

Skadden, Arps, Slate, Meagher & Flom LLP  
& Affiliates

*If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.*

#### London

Richard A. Ely  
+44.20.7519.7171  
richard.ely@skadden.com

Lorenzo Corte  
+44.20.7519.7025  
lorenzo.corte@skadden.com

Patrick Brandt  
+44.20.7519.7155  
patrick.brandt@skadden.com

#### Frankfurt

Matthias Horbach  
+49.69.74.220.118  
matthias.horbach@skadden.com

#### Paris

Pascal Bine  
+33.1.55.27.11.01  
pascal.bine@skadden.com

#### Washington, D.C.

William J. Sweet, Jr.  
+1.202.371.7030  
william.sweet@skadden.com

#### New York

Sven G. Mickisch  
+1.212.735.3554  
sven.mickisch@skadden.com

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Four Times Square, New York, NY 10036  
Telephone: +1.212.735.3000

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## European Commission Proposes That European Central Bank Become Prudential Supervisor of Eurozone Banks

On September 12, 2012, the European Commission (the Commission) announced a much-anticipated proposal for a Council of the European Union (the Council) regulation to confer on the European Central Bank (the ECB) new wide-ranging powers relating to the prudential supervision of credit institutions pursuant to Article 127(6) of the Treaty on the Functioning of the European Union (the Proposal).<sup>1</sup>

The Proposal would represent a significant shift away from the supervision of individual Eurozone banks primarily by national authorities and towards enhanced European integration in the supervision of Eurozone banks under the authority of the ECB. However, the Proposal does not address key aspects of architecture that are considered by the Commission to be integral to the establishment of a European banking union, such as a common European resolution authority or a European deposit insurance scheme, which are anticipated to be introduced only after the implementation of the new common European supervisory regime.

As has been widely reported in the press, the adoption of the regulation in its proposed form and on the Commission's desired timeline by the end of the year is highly uncertain, given significant reservations in certain member states, notably Germany, regarding the scope of banks covered, the degree of central power granted to the ECB and the proposed pace and sequence of implementation. It remains to be seen if, when and how these differences will be resolved. This memorandum provides an overview of the Proposal as submitted by the Commission and discusses the process and next steps in the implementation of the proposed single European supervisory regime.

### Overview of the Commission's Banking Union Proposal

*Scope of Coverage.* The Proposal provides that the ECB would exercise supervision over all credit institutions established in Eurozone countries. The ECB also would be authorized to carry out supervision on a consolidated basis over credit institutions' parents established in Eurozone countries, including over financial holding companies and mixed financial holding companies, and to participate in supervision on a consolidated basis with respect to parents not established in a Eurozone country. Moreover, the ECB would be entitled to participate in supplementary supervision of a financial conglomerate in relation to the credit institutions included in the conglomerate and assume the task of a coordinator between regulatory agencies where it is so appointed pursuant to EU law.

Non-Eurozone member states of the EU would be able to optin to the common supervisory regime on a voluntary basis, subject to satisfaction of certain cooperation requirements between the ECB and the relevant non-Eurozone member states.

*ECB's Supervisory Powers.* The Proposal notes that the ECB should be conferred those specific supervisory tasks that are "crucial to a coherent and effective

<sup>1</sup> Proposal for Council Regulation, 2012/0242 (CNS), Sept. 12, 2012, available at [http://ec.europa.eu/internal\\_market/finances/docs/committees/reform/20120912-com-2012-511\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-511_en.pdf).

implementation of the policies relating to the prudential supervision of credit institutions,” while other tasks should remain with national authorities. The specific powers actually proposed to be granted to the ECB are wide-ranging and include many of the key supervisory tasks that were previously held by national authorities. The authorities that the ECB would be exclusively competent to carry out under the Proposal include the following:

- the authorization of credit institutions and the withdrawal of authorizations of credit institutions;
- the assessment of acquisitions and disposals of holdings in credit institutions;
- the imposition of prudential requirements on credit institutions in respect of areas such as capital levels, exposure limits to individual counterparties, liquidity, leverage, reporting and public disclosure, as well as the imposition of additional capital buffers on credit institutions, including potential capital conservation buffers and countercyclical capital buffers, and other measures to address systemic risks specifically set forth in EU law;
- the application and assessment of governance arrangements and risk management processes of credit institutions as well as mechanisms to assess internal capital adequacy, and the imposition of institution-specific capital, publication and liquidity requirements;
- the application of supervisory stress-tests on credit institutions to support the ECB’s supervisory review; and
- the application of early intervention actions in coordination with relevant resolution authorities where an institution is likely to breach applicable prudential requirements.

