THE EUROPEAN UNION EXPLAINED

Banking and finance

A well-functioning single market for financial services contributes to economic prosperity, stability and growth

EU-wide action in the financial sector ensures a resilient financial services industry, enabling citizens and businesses to save, insure against risks and invest in our collective future.

THE EUROPEAN UNION EXPLAINED

This publication is a part of a series that explains what the EU does in different policy areas, why the EU is involved and what the results are.

You can find the publications online:

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The European Union explained: Banking and finance

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Why do we need a single market for financial services?

Financial institutions and markets play a vital role in any developed economy. They provide lending to households and businesses. They allow individuals to save and invest in their future and channel savings to support the economy. They help corporations and households to better manage and insure against risks; they also facilitate payments. By performing these key functions, a well-functioning financial system contributes to economic prosperity, stability and growth. Conversely, failure of the financial system can have profound negative consequences for the wider economy.

Financial markets are closely integrated: the recent financial crisis showed that no single EU country can manage the financial sector and supervise financial stability risks alone. In the wake of the crisis, the EU has undertaken an ambitious reform of the financial regulatory system with the aim of restoring financial stability, building a sound and resilient financial system that serves the economy and strengthens the EU's ability to deal with future financial and economic shocks. The EU established a 'Single Rulebook', providing a single regulatory framework for the financial sector and its uniform application across the EU. To deliver on this reform agenda, the Commission has, over the past 5 years, tabled more than 40 legislative proposals aiming to restore market confidence, financial stability and the integrity and efficiency of the European financial system. The most fundamental of these reforms was the creation of the banking union (*see below*).

The four freedoms

The cornerstones of the single market are the free movement of people, goods, services and capital, known collectively as the 'four freedoms', enshrined in the EU Treaty. The same Treaty empowers EU institutions to adopt laws which are binding on national authorities. The European Commission has the important function of proposing EU legislation on financial services and ensuring that EU law is properly applied throughout the EU — by individuals, companies, national authorities and other EU institutions. EU legislation is proposed by the Commission and adopted by the European Parliament, directly elected by European citizens, and the EU Council of Ministers, where all 28 Member States are represented by national governments. Together, the Parliament and the Council are referred to as the 'co-legislators'.

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Restoring confidence in the financial system is one of the driving forces behind the EU banking union and the Single Rulebook.

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The EU has taken measures to reform and strengthen its financial services sector, with a particular focus on the surveillance of banks and the restructuring of banks in difficulty (banking union).

EU legislation enables the functioning of integrated, open, competitive and efficient European financial markets and services, which bring many advantages to us all. For individuals, it means the ability to avail themselves of high-quality financial services wherever they are in the EU, such as opening a bank account, investing where the best return is or purchasing real estate. For companies, it can mean being able to expand across borders or to attract funding from another EU country.

A single market for consumers and companies alike

The single market for financial services exists for the benefit of the EU's 500 million consumers and millions of companies, who have the right to buy financial services from any provider (under the same conditions and contractual obligations throughout the Union). It allows them to make more informed choices which, in turn, lead to stronger returns on investment and a greater impact on strengthening the single market and on stimulating competition, innovation and growth.

EU regulatory reform of financial services

Over the last 5 years, the EU has pursued an ambitious regulatory reform agenda, geared to comply with the standards agreed with international partners in the G20. As the recent financial crisis evolved and specific risks emerged which threatened financial stability in the euro area and the EU as a whole, deeper integration was necessary to put the banking sector on a more solid footing and restore confidence in the euro. That led to the development of what is known as the banking union.

The aim of all EU financial legislation has been to restore financial stability and to build a financial system that serves the EU economy and contributes to putting the EU back on the path of sustainable growth. To meet this objective, the Commission has proposed over 40 laws in under 5 years to ensure that banks hold more and better capital, that they strengthen their risk governance and that they curtail the excesses of the past. The reform has improved the way financial markets operate and made financial services infrastructures, such as central securities depositaries, more stable and more resilient to crises. The EU has introduced common rules to ensure that shareholders and creditors — not EU taxpayers — are the first ones to foot the bill when a bank fails.

