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Technical advice to the European Commission on a review of Article 16 of Directive 2000/12/EC

Background

1. At the end of January 2005 CEBS received a mandate from the European Commission asking for technical advice on the review of Article 16 of Directive 2000/12/EC (the "Consolidated Banking Directive", or CBD). The mandate was issued as a consequence of the Commission's commitment to review Article 16 after the informal ECOFIN meeting of 11 September 2004, which had discussed why there appeared to be a lower incidence of cross-border mergers and acquisition (M&A) in the EU financial sector compared with other economic sectors.

2. The Commission's call for advice sought technical advice on five possible options for ensuring that Article 16 does not improperly curb mergers and acquisitions in the EU. In this context, CEBS designed a road map that included early involvement of the Consultative Panel and the launching of a questionnaire through the CEBS web site. The advice presented by CEBS in this paper has taken into account the useful input from these procedures.

Areas on which technical advice is to be delivered

3. The Commission's mandate included two core options on which the advice of CEBS was requested: (i) explicit criteria to be used when assessing the suitability of qualifying shareholders and (ii) considering mutual recognition agreements; and three others on which advice "would be welcome": (iii) review of the thresholds at which supervisors must be informed, (iv) adding transparency provisions to negative decisions, and (v) making a redress mechanism available. CEBS has focused its advice on all of these topics except the last.

General views on the issue

4. Article 16 of the CBD is an important element in the prudential framework that has proven valuable and has worked well to ensure prudential requirements are met when there is a change in control at a credit institution. Nevertheless, in providing technical advice on the options for ensuring that Article 16 does not improperly impede or delay mergers and

acquisitions in the EU, CEBS agrees that it would be desirable to make progress towards a consistent interpretation of the term ¨suitability¨.

5. CEBS is of the view that Article 16 must leave a good deal of flexibility and discretion to the competent authorities if it is to work properly. The potential for varying situations and the changing environment make a case-by-case judgement necessary.

6. CEBS would also like to highlight that Article 16 has to be consistent with Article 7 of CBD.[1] Moreover, under Article 14(1)(c) of the CBD credit institutions have to comply with the suitability requirements on a continuous basis, which means that it should be applied to changes in qualifying ownership.

7. The mandate provided by the Commission did not request CEBS to obtain evidence on whether Article 16 has been abused by Member States' competent authorities or was a direct cause of the (perceived) slower pace of M&A activities in the financial sector.

8. As part of its work CEBS conducted an open questionnaire, the responses to which indicated that a variety of factors pose obstacles to cross border consolidation in the financial sector. These factors include:

    - differences in the corporate/managerial culture,
    - customer habits as perceived by institutions,
    - fragmented rules in consumer protection,
    - differences in deposit guarantees schemes,
    - labour codes,
    - tax provisions,
    - local market structures, and
    - legal, cultural and economic reasons.

    It is clear that Article 16 should not be changed solely to facilitate cross border consolidation if to do so would risk a reduction in the prudential benefit currently provided by Article 16.

9. Therefore the responses to CEBS' open questionnaire suggest that the industry in general recognises the role of Article 16 in preserving financial stability and the need for discretion in its implementation. Moreover, respondents have not identified Article 16 as an important issue in preventing mergers and acquisitions. Nevertheless, some responses to the open questionnaire identified that the absence of a common

[1] Whereas Article 16 clearly states that the competent authorities can oppose the intention by any natural or legal person to hold a qualifying shareholding in an institution if they are not satisfied as to the suitability of that person to ensure sound and prudent management, Article 7 specifies that competent authorities shall refuse authorization for the taking up of the business of credit institutions if, taking into account the need to ensure the sound and prudent management, they are not satisfied as to the suitability of the shareholder's that have qualifying holdings.

interpretation of the suitability criteria in Article 16 could become a significant obstacle to increased M&A activity in the single market.

10. It is important to note that the importance of Article 16 for prudential purposes has not been questioned. The Commission's interest is the use of Article 16 for reasons not related to prudential supervisory concerns; the use of Article 16 in this way does not arise from the way it is drafted, nor from the way EU Member States have transposed it. Moreover, if a competent authority imposes strong requirements when applying Article 16, this should be regarded as a legitimate use of the Article.

11. The possible use of "moral dissuasion", to retain control of financial institutions in national hands, is outside the scope of this advice.

