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# THE BANKING REGULATION REVIEW

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SEVENTH EDITION

EDITOR  
JAN PUTNIS

LAW BUSINESS RESEARCH

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Seventh Edition

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# CONTENTS

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<b>Editor's Preface</b>	.....vii
	<i>Jan Putnis</i>
<b>Chapter 1</b>	INTERNATIONAL INITIATIVES ..... 1
	<i>Jan Putnis and Kristina Locmele</i>
<b>Chapter 2</b>	ARGENTINA..... 27
	<i>Santiago Carregal and Diego A Chighizola</i>
<b>Chapter 3</b>	AUSTRALIA..... 40
	<i>Hanh Chau, Adam D'Andreti, Peter Feros, Paula Gilardoni, Deborah Johns, Louise McCoach, Duncan McGrath and Peter Reeves</i>
<b>Chapter 4</b>	BARBADOS ..... 60
	<i>Sir Trevor Carmichael QC</i>
<b>Chapter 5</b>	BELGIUM..... 69
	<i>Anne Fontaine and Pierre De Pauw</i>
<b>Chapter 6</b>	BRAZIL ..... 83
	<i>Tiago A D Themudo Lessa, Rafael José Lopes Gaspar and Gustavo Ferrari Chauffaille</i>
<b>Chapter 7</b>	CAMBODIA ..... 94
	<i>Bun Youdy</i>
<b>Chapter 8</b>	CANADA ..... 111
	<i>Scott Hyman, Carol Pennycook, Derek Vesey and Nicholas Williams</i>
<b>Chapter 9</b>	COLOMBIA..... 127
	<i>Luis Humberto Ustáriz González</i>

<b>Chapter 10</b>	DENMARK.....	142
	<i>Morten Nybom Bethe</i>	
<b>Chapter 11</b>	EUROPEAN UNION.....	152
	<i>Jan Putnis, Timothy Fosh and Helen McGrath</i>	
<b>Chapter 12</b>	FINLAND .....	177
	<i>Janne Lauha and Hannu Huotilainen</i>	
<b>Chapter 13</b>	FRANCE .....	188
	<i>Olivier Saba, Samuel Pariente, Mathieu Françon, Jessica Chartier and Béna Mara</i>	
<b>Chapter 14</b>	GERMANY .....	209
	<i>Thomas Paul, Sven H Schneider and Jan L Steffen</i>	
<b>Chapter 15</b>	HONG KONG .....	222
	<i>Peter Lake</i>	
<b>Chapter 16</b>	HUNGARY .....	239
	<i>Péter Köves and Szabolcs Mestyán</i>	
<b>Chapter 17</b>	INDIA .....	247
	<i>Cyril Shroff and Ipsita Dutta</i>	
<b>Chapter 18</b>	INDONESIA.....	263
	<i>Yanny M Suryaretina</i>	
<b>Chapter 19</b>	IRELAND.....	286
	<i>William Johnston, Robert Cain and Sarah Lee</i>	
<b>Chapter 20</b>	ITALY .....	301
	<i>Giuseppe Rumi and Andrea Savigliano</i>	
<b>Chapter 21</b>	JAPAN .....	316
	<i>Hirohito Akagami and Wataru Ishii</i>	

<b>Chapter 22</b>	LATVIA .....	326
	<i>Armands Skudra</i>	
<b>Chapter 23</b>	LUXEMBOURG .....	336
	<i>Josée Weydert, Jad Nader and Milos Vulevic</i>	
<b>Chapter 24</b>	MALAYSIA .....	355
	<i>Rodney Gerard D’Cruz</i>	
<b>Chapter 25</b>	MEXICO .....	374
	<i>Federico De Noriega Olea and Juan Carlos Galicia Orozco</i>	
<b>Chapter 26</b>	NETHERLANDS .....	385
	<i>Mariken van Loopik and Maurits ter Haar</i>	
<b>Chapter 27</b>	NEW ZEALAND .....	400
	<i>Guy Lethbridge and Debbie Booth</i>	
<b>Chapter 28</b>	NORWAY .....	414
	<i>Terje Sommer, Richard Sjøqvist, Markus Nilssen and Steffen Rogstad</i>	
<b>Chapter 29</b>	PANAMA.....	426
	<i>Mario Adolfo Rognoni</i>	
<b>Chapter 30</b>	PHILIPPINES .....	437
	<i>Rafael A Morales</i>	
<b>Chapter 31</b>	POLAND .....	452
	<i>Tomasz Gizbert-Studnicki, Tomasz Spyra and Michał Torończak</i>	
<b>Chapter 32</b>	PORTUGAL.....	471
	<i>Pedro Ferreira Malaquias and Helder Frias</i>	
<b>Chapter 33</b>	SINGAPORE .....	484
	<i>Francis Mok and Wong Sook Ping</i>	

