Are EU Banks Safe?

Roel Theissen

eleven
international publishing

Are EU Banks Safe?

Are EU Banks Safe?

Zijn EU banken veilig?

PROEFSCHRIFT

ter verkrijging van
de graad van doctor aan de Erasmus Universiteit Rotterdam
op gezag van de rector magnificus Prof.dr. H.A.P. Pols
en volgens besluit van het College voor Promoties.
De openbare verdediging zal plaatsvinden op
donderdag 5 december 2013 om 10.00 uur

door

Roeland Johannes Theissen

geboren te Eindhoven

ERASMUS UNIVERSITEIT ROTTERDAM

Promotiecommissie

Promotor:	Prof.mr. H.M. Vletter-van Dort
Overige leden:	Prof.mr. M.J. Kroeze
	Prof.dr. M. Tison
	Prof.mr. J.B.S. Hijink

The commercial edition of this book is published by Eleven International Publishing
ISBN 978-94-6236-105-8
ISBN 978-94-6094-930-2 (e-book)

Published, sold and distributed by Eleven International Publishing
P.O. Box 85576
2508 CG The Hague
The Netherlands
Tel.: +31 70 33 070 33
Fax: +31 70 33 070 30
Website: www.elevenpub.com

Sold and distributed in USA and Canada
International Specialized Book Services
920 NE 58th Avenue, Suite 300
Portland, OR 97213-3786, USA
Tel: 1-800-944-6190 (toll-free)
Fax: +1 503 280-8832
orders@isbs.com
www.isbs.com

Eleven International Publishing is an imprint of Boom uitgevers Den Haag.

Table of Contents

Opening Remarks

What exactly are the rules banks are subject to, and are they fit for purpose? These are the two questions addressed in this book 'Are EU banks safe?' and its descriptive companion book 'EU banking supervision'. The full rulebook on banks is difficult to find and grasp nowadays, both as to size and as to sources. Even if only looking at the European Union (EU), it runs to thousands of pages spread over regulations, directives, standards, guidelines and communications. These rules, their explanations and specifications are issued by legislators, supervisors and courts. The EU rulebooks are supplemented by thousands of pages at the national level in each member state that often overlap with or can be overruled by the EU level rules. Where the details can easily be overwhelming, the underlying structure is difficult to see, and the reasons why these were introduced are presented superficially at best in the recitals. The achievement of these goals is thus as difficult to confirm as the full rulebook is difficult to oversee. As the EU has been the primary rule maker in this area and will for the foreseeable future take over the standard setting for each bank operating in the EU, both books focus on the EU level rulebook and procedures and their repercussions for the banks, their supervisors and the member states.

The descriptive book 'EU banking supervision' serves the purpose of providing a full overview of what the author would have liked to know – or to have had easy access to – when starting to work in this field. That book is aimed to be useful both for such new entrants as well as for experts in some of the areas that would like to achieve an overview of the full banking supervision picture. Learning by doing – my personal experience – means that practitioners often know a lot about the subject they have been personally involved in, but little about other subjects that are equally important to achieve the goals of banking supervision.

This book 'Are EU banks safe?' has a different intent, and is focused on persons who are interested in changing or maintaining the way prudential banking supervision is structured and performed. It builds on the descriptive companion book, but focuses on what banking supervision should do, and whether it is able to deliver. Do and can banks and supervisors deliver what it says 'on the box', and is the description on the box correct in the first place? This analysis is based on my personal experience and expertise, gathered as a customer of banks, a legal/supervisory/policy advisor on banking regulation, and my involvement in national, EU and worldwide negotiations on new legislation.

The research for this book has been closed as per 1 July 2013.

1 Introduction

1.1 Questioning EU Banks and Their Regulation

Introduction
Banking supervision has returned to the centre of public and political attention. New laws are being introduced to address lessons learnt from the most recent financial crisis; the 2007-2013 subprime crisis. What went wrong and what type of laws should be introduced or reinforced? Whether this is the right question or not is debatable. A prior question is what the current rules are, and whether a crisis could have been avoided if the existing requirements and supervision had been properly applied? And what does society actually want to achieve by banking supervision, and can such purpose be achieved by the current or future framework?

Over a period of four decades, the main features of the national laws and authorities in the EU member states have gradually become similar – harmonised – by EU laws. Financial services are essential to the goal of achieving a single market for services in the EU. This harmonisation policy has been successful in many respects. The vast majority of banking assets are now owned by a limited number of banks that operate in multiple member states. Wholesale customers roam freely in the single market. Retail customers could do so if they chose to. For civil law, tax law, language and for other reasons, they are less likely to cross borders to foreign banks, though they appear relatively happy to do business with subsidiaries and branches of foreign banks in their own jurisdiction. The success of this policy results in more drivers to harmonise the rules over the last four decades. This compensates for the fact that national public authorities no longer have full control of such cross border business, while the backup facilities for failing banks remain national.

The national laws and authorities – and the large number of EU rules they have to comply with – have come under criticism. Politicians and voters had the impression that supervision would prevent banking failures and financial crises. They were rudely disabused of this notion in the 2007-2013 subprime crisis. In search for safety, the body of EU rules continues to grow, both in the number of rules and in the impact of the rules. New proposals are partly copied from national experience, partly invented by Brussels legislators, and partly derived from the global discussion in the context of the G20 or the Basel Committee of Banking Supervisors (BCBS). Discussions at the global level sketch the general direction on banking supervision, and have great informal authority. However, as they are not based on treaties, they are not binding on banks or on banking legislators/supervisors.

This is different for the EU rules. Member states have committed themselves (and their citizens) in the EU treaties to abide by the jointly agreed rules. In banking, the room to manoeuvre for member states has declined. The tendency has been to further limit national deviations from the EU standard, which process has only accelerated in the wake of the 2007-2013 subprime crisis. The bulk of national rules will be amended by a new – largely directly applicable – set of European rules. The new set of rules contains copy paste sections of existing rules; some truly new proposals based on for instance new global standards, and some upgrades of existing features.

Background

Prudential banking supervision regulation in the EU has grown pragmatically. Starting from humble, national frameworks with a minimum overlay of EU core rules, it is developing into an ever larger – but not consistently sophisticated – EU rulebook with diminishing national flavours[1]. The growth of the EU banking-rulebook was not driven by inner consistency reasons but by external drivers such as the bankruptcy of the first cross border operating banks (BCCI, Herstatt), the work in Basel by the BCBS and by various crises. Such growth spurts focus on issues where the gaps between supervision and bankruptcy frameworks were most glaringly obvious at that point in time. A consensus between member states and between supervisors can then be arrived at on the protection of banks and of their clients to fill such obvious gaps, or to increase existing demands. Other drivers for the growth of the rulebook were technical innovations by banks and in financial markets, and changing political views on the importance of banks to specific parts of the economy. The banking/finance industry plays a key supporting role in the economy for commercial companies, fiscal lawyers, lawyers, accountants and tax authorities and vice versa. Banks provide finance or advice on funding options for small- and medium sized companies, national champions in industry, state debt, housing, and also provide services to consumers including the safekeeping of assets.

Both the European commission (commission) and the committee of European banking supervisors, since 2011 replaced by the European banking authority (CEBS/EBA) have performed an analysis of what could be improved in the current revision of prudential banking supervision for the discussions on the so-called CRD IV project[2]. These analyses focus on plugging gaps contained in the capital requirements directives (CRD[3]), reducing goldplating, implementing the agenda of the G20, and fighting a running battle on the fall-out of the 2007-2013 subprime crisis, as well as adding additional sets of rules on amongst others the resolution of banks when they fail. Though the rules on banking supervision are amended as a result of such analysis and political goals, the changes

1 See Chapter 1.2; and R.J. Theissen, *EU Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapters 1, 2 and 3.5.

2 The CRR 575/2013 and the CRD IV Directive 2013/36/EU will replace the CRD, gradually becoming applicable in the period of 2014-2021. See the Commission, impact assessments accompanying the commission proposals for the CRD IV Regulation and Directive, SEC(2011) 949 final and SEC(2011) 952 final, 20 July 2011; CEBS-EBA, Analysis on the Scope of Full Harmonization in the CRD, 8 October 2010.

3 The CRD actually consists of two directives, the Recast Banking Directive (RBD) and the Recast Capital Adequacy Directive (RCAD), while its successor legislation – the CRD IV Project that will start to apply in 2014 – consists of a regulation and a directive.

focus primarily on institutional improvements, political compromise on noticed gaps, and on headline numbers. Whether this will indeed help to fulfil the goals of banking supervision, or whether it mainly addresses short term events is not entirely clear (though addressing short term events in a crisis is a worthy purpose in and of itself).