With respect to the power to license institutions, the ECB would be required to work closely with national authorities that are the licensing agencies of Eurozone banks currently. New bank applications would continue to be filed with national authorities in accordance with the requirements set out in national legislation. If the national authority takes the decision to propose to the ECB to grant the new bank authorization, it would notify the ECB and the applicant of such decision, and the ECB would then grant its own authorization if the application also meets the conditions set out in EU law. With respect to the withdrawal of banking licenses, the ECB would be empowered to act on its own or on the recommendation from a competent national authority.

Regarding the ECB’s power to review and assess acquisitions and sales of ownership stakes in Eurozone credit institutions, the Proposal raises many significant questions and potential issues that would need to be addressed in future rule-making and supervisory practice. As written, the Proposal does not apply any materiality threshold to the ECB’s power to review shareholdings. Currently, applications at the national level for approval of acquisitions in most member states generally are required at a 10 percent threshold and, consistent with this current regime, the Proposal’s introduction makes reference to the ECB’s review of a “purchase of a significant stake” in a credit institution, but the terms of the proposed regulation could apply to a wider array of shareholdings. In addition, by its terms, the ECB also would have the right to assess “dispositions” of shareholdings, which raises concerns regarding the ability of significant shareholders to exit their investment in a banking institution without prior ECB review. In order to attract new capital to the Eurozone banking system, it will be necessary to clarify promptly the ECB’s regime of review of ownership and control of credit institutions in the Eurozone.

The references to the ECB’s early intervention powers fall short of a common resolution authority. The ECB’s role would be limited to carrying out supervisory tasks regarding early intervention and assistance in a potential future resolution regime. The Proposal notes that a European resolution

authority (backed up by the possibility of direct recapitalizations of Eurozone credit institutions by the European Stability Mechanism) and common depository scheme are necessary ingredients of a European banking union, but concludes that a single supervisory mechanism is the necessary basis preceding these steps because any introduction of common intervention mechanisms should be grounded in a common control environment that reduces the likelihood that rescue mechanisms will need to be utilized.

While the ECB's new supervisory powers would be broad, the Proposal states that any powers not granted to the ECB would remain with national authorities. The Proposal notes that some of the powers not conferred on the ECB and that therefore would remain with national authorities include the power to receive notifications regarding the right of establishment and free provision of services, to supervise credit institutions not under the ECB's supervision but supervised as credit institutions under national law, to supervise credit institutions from third countries establishing a branch or providing services in the EU, to supervise payment services, to carry out day-to-day verifications of credit institutions, to carry out oversight of credit institutions relating to markets in financial instruments, and to prevent money laundering and terrorist financing in the financial system.

Additionally, the Proposal notes that national authorities are envisaged to retain significant on-the-ground authority to assist the ECB with the application of its supervisory powers. For example, the Proposal contemplates that national authorities could perform most day-to-day verifications and other supervisory activities necessary to implement the ECB's new supervisory powers. The Commission also highlighted that national authorities have a long-established expertise in the supervision of credit institutions within their markets along with highly trained staff. The ECB would therefore be expected to rely on national authorities to provide ongoing assessments of a credit institution's condition and related on-site verifications in order to implement ECB rules and to bring issues to the attention of the ECB. For example, as a practical example of the interplay between the ECB's and national authorities' responsibilities, the Commission contemplates that in the case of a credit institution requesting the use of an internal risk model, national authorities would have primary responsibility to assess the request and its compliance with applicable EU law and ECB rules, propose to the ECB whether to validate the model, including any conditions therewith, and monitor the application and use of the model.

*ECB's Investigative and Sanctions Powers.* The Proposal would endow the ECB with wide-ranging investigative and inspection powers over credit institutions, financial holding companies, mixed financial holding companies, mixed-activity holding companies and any persons "closely and substantially related or connected" to the activities of such entities, including vendors providing outsourced services. In order to carry out its supervisory tasks, the ECB would be able to request all necessary information and to conduct all necessary investigations and on-site inspections relating to such institutions and persons.

The Proposal also would provide the ECB with the power to sanction credit institutions, financial holding companies and mixed financial holding companies that, intentionally or negligently, breach rules under directly applicable EU law. The ECB could impose administrative pecuniary sanctions of up to twice the amount of profits gained or losses avoided because of the breach, or up to 10 percent of the bank's total annual turnover in the preceding business year. National authorities also would be able to apply further sanctions on banks based on their failure to comply with national law, and the ECB would be empowered to require national authorities to take action to ensure appropriate sanctions are imposed.

*ECB Organizational Principles.* In order to protect against conflicts of interest between the monetary policy function of the ECB and the ECB's new role as prudential supervisor of Eurozone banks, the ECB's supervisory authority would be independent from its tasks relating to monetary policy to ensure that each function is exercised pursuant to its applicable objectives.