<b>Chapter 34</b>	SLOVENIA.....	495
	<i>Simon Žgavec</i>	
<b>Chapter 35</b>	SOUTH AFRICA.....	514
	<i>Ina Meiring</i>	
<b>Chapter 36</b>	SPAIN.....	525
	<i>Juan Carlos Machuca and Joaquín García-Cazorla</i>	
<b>Chapter 37</b>	SWEDEN.....	545
	<i>Fredrik Wilkens and Helena Håkansson</i>	
<b>Chapter 38</b>	SWITZERLAND.....	554
	<i>Shelby R du Pasquier, Patrick Hünerwadel, Marcel Tranchet, Maria Chiriaeva and Valérie Menoud</i>	
<b>Chapter 39</b>	UNITED ARAB EMIRATES.....	575
	<i>Amjad Ali Khan and Stuart Walker</i>	
<b>Chapter 40</b>	UNITED KINGDOM.....	584
	<i>Jan Putnis, Nick Bonsall and Edward Burrows</i>	
<b>Chapter 41</b>	UNITED STATES.....	607
	<i>Luigi L De Ghenghi</i>	
<b>Appendix 1</b>	ABOUT THE AUTHORS.....	659
<b>Appendix 2</b>	CONTRIBUTING LAW FIRMS' CONTACT DETAILS.....	683

# EDITOR'S PREFACE

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Nearly eight years after the collapse of Lehman Brothers it might have been expected that fundamental questions about the business models, governance and territorial scope of large banks would have been answered clearly, but that is not yet truly the case. Debates rage on in many countries about 'too big to fail', management accountability in banks, resolution planning and conduct issues in the banking sector. What is the 'safest' form of international banking and what might shareholders in banks reasonably expect as a long-term rate of return on their investment? When is all this uncertainty going to end? Perhaps it never will for so long as large banks remain as important to the global economy as they are and the political classes throughout the world remain divided on whether this is a good thing. It is also worth remembering that the reform agenda that was born in the financial crisis of 2007–2009 established a very long implementation period – to 2019 and beyond – for many of the regulatory changes agreed upon by the G20 and the Basel Committee. So we are still in the midst of what will no doubt be seen in decades to come as the 'post-crisis' period in banking regulation.

Looking forward then, what can we see beyond the implementation of the post-crisis reforms? That depends, of course, in part on whether there is another cross-border banking crisis. It is worth noting in this context that localised banking failures remain commonplace, and with more countries around the world introducing specialised bank resolution regimes there will be further opportunities to test the uses and pitfalls of bail-in and other resolution powers.

The continuing debate about the impact of technology on banks has increased significantly in volume in much of the world in the past year. Forecasts of the eventual eclipse of banks by technology firms seem wide of the mark in the short to medium term, although there is clearly an 'adapt or die' threat to many banks in the longer term. One adaptation of sorts that we may well see more of in the next few years is banks acquiring technology firms (or otherwise entering into strategic partnerships with them).

The most obvious benefits of new technology in the banking sector concern the customer interface and market infrastructure. However, some important but less immediately obvious ways in which technology will continue to revolutionise banking arise in the context of the safety and soundness of banks. For example, some banks are looking at how innovative

uses of technology can improve their risk management, and ultimately the credibility of their recovery and resolution plans through, for example, more precise classification and management of derivative positions and counterparty relationships.

Many of the largest cross-border regulatory investigations into past conduct in the banking sector have drawn to a close over the past year. While for some that signalled the close of a painful and costly chapter in the post-crisis development of the banking sector, it remains difficult to conclude that the threat of further such investigations has gone away.

As an English lawyer it would be odd if I did not mention the June 2016 referendum in the UK on membership of the European Union, parochial though that may seem to some readers outside Europe. The legal and regulatory regime that will apply to business that banks undertake in and from London is, however, of global interest, and the result of the referendum, and its aftermath, will therefore be of very considerable importance to all large banks and many smaller ones.

This seventh edition of *The Banking Regulation Review* contains chapters provided by authors in 39 countries and territories in March and April 2016, as well as chapters on International Initiatives and the European Union. My sincere thanks, as in previous years, go to the authors who have made time to contribute their chapters despite their heavy workload.

The team at Law Business Research have, once again, tolerated the hectic schedules and frequent absences on business of many of the authors, and I would like to thank them for doing so with such good humour and understanding. Thank you also to the partners and staff of Slaughter and May in London and Hong Kong for continuing to encourage projects such as this book, and in particular to Ben Kingsley, Peter Lake, Nick Bonsall, Edward Burrows, Tim Fosh, Kristina Locmele and Helen McGrath.

**Jan Putnis**

Slaughter and May  
London  
May 2016

## Chapter 11

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# EUROPEAN UNION

*Jan Putnis, Timothy Fosh and Helen McGrath<sup>1</sup>*

### 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. 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 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 problems arising from European monetary union. This 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 IX, *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.

