The Challenges of the Banking Union in the EU 60 years after the Treaties of Rome and in the wake of the financial crisis: Competition and Regulation in the Banking Union.

**Presentation to be transformed in Paper in preparation - do not quote at this stage without author’s permission**
I - Introduction and Key Issues - Setting the Scene

• The international financial crisis had major repercussions to the EU when approaching its 60th anniversary
• These included serious risks of desaggregation of European Monetary Union (EMU) and serious stress for financial systems in EU
• It led to major consequences in terms of reform of financial regulation: – the launching of European Banking Union and key issues of reform and interplay with competition law
• Current challenge in Europe of deepening the Banking Union – at critical crossroad – different ways to interpret the Banking Union...
• Deepening of European Banking Union (EBU) and other areas of potential tension between the BUILDING BLOCKS of the EBU and EU competition law and policy......
• Does it matter to the rest of the World – China and East Asia? A lot – desaggregation of EMU would send shockwaves in the international financial system/tensions in the financial system in EU would spill over....
II - AGENDA - for Discussion

1. - The context of **reform of financial regulation** in the EU in the wake of the financial crisis

2. – Within that context – the launching and deepening of the European Banking Union (EBU) Project & different ways to interpret the Banking Union...

3. – The building blocks of the **European Banking Union**
   - Different view of **multilevel governance of Europe** – G.Court ruling “Landeskreditbank” of 16 May 2017 (T-122/15) - Banking prudential competences allocated **exclusively** to ECB with National Authorities acting by ‘delegation’ of ECB when executing their ‘own’ powers...

4.1. - EBU as **work in progress** and with an **unfinished agenda** – tensions arising from **transfers of sovereignty vis a vis areas of non mutualisation of responsibilities to the EU level**
II - AGENDA - for Discussion

4.2. - A typical EU contradiction - critique for too much transfer of sovereignty vs critique for lack of EU solidarity and command – where to draw the line? Will this imply serious centrifugal forces? (potential for financial fragmentation) – the tension between a so called rules-based Union and a so-called Transfer-Union

5. - Particular areas of potential tension between EBU and EU competition law and policy – State aid control – how to avoid a too strict approach in this domain?

6. – Prospective view of the EU architecture of integration
III - EU reform of financial regulation in the wake of the financial crisis

• The financial crisis set in motion in the EU various impulses to reform financial regulation and structures of financial regulation – starting with the LAROSIERE REPORT of 2009 (Brussels 25 February 2009)

• Whereas the crisis of the financial sector led in the US to the comprehensive reform of the 2010 Dodd Frank Act (now called into question by the TRUMP Administration), in the EU the LAROSIERE REPORT led to the approval in September 2010 of a comprehensive reform package on the basis of which a new architecture of financial regulation in Europe was attempted.

• The new architecture involved the establishment of new supranational (European) Authorities of Financial Regulation, comprehending the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA).
III - EU reform of financial regulation in the wake of the financial crisis

- However, this new post-Larosiere (2010) EU architecture of financial regulation and supervision did not introduce any rupture with the previously prevailing principles of financial regulation in the EU – principles of (i) **decentralization**, (ii) **cooperation** and (iii) **segmentation**.

- **Decentralization** – because **prudential supervision** (oriented towards assessment of financial balance of Institutions) *remained basically decentralized* at the level of individual EU Member States on the basis of the **Home Country Control parameter** and of **mutual recognition of national legislations based on previous harmonization**.
III - EU reform of financial regulation in the wake of the financial crisis

• **Cooperation** – because this financial supervision largely relying on national Authorities implies a large degree of intensive cooperation between these Authorities subject to some coordination at European level (through specialised committees and the new EU Authorities).

• **Segmentation**, due to a **prevailing specialization** of supervision with different Authorities entrusted with supervision of (i) banks, (ii) insurance and pension funds and (iii) securities markets.

• **The 2010 post-Larosière reforms only mitigated these three core principles of the architecture of regulation and supervision of the financial sector in the EU**

• Accordingly, these limited post-Larosière reforms proceeded through **2 intertwined pillars** – (i) The establishment of a European Systemic Risk Board and of a (ii) European system of financial supervisors.
III - EU reform of financial regulation in the wake of the financial crisis

- **FIRST PILLAR** - The European Systemic Risk Board - ESRB (Regulation EU Nº 1092/2010, of 24/11/2010) – a new EU entity entrusted with **macroprudential supervision** of systemic risks within the EU financial systems.

- Key task of the ESRB of timely identification of **systemic risks** – as risks not limited to individual institutions, or originating as a spill over of risks or malfunctions that taken in an isolated manner do not seem relevant.