While the Governing Council of the ECB would remain ultimately responsible for taking decisions, a supervisory board would be established within the ECB to which the Governing Council could delegate supervisory tasks or decision-making power and that would be in charge of the planning and execution of the tasks conferred upon the ECB. The supervisory board would be comprised of four representatives of the ECB appointed by the ECB's Executive Board and one representative of the relevant national authority in each Eurozone country. Additionally, the supervisory board would include a chair elected by members of the ECB's Governing Council from the members of the Executive Board (excluding the president) and a vice-chair elected by and from the Governing Council of the ECB, whose terms would not exceed five years and would not be renewable. Representatives from non-Eurozone member states of the EU that have established close cooperation with the ECB regarding the single supervisory regime would be able to participate in the activities of the supervisory board in accordance with the conditions of cooperation.

While members of the supervisory board and the staff of the ECB carrying out supervisory duties would be subject to professional secrecy requirements under EU law, even after their duties had ceased, these requirements would not prevent the ECB from exchanging information with national or European authorities where national or EU law provides for the disclosure of such information.

The budget necessary to fund the ECB's new supervisory function would be financed through fee assessments on credit institutions subject to ECB supervision. The Proposal states that the amount of the fees levied on a credit institution would be proportionate to the importance and risk profile of such institution. There is no indication regarding the scale or structure of the supervisory fees envisaged by the Proposal.

In order for the ECB to put in place its new supervisory system, the Proposal states that the ECB would ensure an appropriate exchange and secondment of staff with and among the national authorities. The ECB also could request that supervisory teams of national authorities involve staff from other Eurozone countries in the supervision of large banks to avoid any conflicts of interest.

The ECB would be accountable to the European Parliament and the Council relating to the implementation of the proposed supervisory regime and would submit a report each year to the European Parliament, the Council, the Commission and the Eurogroup (a meeting of the Eurozone finance ministers that typically convenes ahead of each Economic and Financial Affairs Council meeting) on the execution of the tasks conferred in the Proposal.

*ECB's Relationship with European Banking Authority.* On the same day as the announcement of the Proposal, the Commission also announced a related proposal for the European Parliament and the Council to amend the regulation establishing the European Banking Authority (the EBA) so that it may take into account the ECB's new supervisory powers. Under the proposed regulation, the EBA would retain the power to develop a single rulebook applicable to all EU countries and would continue to seek to ensure the supervisory convergence and consistency of supervisory outcomes within the EU. Moreover, the related proposal applicable to the EBA would change the voting arrangements applicable to the EBA in certain cases to take into account the interests of Eurozone and non-Eurozone countries in the EBA in light of the proposed single supervisory mechanism in the Eurozone, and to alleviate non-Eurozone country concerns relating to domination of the EBA by a bloc of Eurozone members and the ECB.

*Timeline for Implementation.* The Commission proposed a swift implementation process whereby the Proposal would enter into force on January 1, 2013, subject to a phase-in process. The phase-in process would be completed within one year with the number of banks under the ECB's supervision increasing progressively. Under the Proposal, on July 1, 2013, the ECB would begin supervising the

most significant banks based on exposure size, cross-border activity and European systemic importance, which would cover at least half of the Eurozone banking sector. Additionally, the ECB could decide to carry out supervisory tasks as soon as January 1, 2013, on those banks that have received or requested public financial assistance. All Eurozone banks are contemplated to be under the ECB's supervision by January 1, 2014.

### **Process for Implementation and Next Steps**

In order for the Proposal to come into effect, the Council, in accordance with special legislative procedure, must unanimously approve the Commission's Proposal after consultation with the European Parliament and the ECB. This means that the Proposal must be approved unanimously by all EU member states. While the Commission aims to have the Council adopt the Proposal by the end of 2012, press reports and official and unofficial commentary since publication of the Proposal place this timeline in doubt.

Some of the terms of the Proposal are facing opposition from Germany and other member states, which may threaten or delay the adoption of the Proposal. For example, Germany has articulated concerns over the scope of banks under the ECB's supervision, the degree of centralization at the ECB and the quick timetable for, and sequence of, implementation. Additionally, Sweden, Poland and the Netherlands have requested a longer timetable in order to negotiate the details of the Proposal. Moreover, concerns about the ECB's power to influence decisions at the EBA have drawn criticism from non-Eurozone countries such as the United Kingdom.

Negotiations among EU countries regarding these and other matters will be ongoing as EU institutions and member states attempt to reach a compromise prior to January 1, 2013. Skadden's European Financial Institutions team will continue to monitor closely and report regularly on ongoing European banking union developments as they arise.