12. CEBS considers that there is some room to introduce measures in respect of Article 16 to address industry concerns over the common interpretation of the suitability criteria. These measures will also impact on Article 7. In particular, CEBS agrees that Articles 16 and 7 are vague on the concept of *suitability*, and that some further development and guidance could lead to greater convergence in its application. This would be in line with national legislation.

13. CEBS has found the issue of mutual recognition as a general concept to be complex, largely due to differences in the wider legal systems in each Member State.

14. CEBS also considers that there is room for progress on disclosure, at an aggregate level, to achieve convergence in practice.

15. Therefore, taking into account this general framework, CEBS' opinion on the four issues considered in its advice is the following:

I. MAKING EXPLICIT THE CRITERIA APPLICABLE WHEN ASSESSING A QUALIFYING SHAREHOLDER.

16. The European Commission has asked CEBS for advice on the relevant criteria that should apply when reviewing the suitability of qualifying shareholdings under Article 16.

17. CEBS considers that, when assessing the suitability of a qualifying shareholder, not only the specific circumstances (fitness and properness) of that particular qualifying shareholder should be analysed, but the assessment should also be based on several other factors pertaining to the concrete interaction between the intended shareholder and the target institution.

Two-step procedure

18. Taking this into account, CEBS considers that suitability should be assessed as a two-step procedure:

1. A general suitability analysis of the fitness and properness of a particular qualifying shareholder.[2]

2. A refined analysis of the suitability of the qualifying shareholder as a controller of the target institution in question.

19. CEBS agrees that there is scope to introduce in the Directive some explicit criteria already included in most, if not all, EU Member States legislation, in each of the two steps depicted above. These would serve at least as an indication of the criteria that must be used when testing the suitability of qualifying shareholders from the point of view of the sound and prudent conduct of the business of the credit institution.

20. Concerning the first step above, CEBS agrees that a set of minimum negative criteria, such as a requirement to not be the subject of "(criminal) negative records", could be introduced as a necessary requirement for suitability (in relation to its fitness and properness) as a qualifying shareholder (although national laws throughout the EU are quite different on the concept of negative records, for some suspicion or bad reputation being enough while for others only conviction implies having "negative records").

21. Concerning the criteria that would have to be assessed in the context of the specific operation CEBS agrees on the general minimum criteria to be fulfilled by the intended qualifying shareholder:

    a. The qualifying shareholder should have "appropriate financial strength" in relation to the characteristics of the target institution, including the complexity of its business.

    b. The qualifying shareholder should have a sound business plan and strategy for the target institution.

    c. The proposed acquirer must have adequate and appropriate proposals for the corporate governance arrangements to be implemented at the target institution and, if appropriate, any wider group, after the proposed acquisition.

    d. If new managers are appointed to the target institution as a result of the cross-border merger or acquisition they should be fit and proper, in the sense of Article 6 of the CBD: this includes both integrity and professional competency.

    e. The group structure should be transparent enough to allow appropriate supervision according to Article 7.3 (close links).

    f. The qualifying shareholder must have appropriate and adequate arrangements for the management of conflicts of interest

[2] It must be noted that in the case of a shareholder of a credit institution already authorised in a Member State, the suitability test (included in Article 7 of the Directive), implies both the need to be fit and proper and the need to be appropriate in relation to the credit institution in which it has a qualifying holding. This test is performed by the Member State where the credit institution was authorised and has to be complied on a continuous basis.

between the qualifying shareholder, existing shareholders of the target institution, and the target institution itself, including where appropriate measures to remove the source of the conflict.

22. Even taking into account these criteria, which might be fleshed out further at level 3, CEBS agrees that supervisors should have the necessary degree of discretion, according to the individual circumstances.

23. CEBS admits that in some cases it could be sensible to apply other requirements (related to the concept of "appropriate financial strength") such as for qualifying shareholders in a credit institution to be ready to support the institution, to contribute "fresh money" under some circumstances, as well as requiring some kind of commitment to stay in the business. The latter is already laid down in some Member State's legislation relating to the authorisation of a credit institution. However, CEBS recognises that it would be very difficult to include these provisions in the Directive and therefore in all Member States legislation. CEBS' opinion is that this is rather an issue to be dealt with through convergence of supervisory practice at level 3.

