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CONTRIBUTION OF THE LEGAL SERVICE¹

Subject: Addendum to the ECB Guidance to banks on non-performing loans:
Prudential provisioning backstop for non-performing exposures
– General considerations on the powers of the ECB

I. INTRODUCTION

1. At its meeting on 8 November 2017, the Financial Services Committee (FSC) held a discussion on guidance from the Single Supervisory Mechanisms (SSM) on non-performing loans. Reference was made in this context to a draft document of the European Central Bank (ECB) entitled "*Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures*", which sets out the ECB's expectations concerning the minimum levels of prudential provisions expected for non-performing exposures.

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Under this draft document, banks are encouraged to comply with the minimum levels of prudential provisioning by booking the maximum level of provisioning permissible under the applicable accounting standards. If the level of accounting provisions does not fulfil the prudential provisioning backstop, banks should adjust their Common Equity Tier 1 capital beyond the minimum requirements established by law (i.e, Article 3 of the Capital Requirements Regulation² (CRR)).

2. At that occasion, the representative of the Council Legal Service (CLS) made an oral intervention setting out some general considerations on the powers of the ECB as concerns prudential supervision. At the request of the FSC, this contribution confirms in writing the points made orally.
3. The present contribution aims at explaining the legal framework and at providing some general considerations on the powers of the ECB as concerns prudential supervision, it being understood that it is not for the CLS to assess the legality of instruments or initiatives, such as the ECB Guidance in question, that are not measures called to become Council acts.

II. LEGAL BACKGROUND

4. Pursuant to Article 127(6) TFEU, “[t]he 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.”

² Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176 of 27.6.2013, p. 1.

5. The Union legislator acted on that Treaty basis when establishing the SSM pursuant to Regulation (EU) No 1024/2013, hereinafter referred to as the SSM Regulation³. This Regulation confers on the ECB "*specific tasks concerning policies relating to the prudential supervision of credit institutions, with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State (...) The scope of the ECB's supervisory tasks is limited to the prudential supervision of credit institutions pursuant to this Regulation.*" (Article 1).
6. The specific tasks conferred on the ECB are set out in Article 4. They include, among others, the tasks to ensure compliance with the relevant Union law which imposes prudential requirements on credit institutions (Article 4(1)(d)) and with the relevant Union law which imposes requirements on credit institutions to have in place robust governance arrangements (Article 4(1)(e)). The ECB shall also carry out supervisory reviews "*in order to determine whether the arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held by these institutions ensure a sound management and coverage of their risks, and on the basis of that supervisory review to impose on credit institutions specific additional own funds requirements, specific publication requirements, specific liquidity requirements and other measures, where specifically made available to competent authorities by relevant Union law*" (Article 4(1)(f)).
7. Article 4(3) makes clear that "*the ECB shall apply all relevant Union law, and where this Union law is composed of Directives, the national legislation transposing those Directives. Where the relevant Union law is composed of Regulations and where currently these Regulations explicitly grant options for Member States, the ECB shall apply also the national legislation exercising those options*".

³ Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287 of 29.10.2013, p. 63.

8. It is further specified in the second subparagraph of Article 4(3) SSM Regulation , that "*[t]o that effect, the ECB shall adopt guidelines and recommendations, and take decisions subject to and in compliance with the relevant Union law and in particular any legislative and non-legislative act, including those referred to in Articles 290 and 291 TFEU. It shall in particular be subject to binding regulatory and implementing technical standards developed by EBA and adopted by the Commission in accordance with Article 10 to 15 of Regulation (EU) No 1093/2010, to Article 16 of that Regulation, and to the provisions of that Regulation on the European supervisory handbook developed by EBA in accordance with that Regulation. The ECB may also adopt regulations only to the extent necessary to organise or specify the arrangements for the carrying out of the tasks conferred on it by this Regulation.*"
9. In this connection, the first indent of Article 132(1) TFEU empowers the ECB to adopt Regulations to the extent necessary to implement, inter alia, its prudential supervision tasks⁴.
10. Recital 34 of the SSM Regulation reads as follows: "*(...) Where the relevant Union law is composed of Regulations and in areas where, on the date of entry into force of this Regulation, those Regulations explicitly grant options for Member States, the ECB should also apply the national legislation exercising such options. Such options should be construed as excluding options available only to competent or designated authorities. (...)*"

⁴ The first indent of Article 34.1 of Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Banks, is drafted in identical terms.

