BRIEFING

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# Banking Union: Completing the Single Rule Book


*Further harmonisation of banking law has been singled out as one of the remaining measures to completing the Banking Union. As explained by the Chair of the Single Supervisory Mechanism (SSM), "the smooth operation of the SSM requires a higher degree of harmonisation, as the application of different rules and processes in each Member State unduly complicates the conduct of supervisory tasks and jeopardises the level playing field".*

*This briefing provides an insight into where banking legislation stands in terms of providing a 'single rule book' for the purposes of supervising banks in the Banking Union. It also identifies the key areas where further harmonisation would facilitate both supervision and resolution.*


## The Single Rule Book in banking - where do we stand?

The term "Single Rule Book" was put forward in 2009 by the European Council in the context of the establishment of the European System of Financial Supervision (ESFS) that led to the creation of the European supervisory authorities (European Banking Authority ('EBA') in banking). A single rule book aims at bringing about a unified regulatory framework for the EU financial sector that would complete the single market in financial services.

To bring about a "single rule book" in banking, the Commission and the co-legislators have developed a three-pronged approach:

- Turning Directives into Regulations. Unlike Directives, a Regulation does not give rise to transposition into national law which may be a source of discrepancies across Member States. A regulation is directly applicable. In that respect, the European Parliament called in its 2017 and 2018 Banking Union reports on the Commission to use and prioritise Regulations in lieu of Directives;
- Further specifying EU banking legislation by regulatory and implementing standards developed by the European Banking Authority;
- Doing away with national options and discretions included in sectoral legislation.

The establishment of the Single Rule Book in banking has been at the forefront of several pieces of legislation over the past decade (see also Figure 1 below):

- The Commission proposed in 2011 a complete overhaul of banking legislation. The Capital Requirement Directive was split into two pieces of legislation: (i) a Directive (Capital Requirements Directive - CRD) and (ii) a Regulation (Capital Requirements Regulation -

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CRR).This first Banking Package adopted in June 2013 implemented the elements that had been agreed on in the Basel Committee on Banking Supervision - the de facto global standard setter for the prudential regulation of banks - in the so called Basel 3 package in the EU[1].

- The EBA has been tasked in 2010 to develop technical standards (as part of an "Omnibus Directive") to bring about a more comprehensive single rule book in banking. Further technical standards have been identified in the CRD4/CRR package in 2013 and more recently as part of the CRD5/CRR2 banking package in spring 2019;
- In relation to options and national discretions, CRD4/CRR went a long way in doing away with many discretionary prudential treatment, but significant options and discretions still remain. Some of these options are given to national supervisors (and thus, exercised by the European Central Bank in the Banking Union), but others remain as national options allowing the Member States to adopt diverging positions (see below).

Single Rule Book in banking is still not complete. There are still areas of banking legislation that are not unified (and certain areas cannot, for legal reasons, be fully covered by regulations). As illustrated in the figure 1 below, banking legislation can be broken down into the following three categories: (i) rules directly applicable; (ii) rules harmonised through directives transposed in national law and (iii) areas left to national competence.

The scope of the Single Rule Book entails significant consequences on the way the Single Supervisory Mechanism performs supervision. While rules fully harmonised in the form of a Regulation, such as the CRR, are directly applicable by the SSM, the SSM shall apply national law - that may vary from one Member State to another - when implementing a Directive, such as the CRD. In addition, it must be noted that the *acquis communautaire* only partially harmonise banking legislation that is left to national law in many areas[2].

## The Single Rule Book (Scope of the Capital Requirements Regulation)

The transformation of the Capital Requirements Directive into a Regulation in 2011 was mainly driven by the likely prospect of facilitating direct European supervision over firms:

- The Larosière report featured, as a second step after the establishment of the European Supervisory Authorities (ESA) wider supervisory responsibilities to be entrusted to the ESAs, including powers to directly supervise some firms[3]. Direct supervision needed to be underpin by a Single Rule Book;
- In accordance with the ESA Regulation, the European Banking Authority (EBA)can only instruct firms in case of breach of Union law in areas of directly applicable Union law;

The CRR - which was adopted before the establishment of the SSM - has facilitated banking supervision inside the banking union by limiting the degree of discretion available to national authorities.

