THE BANKING REGULATION REVIEW

Fifth Edition

Editor

JAN PUTNIS

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CONTENTS

Editor’s Preface ........................................................................................................... xi
Jan Putnis

Chapter 1 INTERNATIONAL INITIATIVES ........................................... 1
Jan Putnis and Tolek Petch

Chapter 2 ANGOLA ................................................................................ 40
Mafalda Oliveira Monteiro and Bruno Sampaio Santos

Chapter 3 ARGENTINA .............................................................................. 52
Santiago Carregal and Diego A Chighizola

Chapter 4 AUSTRALIA ............................................................................ 66
Louise McCoach and David Landy

Chapter 5 AUSTRIA ............................................................................... 115
Alexander Taiyo Scheuwimmer

Chapter 6 BARBADOS .......................................................................... 125
Sir Trevor Carmichael QC

Chapter 7 BELGIUM ................................................................................. 134
Anne Fontaine

Chapter 8 BOLIVIA .................................................................................. 146
Carlos Pinto-Meyer and Lindsay Sykes

Chapter 9 BRAZIL ..................................................................................... 154
José Eduardo Carneiro Queiroz

Chapter 10 CAMBODIA ............................................................................. 160
Bun Youdy
Chapter 11  CANADA .............................................................. 176
Scott Hyman, Carol Pennycook, Derek Veasey
and Nicholas Williams

Chapter 12  CAYMAN ISLANDS ............................................. 192
Richard de Basto

Chapter 13  CHINA .............................................................. 203
Wantao Yang, Borong Liu and Dongyue Chen

Chapter 14  COLOMBIA ....................................................... 224
Luis Humberto Ustariz

Chapter 15  DENMARK ........................................................ 239
Morten Nybom Bethe

Chapter 16  EGYPT ............................................................. 249
Aly El Shalakany

Chapter 17  EL SALVADOR .................................................... 258
Oscar Samour

Chapter 18  EUROPEAN UNION ........................................... 269
Jan Putnis and Michael Sholem

Chapter 19  FINLAND .......................................................... 294
Tarja Wist and Jussi Salo

Chapter 20  FRANCE ........................................................... 307
Samuel Pariente, Jennifer Downing, Jessica Chartier
and Simon Lange

Chapter 21  GERMANY ......................................................... 345
Thomas Paul and Sven H Schneider

Chapter 22  GREECE .......................................................... 362
Dimitris Passas and Vassilis Saliaris

Chapter 23  GUATEMALA ....................................................... 386
María Fernanda Morales Pellecer
Contents

Chapter 24 GUERNSEY ................................................................. 400
John Lewis and Helen Wyatt

Chapter 25 HONG KONG ......................................................... 412
Laurence Rudge and Peter Lake

Chapter 26 HUNGARY .............................................................. 429
Péter Köves and Szabolcs Mestyán

Chapter 27 INDIA .................................................................. 436
Cyril Shroff and Ipsita Dutta

Chapter 28 INDONESIA ........................................................... 452
Yanny M Suryaretina

Chapter 29 IRELAND ............................................................... 476
William Johnston, Robert Cain, Eoin O’Connor and Niall Esler

Chapter 30 ITALY ................................................................. 491
Giuseppe Rumi and Andrea Savigliano

Chapter 31 JAPAN .................................................................. 505
Hirohito Akagami and Wataru Ishii

Chapter 32 JERSEY ................................................................. 516
Simon Gould and Sarah Huelin

Chapter 33 KOREA ................................................................. 528
Sang Hwan Lee, Chan Moon Park and Hoin Lee

Chapter 34 KUWAIT ............................................................... 540
Haifa Khunji and Basem Al Muthafer

Chapter 35 LATVIA ............................................................... 554
Armands Skudra

Chapter 36 LUXEMBOURG .................................................... 565
Franz Fayot
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Country</th>
<th>Pages</th>
<th>Authors</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td>MALTA</td>
<td>586</td>
<td>David Griscti and Clint Bennetti</td>
</tr>
<tr>
<td>38</td>
<td>MOZAMBIQUE</td>
<td>596</td>
<td>Paulo Pimenta and João Leite</td>
</tr>
<tr>
<td>39</td>
<td>NETHERLANDS</td>
<td>606</td>
<td>Joost Schutte, Annick Houben and Mariken van Loopik</td>
</tr>
<tr>
<td>40</td>
<td>NEW ZEALAND</td>
<td>619</td>
<td>Guy Lethbridge and Debbie Booth</td>
</tr>
<tr>
<td>41</td>
<td>NICARAGUA</td>
<td>633</td>
<td>Rodrigo Taboada R</td>
</tr>
<tr>
<td>42</td>
<td>NORWAY</td>
<td>646</td>
<td>Terje Sommer, Richard Sjøqvist and Markus Nilssen</td>
</tr>
<tr>
<td>43</td>
<td>PHILIPPINES</td>
<td>657</td>
<td>Rafael A Morales</td>
</tr>
<tr>
<td>44</td>
<td>POLAND</td>
<td>673</td>
<td>Tomasz Gizbert-Studnicki, Tomasz Spyra and Michał Bobrzyński</td>
</tr>
<tr>
<td>45</td>
<td>PORTUGAL</td>
<td>688</td>
<td>Pedro Cassiano Santos</td>
</tr>
<tr>
<td>46</td>
<td>ROMANIA</td>
<td>706</td>
<td>Alexandru Birsan, Carmen Peli and Alexandra Manciulea</td>
</tr>
<tr>
<td>47</td>
<td>RUSSIA</td>
<td>721</td>
<td>Vladislav Skvortsov and Stefan Wolfgang Weber</td>
</tr>
<tr>
<td>48</td>
<td>SINGAPORE</td>
<td>736</td>
<td>Francis Mok and Wong Sook Ping</td>
</tr>
<tr>
<td>49</td>
<td>SPAIN</td>
<td>748</td>
<td>Juan Carlos Machuca and Tomás José Acosta</td>
</tr>
<tr>
<td>Chapter</td>
<td>Country</td>
<td>Page</td>
<td>Authors</td>
</tr>
<tr>
<td>---------</td>
<td>-------------------------------</td>
<td>-------</td>
<td>------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>50</td>
<td>SWEDEN</td>
<td>777</td>
<td>Niclas Rockborn, Nils Unckel and Björn Dahlén</td>
</tr>
<tr>
<td>51</td>
<td>SWITZERLAND</td>
<td>797</td>
<td>Shelby R du Pasquier, Patrick Hünerwadel, Marcel Tranchet, Valérie Menoud and David Violi</td>
</tr>
<tr>
<td>52</td>
<td>THAILAND</td>
<td>821</td>
<td>Montien Bunjarnondha and Rabat Alikhan</td>
</tr>
<tr>
<td>53</td>
<td>UKRAINE</td>
<td>836</td>
<td>Denis Lysenko, Yulia Kyrpa and Maryna Fedorenko</td>
</tr>
<tr>
<td>54</td>
<td>UNITED ARAB EMIRATES</td>
<td>848</td>
<td>Amjad Ali Khan and Stuart Walker</td>
</tr>
<tr>
<td>55</td>
<td>UNITED KINGDOM</td>
<td>855</td>
<td>Jan Putnis, Benjamin Hammond and Nick Bonsall</td>
</tr>
<tr>
<td>56</td>
<td>UNITED STATES</td>
<td>888</td>
<td>Luigi L De Ghenghi and Reena Agrawal Sahni</td>
</tr>
<tr>
<td>57</td>
<td>VENEZUELA</td>
<td>978</td>
<td>Pedro Planchart Pocaterra and Ana Karina Gomes Rodriguez</td>
</tr>
<tr>
<td>58</td>
<td>VIETNAM</td>
<td>987</td>
<td>Samantha Campbell and Pham Bach Duong</td>
</tr>
<tr>
<td>Appendix 1</td>
<td>ABOUT THE AUTHORS</td>
<td>1009</td>
<td></td>
</tr>
<tr>
<td>Appendix 2</td>
<td>CONTRIBUTING LAW FIRMS’ CONTACT DETAILS</td>
<td>1045</td>
<td></td>
</tr>
</tbody>
</table>
The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as ‘interim conclusions’ because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly
shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks’ corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital.
and what form that capital will take. Particularly in Europe, the issue of additional Tier I capital and other contingent capital instruments has added complexity to banks’ capital structures and a need for banks to engage with current and potential investors to explain those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided by authors in 56 jurisdictions between late February and mid-April 2014, as well as the chapters on ‘International Initiatives’ and the European Union. Preparing the chapters has been a particularly onerous task for the authors this year because many of their clients have now moved from observing the regulatory revolution that has taken place in the banking sector to taking tangible steps to reorganise in order to make themselves fit for the new world in which the sector finds itself. My thanks go to all of the authors for their dedication in completing their chapters.