11. The ECB's supervisory powers are set out in Article 16 of the SSM Regulation. They include among others the power to require institutions to hold own funds in excess of the capital requirements laid down in the relevant acts of Union law related to elements of risks and risks not covered by the relevant Union acts. The ECB can make use of its supervisory powers in any of the circumstances listed in Article 16(1): (a) the credit institution does not meet the requirements of relevant Union law, (b) the ECB has evidence that the credit institution is likely to breach these requirements within the next 12 months, and (c) based on a determination, in the framework of a supervisory review, that the arrangements, processes and mechanisms implemented by the credit institution and the own funds and liquidity held by it do not ensure a sound management and coverage of its risks.

III. LEGAL ANALYSIS

12. Article 127(6) TFEU allows the conferral to the ECB of specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions. It does not provide a legal basis for a generic or unlimited attribution of competences to the ECB. Nor does it provide a legal basis for the conferral of tasks not related to prudential supervision. Therefore, when the legislator confers supervisory tasks on the ECB on the basis of this Treaty provision, the legislator has the obligation to limit the conferral to supervisory tasks and to clearly define these tasks.
13. This is what the Council did when adopting the SSM Regulation, which establishes in an exhaustive manner the framework of action within which the ECB must exercise its supervisory tasks and powers (see Article 1).
14. The SSM Regulation makes clear that the ECB, when exercising its powers of supervision, is held to apply "all relevant Union law" (see Article 4(3)). This is a reference to the material law, adopted by the Union legislator, concerning prudential requirements.

15. The competence to establish the regulatory framework on prudential requirements for institutions, that relate to the functioning of banking and financial services markets and are meant to ensure the financial stability of the operators on those markets as well as a high level of protection of investors and depositors, is one that lies with the legislator on the basis of Article 114 TFEU. Indeed legislation concerning prudential requirements of credit institutions is at the core of the internal market and not limited to the euro area (as are, otherwise, the powers of the ECB).
16. It is on this legal basis that the Union legislator acted when adopting the CRR and Capital Requirements Directive⁵ (CRD). Together these acts establish the set of rules which govern the access to the activity of credit institutions as well as the prudential and supervisory requirements that must be met by them. They form the core of the “relevant Union law” which the ECB is held to apply when carrying out its supervisory tasks.
17. The legislator exercises the competence to set prudential requirements for credit institutions in the internal market in conjunction with the Commission, where the Commission is empowered in the basic acts to adopt delegated or implementing acts, as well as with the European Banking Authority (EBA), the agency which the Union has entrusted with quasi-regulatory powers with a view to maintaining financial stability in the EU and safeguarding the integrity, efficiency and orderly functioning of the banking sector.
18. The SSM Regulation does not confer on the ECB the power to regulate prudential requirements. As indicated above, this would not have been in conformity with Article 127(6) TFEU, the legal basis of the SSM Regulation, which limits the ECB powers to “specific tasks” concerning policies relating to the prudential supervision.

⁵ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176, 27.6.2013, p. 338.