---

<sup>1</sup> Jan Putnis is a partner and Timothy Fosh and Helen McGrath are associates at Slaughter and May.

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 that apply directly in all Member States. Following recent changes to the European supervisory architecture and the commitment of the European Commission (Commission) 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 the form of directly applicable EU regulations.

## **II EUROPEAN REGULATORY AND SUPERVISORY FRAMEWORK**

### **i Key EU institutions**

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 (Council) represents the interests of the individual Member States. The European Parliament (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 the Parliament, which then usually goes through the ‘ordinary legislative procedure’ (previously known as the ‘co-decision procedure’). 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 financial services legislation that involves the following:

- a* a legislative act (Level 1) – the framework legislation is proposed and adopted under the ‘ordinary legislative procedure’. Individual articles in that legislation specify where power is delegated to the Commission to adopt Level 2 measures;
- b* implementing measures drafted and adopted by the Commission, following advice from the ‘specialist committees’ (Level 2);
- c* consultation and guidance by the ESAs (Level 3); and
- d* supervision and enforcement, principally by the regulators in each Member State (Level 4).

### **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 Supervision (ESFS), 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 European 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 merely advisory. These supervisory structures are discussed in Section XVII, *infra*.

The Commission has committed itself to replacing separately implemented rules within Member States with a 'Single Rule Book' within the EU. The ESAs advance this project by developing draft technical standards, which will then be adopted by the Commission as EU law, and by issuing 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 the 'gold-plating' of EU legislation by individual Member States. The Commission's intention is that national options and discretions should be reduced, and that Member States should 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 legislation affecting the regulation of banks, together with several recent legislative initiatives that will affect banking activities in the EU.

### 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 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 the CRD IV Directive and 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.<sup>2</sup> In addition, banks are required to include ‘participations’<sup>3</sup> 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:

- a* 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;
- b* measures to strengthen capital through the redefinition of capital into common equity Tier 1, additional Tier 1 and Tier 2 (eliminating distinctions between different types of Tier 2 capital and abolishing innovative Tier 1 capital and Tier 3 capital completely). The minimum ratios for common equity Tier 1 and total Tier 1 capital are set at 4.5 and 6 per cent respectively (although the minimum capital ratio, ignoring capital buffers, remains at 8 per cent);
- c* new capital conservation and countercyclical capital buffers, which apply on top of the increased capital ratios and 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, and is set by national regulators and used as a tool to require banks to build up capital during periods of excessive credit growth. This buffer also comprises common equity;
- d* a leverage ratio acting as a cap on the ratio of banks’ Tier 1 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:

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

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2 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.

3 A ‘participation’ includes, broadly, a direct or indirect holding of 20 per cent or more of the voting rights or share capital in another undertaking. Participations are consolidated on a proportionate basis.

- b* strengthened sanctioning powers where banks breach CRD IV requirements, including the establishment of minimum administrative sanctions to be applied by national regulators;
- c* 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;
- d* a bonus cap: the variable remuneration of certain individuals at banks is 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 their fixed remuneration. This cap applies broadly to categories of staff including senior management, risk takers, staff engaged in control functions, and employees 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; and
- e* 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 laws. 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 are provided for in the CRR), Member States do have a degree of flexibility in relation to the calibration of capital buffers (these are 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 (although national regulators retain limited discretion to utilise transitional provisions in relation to certain deductions from own funds until 2024).

#### **IV PAYMENT SERVICES DIRECTIVE**

The Payment Services Directive (PSD)<sup>4</sup> is intended to harmonise conduct of business rules for all providers of electronic payment services across the EU, and to create a tiered prudential authorisation regime for non-bank payment service providers, known as 'payment

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4 2007/64/EC.

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 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 the PSD 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 proposed a revised and recast Payment Services Directive (PSD2)<sup>5</sup> and a Multilateral Interchange Fees Regulation (MIF Regulation).<sup>6</sup>

PSD2 was formally adopted on 25 November 2015 and has an implementation deadline of 13 January 2018. The directive updates the existing framework for the regulation of the provision of payment services in the EU, covering payment services providers (PSPs) not previously regulated under the PSD, and introducing enhanced transparency and security requirements.

The directive increases the geographical scope of the PSD, applying transparency and information requirements to payment transactions in all currencies and to payment transactions where only one PSP is located in the EU (the PSD only applied where both PSPs were located in the EU). It also brings certain PSPs (such as those providing payment initiation services and account information services) within the scope of the directive, and limits the exemptions that were available under the PSD.