- Limited formal powers of ESRB – issuing **early warnings on risk factors** and **recommendations to other supervisory authorities** as well as **monitoring** actions arising from those recommendations.

- ESRB composed of President of ECB, Governors of central banks of ESCB, Presidents of the European Regulatory Authorities, E Commission, Representatives of national Authorities – **not very adequate to maximize operationality and efficiency!!!**
III - EU reform of financial regulation in the wake of the financial crisis

- **The second pillar** of the 2010 Post-Larosiere reforms – the European system of financial supervisors: a network system that comprehends the national financial supervisory authorities of the EU Member States and the three new EU Supervisory Authorities (EBA, ESMA and EIOPA).

- So called 3 "European Supervisory Authorities" (ESAs) – but in essence Regulatory Authorities - Day-to-day supervision remains with national financial supervisory authorities – the EU Authorities may issue guidelines and recommendations and use general powers of coordination of national supervisors (they can, nonetheless, use mandatory powers to obtain certain information and data from national Authorities).

- Loose network structure, beside maintaining segmentation along different financial subsectors did not address immediately the fundamental problem of the lack of a truly European Supervisory structure and an EU Authority to adopt decisions of resolution, restructuring or winding up of financial institutions, involving, in the process, guarantees to clients at European level.
III - EU reform of financial regulation in the wake of the financial crisis

• The gaps of the post-2010 Larosiere Reforms and the decision to launch a EUROPEAN BANKING UNION – the landmark Euro Area Summit of 29 June 2012 – “We affirm that it is imperative to break the vicious circle between banks and sovereigns”

• The European Banking Union Project starts from the perception that imbalances of the banking sector lead to state interventions and to subsequent problems of public finance and sovereign debt imbalances and crises (protracted sovereign debt crisis in EU), which, in turn, ultimately affect the banking sectors of States with sovereign debt problems – Hence there is a vicious circle to cut!
IV - The European Banking Union and its building blocks

- The **European Banking Union** Project launched in 2012 -based on **four intertwined pillars**, comprehending (1) a single rule book – more uniform EU rules on prudential regulation of banks, covering bank capital, leverage, liquidity and risk management, (2) some level of unified – supranational – banking supervision, (3) bank resolution, involving both a decision making process and, with the assumption that orderly resolution may involve a cost, a joint funding mechanism and (4) a European deposit insurance.

- The scope of each pillar corresponds to a growing body of international standards issued by global financial authorities hosted by the Bank for International Settlements in Basel.

- The **European Banking Union** is however a unfinished legal and economic building with significant progress at the level of Pillar 1, appreciable progress of Pillar 2, relevant progress of Pillar 3 and almost none so far of 4!
IV - The European Banking Union and its building blocks

• We shall not dwell here with the numerous Regulations and Directives on the single rule book on EU prudential regulation of banks (see developments at ec.europa.eu/internal_market/finances/index_en.htm)

• However, the special importance of the new CAPITAL REQUIREMENTS REGULATION of 2013 should be singled out (Regulation EU nº 575/2013, of 26 June 2013), as, for the first time, this normative instrument establishes key prudential requirements in a fully harmonized or uniform manner.

• Significant importance too of the Bank Recovery and Resolution Directive (BRRD) - Directive 2014/59/UE establishing (article 38) the general principle of BAIL IN of Banks (private shareholders/creditors – with the exception of smaller creditors covered by the system of deposit guarantee – required to suffer losses as pre-condition to Bail-Out by public authorities
IV - The European Banking Union and its building blocks

- The **second pillar of EBU** requiring some level of **unified** – supranational – **banking supervision** translated into the commitment to establish a SINGLE SUPERVISORY MECHANISM (SSM) with **direct supervisory authority over banks above a certain financial threshold** (medium size to large banking groups at the European scale) being handed over to such new body (SSM) within the European Central Bank – this commitment has been fulfilled – SSM within ECB fully operating since November 2014 – **Regulation EU nº 1024/2013, of 15 October 2013** (SSM Reg) - The SSM is centered at the ECB (see **case “Landeskreditbank”** of 2017 , quoted – slide 3) although being integrated also by national banking supervisory authorities (art 6) – Why ECB? Because the TFEU contemplated the possibility of ECB intervening on banking supervision
IV - The European Banking Union and its building blocks