CEBS' advice on explicit criteria to be used when assessing the suitability of shareholders[3]:

Measures should be taken to supplement Articles 7 and 16 of the Directive with indicative criteria to be applied when assessing the suitability of a person for the purposes of those articles. The criteria must be indicative and non-exhaustive because no specific criteria can cover the necessary range of cases and there are differences in what the wider law will allow in each country. The criteria in relation to the suitability of the qualifying shareholders should be:

- Qualifying shareholders should be fit and proper. This implies, among other possible tests, the absence of criminal records relating to commercial activity, bearing mind national legal systems and spent conviction rules.
- Qualifying shareholders should be appropriate in relation to the credit institution they are establishing or which they wish to acquire. This implies, among other possible tests, that they should have appropriate financial strength in relation to that credit institution.

[3] CEBS wants to make clear that this advice should not be interpreted as a drafting proposal of Articles 7 and 16 of the Directive. It is a proposal regarding the criteria that CEBS considers would be useful to include in the Directive to facilitate a common interpretation of the term ¨suitability¨ when applied to a qualified shareholder. Given that this concept appears both in Article 7, applied to qualified shareholders of a new credit institution, and in Article 16, referred to relevant changes in the shareholding structure of an already established credit institution, the above mentioned criteria could be grouped in Article 7 in such a way that would allow just a reference to Article 7 in Article 16.

Article 16 should be supplemented by adding the following criteria to the assessment of qualifying shareholders intending to acquire a credit institution:

- The qualifying shareholder should have appropriate financial strength to perform the operation and to ensure a sound performance of the target credit institution's business[4]. The qualifying shareholder should have a sound business plan and strategy for the target institution.
- The proposed acquirer must have adequate and appropriate proposals for the corporate governance arrangements to be implemented at the target institution and, if appropriate, any wider group, after the proposed acquisition.
- The managers appointed to the target credit institution, if any, should be fit and proper according to Article 6.
- The resulting credit institution or group should have a transparent structure that allows effective supervision.
- The qualifying shareholder must have appropriate and adequate arrangements for the management of conflicts of interest between the qualifying shareholder, existing shareholders of the target institution, and the target institution itself, including where appropriate measures to remove the source of the conflict.

The criteria listed above should be taken as an indicative list. A complete harmonisation on these criteria is not deemed desirable. It is impossible to list an exhaustive set of rules for the competent authorities to adhere to and at the same time leave open the possibility for supervisors to incorporate additional situations.

CEBS could be encouraged to develop guidance at level 3. The establishment of the criteria listed above as requirements in the Directive does not preclude efforts by the competent authorities to pursue further convergence at level 3.

II MUTUAL RECOGNITION

24. The Commission asked if it would be possible to agree on mutual recognition for "suitable shareholders", that is, if it was possible for competent authorities of all other Member States to rely on the assessment already made by a competent authority of any one EU Member State that a particular qualifying shareholder is "suitable".

[4] In some cases, this requirement could be applicable to the indirect or ultimate shareholder instead of to the direct ones.

First step

25. In relation to the first step above (the fitness and properness of the qualifying shareholder), CEBS agrees that there could be mutual recognition of an assessment, by the competent authority of another EU Member State, that a particular qualifying shareholder is **not** suitable for the purposes of Article 16.

26. Concerning the **positive** assessments made by the competent authority of an EU Member State (also in relation to the first step above), the situation is more complex.

27. First, it must be noted that if there has been a positive assessment, this implies that the qualifying shareholder in question has obtained a banking licence in the EU Member State that has performed the assessment.

28. Second, it must be noted that, in accordance with the Directive, any credit institution already authorised in a EU Member State and any qualifying shareholder of a credit institution authorised in a EU Member State have to be suitable on a continuous basis, according to the regulations of the EU Member State of incorporation.

29. CEBS understands that it might be useful to have mutual recognition of positive assessments. However, it has not been possible to reach a consensus on this matter. This is due to the complexity of the issue and the different legal systems in the Member States, and the fact that EU legislation attributes competence in this matter to Member States. It would be very difficult to have a fully harmonised suitability test applied throughout the EU. It would have far-reaching legal and technical implications and might therefore benefit from further consideration.

30. On an immediate basis, CEBS agrees that the suitability of a qualifying shareholder assessed in an EU Member State should be a first and important input when assessing its suitability in other EU Member State. In the case of credit institutions becoming subsidiaries or under control of other EU Member States' credit institutions, a procedure for prior consultation between competent authorities is already established in Article 16.2. To reinforce this principle CEBS is proposing to apply this prior consultation to any acquisition of a qualifying shareholding.