The resulting EU rulebook does not fit well with what is known of the initial goals of this eclectic collection of modern and older rules regarding banks and their supervision as described in 'EU banking supervision'. Core parts of EU banking supervision legislation were written when EU banks were relatively small, relatively national, and operating in non-liberalised capital markets. The goals and the content of the rules were not very well defined to begin with. The CRD licensing requirement focuses on pure deposit taking and lending business, while larger and smaller banks have broken out of such confines (if those ever existed). Traditional banks are not the main focus of the new capital calculation rules that have been introduced since, e.g. on securitisation or derivatives. These instead focus on the large, cross-border and very diversified financial businesses of banks and the groups to which they belong. In this book, the term 'bank' generally refers to licensed banks (in EU terminology 'credit institutions') currently operating in the EU, though whether the underlying definition and the target of the licensing obligation are correct is the subject of chapter 4.3 and 4.4.

Capital buffers intend to reduce the chances of failure of a bank; and to increase a high pay-out if a bank does fail. Phrased in this manner, the goal of the calculation of capital requirements commits banks and the prudential authorities involved to *aspire* towards achieving stability and protection, and not to *guarantee* the achievement of stability and protection. This is also emphasized by prudential supervisors[4]. However, in case of an actual bankruptcy or in times of a crisis, the expectations of the general population of politicians, and even of banks, appears to indicate a commitment of some sort as to the result, perhaps even a no-fail regime. This may be a result of changing societal expectations since the 1970's when capital buffers were first introduced, or because nobody ever believed or wanted to believe the formal limitations on the achievability of the goals set.

Alternatively, the discrepancy between aspirational goals and crisis-expectations can be the result of changing market circumstances, with banks anno 2013 playing different and more systemic roles than tradition dictates. There appears to be no commonly agreed theoretical background for banking supervision, neither is there any agreement

4 Recital 34 CRD IV Directive. T. Padoa-Schioppa, *Regulating Finance*, OUP, Oxford, 2004, Chapter 1. Also see various authors in A. Joanne Kellermann, J. de Haan, F. de Vries, (Eds.), *Financial Supervision in the 21*st *Century*, Springer, Amsterdam, 2013. R.J. Theissen, *European Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapter 4.3.

on the goals thereof and the level of certainty that the goals will be achieved between the public, politicians, academia, banks and supervisors[5].

1.2 An Introduction to EU Banking Supervision

Introduction

The discussion on the desirability and impact of the new rules is hampered by the fact that a full overview of existing banking rules is difficult to obtain. Most proposals focus on specific features, without necessarily setting out what was already there, what the actual upgrade is (if any), and how it fits into the wider picture of banking supervision related legislation. As the EU rules increasingly dictate the exact conditions under which banks and banking supervisors operate in the member states, a full description is also useful in and of itself.

The core of the current EU legislation on the supervision of banks is formed by the Capital Requirements Directive or CRD. Even though the term CRD suggests a single piece of work, it actually consists of two directives:

- directive 2006/48/EC of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast); and
- directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast).

These are referred to as the 'Recast Banking Directive' (RBD) and the 'Recast Capital Adequacy Directive' (RCAD) respectively in this book. In the RBD, the main elements of licensing, ongoing prudential supervision and termination of banks are dealt with. The RCAD deals with a specific subject only: the treatment of market risk. This has been kept outside the RBD, because it is also relevant to specialised non-bank firms which operate in the financial markets. The RCAD contains the common framework for banks and non-bank investment firms for the treatment of market risk (and the prudential treatment in general of non-bank investment firms). The RBD and RCAD will be replaced by a new regulation and directive in the context of the CRD IV project. It will recast the existing version of the CRD into the capital requirements regulation 575/2013 ('CRR') and the capital requirements directive IV 2013/36/EU ('CRD IV directive'). These will replace the RBD and RCAD from the start of 2014, though large parts of the CRR will enter into force only at the end of 2014, and the main innovations (on capital quality and the amount of such capital needed) will only enter into force from 2016-2021[6]. The division of subjects is different here, with common and directly applicable rules contained in

5 Along these lines also C. A.E. Goodhart, 'Financial Regulation, Credit Risk and Financial Stability', *National Institute Economic Review*, Vol. 192 (1), 2005, pp. 118-127, who also notes the lack of economic theory behind capital requirements.

6 Art. 163 CRD IV Directive and Art. 521.2 CRR. Aspects of a liquidity ratio will apply from 2015; see below.

the regulation, while subjects where more flexibility was deemed necessary was allocated to the directive. The CRD IV directive needs to be implemented in the laws of each member states before it becomes applicable to banks.

The focus of this book and of the companion book 'EU banking supervision' is both on the currently applicable regulations and the legislative agenda being rolled out after the most recent financial crisis hit. Most of the current rules were drafted before the crisis, though they are in the process of being amended at the date of this publication (for instance by the CRD IV project). Additional rules are being discussed (such as the projected use of European rescue funds to recapitalize national banks, or the proposals on crisis management tools that have so far been left to national discretions). The detailed description contained in 'EU banking supervision' serves a dual purpose. It aims to provide a common basis of knowledge for people working or studying in the field of banking supervision in the EU, or unfamiliar with parts of the broad array of banking supervision requirements and instruments. A practical problem for that detailed discussion – and for the subsequent analysis in this book – is that banking supervision is not a particularly academic piece of work, nor can it be looked at in isolation from a range of other academic and practical issues. Banking and its supervision are strongly influenced by tax law, accountancy, company law, public law, economic models, monetary policy, pragmatism, politics and lots and lots of money. The result makes both the law and the practice complex, and subject to continuous change. An additional problem is that there is little consensus on exactly how banking supervision works, or how the law should be applied. Both 'EU banking supervision' and this book are thus built upon my interpretation of the requirements, and my reading of the facts. These interpretations are where possible based on jurisprudence, literature, and EU based supervisory publications. This chapter introduces the key points of this analysis of the existing situation of prudential supervision as derived from the descriptive book.

Licensing, living, liquidating – the lifecycle of a bank

The focus of this book is on banks. This is a relatively narrowly defined concept, though they perform a wide range of financial services. The definition used in the CRD is given for a so-called 'credit institution'. It is 'an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account'. The credit institution term is used by EU legislators when they want to refer to banks[7]. This automatically implies that credit is the core business of banks, even though banks offer a much wider range of services, and credit may only be a supporting function to bank's investment, payment or other services. This legislative custom is not used in this book, instead the more common terminology of banks is used. When using it in the context of the legislation, and for instance answering the question whether the definition used is fit for purpose (see chapter 4.3), the term bank is used as synonymous to the CRD-terminology of credit institution.

7 Art. 4.1 RBD and Art. 4.1 sub 1 CRR.

Like persons, undertakings and legal entities are born (established), live (function) and die (are liquidated with their assets distributed to others). Almost all banks are legal entities, though unlike for some other types of prudentially supervised financial enterprises, this is not a condition imposed by EU law[8]. The definition of a bank instead focuses on any undertaking that performs the so-called transformation function by using deposits and other repayable funds obtained from members of the public (and often due to be repaid immediately at the discretion of the client), and 'transform' those funds into long term loans for the own account of the bank to for instance consumers or to businesses and governments. As part of establishing itself as a bank, a new or existing undertaking will need to obtain a license in its member state. A new bank has to fulfil a range of conditions to obtain such an authorisation to operate as a bank, including having sufficient initial capital, suitable management and owners, and presenting a business plan under which it shows it will be able to function while fulfilling on a continuous basis both these initial licensing requirements and any requirements that will apply once it becomes a bank[9].

The EU treaty freedom of establishment allows persons, including legal entities, to establish themselves anywhere in the EU, subject to certain safeguards in the public interest. Banking is one of the industries that have a high impact on the local economy and financial system. If non-harmonised, under the general good/public policy exceptions, a member state could thus impose their own requirements on banks from other member states that want to perform these activities in their territory, making the freedom of a theoretical nature only for banking services. The EU can attempt to harmonize the areas where member states could and would otherwise act unilaterally in a way that limits cross border activities. For banking, this has taken the form of introducing minimum standards of prudential banking requirements and the supervision thereof[10]. This reduces the scope for unilateral action under the general good/public policy rule, as the member states – when sufficient member states agree to the harmonised rules under the qualified majority voting system in place – indicate that this is the level of protection needed. As a result, once an entity has obtained a banking license from a EU supervisor and is supervised under the agreed minimum level or requirements, other member states can only claim the need to perform additional tests or set additional demands for the remaining unharmonised areas (such as the amount of cash a bank needs to have available to fulfil

8 An undertaking of a natural person or a partnership that does not qualify as a legal entity under local laws is not prohibited from obtaining a license. A new bank will generally be incorporated into a legal entity to separate its assets from the (debts and other) assets of its owner, and to be able to raise capital. Arts. 4.1, 4.2, and 6 RBD respectively Art. 8 CRD IV Directive and 4.1 sub 1 and 42 CRR. Compare Art. 17 and Annex III Solvency II Directive 2009/138/EC that allows only specific legal forms for insurers, or Art. 4.1 sub 1 Mifid 2004/39/EC that defines an investment firm to be a legal person (with a national discretion to allow exemptions), and Art. 2 sub 1 Electronic Money Directive 2009/110/EC.

