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From meta-regulation to technocratic fine-tuning: The regulatory powers of administrative authorities in the EU law bank capital requirements framework

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Background

- Research question: How much discretion do bank supervisors wield over the capital requirements of banks under the current EU/EEA law framework?
- Here illustrated by one case study: the framework for supervisory determination of «pillar 2» requirements.
- Work in progress, comments are very welcome!

Background

- Research question: How much discretion do bank supervisors wield over the capital requirements of banks under the current EU/EEA law framework?
- Why is this interesting?
  - A topic of significant economic relevance, but subject to little legal research.
  - Is decentralized administration of a 'single rulebook' possible?
  - Should this type of discretion be delegated to independent administrative authorities?
    - CRD IV art 4(4): 'Member States shall ensure that the competent authorities have the expertise, resources, operational capacity, powers and independence necessary to carry out the functions relating to prudential supervision ...'

Agenda

- A brief overview of the capital requirements framework
- How do CRD IV and relevant guidelines seek to govern pillar 2 decision-making?
- How will courts approach judicial review of pillar 2 decisions?

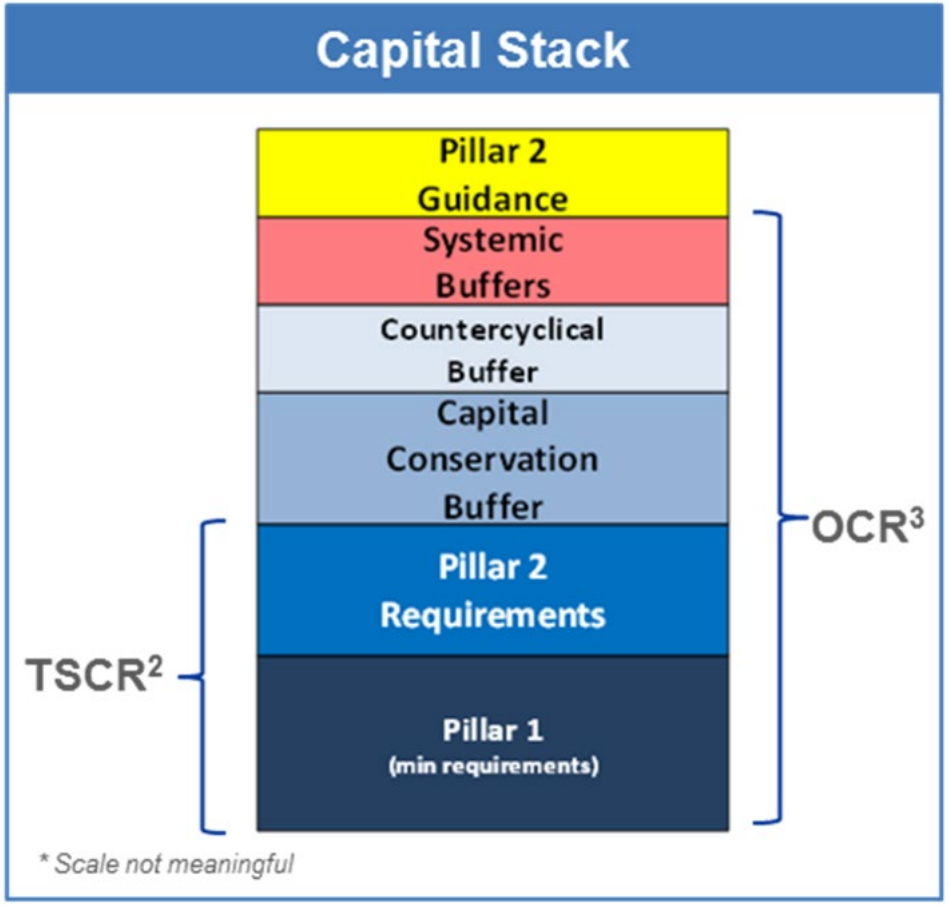
The capital requirements framework

Banks are subject to risk-weighted and unweighted capital requirements

Here: The risk-weighted requirement

The risk weighted requirement consists of:

- The minimum requirements set out in the Capital Requirements Regulation (reg. 575/2013) (CRR) art. 92. ('pillar 1')
- Any pillar 2 requirements
- Buffer requirements
  - Some buffer requirements follow from national legislation transposing the Capital Requirements Directive (CRD) IV (dir. 2013/36), while others are made by administrative authorities
- (Pillar 2 guidance)



Source: https://www.bankingsupervision.europa.eu/banking/srep/2021/html/ssm.srep202101_supervisorymethodology2021.en.html