• **Third Pillar of EBU – Regulation on SRM – Single Resolution Mechanism** (going beyond BRRD) Regulation (EU) N.º 806/2014 - involving namely a single system of resolution for closing or restructuring the 130 biggest Eurozone banks if in trouble or financial distress – backed by SINGLE RESOLUTION FUND (SRF) of 55 billion Euros (76 billion dollars) gradually built up over 8 years, through levies on banks (starting as from past January 2016)

• **Bank resolution – new legal concept** – restructuring banks through process of *coercive public intervention alternative to winding up* (for reasons of financial stability) and compressing (under *proportionality* parameters) property rights – 4 optional resolution schemes to be applied by New EU Agency – Single Resolution Board (SRB) in articulation with National Resolution Authorities (NRAs) which form together the SRM – **very complex institutional architecture** – SRB coordinates activities of NRAs – articulates with Commission and Council (given limitation on delegation of executive powers to EU agency not established in the EU Treaties – **MERONI DOCTRINE**
V - EBU - State of the art...

- EBU – a gradual/phased process – where are we?
- 1 - Limited progress on banking resolution (third Pillar) – limited firepower of SRF so far – Hence decision to submit significant banks to resolution – supranational - SRB in articulation with SSM – Bank failing or likely to fail (SSM) – public interest (SRB) justifying European intervention – BUT still limited mutualization at EU level of financial assistance to resolution process (through SRF and related financial arrangements)
- 2 - Very little progress at all as regards the Fourth Pillar of the European Banking Union – Lack of a common arrangement for a EU-Wide deposit guarantee program – political agreement in December 2013 between EU Member States to harmonise further national rules for deposit guarantees – leading to the EU Directive 2014/49, which harmonizes the key features of national deposit guarantee schemes, but running short of a central EU deposit insurance (EDIS)
- Significantly President of the ECB – Mario Draghi stressing as from 2015 – and afterwards... - that only some pillars of the banking union have been put in place....
V - EBU - State of the art...

- European Commission proposal – November 2015 for **limited mutualisation of deposit guarantee scheme**... (EDIS) but the process is far from its conclusion... and political and institutional uncertainty on this...

V - EBU - State of the art...

• Getting out of the deadlock – the new Commission gradual approach for Euro-wide deposit insurance: Commission Communication to the European Parliament, the Council, the ECB and Social Committee and the Committee of the Regions on completing the Banking Union – COM(2017) 592 final, 11 October 2017

• (a) Possible initial phase of re-insurance – EDIS would only provide a liquidity line up to a certain proportion of the liquidity shortfall of national deposit guarantee scheme/DGS (rising from 30% in first year, to 60% in the second and 90% in the third and final year of Phase One) - the rest covered by national DGS with resources not transferred to the EDIS Fund and if needed by additional ex post contributions by the banks in that country.
• (b) Possibility that the transition to Phase Two of co-insurance – involving some loss cover – would be subject to conditions to be assessed by a Commission decision, based on a **targeted Asset Quality Review (AQR)**, especially to verify progress in the reduction of NPLs (also of Level III assets)

• **Gradual approach** can be a realistic way out of the deadlock – but **urgency needed here** and **realism/reasonability** in addressing the **legacy of NPLs** in certain Member States!
V - EBU - State of the art...

- Realism/reasonability – (new) **gradual approach to mutualisation** of protection of depositors – Conditions for its **political feasibility** and for a **decisive legal breakthrough** involving **some sort of diversification of sovereign risks in the banks’ balance sheets** *(but also gradualism and prudence required here)*

- Possible other developments of fiscal backstop through a liquidity line from the European Stability Mechanism (ESM) once DGS and EDIS Fund exhausted their ressources
V - EBU - State of the art...

• Political agreement/consensus for mutualisation of protection of deposits and for fiscal backstop largely dependent on **addressing adequately legacy problems** (e.g. NPLs)

• **ECB approach/proposal on NPLs** (seeking the power to demand lenders set aside 100 per cent of the value of loans that go sour in the future)

• ECB Proposals intended for implementation as from January 2018 postponed – **European Parliament and Council critical of Proposals** (Autumn 2017) – **ECB overstepping its mandate, “writing rules”** as opposed to simply “applying them”? **Has the ECB gone too far here?** In any case – Need to re-think legal and operational methodology here....
Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures – October 2017:

“On 20 March 2017 the ECB published its final guidance to banks on non-performing loans1 (NPL Guidance). The NPL Guidance is a supervisory tool that clarifies supervisory expectations regarding identification, management, measurement and write-offs of NPLs in the context of existing regulations, directives and guidelines. The NPL Guidance stresses the need for timely provisioning and write-off practices related to non-performing loans2 as these serve to strengthen the balance sheet of banks enabling them to (re)focus on their core business, most notably lending to the economy”.

