Common Banking Supervision in the Eurozone: Strengths and Weaknesses

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Abstract

In this paper we analyse various instances of supervisory centralization either implemented or proposed in Europe in the aftermath of the financial crisis and the sovereign debt crisis. Our central thesis is that supervisory fragmentation is a cause of systemic risk, as cooperation amongst national authorities is bound to fail in crisis situations, while the absence of common resolution mechanisms and common deposit guarantee schemes aggravates the costs of a banking crisis and increases the chances of a bailout. We argue, in particular, that the current European supervisory architecture introduced in 2010 substantially belongs to the model of 'enhanced' cooperation, despite including elements of the other two models of supervisory centralization (lead supervisor and single supervisor), and is the outcome of a political compromise. Presently, European supervisory authorities, including EBA, coordinate the national ones, rather than supervising financial firms directly. National authorities cooperate in a network (the ESFS) under local mandates and are therefore prone to domestic biases, particularly in crisis situations.
The situation will be different under the Banking Union when the Single Supervisory Mechanism (SSM) is in place. We argue, however, that the SSM includes elements of cooperation and delegation, which will help the ECB to perform its tasks as a central supervisor, but will also give rise to conflicts of interest and information asymmetries. Moreover, the SSM will be limited to the eurozone, so that the enhanced cooperation and lead supervisor's models will nevertheless apply in the relationships with other countries. The ECB will also have to cooperate with EBA that will keep its regulatory and mediation tasks, as already provided by the 2010 reforms. As a result, cross-border banking groups will often be subject to substantial supervisory fragmentation. The seriousness of these weaknesses could be tempered by an extension of the Banking Union to a sufficient number of non-euro countries under the regime of close cooperation. However, we show that the incentives for these countries to opt into a similar regime are modest and that there could be greater incentives to stay out of the SSM and exploit the voting power of non-euro countries within the EBA's Supervisory Board.

Keywords: Banking Supervision, Banking Union, Euro, European banking, European Banking Authority, European Central Bank, Prudential Regulation

JEL Classifications: E50, E52, E53, G01, G21, G28

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Abstract: *In this paper we analyse various instances of supervisory centralization either implemented or proposed in Europe in the aftermath of the financial crisis and the sovereign debt crisis. Our central thesis is that supervisory fragmentation is a cause of systemic risk, as cooperation amongst national authorities is bound to fail in crisis situations, while the absence of common resolution mechanisms and common deposit*

[1] Prior drafts of this paper were presented at the Conference "The Eurozone Banking Union – Messiah or Flight of Fancy?" (Jesus College, Oxford, 11 – 12 April 2013) and as a Commerzbank-Stiftung Public Lecture (ILF, Frankfurt, 22 May 2013). We are grateful to Theodore Baums, Danny Busch, Andreas Cahn, Paul Davies, Eilis Ferran, Clemens Fuest, Jeffrey Gordon, Patrick Kenadjian, Fabio Recine, Tobias Tröger and Eddy Wymeersch for helpful comments. Sections II and III partly draw on G. Ferrarini and F. Chiodini, 'Nationally Fragmented Supervision over Multinational Banks as a Source of Global Systemic Risk: a Critical Analysis of Recent EU Reforms', in E. Wymeersch, K. J. Hopt and G. Ferrarini (eds), Financial Regulation: A Post Crisis Analysis, Oxford University Press (2012).

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guarantee schemes aggravates the costs of a banking crisis and increases the chances of a bailout.

We argue, in particular, that the current European supervisory architecture introduced in 2010 substantially belongs to the model of 'enhanced' cooperation, despite including elements of the other two models of supervisory centralization (lead supervisor and single supervisor), and is the outcome of a political compromise. Presently, European supervisory authorities, including EBA, coordinate the national ones, rather than supervising financial firms directly. National authorities cooperate in a network (the ESFS) under local mandates and are therefore prone to domestic biases, particularly in crisis situations.

The situation will be different under the Banking Union when the Single Supervisory Mechanism (SSM) is in place. We argue, however, that the SSM includes elements of cooperation and delegation, which will help the ECB to perform its tasks as a central supervisor, but will also give rise to conflicts of interest and information asymmetries. Moreover, the SSM will be limited to the eurozone, so that the enhanced cooperation and lead supervisor's models will nevertheless apply in the relationships with other countries. The ECB will also have to cooperate with EBA that will keep its regulatory and mediation tasks, as already provided by the 2010 reforms. As a result, cross-border banking groups will often be subject to substantial supervisory fragmentation.

