

SPECIAL INTEREST PAPER



Report prepared for the International Regulatory Strategy Group
by Anita Millar
October 2012

EU Banking Union – Operational Issues and Design Considerations

City of London Economic Development
PO Box 270, Guildhall, London, EC2P 2EJ
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Risk, Regulation & Strategy Ltd

IRSG

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1 Introduction

A eurozone Banking Union (BU) was agreed, in principle, at the euro-area summit on 29 June 2012. The euro summit statement and other documents released around that time indicated that BU could include:¹

1. A European single rule book.
2. A prudential supervisory mechanism, focused on crisis prevention, having both European and national dimensions.
3. A resolution authority focused on crisis resolution, having both European and national dimensions.
4. A European resolution fund.
5. A European deposit insurance scheme.
6. A fiscal backstop such as the European Stability Mechanism (ESM).

On 12 September 2012, the EU Commission followed up with a proposed design for the second element of BU in the form of a Single Supervisory Mechanism (SSM), and a proposal relating to the responsibilities of the European Banking Authority (EBA) for the first element); ensuring that EBA's decision-making will remain balanced in light of the new SSM.² The Commission also confirmed that a proposal for a single resolution mechanism would follow.

Through proposing a supervisory architecture squarely aimed at safeguarding financial stability, BU involves a significant departure from the current EU framework for financial markets, based on home country supervision and accommodation of national specificities in EU financial services regulation and mutual recognition. So it is important to identify the potential implications of the changes that will be needed to bring BU about.

The Commission's proposals, while helping to ground key elements of the BU debate, do not rule out its final form taking any number of configurations. Moreover, BU's design can draw upon a number of institutional/regulatory/market frameworks, for example:

- Existing EU treaties.
- The European System of Central Banks (ESCB).
- The new European System of Financial Supervisors (ESFS).
- Current support mechanisms such as European Financial Stability Facility (EFSF).
- EU regulations already in place or in train (such as proposals for the Recovery and Resolution Directive (RRD) and revision of the Directive on Deposit Guarantee Schemes (DGS)).
- Current reviews pertaining to the character/definition/structure of the EU's firms and financial markets (such as the Liikanen Review).

¹ In addition to the 29 June 2012 summit statement – http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf – it is also worth examining the EU Council's statement at the conclusion of the summit – http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf – and the pre-summit report presented by Herman Van Rompuy, the President of the EU Council, *Towards a Genuine Economic and Monetary Union* – http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf

² For the EU Commission's BU proposals, see http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1

This report aims to support BU by analysing the components of BU that are identifiable at this stage, and by providing an initial description and discussion of the operational issues, taking account of the above frameworks as well as other influences such as the broader call for changes in the style of supervision and the culture of banking. Particular focus is given to the future form and nature of supervision, the institutional changes which BU may introduce, potential changes to the EU financial markets and the operation of the single market more broadly.

The Commission's 12 September 2012 proposals inform this report, but do not dictate the investigation. The report does not focus on the political dimensions of BU, and while it does refer to various EU treaties and regulatory text, the comments provided are not intended as legal guidance.

2 Organisation

Section 3 of this report contains themes and suggestions that emerge from the analysis which could be used to help frame and advance BU's design. The conclusions that arise from the analysis at this stage of BU's evolution are reported in Section 4, and further background material is included in Section 5.

The background section sets the stage for the analysis. It explains how the elements of BU have been disclosed and what they *may* entail, puts BU in the context of its economic drivers, and discusses relevant changes in the EU's supervisory architecture and EU regulatory initiatives that are in various stages of progress. Also covered are wider environmental factors such as global concerns about banking culture and deficiencies in supervision, and some of the debate arising from regulatory reform in the UK (in response to supervisory failures to date).

Annex 1 and Annex 2 provide further reference materials. Annex 1 reproduces often-cited treaty text, while Annex 2 provides a breakdown of the frameworks referred to in this report.

3 Themes and suggestions arising from the analysis

Following an examination of BU's main elements – and given the Commission's proposals – an analysis of the operational issues that arise underlines the fact that BU's final design will entail a number of carefully balanced trade-offs. Getting these trade-offs right will help to ensure that BU is effective and widely supported. So with a view of contributing to BU's design the key themes emerging from the analysis are reported together with possible suggestions for going forward.

Systemic risk/macro- micro-supervision

One of the key themes is the treatment of systemic risks and the choices that need to be made as to whether a bifurcated/two-tier approach to micro-prudential supervision is adopted (or rejected). In broad terms, under such an approach, the supervision of cross-border and/or Systemically Important Financial Institutions or Banks (SIFIs/SIBs) would be the responsibility of a

centralised EU-level body, with national authorities retaining supervisory responsibilities for all other financial firms in the euro area. Owing to concerns about the risks presented by small banks, the Commission's proposals rejects a two-tier approach and puts the prudential supervision of all euro-area banks under the European Central Bank (ECB).

Nevertheless the proposed Single Supervisory Mechanism (SSM) includes both the ECB and the national supervisory authorities, and these authorities will retain a significant role for many areas of the prudential supervisory process. So in practice, the SSM may be a hybrid of a bifurcated/two-tier system – one that features an extra layer of protection provided by the ECB's right to take over active supervision at any time, but without the cover of national supervisors being held responsible for their role in prudential supervision. This could introduce moral hazard issues and further consideration will need to be given as to how roles and responsibilities align.

Given that BU is a multidimensional framework, it is important to clearly elaborate how macro-prudential risks are to be managed and to consider the opportunities this dimension might present for the design of BU and the safeguards it might introduce in relation to a powerful micro-prudential supervisor with scope to impose countercyclical buffer rates and other macro-prudential measures. As it currently stands, the Commission's proposals do not provide a detailed discussion of the ECB's proposed supervisory responsibilities in relation to the current responsibilities of the European Systemic Risk Board (ESRB) for monitoring and assessing systemic risks and providing recommendations for remedial action in response to these risks. Perhaps, they also overlook the role that the ESRB and European Supervisory Authorities (ESAs) can play in identifying sources of financial instability not only associated with smaller yet connected firms, but also with those that may not be prudential in origin.

Financial stability/crisis prevention/crisis management and resolution

At the core of BU's design are the concepts of financial stability and the roles that supervisory authorities play in both crisis prevention and crisis management and resolution, so these ideas need to be fully discussed and developed. Moreover, unlike price stability or balanced economic growth, financial stability is not enshrined in the Treaty on European Union (TEU).

Supervision

In order for BU to deliver improved supervision, the work should not end with the Commission's plans for a single supervisory handbook to complement the single rule book and promote coherent and convergent supervision across the single market. Further work will need to be done on how supervision, whether at the Member State or EU level, can become more effective, with a view to perhaps incorporating the work of the Financial Stability Board (FSB) in

this area³ and promoting the implementation of bank standards focused on personal integrity, internal risk governance, and corporate governance.⁴

Growth

While BU needs to create an institutional and behavioural framework that can address sources of financial instability within the eurozone, it also needs to support sustainable growth. These two goals should be complementary, but an overly aggressive approach to the former could undermine the latter. So the determination of which financial services firms should be in scope of BU needs to safeguard sources of funding and credit that banks and investment firms cannot provide, but are particularly important for small- and medium-sized businesses.

Look for ways to include democratic processes

As it looks likely that the first phase of the BU process will rely on a treaty provision that denies the EU Parliament any significant role in the establishment of a centralised micro-prudential supervisor, it is probable that the Parliament will look to insert the democratic process through leveraging its responsibilities for legislation most associated with BU – the RRD and CRR/CRD 4⁵ – or perhaps via any proposed amendments to the regulations governing the EBA that would be voted on by the Parliament.

Technical issues

As the design for BU unfolds, the focus will turn to technical issues. The Commission's proposals anticipate this by including details concerning the licensing of firms, passporting arrangements, and the treatment of third country banks establishing branches or providing cross-border services. Although not examined closely for the purposes of this report, each of these will initiate a series of specific and specialised discussions that could become detached from the broader question of BU and what it needs to deliver. So the outcomes of these types of technical discussions will need to be checked to ensure they do not go against the grain of BU's final design.

³ The FSB's publications on this question can be found at http://www.financialstabilityboard.org/list/fsb_publications/tid_147/index.htm. The Association for Financial Markets in Europe (AFME) has also looked at this issue – see Annex 1 of AFME's 2010 *Prevention and Cure: Securing Financial Stability after the Crisis* which explores the question of enhanced supervision and what it may entail in practice.

⁴ There are numerous examples of such standards. The Commission is expected to produce a corporate governance roadmap in the autumn of 2012 and in September 2011 EBA published *Guidelines on Internal Governance* – [http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2011/EBA-BS-2011-116-final-\(EBA-Guidelines-on-Internal-Governance\)-\(2\)_1.pdf](http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2011/EBA-BS-2011-116-final-(EBA-Guidelines-on-Internal-Governance)-(2)_1.pdf)

⁵ The Recovery and Resolution Directive and the Capital Requirements Regulation/Capital Requirements Directive.

4 Conclusions

The analysis of the central elements of BU's design – given the various EU institutional/regulatory/market frameworks – yields a number of operational issues and highlights possible routes that BU's design could take. The package of documents issued by the Commission in connection with its proposals on 12 September 2012 informs this report, but has not dictated the shape of the analysis, as BU may still take a number of twists and turns.

The Commission's package included two proposals: proposed amendments to the regulation establishing the EBA (COM (2012) 512 final) and a regulation conferring specific tasks on the ECB (COM (2012) 511 final). Also issued was *A Roadmap towards a Banking Union* (COM (2012) 510 final) and a very helpful frequently asked questions (FAQ) document (no reference number given). All four documents are referenced in the following conclusions.

4.1 The Treaties

4.1.1 *The financial stability objective*

- At the heart of prudential supervision is the concept of financial stability, whether it is in the context of micro-prudential supervision (the safety and soundness of individual firms) or macro-prudential supervision (the health of the entire financial system in the face of risks building up in the system as a whole).
- Maintaining financial stability is also at the core of resolution, whether it be dealing with an individual firm or with a group of firms that present a risk to the financial system as a whole.
- Financial stability, however, does not appear to be equivalent to other core EU objectives such as growth or price stability.
- Consider that:
 - TEU⁶ 3 (3) clearly states the Union's goal is to establish an internal market based on a number of elements including balanced economic growth and price stability, but notably financial stability is not explicitly mentioned.
 - TFEU⁷ 127 (1) sets the objectives and tasks for the ESCB in terms of price stability (and not financial stability).
 - This is reconfirmed by Article 2 of Protocol (No.4) on the Statute governing the ESCB and ECB which clearly states that the ESCB's primary objective is to maintain price stability. It is without 'prejudice to the objective of price stability' that it shall support the general economic policies of the Union that contribute to the objectives of TEU 3 (3).
- Nevertheless, TFEU 127 (5) appears to be forward-looking and considers the ESCB's role in contributing to financial stability through the policies pursued by the relevant competent authorities.