The MIF Regulation was formally adopted on 29 April 2015 and will become fully effective on 9 June 2016. The regulation imposes caps on interchange fees of 0.2 per cent and 0.3 per cent of transaction value for consumer debit card and credit card transactions respectively. These caps came into effect on 9 December 2015, though for a period of five years from that date Member States can apply the cap of 0.2 per cent in respect of domestic debit card transactions to the annual weighted average transaction value of all such transactions within the card scheme. After the expiry of this period, the cap must be set by reference to transaction value. The regulation also requires the organisational separation of payment schemes and transaction processing infrastructure and prohibits territorial restrictions in licensing agreements or payment scheme rules.

## **V ACQUISITIONS DIRECTIVE**

The Acquisitions Directive<sup>7</sup> was formally adopted on 5 September 2007. It was intended to harmonise the criteria that regulators apply in deciding whether to approve changes of control of financial institutions (specifically, credit institutions, investment firms, insurers and reinsurers) and to harmonise some important aspects of the process by which they do so.

Member States were required to implement the Acquisitions Directive into national law by 21 March 2009. Non-binding guidelines, aimed at ensuring closer cooperation between regulators in the EU when considering cross-border changes of control and

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5 Directive (EU) 2015/2366.

6 Regulation (EU) 2015/751.

7 2007/44/EC.

promoting harmonisation of the processes that those regulators apply, were published in December 2008 by a joint committee comprising representatives of CEBS, CESR and CEIOPS<sup>8</sup> (referred to as the 3L3 Committee).

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 share 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 purpose of determining whether ‘control’ has been or would be attained, where those parties are ‘acting in concert’. The 3L3 Committee gave 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. The Commission did, however, ask the ESAs to clarify new Level 3 guidance on the Directive in relation to a number of issues, including the definition of ‘acting in concert’. In response to this request, in July 2015 the Joint Committee of the ESAs published a consultation paper setting out proposals for draft guidelines to replace the existing Level 3 guidelines. The consultation closed on 2 October 2015. At the time of writing, the ESAs were yet to publish any final guidelines.

## **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,<sup>9</sup> 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 subject 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. The criteria for determining whether a group is a financial conglomerate for the purposes of the FGD depend on whether it is headed by a regulated entity. If this is the case, the regulated entity at the head of the group must be the parent undertaking of, hold a participation in or be linked by a consolidated with, an entity in the banking, investment or insurance sector. Where the entity

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8 Although the CEBS, CESR and CEIOPS have since been replaced by the EBA, ESMA and EIOPA respectively, this guidance has been ‘grandfathered’ and will remain relevant until it is replaced by the guidance to be issued by the Joint Committee of the ESAs.

9 2002/87/EC (as amended).

at the head of the group is not regulated, 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) must account for at least 40 per cent of the group's total gross assets worldwide.

In both cases, groups must also meet the following criteria:

- a* at least one member of the group carries on business in each of the banking or investment services, and insurance sectors; and
- b* 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 with 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. At the initiative of the 'lead' European regulator (to be identified or agreed among the national regulators that supervise members of the group in the EEA), 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.

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.

Upon becoming a financial conglomerate, the relevant ratios are lowered for three years from that date, unless the relevant national regulators agree otherwise. This minimises 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.<sup>10</sup>

In December 2011, the FGD was amended, with these amendments required to be implemented in full by Member States 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 that 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. Its 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. Recital (80) to the CRR stated that a review of the FGD is expected in 2015. In October 2015, the Commission announced in an Annex to its Work Programme for 2016 that it would conduct a review into the FGD to assess whether it could be considered 'fit for purpose', although no such review was under way at the time of writing.

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<sup>10</sup> Not all national regulators have exercised this discretion.

## **VII MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MIFID)**

MiFID<sup>11</sup> replaced the Investment Services Directive (ISD),<sup>12</sup> which had constituted one of the foundations upon which the single European market in financial services was 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 other 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.

The implementation of MiFID has had an important impact on the securities markets and investment firms of all EEA Member States, although its impact 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:

- a* 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;
- b* 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;
- c* national-level barriers to investment services within the EU single market have been reduced;
- d* important core business standards for investment services are now prescribed in detail at EU level; and
- e* 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 European Market Infrastructure Regulation, which is discussed below). The provisions of the MiFID II Directive and Market in Financial Instruments Regulation (MiFIR) came into force on 2 July 2014. Member States have until 3 July 2016 to transpose the majority of the measures contained in the MiFID II Directive into their national laws, and must apply those provisions from 3 January 2017. The majority of the provisions of MiFIR will apply from 3 January 2017. On 10 February 2016, the Commission published a proposal for a directive amending the MiFID II Directive and a proposal for a regulation amending MiFIR to delay the application date of the MiFID II legislative package until 3 January 2018. The proposed delay reflects the difficulties met by ESMA and the Commission in delivering the necessary

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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.

technical standards and delegated acts and the difficulties in developing the infrastructure required for the collection of financial instrument reference data that trading venues and other entities are required to provide under the new regime.