Thank you also to Adam Myers, Shani Bans, Nick Barette and Gideon Roberton at Law Business Research Ltd for their patience, understanding and – above all – great effort in preparing this edition.

The partners and staff of Slaughter and May in London and Hong Kong also deserve more than the usual mention, above all for their continuing tolerance of my involvement in this project. Particular thanks go to Ben Kingsley, Peter Lake, Laurence Rudge, Nick Bonsall, Ben Hammond, Tolek Petch and Michael Sholem.

**Jan Putnis**
Slaughter and May
London
May 2014
I INTRODUCTION

This chapter provides an introduction to the most important EU legislation affecting the regulation of banks. It also analyses developments that have led to the concentration of certain regulatory powers in a series of EU supervisory authorities.

The development of this legislation since 2011 has taken place against the background of the eurozone crisis, which has highlighted concerns about the prudential position of eurozone banks and related threats to financial stability in the eurozone and beyond. The past year has seen an apparent easing of the crisis, although many commentators believe that it is no more than in abeyance and could easily re-emerge to again threaten eurozone financial stability.

While eurozone contingency planning exercises have, to an extent, become quite a distraction for banks, they have, in some cases, also served the useful purpose of identifying ways in which contagion may spread within banking groups (and more generally through the banking system) and stimulating analysis and discussion about how that might be addressed.

The legislative response to the eurozone crisis can be characterised as consisting of two different approaches. First, an urgent and necessary fire-fighting operation was carried out, through the establishment of the temporary European Financial Stability Facility and the European Financial Stabilisation Mechanism, together with the permanent European Stability Mechanism and other related measures designed to shore up embattled eurozone economies and banks. Second, a more fundamental restructuring of the foundations of financial supervision as a whole has been considered necessary to prevent a recurrence of the crisis, with more European integration in many areas being seen as the long-term solution to the problems of European monetary union. This

1 Jan Putnis is a partner and Michael Sholem is a special adviser at Slaughter and May.
second, more fundamental development is another step towards the fulfilment of the ‘ever closer union’ envisaged by EU Member States in the preamble to the Treaty on the Functioning of the European Union.

Section XI, infra, summarises the developments in relation to the second of these developments, in particular the implementation of a Single Supervisory Mechanism (SSM) for banking institutions in the eurozone and common bank recovery and resolution arrangements.

It is important to note that much of the EU legislative activity in the area of banking regulation has traditionally been in the form of EU directives, which do not normally have legal effect in Member States of the EU until implemented by provisions of their national law. There have, however, been some EU measures affecting the regulation of banks that have taken the form of EU regulations, which apply directly in all Member States. Following recent changes to the European supervisory architecture and the European Commission’s commitment to introduce an EU-wide ‘Single Rule Book’ for financial services (both discussed in this chapter), the introduction of new EU rules relevant to banks is increasingly taking a directly applicable form through EU regulations.

II EUROPEAN REGULATORY AND SUPERVISORY FRAMEWORK

i Key EU institutions

The European Commission (the Commission) represents the interests of the EU as a whole, and has the sole right to propose new legislation. The Council of the European Union (the Council) represents the interests of the individual Member States. The European Parliament (the Parliament) represents the interests of EU citizens, and is directly elected by them.

ii Legislative procedure

The Commission, after consultation with interested stakeholders, will put forward a legislative proposal for joint adoption by the Council and Parliament, which then usually goes through the ‘ordinary legislative procedure’ (known as the ‘co-decision procedure’ prior to the Treaty of Lisbon in 2009). In addition to its role in adopting legislation proposed by the Commission, the Parliament has a limited power to request the Commission to submit appropriate proposals on matters on which it considers that an EU legislative measure would be appropriate.

iii Lamfalussy approach to adoption of European financial services legislation

The Lamfalussy approach is a four-level procedure adopted by the EU for the development and application of legislation for the financial services industry that involves the following:

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2 Named after Alexandre Lamfalussy, who chaired the EU group that proposed the process for the development of EU securities legislation in 2001 (later extended to the fields of banking.


iv Reform of the EU supervisory framework

Until 2011, three ‘Level 3 Committees’ existed – the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR). These brought together regulators from each Member State to agree on the details of implementing measures and to help to coordinate the supervision of cross-border institutions. The failings in prudential regulation that were highlighted by the financial crisis led to criticism that these advisory committees did not have sufficient powers or influence to address the complex challenges of cross-border regulation.

Following recommendations contained in the 2009 de Larosière Report, the Commission proposed to establish a new European Systemic Risk Board, responsible for macro-prudential oversight, and a European System of Financial Supervisors, comprising three new pan-European Supervisory Authorities (ESAs) to replace the Level 3 Committees:

- the European Banking Authority (EBA);
- the European Insurance and Occupational Pensions Authority (EIOPA); and
- the European Securities and Markets Authority (ESMA).

The ESAs have been established to oversee the financial system at a micro-prudential level and to achieve convergence between Member States on technical rules and coordination between national supervisors. The ESAs’ powers go beyond those of the Level 3 Committees and their role is no longer essentially merely advisory. These supervisory structures are discussed in Section XII, infra.

The Commission has committed itself to replacing separately implemented rules within Member States with a ‘Single Rule Book’ within the EU (and the ESAs advance this project significantly through their development of draft technical standards, which will then be adopted by the Commission as EU law) and issuance of guidance and recommendations with which national supervisors and firms must make every effort to comply. In addition, the Commission’s legislative proposals are increasingly taking the form of directly applicable EU regulations or otherwise employ the ‘maximum harmonisation’ principle. This principle requires that national legislative implementation should not exceed the terms of the original EU legislation, and therefore prohibits insurance and pensions regulation).
the ‘gold-plating’ of EU legislation by individual Member States. The Commission’s intention is that national options and discretions will be reduced and Member States will be permitted to apply stricter requirements only where these are justified by national circumstances, financial stability, or a bank’s specific risk profile.

There follows a brief description of some of the most important EU directives and EU regulations affecting the regulation of banks, together with several recent legislative initiatives that will affect banking activities in the EU. The most important EU legislation concerning the prudential regulation of banks is the CRD IV package of legislation. The description below starts with that legislation.

III CAPITAL REQUIREMENTS DIRECTIVE

In the EU, the principal legislation regarding the prudential regulation of banks was, between 2006 and 1 January 2014, the Capital Requirements Directive (CRD I), which in fact comprised two directives, commonly referred to as the Banking Consolidation Directive and the Capital Adequacy Directive. This legislation, which implemented many of the Basel II reforms, was amended in 2009 and 2011 by two further directives, CRD II and CRD III. CRD I was wider in scope than Basel II, as it applied not only to internationally active banks, but also to smaller banks, mutuals and investment firms. Changes to the prudential regime for banks were required as part of the Basel III international programme (discussed in the ‘International Initiatives’ chapter). A new package of legislation, in the form of a directive (the CRD IV Directive) and a regulation, in the form of the Capital Requirements Regulation (CRR) has now replaced CRD I and has consolidated the changes introduced by CRD II and CRD III.

The CRD IV package continues to set out prudential rules for banks on a solo and a consolidated basis, including solo and consolidated capital requirements. Consolidated supervision is, broadly, carried out in respect of groups or sub-groups headed by parent undertakings incorporated in the EEA. In addition, banks are required to include ‘participations’ within the scope of consolidated supervision.