The seriousness of these weaknesses could be tempered by an extension of the Banking Union to a sufficient number of non-euro countries under the regime of close cooperation. However, we show that the incentives for these countries to opt into a

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similar regime are modest and that there could be greater incentives to stay out of the SSM and exploit the voting power of non-euro countries within the EBA's Supervisory Board.

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I. Introduction

In the midst of the recent sovereign debt crisis, the eurozone leaders committed themselves to moving expeditiously toward a major centralization in banking supervision within the framework of a Banking Union.[2] This term generally refers to an institutional setup under which the regulation and supervision of banks in the Eurozone are coordinated through a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Common Deposit Guarantee Fund. In this paper, we analyse the SSM, which is the central element of the Banking Union, against the backdrop of the EU current supervisory framework, which was instituted after the 2008 financial turmoil. We analyse, in section II, the main reasons for centralizing bank supervision, with reference to cross-border banking groups in particular and to the recent systemic banking failures in Europe. We go on to examine, in section III, the main centralization models and their implementation through recent EU reforms, focussing on enhanced cooperation amongst supervisors and the lead supervisor model. We critically examine, in particular, the

[2] On 23 May 2012, the European Council - in order to "strengthen economic union and make it commensurate with the monetary union" - asked president Van Rompuy and other top European officials to identify 'building blocks', among which "a more integrated banking supervision and resolution, and a common deposit insurance scheme" – in short, a banking union: see the Remarks by President of the European Council Herman Van Rompuy available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/130376.pdf>. On 19 June 2012, the G20 leaders expressed support for "the intention to consider concrete steps towards a more integrated financial architecture, encompassing banking supervision, resolution and recapitalization, and deposit insurance": see G20 Leaders Declaration, available at <http://www.g20.org/documents/>. On 29 June 2012, the Euro area Heads of State or Government called on the Commission to present proposals to provide for a single supervisory mechanism involving the European Central Bank (ECB)– see European Council conclusions, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf>.

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current supervisory architecture that was introduced following the De Larosière Report's recommendations and find that the same represents a weak form of supervisory centralization. In section IV, we analyse the current proposals for supervisory centralization in the Eurozone. After introducing the origins of the Banking Union in the current sovereign debt crisis, we examine the main elements of the SSM and critically analyse the same from the perspective of the arguments developed throughout the paper in support of the single supervisor model, showing that the SSM represents a semi-strong form of centralization. In section V we draw some general conclusions.

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II. Why centralise supervision?

In this section, we analyse the reasons for centralising supervision at EU level, focussing on cross-border banking groups and the risks created by fragmented supervision (para. 1). We also examine the criticism of centralisation advanced by some scholars, but reject the same on the basis of the benefits generated by cross-border banks and their internal capital markets, and of the obstacles to market integration created by supervisory fragmentation (para. 2). We subsequently argue that also crisis management should be centralised, given that home and host authorities have conflicting interests in the supervision of multinational banks, particularly in the case of closure decisions (para. 3). We finally set the grounds for our analysis of the Banking Union by illustrating its origins in the current sovereign debt crisis. We argue, in particular, that Eurozone financial system has fragmented along national borders creating the need for centralization through a Banking Union to reactivate the channels for the transmission of monetay policy (para. 4).

1. Supervising cross-border banking groups

Cross-border banks usually take the form of integrated groups, operating through either branches or subsidiaries. Subsidiaries are incorporated under national law and face limited liability as legally separated entities. Branches are not legally separated from their head office, face joint liability with the latter and are subject to the same law. Also, supervisory responsibilities of home and host country authorities depend on whether the

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bank operates through either branches or subsidiaries[3]. From an economic perspective, however, this distinction is often blurred, with group functions usually organized along business lines rather than legal entities.[4]

In the EU, mutual recognition and the single licence allow a European financial institution to establish branches in other Member States under the prudential regulation and supervision of the home country.[5] Subsidiaries, on the contrary, fall under the

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[3] The Basel Committee set the guidance for the allocation of supervisory powers over cross-border banks amongst home and host countries' regulators, emphasizing the importance of cooperation. The Committee stated that, in principle, home country authorities should be responsible for the prudential supervision of foreign established branches, while host supervisors should retain responsibility over foreign owned subsidiaries. However, the Committee also suggested: 'where "mind and management" are centralized in the banking group or where techniques are consistently applied across the group, the home country supervisor will probably be better placed to lead approval work. In such circumstances, the host country supervisor may choose to rely entirely on approval work conducted by the home country supervisor'. See Basel Committee, 'Report to the Governors on the Supervision of Banks' Foreign Establishments' (1975), available at <http://www.bis.org/bcbs/>; ibid, 'Consolidated Supervision of Banks' International Activities' (March 1979); ibid, 'Principles for the Supervision of Banks' Foreign Establishments' (May 1983); ibid, 'Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments' (July 1992); ibid, 'The Supervision of Cross-Border Banking. Report by a working group comprised of members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors' (1996); ibid, 'High-level Principles for the Cross-border Implementation of the New Accord' (August 2003); 'ibid, Home–host Information Sharing for Effective Basel II Implementation' (June 2006).

