-creep, is unclear.

The one substantial change to the EBA concerns the voting methods used by the EBA when taking decisions. Given that the ECB will co-ordinate a “common position” for all SSM Participants, there is a risk that, under the old EBA voting system, the ECB’s common position would dominate the EBA’s decision-making. The proposed changes to the EBA’s ‘voting modalities’ are designed to help safeguard the position of non-SSM Member States.

The old and new EBA voting systems compared:

<table>
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<tr>
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<th>New Voting System</th>
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<td>Simple majority voting.</td>
<td>Voting replaced by decision of an independent panel. This decision may be rejected by a simple majority vote which includes at least three votes each from SSM and non-SSM Member States.</td>
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<th>Action in emergency situations.</th>
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<td>Qualified majority voting.</td>
<td>Qualified majority voting. including at least a simple majority of SSM Participants and a simple majority of non-</td>
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Simple majority voting means one vote per Member State on the EBA Board of Supervisors (which consists of the EBA chairman plus representatives from each Member State).

Qualified majority voting is more complicated: at present, votes are weighted according to population size (e.g. so the UK has 29 votes while Malta has three votes); but a new and more complex system will come into force from 1 November 2014, which is based on both population size and the number of Member States for and against a proposal.

Collectively, Eurozone Member States hold a simple majority, but not a qualified majority under the present system. Under the post-1 November 2014 system, however, they will hold both a simple and qualified majority.

Cross-Border Implications

One of either the home or the host Member State is an SSM Participant, and the other is not

Arrangements will be essentially the same as under the present system. The ECB will be the home or host supervisor (as applicable) for the SSM Participant. Procedures for co-ordination between home and host supervisors, including the use of colleges of supervisors, will be the same as before (the ECB will participate in the college of supervisors). Powers of non-SSM Member States will not be affected.

Note that this only applies to matters within the ECB’s jurisdiction (see above); for matters remaining with the relevant national supervisor, the existing system for cross-border co-operation will continue to apply.

Both home and host Member States are SSM Participants

In this situation, ECB will be both the home supervisor and the host supervisor. Existing cross-border co-ordination procedures will be replaced with new arrangements inside the ECB. Colleges of supervisors will be replaced by new “internal coordination groups [...] involving the relevant national supervisors”.

Notification requirements, and other legislation dividing up tasks between home and host regulators, will no longer apply between SSM Participants.

The above was based on the European Commission FAQ and ‘Explanatory Memorandum’ published in September 2012; however the Barnier memo of March 2013 stated that for “cross-border banks active both within and outside Member States participating in the SSM, existing home/host supervisor coordination procedures will continue to exist as they do today”.

This suggests that there may not, in fact, be much difference in practice between the old and new cross-border systems.

As above, please note that this only applies to matters within the ECB’s jurisdiction (see above); for matters remaining with the relevant national supervisor, the existing system for cross-border co-operation will continue to apply.

Third Countries

Within the SSM, the supervision of third country credit institutions will not go to the ECB, but will remain within the jurisdiction of Member States’ national supervisors.

The licensing and authorisation of such credit institutions, however, will be assigned to the ECB.

Other elements of the proposed Integrated Financial Framework, 2013-present

Single Resolution Mechanism (‘SRM’)

On 10 July 2013 the European Commission published a proposal for a Single Resolution Mechanism.

For more information on this subject, please see our RegZone report ‘The EU Single Resolution Mechanism’.

Common Deposit Guarantee Scheme
On 12 July 2010 the European Commission proposed a **Directive on Deposit Guarantee Schemes** (‘the Directive’). This chiefly concerned harmonising the rules for such schemes, although it did also propose a ‘mandatory mutual borrowing facility’, whereby a deposit guarantee scheme in one Member State which found itself with insufficient funds could borrow from a deposit guarantee scheme in another Member State (up to a maximum figure of 0.5% of the value of the eligible deposits of the former).

In the September 2012 FAQ on its SSM proposals, the European Commission expressly called it “the first step towards a pan-EU deposit guarantee scheme”.

The European Parliament voted in favour of the Directive in February 2012, but it is yet to make it past the Council of the EU, despite the European Commission’s call for progress be “accelerated” in September 2012.


The common EU framework that the Directive creates for deposit guarantee schemes would presumably be a prerequisite for any common Eurozone-wide guarantee scheme. At the time of writing, the European Commission have not yet published a proposal for the latter; although in late April 2013 news sources reported that Chancellor Merkel had dismissed such a scheme “at least for the foreseeable future”.

Following the Cyprus bailout in mid-2013, some commentators suggested the common deposit guarantee scheme has been quietly dropped.

**Insurance Union?**

It was reported in November 2013 that the head of both BaFin (the German Federal Financial Supervisory Authority) and the Banque de France had rejected the idea of an EU insurance union corresponding to the Banking Union.

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