The CRD IV package continues to enshrine ‘passport’ rights for credit institutions, including banks, which broadly allow a bank authorised in one Member State of the EEA to provide a range of services for which it is so authorised in other Member States, or to establish a branch in other Member States, without having to obtain additional authorisation from the regulators in those Member States. The most important features of the CRD IV package are summarised below.

The Basel III-related reforms include the introduction of:

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3 The legislation provides that a lead regulator, agreed or determined from among the national regulators of members of the group in the EEA, carries out certain coordinating activities. In addition, the scope of consolidated supervision may, in principle, extend worldwide in certain circumstances but in practice it is usually confined to an EEA-incorporated parent undertaking and its subsidiary undertakings and participations.

4 A ‘participation’ includes, broadly, a holding of 20 per cent or more of the share capital in another undertaking. Participations are consolidated on a proportionate basis.
new liquidity standards (a 30-day liquidity coverage ratio to promote short-term resilience to the risk that liquidity will cease to be available to a bank and a net stable funding requirement to promote resilience to liquidity risk over longer periods) and a set of common monitoring metrics and application standards;

measures to strengthen capital through the redefinition of capital into common equity Tier I, additional Tier I and Tier II (including eliminating distinctions between different types of Tier II capital and abolishing innovative Tier I capital and Tier III capital completely). The minimum ratios for common equity Tier I and total Tier I capital will rise to 4.5 per cent and 6 per cent respectively (although the minimum capital ratio, ignoring capital buffers, will remain at 8 per cent);

ew new capital conservation and counter-cyclical capital buffers, which apply on top of the increased capital ratios which are intended to address the pro-cyclicality inherent in risk-based capital standards. The capital conservation buffer is set at 2.5 per cent of risk-weighted assets and must consist of common equity, with the bank's ability to make distributions limited if its capital ratio falls into the buffer. The countercyclical capital buffer is intended to supplement the capital conservation buffer. It will be set by national regulators and used as a tool to require banks to build up capital during periods of excessive credit growth in a particular Member State or States. This buffer will also comprise common equity;

a leverage ratio acting as a cap on the ratio of banks' Tier I capital to total non-weighted assets and off-balance sheet exposures, intended to form a backstop to risk-based capital measures; and

e new rules on counterparty credit risk (increasing requirements in respect of exposures arising from derivatives, repos and securities financing activities).

Measures in the CRD IV package not flowing directly from Basel III include:

strengthened corporate governance arrangements and processes, including risk-management arrangements;

strengthened sanctioning powers where banks breach CRD IV requirements, including the establishment of minimum administrative sanctions to be applied by national competent authorities;

reflecting principles promulgated by the Financial Stability Board, limited measures to reduce banks' reliance on external credit ratings, including requirements for banks to develop internal models to assess risk in portfolios and counterparty exposure;

a bonus cap: the variable remuneration of certain individuals at banks will be limited to 100 per cent of their fixed remuneration. This can be increased, subject to shareholder approval under certain circumstances, to 200 per cent of the fixed remuneration. This cap applies broadly to categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket
as senior management and risk takers, whose professional activities have a material impact on a bank’s risk profile;\(^5\) and further developments to the requirements in CRD III on remuneration to require the disclosure of the number of individuals within a bank receiving total remuneration of €1 million or more in each financial year (broken down into pay bands of €500,000).

CRD IV is intended to be a key instrument through which the Commission advances the development of a Single Rule Book for financial services. The CRR is, by its nature, a maximum harmonisation measure that includes the majority of CRD IV’s prudential requirements. As an EU regulation, the CRR is directly applicable in all Member States and divergences between national rules will thereby be minimised. On the other hand, provisions addressing, for example, the authorisation of credit institutions, cross-border passporting and the mechanics of prudential supervision (i.e., areas where there is more room for Member State discretion as well as a need to be more responsive to differences in national law) are contained in the CRD IV Directive. As an EU directive, Member States have had some discretion as to how they choose to transpose the CRD IV Directive into their national law. An important illustration of this is that, while Member States have not generally been able to impose minimum capital requirements in excess of the CRD IV levels (these will be provided for in the CRR), Member States do have a degree of flexibility in relation to the calibration of capital buffers (addressed in the CRD IV Directive).

CRD IV entered into force on 1 January 2014. Full implementation of the capital and liquidity requirements in CRD IV remains subject to a staggered timeline, although CRD IV permits national regulators to accelerate implementation of CRD IV ahead of the January 2019 deadline for full implementation.

IV PAYMENT SERVICES DIRECTIVE

The Payment Services Directive (PSD)\(^6\) is intended to harmonise conduct of business rules for all providers of electronic payment services across the EU, and create a tiered prudential authorisation regime for non-bank payment service providers, known as ‘payment institutions’. It affects banks, building societies, e-money issuers, money remitters, non-bank credit card issuers and non-bank merchant acquirers and their customers. The PSD focuses on electronic means of payment, including direct debits, debit cards, credit cards, standing orders, mobile or fixed phone payments and payments

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\(^5\) The UK government has challenged certain provisions of the CRD IV package, including the variable remuneration cap, in the European Court of Justice. The challenge was brought on 20 September 2013. At the time of writing, the European Court of Justice has not yet considered the challenge. The cap has, however, been implemented in the United Kingdom pending the outcome of the challenge.

\(^6\) 2007/64/EC.
from other digital devices as well as money remittance services. It does not apply to cash-only transactions or paper cheque-based payments.

The PSD was formally adopted on 13 November 2007. Member States were required to transpose this directive into their national laws by 1 November 2009. On 24 July 2013, the Commission adopted a legislative package that seeks to amend the EU payments framework. The package proposes a revised and recast Payment Services Directive (PSD2) and a Regulation on Multilateral Interchange Fees.

V ACQUISITIONS DIRECTIVE

The Acquisitions Directive\(^7\) was formally adopted on 5 September 2007. It is intended to harmonise the criteria that regulators apply in deciding whether to approve changes of control of financial institutions (specifically, credit institutions, investment firms, and insurers and reinsurers) and to harmonise some important aspects of the process by which they do so. Member States were required to implement this directive into their national law by 21 March 2009. The origin of this directive lay in concerns that national interests, and other matters of potential concern in the context of the EU single market, were informing regulators’ decision-making processes in the context of some cross-border mergers of financial institutions. A joint committee comprising representatives of CEBS, CESR and CEIOP\(^8\) (referred to as ‘the 3L3 Committee’) published non-binding guidelines in December 2008 aimed at ensuring closer cooperation between regulators in the EU when considering cross-border changes of control and promoting harmonisation of the processes that those regulators apply.

The Acquisitions Directive is a ‘maximum harmonisation’ directive in the sense that it prohibits Member States from imposing requirements for the notification to, and approval by, regulators of direct or indirect acquisitions of voting rights or capital that are more stringent than those set out in the directive. The definition of ‘control’ (at or above which the person holding such control requires regulatory approval) is set at 10 per cent of share capital or voting rights, which follows previously existing EU directives. The Acquisitions Directive also introduced a concept of aggregation of multiple parties’ interests for the purposes of determining whether ‘control’ has been or would be attained, where those parties are ‘acting in concert’. The 3L3 Committee has given some, albeit vague, guidance on the meaning of this expression in that context in its guidelines referred to above.

Between 8 December 2011 and 10 February 2012 the Commission consulted on the application of the Acquisitions Directive. In February 2013, the Commission published its report; it concluded that overall, the regime created by the Acquisitions Directive was working satisfactorily. That said, the Commission did state that it would ask the ESAs to clarify new Level 3 guidance on the Directive in relation to a number

\(^7\) 2007/44/EC.

\(^8\) Note that, although CEBS, CESR and CEIOPS have since been replaced by EBA, ESMA and EIOPA respectively, this guidance has been ‘grandfathered’ and so remains relevant.

275
of issues, including the definition of ‘acting in concert’. At the time of writing, no modifications have yet been made to the Level 3 guidance in this regard.

VI FINANCIAL GROUPS DIRECTIVE

There is a separate EU regime for the consolidated supervision of mixed activity financial groups (financial conglomerates), established by the Financial Groups Directive, also referred to as the Financial Conglomerates Directive or ‘the FGD’.

Financial conglomerates, within the meaning of the FGD, are groups that carry on financial services activities as a substantial portion of their business and that have significant interests in each of the banking or investment services and insurance sectors.

