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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Legal Obstacles to the Free Movement of Funds between Institutions within a Single Liquidity Sub-Group

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1. INTRODUCTION & OBJECTIVES

Background

Regulation (EU) No 575/2013[1] ("**CRR**") and Directive 2013/36/EU[2] ("**CRD**") form the legal framework governing the access to the activity and the supervisory framework and prudential rules for credit institutions and investment firms (referred to collectively as "**institutions**").

CRR contains the prudential requirements for institutions that relate to the functioning of banking and financial services markets. The objective is to ensure the financial stability of operators on those markets as well as achieve a high level of protection for investors and depositors. In order to avoid market distortions and regulatory arbitrage, these prudential requirements should ensure a very high level of harmonisation.

However, several options and discretions remain available to national competent authorities and Member States. These include the possibility under Article 8 CRR for competent authorities to waive liquidity requirements on an individual basis. Whilst the waiver is subject to national discretion, it will greatly facilitate the application of the new liquidity rules in a group context.

The reason for this report

According to Article 8 CRR, the competent authorities may waive in full or in part the application of Part Six of CRR, i.e. the liquidity requirements, to an institution and to all or some of its subsidiaries in the Union and supervise them as a single liquidity sub-group ("**SLSG**"), so long as they fulfil all stated conditions.

Those conditions are:

(a) the parent institution on a consolidated basis or a subsidiary institution on a sub-consolidated basis complies with the obligations laid down in Part Six;

(b) the parent institution on a consolidated basis or the subsidiary institution on a sub-consolidated basis monitors and has oversight at all times over the liquidity positions of all institutions within the group or sub-group, that are subject to the waiver and ensures a sufficient level of liquidity for all of these institutions;

(c) the institutions have entered into contracts that, to the satisfaction of the competent authorities, provide for the free movement of funds between them to enable them to meet their individual and joint obligations as they become due;

[1] Regulation 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, 27.6.2013, p. 1.

[2] 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.

(d) there is no current or foreseen material practical or legal impediment to the fulfilment of the contracts referred to in (c).

According to the last subparagraph of Article 8(1) CRR, the Commission shall report to the European Parliament and the Council on any legal obstacles which are capable of rendering impossible the application of condition (c) and is invited to make a legislative proposal, if appropriate, by 31 December 2015, on which of those obstacles should be removed.

In the past few months, the European Commission has consulted directly with both industry and national public authorities to identify possible obstacles to the free movement of funds between institutions within a SLSG in the EU; to consider how these might be overcome; and whether there is a need for regulatory action at EU level. The Commission has also discussed this topic in the Commission Expert Group on Banking, Payments and Insurance in September 2013.

2. POSSIBLE OBSTACLES TO THE FREE MOVEMENT OF FUNDS

The focus of this report is primarily on cross-border situations, since this is the context within which obstacles are most likely to emerge in practice. Moreover, the waiver regarding the application of liquidity requirements on an individual basis for institutions and to all or some of its subsidiaries, where all institutions of the SLSG are authorised in the same Member State, is separately regulated under Article 8(2) CRR.

It should be noted that potential obstacles in third countries will not be analysed in this report as, according to Article 8(1) CRR, the waiver only applies within the Union, even though the Commission acknowledges that such obstacles would be a concern within the context of supervision on a consolidated basis.

Freedom of capital movement as a general EU rule

As a rule, there should be no restriction to the free movement of capital within the European Union. Under Article 63 of the Treaty on the Functioning of the European Union ("**TFEU**"), all restrictions on the movement of capital and payments between Member States shall be prohibited.

Therefore, a national law preventing institutions from entering into contracts providing for the free cross-border movement of funds between them to meet their individual and joint obligations as they come due would in principle be a restriction forbidden by the Treaty, which may be subject to infringement proceedings under Articles 258 et seq. TFEU. Consequently, Member States cannot, as a general principle, introduce national laws directly prohibiting the free movement of capital.

On the other hand, Article 65(1)(b) TFEU sets out that the general rule expressed in Article 63 should be without prejudice to the right of Member States to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of prudential supervision of financial institutions, or to take measures which are justified on grounds of public policy or public security. According to Article 65(3) TFEU, those measures should not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments.

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As a result, national requirements having restrictive effects on capital flows cannot be considered per se as breaches of Article 63 TFEU when they are not discriminatory, and are duly justified for prudential purposes, suitable for securing the objective they pursue and proportionate to that objective.

Exceptional circumstances may arise where it may be justified to restrict the free circulation of capital by, for example, imposing capital controls. In this regard, the Commission recently considered that temporary restrictions to capital movements imposed by Cyprus were justified on grounds of public policy/public security (Article 65(1)(b) TFEU) and overriding reasons of general interest.

