



ENFORCEMENT ACTIONS OF BANKING SUPERVISION AUTHORITIES IN EUROPEAN UNION: NON-COMPLIANCE WITH POST-CRISIS BANKING REGULATIONS

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This paper focuses on the issue of post-crisis banking regulations in the European Union and issues related to ensuring compliance with them and minimizing enforcement actions related to them. The aim of this paper is to consider the nature of enforcement actions in the post-crisis years. Based on the analysis, the hypothesis was formulated that the importance of regulatory compliance increases with the intensification of the enforcement actions of banking supervision authorities. The research question arises whether compliance units can identify non-compliance in advance and prevent or minimize the application by the supervisor of enforcement actions. The article attempts to describe the unexplored dependencies between the increase in regulatory requirements for banks in the post-crisis years and the dynamics of enforcement actions.

Keywords: Bank, Compliance, Enforcement actions, Post-crisis regulations.

Introduction

In response to the financial crisis of 2008, the banking industry has been undergoing fundamental regulatory and supervisory changes, imposed by CRD IV / CRR package in European Union (EU), Dodd-Frank Act – in the United States (US) and the Basel III Agreement. In the post-crisis years, the European banking sector has become the subject of many regulatory and supervisory modifications. Fundamental changes for European banks consisted of the following:

- tightening prudential regulations (the so-called CRD IV / CRR package - Capital Requirements Directive IV / Capital Requirements Regulation)¹;
- introduction of a European supervisory structure²;
- creation of the concept of a Banking Union³.

¹ *Capital Requirements Directive IV / Capital Requirements Regulation*, Prudential requirements https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-requirements_en.

² *The European system of financial supervision*, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/european-system-financial-supervision_en.

³ *Banking Union*, The European Central Bank, <https://www.bankingsupervision.europa.eu/about/bankingunion/html/index.en.html>.

Within 10 years after the crisis, regulatory activity at the national and European level was still intense, which results that the majority of the banking regulations currently in force in the EU were introduced in the post-crisis period. The evidence of this is a significant increase in a number of pages of the legal acts, namely from 110 pages before 2008 up to 2431 pages in 2017⁴. In the post-crisis years, the dynamics of production and amendments of banking regulations in the European Union in was on average 387 pages or 77% per year⁵.

Ensuring Compliance with the Post-Crisis Banking Regulations

Due to the fact that the number of applicable regulations is increasing, the compliance function has begun to gain importance in order to secure compliance of the bank's activities with the applicable law, internal regulations and standards of conduct adopted by the bank. In the pre-crisis period, the Basel Committee on Banking Supervision has defined the compliance function, identified her principles, purpose, and role⁶⁷. According to the Basel, the purpose of the compliance function is to assist the bank in managing its compliance risk, which can be defined as the risk of legal or regulatory sanctions, financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with all applicable laws, rules and standards⁸.

Ensuring the proper functioning of the compliance within bank depends on the effective operation of many factors, namely the location of compliance units in the bank's structure, their function, shape and scope of duties, possession of compliance programs and Compliance Management Systems, level of the compliance culture and others. Everything above mentioned leads to the fact that very high are compliance costs, which are a part of the costs of doing business. Managing these costs will continue to be a major task for banks. By the European Banking Report (2017), large European banks spend on average from €600 million to €800 million a year on global compliance, operational risk, and regulatory programs⁹.

As it is indicated in the McKinsey report *Compliance 2.0: Emerging Best Practice Model* (2015), the traditional compliance model was designed an enforcement arm for the legal function¹⁰. However, in the practical activities of banks in recent years, the problem has arisen that the banks introduced compliance systems and announced internal policies largely in advisory purposes with a limited focus on actual risk identification and management. Which often resulted in the limited or unproven impact on the reduction of operational risk and immediate response on crisis phenomena.

Currently, from compliance units in the bank are also expected to have high control capabilities, thanks to which banks will more effectively avoid financial penalties and fines for non-compliance or violation of applicable regulatory requirements. In other words, it is expected that the effective operation of the compliance function will affect the minimization of financial penalties, fines and settlements against banks by supervisors as part of their enforcement actions.