The FGD requires that a bank, investment firm or insurer that is authorised by an EEA regulator and that is a member (or parent) of a financial conglomerate group should be subjected to supplementary supervision on a group-wide basis in addition to relevant sectoral (i.e., insurance or banking) consolidated supervision. The rules on how this supervision is effected may differ from those that apply to banking-only groups.

A group will be a financial conglomerate for the purposes of the FGD if, broadly:

a at least one member of the group carries on business in each of the banking or investment services and insurance sectors;

b the gross assets attributable to all of the group’s financial business activities (that is, all of its banking or investment services and insurance businesses) account for at least 40 per cent of the group’s total gross assets worldwide; and

c the group’s business activities in each of the banking or investment services and insurance sectors are ‘significant’.

Significance is measured by reference to the average of two tests: a balance sheet ratio test and a solvency requirements ratio test comparing the significance of each sector to the combined position of all financial sector entities in the group. The average ratio for each of the banking or investment firms and insurance businesses of the group must exceed 10 per cent for the group to be treated as a financial conglomerate. The national regulators that supervise members of the group in Member States may agree to substitute or supplement the significance test, or to exclude certain group members from its calculation, if they consider it appropriate to do so. This would happen at the initiative of the ‘lead’ European regulator. The FGD indicates how that lead regulator is to be identified or agreed among the national regulators that supervise members of the group in the EEA.

The significance test can also be satisfied if the gross assets of the smaller of the group’s financial sector businesses (banking or investment services as against insurance) exceed €6 billion. If, however, the 10 per cent average ratio test is not satisfied, the relevant national regulators can agree that the group should not be regarded as a financial conglomerate.

9 2002/87/EC (as amended).
If, having become a financial conglomerate, a group would otherwise cease to be so, the relevant ratios are lowered somewhat for three years from that date unless the relevant national regulators agree otherwise, the idea being to avoid scenarios where a group moves in and out of the FGD regime. The FGD also permits relevant regulators to treat a conglomerate as such for three years from the date on which it last satisfied the conglomerate test.\(^{10}\)

On 9 December 2011, the FGD was amended with the majority of the amendments required to be implemented by Member States by 10 June 2013 (certain provisions relating to asset management companies and alternative investment fund managers had to be implemented by 22 July 2013).

The amendments are intended to address certain deficiencies in the way the FGD interacts with CRD IV and equivalent sectoral rules for insurers which mean supplementary supervision cannot presently be carried out for certain groups or on a fully group-wide basis because of their legal structure. The amendments also introduce, *inter alia*, more discretion for supervisors in applying the ‘significance test’ and in deciding whether to identify ‘small’ groups (those with under €6 billion in total assets) as financial conglomerates.

In February 2012, the Commission launched a review of the FGD. On 9 January 2013, the Council published the results of this review. The report identified future issues that would be addressed in further revisions to the FGD; these included the criteria for the identification of a conglomerate, the identification of the parent entity responsible for meeting group requirements and the strengthening of enforcement in relation to group entities. The Commission recommended, however, that further revisions to the FGD should not occur until the major sectoral changes to the prudential supervision of banks and insurers had been implemented.

**VII MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE**

The Markets in Financial Instruments Directive (MiFID)\(^{11}\) replaced the Investment Services Directive (ISD),\(^ {12}\) which had constituted one of the foundations upon which the single European market in financial services had been developed. The ISD introduced a system of ‘passports’ under which an investment firm authorised as such in one Member State could carry out certain regulated activities for which it was so authorised in other Member States or establish a branch in other Member States without having to obtain additional authorisation from the regulators in those Member States. MiFID retained and expanded this passporting framework.

MiFID is very important to the very large number of EU banks that provide investment services as well as carrying on deposit-taking and lending activities.

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10 Not all national regulators have exercised this discretion. For example, the Prudential Regulation Authority in the United Kingdom has not done so.

11 2004/39/EC (as amended). This Directive was supplemented by implementing measures in the form of an EU Regulation (1287/2006/EC) and a further Directive (2006/73/EC).

12 93/22/EEC.
The implementation of MiFID has had an important impact on the securities markets and investment firms of all EEA Member States. MiFID was designated as a ‘maximum harmonisation’ directive, yet the impact of the implementation of MiFID in each Member State has varied. MiFID has nevertheless had some important consequences for the market for investment services in the EEA as a whole:

- the scope of regulation of the investment services sector required by EU law has expanded, with the addition of important new regulated investment services and products;
- as a result, the investment services passport now enables firms to provide a wider range of investment services on a cross-border basis or from branches within the EEA than was previously the case;
- national-level barriers to investment services within the EU single market have been reduced;
- important core business standards for investment services are now prescribed in detail at EU level; CESR, the predecessor to ESMA, played an important role in this respect; and
- the rules applying to different securities trading venues have been harmonised to a significant degree, resulting in a wider range of regulated trading venues, such as multilateral trading facilities (MTFs).

The deadline for the implementation of MiFID into the national law of each Member State was 1 November 2007.

In October 2011, the Commission published a legislative proposal to amend MiFID (MiFID II). MiFID II comprises a directive and a regulation (the latter will also amend the EU regulation on OTC derivatives, central counterparties and trade repositories, or ‘EMIR’, which is discussed below).

MiFID II covers a range of issues, some of which are self-evidently matters of regulatory policy playing catch-up with market developments, for example in relation to new trading methods such as high-frequency and algorithmic trading strategies. However, other measures demonstrate a prescriptive and rigid response to perceived or suspected potential for investor detriment. In some cases, indeed, the measures seem to cross the line between the regulation of firms’ conduct and the imposition of specific conduct requirements, even to the extent of banning certain products or activities. Key elements of the MiFID II proposals include the following:

- a new type of trading venue, the organised trading facility (OTF), will be brought within the scope of MiFID. OTFs will be subject to the same core requirements for a trading venue’s operation as existing platforms and will be defined broadly to capture all forms of organised trading not matching existing categories;
- all trading of derivatives, which are eligible for clearing and which are sufficiently liquid, will move either to regulated markets, MTFs or to the new OTFs;
- improved transparency of trading activities in equity markets, including ‘dark pools’. The proposals will also introduce a new trade transparency regime for non-equity markets;
- new safeguards for algorithmic and high-frequency trading activities;
in coordination with ESMA or the EBA and under defined circumstances, supervisors will be able to ban specific products, services or practices in case of threats to investor protection, financial stability or the orderly functioning of markets;

new powers for regulators to monitor and intervene in trading in commodity derivatives, including taking action to reduce a position, if there are concerns about disorderly markets;

stricter requirements for portfolio management, investment advice and the offer of complex financial products such as structured deposits; and

a ban on third-party inducements in the case of portfolio management and for firms providing independent advice.

On 14 January 2014, the Parliament and the Council agreed in trilogue negotiations on the text of the MiFID II legislation. The Parliament is expected to consider MiFID II in plenary session on 15 April 2014. ESMA will then begin finalising a large number of Level 2 measures required under the legislation; this will occur after the Parliament has approved the final text of MIFID II in plenary session. It is currently expected that MiFID II will then come into force in late 2016.

VIII EUROPEAN MARKET INFRASTRUCTURE REGULATION

At the September 2009 summit in Pittsburgh, G20 leaders agreed that all standardised OTC derivative contracts should be cleared through central counterparties (CCPs) by the end of 2012 at the latest and that OTC derivative contracts should be reported to trade repositories. The EU’s response to this commitment is the Regulation on OTC derivatives, central counterparties and trade repositories (commonly referred to as the European Market Infrastructure Regulation or ‘EMIR’). The Regulation entered into force on 16 August 2012, although where requirements rely on the publication and implementation of Level 2 measures required under the legislation; this will occur after the Parliament has approved the final text of MIFID II in plenary session. It is currently expected that MIFID II will then come into force in late 2016.