⁶ The Treaty on European Union

⁷ The Treaty on the Functioning of the European Union

- However, with the establishment of the new ESFS, aimed at improving the regulation and supervision of financial institutions, perhaps it is unsurprising that the notion of financial stability is now being explicitly introduced and discussed as an idea as well as an objective. Indeed:
 - In the November 2010 legislative act – Regulation 1092/2010 – that establishes the ESRB, financial stability is discussed in Recitals 1 and 24 and Article 3. Under Recital 1, financial stability is cited as a precondition for the real economy to provide jobs, credit and growth. Then later, under Recital 24, it is stated that the ECB and National Central Banks (NCBs) have existing responsibilities in the area of financial stability (as well as expertise). Article 3 clearly states that the ESRB has an oversight role in prevention and mitigation of systemic risks to the financial stability of the Union, so as to avoid periods of widespread financial distress.
 - In Article 2 of each piece of legislation establishing the three new European Supervisory Authorities (ESAs), the ESAs are tied to the objective of the ESFS which is to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability, and to ensure confidence in the system as a whole.
 - Article 1 (5) of the legislation establishing the ESA responsible for Banking – the European Banking Authority (EBA) – states that its objective is defined as protecting the public interest by contributing to short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses.
- Financial stability is also an overriding objective of the proposed RRD which is designed to allow ailing institutions of any size and type to fail without risk to financial stability, while avoiding costs to taxpayers.
- Financial stability is also a cornerstone of the Commission's September proposals. The ECB's experience with financial stability issues is one motivation behind the proposal to put it at the centre of the SSM (Recital 11, COM (2012) 511 final).

Operational concerns

- The delivery of financial stability under the proposed SSM, or by any prudential supervisor (micro or macro), or indeed by any resolution authority, may be hindered by the lack of explicit equivalence for financial stability in the TEU and TFEU with core EU objectives, such as growth or price stability.
- If the parameters of financial stability are not well defined and enshrined in the treaties, an important limit on the ECB's mandate, under the proposed SSM, they may not be fully appreciated and may potentially be underutilised.

4.2 Single rule book

4.2.1 Achieving a 'single rule book'

- The single rule book has been identified as a basic building block of BU, but even its contours have yet to be fully agreed. In particular, there are ongoing discussions regarding how the inflexibility that a single rule book implies can be married to the deployment of (mostly) micro-prudential tools for macro-prudential purposes.
- The single rule book is generally described as the goal of developing and implementing a set of harmonised rules across the EU. In many instances these rules will take the form of detailed technical regulations which will be developed by the ESAs and which will bypass the EU Parliamentary and Member State rule-making processes. The price of harmonisation, with all its advantages, will be a loss of flexibility at the national level to modify these rules, for example on aggregate capital levels or liquidity buffer requirements, to address national-level macroeconomic or sector-specific concerns.⁸
- There is a risk that progress on BU could be undermined if a consensus is not reached on the degree of 'constrained discretion' (i.e. flexibility at the Member State level - across the single market - to adjust these rules) that might be appropriate, and the safeguards that might be needed to ensure that this discretion is contained within agreed parameters.
- The Commission's proposal (COM (2012) 512), which amends the regulation governing the EBA, preserves the EBA's role with respect to the single rule book and confirms its development for all EU Member States. It also clarifies that in relation to the EBA, the ECB is a competent authority, so that the ECB is included in all the articles relating to competent authorities under Regulation 1093/2010 which establishes the EBA.
- Nevertheless, the Commission proposal establishing the SSM (COM (2012) 511 final), also gives the ECB the power to impose capital buffers including countercyclical buffers for other macro-prudential measures (Article 4 (1) (e)), and clarifies (under Recital 26), that the ECB can exercise powers to adopt regulation where (i) there is none to deal with certain aspects necessary for the proper exercise of the ECB's tasks, or (ii) the regulation in place does not deal with them in sufficient detail.

⁸ On 29 March 2012, Mario Draghi, in his capacity as chair of the ESRB, outlined that macro-prudential authorities at the Member State and Union level need discretion to require additional disclosures and to temporarily tighten a diverse range of Pillar 1 calibrations for broad requirements such as aggregate capital levels, liquidity requirements and limits to large exposures and to leverage, and for more targeted requirements such as sectoral capital requirements to address specific vulnerabilities (e.g. households, corporate, real estate, intra-financial system) across different parts of banks' balance sheets in order to limit arbitrage. He also noted that the ESRB is working to develop additional macro-prudential tools; and in the case where these are also used for micro-prudential purposes, on ways to ensure consistency. The letter, *Principles for the development of a macro-prudential framework in the EU in the context of the capital requirements legislation*, containing these comments is available at http://www.esrb.europa.eu/pub/pdf/2012-03-29_CRR-CRD_letter.pdf?dafdc180851e9f99b38d4678f4cc5c74

Operational concerns

- A conservative vision of the single rule book, that disallows any flexibility in the national implementation of micro-prudential measures, undermines its use as an effective building block for BU from a macro-prudential perspective.
- Even if ECB powers in relation to macro-prudential measures help to accommodate a more flexible vision of the rule book (i.e. a central authority is deploying these measures rather than national authorities that may be struggling with competing agendas), it is not clear how these powers marry with EBA rule-making.
- Similarly, if the ECB uses its powers to adopt regulation where Union acts (based on drafts developed by the EBA) leave gaps in respect of the ECB's new responsibilities, this could introduce a rule book for Member States participating in the SSM that departs from that applying to Member States outside of the SSM.

Operational benefits

- A single rule book would reduce compliance costs for all cross-border financial services firms operating in the EU and would likely produce a more coordinated supervisory approach.

4.2.2 The form versus style of supervision

- To date, BU has focused on the elements and potential architecture of BU, rather than considering how supervision needs to change to be more effective. Given that BU is in its very early stages, this is probably unsurprising but the issue will need to be addressed to help strengthen market confidence.
- As part of the ESFS, the ESAs have responsibility for fostering convergent supervisory practices across the EU and promoting a coherent functioning of EU supervisory colleges. As summarised by Andrea Enria, this approach reflects the idea that 'it is possible to drive supervision to persistent outcomes while leaving ample flexibility in terms of national processes', although it is an approach that he now questions.⁹
- Enria has suggested that one answer may be a 'Single Guidebook for supervisors – a manual that defines common procedures and processes for examiners.'¹⁰ It appears that the EU Commission has responded to his suggestion with plans for a 'single supervisory handbook' included in the Commission's roadmap for BU. The proposed single supervisory handbook is to complement the single rule book and cut short any opportunities for regulatory arbitrage that might occur with dissimilar regulatory approaches between the euro area and the rest of the EU.

⁹ Speech by Andrea Enria, Chair of the EBA, 5 December 2011, *Banking Supervision: towards an EU Single Rulebook* – <http://www.eba.europa.eu/cebs/media/aboutus/Speeches/Belgian-Financial-Forum-Banking-Supervision---Towards-an-EU-Single-Rulebook---Brussels-5-Dec-2011.pdf>

¹⁰ In his 5 December 2011 speech, Mr Enria pointed to work in the US by the Federal Financial Institutions Examination Council (FFIEC) in the creation of a manual that defines common procedures and training for examiners.

- Even a renewed focus on how to support the convergence of supervisory practices could miss the question of the style of supervision which, whether at the Member State or EU level, has become inextricably linked with improving the culture within financial services firms. As highlighted by the UK's FSA experience, rules matter but it is the style of supervision that can make the difference.¹¹

Operational concerns

- If BU does not consider how the style of supervision needs to change to become more effective, the result could actually be a very detailed single rule book accompanied by a single supervisory handbook and complicated architecture that simply fail to deliver the required standard of supervision.

4.3 Scope

4.3.1 Banks versus other financial services firms

- BU could potentially apply to a very wide range of EU investment firms as well as EU credit institutions.
 - Article TFEU 127 (6), which allows the EU Council to confer tasks upon the ECB relating to prudential supervision, only excludes insurance undertakings (from the credit and investment firms that fall within the Article's scope).
 - The primary EU legislation setting out the micro-prudential rules for EU credit institutions – the Capital Requirements Directive (CRD) (2006/48/EC) – also already applies to a wide range of investment firms including many of those within the scope of the Markets in Financial Instruments Directive (MiFID).¹²
 - The Commission proposal (COM (2012) 511 final) applies, where specified, to credit institutions and financial holding companies as defined under the CRD, and mixed financial holding companies and financial conglomerates as defined under the financial conglomerates directive (2002/87/EC) and set out in the definitions contained under Article 2 of the proposal. Under Article 9, ECB's requests for information can apply to persons involved in the activities of these entities or closely and substantially related or connected to the activities of these entities.
- So if BU is applied broadly, a key issue for many financial services firms will be its application to various segments of the sector particularly in light of:
 - The EU Commission's current examination of shadow banking.

¹¹ As highlighted in the 12 December 2011 FSA press release on the publication of the report on *The Failure of the Royal Bank of Scotland* – <http://www.fsa.gov.uk/library/communication/pr/2011/110.shtml>

¹² MiFID firms are brought into the scope of the MiFID via Annex IV of the CRD (2006/48/EC), which in its identification of derivative transactions includes a cross reference to the MiFID (2004/39/EC) Annex I which lists the services and activities in scope of the MiFID.

- The Liikanen Review on structural aspects of the banking sector.¹³

Operational concerns

- With regard to shadow banking, there is a need to balance the 'same business, same risk, so same rules must apply' view with the need to ensure a place for firms that can provide financial services to the economy that banks and other investment firms cannot. Also, as part of that, the extent to which small banks should be distinguished ought to be given consideration as well.
- If the Liikanen Review recommends, like Vickers did in the UK,¹⁴ a ring fence around retail banking, then consideration will need to be given to how BU is applied to firms within and outside of that ring fence.

4.3.2 Systemic firms

- The EU does not have a specific regulatory initiative aimed at EU Systemically Important Financial Institutions (SIFIs).¹⁵ However, it is expected to adopt the recommendations of the Financial Stability Board (FSB) on SIFIs and the upcoming standards on Globally Systemically Important Banks (G-SIBs) from the Basel Committee on Banking Supervision (BCBS), and implement them through amendments to the CRR/CRD 4.¹⁶
- Given that the impetus for BU has been motivated, in part, by the need to better supervise SIFIs/SIBs, a bifurcated/two-tier approach to BU is being discussed.¹⁷ Under such an approach, only large multi-jurisdictional institutions would be subject to centralised (micro-prudential) supervision and, perhaps, subject to a centralised resolution authority.
- The Commission proposal (COM (2012) 511 final) rejects the notion of a two-tier regime. Under Recital 13, it recognises that the safety and soundness of large banks is essential to ensure the stability of the financial system but also points to the experience with small banks.
- As such, under its transitional arrangements, as outlined under Article 27 of the proposal (COM (2012) 511 final) and the BU roadmap (COM (2012) 510 final), from the first day of the SSM's establishment the ECB will be empowered to take over the supervision of any firm in scope of the regulation if it so decides, particularly if it is receiving public support. On the first day (1 July 2013 has been proposed) significant European

¹³ References to the shadow banking and Liikanen reviews are contained in Annex 2.