[4] See D. Schoenmaker and S. Oosterloo, 'Cross-Border Issues in European Financial Supervision' in D. Mayes and G. Wood (eds), *The Structure of Financial Regulation* (2005) also available at <http://staff.feweb.vu.nl/dschoenmaker/Cross-border%20issues%20(BoF%2021-2-2005).pdf>; E. Huepkes, "Form Follows Function" - A New Architecture for Regulating and Resolving Global Financial Institutions' (2009) 10(3) EBOR 369 ff; G. Ferrarini and F. Chiodini, *supra* note 1.

[5] An exception to this principle regards the supervision of liquidity and monetary policy. The former remains under the responsibility of the host authority in cooperation with the home supervisor. The latter, to the extent that it is not attributed to the European System of Central Banks, lies within the power of the host authority. See recital 21 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (hereafter CRD), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF> (accessed September 2011), stating: 'Responsibility for supervising the financial soundness of a credit institution, and in particular its solvency, should lay (sic) with its home Member State. The host Member State's competent authorities should be responsible for the supervision of the liquidity of the branches and monetary policies. The supervision of market risk should be the subject of close

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competence of their state of incorporation. This allocation of supervisory powers and responsibilities is reflected in the treatment of bank insolvency. Indeed, reorganization and winding-up procedures in the home state apply to cross-border branches, while subsidiaries are wound up under the insolvency rules of their state of incorporation.[6]

Notwithstanding EU harmonization of prudential regulation, there is substantial divergence in national implementation and supervisory practices. As a result, the consolidating supervisor has limited powers over the whole group, which is subject to nationally fragmented regulation and supervision. Moreover, bank insolvency rules are not harmonized and present striking differences across countries.

The mismatch between the scope of cross-border groups and the national character of supervision has a negative impact on crisis prevention, management, and resolution of financial institutions. Indeed, cross-border supervision essentially relies on voluntary cooperation between national authorities. However, in the recent crisis, cooperation proved to be insufficient and was constrained by home- and host-country biases and regulatory forbearance. Lack of cooperation among national authorities contributed to the crisis and eventual break up of Fortis Group, a Belgian/Dutch financial conglomerate with systemically significant subsidiaries in Belgium, the Netherlands, and Luxembourg.[7]

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cooperation between the competent authorities of the home and host Member States.' See Arts 40 and 41 of the CRD.

6 This is the so-called 'universality principle'. See Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions (hereafter Winding up Directive), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:125:0015:0023:en:PDF> (accessed September 2011).

7 See Basel Committee, 'Report and Recommendations of the Cross-Border Bank Resolution Group' (September 2009), 11, available at: <http://www.bis.org/publ/bcbs162.htm> (accessed September 2011). For a brief case study on Fortis see M. Cihack and E. Nier, 'The Need for Special Resolution Regimes for Financial Institutions - The Case of the European Union', IMF Working Paper, WP/09/200 (2009), available at: <http://www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf> (accessed September 2011).

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Moreover, in the recent turmoil, governments did not always take the cross-border externalities of supervisory failures sufficiently into account.[8] Iceland, in particular, was unable to meet the liabilities of its national guarantee scheme towards foreign depositors in Icelandic banks. As a result, the UK government and deposit guarantee scheme had to provide depositor protection for £4.5 billion to Landesbanki, which operated in the UK through a branch.[9] In the case of Kaupthing, another Icelandic bank operating across borders, the foreign guarantee schemes paid the bank's liabilities *vis-à-vis* local depositors, irrespective of the legal nature of the establishment (either branch or subsidiary).[10] The systemic impact of cross-border banking had obviously been underestimated.[11] In addition, the failure of Lehman Brothers[12] proved that the interconnectedness of subsidiaries within cross-border groups does not allow for effective separation of risks and liabilities of different legal entities.[13]

To sum up, cooperation proved particularly difficult in emergency situations, where urgent decision-making was needed. Incentives to cooperate were diminished by the

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However in the crisis of Dexia, a cross-border banking group based in Belgium, France, and Luxembourg, coordination of national authorities prevented the break up of the group along national boundaries. See the Basel Committee (2009), at 17.