The requirements of EMIR, which extend to all derivative contracts and not just to standardised OTC derivative contracts, include:

a reporting obligation in respect of derivatives entered into by EU financial and non-financial firms, requiring detailed information to be reported to trade repositories and made accessible to supervisory authorities (this reporting obligation came into force on 12 February 2014);

a clearing obligation for derivatives that meet certain eligibility criteria. ESMA is responsible for identifying contracts subject to the clearing obligation;

measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, including risk mitigation standards (such as exchanges of collateral) for contracts not cleared by a CCP;

prudential requirements for CCPs and trade repositories, including requirements for authorisation, capital, the provision of margin, the establishment of a default fund, organisational rules and conduct of business standards. These include
an obligation on trade repositories to publish aggregate positions by class of derivatives accessible to all market participants. ESMA will be responsible for the supervision of trade repositories (including granting or withdrawing their registration) and will be a member of the colleges supporting national authorities supervising CCPs operating in more than one Member State; and

e rules on the interoperability of CCPs.

ESMA has drafted regulatory technical standards for the application of these rules; some of the standards have now been adopted by the Commission and are binding on counterparties, while others are still being developed, most notably in relation to the eligibility criteria for instruments subject to the clearing obligation and functioning of the collateral exchange provisions.

At the time of writing, it is expected that ESMA will issue draft standards on the clearing obligations in September 2014, meaning that it is unlikely that the clearing obligation will come into force before 2015. The manner in which such standards become binding is discussed in further detail in Section XII, infra.

IX SHORT-SELLING REGULATION

In distressed markets, short selling can amplify price falls and may lead to disorderly markets giving rise to systemic risk. In 2008 fears of such risks led to various Member States suspending short selling, although there was no coordinated approach across the EU. In order to address the perceived risks in a coordinated manner, on 18 October 2011 political agreement was reached by the European Parliament and the Council on a regulation on short selling and certain aspects of credit default swaps.

The regulation:

a increases transparency on short positions in certain situations relating to EU shares and EU sovereign debt, and also to persons with significant credit default swap positions relating to EU sovereign debt issuers;

b requires that those who enter into short sales of European sovereign debt instruments or shares admitted to trading on an EU regulated market, or a multilateral trading facility, must have borrowed, entered into an agreement to borrow or made other arrangements which ensure that the relevant instruments are available for borrowing. This effectively bans ‘naked’ short selling;

c obliges disclosure of a short position in shares of an EU company to the relevant regulator once the short position reaches 0.2 per cent, and to the market once it reaches 0.5 per cent, of the target’s share capital. Only ‘significant’ short positions in credit default swaps or EU sovereign bonds will need to be disclosed to the regulator (and not the market);

d requires trading venues to ensure that there are default arrangements and penalties in place in case a short settlement fails;

e requires that all short orders should be flagged as such;

f empowers competent national authorities to impose temporary (up to three months) restrictions on short selling and related derivative transactions where there is a serious threat to financial stability or market confidence in a Member
State or the EU more generally, and very short-term restrictions where there is a significant fall in the price of a financial instrument; and

g provides that ESMA will coordinate cross-border measures and intervene in situations where national authorities have not taken sufficient action to address a threat.

The text of this regulation was formally adopted by the Parliament on 15 November 2011 and by the Council on 21 February 2012. The regulation came into force on 1 November 2012.

X CONSUMER PROTECTION DIRECTIVES RELEVANT TO THE BANKING SECTOR

A number of other EU directives of importance to banks have been enacted, broadly with the aim of achieving harmonised consumer protection measures in the areas to which they relate. These directives include those briefly summarised as follows.

i Deposit Guarantee Schemes Directive\textsuperscript{13}

This directive established minimum levels of protection that Member States are required to provide to depositors of banks that their national regulators supervise. In February 2009 the Council adopted an amending directive\textsuperscript{14} that:

\textit{a} raised the minimum deposit coverage level to €50,000 as from 30 June 2009 (from €20,000) and set the coverage level at €100,000 as from 31 December 2010; and

\textit{b} reduced the maximum payout delay to 25 working days (a period of five working days to establish that a credit institution has failed to repay deposits that are due and payable followed by a period of 20 working days), subject to extension by 10 working days, to make the maximum payment.

The amending directive came into force in March 2009 and was required to be transposed into the national laws of Member States by 30 June 2009, although full implementation of certain provisions of the directive was not necessary until 31 December 2010.

On 12 July 2010, the Commission published a legislative proposal for further amendments to the Deposit Guarantee Schemes Directive. The proposals include:

\textit{a} reducing the time permitted for payout to one week by 2024 and, in order to facilitate this more rapid timetable, requiring managers of schemes to inform authorities of likely bank failures and requiring banks to be able to provide a breakdown of the aggregated deposits of a depositor at any time;

\textit{b} requiring the provision of standard information to depositors about the scheme that applies to them;

13 94/19/EC.
14 2009/14/EC.
within 10 years of the Directive coming into force, funds of schemes would be required to reach 0.8 per cent of covered deposits, although the Commission may permit a Member State to set a lower level where that Member State has a concentrated banking sector (although there will be an absolute floor of 0.5 per cent); and

ing a principle of risk-based contributions, whereby riskier banks are required to make greater contributions to the relevant deposit guarantee scheme.

On 17 December 2013, political agreement was reached between the Parliament and the Commission on the amending directive. At the time of writing, it is expected that this compromise proposal will be endorsed by the Parliament in plenary session in April 2014.

ii Unfair Terms in Consumer Contracts Directive\textsuperscript{15}

This directive requires Member States, \textit{inter alia}, to enact provisions in their national laws rendering unenforceable certain ‘unfair’ terms in consumer contracts. These contracts are defined as contracts between a ‘seller or supplier’ (meaning ‘any natural or legal person’ who, in contracts covered by the directive, is ‘acting for purposes relating to his trade, business or profession’) and a ‘consumer’ (meaning ‘any natural person’ who, in contracts covered by the directive, is ‘acting for purposes which are outside his trade, business or profession’). In particular, a term of such a contract that has not been individually negotiated is ‘unfair’ (and therefore unenforceable) if, ‘contrary to the requirement of good faith’, it causes a ‘significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer’.

An annex to the directive contains an indicative and non-exhaustive list of terms that may be regarded as ‘unfair’. This directive also introduced a requirement that Member States implement requirements ensuring that contracts to which the directive relates be drafted in plain, intelligible language.

In October 2008 the Commission published a communication proposing the repeal and replacement of this directive with a single EU directive on consumer rights that would also repeal and replace certain other consumer protection directives. However, this initiative has not since progressed significantly.

iii Anti-money laundering legislation

There are also extensive provisions of EU law setting out anti-money laundering requirements. These are beyond the scope of this chapter.

XI FUTURE LEGISLATIVE DEVELOPMENTS

A number of measures of importance to banking activities have recently been proposed by the Commission. These include those briefly summarised below.

\textsuperscript{15} 93/13/EEC.
i Banking union and the single supervisory mechanism and the single resolution mechanism

Herman van Rompuy, President of the European Council, published a report on 26 June 2012 entitled ‘Towards a Genuine Economic and Monetary Union’, in which he set out his vision for the future of EU economic and monetary union. This was based on four elements: an integrated financial framework; an integrated budgetary framework; an integrated economic policy framework; and democratic legitimacy and accountability.

The proposals for an integrated financial framework (otherwise known as a ‘banking union’) comprise:

- a new role for the European Central Bank (ECB), giving it responsibility for the prudential regulation of all ‘credit institutions’ (meaning all banks, mutuals and other deposit-taking entities) established in the eurozone, resulting in a Single Supervisory Mechanism (SSM) for banking supervision;
- a single prudential rulebook applicable across the EU, the core elements of which are already contained in CRD IV;
- a harmonised recovery and resolution framework for credit institutions and other systemic firms in the eurozone on the basis of the Commission’s current proposals in this area (see Section XI.ii, infra); and
- a common deposit guarantee scheme for the EU.

The Single Supervisory Mechanism

The legislation establishing the SSM includes two regulations: one conferring supervisory tasks on the ECB (the SSM Regulation) and the other modifying the regulation establishing the EBA (the EBA Amending Regulation). The SSM Regulation entered into force on 15 October 2013 and the EBA Amending Regulation entered into force on 22 October 2013. In accordance with the SSM Regulation, the ECB should assume its supervisory role on 4 November 2014; however, a mechanism has been set out for ECB to delay this date if it considers that it will not be ready in time.