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 MiFID II include the following:

- a* a new type of trading venue, the organised trading facility (OTF), is within the scope of MiFID II. OTFs will be subject to the same core requirements for a trading venue's operation as existing platforms, and are defined broadly to capture all forms of organised trading not matching existing categories;
- b* 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;
- c* improved transparency of trading activities in equity markets, including 'dark pools', and a new trade transparency regime for non-equity markets;
- d* new safeguards for algorithmic and high-frequency trading activities;
- e* in coordination with ESMA or the EBA and under defined circumstances, supervisors will be able to ban specific products, services or practices in the case of threats to investor protection, financial stability or the orderly functioning of markets;
- f* new powers for regulators to monitor and intervene in trading in commodity derivatives, including the imposition of position limits;
- g* stricter requirements for portfolio management, investment advice and the offer of complex financial products such as structured deposits; and
- h* a ban on third-party inducements in the case of portfolio management and for firms providing independent advice.

ESMA submitted various final draft regulatory technical standards and implementing technical standards to the Commission for approval on 28 September 2015 and further implementing technical standards on 11 December 2015. While the Commission had indicated that the proposed delay to the implementation of MiFID II would not affect the timeline for the adoption of Level 2 measures, it is yet to adopt any of the final draft technical standards submitted by ESMA.

### **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,

those requirements will come into force when the relevant Level 2 measures are implemented. In particular, the first clearing obligations will start to be phased in from 21 June 2016 in respect of certain interest rate derivatives.

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

- a* a reporting obligation in respect of derivatives entered into by EU financial and non-financial counterparties, requiring detailed information to be reported to trade repositories and made accessible to supervisory authorities (this obligation came into force on 12 February 2014);
- b* a clearing obligation for derivatives that meet certain eligibility criteria set by ESMA;
- c* measures to reduce counterparty credit risk and operational risk for uncleared OTC derivatives, including risk mitigation standards (such as exchanges of collateral);
- d* 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; and
- e* rules on the interoperability of CCPs.

ESMA has drafted regulatory technical standards for the application of these rules; most of these standards have now been adopted by the Commission and are binding on counterparties, while others are still being developed, most notably in relation to measures to reduce counterparty credit risk for uncleared OTC derivatives, including the functioning of the collateral exchange provisions. The manner in which such standards become binding is discussed in further detail in Section XVII, *infra*.

## **IX THE BANKING UNION, THE SSM AND THE SINGLE RESOLUTION MECHANISM (SRM)**

Herman van Rompuy, former 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* 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 an SSM for banking supervision;
- b* a single prudential rulebook applicable across the EU, the core elements of which are already contained in CRD IV;
- c* 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; and
- d* a common deposit guarantee scheme for the EU.

**i The SSM**

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). These are supplemented by the SSM Framework Regulation, which sets out detailed procedures for the SSM. The SSM Regulation entered into force on 3 November 2013 and the EBA Amending Regulation entered into force on 30 October 2013. In accordance with the SSM Regulation, the ECB assumed its supervisory role on 4 November 2014.

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:

- a* direct supervisory responsibility for the ECB over significant credit institutions (generally, those with assets of more than €30 billion, representing more than one-fifth of a Member State's national output (where those total assets exceed €5 billion), or with a ratio of cross-border assets or liabilities to total assets or liabilities (respectively) which exceeds 20 per cent). Other banks largely remain under the supervision of the national competent authorities in the participating Member States. The ECB does, however, have the supervisory role of licensing and authorising credit institutions, and assessing the qualifying holdings for all credit institutions;
- b* the ECB will issue regulations, guidelines or general instructions to the national supervisors for the performance of their supervisory responsibilities; and
- c* investigatory and enforcement powers for the ECB. It 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. It does not, however, 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 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).

Although non-eurozone Member States do not participate in the SSM, the SSM Regulation allows such countries to enter into close supervisory cooperation with the ECB. To date, none of the nine non-eurozone Member States have opted to do so.

**ii The SRM**

In addition, the Single Resolution Mechanism Regulation, certain provisions of which have applied since August 2014 and which has been fully effective since 1 January 2016, established the SRM. Its key elements include:

- a* the establishment of a single resolution board (SRB). The SRB's main role is 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 is funded through contributions made by all banks established in participating Member States. The level of contributions payable by banks 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 Bank Recovery and Resolution Directive (BRRD), discussed below. The framework includes preparatory and preventive measures, early intervention measures and resolution tools, including bail-in.

## **X 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, the Commission proposed 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 failing banks could 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 BRRD is the framework legislation passed as a result of the Commission’s proposal to deal with future bank failures. It came into force on 2 July 2014 and establishes new tools and powers for national regulators to deal with bank crises, including:

- a* rules requiring banks to prepare recovery plans and requiring resolution authorities to prepare resolution plans based on consultation with the institution concerned;
- b* 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
- c* 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.