“This addendum [October 2017] thus reinforces and supplements the NPL Guidance by specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for non-performing exposures (NPEs)”
Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures – October 2017 (cont.)

While the addendum is non-binding, banks are expected to explain any deviations and should report on the compliance with the prudential provisioning backstop laid out in this addendum at least annually as outlined in Section 5

Indeed, possible need to re-think legal and operational methodology here....
VI - Key provisional findings

1 - Reform of financial regulation & supervision is still a largely incomplete process in the EU.
2 - The creation of EBA, ESMA and EIOPA in 2010 left financial supervision essentially untouched (a major gap).
3 - The 2012 project of European Banking Union has been initially oriented towards eliminating those gaps in the European infrastructure of financial supervision.
4 - However EBU itself is being erected on the basis of a limited third pillar and a fourth essential pillar is entirely missing until now.
5 - Insufficient or even almost null progress to address the problem of too big to fail financial groups and their excessive complexity and legacy problems of European banks (Non-Performing Loans – NPLs – coming from the past – no equivalent in EU to the TARP program in US)
6 - At a different level - Need of a new interplay of competition and financial regulation.... – See VII
VI - Key provisional findings

- 7.1. – On the dimension of reform of financial regulation – addressing the problem of **too big to fail institutions** – Recommendations of the Liikanen High-Level Expert Group formed in February 2012 to examine **possible reforms to the STRUCTURE of EU banking sector**

- 7.2. - **Proposal of the European Commission of January 29, 2014** aimed at implementing recommendations of the **Liikanen Group** – mandatory separation in some cases (legal, economic and operational separations) between the core credit institution and the trading entity in banking groups – is this a modern European Glass-Steagall Act??

- Significant indefiniton remained – what would ultimately be the Authority deciding on the separation between commercial and investment banking? And - Too many political hurdles - **Final outcome – 2017 – Commission discontinues its 2014 Proposal for implementation of Liikanen Recommendations – different approaches being developed in EU to deal with too big groups??**
VII - Interplay of EBU with EU competition law

- New reformed EBU rules on supervision and restructuring of banks but how to deal with financial institutions in distress and how will those reformed sectoral regulation rules interact with competition law – especially state aid rules and state aid control (art 107.º 108.º TFEU) by the Commission in light of the recent track-record – 2008 – 2016?

- Particularly, considering the financial problems of banks may be very diverse – problems of solvency... vis a vis...problems of liquidity....Lesson of last financial crisis – systemic importance of liquidity problems – Many banks may collapse due to liquidity and not solvency problems (see first European resolution – June 2017 – Spanish Banco Popular) – unsolved issue at EBU – how to adress coherently/consistently liquidity problems??
VII - Interplay of EBU with EU competition law

- **Quick look to the recente track-record:** In the period 2007-2015, the Commission has taken almost 500 State aid decisions, determining the restructuring or orderly liquidation of 117 European banking institutions.

- In other words, as a result of the crisis, **around 30% of the European banking sector is or has been under State aid control** (art 107-º TFEU)

- In fact, during this period, out of the top 20 European banks, the Commission approved aid to 12 of them, of which six, were subsequently restructured, five received aid through approved aid schemes and one was orderly liquidated. **Source:** Commission
VII - Interplay of EBU with EU competition law

Against this context, a key element of this EBU is the **change from bail-out to bail-in** - a tough way out of critical situations in the European banking sector... *Too tough? Too rigid?*

The options here would be sovereigns – **bail out (i)** (which can't be the first one if we want to break the vicious circle and reinforce protection of taxpayers), shareholders and creditors supporting costs of restructuring (which means **bail-in** (ii)) or other, involving the financial sector as a whole on mutualisation of costs (leading to resolution funds with financial contributions by banks) (iii)

**Option retained – (ii) complemented with (iii)**

In this new scenario, State aid control (competition law) will remain a central element of the EBU as **State aid rules will continue applying alongside the Bank Recovery and Resolution Directive (the BRRD)**

In addition, it is considered that State aid control is a key element for successfully achieving the **paradigm change from bail-out to bail-in**
VII - Interplay of EBU with EU competition law

• In fact, any kind of public financial support (including the use of deposit guarantee schemes or resolution funds) is subject to **State aid control** and will have to comply with these rules, **both within and outside resolution**...

• ... and any State aid measure or resolution scheme that implies the use of the resolution fund will need a prior approval from the Commission under State aid rules before it can be granted or the scheme adopted.