The SSM Regulation is the key piece of legislation establishing the SSM elements of the banking union. The key elements of the SSM regulation include:

- the ECB will have direct supervisory responsibility for significant credit institutions: credit institutions with assets of more than €30 billion or representing more than one-fifth of a Member State’s national output (where those total assets exceed €5 billion), rather than all of the banks (of which there are approximately 6,000) in the eurozone. The other banks will largely remain under the supervision of the national competing authorities in the participating Member States. The ECB will, however, have the supervisory role of licensing and authorising credit institutions, and assessing the qualifying holdings for all credit institutions;
- the ECB will issue regulations, guidelines or general instructions to the national supervisors for the performance of their supervisory responsibilities; and
- the ECB will have investigatory and enforcement powers. The ECB may impose fines of up to twice the amount of the profits gained or losses avoided as a result of a breach (where these can be determined) or up to 10 per cent of the total annual turnover of a legal person in the preceding business year. The ECB will, however, not have the power to impose sanctions on individuals.
The EBA Amending Regulation revises the EBA Regulation in relation to voting procedures in respect of the EBA. It includes revised decision-making arrangements in respect of the EBA, which will require a majority of non-SSM countries to approve EBA decisions (to prevent the EBA from being dominated by the ECB, representing the SSM Member States).

The United Kingdom, the Czech Republic and Sweden have indicated that they do not intend to participate in the SSM.

The Single Resolution Mechanism
In addition, the Council and the Commission have agreed on a general approach on the establishment of a single resolution mechanism (SRM). A proposed regulation on the SRM was adopted on 10 July 2013. The key elements of the proposal include:

a the establishment of a single resolution board (SRB). The SRB’s main role will be to assess whether an individual bank needs to be placed under resolution, and to determine the application of the resolution tools and the use of the single bank resolution fund (SBRF);

b the establishment of the SBRF, which will be funded through contributions made by all banks established in participating member states. The level of contributions payable by banks will reflect differences in their sizes and business models; and

c the establishment of a resolution mechanism that is intended to reflect the mechanism used by national authorities under the Resolution and Recovery Directive, referred to below. The framework includes preparatory and preventive measures, early intervention measures and resolution tools, including bail-in.

The SRM is expected to enter into force on 1 January 2015 and the bail-in and resolution functions are expected to apply from 1 January 2016.

ii Recovery and resolution plans
Both the G20 and the Financial Stability Board have advocated the development of recovery and resolution plans – ‘living wills’ – for financial institutions. The numerous high-profile banking failures in the EU during the financial crisis (e.g., Fortis and Anglo Irish Bank) revealed shortcomings in the existing arrangements for organising an orderly wind-down of ailing banks and financial institutions, which left Member States with no choice but to bail out their banking sectors.

In response to this, on 20 October 2010 the Commission issued a communication proposing an EU framework for crisis management in the financial sector with common and effective tools and powers to deal with failing banks at an early stage, and to minimise costs for taxpayers. The overriding objective of the proposal was to ensure that banks can be resolved in ways that minimise the risks of contagion and ensure continuity of essential financial services, including continuous access to deposits for insured depositors.

The Commission conducted a consultation on a framework to deal with future bank failures and a legislative proposal was published on 6 June 2012 (the Recovery and Resolution Directive or ‘RRD’).

The RRD will establish new tools and powers for national regulators to deal with bank crises, including:
rules requiring banks to prepare recovery plans and requiring resolution authorities
to prepare resolution plans based on consultation with the institution concerned; \[a\]
new powers of supervisory intervention at an early stage and in a crisis situation,
such as the ability to require a bank to implement its recovery plan; and \[b\]
powers giving regulators new tools to deal with the failure of a firm, including a
sale-of-business tool, a bridge institution tool, an asset-separation tool and a 'bail-
in' tool. \[c\]

The RRD will also establish new mechanisms for cross-border cooperation for handling
banking crises, including a much greater role for the EBA.

Trilogue agreement on the text of the RRD was reached between the Council, the
Parliament and the Commission on 12 December 2013. The Parliament has indicated
that it will consider this agreed text at its plenary session scheduled for 14 to 17 April
2014. It is proposed that Member States will have to transpose the RRD into national
law by 31 December 2014, with all the provisions of the directive (except for the bail-in
tool for use by national regulators) coming into force on 1 January 2015. The provisions
relating to the use of the bail-in tool will come in to force on 1 January 2016, although
Member States will be permitted to bring these provisions into force sooner.

### iii Possible separation of proprietary trading activities from retail banking

Following the proposals by the United Kingdom’s Independent Commission on Banking
in September 2011 for structural reforms in the UK banking sector (discussed in the
United Kingdom chapter), the EU’s Internal Market Commissioner, Michel Barnier,
announced that the Commission would constitute a high-level expert group to consider
structural aspects of the EU banking sector, including ring-fencing retail banking.

In January 2012 it was announced that this group had been formed, led by Erkki
Liikanen,\[16\] to determine whether, in addition to ongoing regulatory reforms, structural
reforms of EU banks would strengthen financial stability and improve efficiency
and consumer protection, and if that was the case to make any relevant proposals as
appropriate. In October 2012, the Commission published the final Liikanen Report,
which made recommendations relating to:

- **a** mandatory separation of proprietary trading activities and other significant
  trading activities;
- **b** additional separation of banking activities conditional on a bank’s recovery
  resolution plan;
- **c** use of bail-in instruments as a resolution tool;
- **d** capital requirements; and
- **e** governance and control of banks.

The Liikanen Report made clear that the high-level group expects CRD IV and the SSM
and RRD proposals to be adopted before the European institutions implement their

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16 Mr Liikanen is the current governor of the Finnish central bank.
recommendations in relation to the separation of proprietary trading activities in banks and investment firms.

On 29 January 2014, the Commission adopted a proposal for a regulation that is based on some of the recommendations in Liikanen Report. The two key elements of the proposal are as follows:

a A credit institution and entities within the same group must not engage in proprietary trading in financial instruments and commodities or invest or hold shares in hedge funds or entities that engage in proprietary trading, or sponsor hedge funds. The proposal defines proprietary trading narrowly as desks’, units’, divisions’ or individual traders’ activities specifically dedicated to taking positions for making a profit for own account, without any connection to client activity or hedging the entity’s risk. Trading in Member States’ government bonds, however, and credit institutions operating dedicated structures for buying and selling money market instruments for the purposes of cash management, are not captured by this prohibition.

b The competent authorities in the Member State will have the discretion and, in certain circumstances, a duty to review trading activities of banking groups and will have the power to separate structurally a subset of activities (market making, risky securitisation, complex derivatives) if certain metrics are exceeded. They will assess whether certain trading activities pose a threat to the financial stability of the core credit institution or the EU financial system as a whole. If a competent authority adopts a decision requiring a core credit institution not to carry out certain trading activities, these activities may still be carried out in the same banking group but they must be performed by a separate legal entity. It is proposed that, subject to meeting certain conditions in relation to national legislation in force, the Commission may grant a derogation from these structural separation arrangements to Member States.

Alongside this proposal, the Commission also adopted accompanying measures aimed at increasing transparency of certain transactions in the shadow banking sector. On 29 January 2014, the Commission published a proposal for a regulation on the reporting and transparency of securities-financing transactions (SFTs). The three key elements of the proposal are:

a transparency of SFTs, including registration and supervision of trade repositories;

b transparency towards fund investors, requiring fund managers to provide detailed information on any recourse they have to SFTs and other financing structures in regular reporting intervals – this measure is aimed at enabling investors to become aware of the risks associated with the use of SFTs and other financing structures; and

c transparency of re-hypothecation, requiring that a counterparty that wishes to re-hypothecate its client’s financial instruments that it holds as collateral do so only after receiving the express consent of the providing counterparty, disclosing the potential risks and having the financial instruments transferred to its own account.
These proposals are now expected to work their way through the EU legislative process. The proprietary trading ban will apply as of 1 January 2017 at the earliest and the effective separation of other trading activities will not (subject to Member State derogations) be compulsory before 1 July 2018.

iv Regulation of benchmarks

Following global investigations into the conduct of a number of banks in relation to attempts to manipulate two key financial market benchmarks, the London interbank offered rate (LIBOR) and the Euro interbank offered rate (EURIBOR), the Commission published a consultation document on the regulation of indices in September 2012.