¹⁴ For more on the UK Independent Commission on Banking (Vickers), see <http://bankingcommission.independent.gov.uk/>

¹⁵ This is in sharp contrast to the US where, under the Dodd-Frank Act, a Financial Stability Oversight Council (FSOC) has been established with responsibilities for identifying and designating financial firms as systemically important.

¹⁶ CRR/CRD 4 refers to the new capital requirements package which updates the current CRD for the new Basel III capital and liquidity standards. The CRR/CRD 4 is still going through the EU legislative process but was proposed by the EU Commission before the FSB and BCBS work had been completed.

¹⁷ Deutsche Bank (DB Research), EU Monitor, *EU Banking Union: Do it right, not hastily!* (23 July 2012) – http://www.dbresearch.de/PROD/DBR_INTERNET_EN-PROD/PROD000000000291512/EU+Banking+Union%3A+Do+it+right,+not+hastily!.pdf

Systemically Important Banks (E-SIBs)¹⁸ will come under ECB supervision and all other firms in scope will follow in a relatively short space of time (it has been proposed that the transition period end on 1 January 2014).

Operational concerns

- A bifurcated approach to micro-prudential supervision or resolution requires:
 - That the EU develops criteria to define what an E-SIB or even E-SIFI might be.
 - Safeguards to ensure that any risks that are not the focus of the centralised or Member State supervisor/authority do not go unreported.
 - Mechanisms to address any regulatory arbitrage that might arise or unforeseen divergences in single market supervisory regimes and multi-jurisdictional regimes.
 - Mechanisms to define which firms are to be supervised centrally (e.g. cross-border and/or systemically important) and which are to be supervised locally.
- The Commission proposal, with its transitional arrangements whereby E-SIBs will be among the first set of firms to be supervised by the ECB, does not avoid the challenge of needing to develop and implement criteria for what an E-SIB might be. In fact, the transitional arrangements (Article 27 of COM (2012) 511 final) already suggest a criteria.

Operational advantages

- A bifurcated approach would provide an alternative to and/or reduce the complexity associated with EU supervisory colleges.

4.3.3 Which Member States

- A key question of scope, and the one generating much discussion, is the application of BU to eurozone versus non-eurozone Member States and whether some elements of BU can be applied to all, while other elements can be applied to a smaller group.
- The EU Commission's 12 September 2012 proposals are based on the understanding that:
 - While a single rule book applying to all Member States will support the reintegration and the functioning of the single market, it does not automatically imply that a single micro-prudential supervisor is necessary for all 27 Member States that are signatories to the rule book.

¹⁸ E-SIBs include any credit institutions, financial holding companies and mixed financial holding companies in scope of the proposed Regulation.

- The centralisation of prudential supervisory responsibilities (to some degree) is a key condition for the establishment of a backstop (in the form of the ESM) for the 17 Member States that have adopted the euro as their currency and the banks that these states have licensed and supervised.
- The yet to be proposed centralised resolution mechanism would complement the SSM, and is therefore likely to be considered with reference to eurozone credit institutions (and other firms in scope of the proposed Regulation).

Operational concerns

- With some elements of BU squarely targeted at eurozone Member States, there is a risk that the concerns of the remaining members of the single market may get overlooked, although all members will be affected by:
 - The single rule book.
 - The interaction of the new centralised supervisory authority with other EU authorities and institutions.
 - Modifications to the working arrangements of existing institutions.

Operational advantages

- Defining the supervisory element of BU in terms of the eurozone only, as reflected by the Commission's proposals, is politically more feasible, and should provide a quicker route to achieving it.

4.4 Building blocks of integrated prudential framework

- The institutions making up the current, but still very new and untested European System of Financial Supervisors (ESFS) – which includes the European Systemic Risk Board (ESRB)¹⁹ and the three European Supervisory Authorities (ESAs) – combined with the European System of Central Banks (ESCB), present the basic building blocks for an integrated prudential supervisory mechanism that has both a macro and micro dimension.
- Some of the modifications that could be undertaken to create an integrated prudential supervisor mechanism would be more fundamental than others so it is important to outline the nature of these building blocks, and to highlight some of these potential changes and their operational implications.
- The Commission's 12 September 2012 proposals leverage both the ESFS and the ESCB, but perhaps in unexpected ways or without a full discussion of all the possible opportunities these building blocks present.

¹⁹ Established under Regulation (EU) No 1092/2010 – the relevant URL is provided in Annex 2.

4.4.1 Bifurcated/two-tier macro-prudential system

- The ESFS potentially provides the basic outlines for a two-tier macro-prudential supervisory structure composed of a centralised EU-level body that is responsible for systemic risks across the system as a whole, in the form of the ESRB, and market/sector-level bodies, that are responsible for the build-up of systemic risks in their respective sectors, perhaps in the form of the three ESAs: European Banking Authority (EBA), European Securities and Markets Association (ESMA), and European Insurance and Occupational Pensions Authority (EIOPA).²⁰
- Shifting this current structure from one where the ESRB has an oversight role – its three main tasks being to monitor and assess systemic risk, provide early warnings when significant risks emerge, and to issue recommendations for remedial actions and monitor their implementation – to one where it has powers to intervene and potentially supervise, is a question of degree, but could involve, for example, giving the ESRB:
 - i. A coordination role in the design and use of macro-prudential tools, used at a national level to develop macro-prudential policies.²¹
 - ii. Powers similar to those envisaged for the UK's Financial Policy Committee (FPC), such that their recommendations would be binding on the bodies to whom they were directed, and they would also have a mandate to develop macro-prudential tools or deploy tools that are readily available (e.g. capital buffer requirements or leverage ratio) to achieve a macro-prudential goal.
 - iii. Powers to intervene when systemic risks, with the potential for undermining EU stability, are identified at the national level.
- Increased powers for the ESRB could also mean increased powers for the ESAs, which already provide data/information to the ESRB in relation to its tasks. Under an alternate model to BU, for example, binding ESRB recommendations could require that the ESAs have the authority to implement ESRB measures (either via national supervisors or directly) rather than (as is currently the case) follow-up on the ESRB recommendations within the limited scope of their mandates, leaving the supervision of individual firms to national supervisors.
- Under Article 4.1 (a) of (COM (2012) 511), the Commission gives the ECB power to 'impose capital buffers ... including countercyclical buffer rates and any other measures aimed at addressing systemic risk or macro-prudential risks'. It does not discuss how the ECB's relationship with the ESRB (or the ESAs) may evolve in the determination of such rates. In part, this may be a consequence of the ESRB's relationship with the ECB. Namely:

²⁰ Respectively established under Regulation (EU) No 1093/2010, Regulation (EU) No 1095/2010 and Regulation No 1093/2010 – URLs to these regulations can be found in Annex 2.

²¹ As suggested in Deutsche Bank (DB Research), EU Monitor 84, *Financial supervision in the EU* – http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000276501.PDF

- The President of the ECB is to chair the ESRB for the first five years of the ESRB's institutional life.
- The ECB President and Vice-President have seats on the ESRB's general board.
- The ECB is responsible for providing the ESRB with a secretariat and thereby analytic, statistical and administrative support.²²

Operational concerns

- In terms of the Commission's proposals there is a need for:
 - Further clarity as to the relationship between the empowered ECB and the EU institutions currently responsible for monitoring, assessing and providing recommendations on macro-prudential policy.
 - Consideration of how the ESRB and ESAs might act as a counterbalance on the ECB in its supervisory capacity.
- ESRB's mission and objectives are currently defined in terms of the Union, not the Eurosystem, so its mission statement would need to be revisited to differentiate between its activities in relation to the Union and its activities in relation to safeguarding the eurozone.
- Greater centralisation of macro-prudential policy will impinge further on the independence of the Member States affected by this centralisation.

Operational advantages

- A cohesive approach to deployment of macro-prudential policy tools could increase market confidence in EU markets and financial services firms.
- An empowered ESRB, even in a coordination role, could help to limit competitive distortions (such as differences in Loan-to-value (LTV) ratios) at the Member State level.
- Empowering the ESRB, or indeed proportionally empowering all the institutions of the ESFS, would, in a macro-prudential context, help to ensure that systemic risks that might be non-prudential in origin (e.g. arising from market abuse) would not be overlooked. This could be particularly important in light of the Commission proposal (COM (2012) 511) which leaves responsibilities for non-prudential tasks with national authorities, as these tasks cannot be conferred on the ECB under TFEU 127 (6). Tasks not assigned to the ECB include consumer protection, money laundering, and the supervision of third country credit institutions

²² Perhaps, most notably, Council Regulation No 1096/2010 was created on the basis of TFEU Article 127 (6) to confer specific tasks on the ECB with respect to the ESRB. ESRB was established under Regulation (EU) No 1092/2010 which sets out wider governance arrangements (for URLs to both these documents see Annex 2 of this document). Notably Article 20 of Regulation (EU) No 1092/2010 states that in 2013 the EU Commission will prepare a report for the European Parliament and Council on the ESRB that will assist in their review of the modalities for the designation or election of the Chair of the ESRB. The outcome of this review will determine how the Chair of the ESRB will be designated for subsequent terms.

establishing branches or providing cross-border services within a Member State.²³

- The legal basis for the ESRB and the ESAs has already been established on the basis of TFEU Article 114, so the treaties would not need to be revisited although the regulations establishing these bodies would.

4.4.2 Bifurcated/two-tier micro-prudential system

- The ESCB potentially provides the basic outline for a two-tier micro-prudential supervisory structure with a centralised EU-level body for selected supervisory tasks – such as perhaps the supervision of cross-border and/or systemically important firms – and the NCBs which, along with the ECB under TFEU Article 127 (5), already have responsibility for contributing to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.
- The apparent treaty basis for conferring the ECB with supervisory tasks is TFEU 127 (6) whereby: 'The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.'
- TFEU 127 (5) and (6) do appear to fit most easily with a bifurcated system, but that does not exclude the alternative of a single centralised supervisor with a responsibility for all banks or indeed a bifurcated system as a building block towards such a system. It also allows for the case when competent authorities are not NCBs.
- Although 127 (5) is written in terms of the ESCB, TFEU 282 (1) also refers to the Eurosystem – the ECB and NCBs of the eurozone – a subset of the ESCB.
- The Commission proposal (COM (2012) 511) makes full use of TFEU 127 (6) and appears to be informed by 127 (5):
 - From 1 July 2013 the ECB will be empowered to take over the prudential supervision of the E-SIBs and, if it so decides, any of the financial firms in scope of the proposed Regulation. By 1 January 2014 any remaining firms in scope of the proposed Regulation will come under the ECB's remit.
 - The proposed SSM is clearly a mechanism composed of the ECB and national authorities where, according to the Commission's 12 September 2012 BU FAQs, most day-to-day verifications and other supervisory activities necessary to prepare and implement the ECB's prudential acts could be exercised by national supervisors operating as part of the SSM.