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

The deadline by which Member States had to transpose the BRRD into national laws was 31 December 2014, and all the provisions of the Directive (except for the bail-in tool for use by national regulators) should have come into force by 1 January 2015. The provisions relating to the use of the bail-in tool came into force on 1 January 2016, although some Member States (including the United Kingdom) chose to bring these provisions into force sooner.

## **XI 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. To

address the perceived risks in a coordinated manner, a regulation on short selling and certain aspects of credit default swaps (Short Selling Regulation) was agreed upon and came into force on 1 November 2012. It includes provisions that:

- a* increase 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* require that those who enter into short sales of European sovereign debt instruments or shares admitted to trading on an EU regulated market, or an MTF, must have borrowed, entered into an agreement to borrow, or made other arrangements that ensure that the relevant instruments are available for borrowing. This effectively bans 'naked' short selling;
- c* oblige 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 (and each 0.1 per cent above this), 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* require trading venues to ensure that there are default arrangements and penalties in place if a short settlement fails;
- e* require that all short orders should be flagged as such;
- f* empower national competent authorities to impose restrictions on short selling and related derivative transactions for up to three months 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* provide that ESMA will coordinate cross-border measures and intervene in situations where national authorities have not taken sufficient action to address a threat.

## **XII 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<sup>13</sup>**

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<sup>14</sup> that: 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 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.

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13 94/19/EC.

14 2009/14/EC.

On 2 July 2014, a recast version of the Deposit Guarantee Schemes Directive<sup>15</sup> came into force, and the overwhelming majority of its provisions had to be implemented by 3 July 2015. Among its key provisions are:

- a* reducing the time permitted for payout to seven working days by 2024 and, 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;
- b* requiring the provision of standard information to depositors about the scheme that applies to them;
- c* requiring funds of schemes to reach 0.8 per cent of covered deposits within 10 years of the Directive coming into force. The Commission may permit a Member State to set a lower level (although not less than 0.5 per cent) where that Member State has a concentrated banking sector; and
- d* introducing a principle of risk-based contributions, whereby riskier banks are required to make greater contributions to the relevant deposit guarantee scheme.

**ii Unfair Terms in Consumer Contracts Directive (the Unfair Terms Directive)<sup>16</sup> and the Consumer Rights Directive<sup>17</sup>**

The Unfair Terms Directive requires Member States, *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’. The Directive also introduced a requirement that Member States implement measures 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. The Consumer Rights Directive came into force on 12 December 2011, but did not repeal the Unfair Terms Directive; instead, it made minor amendments to that Directive. Among its key provisions are: an extension of consumer withdrawal rights on distance purchases to 14 days across the EU; a cap on fees for use of means of payment equal to the cost borne by the trader for the use of such means; and the provision of mandatory information by the trader to the consumer on distance and off-premises contracts.

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15 2014/49/EU.

16 93/13/EEC.

17 2011/83/EEC.

Member States were required to implement the measures contained in the Consumer Rights Directive by 13 June 2013, and to apply those measures from 13 June 2014.

**iii Anti-money laundering legislation**

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

**XIII THE SFT REGULATION**

In its September 2013 Communication on shadow banking, the European Commission identified increasing the transparency of securities financing transactions (SFTs) as a priority area. This prompted it to publish a proposal for a regulation on the reporting and transparency of SFTs in January 2014. The final text of the regulation (the SFT Regulation)<sup>18</sup> was formally adopted on 25 November 2015 and came into force on 12 January 2016.

The SFT Regulation imposes the following requirements on counterparties to SFTs:

- a* counterparties must report details of SFTs to a registered or recognised trade repository no later than the working day following the conclusion of the transaction;
- b* fund managers must provide detailed information on any recourse they have to SFTs and other financing structures in pre-contractual documents and at 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* a counterparty that wishes to re-hypothecate its client's financial instruments that it holds as collateral can 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.

The SFT Regulation covers repurchase transactions (repos), securities and commodities lending and borrowing transactions, buy-sell back and sell-buy back transactions and margin lending transactions and applies to all counterparties in SFT transactions that are domiciled in the EU or acting through an EU branch, as well as certain fund managers and counterparties engaging in re-hypothecation.

**XIV THE MARKET ABUSE REGULATION**

In October 2011 the Commission published legislative proposals for a regulation and directive to replace the Market Abuse Directive (MAD)<sup>19</sup> and to strengthen and update the existing EU market abuse regime. Following consideration by the Council and Parliament, the final texts of the Market Abuse Regulation (MAR)<sup>20</sup> and the Directive on Criminal Sanctions for Market Abuse (CSMAD)<sup>21</sup> (referred to collectively as MAD II) were published on 12 June 2014 and came into force on 2 July 2014.

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18 Regulation (EU) 2015/2365.

19 2003/6/EC.

20 Regulation 596/2014.

21 2014/57/EU.