In reference to what, the research question arises whether compliance units can identify non-compliance in advance and prevent or minimize the application by the supervisor of enforcement actions. In our opinion, the answer to this question might be yes, that compliance units can prevent and minimize

⁴ Own elaboration based on *EU Mapping 2017: Systematic overview on economic and financial legislation*, p.13, <http://www.europarl.europa.eu/RegData> and EUR-Lex: EU law Base, <https://eur-lex.europa.eu/legal-content/>.

⁵ Own elaboration based on *EU Mapping 2017: Systematic overview on economic and financial legislation*, p.13, <http://www.europarl.europa.eu/RegData> and EUR-Lex: EU law Base, <https://eur-lex.europa.eu/legal-content/>.

⁶ *Compliance and the compliance function in banks*, The Basel Committee on Banking Supervision, April 2005.

⁷ *The compliance function in banks*, The Basel Committee on Banking Supervision, October 2003, p. 3.

⁸ *The compliance function in banks*, The Basel Committee on Banking Supervision, October 2003, p. 1.

⁹ *Beyond Restructuring the New Agenda*, European Banking 2017, https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2017/oct/European-Banking-Report_2017.pdf, p. 25.

¹⁰ *Compliance 2.0: Emerging Best Practice Model*, Report McKinsey&Complany, October 2015, <https://www.mckinsey.com>, p. 3.

the enforcement actions against banks. The detailed answer to the research question will be discussed in the next section of this article.

The Nature of Banking Enforcement Actions in the Post-Crisis Years

Enforcement actions are a key tool for banks' supervisors in order to make banks comply with the prudential requirements set out in banking regulations, standards and sets of recommendations. Enforcement actions are used in case of breaching of legal regulations and of using of undesirable practices by banking institutions or natural persons.

The main entity applying enforcement actions within the European Union is the European Central Bank (ECB), which can impose enforcement measures, such as efficient, proportionate and dissuasive sanctions¹¹. On the other hand, at the national level enforcement actions are exercised by national supervisors, e.g. in Poland - the Polish Financial Supervision Authority (KNF), in the United Kingdom - the Prudential Regulation Authority (PRU) and the Financial Conduct Authority (FCA), in Germany - Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Office for Banking Supervision – BaFin)¹².

One of the most important post-crisis initiatives in the European Union was a project named The Banking Union, which aims to consolidate the banking sector of the European Union. According to this project, The European Central Bank has become at the heart of banking supervision and enforcement actions in the EU and in particular in the Eurozone¹³. Moreover, it is important to note that the significant credit institutions are under direct supervision by the ECB however, the national authorities still have enforcement powers on less significant credit institutions (please see a distinction¹⁴).

The main enforcement measures of the ECB include sanction mechanism. The main purpose of sanctions is to punish misconduct by a supervised bank that breach directly applicable European Union law or regulations. Unlike periodic penalty payments (see below), sanctions can be initiated not only during on-going breaches but also after the breach has ceased, as long as the limitation period is respected. The most commonly used type of sanctions by ECB is pecuniary penalties. Pecuniary penalties are calculated at up to twice the amount of the profits gained or losses avoided because of the breach, or up to 10% of the bank's total annual turnover in the preceding business year¹⁵. For instance, the ECB with the support of the national authorities, in July 2017 has imposed financial penalties of 4.4 million EUR on the Cr dit Agricole S.A Bank due to non-compliance with capital requirements¹⁶.

Important instruments in enforcement actions of the ECB are periodic penalty payments and other enforcement measures. The enforcement measures directly available to the ECB are periodic penalty payments when the bank concerned has to pay a daily amount – up to 5% of its average daily turnover – for every day the infringement continues during a maximum period of 6 months¹⁷. The ECB can also

¹¹ *Enforcement*, The European Central Bank,

<https://www.bankingsupervision.europa.eu/banking/tasks/enforcement/html/index.en.html>.

¹² Godlewski A., *Niemiecki nadz r finansowy si ga po nowe uprawnienia*, Obserwator finansowy, <https://www.obserwatorfinansowy.pl/tematyka/bankowosc/niemiecki-nadzor-finansowy-siega-po-nowe-uprawnienia/>.

¹³ Allegrezza S., Voordeckers O., *Investigative and Sanctioning Powers of the ECB in the Framework of the Single Supervisory Mechanism*, Mapping the Complexity of a New Enforcement Model, Eucrim 4 / 2015, p. 151.