Ring-fencing

In practice, competent authorities in Member States sometimes take actions aimed at retaining liquidity, dividends and other bank assets within national borders, with potential prejudicial effects on other Member States, i.e. so-called “ring-fencing” measures. Such ring-fencing measures can be restrictions to the free movement of capital that are prohibited by the Treaty unless duly justified and proportionate. There is also a concern that national competent authorities may sometimes seek to evade the cooperation obligations with other Member States required by the CRR and CRD.

Based on a confidential survey launched amongst twenty-seven Member States, the Commission services have identified Pillar 2[3], the large exposures regime[4] and domestic liquidity frameworks[5] as specific areas where the free movement of capital between institutions may be hindered, either through measures authorised by the CRR/CRD framework or other informal actions.

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[3] Where the position of an institution is deemed not sufficiently strong or stable despite the fulfilment of the Pillar 1 requirements, competent authorities are authorised to take Pillar 2 measures. According to Article 86(3) CRD, competent authorities shall take effective action where institutions have risk profiles in excess of those required for a well-functioning and robust system. Articles 104((1)(k) and 105 CRD allow imposing specific liquidity requirements.

[4] Under the large exposures regime, there is potential leeway for capital movement restriction where intra-group exposures are restricted within a binding large exposures limit. According to Article 395(1) of the CRR, an institution shall not be exposed to another group entity, after taking into account the effect of credit risk mitigation, beyond 25% of its eligible capital, unless exempted from the large exposures regime according to Articles 400(1)(f) and 400(2)(c), (e) and (f) CRR. The competent authorities may also impose stricter large exposures limits on institutions under Pillar 2, in particular where they consider that the concentration risk is not appropriately monitored and addressed (Article 81 CRD). The large exposures regime also establishes specific provisions aimed directly at intra-group exposures for which Member States may, under certain conditions, apply a large exposures limit below 25% on a sub-consolidated basis (Article 395(6) CRR). However, in this particular case, the Commission may reject the proposed national measures if it considers that they, inter alia, create an obstacle to the free movement of capital in accordance with the provisions of the TFEU (Article 395(8) CRR).

[5] Under Articles 412(5) and 413(3) CRR, Member States may maintain or introduce national provisions in the area of liquidity and stable funding requirements before binding minimum standards are specified and fully introduced in the Union. As a result, and at least until 2018 (or 2019 where the Commission decides to alter the phase-in specified in Article 460 and defers until 2019 the introduction of a 100 % binding minimum standard for the liquidity coverage requirement (Article 461 CRR)) for the liquidity coverage requirement, Member States are allowed to maintain or introduce national provisions in the area of liquidity, that are more conservative than the CRR/CRD framework and require a binding liquidity coverage requirement of up to 100%.

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The boundary between legal and illegal action is sometimes blurred, as ring-fencing measures often occur within the context of (or are masked by) legally authorised actions and/or in areas where competent authorities enjoy discretionary powers.

However, the instruments used in the areas mentioned above, such as Pillar 2 powers, clearly serve a valid and useful purpose, provided they are applied in accordance with the law and are not disproportionate to their prudential purpose. The mere fact that their use may result in a negative effect on the possibility to transfer funds within a group does not justify their automatic categorisation as legal obstacles in the sense of Article 8 CRR. It is only where these instruments are used for a purpose not in line with EU legislation that they may be considered as obstacles. Such inappropriate use should be avoided but does not imply that the instruments themselves should be modified.

Moreover, the purpose of this report is not to put in question the recently agreed provisions in CRR and CRD relating to the above-mentioned instruments. There is a clear and valid need for such instruments and their inclusion in CRR/CRD is the result of long-standing and well-established supervisory needs. Rather the purpose of this report is to examine legal obstacles arising from other sources than the provisions of CRR and CRD.

Provisions under Company law

Some company law provisions, that prevent institutions from providing liquidity to other members of the same group in an unrestricted way, were cited during a consultation of stakeholders as a possible obstacle to the free flow of capital within a group. This is especially the case where the management of an institution is bound by a general fiduciary duty to protect the interests of their institution (also at the expense of the wider interests of the group of which an institution forms part). Therefore, even though an institution enjoys excess liquidity, it is not automatically entitled to transfer this to other group members, where repayment cannot be guaranteed. An institution therefore cannot freely (at least not without further consideration) enter into a contract with other group members that would provide for the free movement of funds between the two.

However, such "obstacles" appear well justified, especially as they are part of general company law principles, i.e. that they also apply to companies in other sectors than banking. It would be rather questionable if such a principle were not to apply. Such issues need to be fairly resolved: either by properly guaranteeing repayment of any liquidity provided or by using a different structures - such as branches - which are not separate legal entities.

