ECB holds sway in new banking order

The *Financial Regulatory Observer* (FRO) talks to Henning Berger, partner in the Financial Institutions Advisory practice of White & Case in Berlin, about how a German lender tried and failed to remove itself from the clutches of ECB supervision – and what it means for the wider banking sector.

In May 2017 a small German state-owned bank lost its fight to escape the clutches of ECB supervision in the first judgement handed down by European General Court relating to Single Supervisory Mechanism (SSM).
When it was introduced in November 2014, the SSM created an institutionalized process of supervising credit institutions and became one of three pillars of European Banking Union along with the Single Resolution Mechanism (SRM) and the European Deposit Guarantee Scheme (DGS). The SSM also established the European Central Bank (ECB) as the lead supervisory body for Eurozone banks holding more than €30 billion in assets. Landeskreditbank Baden-Württemberg, which has assets of €70 billion, argued that it should be regulated instead by its national competent authority (NCA)—in this case German watchdog Bafin and the Bundesbank– rather than the ECB on the grounds that its debt is guaranteed by the state of Baden-Württemberg, and as such it posed no systemic threat. L-Bank preferred to be supervised by its national regulator because of the lower cost of compliance.

The General Court rejected the L-Banks's claim in every aspect. It stated that an exemption from the ECB's supervision can only be made upon proof that the NCAs' supervision is better able to attain the supervisory objectives. Hence, L-Bank`s plea that the German NCAs' supervision was sufficient to attain these objectives couldn't justify its claim. In short, the judge ruled that the ECB has free reign when it comes to which banks it wants to supervise and delegates to NCAs at its own discretion.

> **SSM created an institutionalized process of supervising credit institutions**

FRO: ***Henning, some observers have been disappointed by the L-Bank judgment, criticizing its "pro-centralization stance" and the fact that it does not address "the substantive questions at hand." Is this convincing?***
Henning Berger (HB): In my view, these observers don't take into account the circumstances of the case. The L-Bank judgment dealt with a rather narrow legal question and seems to have been led more out of principle than to clarify many of the open questions regarding the SSM. One of these questions concerns the competent courts when the ECB and the NCAs act "in concert". Regarding the latter, there are currently a number of pending cases before the General Court concerning the European Banking Levy, which may give a better understanding of the court's review of administrative decisions in the European Banking Union.

FRO: ***So is there anything we can infer from the L-Bank judgment?***
HB: The court has confirmed that there is no easy escape from the supervision of the ECB: The ECB has a margin of discretion concerning the question of whether an exemption from its supervision should be made due to its inappropriateness. Hence, the judgment confirms what was to be expected: Significant credit institutions will remain under the direct supervision of the ECB and cannot expect to be easily released into the supervision of the NCAs.

€30 billion

Banks with more than €30 billion in assets fall under ECB Supervision

FRO: ***Taking into account the leading position of the ECB in the SSM, what is the remaining role of the NCAs? And how can an institution determine the competent authority?***
HB: In general, supervision is now under the umbrella of the ECB, but the NCAs still play an important role in the process. Both act in close cooperation. Firstly, in order to determine the competent authority, we must differentiate between CRR-credit institutions categorized as significant and those that are not. The supervision of significant institutions is carried out directly by the ECB, whereas the supervision of non-significant institutions lies in the hands of the NCAs.
Regardless of the size and significance of an institution, the ECB has some exclusive competences, such as the granting or withdrawal of banking authorizations. But this exclusive competence does not mean that NCAs are excluded from the decision. For example, in case of the authorization of an institution, requests must be addressed to the acting NCAs. The NCAs review the criteria and prepare reasoned proposals for the ECB, which then reviews and adopts where appropriate.
In a nutshell, the SSM is a complex and interwoven system of shared and sole competencies. The ECB and NCAs are acting in close cooperation, but in most cases the ECB has the last word.

FRO: ***In case a decision is made by the ECB but prepared by the NCA, for example the withdrawal of an authorization, related what are the legal steps an institution can undertake to defend itself?***

HB: All ECB decisions can be reviewed on an administrative level and an institution can seek judicial protection irrespectively. The competent court depends on the measure in dispute. National administrative courts have exclusive jurisdiction in matters of legal protection against measures taken by a national authority. The actions of a Union authority can only be reviewed by the Court of Justice of the European Union (ECJ).

As some decisions by the SSM are composed of actions by both the NCAs and the ECB, it may be necessary to take legal action before national courts and the ECJ in parallel. In cases where the allocation of a measure is not clear, it may be necessary to seek legal protection before both courts simply as a precaution. The pending cases concerning the European Banking Levy demonstrate how difficult it is even for the authorities themselves to determine who is responsible for a certain measure.

FRO: ***The NCAs and ECB apply both European Law, for example the SSM Regulation, and national law. Doesn't this lead to uncertainties when there are different rules?***

HB: There can be uncertainties, but that's not always the case. Basically, the new European norms apply in addition to the existing national supervisory law, such as the French code monétaire et financier or the German KWG. Together, they establish the supervisory requirements that an institution has to fulfill. Conflicts can result from the fact that these requirements are applied by both the ECB and the NCAs, and the authorities may deviate in their practices.

In this regard, a revolutionary feature of the SSM is that the ECB must apply national law based on European law. As the applicable national laws may differ, the ECB will strive to harmonize its practice as far as possible.

> **SSM is a complex and interwoven system of shared and sole competencies**

FRO: ***Are there examples of this practice?***

HB: Of course. For example, in the ECB's application of the fit-and-proper-rule, the compulsory assessment procedure concerning the appointment of new management does not apply across the entire EU. However, the ECB has developed a formal procedure that it applies to the appointment process within all member states. Consequently, in member states that don't prescribe the formal approval of members of the management body, the ECB has factually introduced such a procedure of approval. This has a significant impact, as fit-and-proper proceedings are of great practical relevance to the institutions.

FRO: ***All in all, what are the main challenges banks have to face under the SSM?***

HB: As the practice of the SSM and the courts develops over time, a clearer allocation of procedural acts and competencies will emerge, making it no longer necessary to seek legal parallel protection. The same is true for other legal uncertainties as the standards of fit and proper the ECB can apply.

Besides that, language barriers between the ECB on the one hand and NCAs and banks on the other hand can be challenging. Even though institutions can choose the language they use for their communication with the ECB, the latter usually aims at establishing English as the language of communication. The communication between the ECB and NCAs has been agreed to be in English. Still, the internal working language in most NCAs and banks is not English. This does not only entail a substantial translation workload, but also a lack of transparency and comprehensibility, especially when an institution cannot easily clarify and defend its practice to the ECB. At first sight, this may seem surprising, but in practice it can be quite an issue.

Meanwhile differing legal cultures among the member states can lead to a diverging understanding of the applicable supervisory criteria and the extent of judicial review of decisions. Although joint supervisory teams (JSTs) have been created to discuss these differences, the ECB's practical approach can differ from that of the NCAs. As a result, banks may expect a different interpretation of the prudential regulations based on national practice than the ECB will take.

All in all, the SSM is a perfect example of the special challenges and difficulties of European cooperation and integration in general. Overcoming these is an ongoing process.

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