While the CRR has gone a long way in bringing about a Single Rule Book, the CRR still include a significant number of options and discretions. According to the ECB, 175 options and discretions (O&Ds) are still available under EU law, 130 of which are available to national supervisors and are now applied in a uniform way across the Baking Union. As the President of the ECB put it: *"the*

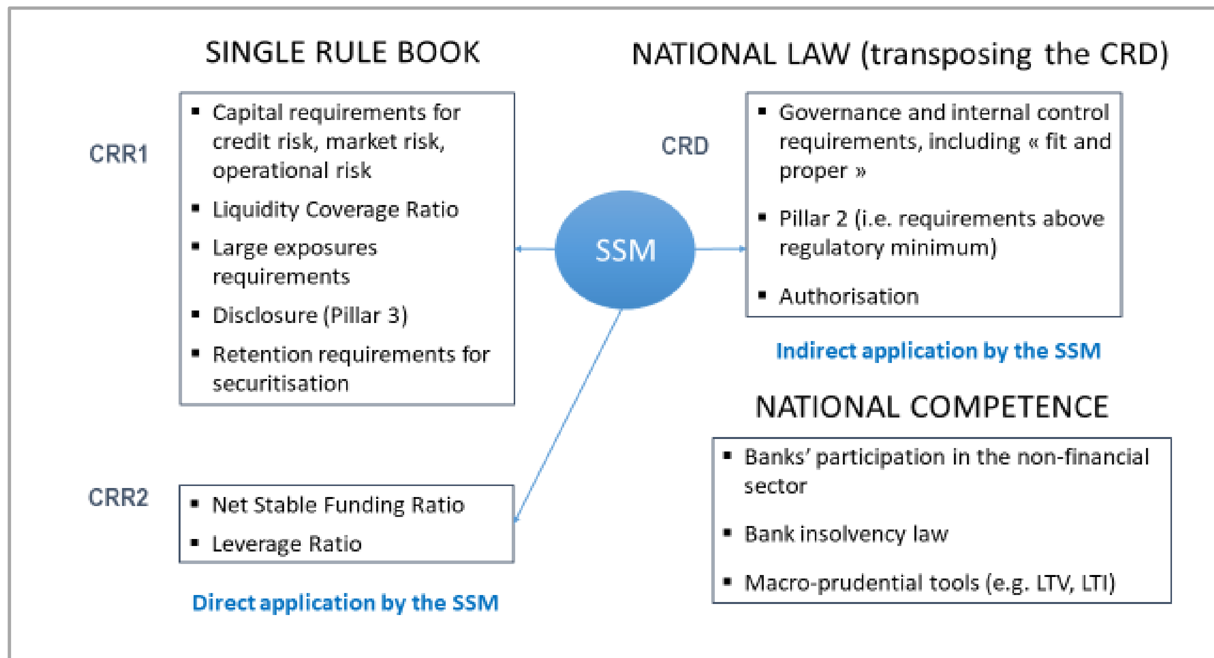
[1] The Basel 3 package is a set of measures developed in response to the financial crisis, which improved the definition of regulatory capital, introduced new capital buffers, introduced measures to constrain excessive leverage and to address liquidity risk, and turned some previous prudential rules laid down in a directive into a Regulation.

[2] There remain various areas in the acquis that are not harmonised, or are harmonised only to a limited extent. Interfering with banking legislation, one can recall, as an example, company law.

[3] Recommendation 24 of the Larosière report. The report even recommended not entrusting supervision to the ECB. (points 171 and following)

*remaining O&Ds exercised by national legislation still stand in the way of a level playing field for banks, and so further legislative action is still needed".*

**Figure 1: Scope of the Single Rule Book**




Source: EGOV

The Council roadmap to complete the Banking Union of 17 June 2016 called on the Commission to table a legislative proposal on national options and discretions by end 2016. Likewise, the 2017 EP Banking Union report recommended that options and discretions be harmonised as much as possible. The 'banking package' proposed in 2016 and agreed upon in spring 2019 does not, however, cover these issues.