The EU has also created three new European authorities for the supervision of financial activities: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority for banks, markets, and insurance and pensions (EIOPA). These European supervisory authorities do not, however replace the relevant national authorities. The goal is not to transfer the control of financial institutions to the EU bodies. The goal is to create a network of authorities, where national authorities are responsible for daily surveillance and the European authorities — working hand-in-hand with the national authorities and drawing upon their expertise — are responsible for coordinating, monitoring and, if need be, arbitrating between national authorities. This network of authorities contributes to

harmonising technical rules applicable to financial institutions under the Single Rulebook.

The EU also established a European Systemic Risk Board (ESRB) to monitor threats to the stability of the financial system. It provides early warnings of system-wide risks that may be building up and issues recommendations on how to deal with them.

These new bodies ensure that all EU countries involved benefit from a level playing field. They enable financial supervisors to use the same supervisory standards across the entire EU. The reforms make financial markets work more effectively in the interest of consumers, small and medium-sized enterprises (SMEs) and the economy as a whole.

Most of the Commission's proposals on financial reform have been adopted by the European Parliament and the EU Council of Ministers in record time, and many of them have already entered into force. That has helped the EU to:

- **strengthen** financial stability and the resilience of the financial system in order to reduce the likelihood and impact of future financial crises in the EU;
- **restore and deepen** the EU single market in financial services, for the benefit of citizens and companies;
- **secure** market integrity and confidence in the EU financial system by protecting consumers and investors, countering market abuse and enhancing disclosure and transparency;
- **improve** the efficiency of the EU financial system, ensuring that transaction costs are minimised and that financial services are priced correctly so as to minimise underlying risks.

The reform has already yielded tangible results. Based on simulations by the Commission, reforms in the banking sector are estimated to deliver economic benefits of around 0.6–1.1 % of EU gross domestic product (GDP) per year (or about €75–140 billion per year, based on 2013 EU GDP), not counting other reforms which enhance the stability of the financial sector.

A single currency to boost the single market

A financial market works better when everyone uses the same currency. The first step towards a shared currency took place on 1 January 1999 with the creation of the euro. Exactly 3 years later, euro notes and coins came into circulation. Today the euro is used by consumers and businesses in 18 EU countries (19 as from 1 January 2015, with the addition of Lithuania), known collectively as the euro area. The euro demonstrated its resilience during the sovereign debt crisis, retaining its purchasing power thanks to the fact that the EU has come to the aid of high-debt countries. It is also widely used in international payments and is now the world's second most important currency after the US dollar. *(For more detailed information on the euro, see the* EU Explained *publication on 'Economic and monetary union and the euro'.)*

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The euro is used as a single currency by consumers and businesses in 19 EU countries.

What are the EU's main areas of activity?

Banking union

In June 2012, EU Heads of State or Government agreed to create a banking union, completing the economic and monetary union and centralising the application of EU-wide rules for banks in the euro area (and any non-euro EU countries wishing to join). The banking union is built on two pillars.