²³ A Roadmap towards a Banking Union (COM (2012) 510).

- The Commission's BU FAQs also provide three separate examples – relating to bank authorisations, day-to-day assessments, and internal risk models – that illustrate how the ECB might relate to, and interact with, the national authorities and the degree to which the national authorities would continue to have a significant role for large segments of the supervisory process.
- The enlarged mandate of the ECB introduces the need for safeguards in the form of organisational principles as set out in (COM (2012) 511 final). These include (but are not limited to):
 - The separation of the ECB's supervisory function from its monetary function.
 - Its accountability to the European Parliament and Council supported by annual reporting to the European Parliament, the Council, the Commission and the Eurogroup.
 - An obligation to respond to questions from the European Parliament or Eurogroup²⁴ either orally or in writing.
 - The creation of an internally distinct supervisory board whose Chair is elected by members of the Governing Council – the body with final responsibility for the ECB's actions.
 - The appointment of the President and Vice-President of the Governing Council by the European Council after consultation with the European Parliament.²⁵

Operational concerns

- Whether TFEU 127 (6) provides sufficient basis for BU may yet be challenged. Its scope of application relies on the phrase 'policies relating to prudential supervision'.
- As already noted TFEU 127 (5) does not, however, anticipate how the ESCB's objectives concerning price stability might be balanced with an expansion of the ECB's tasks. So even if 127 (5) and (6) are considered sufficient and there was a view that only the Protocol on the Statute governing the ESCB and ECB²⁶ needed to be revisited, Article 2 of that Statute clearly states that the ESCB's primary objective is to maintain price stability. So again, if the ECB took on a more enhanced role, its objective set and that of the Eurosystem, if not the ESCB, would need to be revisited.
- Deployment of Article 127 (6) raises concerns about the democratic processes associated with BU – the European Parliament will only be consulted on the expansion of the ECB's mandate and does not have powers of co-decision under the Article.

²⁴ The Eurogroup refers to the finance ministers from the EU Member States that have adopted the euro as their currency.

²⁵ As highlighted in 12 September 2012 EU Commission BU FAQs.

²⁶ Protocol (No 4) of the Statute of the European System of Central Banks and of the European Central Bank, in the Protocols accompanying the consolidated TEU and TFEU – <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0201:0328:EN:PDF>

- The ECB is already a powerful organisation, so the sufficiency of safeguards aimed at ensuring it is independent but democratically accountable will need to be fully debated as will the checks and balances governing the division of the ECB's tasks internally and its relationship to other bodies in the EU.
- Despite the Commission's rejection of the notion that the ECB be responsible only for the prudential supervision of E-SIFIs/SIBs, in practice, the SSM may be a hybrid of a bifurcated/two-tier system, featuring an extra layer of protection provided by the ECB's right to take over active supervision at any time, but without the benefits associated with national supervisors being held responsible for their role in prudential supervision. This could introduce moral hazard issues.

4.5 Building an integrated EU resolution framework

- The building blocks for an integrated approach to crisis management and resolution are not as evolved as they are for crisis prevention (i.e. integrated prudential micro- and macro-supervision). Each Member State has its own legal framework and cultural approach to dealing with firms which are no longer viable or do not look to be viable in the longer term. Consequently, arriving at a common view, let alone the details, of an integrated framework with a centralised resolution authority will be a challenge.
- The Commission's roadmap on BU indicates that it envisages making a proposal for a single resolution mechanism that would complement the SSM. So it is important to consider what a new resolution framework might include by identifying the building blocks that are available against what is required, and the operational issues they entail.

4.5.1 RRD founding principles

- The proposed Recovery and Resolution Directive (RRD), although decentralised to Member State level in approach, details many of the key elements that are likely to form the basis of an integrated EU resolution framework, regardless of its final form. These include:
 - The underlying principles on which resolution is to be based.
 - The requirements for recovery and resolution planning.
 - The principles determining the relationship between the Member State supervisory and resolution authorities and their relationship to the regulatory authority.
 - Identification of the key resolution tools and their relationship to each other.
- The RRD requirement that each Member State establish a resolution authority that is independent from the supervisory authority,²⁷ is aligned

²⁷ Under the proposed RRD, the resolution authority designated by the Member State to act in accordance with the Directive may also be the same competent authorities as under the CRD, if there is a clear separation of resolution and supervisory functions.

to the existing UK approach – although this is now subject to significant revision with the passage of the Financial Services Bill through the UK Parliament – and to the German framework where responsibilities for supervision and resolution reside with two distinct authorities.²⁸ The US has the Federal Deposit Insurance Corporation (FDIC), which is also an independent authority responsible for resolution, although it does supervise a number of small banks for operational safety and soundness.

Operational concerns

- RRD has only started its legislative journey, so it is possible that these key elements may change and perhaps take a direction that does not align with efforts to design a more integrated resolution framework. However, the Commission appears to be mitigating this risk with its indication that (i) a proposal for a single resolution mechanism would follow once there is agreement on the existing Deposit Guarantee Schemes (DGS) and RRD proposals and (ii) both the DGS and RRD proposals should be accelerated and adopted by the end of 2012.²⁹

4.5.2 A centralised resolution fund and the national fund network

- A central element of the EU resolution framework, envisaged in Herman Van Rompuy's report, is a European resolution scheme/fund. Such a fund would typically be used:
 - i. To pay out funds to creditors if it is found that they received less in economic terms than if the institution had been liquidated (the 'no creditor worse off' principle).
 - ii. To finance operational costs of resolution.
 - iii. To minimise taxpayer exposure to losses from solvency support (to say a bridge bank).
- The RRD is based on the premise of home country supervision, so instead of a centralised fund it proposes a European System of Financing Arrangements (ESFA) based on the establishment of resolution funds at the national level that allows for borrowings between national arrangements and mutualisation of financing arrangements in the case of a group resolution.
- The RRD specifies how national funds should be funded and to what levels, but not which national authority should manage these funds, despite specifying that Member States designate a resolution authority. In contrast, the plan for BU does not suggest financing arrangements, but does suggest that a common resolution authority control the fund.
- The Commission's roadmap for BU does not go as far as to discuss a European resolution fund, but it does signal that a single resolution mechanism could also be entrusted with further tasks of coordination with regard to the management of crisis situations and resolution tools.

²⁸ BaFin is responsible for supervision and the FMSA is responsible for resolution.

²⁹ 12 September 2012 EU Commission FAQs on BU.

Operational concerns

- A pan-European resolution framework will need to reconcile the funding requirements of a central fund with national resolution funds, particularly in a bifurcated/two-tier supervisory system where some firms might balk at paying into multiple funds (thereby resulting in funding shortfalls).
- The decisions concerning the establishment of the new centralised authority and its relationship to other EU institutions may also determine how national funds are managed.

4.5.3 A European deposit insurance scheme and the proposed DGS

- The proposed Deposit Guarantee Schemes (DGS) directive has been difficult to produce and is aimed at harmonising and simplifying protected deposits schemes, ensuring a faster payout and improving the financing of national schemes.
- We have no knowledge of the shape or form of the envisaged European deposit insurance scheme, but as highlighted by some commentators, deposit guarantee schemes are of 'limited relevance' in the context of large cross-border failures, where assets like deposits are normally transferred to the good 'bridge bank'.³⁰
- Then there is the outcome of the Liikanen Review to consider and the potential for retail banks to be ring-fenced, with such schemes potentially only applying within the ring fence.
- The Commission's roadmap for BU provides no further comment on a European deposit insurance scheme, but as indicated above, in the FAQs on BU the Commission has indicated that the DGS proposal should be accelerated and adopted by the end of 2012.

Operational concerns

- The Commission's wish for the passage of the proposed DGS directive to be accelerated is dependent on legislative and democratic processes.
- There is a need to ensure that European deposit schemes fit the characteristics of the marketplace they operate in and acknowledge the national schemes that are already in place, so perhaps suggestions to complement national schemes with a European reinsurance scheme (which could back up the national schemes)³¹ should be actively considered.
- Need to address how national schemes would be funded if a central deposit scheme was established.

³⁰ Deutsche Bank (DB Research), EU Monitor, *EU Banking Union: Do it right, not hastily!* (23 July 2012) – http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000291512/EU+Banking+Union%3A+Do+it+right%2C+not+hastily%21.pdf;jsessionid=F9C2CF3E2FD13BF37816A0F7E9C4DE8B.srv-loc-dbr-com

³¹ Deutsche Bank (DB Research), EU Monitor, *EU Banking Union: Do it right, not hastily!* (23 July 2012) – http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000291512/EU+Banking+Union%3A+Do+it+right%2C+not+hastily%21.pdf;jsessionid=F9C2CF3E2FD13BF37816A0F7E9C4DE8B.srv-loc-dbr-com

4.5.4 Common insolvency regime

- A common resolution authority requires a common legal framework for dealing with the insolvency of credit and other financial institutions.
- However, the EU currently lacks such a framework. The current EU Bank Winding-Up Directive (WUD) applies only to EU credit institutions with branches in other Member States, so it is limited in scope and does not address the issues particular to the reorganisation and winding-up of cross-border banking groups, let alone investment firms. The WUD is also based on home country principles – it assumes that national authorities will oversee the winding-up of a bank – so it would seem that the directive would need to be amended if BU requires that resolution be done centrally.
- Further work on issues relating to the winding-up of cross-border credit institutions was kicked-off in 2007 when the EU Commission launched a consultation on the WUD, but a proposal for a new or revised Directive has yet to be produced.

Operational concerns

- The feasibility of delivering a pan-European insolvency regime that aligns to the changes in responsibilities (for winding-up) and timeframes suggested by BU.
- The WUD is not discussed under either the roadmap for BU or the FAQs on BU.

4.5.5 Considerations in the determination of a centralised/common resolution authority

- At the core of a resolution authority's responsibilities are decisions on the distribution of burdens between shareholders, creditors, other financial participants and taxpayers (where their exposure to financial firms deemed 'too big to fail' has not been fully eliminated). This brings a political dimension to the role and is why responsibilities for banking supervision (which need to remain apolitical) are normally independent from the resolution authority.
- As already highlighted, various countries have approached this issue in different ways. But perhaps, most notably, in the UK, it is proposed that the Bank of England (BOE) has operational responsibilities for crisis management in addition to its responsibilities for monetary policy, macro-prudential supervision and its role in micro-prudential supervision through its subsidiary, the Prudential Regulation Authority (PRA). This model seeks to give significant powers to the central bank, and then seeks to create a series of internal checks and balances. So, in the UK case, in the context of financial crisis management, a check on the BOE's powers is the requirement that once there is a risk to public funds, regardless of the

amount, the Treasury must be notified and then it is the Chancellor and the Treasury that are involved in any decision involving public funds.³²

- Another motivation for ensuring that supervisory and resolution functions are independent is the potential conflict of interest issue that can arise. If these functions are one and the same, supervisors may be reluctant to take immediate action when faced with a failing firm since this would point to their own supervisory failures. UK regulatory reform, as envisaged under the Financial Services Bill introduced in January 2012, does not address this issue.