In its October 2017 report on the SSM, the Commission painted a nuanced picture of the way ECB dealt with national options and discretions: "*In its start-up phase, the ECB has dedicated remarkable efforts to harmonising the exercise of options and discretions. These efforts were successful and need to be praised, as the resulting harmonised rules on the exercise of options and **discretions** by competent authorities contributed to improving the level playing field in the euro area, for both SIs and LSIs. It is welcomed that the ECB does not take a broad-brush approach towards harmonisation, but considers each option and discretion individually in the context of different starting points in the participating Member States and different needs characterising the national banking sectors. It is also appreciated that the ECB aims to achieve a level playing field by extending the harmonisation exercise to the supervision of LSIs, whilst taking due account of proportionality. However, it is regrettable that for some options and discretions the goal of issuing a fully harmonized standard has not been reached, with the ECB accepting that different regimes will coexist".*

For further background information on how the SSM has handled options and discretions when implementing CRDIV/CRR, see EGOV Briefing "National options and discretions in EU banking regulation" (January 2017).

## National law transposing the CRD (Capital Requirements Directive)

Absent a Single Rule Book, as competent authority, the SSM needs to apply 19 different rules. This "indirect application" of harmonised national rules is made possible under the SSM Regulation. According to Article 4(3), "*for the purpose of carrying out the tasks conferred on it by this Regulation, and with the objective of ensuring high standards of supervision, the ECB shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives*".

From a legal perspective, not all banking rules can take the form of a Regulation. According to Article 53 of the Treaty, rules governing the taking up or pursuit of an activity within the internal market should be enacted through Directives, while the *"adoption of measures for the approximation of national provisions which have as their object the establishment and functioning of the internal market*" is subject to a different legal basis (Article 114). The CRD that "coordinate national provisions concerning the access to the activity of credit institutions and investment firms, the modalities for their governance, and their supervisory framework" is therefore based on Article 53(1) TFEU, as explained by Commission explanatory memorandum.

While the CRD lays down the framework for the free provision of services and the free establishment, it also features many supervisory powers and rules. This includes:

- Supervisory powers which may differ from one Member States to another under national law transposing the Directive;
- Governance and internal control rules;
- Sanctions;
- Rules governing the authorisation of credit institutions, including "fit and proper" rules;
- Capital buffer (systemic risk buffer and Counter-Cyclical Buffer) that provide national authorities with a large degree of discretion.

In general terms, Pillar 1 rules (i.e. minimum prudential requirements) are dealt with in the Capital Requirement Regulation (CRR) while Pillar 2 (i.e. additional requirements or supervisory measures imposed by supervisors in view of banks' risk profile) is addressed in the Capital Requirements Directive (CRD).

National law transposing the CRD has a significant bearing on how the SSM performs supervision on a daily basis. By way of example, as noted in the SSM supervisory manual (March 2018), the SSM needs to factor in national practices for the following supervisory tools: (i) national law may require pre-approval of additional Tier 1 or Tier 2 own funds instruments, which is not the case in all Member States; (ii) some national laws subject the fit and proper assessment to deadlines; (iii) Member States' national law varies as to whether the extension of credit institution's authorisation needs to be authorised. Where this is the case, the SSM shall grant that authorisation.

The SSM makes use of "instructions" to instruct National Competent Authorities to make use of their power under national law, including enforcement and sanctioning powers laid down in national law (See Box 1).

Pillar 2 methodologies are left to national law implementing the CRD. The Commission has repeatedly proposed (i.e. in the 2009 Omnibus II Directive, the 2011 CRD4 and the CRD5) to further frame Pillar 2 by entrusting EBA with the task of developing technical standards in this field. Those proposals met with resistance by supervisors who feared that a directly applicable and harmonised framework would limit supervisory discretions. As explained by the ECB in September 2017: "*The proposal to frame Pillar 2 decisions in technical standards issued by the European Banking Authority (EBA) may prove too restrictive, limiting supervisory flexibility*".

While the CRR is by its very nature a maximum harmonisation legislative instrument, the CRD may be "gold-plated", i.e. Member States - unless otherwise specified[4] - may impose higher requirements and go beyond regulatory requirements laid down in the CRD. In the Banking Union, that "gold-plating" raises according to the SSM "*complicated legal questions: what powers does the SSM have in applying national law that goes beyond European norms*?" In more general terms, implementation of national law by the SSM comes up against the difficulty in telling what pertains to a strict implementation of CRD4 from the "national provisions that are rooted in CRD IV".