¹⁴ According to the Art. 6(4) Council Regulation (EU) no 1024/2013 of 15 October 2013 (SSMR) "The significance shall be assessed on based on the following criteria: (i) size; (ii) importance for the economy of the Union or any participating Member State; (iii) significance of cross-border activities". With respect to the 'size', an entity shall not be considered less significant, unless justified by particular circumstances to be specified in the methodology, if any of the following conditions is met: (i) the total value of its assets exceeds EUR 30 billion; (ii) the ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20 %, unless the total value of its assets is below EUR 5 billion; (iii) it is one of the three most significant credit institutions in a participating Member State."

¹⁵ *Sanctions*, ECB, <https://www.bankingsupervision.europa.eu/banking/tasks/sanctions/html/index.en.html>.

¹⁶ *Supervisory sanctions*, ECB, <https://www.bankingsupervision.europa.eu/banking/sanctions/html/index.en.html>.

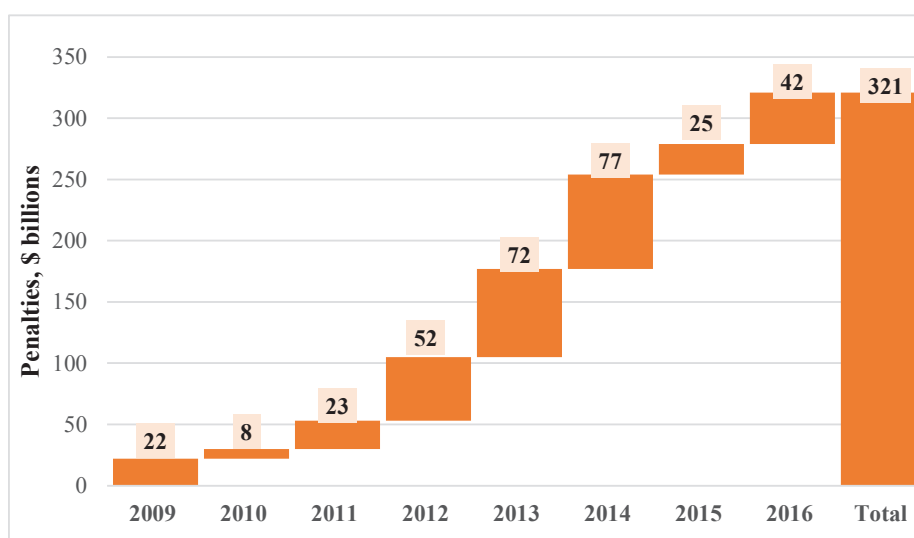
¹⁷ *Enforcement*, ECB, <https://www.bankingsupervision.europa.eu/banking/tasks/enforcement/html/index.en.html>.

apply the enforcement measures available in the national legislation in the relevant participating Member State of the EU. It can also instruct the national competent authorities, e.g. the Polish Financial Supervision Authority, to adopt purely national enforcement measures.

Furthermore, it is important to note that the ECB is guided by the principle of proportionality when exercising its enforcement powers. The ECB assess the mitigating circumstances of the case, such as duration of the breach, degree of responsibility, cooperation during the investigation, remedial actions adopted by the bank, and previous breaches committed¹⁸.

According to statistics, by 31 December 2017, the ECB had imposed five penalties amounting to 15.3 million EUR. The ECB also submitted 12 requests to national authorities to open proceedings, which so far have led to total penalties of 5.1 million EUR¹⁹. The main areas on which the ECB focuses on enforcement actions include following, namely capital and liquidity requirements, large exposures, reporting obligations and governance in banks.

Exhibit 1. Regulatory financial penalties, fines, and settlements imposed on the 50 largest US and EU important banks, 2009-2016



Source: *Staying the course in banking*, Global risk 2017, The Boston Consulting Group, p. 16.

In the post-crisis years in the European Union, as well as in the United States, there is a trend of rising costs of non-compliance and law-breaking in the banking sector, which expressed in enforcement actions, namely penalties, fines, and settlements, imposed by supervisory authorities. Confirmation of what is Exhibit 1, which presents the value of the financial penalties imposed on for the 50 largest European and American banks, which belong to the group of global systemically important banks (G-SIB).