Operational concerns

- That when the centralised/common resolution authority is established, its objectives and role are well understood, and its independence safeguarded.
- That putting the ECB in charge of the common resolution authority would align the ECB's set-up to the BOE, an outcome that would require numerous safeguards.

4.6 European Stability Mechanism (ESM) and the ECB

- The yet to be established ESM will be a permanent institutional mechanism that, subject to specific conditions being met, will provide financial assistance to euro-area Member States where that assistance is needed to safeguard the euro.
 - Its establishment is subject to the ratification of the founding treaty by Member States representing 90% of its capital requirements³³ and is also conditional on the ratification of the amendment to TFEU Article 136 (3).³⁴
 - Unlike the European Financial Stability Facility (EFSF), which the ESM will replace, it will also have a substantial amount of 'paid in capital'. Moreover, because of its status as a permanent international organisation, loans from the ESM will be recorded as direct loans, so unlike the EFSF will not be routed through the national accounts of the eurozone countries providing the support and will not increase their debt levels.³⁵
- The ECB will be involved in the ESM's operations in the following ways:
 - It will liaise with the European Commission and the IMF to assess where there is a risk to the financial stability of the eurozone as a whole.

³² For high level details on UK regulatory reform and reference materials, see Annex 2.

³³ Statement by the Euro Area Heads of State or Government, European Council press release, 9 December 2011 – http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf

³⁴ The expected July 2012 ratification of the ESM has been delayed, most notably by developments in Germany. This has been widely reported in the press – see for example reports in Spiegel Online and the Irish Times – <http://www.spiegel.de/international/germany/german-high-court-requests-delay-in-esm-and-fiscal-pact-ratification-a-840295.html> and <http://www.irishtimes.com/newspaper/world/2012/0711/1224319791885.html>

³⁵ ECB Monthly Bulletin, July 2011, *The European Stability Mechanism* – http://www.ecb.int/pub/pdf/other/art2_mb201107en_pp71-84en.pdf

- ECB staff will provide technical advice to the negotiation of a macroeconomic adjustment programme and the monitoring activities of the ESM.
- The ECB president will be a member of the ESM's Board of Governors.
- It may also be used as a mechanism to directly capitalise eurozone banks, as part of the agreement on BU, *but only* if a centralised (and presumably micro-prudential) supervisor is established.
- The ESM's financial resources are such that there are limits to its ability to recapitalise banks, so the precedents set by the Spanish Memorandum of Understanding (MoU)³⁶ will become a key feature of BU, in terms of:
 - i. Setting the bank standard for restructuring – with respect to the bailing in of unsecured creditors up to and including unsecured bank debt holders³⁷ – with a view to eliminating, or at least reducing, the need for taxpayer support.
 - ii. Specifying that EFSF financial assistance once transferred to the ESM will not gain seniority status.

Operational concerns

- While the ECB undoubtedly has the technical expertise to support the ESM, this is another example of how its role might be expanded (and perhaps in practice its independence undermined) under BU.
- The possibility for Member States to use their own fiscal resources to bail-out banks will presumably remain subject to competition policy/state aid requirements.

5 Background

5.1 The economic drivers

While a common currency presents a number of advantages in facilitating the trade of goods and services and cross-border investment for its members and trading partners, for example the reduction of transaction costs, it also requires that the economies within the Union respond to economic challenges and support the creation of economic opportunities in a manner that ensures their fiscal health and productive capacities remain aligned. An absence of economic growth can reveal disparities in productivity and fiscal approaches and perhaps, depending on the severity of any economic downturn, limit the range of any number of policy options. This, combined with insufficient fiscal transfers between members of the Union, will put the sustainability of any currency union under stress, as its members (and the markets) try to evaluate the benefits of returning to/developing a national

³⁶ Under this MoU, in order to receive 100 billion euros in support from the EFSF and, eventually, the ESM, banks drawing on these resources would have to 'bail in' their unsecured creditors up to and including unsecured debt holders. For further details on the MoU – EFSF (2012), *Spain: Memorandum of Understanding on Financial-Sector Policy Conditionality, 20 July 2012* – see http://ec.europa.eu/economy_finance/eu/countries/pdf/mou_en.pdf

³⁷ Citi Research, Global Economics View, 2 August 2012, *Three unanticipated consequences of banking union* – <http://www.scribd.com/doc/102178706/CITI-BUITER-Three-Unanticipated-Consequences-of-Banking-Union>

currency that can be devalued to reflect and address misalignments and help support the competitiveness of states.

As concluded by the Bank for International Settlements (BIS)³⁸ the global economy has yet to overcome the legacies of the financial crisis that took hold in 2007 to achieve balanced and sustained growth and, in different ways, vicious circles are hindering this. In the case of the eurozone, the BIS and the IMF³⁹ have identified these specific feedback loops as being between sovereigns and their banks which, in turn, have encouraged financial de-integration as investors and counterparties lose confidence.

In some cases concerns about eurozone member banks' solvency are directly linked to their holdings of sovereign debt, in the face of concerns about the ability of the sovereign to meet its debt obligations. In other cases, governments are struggling with the fiscal risks arising from the contingent liabilities of weak banking sectors where sovereigns are being forced to act as a backstop to weak banks⁴⁰ to protect depositors. With depositor confidence at a low in the affected eurozone states and diverging perceptions of sovereign and banking risks (in a system where delivering financial stability remains a national concern), the IMF has tracked the movement of capital from the affected states to 'safer' eurozone states or abroad, and the increasing fragmentation of financial markets away from an area-wide system to national markets. According to the IMF, 'the sovereign bond and interbank markets have been most deeply affected by withdrawals of intra-euro-area cross-border capital flows.'

Recognising that private sector adjustments are also required, BU is widely viewed as a way for the eurozone to sever the feedback loops between sovereigns and banks, and to provide the necessary incentives to return to the financial integration that was occurring before the crisis. Indeed both the BIS and IMF have indicated that the centralisation of the lender of last resort functions and responsibility for financial stability would unify the eurozone's banking system. They also suggest that BU could operate within existing terms of the currency union, and that unifying fragmented banking rules would support the centralisation of responsibility with a common regulator, supervisor, deposit insurer and resolution authority.

5.2 Identifying BU

An analysis of BU for the purposes of identifying key operational issues requires some common understanding of its basic components. However, as BU is still in the design stages, it is important to identify its likely elements as well as other considerations that could influence its final shape and scope.

³⁸ BIS Annual Report 2011/2012 – <http://www.bis.org/publ/arpdf/ar2012e.pdf>

³⁹ BIS Annual Report 2011/2012 – <http://www.bis.org/publ/arpdf/ar2012e.pdf>, IMF Country Report No. 12/181, 2012 Article IV Consultation (July 2012a) – <http://www.imf.org/external/pubs/ft/scr/2012/cr12181.pdf>, IMF Country Report No. 12/182, Euro Area Policies: 2012 Article IV Consultation – Selected Issues Paper (July 2012b) – <http://www.imf.org/external/pubs/ft/scr/2012/cr12182.pdf>

⁴⁰ These banks might be large 'systemic' banks or groups of smaller banks, for example, like the Spanish savings banks (or *cajas*).

5.2.1 Known elements of BU

As a means to break 'the vicious circle between banks and sovereigns', a eurozone BU was agreed in principle at the euro-area summit on 29 June 2012. The summit statement together with the pre-summit report presented by Herman Van Rompuy, the President of the EU Council, *Towards a Genuine Economic and Monetary Union*, and the EU Council's published statement at the conclusion of the summit⁴¹ set out a vision of BU that included at least six distinct elements:

1. A European single rule book.
2. A prudential supervisory mechanism that:
 - o Is focused on crisis prevention.
 - o Integrates supervision at the European and national levels dimensions.
3. A resolution authority that:
 - o Is focused on crisis management and resolution.
 - o That has both European and national dimensions.
 - o Is part of a European resolution framework.
4. A European resolution fund that is part of a European resolution framework and further fortified by a fiscal backstop.
5. A European deposit insurance scheme that is also perhaps fortified by a fiscal backstop.
6. A fiscal backstop such as ESM.

The summit statement included key details concerning elements of the BU decision. Firstly, that the establishment of an 'effective single supervisory mechanism' would involve the ECB on the basis of the Treaty on the Functioning of the European Union (TFEU), Article 127 (6).⁴² The statement also made clear that another element of BU, the yet to be ratified European Stability Mechanism (ESM)⁴³ – a backstop for Member States of the euro area – could possibly recapitalise euro-area banks directly, although this would be conditional, of course, on the effective single supervisory mechanism being established. Furthermore, the statement also pointed to how resolution tools might develop given the affirmation that the financial assistance currently provided to eurozone banks via their sovereigns will be transferred to the ESM without gaining seniority status once the ESM becomes available.

Nevertheless, Herman Van Rompuy's report's consideration of the wider European financial framework, and the possible split of powers between a centralised supervisor and national authorities, helped to underline the multidimensional nature of BU and the range of possible consequences it might have for a variety of stakeholders. As such, over the summer a number

⁴¹ For the 29 June 2012 euro area summit statement see http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf, for the European Council 28/29 June 2012 conclusions see http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf, and for *Towards a Genuine Economic and Monetary Union* see http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf

⁴² Article 127 is reproduced in Annex 1 of this document and a consolidated version of TFEU can be found at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF>

⁴³ ESM is more fully outlined in Annex 2, and the (yet to be ratified) treaty can be found at http://www.consilium.europa.eu/media/1406404/treaty_establishing_the_esm_2012_final.pdf

of influential actors outlined their vision as to how BU might fit into a refashioned EU financial framework.⁴⁴

As instructed by the Council, on 12 September 2012 the EU Commission published its vision of BU with:

- A proposed design for the second element of BU in the form of a Single Supervisory Mechanism (SSM).
- A proposal relating to the EBA's responsibilities for the first element – a single rule book – while ensuring that EBA's decision-making remained balanced in light of the new SSM.
- Confirmation that a proposal for a single resolution mechanism would follow as part of the roadmap for BU.⁴⁵

At the heart of the Commission's proposed design is an expanded role for the ECB that, as foreshadowed by the 29 June euro summit statement, depends on TFEU 127 (6). This treaty Article allows:

'The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.'

While the Commission's 12 September 2012 proposals and communications cover a lot of ground, these documents do not explicitly discuss the role of the ESRB and its relationship to the ECB's supervisory function, particularly in relation to systemic risks that might initially be non-prudential in form. Neither is it clear whether the conditionality associated with the establishment of the ESM is met with the establishment of the proposed SSM or whether perhaps a resolution mechanism also needs to be in place. The Commission's 12 September 2012 package does not expand on plans for the ESM. However, this was probably owing to constitutional discussions concerning the ratification of the ESM by Germany.⁴⁶

5.2.2 The possible influences on BU's design

Even within these parameters, BU's shape can take on any number of possible variations. Nonetheless the EU has a number of institutional/regulatory/market frameworks that can be drawn upon, as well

⁴⁴ For instance, Mark Hoban suggested that to avoid fragmenting the single market, BU – as it applies to supervision and resolution – is a matter for the eurozone states, while a single rule book should apply to all 27 members of the EU (as is the case today) – *Banking Union in the eurozone* (9 July 2012) – http://www.hm-treasury.gov.uk/fst_speech_090712.htm. Whereas Michel Barnier stated that in his personal view BU should be built for all 27 Member States – *Towards a European financial union and a more solid European banking sector* (12 July 2012) – <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/554&type=HTML>.