Following the consultation, on 18 September 2013 the Commission adopted a proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts (the Benchmarks Regulation). The key elements of the proposal are as follows:

a The activity of the provision of benchmarks will be subject to prior authorisation and ongoing supervision at national and EU level. For ‘critical’ benchmarks (a class likely to include LIBOR and EURIBOR), colleges of supervisors will be formed to enhance the exchange of information and ensure uniform authorisation and supervision.

b Provisions to improve the quality of input data are provided. Input data used to produce a benchmark should be sufficient and accurate to reflect actual market reality, the data should be obtained from a reliable and representative panel of submitting institutions and the benchmark administrator should use robust and reliable methodology for determining the benchmark.

c The benchmark administrator will be required to draw up a code of conduct for contributors that clearly specifies their obligations and responsibilities when they provide input data for the determination of the benchmark.

d Detailed provisions will be provided for commodity benchmarks and interest rate benchmarks. Additional requirements will be imposed on critical benchmarks, including the power for the relevant competent authority to mandate submission data from contributors.

e Transparency provisions require administrators to provide a statement setting out what the relevant benchmark measures, its vulnerabilities and the underlying data, thus allowing users to choose the most appropriate and suitable benchmark.

Separately, in January 2013, the following reports were published: (1) an ESMA/EBA report on EURIBOR, which included 10 recommendations, including reducing the number of rates produced; (2) EBA recommendations to national authorities on the supervisory oversight of banks participating in the EURIBOR panel; and (3) a joint ESMA/EBA consultation paper (which closed on 15 February 2013) on proposed principles for benchmark rate-setting processes. ESMA and the EBA published the final report on 6 June 2013, which sets out the final text of the Principles for Benchmark-Setting Processes in the EU. Although these Principles are not legally binding, they are intended to provide a common framework for benchmark users, administrators, calculation agents
and publishers, and to provide a transitional path towards the implementation of the Benchmarks Regulation.

XII EU REGULATORY BODIES

In the second half of 2008 and early 2009 the Commission carried out an extensive investigation into the existing arrangements for EU financial supervision. This resulted in the ‘de Larosière report’. In May 2009 the Commission announced a new financial services supervisory framework for the EU. In November 2010 the Council and European Parliament adopted legislation creating, from 1 January 2011, two structures around which new European financial supervisory arrangements were established: a European Systemic Risk Board (ESRB), which is concerned with macro-prudential supervision and a European System of Financial Supervisors (ESFS), which is focused on micro-prudential supervision.

This change in European regulatory architecture was made in the context of widespread dissatisfaction among politicians and regulators with the way in which the previous EU regulatory system, with its network of national regulators and the division of responsibilities for cross-border institutions between ‘home’ and ‘host’ authorities, coped, or failed to cope, in the financial crisis. This is highlighted in Recital (1) to each EU regulation establishing the EBA, ESMA and EIOPA. In each case it reads:

The financial crisis in 2007/2008 exposed important shortcomings in financial supervision, both in particular cases and in relation to the financial system as a whole. Nationally-based supervisory models have lagged behind the integrated and inter-connected reality of European financial markets, in which many financial firms operate across borders. The crisis exposed shortcomings in the area of co-operation, co-ordination, consistent application of Community law and trust between national supervisors.

Targeted powers, including powers to overrule national regulators and, in limited cases, to intervene directly in the supervision of individual firms have been allocated to the new EU authorities.

In the case of macro-prudential supervision, the changes were not so much a matter of making the previous arrangements work better as addressing the significant gap in those previous arrangements that arose from the fact that systemic supervision at an EU level was not within the remit of national regulators.

17 In October 2008, the President of the European Commission, José Manuel Barroso, asked Jacques de Larosière to chair a high-level group to give advice on the future of European financial regulation and supervision. The resulting ‘de Larosière report’ was published in February 2009 and provided the basis for many of the proposals for the reforms of EU financial supervisory arrangements that the European Commission subsequently made.

The ESFS

Three ESAs were established, which are independent EU bodies with full legal personality: the EBA, ESMA and EIOPA. The former committees (CEBS, CESR and CEIOPS) were replaced, and effectively merged into the ESAs. The ESA of most importance to the banking sector is the EBA.

The regulations which have created the ESAs\textsuperscript{19} are supported by the Omnibus I Directive,\textsuperscript{20} which amended financial services legislation (other than Solvency II).\textsuperscript{21} Together, these pieces of legislation give the ESAs significant powers including the power to take decisions that bind national regulators and, in certain circumstances (particularly in an emergency), even circumvent national regulators in the supervision of significant financial institutions. ESMA also has direct responsibility for the regulation of credit rating agencies.

The powers of the ESAs may be summarised as follows:

\textit{a} to develop binding ‘technical standards’ in connection with specific areas of existing directives;

\textit{b} to ensure consistent application of EU rules by national regulators, including requesting the European Commission to make ‘decisions’ binding on national regulators;

\textit{c} in cases designated by the Council as ‘emergency situations’, to take ‘decisions’ that bind national regulators or to intervene directly in the supervision of financial institutions in limited cases. In such circumstances, the ESAs also have the power to require competent national regulators to take necessary action in accordance with EU law where developments threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system of the EU;

\textit{d} to arbitrate disagreements between national regulators, including taking ‘decisions’ that bind regulators in order to end disagreements and the power to address decisions to financial institutions if a national regulator does not comply with a decision of ESMA in respect of requirements directly applicable to the institutions (i.e., under EU regulations); and

\textit{e} the EBA may temporarily prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in cases specified and under the conditions laid down in EU legislation or, if so required, in emergency situations as provided for in the regulation.

\textsuperscript{19} The European Banking Authority was created by Regulation No. 1093/2010, the European Securities and Markets Authority by Regulation No. 1095/2010 and the European Insurance and Occupational Pensions Authority by Regulation No. 1094/2010.

\textsuperscript{20} 2010/78/EU.

\textsuperscript{21} Solvency II is to be amended by the Omnibus II Directive, the legislative proposal for which was published by the Commission on 19 January 2011.
The last two powers are subject to the important proviso that no decision adopted in their exercise should ‘impinge in any way on the fiscal responsibilities of Member States’. These powers are examined in more detail as follows.

**Technical standards**
The ESAs’ powers to set technical standards are intentionally limited. Only those issues identified in the relevant EU legislation may be subject to technical standards. Selection of the issues to which technical standards may relate is based on the following high-level principles:

- **a** the issues must be genuinely technical, where the development of standards is best left to supervisory experts. They are not areas that involve strategic or policy decisions, although distinguishing between technical and policy matters may be difficult;
- **b** issues where a common approach or predictability would be of benefit to all concerned are candidates for technical standards; and
- **c** the areas selected should be ones where detailed technical rules promote financial stability, consumer protection and market efficiency and integrity.

The ESAs do not themselves have the power to make binding technical standards; the Commission must enact the standards, usually in the form of a decision or a directly applicable EU regulation, for them to be binding. It is, however, open to the Commission not to endorse the technical standards submitted by an ESA, or to endorse them only in part. In addition, both the Council and the European Parliament have the right to object to technical standards, in which case such standards will not enter into force or will only enter into force with amendments.

Before proposing technical standards to the Commission, the EBA is generally required to hold a public consultation and to obtain the opinion of the ‘Banking Stakeholder Group’. This is a group of 30 members, representing credit and investment institutions operating in the EU, their employees’ representatives as well as consumers, users of banking services and representatives of small and medium-sized enterprises. At least five of its members are required to be independent top-ranking academics and 10 of its members to represent financial institutions, three of whom must represent cooperative and savings banks.

The EU has already made amendments to existing directives to allow for the development of technical standards. In the banking sector these include: (1) criteria for identifying financial conglomerates under the FGD; (2) the requirements for authorisation of credit institutions; (3) sharing of information between national regulators in connection with the monitoring of credit institutions; (4) conditions for recognising institutions’ own credit risk models; and (5) conditions for recognising Tier I hybrid capital instruments. More have followed under the CRD IV Directive and, *inter alia*, the CRR and EMIR.