19. While the ECB has among its supervisory powers the possibility, for instance, to require institutions to hold own funds in excess of the capital requirements laid down in relevant Union law or to require institutions to apply a specific provisioning policy in terms of own funds requirements (Article 16(2)(a) and (c) SSM Regulation, as referred to above), it can only make use of those powers in the circumstances listed in a limitative manner in Article 16(2) SSM Regulation⁶. This means that the powers to require for instance a specific provisioning policy can only be exercised vis-à-vis a specific credit institution and cannot be exercised by issuing requirements that apply *erga omnes* and are hence intended to bind or produce legal effects vis-à-vis an entire class of operators. The latter power lies with the Union legislator, not with the ECB.
20. There is therefore a fundamental difference between the role of the ECB as regards *monetary policy* – which is designed and applied by the ECB - and *supervisory policy* - where the ECB executes the policy devised by the Union legislator, the Commission and the EBA.
21. The above leads to the conclusion that the ECB is prevented from adopting rules of general application in the field of prudential requirements.
22. The possibility of the ECB, foreseen in Articles 132(1) TFEU and 4(3) SSM Regulation, to adopt regulations, guidelines or recommendations in the context of its supervisory powers, must be understood in the light of this limitation. Both Article 4(3) and recital 34 SSM Regulation make it abundantly clear that, when adopting any of these instruments, the ECB shall act subject to and in conformity with the relevant Union law and in particular any legislative and non-legislative act, including delegated and implementing acts, binding regulatory and implementing technical standards and the European Single Rulebook. The SSM Regulation establishes a clear hierarchy between these acts and the powers of the SSM.

⁶ That is, where a specific credit institution does not meet the requirements of Union law, is likely to breach them or where it has been determined that there is no sound management and coverage of the institution's risks.

23. First of all, the ECB's power to adopt regulations is explicitly limited to organisational aspects. Article 4(3) SSM Regulation makes clear that regulations can only be adopted "*to the extent necessary to organise or specify the arrangements for the carrying out of the tasks conferred on it by this Regulation*". In this context, reference can also be made to Article 132 TFEU, which has served as the basis for the adoption of an ECB Regulation establishing the framework for cooperation between the ECB and national competent authorities and with national designated authorities.⁷
24. Secondly, the power of the ECB to "*adopt guidelines or recommendations*" consists of a power to adopt non-binding instruments of so-called 'soft law' which may contribute to the objective of ensuring high standards of supervision within the framework of the relevant Union law. Guidelines and recommendations cannot be used though as a disguised instrument of harmonization.
25. It is recalled in this context that it is not because an instrument is called a guideline or a recommendation that it is automatically devoid of legal effects. According to settled case-law, whether an act is capable of having legal effects depends on its wording and context, its substance and the intention of its author.⁸ An instrument such as the draft addendum to the ECB guidance to banks on non-performing loans, founded on a comply or explain mechanism whereby deviations from the suggested prudential provisioning criteria should be justified by the financial entity concerned and "non-compliance" may trigger supervisory powers of the ECB, would be clearly intended to impose compliance on an entire class of persons (banks) and would then entail regulatory effects.

⁷ Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation), OJ L 141 of 14.5.2014, p. 1.

⁸ An examination of these elements led the General Court to conclude that the statement of location policy for CCPs in the Policy Framework's had legal effects. The General Court came to this conclusion after it had found the statement to be particularly specific, rendering it readily applicable and because it "*in fact intended to impose compliance with a location requirement for CCPs and therefore constituted the ECB's definitive position*". Judgment of the General Court (Fourth Chamber) of 4 March 2015 in Case T-496/11, United Kingdom v European Central Bank, ECLI:EU:T:2015:133, paragraph 31 and following.

26. If a guideline or a recommendation amounts to being a regulation in all but name, it can only deal with the organisational matters referred to above or, otherwise, with matters for which the applicable legislation expressly entrusts the competent supervisory authorities (in this case the ECB) with the discretion to apply the material rules on prudential requirements (see recital 34 SSM Regulation).
27. Hence a guideline or recommendation cannot serve the purpose to regulate fields which the legislator has, for the time being, decided not to harmonise. Nor can soft law instruments serve the purpose of completing Union law when the latter (be it in Directives or in Regulations) leaves options or discretions to the national legislator (see first subparagraph of Article 4(3) SSM Regulation) or to the financial institutions themselves (as the case is under Article 3 of CRR). The power to act by adopting rules of general application on these matters lies with the Union legislator, together with the Commission and the EBA, as appropriate, in conformity with the Treaties.

IV. CONCLUSION

28. The SSM Regulation prevents the ECB from adopting instruments of soft law, such as the draft addendum to the ECB guidance to banks on non-performing loans, intended to ensure compliance by banks of criteria for minimum provisioning which are not, or not yet, the object of harmonisation by the EU legislator and for which application banks themselves are granted a margin of discretion under current legislation.