⁴⁵ For the EU Commission's BU proposals see

http://ec.europa.eu/internal_market/finances/committees/index_en.htm#maincontentSec1

⁴⁶ On the same day that the Commission's proposal was announced – 12 September 2012 – Germany's Federal Constitutional Court ruled against petitioners challenging the ESM. For more on this see *A Setback for Germany's Euroskeptics*, as reported by Spiegel Online – <http://www.spiegel.de/international/europe/constitutional-court-ruling-a-setback-for-germany-s-euroskeptics-a-855413.html>

illustrated by the Commission's September package. In summary, these include:

- Existing EU treaty provisions.
- The European System of Central Banks (ESCB) – the ECB and NCBs of the 27 Member States.
- The new European System of Financial Supervisors (ESFS): the European Systemic Risk Board (ESRB) – which is responsible for macro-prudential oversight – and three European Supervisory Authorities (the ESAs).
- Current support mechanisms: European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF).
- Regulations in place – such as the Bank Winding-up Directive – or in train – for example, the new elements of the Capital Requirements Regulation and the Capital Requirements Directive (CRR/CRD 4), the Recovery and Resolution Directive (RRD), and the proposed revision of the Directive on Deposit Guarantee Schemes (DGS).
- Current reviews pertaining to the character/definition/structure of the EU's financial firms and markets, such as the Liikanen Review.

In all likelihood, BU's final design will also be influenced by regulatory reform elsewhere in the EU – not least in the UK – and the broader call for changes in the style of supervision. Discussions on the style of supervision are also now being linked to the call for changes in the culture of banking through the implementation of improved banking standards (e.g. corporate and internal (risk) governance standards) and professional codes of conduct which should support better people risk management.

The current regulatory focus on the supervision of Systemically Important Financial Institutions/Systemically Important Banks (SIFIs/SIBs) will also continue to shape BU.⁴⁷ Therefore developments on this front also need to be monitored and considered as BU is negotiated.

⁴⁷ Annex 2 includes references to the work done by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) on SIFIs and SIBs, as well as FSB's work on enhanced supervision and the July 2012 call for evidence on banking standards by a UK Parliamentary Commission.

Annex 1: Treaty provisions

The *Treaty on European Union (TEU)* and *The Treaty on the Functioning of the European Union (TFEU)*⁴⁸ are the EU treaties most cited for determining whether the legal basis exists for the elements that have been identified as central to the formation of BU in the EU. The most often-cited Articles are provided below.

Also included is the Official Journal entry of the proposed amendment to Article 136⁴⁹ which would establish the legality of proposed the European Stability Mechanism (ESM). At the time of publication of this report, this amendment had not yet been ratified.

The comments on the importance of these Articles are not legal guidance, but are the views of the author of this report and are highlighted to help the reader with the complex legal background that BU entails.

Treaty reference	Importance	Treaty text
TEU 3 (3)	TEU 3 (3) clearly states that the Union's goal is to establish an internal market based on a number of elements including balanced growth and price stability. Notably, financial stability is not explicitly mentioned.	3. The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability , a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance.

⁴⁸ For the consolidated TEU and TFEU and related Annexes see <http://eur-lex.europa.eu/JOHtml.do?uri=OJ:C:2010:083:SOM:EN:HTML>

⁴⁹ Official Journal entry L91/1, 6 April 2001 – <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:091:0001:0002:EN:PDF>

Treaty reference	Importance	Treaty text
TEU 3 (4)	TEU 3 (4) clearly states that the Union shall establish an economic and monetary union whose currency is the euro.	4. The Union shall establish an economic and monetary union whose currency is the euro.
TEU 13	TEU 13 (1) establishes the ECB as one of the institutions within the Union's institutional framework that serves to promote the Union's values, advances its objectives, serves its interests and ensures the consistency, effectiveness and continuity of its policies and actions.	<p>1. The Union shall have an institutional framework which shall aim to promote its values, advance its objectives, serve its interests, those of its citizens and those of the Member States, and ensure the consistency, effectiveness and continuity of its policies and actions.</p> <p>The Union's institutions shall be:</p> <ul style="list-style-type: none"> o The European Parliament. o The European Council. o The Council. o The European Commission (hereinafter referred to as 'the Commission'). o The Court of Justice of the European Union. o The European Central Bank. o The Court of Auditors. <p>2. Each institution shall act within the limits of the powers conferred on it in the Treaties, and in conformity with the procedures, conditions and objectives set out in them. The institutions shall practice mutual sincere cooperation.</p> <p>3. The provisions relating to the European Central Bank and the Court of Auditors and detailed provisions on the other institutions are set out in the Treaty on the Functioning of the European Union.</p> <p>4. The European Parliament, the Council and the Commission shall be assisted by an Economic and Social Committee and a Committee of the Regions acting in an advisory capacity.</p>
TEU 48	Article 48 concerns the	1. The Treaties may be amended in accordance with an ordinary revision procedure. They may

Treaty reference	Importance	Treaty text
	<p>amendment of the Treaties under ordinary and simplified revision procedures, 48 (3) and 48 (6) respectively ensure that under both procedures the ECB shall be consulted in the case of institutional changes in the monetary area.</p>	<p>also be amended in accordance with simplified revision procedures.</p> <p>Ordinary revision procedure</p> <p>2. The Government of any Member State, the European Parliament or the Commission may submit to the Council proposals for the amendment of the Treaties. These proposals may, inter alia, serve either to increase or to reduce the competences conferred on the Union in the Treaties. These proposals shall be submitted to the European Council by the Council and the national Parliaments shall be notified.</p> <p>3. If the European Council, after consulting the European Parliament and the Commission, adopts by a simple majority a decision in favour of examining the proposed amendments, the President of the European Council shall convene a Convention composed of representatives of the national Parliaments, of the Heads of State or Government of the Member States, of the European Parliament and of the Commission. The European Central Bank shall also be consulted in the case of institutional changes in the monetary area. The Convention shall examine the proposals for amendments and shall adopt by consensus a recommendation to a conference of representatives of the governments of the Member States as provided for in paragraph 4.</p> <p>The European Council may decide by a simple majority, after obtaining the consent of the European Parliament, not to convene a Convention should this not be justified by the extent of the proposed amendments. In the latter case, the European Council shall define the terms of reference for a conference of representatives of the governments of the Member States.</p> <p>4. A conference of representatives of the governments of the Member States shall be convened by the President of the Council for the purpose of determining by common accord the amendments to be made to the Treaties.</p> <p>The amendments shall enter into force after being ratified by all the Member States in accordance with their respective constitutional requirements.</p>

Treaty reference	Importance	Treaty text
		<p>5. If, two years after the signature of a treaty amending the Treaties, four fifths of the Member States have ratified it and one or more Member States have encountered difficulties in proceeding with ratification, the matter shall be referred to the European Council.</p> <p>Simplified revision procedures</p> <p>6. The Government of any Member State, the European Parliament or the Commission may submit to the European Council proposals for revising all or part of the provisions of Part Three of the Treaty on the Functioning of the European Union relating to the internal policies and action of the Union.</p> <p>The European Council may adopt a decision amending all or part of the provisions of Part Three of the Treaty on the Functioning of the European Union. The European Council shall act by unanimity after consulting the European Parliament and the Commission, and the European Central Bank in the case of institutional changes in the monetary area. That decision shall not enter into force until it is approved by the Member States in accordance with their respective constitutional requirements.</p> <p>The decision referred to in the second subparagraph shall not increase the competences conferred on the Union in the Treaties.</p> <p>7. Where the Treaty on the Functioning of the European Union or Title V of this Treaty provides for the Council to act by unanimity in a given area or case, the European Council may adopt a decision authorising the Council to act by a qualified majority in that area or in that case. This subparagraph shall not apply to decisions with military implications or those in the area of defence.</p> <p>Where the Treaty on the Functioning of the European Union provides for legislative acts to be adopted by the Council in accordance with a special legislative procedure, the European Council may adopt a decision allowing for the adoption of such acts in accordance with the</p>

Treaty reference	Importance	Treaty text
TEU 50	<p>Article 50 allows a Member State to withdraw from the Union.</p> <p>There is no equivalent Article that would allow a Member State to withdraw from the eurozone.</p>	<p>ordinary legislative procedure.</p> <p>Any initiative taken by the European Council on the basis of the first or the second subparagraph shall be notified to the national Parliaments. If a national Parliament makes known its opposition within six months of the date of such notification, the decision referred to in the first or the second subparagraph shall not be adopted. In the absence of opposition, the European Council may adopt the decision.</p> <p>For the adoption of the decisions referred to in the first and second subparagraphs, the European Council shall act by unanimity after obtaining the consent of the European Parliament, which shall be given by a majority of its component members.</p>
		<p>1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.</p> <p>2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.</p> <p>3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.</p> <p>4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.</p>

Treaty reference	Importance	Treaty text
		<p>A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.</p> <p>5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.</p>
TFEU 114	<p>Article 114 is cited as the legal basis for a number of key pieces of financial services regulation (such as the regulations establishing the ESRB and the ESAs).</p>	<p>1. Save where otherwise provided in the Treaties, the following provisions shall apply for the achievement of the objectives set out in Article 26. The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. (Refer to the TFEU for the remainder of Article 114).</p>
TFEU 122 (2)	<p>Article 122 (2) provides for the <u>establishment of a European Financial Stability Mechanism (EFSM)</u>.</p>	<p>2. Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken.</p>
TFEU 123	<p>Article 123 <u>safeguards ECB independence</u>.</p> <p>Subparagraph (1) disallows ECB from lending to governments or primary market purchases and subparagraph (2) sets the scope.</p>	<p>1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.</p> <p>2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.</p>

Treaty reference	Importance	Treaty text
TFEU 125 (1)	Article 125 (1) <u>disallows bail-outs of Member States.</u>	<p>1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State. without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.</p>
TFEU 127	Article 127 sets the objectives and tasks for the ESCB and, looking to the future, 127 (5) may provide the basis to increase the supervisory powers of the ESCB and 127 (6) provides scope for the ECB to be given responsibilities concerning policies relating to the prudential supervision of credit institutions and other financial institutions (with the exception of insurance undertakings).	<p>1. The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.</p> <p>2. The basic tasks to be carried out through the ESCB shall be:</p> <ul style="list-style-type: none"> o To define and implement the monetary policy of the Union. o To conduct foreign-exchange operations consistent with the provisions of Article 219. o To hold and manage the official foreign reserves of the Member States. o To promote the smooth operation of payment systems. <p>3. The third indent of paragraph 2 shall be without prejudice to the holding and management by the governments of Member States of foreign-exchange working balances.</p> <p>4. The European Central Bank shall be consulted:</p> <ul style="list-style-type: none"> o On any proposed Union act in its fields of competence. o By national authorities regarding any draft legislative provision in its fields of competence, but within the limits and under the conditions set out by the Council in accordance with the procedure laid down in Article 129(4). The European Central Bank