The two pillars of the banking union

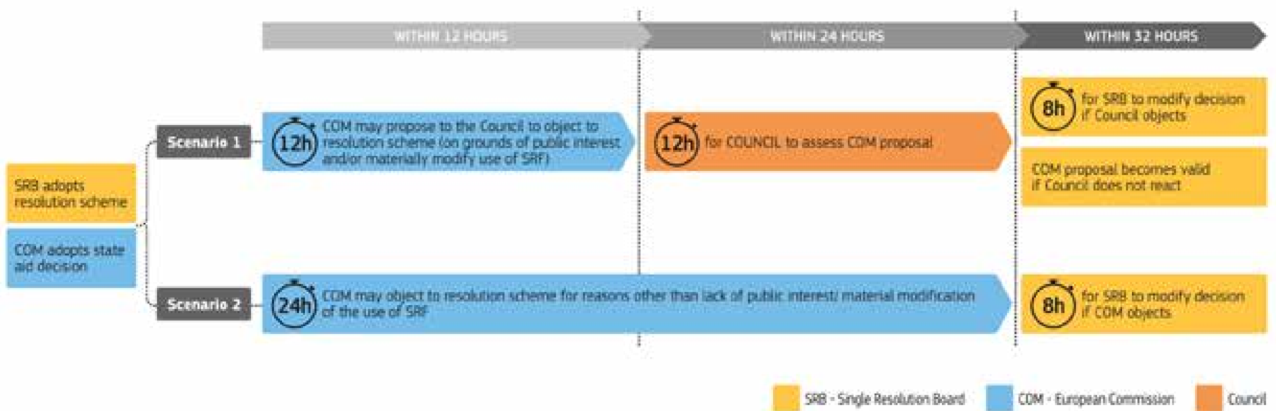
— ***The first pillar is the single supervisory mechanism (SSM)****, which transfers key supervisory tasks for banks in the euro area and other participating countries to the European Central Bank (ECB). The main task of the ECB and the national supervisors, working closely together within an integrated system, is to check that banks comply with EU banking rules and to tackle financial problems early on. The ECB, which became fully empowered to exercise its supervisory role as of 4 November 2014, directly supervises the largest or most significant banks, while the national supervisors continue to monitor all of the others.*

— ***The second pillar is the single resolution mechanism (SRM)****. In the rare cases where banks fail, the single resolution mechanism (SRM) will allow bank resolution to be managed more effectively through a Single Resolution Board (SRB) and a Single Resolution Fund (SRF). Shareholders and creditors, and only after that the SRF, will cover the costs of a failing bank, rather than taxpayers as in the past. The SRF is financed solely through contributions from all banks in participating countries. The SRM, endowed with clear decision-making rules for cross-border bank resolution and highly experienced staff, will be much more effective in carrying out resolutions than the existing patchwork of national resolution authorities. Most of the SRM provisions apply from 1 January 2015, while the SRM will be fully operational from 1 January 2016.*

An overview of the main elements composing the EU's banking union.

The banking Uunion relies on the new regulatory framework with common rules for banks in all 28 EU countries, the Single Rulebook. Common rules help to prevent bank crises in the first place and, if banks do end up getting into difficulty, set out a common framework to manage the process, including a means to wind them down in an orderly way. Common rules will also guarantee EU savers that their deposits are protected up to certain limits at all times and everywhere in the EU *(see below for more information).*

Together with the new EU regulatory framework for the financial sector, the completed banking union is a fundamental step in the economic and monetary integration of the EU. It will put an end to the era of massive bailouts paid for by taxpayers and will help to restore financial stability across the Union.



'Bank resolution' is the procedure followed in the rare cases where banks fail.

Stress tests and comprehensive assessment – assessing banks' resilience

In October 2014, the European Banking Authority (EBA) and the European Central Bank (ECB) published the results of an EU-wide 'stress test' and a 'comprehensive assessment' of the most significant European banks. The goal of this year-long assessment was to identify and address any remaining vulnerabilities in the EU banking sector. The tests have been the most complete, transparent and rigorous evaluation that European banks have ever faced. Overall, the results have confirmed the improvements in the resilience of European banks over the last few years. European banks have made significant efforts to ensure they hold sufficient capital, efforts triggered by the new regulatory framework, supervisory actions and market pressure. The capital ratios of EU banks are now at 12 %, similar to US peers. The vast majority of banks have a significant buffer to withstand hypothetical financial shocks. This is an important step in reassuring investors about the quality of EU banks' balance sheets.

But the results have also highlighted areas where banks still have to work on strengthening their positions. Some 25 banks participating in the exercise failed the test with a total capital shortfall of €25 billion at the end of 2013, although this did not concern any of the large European banks. Taking into account banks' efforts to raise their levels of capital throughout 2014, 14 banks have been identified with an overall capital shortfall amounting to almost €10 billion. It is now absolutely crucial for banks and the competent supervisory authorities to ensure rigorous and timely follow-up/corrective actions so as to restore full confidence in European banks, which should also help banks in their financing of the wider economy. It is essential for supervisory authorities to continue being highly vigilant in their supervision of all banks. The Single Supervisory Mechanism (SSM), with the European Central Bank (ECB) at its helm, started its work on 4 November 2014, a key milestone in the process towards a healthier and more robust banking system in Europe.