**Box 1 - Allocation of sanctioning powers between the ECB and NCAs**

The ECB can impose pecuniary penalties on significant institutions that breach directly applicable EU law, including ECB decisions or regulations. The ECB can also sanction less significant institutions for breaches of ECB regulations or decisions imposing on those entities obligations vis-à-vis the ECB.

As regards significant institutions, in the event of breaches of national law implementing EU directives, breaches committed by natural persons, or when a nonpecuniary penalty has to be imposed, the ECB may request that the relevant NCA open the appropriate proceedings. The NCA conducts these proceedings and decides on the resulting penalties in accordance with applicable national law.

Source: SSM Supervisory Manual, March 2018

## National competence

Banking law is only partially harmonised:

- In terms of macro-prudential powers, the *acquis communautaire* only partially harmonises macro-prudential tools (namely Counter-cyclical buffer). Other tools (e.g. maximum loan-to-value (LTV) and loan-to-income (LTI) requirements, systemic risk buffer) involve a large degree of discretions (for further background information, see EGOV Briefing: the EU macro-prudential policy framework);
- Insolvency law is left to national law. While BRRD has harmonised 'resolution tools' to deal with systemic banks that meet a 'public interest test', other banks are wound down in accordance with national insolvency law that has not been harmonised yet. Some national laws feature bank specific resolution powers while other liquidate banks like an ordinary company (See below for more details);
- Administrative sanctioning regimes, powers and instruments are not harmonised;
- Company law is only harmonised to a certain extent;
- Some supervisory tools are not harmonised.

In relation to supervisory powers and tools, the SSM particularly pointed to the monitoring of banks' participations in the non-financial sector as a potential "source of regulatory fragmentation": "*This concerns, for instance, major transactions which can be very relevant for the risk profile of a bank: for example, a bank acquiring a non-bank, or mergers and de-mergers involving a bank or transfers of assets. In some Member States, these transactions need to be approved by the competent authority (and rightly so), in others they do not*".

In areas not covered by the Single Rule Book, Member States and supervisors keep a large degree of discretions. As emphasised in recital 13 of the CRR, "*In areas not covered by this Regulation, such as dynamic provisioning, provisions on national covered bonds schemes not related to the treatment of covered bonds under the rules established by this Regulation, acquisition and holding of participations in both the financial and non-financial sector for purposes not related to prudential requirements specified in this Regulation, competent authorities or Member States should be able to impose national rules, provided that they are not inconsistent with this Regulation*".

[4] The CRD frames the discretion of national authorities to impose higher level of systemic risk buffer.

# Completing the Single Rule Book

As the SSM put it, "*there is now an imbalance between the harmonisation of banking supervision and banking regulation. In order to fully exploit the potential of the banking union, and to reap its benefits, we should restore that balance*". Further harmonisation of banking legislation may include the following.

## Enacting substantial requirements through the Capital Requirements Regulation

In terms of priorities, the SSM identified "Fit and proper rules" that "are not harmonised at all". That lack of harmonisation has significant bearing on the effectiveness of money laundering/terrorist financing (ML/TF) supervision. As explained by the EBA at the April 2018 EP Tax 3 Hearing, the EU's rules on authorisations and fitness and propriety rely heavily on national transpositions and interpretations: "Despite guidelines we have issued, concerns remain that some competent authorities think that they are unable to act on ML/TF concerns unless they can find evidence of criminal convictions".

Other areas of further harmonisation include governance or internal control rules that are not directly applicable but currently dealt with in CRD. From a legal point of view, those rules pertain more to supervisory requirements that lend themselves to the legal basis of Article 114 (Regulation) than to rules governing the single market that needs to be addressed in a Directive (legal basis of Article 53). One alternative to incorporating such rules in a regulation would be to still keep them in a directive but ensure as much as possible a direct effect of the provisions of such directive.

