Are EU Banks Safe?

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Opening Remarks

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

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

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

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

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1 INTRODUCTION

1.1 QUESTIONING EU BANKS AND THEIR REGULATION

Introduction

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

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

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

This is different for the EU rules. Member states have committed themselves (and their citizens) in the EU treaties to abide by the jointly agreed rules. In banking, the room to manoeuvre for member states has declined. The tendency has been to further limit

national deviations from the EU standard, which process has only accelerated in the wake of the 2007-2013 subprime crisis. The bulk of national rules will be amended by a new – largely directly applicable – set of European rules. The new set of rules contains copy paste sections of existing rules; some truly new proposals based on for instance new global standards, and some upgrades of existing features.

Background

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

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

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

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

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

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

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

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

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

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

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

1.2 AN INTRODUCTION TO EU BANKING SUPERVISION

Introduction

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

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

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

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

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

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

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

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

Licensing, living, liquidating – the lifecycle of a bank

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Quality, quantity and common sense

To limit the chance that the bank or the supervisor need to decide that the bank is broke or unlikely to meet obligations at a future date, the EU rules set out several categories of requirements on banks. The main categories are:

- quantitative requirements;
- qualitative requirements;
- public disclosure requirements;
- reporting and other information provision requirements to the supervisor.

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

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

15 Arts. 9 and 75 RBD and Art. 18 RCAD, respectively Art. 12 CRD IV Directive and Arts. 92-93 CRR.

16 For large exposures a small add-on capital requirement is calculated if certain maximum thresholds are exceeded.

17 Arts. 57, 66 and 75 RBD and Art. 18 RCAD.

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

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

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

18 Arts. 25-88, 92, 465-491, 494, 501, 504 CRR and Arts. 129-134, 160, 162 CRD IV Directive.
19 Arts. 86-87 CRD IV Directive and Arts. 8, 21, 412-413, 429, 451, 460-461, 499, 509-511 and 521 CRR.
20 Arts. 123 and 124 RBD, and Arts. 73 and 97-98 CRD IV Directive.

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

Standing alone or together

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

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

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

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

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

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

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

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