MAR is intended to expand and develop the market abuse regime under MAD by establishing a common regulatory framework on market abuse. This regulation is intended to complement the MiFID II legislative package, and the two regimes were updated together to ensure that they are coherent and support each other's objectives and principles.

The framework established by MAR prohibits insider dealing, the unlawful disclosure of inside information and market manipulation. Key changes made to the existing EU market abuse regime by MAR include:

- a* an expansion of scope to cover market abuse relating to financial instruments traded on an OTF or MTF, certain over-the-counter activities and, in some cases, spot commodity contracts;
- b* extraterritorial reach, covering behaviour both within and, where such behaviour relates instruments traded on an EU trading venue, outside the EU;
- c* the introduction of a prohibition on attempted market manipulation;
- d* the extension of the market manipulation prohibition under MAD to cover the manipulation of benchmarks; and
- e* the introduction of a new 'market soundings' safe harbour to the offence of unlawfully disclosing inside information.

The majority of MAR's provisions are set to apply from 3 July 2016, though a proposal for a regulation published by the Commission on 10 February 2016 suggests that MAR may be amended to delay the application of certain of its provisions that are based on concepts introduced by MiFID II until MiFID II is implemented.

CSMAD is intended to complement MAR by requiring Member States to implement minimum rules for criminal sanctions in the most serious instances of market abuse. Under CSMAD, 'serious' instances of market abuse are broadly those that cause a great impact on the integrity of the market, or under which (1) the profit gained or loss avoided, (2) the level of damage caused to the market, or (3) the overall value of the financial instruments concerned, is high.

Member States must transpose CSMAD provisions into domestic law by 3 July 2016 but, as CSMAD is a minimum harmonisation directive, are free to impose more stringent requirements. Two Member States, Denmark and the United Kingdom, have opted out of CSMAD.

## **XV THE MORTGAGE CREDIT DIRECTIVE**

In March 2011, the Commission published a proposal for a directive on credit agreements relating to residential immovable property for consumers. The Mortgage Credit Directive (MCD) was published in the Official Journal on 28 February 2014 and had to be transposed and implemented by Member States by 21 March 2016.

The MCD introduces requirements in the EU for residential mortgage lending, and places obligations on credit intermediaries and creditors. The MCD imposes requirements in relation to, *inter alia*, advertising and marketing, standard pre-contractual information, calculation of the annual percentage rate of charge, creditworthiness and suitability assessments and advice, and introduces a right of the borrower to make early repayment.

## XVI FUTURE LEGISLATIVE DEVELOPMENTS

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

### **i Possible separation of proprietary trading activities from certain banking activities**

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.

A group, led by Erkki Liikanen, was subsequently formed 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* the mandatory separation of proprietary trading activities and other significant trading activities;
- b* the additional separation of banking activities conditional on a bank's recovery and resolution plan;
- c* the use of bail-in instruments as a resolution tool;
- d* capital requirements; and
- e* governance and control of banks.

On 29 January 2014, the Commission adopted a proposal for a regulation that is based on some of the recommendations in the Liikanen Report, the two key elements of which 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; and
- b* the competent authorities in the Member State will have the discretion and, in certain circumstances, the duty to review trading activities of banking groups and will have the power to separate structurally a subset of activities (market making, risky securitisation and 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.

On 7 January 2015, the European Parliament's Committee on Economic and Monetary Affairs (ECON) published a draft report on the proposed regulation for structural reform, which suggested a number of amendments, including the removal of a proposed derogation from certain requirements where equivalent measures were in place in a particular Member State. ECON voted to reject the Commission's proposal in May 2015 and is currently considering its position on the proposed regulation. The Council of the EU published its general approach on the proposed regulation in June 2015, and in January 2016 the Netherlands Presidency of the Council of the EU stated in its work programme for 2016 that trialogue negotiations would begin once the Parliament has determined its position. It is unclear when such negotiations will commence or when agreement might be reached among the parties.

## **ii 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, the Commission adopted a proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts (Benchmarks Regulation). The Council and the Parliament reached a preliminary political agreement on the Benchmark Regulation on 25 November 2015. It is currently anticipated that the regulation will be adopted in April 2016.

The key elements of the regulation 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. Different governance and control requirements will apply to administrators depending on whether they administer 'critical', 'significant' or 'non-significant' benchmarks. 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 or economic 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 and mandate administration; and
- e* transparency provisions will require administrators to provide a statement setting out what the relevant benchmark measures and its vulnerabilities, to allow users to choose the most appropriate and suitable benchmark.

Separately, in January 2013, the following reports were published: an ESMA and EBA report on EURIBOR, which included 10 recommendations, including reducing the number of rates produced; EBA recommendations to national authorities on the supervisory oversight of banks participating in the EURIBOR panel; and a joint ESMA and 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. The Principles are designed to be consistent with the principles on financial benchmarks which were published by the International Organization of Securities Commissions in July 2013, and which the Commission was involved in drafting. In February 2014, ESMA and the EBA also published a report on the review of the implementation of their 2013 recommendations.