9 Arts. 6-17 RBD and Arts. 8-18 CRD IV Directive.

10 *Case C-233/94, Deposit Guarantee Case, Germany/Parliament and Council*, Court of Justice 13 May 1997, § 10-21. *Case 2/74, Reyners/Belgium*, Court of Justice 21 June 1974. Also see R.J. Theissen, *EU Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapters 3.5 and 5.

obligations towards depositors and other creditors). Any subsequent activities a bank wants to develop in other member states, benefit from a lighter touch assessment either under a notification procedure referred to as the European passport (for branches and cross border services that are considered activities that take place within the legal entity that has obtained the banking license), or under the EU treaty freedom of establishment. For subsidiary legal entities, the bank has to obtain a separate license, but under the EU treaty freedom of establishment the right of refusal of the supervisor of the subsidiary is limited. This applies also for the assessment whether the parent bank is a proper (full or partial) owner of a subsidiary bank[11].

With a license, obligations and rights are bestowed upon a bank. It becomes subject to prudential requirements that aim to increase its solidity, so that it becomes a dependable part of the financial system, as well as subject to supervisors with a range of instruments to verify and enforce such requirements (see below). Its license allows it to attract funds without a prospectus from retail clients as well as from wholesale clients. It also allows it to operate a wide range of services which are the subject of a series of conduct of business and consumer protection directives and regulations that regulate issues such as consumer credit, payment services, e-money instruments, or investment services, without becoming subject to separate licensing procedures and mostly avoiding additional prudential rules (except for specific internal governance demands)[12]. The conduct of business requirements for performing such regulated services do apply also if the service provider is a bank instead of a specialised provider. The conduct of business requirements are not the subject of this book, which focuses on the prudential side of banking supervision. They nonetheless provide important safeguards for public policy/general good, by requiring banks to treat all or certain customers fairly, which is sometimes specified in great detail, to act with integrity in the markets, and to disclose relevant information to clients or to markets.

As long as the bank complies with all specific prudential demands, it is likely (but not guaranteed) to retain its license and to continue to operate under its own management,

11 Recitals 7 and 10 and Arts. 16, 22-40 RBD, and Recitals 15 and 16 and Arts. 17, 33, 35-52 CRD IV Directive establishes the European passport for branches and subsidiaries. Both branches and subsidiaries are covered by Art. 53 TFEU, that allows any local company to perform activities elsewhere either in the form of a branch or a subsidiary, at its discretion. The public policy exceptions allow a host member state to do a limited assessment under the agreed notification procedure for branches and the licensing procedure for subsidiaries, but only to the extent necessary to safeguard such public policy goals. See for the limited possibilities to add requirements for instance, *Case C-442/02, Caixabank France*, Court of Justice 5 October 2004, and *Case C-452/04, Fidium Finanz*, Court of Justice 3 October 2006.

12 Art. 23 and Annex I RBD, and Art. 33 and Annex I CRD IV Directive on Deposit Taking and on the Range of Services Covered for Prudential Purposes by the European Passport. Also see Art. 1.2 Mifid Directive 2004/39/EC, Arts. 1.1 sub a, 3, 10 and 11 Electronic Money Directive 2009/110/EC, for examples of the exemptions from the licensing process given to banks supervised under the CRD (and for the absence of exemptions on internal governance aspects and conduct of business and consumer protection requirements).

setting out is own course within the boundaries set by company law, prudential and conduct of business requirements. Both to the benefit of the bank and to its detriment, the prudential requirements have a certain flexibility built into their phrasing. This can be the result of (i) the use of 'adequate' or other non-specific qualifiers in demands, or (ii) due to their use of undefined or incomprehensively defined terms (effectively direct, own funds, public), as well as (iii) due to the subjectivity and margin of appreciation built into the triggers for action of central banks, governments, deposit guarantee funds and supervisors to intervene not only when it is clear that a bank is a danger to society, but also when it appears likely that it will become a danger to society due to future risks or developments[13]. This flexibility allows that a supervisor gives a bank the benefit of the doubt even if it is not strictly (or only in a very lenient interpretation) compliant with the requirements, or is very likely to return to compliance in an acceptable time-frame (regulatory forbearance). On the other hand, a supervisor can decide to act to replace management or to require additional buffers when there are 'only' doubts about future non-compliance instead of also certainty about current non-compliance. When either the bank or the public authorities that are involved thinks the bank is no longer viable, or is no longer viable in a profitable manner, the bank can be voluntarily or – if requirements following from administrative law and human rights protections are met – involuntarily liquidated. If the bank is relatively small and has many competitors that are alternative service providers, such a demise is relatively painless, except if any unexpected losses surface which would eat into the financial buffers of the bank to the extent that its commitments cannot be fully met on time (or at least after the liquidation of all its assets). If the bank is large, has large unexpected losses, or is the only provider of a specific useful service, this may disrupt the market as well as the trust clients of other banks put in their banks. The triggers for intervention by public authorities are made flexible to allow them to try to avoid such disruptions. Determining when to fail a bank is difficult in the light of the flexibility given, the potential but unknown impact of the failure on counterparties and the financial system as a whole, and meeting any burden of proof to show that invasive action is needed if that is not in consensus with the bank or its owners. The outer limit set for intervention is not part of the CRD, but of the deposit guarantee directive. This directive serves a dual purpose: it protects consumers and small- and medium sized companies from the negative effect of losing cash entrusted to a bank (for instance savings or current accounts) up to an amount of 100.000 euro per person per bank, but on the other hand indicates that public authorities cannot allow a bank to continue operating in an undisturbed manner if either a judge has pronounced it bankrupt or in a moratorium of debts procedure, of if a deposit that is due and claimed has not been repaid to the client for a certain number of days[14].

---

13 Arts. 54, 124 and 136 RBD and Arts. 97, 102 and 104 CRD IV Directive. Also see below on the use of the instruments of supervisors.

14 Arts. 1, 2, 3.5, 7, 10 and Annex I Deposit Guarantee Directive 1994/19/EC.

Quality, quantity and common sense
To limit the chance that the bank or the supervisor need to decide that the bank is broke or unlikely to meet obligations at a future date, the EU rules set out several categories of requirements on banks. The main categories are:
- quantitative requirements;
- qualitative requirements;
- public disclosure requirements;
- reporting and other information provision requirements to the supervisor.

Quantitative requirements focus on the solvency ratio and on the initial capital requirement. The latter is a rough and ready minimum level of financial buffers (in that case, mainly composed of equity and published reserves) of at least 5 million euros that has to be available both when applying for a license and on a continuous basis after absorbing any losses[15]. The solvency ratio is the reason why the CRD has its current name. This capital requirements calculation on which the vast majority of the current CRD provisions focus, establishes how large the financial buffers need to be to cover unexpected losses due to credit risk, market risk and operational risk[16]. For these three main risk categories, capital requirements are calculated using either a standardised model set out in the CRD, or alternatively using an internal model of the bank that fulfils minimum requirements set out in the CRD and is approved by the supervisors. For credit risk and market risk, the calculation is made per exposure (an asset such as a mortgage loan to a client or an off balance sheet potential claim) that looks at the relative risk that the claim will not be repaid respectively which will decline in value due to for example fluctuating foreign exchange rates or market values. For operational risk, an assessment is made that to for instance fraud by employees or clients, a fire or a terrorist attack which will lead to costly disruptions or other losses.

The amount of financial buffers needed due to the solvency ratio is 8 %. In essence, the risk weighted capital requirements for the risk categories are added up, and need to be met by certain types of buffers to the tune of in total 8% of this amount. Theoretically, if the unexpected risks that are calculated all materialize over the next year, the bank would be able to absorb all of such losses with its buffers (and may be bankrupt as a result, but at least all claims of normal creditors would still be repaid upon liquidation). At the moment, only a quarter of this 8% demand needs to consist of high quality equity and public reserves, the rest of the demanded financial buffers can be covered by hybrid bonds, long term and even short term subordinated loans, in an area riddled by national discretions that allow local legislators to allow their banks to insert even lower quality capital components[17]. Both the amount of financial buffers and the quality demands are increased in the wake of the 2007-2013 financial crisis (mostly from 2016), while certain improvements in the

15 Arts. 9 and 75 RBD and Art. 18 RCAD, respectively Art. 12 CRD IV Directive and Arts. 92-93 CRR.
16 For large exposures a small add-on capital requirement is calculated if certain maximum thresholds are exceeded.
17 Arts. 57, 66 and 75 RBD and Art. 18 RCAD.

calculation of capital requirements (mostly for market risk and for the treatment of securitised assets) have been in place since 2010. The financial buffers improvement means that a larger component of the 8% will need to be covered by equity and public reserves, thus certain capital components such as short term subordinated loans will no longer be acceptable, and that additional buffers will need to be maintained on top of the 8%, depending on the business of the bank and its systemic relevance to around 13% of the risk weighted capital requirements[18]. In due course, additional quantitative demands will need to be met to address liquidity risks (can the bank fulfil – even in a crisis situation – in the short and in the long term its obligations to give cash back to its investors and creditors as promised), and a so-called leverage ratio (in an unweighted manner, how much financial buffers does the bank have that can absorb unexpected losses)[19].
Any expected losses are left out of scope of the capital requirements, and are required to be deducted from the financial buffers before checking whether there are sufficient buffers to meet the minimum 8% requirement. These quantitative demands are often referred to as the first pillar of banking supervision.