Extending the scope of CRR would involve taking stock of existing national law and defining common standards. By way of comparison, the preparatory work of turning prudential rules of CRD into a Regulation (CRR) involved the European Banking Authority and banking supervisors working together for more than one year in the context of a "Single Rule Book" working group facilitated by Commission. That working group was tasked with removing discretions and harmonising 'upwards' national requirements transposing the CRD, taking into account Member States' specificities.

In any event, further harmonising banking legislation will still leave out of the Single Rule Book relevant aspects of legislation applying to banks that may render the playing field unbalanced. The strict remits of company law, enforcement and sanctioning powers, taxation, investor protection standards, still (and will) remain national competencies.

## Making national option a supervisory competence

CRR still includes a Member State option whereby intragroup large exposures rules may be imposed by national legislator to limit where appropriate the exposure of a subsidiary to its parent. As explained by the SSM, that Member State option limits the power of the ECB to supervise liquidity across different legal entities by applying liquidity waivers as provided for in CRR: the SSM "*power is limited because the large exposure waivers on intragroup lending are in the hands of the national legislators, who have no incentive to authorise them. And this leads back to national options and discretions. The option to set up large exposure limits should be left to the national supervisory authorities, hence to European banking supervision*".

That option has been instrumental in balancing home and host interests during the CRR1 and CRR2 negotiations. In its June 2019 report (considerations on the further strengthening of the banking union, including a common deposit insurance system), the Chair of the Eurogroup High level working group pointed to the need of additional safeguards for the host Member States so that to facilitate "*the withdrawal of then no longer justified national options and discretions and home-host related provisions*".

For further background information, see EGOV Briefing: "Banking Union: defusing the home/host debate".

## Enacting supervisory powers in Regulation

In lieu of expanding the scope of directly applicable norms or pending the completion of the single rule book, directly applicable standards may also be achieved by means of supervisory powers entrusted to the SSM that apply across the board to all national supervisors and banks of the Banking Union. That approach has been proposed by the SSM: *"establishing a level playing field is impossible if the single supervisor needs to apply different legal frameworks in different countries. The legislator can help either by expanding the scope of directly applicable norms, or by placing the in-built margins of flexibility of the legislation in the hands of the supervisory authority; in this case, the ECB can at least harmonise rules at the SSM level. This was done last year, in part, in our policy on options and discretions, which you may be familiar with".*

That approach would be facilitated if the SSM may avail of supervisory powers laid down in a Regulation instead of resorting to national laws transposing the CRD which may lead to legal and practical difficulties. In that respect, in its October 2017 report on the SSM, the Commission proposed extending the scope of directly applicable supervisory powers: "*As the ECB's powers can be exercised only within the limits of the tasks conferred on the ECB, it needs to be ascertained on a case-by-case basis whether a specific power given under national law is within the remit of the specific tasks conferred on the ECB or not. Given that such case-by-case analysis is cumbersome and not always predictable, it is suggested that future relevant EU legislation spells out explicitly supervisory powers in directly applicable provisions*". In that respect, the Chair of the SSM suggested turning the BRRD into an EU Regulation as "*many crisis-related supervisory competences are not harmonised*".

## Further harmonising insolvency law

Further harmonisation of bank insolvency law in the EU has been advocated by the ECB, the SSRB, the IMF and other international organisations. These organisations advocated the setting-up of new institutional arrangements in the Banking Union combining depositor insurance protection and liquidation.

For further background information, see EGOV Briefing "Further harmonising insolvency law from a Bank resolution perspective" (July 2018) and EGOV Briefing "Liquidation of Banks: towards a FDIC for the Banking Union?" (February 2019).

The Eurogroup is also considering ways to improve the resolution framework. As reported by the Chair of the High Level Working Group (HLWG) on EDIS, "*the framework for resolution and liquidation, including the burden sharing rules, would be further enhanced in order to ensure consistency and improve its ability to deal with all cases. Broad agreement exists on the need for a harmonisation of necessary parts of bank insolvency law, including with regard to cross-border groups and the ranking of creditors, while the toolbox for resolution might need to be expanded*".

For further background information, see EGOV Briefing "Further harmonising insolvency law from a Bank resolution perspective" (July 2018) and EGOV Briefing "Liquidation of Banks: towards a FDIC for the Banking Union?" (February 2019).

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