Although Member States currently retain significant powers regarding liquidity management by branches, these are of a different character. They are related to prudential requirements and not to company law obligations. Moreover, they will diminish in importance (see below - developments on European liquidity rules and the Single Supervisory Mechanism).

Tax laws

While the existence of tax laws limiting tax deductibility of interest paid on loans from other group members may arguably hinder the free flow of capital, this does

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not seem to prevent institutions from entering into a contract providing for the free flow of capital between the two.[6]

3. ON THE NEED TO ADDRESS THE CURRENT SITUATION

This review indicates that there do not appear to be substantial legal obstacles preventing institutions from entering into contracts that provide for the free movement of funds between them, at least not in the sense of unsubstantiated legal obstacles.

The first group of difficulties that institutions might encounter when trying to enter into such contracts are supervisory requirements (imposed by competent authorities) that in some cases hinder the free flow of capital in the group. These requirements may be either justified – where they are validly required by the situation of the individual institution targeted by the supervisory requirement – or they may be questionable – where the real, underlying objective of competent authorities is to retain liquidity within their territories, thus excessively protecting national taxpayers and creditors of the institution they supervise at the expense of taxpayers in other EU Member States and creditors of other parts of the group.

The reactions from many Member States and their competent authorities demonstrate that such considerations are common and even openly admitted. This suggests that many competent authorities are not fully comfortable with the notion of a (cross-border) SLSG, as they see it as a potential danger to national interests. Such behaviour (ring-fencing practices) – logical from a purely national perspective, but with clear and significant negative effects from a wider European perspective – is difficult to change without further integration of the current regulatory and supervisory framework. In other words, to effectively eliminate these practices, it is not sufficient to address only the symptoms of the problem but also the underlying causes and fears. Therefore, unless these underlying causes and fears are also addressed, competent authorities could seek alternative means to achieve the same objectives.

To the extent that the underlying problem is one of national self-interest, aligning the objectives of the public stakeholders through greater European integration in the field of financial services and more integrated supervisory responsibilities would seem a more efficient way forward.

The European Banking Authority

A first important avenue to avoid or address supervisory practices that limit the free flow of capital (to the extent that they are not justified) is through the European Banking Authority ("**EBA**"). EBA plays an increasingly important role in facilitating cooperation among competent authorities, providing expertise and establishing the Single Supervisory Rulebook.

In particular, competent authorities should be encouraged to improve cooperation and to make use of non-binding EBA mediation in cases of disagreement on the

[6] However, these tax laws may limit the incentive to provide for the free flow of capital, as they increase the tax burden for the group.

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question of whether the conditions for the establishment of a SLSG are met. This is also true during the period before 2015, after which the CRR provisions on joint decision making and non-binding mediation on this matter will become applicable[7].

After the observation period and after full implementation of a liquidity coverage requirement in accordance with CRR, the Commission will assess whether additional measures are necessary.[8]

The Single Supervisory Mechanism

An important step forward has been achieved with the creation of the Single Supervisory Mechanism ("**SSM**") through Council Regulation (EU) No 1024/2013[9]. The ECB will indeed have the legal capacity to supervise all credit institutions of the euro area as well as those of countries that decide to join the Banking Union.

The SSM Regulation confers key supervisory tasks and powers to the ECB over all credit institutions established within the euro area. The ECB will directly supervise certain large credit institutions and credit institutions which have requested or received direct public financial assistance. The ECB will also monitor supervision by competent authorities of less significant credit institutions. The ECB may, at any moment, decide to directly supervise one or more of these credit institutions to ensure consistent application of supervisory standards.

For cross-border credit institutions, active both within and outside Member States participating in the SSM, existing coordination procedures among home/host competent authorities will continue to exist as they do today. However, to the extent that the ECB has taken over direct supervisory tasks, it will carry out the functions of the home and host authority for all participating Member States. This should lead to a significant elimination of undesirable ring-fencing practices as described above. The greater the number of Member States participating in the SSM, the less likely undesirable ring-fencing practices will become.

The Single Resolution Mechanism

The establishment of the SSM is a first step towards the Banking Union and one of the pre-conditions for direct recapitalisation of credit institutions by the European Stability Mechanism. An integrated Banking Union also includes a common credit institution resolution mechanism underpinned by a single rulebook.

The Commission emphasized the importance of reaching agreement on the proposals on credit institution restructuring and resolution and deposit guarantee schemes, and on the Commission's proposal for a single European resolution mechanism, to deal efficiently with cross-border credit institution resolution and avoid taxpayers' money going into rescuing credit institutions. The agreed

[7] See Article 8(3) and Article 21 CRR in connection with Article 521(2)(a) CRR .

[8] See recital 30 of CRR.

[9] Council 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, 29.10.2013, p. 63.

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legislation should contribute significantly to the alignment of the objectives of public authorities and further limit incentives for ring-fencing practices.