The qualitative requirements focus on the internal organisation of the bank, and especially on the checks and balances and the trustworthiness of its books. The major managers who effectively direct the business of the bank need to be both competent and trustworthy (be suitable/fit and proper) for their tasks, manage an organisation that keeps records and should be able to make decisions in a risk-appropriate way, verified by internal back office procedures (risk control functions). Supervisory authorities often do not have extensive resources, therefore a large part of verifying the health of the institution builds on the strength of the internal management layers, the correctness of the internal reports on risks and trends, and the self-cleansing capacities of the bank's procedures. These demands are both part of the initial assessment whether a bank can obtain a license, and need to be met on an ongoing basis. If a bank makes use of more sophisticated internal models to calculate pillar 1 capital requirements, it will need to meet additional specific demands to ensure that its models lead to trustworthy results, or are upgraded when they show deficiencies. As part of additional ongoing requirements, a banks needs to self-assess whether its organisation (and its buffers) are sufficient to withstand any risks it faces or may face (and to take measures if it does not think so, including upgrades in its organisation or holding additional financial buffers). This self-assessment – with the supervisory review of that self-assessment that is a key part of supervisory tasks – is often referred to as the second pillar of banking supervision[20].

Banks are subject to a range of reporting obligations to the public and to supervisors. The public transparency obligations flow from normal company law/annual accounts rules, but the CRD adds to these by instituting additional public disclosure requirements on information that relates to the banks risks, and how it meets such risks from a

18 Arts. 25-88, 92, 465-491, 494, 501, 504 CRR and Arts. 129-134, 160, 162 CRD IV Directive.

19 Arts. 86-87 CRD IV Directive and Arts. 8, 21, 412-413, 429, 451, 460-461, 499, 509-511 and 521 CRR.

20 Arts. 123 and 124 RBD, and Arts. 73 and 97-98 CRD IV Directive.

prudential supervision perspective (often referred to as the market discipline component or third pillar of banking supervision) and an even wider set of periodic and ad hoc reporting requirements to the supervisory authorities[21].

Standing alone or together

The supervision of the bank is different if it is a fully stand-alone entity, or if it is part of a group. This is the result of a discrepancy between economic/commercial and legal approaches, which are both accommodated in the CRD. The requirements on capital adequacy and organisation are primarily developed by economists/accountants and managers, who look at a functioning banking group as in essence one economic entity, perhaps divided in different business lines to make a bank more manageable and to better allocate resources. This mind-set is dominant in for instance the worldwide set of standards on capital in the form of the Basel capital accord (in any of its versions from the 1988 Basel I version to the Basel III version that will be implemented via the CRD IV project in the EU from 2014). From the legal point of view, such a group-wide economic entity does not exist, or rather it exists but as a group – with ownership and contractual ties – of legal entities. The group does not have a license, only an individual legal entity has a license, and it alone is allowed to operate – and subjected to prudential requirements – as a bank. These requirements also can be enforced only against the legal entity to which they are addressed. Importantly, it is the legal entity that goes bankrupt. Once a liquidation scenario approaches, the pay-out to individual creditors will be determined by the health of that individual entity in the form of the assets of that entity compared to its liabilities, not by the group wide assets and liabilities.

This leads to a two-step approach to accommodate the economic reality of the group during the lifetime of the bank with requirements both on a solo basis to prepare for a liquidation, and on a consolidated basis to address the group-wide economic entity; simultaneously preventing the multiple legal entities from being used to hide existing risks from the eyes of creditors and supervisors. The licensing and liquidation phase meanwhile remain firmly solo based, at best looking sideways at claims and service agreements between group entities as a source of relief or of risk.

Many of the ongoing quantitative and qualitative requirements will be applied to each individual bank legal entity on a solo basis, and will also need to be met on a consolidated basis by the relevant bits of the group of which the bank is part. This consolidated view of the group includes any parent, its parents, siblings and subsidiaries within the group. The consolidation concept is derived from the accountancy concept, with adaptations to include the relevant parents, and exclude entities that are not deemed relevant, or that are used to manage risks in another manner. Examples of excluded entities are vehicles used

21 For public disclosure see Art. 145 and Annex XII RBD and Arts. 13, 431-455 CRR, and for reporting obligations see for instance Art. 74.2 RBD and Art. 99-101CRR, and a range of specific obligations spread over the CRD and the CRD IV/CRR (for instance Arts. 26, 40 CRD IV Directive and Art. 430 CRR).

to manage securitised assets, or non-financial parents or industrial production subgroups owned by the same parent (such as a holding that owns a car financing bank subsidiary and a car production subsidiary). Other demands only apply at the consolidated level, or the licensing supervisor can give exemptions of solo application of requirements[22]. For instance, disclosure of additional CRD information under the so-called third pillar is mandatory for the group (applied to the highest entity), while subsidiaries are mostly exempted. Whether or not pillar 2 requirements are made on subsidiary banks depends on the local supervisor. The subsidiaries and parents are captured in the consolidated check of compliance, depending on the exact structure of the group, and on the business of the individual entities involved.

Where the bank can be subject to solo and consolidated requirements, the public authorities can have or take a parallel responsibility. The primary responsibility is for the entities it licenses, but sometimes it is given additional tasks – and in fewer cases instruments – in relation to both that entity and its subsidiaries and other related companies captured in the consolidation. The supervisor that licensed the (generally highest) bank in the group is called the consolidating supervisor. In ongoing supervision, this supervisor has the responsibility to coordinate the flow of information between the relevant supervisors, prepare joint decisions of all these supervisors on issues specifically identified in the CRD to be of joint interest, and try to influence them to act in a coordinated manner. The interested supervisors will include all supervisors that licensed a bank which is part of the group, or where a branch is located that is locally systemically relevant (plus other public authorities such as EBA and central banks). This type of joint work per banking group is performed in the context of so-called colleges of supervisors. The colleges do not have decision making power, but are a forum for consultation and coordination. Their effectiveness is monitored and supported by EBA, the European banking authority of which all national supervisors are part (its highest decision making board is composed of representatives of member state supervisors). Powers are vested primarily on the national supervisors, except that the coordinating supervisor can overrule other supervisors on the approval of internal models by banks to calculate the capital requirements for credit risk, market risk and operational risk; and has a strong say at the consolidated level for supervisory reviews of the risks a bank faces (but on a solo basis, the other supervisors can deviate from the position taken by the college). EBA is empowered to mediate in conflicts within colleges, and sometimes to take a binding decision if the EU rules specifically allocate that power to it, and as long as it does not touch upon the fiscal responsibilities of a member state. That latter exemption will almost always be the case in a crisis situation. Neither EBA nor other supervisors in a college can prevent a supervisor on an individual entity to take emergency measures, though they are requested to take into account the financial stability consequences in other member states of unilateral actions[23]. Within the Eurozone, the intent is to create a banking union with a joint supervisor and joint

22 Recital 13 and 15 and Arts. 1.2, 68-70, 118- RBD, respectively Arts. 108-110, 129-131 CRD IV Directive and Arts. 6-23 CRR.

23 Arts. 40.3, 42a.3, 131a.2 and Annex XI § 1a RBD and for instance recital 50 CRD IV Directive.

financing of crisis measures, alongside the joint monetary authority/lender of last resort. Though political agreement has been achieved, the financing, cooperation measures and transitional regimes were not published when this book closed, and will require successful negotiations on all aspects and details, and building up funds and practices to make it work successfully in practice from – currently predicted – the end of 2014 or the start of 2015[24].

EBA succeeded the so-called committee of European banking supervisors or CEBS in 2010[25]. It is the most recent and most powerful of a range of bodies set up to foster co-operation between European supervisors, starting in 1972 with the groupe de contact. In addition to the informal discussion, cooperation and policy development roles played by its predecessors, EBA has gained an explicit role in developing binding legislation (by drafting standards that are expected to be adopted unchanged by the commission, that will subsequently apply directly both to supervisors and banks), its role in colleges and its mediation and conflict resolution tasks. In addition, it can perform EU wide stress test exercises, and intervene in certain crisis circumstances.