Treaty reference	Importance	Treaty text
		<p>may submit opinions to the appropriate Union institutions, bodies, offices or agencies or to national authorities on matters in its fields of competence.</p> <p>5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.</p> <p>6. The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings</p>
TFEU 130	Article 130 protects the ECB's independence.	When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any Government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.
TFEU 132	Article 132 allows the ECB to make regulations and impose fines.	<p>1. In order to carry out the tasks entrusted to the ESCB, the European Central Bank shall, in accordance with the provisions of the Treaties and under the conditions laid down in the Statute of the ESCB and of the ECB:</p> <ul style="list-style-type: none"> – make regulations to the extent necessary to implement the tasks defined in Article 3.1, first indent, Articles 19.1, 22 and 25.2 of the Statute of the ESCB and of the ECB in cases which shall be laid down in the acts of the Council referred to in Article 129(4), – take decisions necessary for carrying out the tasks entrusted to the ESCB under the Treaties and the Statute of the ESCB and of the ECB,

Treaty reference	Importance	Treaty text
		<ul style="list-style-type: none"> - make recommendations and deliver opinions. 2. The European Central Bank may decide to publish its decisions, recommendations and opinions. 3. Within the limits and under the conditions adopted by the Council under the procedure laid down in Article 129(4), the European Central Bank shall be entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions.
TFEU 133	Article 133 allows the European Parliament and Council to lay down measures necessary for the euro.	Without prejudice to the powers of the European Central Bank, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure, shall lay down the measures necessary for the use of the euro as the single currency. Such measures shall be adopted after consultation of the European Central Bank.
NOT YET RATIFIED TFEU 136 (3)	Article 136 amendment/ in addition is the basis for the treaty establishing the ESM	3. The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.
TFEU 282–284	Articles 282–284 set out, in broad terms, the governance articles for the ESCB and ECB and identify the Eurosystem. They do not envisage the checks and balances BU would require if the ECB has a supervisory role.	Articles not reproduced here.
TFEU 352	Article 352 may provide	1. If action by the Union should prove necessary, within the framework of the policies defined in

Treaty reference	Importance	Treaty text
	<p>the basis for the establishment of BU absent the availability of the usual treaty heads. However, it requires unanimity in the Council, for the Council to act on a proposal from the Commission, and consent from the European Parliament.</p>	<p>the Treaties, to attain one of the objectives set out in the Treaties, and the Treaties have not provided the necessary powers, the Council, acting unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament, shall adopt the appropriate measures. Where the measures in question are adopted by the Council in accordance with a special legislative procedure, it shall also act unanimously on a proposal from the Commission and after obtaining the consent of the European Parliament.</p> <p>2. Using the procedure for monitoring the subsidiarity principle referred to in Article 5(3) of the Treaty on European Union, the Commission shall draw national Parliaments' attention to proposals based on this Article.</p> <p>3. Measures based on this Article shall not entail harmonisation of Member States' laws or regulations in cases where the Treaties exclude such harmonisation.</p> <p>4. This Article cannot serve as a basis for attaining objectives pertaining to the common foreign and security policy and any acts adopted pursuant to this Article shall respect the limits set out in Article 40, second paragraph, of the Treaty on European Union.</p>

Annex 2: A brief explanation of key terms and EU institutions

The table below provides a listing and identification of EU frameworks, EU and non-EU regulatory approaches and other structures that may inform the final design of an EU BU. Rather than list the various institutions, regulations (current and proposed) and mechanisms in alphabetical order, they are grouped in accordance with the framework/structures they are associated with for the purposes of the report. The aim is to provide the reader with relevant background information and references to source material.

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
European Central Banks	ESCB	European System of Central Banks	<ul style="list-style-type: none"> The ESCB includes NCBs of all EU Member States, even those which have not adopted the euro. 	http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:EN:PDF (as per Article 282 TFEU)
	ECB	European Central Bank	<ul style="list-style-type: none"> The ECB was established on 1 June 1998. 	http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0201:0328:EN:PDF (Protocol (No 4) on the Statute governing the ESCB and ECB)
	NCBs	National Central	<ul style="list-style-type: none"> National Central Banks of the European Union. 	As per ESCB http://www.ecb.int/home/html/index.en.html (ECB homepage)
				As per the ESCB

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
		Banks Eurosystem	<ul style="list-style-type: none"> National Central Banks of the eurozone. 	As per the ESCB
Current (but new) EU regulatory architecture	ESFS	European System of Financial Supervisors	<ul style="list-style-type: none"> Includes the ESRB and the three ESAs (EBA, ESMA, EIOPA). 	http://www.cliffordchance.com/publicationviews/publications/2010/12/eu_financial_supervisionanewframework.html (Clifford Chance summary of the new EU Financial Supervision Framework as of December 2010) http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000276501.PDF F (Deutsche Bank Research, EU Monitor 84, Financial Supervision in the EU)
	ESRB	European Stability Risk Board	<ul style="list-style-type: none"> The legislation establishing the ESRB entered into force on 6 December 2010. Has an oversight role in prevention and mitigation of systemic risks to the financial stability of the Union, so as to avoid periods of widespread financial distress. Can issue warnings and recommendations but does not have the right to set and implement macro-prudential policy (via macro-prudential 	http://www.esrb.europa.eu/share_d/pdf/ESRB-en.pdf?d6cfd6053c76e1c4ca7926f6057ccb86 (Regulation No 1092/2010 on macro-prudential oversight and establishing the ESRB) http://www.esrb.europa.eu/share

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
			tools).	d/pdf/ESRB-ECB-en.pdf?789cc70e89b7524a7d52ce4ce784128c (Council Regulation No 1096/2010 conferring specific tasks upon the ECB concerning the functioning of the ESRB)
	EBA	European Banking Authority	<ul style="list-style-type: none"> • Came into being on 1 January 2011 taking over the responsibilities of the Committee of European Banking Supervisors (CEBS). • One of the three European Supervisory Authorities (ESAs) and part of ESFS (ESAs + ESRB). • Responsibilities have a macro and micro dimension: <ul style="list-style-type: none"> ◦ In terms of macro-prudential, most notably, it is required to identify and measure, in collaboration with ESRB, systemic risks. ◦ In terms of micro-prudential, most notably, it can draft/issue binding technical standards where these powers have been delegated (in the case of, for example, the CRD). • With few exceptions, it does not have any 	http://lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF (Regulation (EU) No 1093/2010 of the EU Parliament and Council of 24 November 2010)

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
	ESMA	European Securities and Markets Authority	<p>direct supervisory powers but does have indirect influence over the supervisory agenda through, for example, its responsibilities for promoting supervisory convergence.</p> <ul style="list-style-type: none"> • Came into being on 1 January 2011 taking over the responsibilities of the Committee of European Securities Regulators. • One of the three European Supervisory Authorities (ESAs) and part of ESFS (ESAs + ESRB). • Macro/micro and supervisory influence is as per the EBA but in relation to the securities market, clearing, fund management and credit rating agencies. 	<p>http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0084:0119:EN:PDF (Regulation (EU) No 1095/2010 of the EU Parliament and Council of 24 November 2010)</p>
	EIOPA	European Insurance and Occupational Pensions Authority	<ul style="list-style-type: none"> • Came into being on 1 January 2011 taking over the responsibilities of the Committee of European Insurance and Occupational Pensions Authority. • One of the three European Supervisory Authorities (ESAs) and part of ESFS (ESAs + ESRB). • Macro/micro and supervisory influence is as per the EBA but in relation to the insurance and pension sector. 	<p>https://eiopa.europa.eu/fileadmin/user_upload/tx_dam/files/Legal_Framework/EIOPA-Regulation.pdf (Regulation (EU) No 1094/2010 of the EU Parliament and Council of 24 November 2010)</p>
Current and future	EFSM	European	<ul style="list-style-type: none"> • Established on the basis of TFEU Article 122 (2). 	<p>http://ec.europa.eu/economy_fin</p>

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
support mechanisms		Financial Stabilisation Mechanism	<ul style="list-style-type: none"> • EFSM provides assistance to Member States where: <ul style="list-style-type: none"> ◦ A Member State is experiencing, or is seriously threatened with, a severe financial disturbance. ◦ The financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned. • It is reliant upon funds raised on the financial markets under an implicit EU budget guarantee. • It is supervised by the Commission. 	<p>ance.eu_borrower/efsm/index_en.htm (EFSM info page)</p> <p>http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0001:EN:PDF (Legal basis for EFSM)</p> <p>http://ec.europa.eu/economy_finance/eu_borrower/documents/qa_en.pdf (EFSM FAQs)</p>
	EFSF	European Financial Stability Facility	<ul style="list-style-type: none"> • The EFSF was created by the euro-area Member States, on 9 May 2010 and soon incorporated as a Luxembourg-registered company owned by euro-area Member States. • The EFSF has been created as a temporary institution. In accordance with its Articles of Association, the EFSF will be liquidated on the earliest date after 30 June 2013 on which there are no longer loans outstanding to a euro-area Member State and all Funding Instruments issued by EFSF and any reimbursement amounts due to Guarantors have been repaid in full. 	<p>http://www.efsf.europa.eu/about/index.htm (EFSF home page)</p> <p>http://www.efsf.europa.eu/attachments/faq_en.pdf (EFSF FAQs document)</p> <p>http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm (EFSM info page – describes EFSM's relationship to the EFSF)</p>

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
			<ul style="list-style-type: none"> • The EFSF is backed by guarantee commitments from the euro-area Member States for a total of €780 billion and has a lending capacity of €440 billion. • It allows financial assistance to Member States, subject to conditionality, to be granted in the form of financial assistance facility agreements ('Financial Assistance Facility Agreements', each a 'Financial Assistance Facility Agreement') to provide financial assistance by way of: <ul style="list-style-type: none"> ○ Loan disbursements. ○ Precautionary facilities. ○ Facilities to finance the recapitalisation of financial institutions in a euro-area Member State (through loans to the governments of such Member States including in non-programme countries). ○ Facilities for the purchase of bonds in the secondary markets on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability. ○ Facilities for the purchase of bonds in the primary market. • The EFSF has been assigned credit ratings by the major rating agencies. 	