Second step

31. CEBS is of the view that the test to be applied when assessing the appropriateness of the qualifying shareholder in respect of the target credit institution (second step above), will recognise that even if a qualifying shareholder is deemed to be suitable "at first sight" he/she should also be suitable for a specific credit institution. The second step in assessing suitability has to take into account, inter alia, the complexity of the target institution's business, the size of the institution (which is related to the concept of having appropriate financial strength) and possible conflicts of interest with the proposed acquirer, etc. The competent authority of the target credit institution should perform an in-

depth analysis of these issues. In this assessment, although some additional and useful information can be provided by the other competent authority, its role is reduced.

CEBS' advice on mutual recognition agreements:

CEBS is of the view that measures could be introduced to require mutual recognition by Member States, when applying the first step of the suitability test under Article 16, of the decisions by other Member States that a qualifying shareholder is not "suitable" for the purposes of that test.

CEBS is of the view that measures should be introduced to require competent authorities to regard the fact that a qualifying shareholder is suitable for the purposes of Article 7 in another Member State, as an important factor when applying the first step of the suitability test under Article 16.

III POSSIBILITY OF REVIEWING THE THRESHOLDS

32. The European Commission asked about the significance of the thresholds for the notification laid down in the Directive if the acquisition does not entail any intention of controlling the target institution, and advocated either establishing higher thresholds or requiring notification only in cases when there is an intention of control the institution. On the other hand, it is a fact that Member States have established additional or lower thresholds for notification than those in the Directive.

33. CEBS' view is that it will be ineffective to set up a higher threshold in the Directive as, in legal terms, EU Member States will still have leeway to apply lower ones. Moreover, CEBS' view is that requiring different thresholds within the EU does not imply an uneven playing field, but rather gives important prudential information.[5] In addition, it should be noted that the industry has not indicated that the thresholds impose an undue burden.

34. CEBS' view is that "reasonable" thresholds for notification will very much depend upon the company legislation of each country and the (general) ownership structure of its banking system. The ownership structure of the target institution is also important given that the same shareholding could have different implications depending on the more or less concentrated ownership.

[5] CEBS agrees that there are least three different situations that deserve notification:
- Shareholdings allowing the exercise of a significant influence,
- Shareholdings giving the possibility to block decisions,
- Shareholdings providing control.

CEBS' advice on the thresholds at which supervisors must be informed:

CEBS considers that there is no reason to change the thresholds.

IV TRANSPARENCY OF THE DECISION TAKEN

35. The Commission also raised questions about the possibility of a public notification of negative decisions when assessing qualifying shareholders. Even though CEBS is of the opinion that a transparent process is crucial in order to assure a decision based on prudential reasons, it considers that a public notification process is not the appropriate way of achieving transparency.[6] The publication of the reasons behind a negative assessment could prove complex, misleading, and damaging for some of the interested parties. The decision might not be well understood or even could have an undue negative repercussion on the acquirer's reputation. Some of the disadvantages were already pointed out in the Commission's call for technical advice.

36. Moreover, it should be noted that EU competent authorities already explain the reasons behind their negative decisions in a response addressed directly to the applicant and, based on this response, all applicants have the right of recourse to the courts to challenge a decision. In this context, it should be noted that Article 10 of the Directive (which deals with refusals to authorise credit institutions) already states that "reasons shall be given whenever an authorisation is refused and the applicant shall be notified thereof within six months of receipt of the application". CEBS considers that it should be made explicit in the Directive that the requirement to notify and explain should also apply in relation to refusals under Article 16.

37. CEBS is also of the opinion that a way to achieve more consistent decisions well supported by prudential grounds is to shed more light on the whole procedure. Against this background, CEBS is proposing some new measures to be applied by the competent authorities.

CEBS' advice on transparency provisions:

CEBS' advice on this particular issue is that the directive should be modified to make it clear that the requirement to notify and explain the reasons for refusing authorisation under Article 10 should also apply to refusals in relation to the taking of control or crossing of thresholds under Article 16.

In addition, apart from a reasoned decision addressed to the prospective qualifying shareholder, the competent authorities could enhance

[6] In some Member States the formal decision to reject applications for qualifying shareholders are made public as a matter of national transparency legislation and the policy of the supervisory authority.

transparency on the assessment process by means of the measures below:

- Publication of the methodology used by the competent authority in assessing the suitability of qualifying shareholders
- Yearly aggregate public disclosure of all cases where a negative decision was taken, without prejudice of confidentiality provisions.[7] This could be published e.g. in the competent authority's Annual Report, and/or disclosure of aggregate information on CEBS' website, within the supervisory disclosure framework
- Sharing of information between relevant competent authorities.

[7] For example, one exception should be made in cases where only one negative decision has been taken.