Instruments vs. trust

To some extent, the goals of the prudential supervisor and of the bank run in parallel. Both are eager to get depositors to deposit their money at the bank, and eager for the bank to perform its funding role to the commercial sector and to the state, as well as to provide other services they perform in the economy[26]. Banks are expected (and forced) to police themselves, and to have effective and efficient reporting in place on financial information and risk factors so that they can manage themselves effectively. The internal part of it is (enforced) self-regulation in which the prudential supervisor trusts[27]. The internal reporting and back office checks serve to make the bank in all its components, including its board, aware of the risks and rewards of each activity, and whether they match. Banks are also mandated – and trusted – to send accurate information on an ongoing basis to the supervisor, and contact the supervisor if incidents occur. The trust the supervisor places in the bank is often well deserved, and supported by the knowledge that the supervisor does sometimes perform a verification of the information provided, and has a range of reparative and corrective instruments at its disposal to evict anyone caught deliberately or incompetently providing false information. Without trusting on the procedures in the bank, the prudential supervisor would need the type of humongous resources that are not available on the public purse, not even if the banks would pay for it. Supervisors basically supervise the internal supervisors (risk officers and the executive

24 The single supervisory mechanism will start functioning at some point late in 2014, a year after the final texts have been published (if the operational preparations are finalized), and a joint resolution authority is proposed to be in place by the start of 2015. See Chapter 4.6.

25 EBA Regulation 2010/1093.

26 See Chapter 2.

27 M. Power, *Organized Uncertainty, Designing a World of Risk Management*, OUP, Oxford, 2007, Chapter 2.

and non-executive board members) who in turn supervise and/or manage the business risks. Part of the investigative instruments focuses on checking whether the trust placed in these internal officers is well deserved. This means that supervisors need to question directly, but also verify independently in a risk aware manner (e.g. by blind testing and validation). If transgressions occur, the response should be commensurate both with the transgression itself as well as with the impact on the trust-based relationship with the external supervisor; taking into account the response of the internal supervisory regime. The latter can be a mitigating, neutral or extenuating factor or even an independent transgression if it involves a cover-up. A gradated response is necessary both to foster a mutual trust environment (this will make the reporting of incidents more speedy), and also to make clear that transgressions are in and of itself a violation of trust[28]. It can be argued that in prudential supervision the final outcome is more important than compliance with each individual requirement. However, if trust is not expected and demanded, and violations of individual requirements punished, that final outcome is certain to be ruinous. The investigative instruments of supervisors (reporting, on site visits, ad hoc information demands addressed to the bank, its accountants and group-companies as well as from other supervisors) are built on trust, and how to verify whether such trust was correctly given[29]. Such verification provides the core of ongoing supervision. The corrective instruments set out the palette that is available to gradate responses to violations in trust, and in primary transgressions. These instruments range from a (formal) disciplinary talk or written warning if the transgression is both small and not repeated within the banks' organisation to – as ultimate sanctions – a withdrawal of the license of the bank or a withdrawal of the supervisory approval of a board member as a fit and proper person. The ultimate intervention is, however, not seen as a punishment or as corrective, and it goes beyond the trust of the supervisor towards the trust of the society in the bank. It involves pushing a bank into liquidation at a moment in time when its continued existence without public action would impact on the society in a too negative manner; for instance when it does not honour its commitments towards depositors any more, or is likely to cause instability of the financial system.

Effective, proportionate, and dissuasive

Even if the supervisor or another authority has a right to act, he can decline to act (unless the law explicitly binds him to act in certain circumstances). Even when he can and wants to act, he is bound to respect the human rights protection and the administrative law protection of the bank, of its employees, and any other legal or natural person who is the addressee or victim of an intervention[30]. The rights of a fair trial, to privacy,

28 See Chapters 2 and 3; J. Viñals & J. Fiechter, *The Making of Good Supervision: Learning to Say 'No'*, 2010, IMF SPN/10/08.

29 Arts. 43 and 137-142 RBD, Art. 36.3 RCAD (respectively Arts. 4, 118, 122-126, 159 CRD IV Directive CRR) and Art. 15 Financial Conglomerates Directive.

30 See for instance *Joined Cases 46/87 and 227/88*, *Hoechst AG v Commission*, Judgment of the Court 21 September 1989, § 12 and 13 and *Case 374/87*, *Orkem S.A. v Commission*, Judgment of the Court 18 October 1989, § 28-33. Also see D. Chalmers, C. Hadjiemmanuil, G. Monti, T. Giorgio, A. Tomkins,

to property, to have a business, and for instance the presumption of innocence in criminal matters need to be respected in the design of rules and in their application, though the right of privacy only protects natural persons such as bank managers, and not legal entities.

Most of such human rights or administrative law protections against measures taken by the supervisor can be limited by the CRD or other prudential rules if the limitation is in line with an exception to the fundamental or administrative right involved. Whether invoking such limits is effective will depend on the circumstances of the case. For instance, actions that impact on the property rights of a bank or of its shareholders can be taken, but only if a clearly identified interest is at stake that is important enough (such as a crisis at the bank with potential negative effects on its clients and on society as a whole), that cannot be solved in another manner and for which provisions have been made in a law to make them proportional. Such outer limits to regulatory actions help to prevent arbitrary actions of a government, or prevent a government from allocating all losses to one party to the unbalanced benefit of the bank or of the government. For instance, expropriation of property rights embedded in bonds or shares without compensation of the market value of such property rights is likely to be illegal, even if there is a crisis. Both the law and the way it was applied needs to be compliant, though public authorities are given leeway to determine whether e.g. there is a crisis, and whether an intervention is appropriate and sufficient compensation is paid[31].

The leeway to not act, to practice legal or informal forbearance[32], is equally not without limits. Under the EU treaties, the member states have to take any appropriate measure, general or particular, to ensure the fulfilment of the obligations arising from the treaties or resulting from e.g. directives or regulations. The court of justice[33] has held that under this obligation, the member states have leeway to choose, for instance, the

---

European Union Law, CUP, Cambridge, 2006, Chapter 6. The European Convention on Human Rights is applicable to all member states as well as several other European countries, and since the entry into force of the Lisbon Treaty, the 'Charter of Fundamental Rights of the European Union' is explicitly part of the EU treaties

31 *Case 34940/10, Northern Rock Grainger/UK*, ECHR, 10 July 2012; *Case 22186/03, Pešková v. the Czech Republic*, ECHR, 26 November 2009. As a rule, compensation of the market value will need to be paid for expropriations of property rights, though this can be mitigated if well-motivated in the public interest, e.g. to take away undeserved or illegally obtained benefits due to for instance value created by already provided lender of last resort support by the central bank.

32 Legal forbearance includes giving a temporary exemption of a requirement, or a short period of time to address a failure to fulfil. This would be illegal if the CRD or domestic laws explicitly order the supervisor to act in certain circumstances, but many instruments of the supervisor allow him, but do not force him to act on transgressions immediately; see for instance Art. 136 RBD. Informal forbearance can be applied if a provision is interpreted in a more lenient manner than normally, or the supervisor by pure coincidence 'fails' to notice a transgression.

33 Art. 4 TEU. *Case C-167/01, Inspire Art*, Court of Justice 30 September 2003. *Case C-45/08, Spector/CBFA*, Court of Justice 23 December 2009, § 70-74. Also see Art. 54 RBD, as amended by CRD III Directive 2010/76/EU.

correct penalty for an infringement of a directive rule, but they must ensure in particular that infringements of directives and other EU laws are penalised in both procedural and substantive requirements that are similar to the treatment of equally important national provisions. The penalty has to be made effective, proportionate and dissuasive. The determination of how to achieve this is left to national legislators, but it can amongst others take into account the gains made by somebody by infringing a directive provision. The proportionality requirement brings with it that a penalty can also be too heavy for the transgression, especially if it is more burdensome for nationals from other member states than for its own nationals. If a rule or instrument is not in line with this benchmark, or is not applied in line with that benchmark, the member state (and its public authorities) are deemed non-compliant with their treaty obligations, and are bound to repair this transgression. However, the court has long standing case law that secondary EU legislation such as directives will be interpreted in line with the treaty provisions if at all possible (instead of being annulled for incompatibility), and that national laws need to be interpreted (and applied) in line with directive provisions[34].