European Liquidity Requirements

The Commission is preparing a delegated act, to introduce a detailed and harmonised liquidity coverage requirement in the Union. This delegated act shall, according to Article 460(2) CRR, enter into force by 31 December 2014, but shall not apply before 1 January 2015.

The delegated act should also help limit any undesirable practices that trap liquidity within national borders, as it will provide for harmonised, uniform, detailed and binding rules on liquidity, thereby promoting mutual supervisory confidence between competent authorities.

In particular, the delegated act should seek to address some issues linked to the cross-border intra-group liquidity management. In the interests of efficiency and effectiveness, some banks conduct their liquidity and treasury management on a group wide-basis. For groups not making use of the SLSG (single liquidity sub-group) waiver, a preferential intra-group flow can act as an important source of liquidity. This is described as 'preferential' because a higher inflow is allowed to the beneficiary bank than would normally be allowed on a ‘solo’ basis under the CRR. This could be coupled if necessary with a corresponding higher outflow for the bank providing the liquidity. Unfortunately, during the financial crisis the realisation of these intra-group flows on a cross-border basis sometimes proved unreliable.

Article 425.4 CRR sets out the conditions that must be satisfied for the competent authorities to grant such a preferential treatment for an inflow under a credit and liquidity facility. Article 425.4d CRR requires the institution and the counterparty to be established in the same Member State. But Article 425.5 CRR allows competent authorities to waive this condition provided additional objective criteria are met. The Commission will examine whether these additional objective criteria can be framed in the forthcoming delegated act. Corresponding provisions exist in Article 422.8d and Art 422.9 CRR in relation to intra-group outflows.

In conclusion, in preparing the liquidity coverage ratio delegated act, the Commission services will examine whether additional objective criteria can be set to enable preferential treatment for cross-border intra-group inflows and outflows. This should clarify and improve the operation of cross-border intra-group flows that have sometimes been problematic in the past.

Defence against discrimination of cross-border groups

One possible source of discriminatory treatment is that national authorities allow SLSG formation at a national level but not for an international group. However, this should be partly mitigated by the fact that according to Article 8(2) CRR, the competent authorities may waive the application of CRR liquidity requirements to

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an SLSG at a national level only if the same basic conditions[10] that a cross-border group has to meet are fulfilled.

As both the EU law requirements on non-discrimination and general administrative legal principles would preclude applying the same conditions in a different manner to purely national and cross-border groups, there would have to be a relevant difference between those groups in order not to allow creating a SLSG in a cross-border context where a SLSG is allowed in national context. The mere fact that a group is a cross-border one and that it is supervised by different competent authorities cannot be considered on itself as a relevant difference.

Future review of CRR and CRD

The Commission is confident that a Single rulebook together with the Banking Union will ensure consistency and safeguard financial stability. These new rules will also ensure a level-playing field across the single market between home and host authorities, as well as between Member States participating and not participating in the SSM, thus preventing regulatory arbitrage opportunities, artificial ring-fencing of capital and liquidity, and facilitating cross-border banking recovery and resolution.

In possible future revisions of CRR and CRD, it might be useful to re-examine the effect of discretionary powers by competent authorities on the free flow of capital within groups. If necessary and where possible (i.e. without impairing the scope and effectiveness of the relevant instruments in justified cases), the Commission will assess whether such powers should be framed in a way which leaves less discretion for potential measures restricting the free flow of capital.

4. CONCLUSION

In conclusion, given the fact that

(i) the legislative process on CRR and CRD has been completed only very recently (and thus the co-legislators' approval of existing national discretionary powers is recent),

(ii) the Commission will explore whether the forthcoming liquidity coverage ratio delegated act can help to limit any undesirable practices that trap liquidity within national borders. In this respect, it can seek to develop uniform, detailed and binding rules on liquidity, thereby promoting mutual supervisory confidence between competent authorities. More particularly,, the delegated act could be an opportunity to establish additional objective criteria facilitating the allowance of a preferential treatment for cross-border intra-group inflows and outflows, thereby clarifying and improving the operation of cross-border intra-group flows,

(iii) there is a steady process improving the alignment of objectives of public stakeholders through greater European integration with a Single Rulebook, the EBA and especially through the Banking Union, and

[10] Those laid down in Art. 8(1) CRR. Where the SLSG has a cross-border nature, also the conditions laid down in Art. 8(3) CRR (applicable as of 1 January 2015) have to be met.

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(iv) this review has not revealed relevant legal obstacles that would prevent institutions from entering into contracts that provide for the free movement of funds between them within a single liquidity sub-group,

the Commission does not see a need currently to present a legislative proposal on this matter. However, the Commission will continue to closely monitor and review the situation and should this deteriorate, the Commission will reassess the need to make such a legislative proposal.

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