**Consistent application of rules**
This power enables an ESA to investigate breaches or non-application of EU law and, in certain limited circumstances, to direct decisions to financial institutions. Use of this power, and in particular the ability to make binding decisions, is triggered if:
[A] competent authority has not applied the [provisions of the relevant EU legislation], or has applied them in a way which appears to be a breach of Union law, including the regulatory technical standards and implementing technical standards […], in particular by failing to ensure that a [financial institution or financial market participant] satisfies the requirements laid down in those acts […].

This is clearly aimed at a national regulator’s failures in the prudential supervision of a financial institution.

The power would be exercised as follows:

a. An ESA may investigate the alleged incorrect application of EU law. This investigation may be undertaken at the ESA’s own initiative or on request from the Commission, the Council, the relevant stakeholder group (which, in the case of the EBA, is the Banking Stakeholder Group) or one or more national regulators. In this last case, such a request might come from a ‘host’ state regulator that is concerned about the adequacy of the ‘home’ state prudential supervision of another EU institution that has a branch or customers in its country under the ‘passporting’ regime.

b. Within two months of commencing an investigation, the ESA may give the national regulator a formal recommendation as to how it should comply with EU law. The national regulator then has only 10 working days to respond with assurances as to the steps it has taken or intends to take.

c. If the national regulator has not complied with EU law within one month of the recommendation, the ESA will inform the Commission of this fact. The Commission may then issue a formal opinion, requiring it to take the necessary action to comply with EU law.

d. The national regulator then has 10 working days to inform the Commission and the relevant ESA of the steps it has taken or intends to take to comply with that opinion.

As is the case with the development of new technical standards, the Commission has the final say. The Commission must issue its opinion no later than three months from the adoption of an ESA’s recommendation, with an option for the Commission to extend this period by one month. The Commission’s power to issue an opinion may be exercised on its own initiative as well as at the request of an ESA.

There are circumstances in which an ESA may take its own action without the involvement of the Commission. If the relevant requirement of EU legislation that is the subject of a Commission formal opinion is ‘directly applicable’ to financial institutions (i.e., it is contained in an EU regulation) then the ESA may adopt an individual decision addressed to a particular financial institution requiring it to take the necessary action to comply with EU law, but only where the national regulator has not complied with the formal opinion within the time specified. This power is exercisable where, in the ESA’s opinion, it is necessary to remedy non-compliance in a timely manner in order

to maintain or restore neutral conditions of competition in the market or to ensure the orderly functioning and integrity of the financial system.

**Action in emergency situations**
The ESAs’ powers here are triggered by the Council adopting a decision determining the existence of an ‘emergency situation’. The Council is required to consult the Commission and the ESRB and, where appropriate, the ESAs. An ‘emergency situation’ is defined as one where there are ‘adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union’.

Where the Council has adopted such a decision, the ESA may, where coordinated action is necessary, adopt individual decisions requiring competent authorities to take action in accordance with EU law, which are needed to address adverse developments in the markets or the stability of the wider financial system by ensuring that financial institutions and competent authorities satisfy the requirements laid down in that legislation. The ESA can enforce a decision if the competent authority does not comply where urgent action is required.

In such circumstances, an ESA may temporarily prohibit or restrict certain financial activities where those financial activities threaten the orderly functioning and integrity of financial markets or the financial stability of the whole or part of the financial system in the EU. An ESA must review such decisions at least every three months and the decision automatically expires after three months if not renewed. The ESA must also reconsider its decision if requested to do so by a Member State. Where the ESA considers that a permanent restriction or prohibition on a particular financial activity is required, it can inform the Commission, which will consider facilitating such action. An ESA is not permitted to take such actions where it would impinge in any way on the fiscal responsibilities of Member States (for example, by requiring the financial rescue of an institution).

**Settlement of disagreements**
These powers arise where a national regulator is in disagreement with another regulator concerning the application of EU legislation. Following a request of one or more of the national regulators concerned, an ESA may attempt to assist the national regulators to reach an agreement. In addition, where disagreement between the national regulators can be determined on the basis of objective criteria the ESA may, on its own initiative, assist national regulators to reach agreement. In that case:

a where, despite such assistance, no agreement is reached, the ESA may make a binding decision requiring one or more of the national regulators to take action to comply with EU law; and

b where a national regulator fails to comply with an ESA’s decision and thereby fails to ensure that a financial institution complies with directly applicable requirements of EU law, the ESA may make a further decision addressed to the financial institution concerned, requiring it to take any necessary action to comply. As above, these powers are also subject to the safeguard that no decision may impinge on the fiscal responsibilities of any Member State.
The ESRB

The establishment of the ESRB addressed an obvious gap exposed by the financial crisis. Recital (11) of the EU regulation establishing the ESRB sets out the problem:

The present arrangements of the Union place too little emphasis on macro-prudential oversight and on connections between developments in the broader macroeconomic environment and the financial system. Responsibility for macro-prudential analysis remains fragmented, and is conducted by various authorities at different levels with no mechanism to ensure that macro-prudential risks are adequately identified and that warnings and recommendations are issued clearly, followed up and translated into action.

Unlike the ESAs, the ESRB is a pan-sectoral body, covering not just the banking or investment services sector but also the insurance sector.

The responsibility of the ESRB is to provide macro-prudential oversight of the financial system within the EU in order to prevent or mitigate systemic risks within the financial system. The ESRB’s main functions are the collection and exchange of information, the identification and prioritisation of systemic risks and the issuing of warnings and recommendations.

Information

The information function is directed primarily at the provision by the ESRB of information on systemic risks to the relevant ESAs. In return, the ESAs, together with national central banks and Member States themselves, are required to cooperate with the ESRB and provide it with information necessary for the fulfilment of its systemic monitoring objective.

Where deemed systemically relevant, the ESRB may address a ‘reasoned request’ to an ESA to provide data about particular institutions.

Warnings and recommendations

Where the ESRB identifies significant systemic risks it must issue a warning and, if appropriate, issue recommendations. Warnings or recommendations may be either general or specific and may be addressed to the EU as a whole, one or more Member States, one or more of the ESAs, one or more national regulators or (in respect of relevant EU legislation) the Commission. Different levels of risks are differentiated by a colour-coded system to enable correct prioritisation. A Member State, an ESA or a national regulator in receipt of a recommendation from the ESRB must respond by setting out either the actions undertaken to implement the recommendation or the reasons for not following the recommendation.

The only tool given to the ESRB to deal with a refusal by the recipient of a recommendation to act on it is to inform the Council or, where relevant, the ESA or ESAs concerned. Those bodies may then take action.

It will be at the discretion of the ESRB whether to make a warning or recommendation public. If it decides to do so, it must inform the Council and the addressee in advance.
Appendix 1

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Jan Putnis has been a partner at Slaughter and May in London since 2003. His practice focuses on financial regulation, with particular emphasis on international corporate and commercial transactions. Mr Putnis acts for a broad range of financial institutions, including banks, insurance groups and asset managers, on strategic regulatory matters and investigations, cross-border and domestic mergers and acquisitions and on outsourcings. His work involves extensive advice on regulatory capital and on capital structures of new businesses as well as capital structures to facilitate acquisitions and group reorganisations. Mr Putnis qualified as a solicitor in 1996. In a previous life, he graduated with a degree in physics from Oxford University in 1992.

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Michael Sholem is a special adviser on European financial regulatory affairs at Slaughter and May. He qualified as a solicitor in England and Wales in 2007. Before becoming a lawyer, he graduated from the University of Edinburgh with a degree in history and politics, and later worked for two years as an assistant to a member of the UK parliament.

During his time at Slaughter and May, Mr Sholem has advised on the supervision and regulation of investment firms, banks, insurance companies and brokers. He assisted in advising the UK government on measures taken to stabilise the UK banking system in 2008 and 2009, and in particular on the government’s recapitalisation of Lloyds Banking Group. Mr Sholem’s practice is now principally focused on developments in UK and European financial regulatory rules and policies. Mr Sholem shares his time between Slaughter and May’s offices in London and Brussels.
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