The power to adopt pillar 2 requirements

- Key provision: CRD IV art. 104a
  - Lengthy: Exceeds 1000 words
- Supplemented by EBA Guidelines Supervisory Review and Evaluation Process (SREP) (EBA/GL/2022/03)
  - Regulation 1093/2010 art. 16(2): ‘The competent authorities … shall make every effort to comply with [EBA’s] guidelines ….’.
  - Several pages devoted to pillar 2 requirements for various types of risks

Pillar 2 requirements: Four key questions

- Immediate objective: to reduce or eliminate the risk that some future event causes a bank to incur so large losses that it becomes insolvent.
- Ultimate objective: financial stability
- Four questions must be addressed:
  - Q1: What risks may *in principle* justify an additional capital requirement?
  - Q2: What is the relevant time horizon?
  - Q3: What is the risk threshold?
    - What probability of a bank not having capital covering losses is acceptable?
  - Q4: How does one determine the amount of capital necessary to ensure that the probability of insolvency over the relevant time horizon is below the risk threshold?

Pillar 2 requirements

- What risks may in principle justify an additional capital requirement?
  - CRD IV art. 104(1)(a): the bank supervisor shall impose an additional requirement if the bank 'is exposed to risks or elements of risk that are not covered or not sufficiently covered' by the minimum capital requirement set out in the Capital Requirements Regulation.
  - Risks either 'not covered or not sufficiently covered' by the minimum requirements potentially includes all *types* of risks
  - CRD art IV art. 104(1)(f) contains a 'catch-all provision': 'other institution-specific situations deemed by the competent authority to raise material supervisory concerns'.
  - Art. 104(1) second subparagraph: Power limited 'to cover the risks incurred by individual institutions *due to their activities*'
    - i.e., not systemic risks (such risks are dealt with by capital buffer requirements)

Pillar 2 requirements

- Are there any limits as to the time horizon of the risks pillar 2 requirements may cover?
  - Nothing in CRD IV art. 104a
  - EBA SREP Guidelines
    - Supervisors shall consider what is necessary to cover losses 'over a 12-month period'.
    - But also possible to impose requirements for risks inherent in business models
- What is the risk threshold?
  - The total amount of capital 'shall cover all risks or elements of risks *identified as material* …'
  - When is a risk material?

Pillar 2 requirements

- How does one determine the amount of capital necessary to ensure that the probability of insolvency over the relevant time horizon is below the risk threshold?
  - Neither the directive nor the guidelines provide any general guidance on the methodologies to be employed.
- Short summary:
  - The bank supervisor may impose capital requirements in respect of any risk that it identifies as material. A constraint applies: the risk must relate to the activities of the bank in question. Systemic risks must be dealt with under the capital buffer requirements.

Judicial review of pillar 2 requirements

- We will consider judicial review in accordance the EU courts' principles for review for the decisions of ECB (and other EU institutions).
- Case T-712/15, *Crédit Mutuel Arkéa v. European Central Bank*
  - Was the ECB justified in concluding 'that … the own funds … held by [by a bank] do not ensure a sound … coverage of its risks', cf. SSMR art. 16.
  - No discussion of whether a risk threshold applied
  - Error-of-law argument recharacterized as a question of error of assessment
  - As the ECB's decision involved a 'complex assessment', a finding of error of assessment required a manifest error.
  - The risk did 'not seem so improbable that taking it into account amounts to a manifest error of assessment by the ECB'.

Judicial review of pillar 2 requirements

- Case C-389/21 P, *European Central Bank v Crédit Lyonnais*
  - Appeal against a General Court's judgment annulling an ECB supervisory decision
  - AG Emiliou's opinion was published 27 October 2022, ECJ has not yet made its judgment
  - Opinion discusses generally what a 'complex' assessment entails
    - Background: Full review of legal questions, deferential review of 'complex assessments'
    - '[a] "complex" assessment is … only one where the relevant factual background *cannot* be established *objectively* or with *absolute certainty*, since reasonable and well-informed persons could … disagree on the outcome of the fact-finding exercise or the legal qualification of the facts' (para 50).
    - Determining what risks are material – and thereby implicitly the risk threshold – is likely a 'legal qualification of … facts'?
    - If so, and assuming the ECJ shares AG Emiliou's view, the implication must be that the review will be limited to manifest error of assessment. End result: Wide *de facto* powers of bank supervisors.

Preliminary conclusions

- On paper, the main constraint on pillar 2 requirements is the materiality requirement.
- The materiality threshold is not defined.
- The approach taken by the GC in *Arkéa* and AG Emiliou’s opinion in *Crédit Lyonnais* suggests that the EU courts will be reluctant to find that ECB overstepped its mandate.
- End result: Few constraints on supervisors’ discretion to impose pillar 2 requirements
  - Counterintuitive result given the amount of legislative text and guidelines dedicated to constraining discretion and ensuring consistent decisions within the internal market
  - Throws into question the possibilities of ensuring consistent application in a decentralized system for administrating fully harmonized EU law?