We can see a drastic increase from 2011 to 2013 (on average 217% each year) in financial penalties, from \$22 billion to \$72 billion. This means that each year the cumulative value of financial penalties imposed by banking supervision authorities almost doubled in comparison to the previous year. After this period from 2014, the increasing trend was normalized and set up on the level around 68% yearly increase in financial penalties.

¹⁸ *Sanctions*, ECB, <https://www.bankingsupervision.europa.eu/banking/tasks/sanctions/html/index.en.html>.

¹⁹ *Enforcement, sanctions and reporting breaches*, Banking Supervision, European Central Bank, https://www.bankingsupervision.europa.eu/press/publications/newsletter/2018/html/ssm.nl180516_4.en.html.

Table 1. Regulatory financial penalties, fines, and settlements imposed on the 50 largest US and EU important banks, 2009-2016, billion \$

	2009	2010	2011	2012	2013	2014	2015	2016
Penalties paid by banks, per year	22	8	23	52	72	77	25	42
Cumulative value	22	30	53	105	177	254	279	321
Absolute growth rate	-	8	23	52	72	77	25	42
Percentage growth rate of the cumulative value of penalties, %	-	36.6%	76.7%	98.1%	68.6%	43.5%	9.8%	15.1%
Average absolute growth	\$42.7 billion							
Average percentage growth, %	49.8%							

Source: own elaboration based on *Staying the course in banking*, Global risk 2017, The Boston Consulting Group, p. 16.

Starting from 2013, we can see a decrease in the percentage growth rate of financial penalties, despite which the scale of this phenomenon is still huge. Furthermore, starting from 2013, we can notice in the European Union a decrease in the percentage growth rate of production new legislation and amendments²⁰. This confirms that there are dependencies between the increase in regulatory requirements for banks in the post-crisis years and the dynamics of enforcement actions.

The US remains the homeland of banking enforcement action in post-crisis years. According to the report, *Staying the Course in Banking* of The Boston Consulting Group, in 2016 about 60 % of the world's financial penalties for non-compliance was imposed by US's supervisory authorities²¹. In post-crisis years, US regulators and supervisory authorities remaining the most active in enforcement actions performed base on the present and past bank's non-compliance behaviour. Moreover, the experts from The Boston Consulting Group expects that the penalties, fines, and settlements, imposed by European and Asian supervisory authorities will rise in coming years²².

As it is noted in the report McKinsey&Complany Compliance 2.0: Emerging Best Practice Model (2015), that the scope of regulators focuses continues to expand in post-crisis years and new regulatory topics continue to emerge, such as to conduct risk, compliance culture, sub-contractors risk and others²³. Which means that in coming years we can expect an increase in introducing new regulations and changing existing ones, which will largely lead to the growth of importance of the compliance function in banks, and thus lead to increase in activity of regulatory enforcement. Which confirms the hypothesis that the importance of regulatory compliance increases with the intensification of the enforcement actions of banking supervision authorities.

Summary

In an effort to maintain a safe banking system, in the post-crisis years, the number of applicable regulations has increased. Consequently, the intensiveness and the number of enforcement actions against

²⁰ Own elaboration based on *EU Mapping 2017: Systematic overview on economic and financial legislation*, p.13, <http://www.europarl.europa.eu/RegData> and *EUR-Lex: EU law Base*, <https://eur-lex.europa.eu/legal-content/>.

²¹ *Staying the course in banking*, Global risk 2017, The Boston Consulting Group, p. 16.

²² *Staying the course in banking*, Global risk 2017, The Boston Consulting Group, p. 16.

²³ *Compliance 2.0: Emerging Best Practice Model*, Report McKinsey&Complany, October 2015, <https://www.mckinsey.com>, p. 1.

banks are also increased due to non-compliance. The supervision and enforcement by regulators are being developed in parallel with the level of regulatory legislation.

By taking enforcement actions, supervisor authorities aim to ensure that all supervised banks fully comply with their obligations. Compliance with regulatory requirements is a key factor in ensuring their safety and the stability of the banking system in the European Union. In order to prevent and avoid enforcement actions in the future, banks have to establish governance with effective compliance operating model and ensure the high level of the compliance culture inside and outside the bank environment, which will allow taking timely and appropriate action by the bank as soon as the non-compliance practice is detected.

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