Further measures to ensure a safer banking sector in the euro area: ending the 'too-big-to-fail' issue

Strengthening the resilience and financial health of the EU's largest and most significant banks will ensure that taxpayers do not end up paying for mistakes made by banks, including any excessive risks taken. That is precisely what happened during the financial crisis: publicly funded bank bailouts swallowed up around 13 % of the EU's yearly GDP, which in turn exacerbated the sovereign debt crisis and led to economic hardship for many citizens.

The crisis demonstrated just how damaging a bank failure can be to public finances and to the economy. The Commission proposed a set of measures to minimise bank failures. In January 2014, the Commission also proposed to ring-fence banks' low-profit operations from potentially riskier investments. The idea behind this is to protect depositors' savings and to prevent the need for any further bank bailouts.

According to this legislative proposal on structural reform, national supervisors would be given the power to transfer the high-risk trading activities of selected banks — such as market making, risky securitisation (*) and investments in complex derivatives (*) — to legally separate companies.

The EU now has a toolbox of measures to deal with banks comprehensively. They include:

- **crisis prevention:** making all banks safer in the first place;
- **early intervention:** ensuring that if banks do face difficulties, supervisors can intervene early enough to manage them effectively;
- **crisis management/bank resolution:** if the worst happens, making sure that tools are in place to manage a crisis situation.

(*) See text boxes on page 9.

The EU now has a comprehensive toolbox to prevent crises and to deal with banks in difficulty. NB: CRD4: capital requirements directive, which concerns gaining access to the activities of credit institutions, as well as the prudential supervision of credit institutions and investment firms. DGS: deposit guarantee system, whereby a pre defined amount is reimbursed to depositors whose bank has failed.

Derivatives

Derivatives are financial instruments whose value is derived from the value of an underlying asset (e.g. the price of an equity, bond or commodity) or market variable (e.g. an interest rate, an exchange rate or a stock index). The main types of derivatives are: forwards, futures, options and swaps. Derivatives can be traded on regulated exchanges or in bilateral, off-exchange trades, known as 'over the counter' or OTC transactions.

They are financial contracts that trade and redistribute risks generated in the real economy. They can be used accordingly for insuring against risk (hedging). However, derivatives have increasingly become used to acquire risk with the aim of making a profit (speculation and arbitrage). An important feature of derivatives is that they allow those who use them to obtain leverage: with a relatively small outlay, the investor is able to take a large position in the market.

Securitisation

Securitisation is the process by which an issuer (usually a bank or other financial institution) creates a financial instrument by combining other financial assets, such as the bank's outstanding mortgages or car loans, and then by marketing different tiers of the repackaged instruments to investors.

Consumer banking

Bank account holders must have confidence that their savings are protected, even if their bank fails. EU legislation therefore ensures that bank deposits in Europe are guaranteed up to €100 000 for each depositor in each bank. Taking the Commission's proposal as a starting point, the co-legislators decided to further harmonise and simplify the rules for protecting depositors, ensuring even faster pay-outs and improving the financing of deposit guarantee schemes.

Taking out a mortgage is one of life's most important long-term financial decisions. The co-legislators have adopted legislation ensuring that residential mortgage lending is tailored to consumers' needs and their ability to repay. All lenders and intermediaries must act in an honest and professional manner, before, during and after any loans are granted.

There are still around 30 million adults in Europe without a bank or payment account and who do not have access to electronic payment systems, which have become increasingly essential for everyday life. The EU has agreed on plans to make it easier for citizens to transfer bank accounts from one EU country to another. The Commission has also contributed to setting up a universal right of access to a basic payment account for all EU citizens and residents.