• It is also important to remind that under the BRRD, **any State aid support** will imply that an institution is deemed as failing or likely to fail and would therefore be an **automatic trigger for resolution of the entity**

• So from January 2016 onwards **very limited scope for state aid without falling in RESOLUTION scheme** ...

...- *is this excessive or too rigid?*
VII - Interplay of EBU with EU competition law

- Just three narrow exceptions to this general "resolution" rule of the BRRD: these are (i) State guarantees to emergency liquidity assistance from central banks, (ii) State guarantees of newly issued liabilities, and the (iii) exception of precautionary recapitalisation.
- However - exception of precautionary recapitalisations has to be interpreted in a very narrow way (because the general rule is resolution) which means that precautionary recapitalisation can only be used to cover capital shortfalls arising under adverse scenario of a stress test. In these cases, only State aid rules apply without resolution.
- I would argue that the 3 exceptions (especially the third one) shouldn’t be too narrow!!!
VII - Interplay of EBU with EU competition law

• As from the 1st of January 2016, SRB has taken over its responsibility for bank resolution within the EBU, but at the same time State aid control (competition rules) will remain an integral part of this Banking Union.

• Under this new scenario, i.e. where State aid leads to resolution of the aided entity we will have to face new challenges as in every banking crisis, the boundaries of the definition of State aid are tested.

• The only hypothetical alternative to state aid and resolution will be instruments like SPV's, funding mechanisms, capital instruments and derivatives or a combination of some or all of them might be devised (market solutions for restructuring of banks and addressing NPLs).

• The question will remain whether such measures (esp when related with some public incentives) are (still?) state aid or not: is the Market Economy Operator Principle applicable/, is the measure non-imputable to state entities/resources/ or is it non-selective? (key elements of the notion of state aid – art 107-º TFEU).
VIII - Uncertainties about EBU and interplay with competition law - a prospective view

- What will be the degree of centralization of the SSM in Frankfurt? Ideally some level of decentralization towards national supervisory authorities within SSM/Conversely lack of consistency in application of key EU concepts/parameters of prudential supervision in different Member States – inviting more centralization – where to draw the line?...to add to complexity SSM/ECB applies national law when this derives from transposition of EU Directives – how to develop proper judicial review of application of National Law by an EU institution??

- SSM provides for Joint Supervisory Teams with National Supervisory Authorities connected in network with the SSM – but what degree of autonomy to national members of those teams?

- Article 5 of the SSM Regulation – Possibility for the SSM for consistency reasons to perform certain supervisory tasks even as regards non significant credit institutions (in principle still under the remit of national banking supervisors) – How much will SSM use that possibility?
VIII - Uncertainties about EBU and interplay with competition law - a prospective view

• Furthermore, how will the Commission as European Competition Authority (DGCOMP) interact with the SSM/ECB and the SRB?
• Some apparent critics of ECB to Commission/DGCOMP in this field.....
• More flexibility in restructuring banks without entering in resolution and in accordance with EU state aid rules – review of soft law – Commission Bank State Aid Guidelines of July 2013 and of BRRD and SRM Regulation???
• A future EU scheme to deal with NPLs and legacy problems of EU banking industry? (see Enria – EBA Chair – Speech in Lisbon – June 2016 – CIRSF Conference...)
• ECB/SSM – in the wake of Consultation (based on “Draft Guidance to Banks on Non-Performing Loans”/September 2016) is developing a ‘regime change’ to banks – more supervisory pressure/new supervisory approach/methodology with supervisory guidance & injunctions to banks to reduce and manage NPLs.... although legal basis for that disputed....
IX - EBU and new financial regulation and supervision approach as a template to other reforms

• Can EU reform of financial regulation and supervisory approach and methodologies (esp. in banking) when EU enters its Sixth Decade be a template for reform internationally? Probably – yes....

• Structural stabilization of EU financial system has worldwide importance – not confined to EU – importance to stabilization of financial system in China and East Asia

• Particularly in context in which in July 27, 2017 - Moody's Investors Service has revised its outlook for China's banking system to stable from negative – EU experience in overcoming tensions of financial sector relevant to enhance this outlook...
X - Concluding remarks

• Congratulating the organizers of **Conference in Macau/China** – it is appropriate to conclude with **CONFUCIUS**:

  • *"It does not matter how slowly you go as long as you do not stop"*

• Probably more accurate than ever about EU – and its current **EBU in interplay with competition law and policy** – but, given **exceptional times**, there is the **risk** in building EBU & when entering 6th decade of EU integration that **going to slowly may lead us to stop and fall** – we need to find the right pace...