The liability of a member state towards individual persons or entities under EU rules can be derived from the 'direct effect' that clear and unconditional EU rules can have[35]. If and in as far as a part of EU legislation was intended to give clear rights to individuals, and the member state can be held responsible (as a serious breach) for failing to give those rights, it becomes liable to repair the loss and damages if those damages would not have occurred if the individual had its rights as intended. In its Peter Paul judgment[36], the court of justice gave some indicators when a banking supervisory authority (or the state in general to be precise) would be liable under EU law. It indicated that the directives that were applicable at the time (the deposit guarantee directive and the predecessor directives of the CRD and Mifid) intended to achieve the essential harmonisation necessary for mutual recognition, allowing banks to operate across the EU on their European passport, with a specific addition for depositor protection in the form of the guarantee under the deposit guarantee directive[37]. The court indicated that some of the individual obligations are explicit (and implied that those could lead to liability). However, where such a specific rule of law that intends to confer rights on individuals is absent, or if such a rule is not infringed, there is no state liability under EU rules.

---

34 See, for instance, explicit considerations of the Court in the so-called co-insurance cases amongst which *Case 220/83, Commission/France*, Court of Justice 4 December 1986. For the relation between national laws and directive, see for instance *Case C-356/00, Testa and Lazzeri/Consob*, Court of Justice 21 November 2002, §43.

35 See R.J. Theissen, *EU Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapters 3.5 and 21.10.

36 *Case C-222/02, Peter Paul/Bundesrepublik Deutschland*, Court of Justice 12 October 2004. Also see *Joined Cases C-6/90 and C-9/90, Francovich and Bonifaci/Italy*, Court of Justice 19 November 1991, and *Joined Cases C-46/93 and C-48/93, Brasserie du Pêcheur and Factortame III*, Court of Justice 5 March 1996.

37 Deposit Guarantee Directive 1994/19/EC. See R.J. Theissen, *EU Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapter 18.5.

The court clearly stated that none of the directives mentioned 'conferred upon depositors a right to have the supervisors take supervisory measures in their interest'. The state/supervisor was thus not the 'agent' for the depositors[38], at least not to the point of mandatory liability under EU rules. Germany was therefore free to stipulate that banking supervision (in general) should be performed solely in the public interest, even if such a determination under national law prevents individuals from claiming compensation for damages resulting from defective supervision on the part of that authority. If the specific rights and obligations of the directives are fulfilled, there is thus no need for domestic legislators to make supervisors liable for faulty supervision in general even if that arguably could have led to the bankruptcy of the supervised bank. In an additional consideration, the court considered that, as the liability issue vis-à-vis depositors was not necessary to ensure mutual recognition, the directives did not need to address the coordination of such liability.

The court based its judgment on the deposit guarantee directive and on the banking supervision directives valid at the time of the incident. The directives at that time did not contain the innovations on cross border cooperation and capital adequacy that were introduced from 2006 until 2013 as a result of amongst others BCBS work. As these changes as well as the proposed amendments to the CRD appear to indicate a 'single market' character more than a 'minimum harmonisation mutual recognition' directive, some of the courts' deliberation on the need for an EU stance on supervisory liability may no longer be valid[39]. Some of the changes on amongst others significant branches could be deemed to protect depositors, though like in the Peter Paul case, these changes could as easily be judged to be (also) instituted in the interest of financial stability and the single market. In other financial sectors, more targeted protection is offered. In the insurance sector, it is quite certain that supervision has as its primary goal policyholder protection, not the public good in general[40]. The Solvency II directive has served to re-emphasize that point, leading to likely civil liability of the state and/or supervisory authorities in case supervision failed to safeguard those interests (possibly with an exemption if nothing the supervisor could have done, even in theory, could have safeguarded those interests, such as in a full financial system collapse). For those instances where the supervisor has been allocated a wider discretion (where it for instance has to take into account a wider range of goals, or has been given the choice to intervene or not in a legal forbearance deliberation), that liability becomes more limited. In no case can the supervisor or its member state be held liable for damages to individuals on the basis of non-compliance with EU laws if either that particular damage or that particular individual is not the intended

38 Some indicate that the supervisor or the state should be the agent to ameliorate the weak points in banking for specific groups of stakeholders (such as depositors), or for all stakeholders jointly. For the latter, see K. Alexander, 'Corporate Governance and Banks: The Role of Regulation in Reducing the Principal-Agent Problem', *Journal of Banking Regulation*, Vol. 7, nos 1-2, 2006, pp. 17-40.

39 L. Dragomir, *European Prudential Banking Regulation and Supervision. The Legal Dimension*, Routledge, Oxford, 2010, p. 309.

40 Arts. 27 and 28 Solvency II Directive 2009/138/EC.

person that should be protected by the EU rule. Several specific obligations, however, do intend to give protection to specific individuals, such as the deposit guarantee obligation. Importantly, the general obligations for supervision – even though they may not be written as general obligations towards depositors – are written as general obligations towards other member states, to fulfil their obligations under the mutual recognition framework. If another member state suffers damages from a failure of a member state to exercise supervision on for example the licensed bank that has a branch in the host member state, it may for that reason try to claim damages it suffers as a result.

Such a case, or at least the liability of a member state towards the citizens of another member state, resulted from the collapse of the Icelandic banking system. One of its banks had branches in the UK and the Netherlands. The deposit guarantee system of Iceland was at the time obliged to pay 20.000 (now 100.000) euro to both domestic and foreign depositors of the bank including its branches. The non-binding recitals to the deposit guarantee directive state that in principle the cost of financing a scheme must be borne by the banks themselves. The obligation to be able to pay within a set time period also indicates that the scheme needs to have funding in place in line with their liabilities, though it was noted that such ability should not endanger the stability of the banking system of the member state as a whole. Both this consideration and an explicit recital on the lack of liability of the member state towards depositors whose claim on a – properly set up – scheme cannot be paid out, have been eviscerated by legislative developments as a result of the Icesave/Landsbanki collapse[41]. The Icelandic scheme did not have sufficient funds to pay out the depositors of its three major banks that collapsed at the same time. In a power struggle between on the one hand the UK and Dutch authorities and the Icelandic authorities on the other hand, the Icelandic scheme and government had to accept liability which was incompatible with the financial stability of the member state and the liability-recital of the directive, in order to survive the broader financial crisis the collapse of its banking system had caused. As Icelandic authorities were blamed for the collapse of the three big Icelandic banks, there was little or no sympathy for their dilemma[42]. Their argument that the deposit guarantee directive did not oblige the authorities to chip in, and did not constitute a guarantee that a scheme once properly set up, would be able to do pay out even if the majority of the banking system collapsed at once, were valid in the face of the directive recitals, and even based in part by the previous case law of the court of justice[43]. Under an amendment of the directive in 2009, each

41 See the last recitals of Deposit Guarantee Directive 1994/19/EC.

42 See, for example, the report into the demise of Icesave and the instruments of the Dutch supervisor in relation to that branch of Landsbanki: A.J.C. De Moor-van Vlugt & C.E. Du Perron, *De bevoegdheden van de Nederlandsche Bank inzake Icesave*, 11 June 2009 (Dutch).

43 *Case C-222/02, Peter Paul/Bundesrepublik Deutschland*, Court of Justice 12 October 2004, indicated that the obligations of the state were limited to setting up the scheme and providing it with information as set out in the directive, and did not provide depositors with claims to supervisors on defective supervision as long as the directive provisions is ensured. The problem for the Icelandic government was twofold: the minimum pay-out was not ensured in the face of the collapse of their financial system, and the responsible authorities had failed to limit the losses of depositors in general, and were aiming to treat local

member state is now under an obligation to implement the directive in a manner that brings the scheme in a position to pay verified claims of depositor within 20 days[44]. If this is a ‘direct effect‘ obligation, which is likely, it effectively creates a sovereign guarantee for the funding of the scheme. The EFTA court since vindicated the Icelandic defence on the basis of the old directive text valid at that time; while acknowledging that under the 2009 version of the directive, the member state would have been liable[45]. Only where a specific obligation is allocated to the member state, the EU courts will find him liable to honour that commitment towards an individual.

Response to the 2007-2013 subprime crisis

In response to the crisis that gradually developed in 2007, escalated in 2008 after the demise of Lehman Brothers and which is still influencing European banks and financial markets at the time of the closing of this book (and may continue into 2014), many worldwide and European actions have been taken. After a range of reports analysing the crisis, financial market participants and regulators have agreed common worldwide (non-binding) policies at the G-20, the Financial Stability Board (FSB) and the Basel Committee of Banking Supervisors (BCBS), and issued binding rules at the national level. The European Union has harmonised the reaction to the financial crisis in some areas, amongst others by introducing legislation for hedge funds and other alternative investment funds (and specifically for their managers) in the alternative investment fund managers directive, for credit rating agencies, adding new agencies and legislators for financial markets in the form of the European Banking Authority (EBA) and similar authorities in the securities and insurance sectors, and initiating tentative steps to address the so-called macroprudential risk by instituting the European systemic risk board. These initiatives address competitors of banks (shadow banks who compete with banks in lending and funding markets such as hedge funds) or service providers to and/or subsidiaries of banks (credit rating agencies, trading venues and hedge funds).