Framework/ Regulatory approaches/ Structures	Acronym	Institution/ Regulation/ Mechanism	Basic high-level facts	Links to info pages
	ESM	European Stability Mechanism	<ul style="list-style-type: none"> • To assume the tasks of the ESFS and EFSM. • A (proposed) stability mechanism that would effectively backstop the euro on behalf of Member States in the eurozone. • Its purpose is to mobilise funding and provide stability support, subject to strict conditionality, to ESM members which are experiencing, or threatened by severe financial problems. • It will be an intergovernmental organisation established by treaty. • Its Board of Governor will be made up by the Eurogroup (i.e. finance ministers of the euro-area countries), the European Commissioner for Economic and Monetary Affairs and the President of the ECB. • The ECB will be involved in parts of the ESM's operations. It will liaise with the European Commission and the IMF to assess where there is a risk to the financial stability of the euro area as a whole. ECB staff will provide technical advice during the negotiation of any macroeconomic adjustment programme and to support the monitoring activities of the ESM. • It will have a total subscribed capital of €700 billion, of which €80 billion will be paid in and €620 billion will be callable. Member State 	<p>http://www.consilium.europa.eu/media/1406404/treaty_establishing_the_esm_2012_final.pdf (Treaty establishing the ESM (subject to ratification))</p> <p>http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:091:0001:0002:EN:PDF (Official Journal entry of the Council Decision to amend TFEU Article 136 – not yet ratified)</p> <p>http://www.ecb.int/pub/pdf/other/art2_mb201107en_pp71-84en.pdf (ECB article on the ESM, July 2011)</p> <p>http://ec.europa.eu/economy_finance/focuson/crisis/ (EU information page focusing on the economic and financial crisis)</p>

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			<p>contributions are agreed under the ESM treaty.</p> <ul style="list-style-type: none"> • ESM will be ratified if the Member States representing 90% of its capital requirements ratify the founding treaty – this also requires that the amendment to TFEU Article 136 is ratified. 	
Current EU regulations and proposals in train	CRR/CRD 4	Capital Requirements Regulation/Capital Requirements Directive 4	<ul style="list-style-type: none"> • Will replace the current EU capital requirements legislation and will implement Basel III in an EU context taking into account EU specificities. • The central measures of the package are: <ul style="list-style-type: none"> ○ Changes in quantity of regulatory capital that is to be held as tier 1, tier 2 and in various capital buffers. ○ Changes in the quality of regulatory capital. ○ Leverage ratio. ○ Liquidity coverage ratio (short-term horizon). ○ Net stable funding ratio (long-term horizon). 	http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm (EU capital requirements information page)
	Directive on DGS	Directive on Deposit Guarantee Schemes (DGS)	<ul style="list-style-type: none"> • The proposed directive on DGS is aimed at harmonising and simplifying protected deposits, providing faster payout and improving financing of schemes. 	http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm (EU DGS information page)

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	MiFID	Markets in Financial Instruments Directive	<ul style="list-style-type: none"> <li data-bbox="500 684 651 1312">• MiFID I is in force and effectively helps to set the CRD's scope through an annex in the CRD (that lists types of derivatives) and refers to financial activities and services listed in the MiFID's Annex. 	http://ec.europa.eu/internal_market/securities/isd/index_en.htm (EU MiFID information page)
	RRD	Proposed Recovery and Resolution Directive	<ul style="list-style-type: none"> <li data-bbox="683 684 769 1312">• Proposal aimed at firms that are no longer viable or might not be viable in the long term. This is a new initiative. <li data-bbox="769 684 987 1312">• Recital (4) of the proposal sets out the aim for RRD to provide authorities with tools to intervene sufficiently early and quickly, so as to ensure continuity of essential financial and economic functions while minimising the impact of the institution's failure on the financial system. <li data-bbox="987 684 1170 1312">• Recital (68) sets out the aim that funds necessary in the successful deployment of resolution tools, notwithstanding the role of central banks in providing liquidity to the financial system in times of stress, should come from the financial industry as a whole. <li data-bbox="1170 684 1317 1312">• Proposal does not allow for a centralised authority. Each Member State is to designate a resolution authority and it can be the prudential authority if there is a clear separation of resolution and supervisory 	http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm (EU RRD information page)

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			<p>functions.</p> <ul style="list-style-type: none"> • EBA will have a role as a mediator in the case of disagreement over group (cross-border) recovery or resolution plans. • EBS and ESRB will issue guidelines for convergent supervisory practices in relation to most of the RRD's measures. • RRD has measures relating to: <ul style="list-style-type: none"> ◦ Recovery planning (responsibility of the institution). ◦ Resolution planning (responsibility of the resolution authority). ◦ Resolution tools that the resolution authority may use (sale of business, bridge bank, asset separation, bail-in). • RRD provides for: <ul style="list-style-type: none"> ◦ EU cross-border framework that includes EU resolution colleges. ◦ Framework for dealing with third countries. • RRD also sets out a resolution funding framework: <ul style="list-style-type: none"> ◦ Based on a European System of Financing Arrangements (ESFA) comprised of national arrangements, borrowing between national arrangements and mutualisation of financing arrangements in the case of a group resolution. ◦ Requires Member States to establish financing arrangements that should reach 	

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			<p>1% of deposits (in their respective territories) within 10 years of the directive coming into force.</p> <ul style="list-style-type: none"> ○ Ex ante contributions are to be raised from institutions authorised in their territory. ○ Requires Members States to ensure that even during resolution depositors have access to their deposits. ○ Requires that deposit guarantee schemes rank <i>pari passu</i> with unsecured non-preferred claims under national insolvency law. 	

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	WUD	Bank Winding-up Directive	<ul style="list-style-type: none"> • The purpose of the WUD was to ensure that a credit institution and its branches in other Member States are reorganised or wound up so that there would only be one set of insolvency proceedings, in which the credit institution should be treated as one entity. • Nevertheless, the WUD is limited in scope, in that it caters only for credit institutions with branches, and does not deal with possible issues which may arise as part of the reorganisation and winding-up of cross-border banking groups. • In 2007 a consultation was launched by the Commission on the WUD, but work is ongoing with a report issued in April 2010 on the feasibility of winding-up credit institutions. 	http://ec.europa.eu/internal_market/bank/windingup/index_en.htm (EU WUD information page)
Other regulatory reforms and/or regulatory structures/ initiatives that may influence the direction of design.	FDIC	Federal Deposit Insurance Corporation	<ul style="list-style-type: none"> • As per the FDIC's website, the FDIC: <ul style="list-style-type: none"> ◦ Insures deposits in banks and thrift institutions for at least \$250,000 and identifies, monitors and addresses risks to the deposit insurance funds and limits the effect on the economy and the financial system when a bank or thrift institution fails. ◦ Directly examines and supervises more than 4,900 banks and savings banks for operational safety and soundness. 	

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			<ul style="list-style-type: none"> ○ Responds immediately when a bank or thrift institution fails, and has several options for resolving institution failures, but the one most used is to sell deposits and loans of the failed institution to another institution (i.e. customers of the failed institution automatically become customers of the assuming institution). 	
	FSOC	Financial Stability Oversight Council	<ul style="list-style-type: none"> • Established under the Dodd-Frank Act, the FSOC is a systemic risk supervisor and has a wider mandate than the ESRB which extends to identifying and designating financial firms as systemically important. 	http://www.treasury.gov/initiative/s/fsoc/Pages/default.aspx (FSOC information page)
	UK regulator reform	New regulatory architecture	<ul style="list-style-type: none"> • Under the new regulatory architecture,⁵⁰ it is proposed that the BOE will have: <ul style="list-style-type: none"> ○ Macro-prudential responsibilities via the Financial Policy Committee (FPC) which will: <ul style="list-style-type: none"> - Monitor the systemic risks attributable to the structure of markets (e.g. interconnectedness of financial institutions), attributable to the distribution of risk within the financial sector, and unsustainable levels of leverage, debt or credit 	http://services.parliament.uk/bills/2012-13/financialservices.html (UK Parliamentary information page on the Financial Services Bill (2012)) http://www.hm-treasury.gov.uk/d/fin_fs_bill_mou_financial_crisis_management_jan2012.pdf (MoU on financial crisis management)

⁵⁰ UK Parliamentary information page on the Financial Services Bill (2012) – <http://services.parliament.uk/bills/2012-13/financialservices.html>

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			<p>growth.</p> <ul style="list-style-type: none"> - Give directions to the Financial Conduct Authority (FCA) or Prudential Regulatory Authority (PRA) requiring them in their regulatory capacity to implement macro-prudential measures. - Make recommendations within the Bank or to Treasury, FCA or PRA, or other persons. - Prepare financial stability reports that will be laid before Parliament by the Treasury. - Be comprised of Governor and Deputy Governors of the BOE, the chief executive of the FCA, a representative of Treasury and other appointees some of which are to be appointed by the Chancellor of the Exchequer. <ul style="list-style-type: none"> o Micro-prudential responsibilities via the new PRA which is to be set up as a subsidiary of the BOE. • Operational responsibilities for financial crisis management.⁵¹ 	
	SIFI and	Systemically	<ul style="list-style-type: none"> • Focused regulation aimed at what are known 	http://www.financialstabilityboard

⁵¹ Memorandum of Understanding on financial crisis management – http://www.hm-treasury.gov.uk/d/fin_is_bill_mou_financial_crisis_management_ian2012.pdf

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	SIBs	Important Financial Institutions and Systemically Important Banks	<p>as Systemically Important Financial Institutions (SIFIs), or Systemically Important Banks (SIBs), is high on the regulatory agenda and been a focus for the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS).</p>	<p>http://www.bis.org/publ/bcbs224.htm (BCBS June 2012 consultation paper on domestic systemically important banks).</p>
	Banking standard s/ culture		<ul style="list-style-type: none"> The culture of banking, the need for improved supervision and their relationship to each other is increasing become a point of focus for policymakers. In 2010, the FSB set out recommendations for making the supervision of financial institutions more intense, effective and reliable, and then followed up in 2011 with a report on their implementation. And in the UK, a Parliamentary Commission has been set up to look at banking standards. 	<p>http://www.financialstabilityboard.org/list/fsb_publications/fid_147/index.htm (FSB list of publications on enhancing supervision)</p> <p>http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/call-for-evidence/ (UK Parliamentary Commission on Banking Standards – call for evidence, 26 July 2012)</p>
The structure of markets	Liikanen	High-level Expert	<ul style="list-style-type: none"> On 16 January 2012 the EU Commission constituted a High-level Expert Group on 	<p>http://ec.europa.eu/commission_2010-</p>

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		Group on the Structural aspects of EU banking	<p>structural aspects of the EU banking sector, to be chaired by Erkki Liikanen. Its mandate will be 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 is the case, to make any relevant proposals as appropriate.</p>	<p>http://ec.europa.eu/internal_mar/ke1/bank/docs/shadow/green-paper_en.pdf (EU green paper on shadow banking)</p>
	Shadow Banking		<ul style="list-style-type: none"> The EU is in the early stages of examining the question of shadow banking (or non-bank credit activity) which does not attract the prudential regulation and supervision that banks do. It is not the only authority to look at this issue and is, in fact, following in the steps of the FSB. 	<p>http://www.financialstabilityboard.org/list/fsb_publications/tid_150/index.htm (FSB list of publications on shadow banking)</p>



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