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The EU Banking Union: Will the New Regulatory Framework Restore Confidence in European Banking?

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The development of the overall supervisory framework for European Union banks is expected to be finalized by May 4, 2014.

The European Union is implementing a single bank regulatory framework ("Banking Union")[1] that formally will cover banks headquartered either in a eurozone country or in a participating non-eurozone EU country. The U.K., Sweden and the Czech Republic, all non-eurozone countries, have indicated that they will not participate. Nevertheless, Banking Union will affect banks headquartered in these countries that maintain branch offices in any participating EU country.

During the recent financial crisis, the EU experienced significant problems in trying to break the "vicious link" between member state sovereigns and an ailing bank sector. As EU countries struggled to recapitalize their banks, financial markets repriced EU sovereign debt to address the additional strain placed on EU countries' public finances. Financial markets also took account of the additional risk that problems in one eurozone country could contaminate others.

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EU lawmakers believe that, when implemented in November 2014, Banking Union will help restore confidence in the EU banking sector through a single EU prudential supervisory framework. However, to break the link between national governments and national banking sectors, Banking Union also will need a single resolution regime to make sure that failing banks with cross-border operations can be "resolved" efficiently without significant adverse market impact. The EU resolution regime has proven more politically contentious.

Banking Union will make the European Central Bank ("ECB") the primary prudential regulator for banks[2] with head offices in a participating EU country. The ECB also will prudentially regulate branches of banks established in participating EU countries, but whose head office is located in a nonparticipating country.[3] The ECB will have formal supervisory and enforcement powers, which will enable it to remove board directors from banks and fine those institutions and, in some cases, their EU parent companies. The ECB will have no formal role in regulating securities and insurance markets but will enter into memoranda of understanding with relevant regulatory bodies, which may increase the ECB's informal persuasive power in a number of areas outside prudential regulation.

SIGNIFICANT INSTITUTIONS

Banking regulators in EU participating countries will retain a major role in the prudential regulation of banks operating in their jurisdictions, although the ECB will have overall responsibility. Operational responsibility will be split between the ECB and national regulators, with the latter having more responsibility for less "significant" institutions. The precise criteria that will be used to determine significance is expected to be finalized in the second quarter of 2014. However, in broad terms, a bank will be significant if:

- its assets exceed €30 billion;
- the total value of its assets is at least €5 billion, and the ratio of those assets exceeds 20 percent of the participating member state's GDP;
- the local national regulator believes that it is significant and, after assess-

ment, the ECB agrees;

- the ECB assesses it as significant when taking its cross-border activities into account;
- it receives, or applies for, bailout funds from the European Financial Stability Facility or the European Stability Mechanism; or
- it is one of the three most significant institutions in a participating EU country, unless the ECB decides otherwise.

The ECB will be responsible for licensing (and removing the licenses of) banks headquartered in participating countries. In addition, the ECB will be responsible for deciding whether to approve in advance the acquisition or disposal of a qualifying holding in a bank, which in the normal course is a 10 percent direct or indirect stake in share capital or voting power. However, national regulators will retain a major role in assessing applications and making recommendations to the ECB.

For significant institutions, the ECB will:

- be responsible for compliance with requirements covering "own funds," "passporting" applications, securitization, large exposures, liquidity, leverage, regulatory reporting and public disclosure;
- supervise overall governance arrangements, including board composition and remuneration policies;
- carry out supervisory reviews and stress tests and decide whether banks need to add more capital, make further liquidity arrangements or publicize their prudential arrangements;
- take a leading role where an institution needs to be resolved;
- supervise banks on both a consolidated (*i.e.*, as part of a group) and solo basis; and
- participate in financial conglomerate supervision relevant to in-scope banks.

In carrying out these functions, the ECB will receive assistance from relevant national regulators. For nonsignificant banks, national regulators will take the lead on all of these matters except for financial conglomerate supervision, where they will coordinate with the ECB under its direction.

NEXT STEPS

The development of the overall supervisory framework is expected to be finalized by May 4, 2014. In the meantime, the ECB and national regulators need to agree which institutions are significant and precisely how coordination will work.

The ECB also will assess the capital adequacy and prudential arrangements of the eurozone's most significant banks before Banking Union is formally implemented in November 2014. The process, called a "comprehensive assessment," also will involve a number of stress tests. National regulators in the relevant countries are preparing intensively for this assessment. The exercise may lead to the recapitalization of some EU banks, which a number of commentators have said has lagged the similar action taken by U.S. regulators a number of years ago. The exercise also may lead to more bank M&A if affected banks believe they must sell assets, business units or subsidiaries to comply with regulatory capital ratios. The comprehensive assessment promises to be the ECB's first significant supervisory exercise in the new prudential framework and a significant indicator of what EU banks can expect of the new regime.

NOTES

1 The legal framework is set out in the Banking Union Regulation (Regulation 1024/2013), which is the main law relating to the single supervisory framework, and in Regulation 1022/2013, which amends laws governing the functions of the European Banking Authority (EBA).

2 The relevant laws use the term "credit institution" and exclude some deposit-taking entities from ECB regulatory scope. However, for present purposes, nearly all retail and investment banks are subject to ECB regulation.

3 In theory, most prudential regulation will be the responsibility of the "home state" regulator, with the ECB having responsibility for a limited number of items including branch liquidity. However, time will tell to what extent the ECB will seek a more prominent role in the prudential regulation of nonparticipating country banks.