Key aspects of the legislative agenda have been targeted directly at the prudential rules for banks and the supervision and public response capacity to problems at banks. In part, these have been implemented already. The CRD II and CRD III directives upgraded some demands on securitisations and on market risk, as well as on cross border cooperation in colleges of supervisors and on branches that are of systemic importance in the host member state, and introduced more specific demands on the management of liquidity risk (how to ensure sufficient cash is available to be able to honour withdrawals, even in stressed circumstances, and on remuneration (aligning the incentives embodied in salaries and bonuses to the long term interest of the bank (and society). The EBA regulation

depositors better than depositors elsewhere in the EU, which was in violation of its obligations under the EU/EEA treaties.

44 Art. 10.1 Deposit Guarantee Directive 1994/19/EC, as amended by Directive 2009/14/EC.

45 *Case E-16/11, EFTA Surveillance Authority/Iceland*, EFTA Court, 28 January 2013, (conclusion in §178 on the Directive as in force in 2008 when the relevant banks failed, and in §138-139 on the 2009 version of the Directive, when Art. 7 was replaced as a result of Directive 2009/14/EC).

and the changes in the CRD upgraded the conflict resolution and harmonisation tools for the collective of EU national supervisors represented in the decision-making bodies of EBA. For the quantitative aspects, these developments heavily relied on fast-track amendments (sometimes referred to as Basel II ½) to the version of the Basel capital accord that was being implemented in the EU at the time the 2007-2013 subprime crisis started to unfold.

A more fundamental overhaul of especially the quality of financial buffers and the amount of such buffers needed was agreed by the BCBS in 2010. These will, with some modifications be implemented in the EU over the period of 2014-2021 via the so-called CRD IV project (see above on amongst others the quality and size of financial buffers). A new directive (the CRD IV directive) and a new regulation (the CRR containing many of the quantitative demands on banks in a set of rules that is directly applicable in all member states) will become applicable in part at the start of 2014, and in part at the end of 2014 (for the areas where more detailed rules are mandated, to be issued or confirmed by the commission as level 2 commission directives or regulations, or as commission backed standards that are developed by EBA). Also expected, but not yet agreed or published in a final form when this book closed, are new instruments to manage the potential or actual demise of a bank via recovery and resolution instruments[46], and aspects of a banking union in the EU, via the establishment of a single supervisory mechanism in the Eurozone, and a resolution agency for the Eurozone.

1.3 Analysing Whether the CRD Is Fit for Purpose

Introduction

The analysis contained in this book is aimed at providing insight and ideas on the types of goals and testing-criteria that are necessary to assess whether the current legislation is fit for purpose. It will be based on the description in 'EU banking supervision', taking into account the concrete amendments already on the table that purport to deal with issues related to the 2007-2013 subprime crisis. It attempts an analysis on what the goals of banking legislation are or should be, and whether these are actually achieved or achievable by the EU banking directives.

Viewpoints that Determine the Outcome of this Analysis

The answer to these questions depends on the viewpoint taken. For me personally, three viewpoints come easily:

- from a supervisory policy development viewpoint;
- from an academic viewpoint;
- from a citizen (depositor/taxpayer/voter) viewpoint.

46 Commission, Proposal for a Recovery and Resolution Directive, COM(2012) 280 final, 6 June 2012.

The three can barely be reconciled with each other, let alone across 31 member states of the EU/EEA, due to different cultural, historical, social, institutional and political links and drivers[47]. For policy reasons, you take the issues where progress can be made towards the goal you aim for, and leave aside those issues that would stall the entire process. That includes some compromises in order to achieve those issues you find important. Policy makers in this process accept the 'bad' issues other negotiators want to achieve. From an academic viewpoint, you strive for perfection, and any 'bad' issues are unforgivable. From a citizen's viewpoint, you want safety, availability of services, freedom and low costs at the same time (but in good times, I want availability of services and freedom, and in crisis times, I want safety, in both situations combined with low costs). These are generalisations, of course, but do reflect some of the difficulty in looking at the question whether the CRD is fit for purpose.

This acknowledges that the actions of banks, their individual supervisors and the member states, as well as of EU institutions such as the ECB and the European commission are subject to a complex set of incentives and considerations. Important among those are not only the text of the law and the purposes it sets out to achieve, but also whether those can be paid for, who will bear losses and in which country, and whether a full application of the law would be proportionate. Ultimately, banking supervision is not an idealistic environment but a very pragmatic environment: 'if I do something now, will it help prevent this bank going bankrupt or will it actually speed it on its route to failure? If I don't do it, will it go bankrupt, and if so, whose interests are still protected?'

To assess whether the CRD is fit for purpose, the criteria set by the court of justice are followed in this book[48]. In its approach, the various viewpoints are condensed to ask whether the legislation works in the way advertised on the box, regardless of how it is exactly implemented in the member state, in the law or institutionally, and regardless of how other public policy goals of the member state interact with the implementation (unless specifically allowed via the limited general good/public policy exemptions). To do so, it looks at the stated goals, how it fits into the EU treaties (TEU and TFEU), the

47 J. Black, *Rules and Regulators*, Clarendon Press, Oxford, 1997, pp. 231-234.

48 Arts. 36 and 114 TFEU for single market harmonisation issues, and Arts. 52, 62 and 65 TFEU for the freedoms of establishment, services and capital. Set out in a range of case law, for instance in *Case C-41/90, Hoefner and Elser/Macroton*, Court of Justice 23 April 1991; *Case C-412/06, Hamilton/Volksbank Filder*, Court of Justice 10 April 2008; *Case C-356/08, Commission/Austria*, Court of Justice 25 June 2009, §37, and *C-438/05, International Transport Workers' Federation and Finnish Seamen's Union/Viking Line*, Court of Justice 11 December 2007, §33, 34, and 57; *Case C-167/01, Inspire Art*, Court of Justice 30 September 2003, §68-70, and *Case C-241/97, Skandia*, Court of Justice 20 April 1999; *Case C-28/99, Verdonck, Everaert and De Baedts*, Court of Justice 3 May 2001, § 37-38; *Case C-233/94, Deposit Insurance Case, Germany/Parliament and Council*, Court of Justice 13 May 1997, §10-19. This is a consequence of the fact that EU laws, issued within the boundaries of the treaties, are supreme over national laws and should be implemented effectively. Also see D. Chalmers, C. Hadjiemmanuil, G. Monti, A. Tomkins, *European Union Law*, CUP, Cambridge, 2006, Chapters 2, 5 and 9; R.J. Theissen, *EU Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapters 3, 4.3 and 5.3; especially Chapter 3.5.

phrasing of the legislation and the way it is applied, and whether these components are consistent. While doing this, the court allows considerable leeway to the legislators (to work in line with the aspirations of the treaty) and to the public authorities translating or applying the EU legislation (to work in line with the legislation within the leeway granted to them).

Market Friendly or Coercion; is the Viewpoint of Banks Important?

A fourth viewpoint is the viewpoint of a bank. In practice, their viewpoint is important during the process of drafting legislation. Due to their expertise, funds, political importance and power, the amount of funds available to lobby, and due to being the primary subject of banking legislation, they have a distinctive voice in the legislative process and in the evaluation of its application. This is a fact of life, and where it concerns state intervention such influence may even be welcome. Governmental interference in the private business should be resisted where possible. Where necessary; it should be instituted in a manner that is effective and efficient (including such issues as choosing the method that results in the most freedom and the least costs possible for the subject of state intervention).

In most areas of government intervention, however, this is balanced by an equally powerful, knowledgeable and experienced lobby for the other interested parties. This is true for e.g. carmakers (drivers associations), medical profession (patient organisations and good causes), public transport (travellers organisations). Even though in some areas of financial services regulation (e.g. consumer credit, deposit guarantee or best execution), consumer organisations and investor organisations have played a role, this has not been the case for prudential supervision, especially not in those areas that are primarily important for the financial stability goal. The 'balancing' role to provide counterarguments to the banking sector in the legislative and policy formation process on prudential regulation has thus fallen to the legislators and/or supervisors themselves. This has led to important downsides. Apart from difficulties in being the claimant on behalf of bank-clients and the judge of the strength of banking requirements at the same time, it has led to prudential regulation being a subject remote from the public eye, with common misperceptions as to the intent and effectiveness outside of an 'elite' of certain banking supervisors and bank lobbyists, together with the individual drafters of banking legislation.