### **iii The European deposit insurance scheme**

In November 2015, the Commission adopted a legislative proposal for a regulation establishing a European deposit insurance scheme (EDIS). The proposal reflects the Commission's concern that national deposit guarantee schemes established under the Deposit Guarantee Schemes Directive (see Section XII, *supra*) may be vulnerable to large local events and form one of the key components of the proposals for a European banking union. The Commission's proposals would only apply in Member States that are participants in the SSM.

Under the legislative proposals, from 2024 EDIS would provide insurance to participating deposit guarantee schemes, funding a participating deposit guarantee scheme where it is required to contribute to a resolution or make a payout under the Deposit Guarantee Schemes Directive. This would be funded by risk-based contributions paid by banks to a deposit insurance fund, which the Commission envisages would be equivalent to 0.8 per cent of the covered deposits of all banks within the banking union by 2024. For more detail on the SSM, see Section IX, *supra*.

### **iv Proposed securitisation regulation**

In September 2015, the Commission published a legislative proposal for a regulation establishing a European framework for simple, transparent and standardised (STS) securitisations, one of the building blocks of the capital markets union action plan adopted by the Commission in September 2015.

The proposed regulation would introduce certain requirements in relation to securitisations, requiring certain institutional investors to conduct due diligence before investing in securitisation instruments and imposing risk retention, reporting and transparency requirements on originators, sponsors and original lenders. The proposal also sets out what constitutes an STS securitisation, and establishes a more risk-sensitive prudential framework in respect of such securitisations. It is also proposed that a separate regulation would amend CRD IV to give STS securitisations more favourable capital treatment.

### **v CCP resolution framework**

In October 2012 the Commission published a consultation paper on the establishment of a recovery and resolution framework for CCPs. The Commission is likely to publish a

legislative proposal during 2016; it is anticipated that this will be similar to the recovery and resolution regime for banks established under the BRRD, though there is currently little information as to the form that any such proposal might take.

## **XVII EU REGULATORY BODIES**

In May 2009, the Commission, in response to the de Larosière Report, announced a new financial services supervisory framework for the EU. In November 2010, the Council and Parliament adopted legislation creating, from 1 January 2011, two structures around which new European financial supervisory arrangements were established: the European Systemic Risk Board (ESRB), which is concerned with macro-prudential supervision, and the 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, failed to cope during the financial crisis.

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.

### **i 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 that created the ESAs<sup>22</sup> are supported by the Omnibus I Directive,<sup>23</sup> which amended financial services legislation (other than Solvency II).<sup>24</sup> 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:

- a* to develop binding ‘technical standards’ in connection with specific areas of existing directives;

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22 The EBA was created by Regulation No. 1093/2010, ESMA by Regulation No. 1095/2010 and EIOPA by Regulation No. 1094/2010.

23 2010/78/EU.

24 Solvency II has been amended by the Omnibus II Directive, which came into force on 23 May 2014. The Solvency II regime must be transposed into national laws by 31 March 2015 and will come into force on 1 January 2016.

- b* to ensure the consistent application of EU rules by national regulators, including requesting the Commission to make ‘decisions’ binding on national regulators;
- 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;
- 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
- 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.

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’.

#### *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 open to the Commission not to endorse technical standards submitted by an ESA, or to endorse them only in part. In addition, both the Council and the 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, top-ranking academics, and representatives of small and medium-sized enterprises.

### *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 [...]*<sup>25</sup>

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;
- 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 that 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; and
- 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.

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25 Regulation No. 1093/2010, Regulation No. 1094/2010 and Regulation No. 1095/2010.

*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 it is 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 (e.g., 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 by 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.

**ii The ESRB**

The establishment of the ESRB addressed an obvious gap exposed by the financial crisis that, at an EU level, responsibility for macro-prudential analysis was fragmented, and conducted

by various authorities at different levels with no mechanism to ensure that macro-prudential risks were adequately identified, and that warnings and recommendations were 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 issuance 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 risk 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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# ABOUT THE AUTHORS

### **JAN PUTNIS**

#### *Slaughter and May*

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 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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Timothy Fosh is an associate in the financial regulation group at Slaughter and May in London. His practice incorporates transactional and non-transactional work for a variety of financial and non-financial institutions. His practice has recently involved providing advice on many elements of UK banking regulation (including the ring-fencing regime, capital requirements and the UK implementation of the Bank Recovery and Resolution Directive), as well as advising on the regulation of the trading of derivatives and financial instruments more generally. He has also recently advised a number of banks and fund managers on structuring and material outsourcing issues, as well as advising on the acquisition of certain consumer credit and intermediary firms. He graduated with a degree in classics from Durham University in 2007, and qualified as a solicitor in England and Wales in 2012.

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