Securities markets

The EU regulates the initial and ongoing conditions for investment firms, establishes requirements for issuing securities and coordinates the conditions applicable to investment funds. The conditions for setting up investment firms and their ongoing business can in some respects be similar to those for banks, and provide for a level playing field between non-bank investment firms and banks providing investment services.

Derivatives play an important role in the economy but are associated with certain risks. Since the beginning of the financial crisis, the EU has been working to address these risks. EMIR — the EU's regulation on derivatives — ensures that information on all European derivative transactions is reported to trade repositories and is accessible to supervisory authorities, including the European Securities and Markets Authority (ESMA), to give a clear overview of what is going on in the markets.

In April 2014, the European Parliament and Council adopted the Commission's proposal on regulating the financial markets. Building on the rules already in place, the new framework also strengthens the protection of investors by introducing robust organisational and conduct requirements or by strengthening the role of management bodies. The new framework also increases the role and supervisory powers of regulators and allows them, in well-defined circumstances, to prohibit or restrict the marketing and distribution of certain high-risk products. A harmonised regime has been introduced which grants firms from non-EU countries access to EU professional markets, based on an equivalence assessment of non-EU jurisdictions by the Commission.

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Stable banks are important for citizens — particularly when buying a new home.

New rules for a global financial system

The EU has agreed with its international partners on an overriding, global priority: no financial product and no market should remain without appropriate regulation and effective supervision. The G20 was instrumental in establishing the core elements of a new financial regulatory framework that will make the global financial system more resilient. These include reforms designed to:

- improve the stability of the banking system through stronger prudential requirements and a framework for crisis management;
- strengthen the regulation of financial markets and infrastructures, especially through the compulsory trading and clearing of derivatives on transparent, regulated platforms.

The Commission has now proposed all the main legislation linked to the G20 commitments and most of these measures, in particular the packages on prudential requirements for banks and the regulation of capital markets, have now entered into force.

Enforcing agreed rules

Each EU country is responsible for the correct and timely implementation of EU laws, and it is the Commission's job to ensure that they do so. Consequently, if they infringe EU laws, the Commission's role is to bring the infringement to an end. The final instance is the Court of Justice of the European Union in Luxembourg. There are several formal stages in the infringement procedure, which usually begins with an investigation by the Commission in response to a complaint. The Commission can also launch an investigation on its own initiative if it believes that there is a problem.

If the matter is not solved in the exchanges of opinions between the Commission and the EU government in question, the Court of Justice can be asked to deliver a judgment stating whether or not there has been an infringement. However, the Court can neither annul a national measure found to be incompatible with EU law nor order the country to pay damages to an individual adversely affected by an infringement of EU law. It is rather up to the country concerned to take whatever measures are needed to comply. If the country still does not comply, the Commission may return to the Court to request periodic penalty payments until the infringement is brought to an end, and/or request that a lump sum penalty be imposed on the country.

Key pieces of the EU-wide financial reform puzzle

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Outlook

European legislation, adopted by the European Parliament and the Council, is sometimes delegated to the Commission which has the duty to draft and adopt 'implementing measures'. These measures are more technical than the basic legislative acts. They lay down specific and detailed rules on how the principles set out in the basic acts are to be implemented. Many of these technical rules are still to be developed and adopted in the years to come regarding the new banking and finance legislation.

After a period of laying down the legislative foundation for structural reforms in the financial services industry, the Commission will vigilantly ensure that the new supervisory and resolution rules are enforced: that will make European banks more robust so that they can get back to lending to the real economy.

The Commission has also announced plans to complement the new European rules for banks with a **capital markets union**. Further developing and integrating capital markets would help to channel more financing into the economy. It would cut the cost of raising capital, notably for small and medium enterprises (SMEs), and help to reduce high dependence on bank funding. It would also increase the attractiveness of Europe in the eyes of foreign investors as a place to invest in.

Find out more

- **For an overview of EU financial services policy, please consult the Commission's website**: http://ec.europa.eu/finance
- **Questions about the European Union? Europe Direct** can help: 00 800 6 7 8 9 10 11 http://europedirect.europa.eu

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