As a result, the actual supervisory rules may be more geared to the demands of banks than desirable, and may be drafted in such a way that they lack any effectiveness. Apart from crisis-times, when the cost of widespread banking failures is high on the public radar and 'muscular action' is taken to show that politicians/banks/supervisors take the concerns of the public debate seriously[49], in the good years that follow prudential supervisors get most attention when it hampers the banks' business or causes them costs, or shocks the public by allowing a bank to fail when everybody had forgotten that such a

49 For instance, the debate on remuneration and on splitting up speculative and useful banks. See Chapters 3.3 and 4. Also see R.J. Theissen, *EU Banking Supervision*, Eleven International Publishing, The Hague, 2013, Chapters 2, 4 and 13.

thing might actually happen. This has led gradually to more market friendly behaviour when a crisis has not occurred recently. Failure to comply with prudential rules does not have a market disciplinary effect, and innovatively risky behaviour in areas not explicitly covered by pre-existing legislation is not addressed vigorously in new laws and supervision. For instance in the area of risk management (such as subprime mortgages or short termism in remuneration practices), problems were not vigorously pursued in supervision even when there are pre-existing high level rules, if such high level rules were not explicitly translated in guidance for a specific topic.

The tendency in the years leading up to Basel II/CRD of 2004/2006 had been to become more market friendly (i.e. bank and financial market friendly) in the western world. Apart from Japan, Spain and Sweden, the main negotiating parties in the BCBS and G10 had no recent experience with crises. As the downsides of Basel I were becoming clearer as banks adjusted their business more and more to its loopholes, the revisions that came out of the negotiating process were developed more and more to accommodate market friendly and very technical theoretical perspectives[50].

Those areas where prudential supervisors are strict (information gathering, capital elements) were either under intense pressure to become more lenient (securitisation, hybrid capital, reporting, mergers and acquisitions controls), or were not on the table for discussion on how to make them stricter (definition of capital, secrecy, licensing conditions). Prudential supervisors, depending also on their local culture and the size and expertise of their counterparts in the banking sector, operated more on a cooperative basis (where consensus with the banks was sought) and less on a coercive basis. In the areas where criminal investigators, consumer or investor organisations were most active (i.e. anti-money laundering and measures to protect individual clients against their financial services providers) a contrary movement could be observed, where ever stricter measures and coercive supervision became the norm, in line with public expectations.

In assessing whether the CRD is fit for purpose, the balance struck between coercive and burdensome measures and the flexibility and efficiency that is possible has to be taken into account. In this respect, it would also be desirable to assess whether prudential banking regulation can be brought out of its ivory tower, and made clearer to its beneficiaries (the participants in the system and the counterparties of banks; not to mention the public treasury that currently operates as lender/saviour of last resort).

Part of the proportionality discussion also focuses on whether supervisory rules and supervision should be commensurate to the goals legislators want to be guarantee or aspire to. When asking what should be minimally useful to achieve prudential goals, it becomes e.g. clearer that the survival of the legal entity with a bank-license is not

50 T. Padoa-Schioppa, *Regulating Finance*, OUP, Oxford, 2004, pp. 2-5 describes the market friendly approach chosen by regulators/legislators.

important from the point of view of the goals; but the continued provision of the functions banking as a whole provides to society/the economy is much more important. Even if the entity fails, the guaranteed aspects of counterparty protection can for example be continued by another legal entity that has taken over the most relevant activities of the failed bank.

In conclusion: This assessment is made from the point of view of policy development, academia and participant in society, aiming to balance pragmatism, usefulness and the holy grail of being objectively 'right'. A downside particular to prudential supervision is that the majority of users of the functions provided by banks choose not to be involved in the development of prudential requirements. In as far as end-users are involved, it concerns professional organisations of (financial) companies arguing for reduced safety requirements on banks when lending to them, or conduct of business areas. In all other cases, the burden of taking into account the interests of users falls on legislators and supervisors, who will unilaterally have to withstand pressure from financial industry lobbyists.

Structuring the Analysis

The question addressed by this book focuses on the determination of what goals should be agreed for banking supervision, and whether these are achieved by the requirements/instruments provided in the CRD. Is the CRD fit for purpose? In this context, it will be important to differentiate goals and instruments. It is for instance a different question whether financial stability or client protection should continue to be aimed for, than whether one of the measuring instruments for achieving such goals should indeed be that a bank has a certain level of financial buffers. Following from an analysis of the goals of prudential banking supervision, the follow-up question is whether the existing (and anticipated) EU rulebook and structures are sufficient to achieve the goals that have been set or should be set. Do the instruments set out at the EU level allow supervision to fulfil the goals?

The analysis is structured along these lines; corresponding to the chapters contained in this book:

1	Defining the question
2	What goals should prudential banking supervision aim for?
3	How absolute are the goals, and what is thus the benchmark against which prudential banking supervision should be assessed?
4	Assessment of prudential banking supervision against the benchmark
5	Overall analysis and conclusions

The references to the structure of banking supervision as described in chapter 1.2 and further analysed in this research is based on the binding and non-binding rules available as well as the available descriptions of practices, policy texts, literature and case law. This book thus does not contain a 'law & economics' or a comparison of legal systems (though where relevant both legal, economic and policy texts of any legal system are used).

The focus is on EU law, EU economics and EU developments in as far as it is relevant for answering the question whether the deduced goals of prudential supervision and the CRD are compatible. As the description in the sister-publication showed, the CRD only contains part of the prudential regime on banks. In the context of this question, whether the CRD is fit for purpose will also take into account elements of prudential supervision that are contained in other EU rules, including related current and future sets of rules on winding-up procedures, guarantee funds and resolution, as well as the developments towards a full or partial banking union. This book adds some overarching discussions on goals, testing criteria, gaps and overlaps.

The analysis is built on investigating the underlying rationale for supervision. In part, the goals will be derived from worldwide accords and papers; in part, they will be specific to the EU and derived from banking legislation and actions, as well as from the EU treaties[51]. This includes the stated reasons, as well as the effective rationale that will have to be derived from the inner consistencies and inconsistencies, the focus of supervision and instruments allocated, as well as from published commentaries on the efficiency and effectiveness of banking supervision.

There is a fair chance that some of the analysis/proposals/solutions put forth in this analysis may be off the beaten path to some (as they are too liberal, too right wing, too communist, take your pick), 'interesting' in the UK sense to others, and difficult to achieve for many. The same can, however, be said of many proposals that are currently on the table or already implemented, that only a short while ago seemed inconceivable for the near future (such as the institution of EBA, or the plans to introduce aspects of a banking union in the Eurozone). The analysis nonetheless tries to evaluate the CRD against the goals it might want to achieve in practice, and finds it lacking.

Some solutions are put forth for the gaps identified. This is not a so-called law/economics or international comparison book; instead, it focuses on gaps in light of the goals that should have been met. Most of the proposals will focus on pragmatic and achievable aspects that borrow from existing experience. Other proposals are based on the idea that some goals should be met even if there is no experience available. In this sense, it is both an idealistic and a cynical/pragmatic study. Some proposals might only be feasible if we can ignore the existing evolutionary legislation and practices on banking supervision in the EU in a 'blank sheet' approach. The underlying purpose of this book is not an enactment of each proposal, but to assist the discussion on solutions that has been ongoing since the start of the latest crisis by setting forth what it should achieve, based on what is already there[52].

51 The Treaty on European Union and the Treaty on the Functioning of the European Union; TEU and TFEU respectively.

52 This refers to the status quo and future developments on the CRD and associated prudential rules and regulations as introduced in Chapter 1.2.

In conclusion: the work related to this book focuses on the solidity of banks, and what can be done to make them safer. The central question is: is the CRD fit for purpose? As shown in 'EU banking supervision', the CRD itself only contains a part of the solidity regime applicable to banks, so the discussion on the CRD includes references to all aspects of 'prudential supervision of banks'. To answer this question of what can be done to make prudential supervision of banks fit for purpose, first, it will be analysed what goals should be agreed on for banking supervision and to what extent those need to be guaranteed. Subsequently, the conclusions of that analysis are used as benchmarks to assess whether the prudential requirements/instruments measure up to them.

Jargon and abbreviations are difficult to avoid when discussing EU banking supervision. The use of abbreviations is avoided where possible. Jargon is infectious. When working in this area, at a certain point in time you stop realising that not everyone knows what an ABS or SPV is, or even what these acronyms mean when written in full as asset backed security or special purpose vehicle, respectively. Where it was realised that jargon/abbreviations are used, jargon is explained where first used, and referenced to later on in the book. Abbreviations are only used for the core players in this field and the core legislative texts they helped develop, and limited to about 40 (see the list of acronyms and definitions at the end of this book). Standard or self-explanatory jargon as used in the business sections of newspapers is, however, used freely.

One key example of jargon is the distinction made in the area of requirements for banking between regulation and supervision. Roughly, practitioners in banking supervision refer to regulation when they mean the legal requirements (including the non-binding advice on how to apply those requirements), while supervision refers to the application of those rules in practice. However, requirements and their application in practice are the same. A requirement without an effective method to ensure application has no impact; supervision without an underlying clear requirement to uphold is meaningless. The test-subject of this book on whether the CRD is fit for purpose is therefore the way the prudential requirements are set, read and applied in practice.