8 For an assessment and measurement of cross-border externalities in the European banking sector see D. Schoenmaker and S. Oosterloo, 'Financial Supervision in and Integrating Europe: Measuring Cross-border Externalities' (2005) 5 *International Finance* 1–27.

9 See the 'The Turner Review: A regulatory response to the global banking crisis' (the Turner Review) (March 2009) 85 et seq. Available at <http://www.fsa.gov.uk/pubs/other/turner_review.pdf>, 37.

10 See Basel Committee (2009) see *supra* note 7, at 12–13.

11 See 'The Turner Review, *supra* note 9, 85 et seq.; K. Pistor, 'Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis' (28 June 2010), ECGI—Finance Working Paper No 286/2010, available at SSRN <http://ssrn.com/abstract=1631940> (accessed September 2011), and in *Festschrift für Klaus J. Hopt*, de Gruyter (2008).

12 For a brief case study on the crisis of Lehman Brothers see, amongst others, Basel Committee (2009), *supra* note 7, at 14 ff.

13 D. Schoenmaker and S. Oosterloo, *supra* note 8, at 4, point out that 'the financial health of the subsidiary is closely linked (via intra-group transactions and/or joint branding) to the well-being of the financial group as a whole'; see also Huepkes, *supra* note 4.

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authorities' national accountability and potential fiscal responsibilities. Early intervention and resolution tools for ailing institutions were not available and could not be agreed upon where needed. As a result, the orderly resolution of insolvent cross-border banks proved impossible, whilst liquidation procedures under national insolvency laws appeared too costly from a systemic perspective. Therefore, bailing out systemically significant institutions was the only option available to governments. Given that taxpayers' money was invested (either through public guarantees, emergency funds, or nationalization), bailed-out groups were divided along national boundaries.[14]

2. Centralization and its critics

The lack of an appropriate regulatory framework is a source of systemic risk, in addition to threatening European financial integration. Indeed, the absence of cross-border supervisory infrastructures and of common crisis management and resolution tools reduces market confidence in cross-border banks. This is especially true in a macro-economic environment where, absent credible burden sharing agreements between governments, countries might experience difficulties in bailing out large institutions, including a risk of contagion spreading from ailing institutions to states. Moreover, the loopholes in the current regulatory framework hamper market discipline. On the one hand, the belief that governments shall bail out insolvent firms generates moral hazard in bank managers, shareholders, and creditors. On the other, the fact that certain countries may not be able (or willing) to afford a bail out with taxpayers' money,[15] creates

14 See the case of Fortis, *supra* note 7.

15 See the case of Icelandic banks' crises, *supra* note 10.

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competitive distortions, penalizing banks in countries with weaker (or smaller, in terms of GDP) economies.

It is clear, therefore, that centralized supervision and crisis management at EU level remedy the mismatch between the cross-border scope of banking groups and the national character of prudential regulation and supervision. A more integrated framework allows financial players to compete in largely integrated and interconnected markets and reduce country bias. No doubt, national regulators lose part of their powers in favour of a supranational body and countries renounce to part of their sovereignty, but this is the price to pay for avoiding national fragmentation of regulation, supervision, and crisis management.

Nonetheless, critics of centralization advocate a 'more nation' solution,[16] in which national authorities would be better empowered to supervise regulated entities in view of safeguarding domestic financial stability. According to similar proposals, new powers would be attributed to host regulators, including the power to impose 'subsidiarization' of foreign branches that are systemically significant in the host state; in other words, regulators would be entitled to treat these branches like subsidiaries for supervisory purposes.[17] In addition, host authorities would be empowered to regulate cross-border financial operations on the basis of their potential effect on host economies (so-called 'effect based regulation').[18] These enhanced powers would supposedly facilitate coordination and cooperation with home authorities. Host regulators would be in a

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16 See Turner Review, *supra* note 9, 99; Pistor, *supra* note 11.

17 See Turner Review, *supra* note 9, 99.

18 See Pistor, *supra* note 11.

position to ‘bargain’ with home regulators, who would be incentivized to take the financial stability of host economies seriously into account.[19]

However, a similar approach might provoke a reversal of market integration, for ‘effect based’ regulation could easily conceal protectionist measures benefiting ‘national champions’. As a result, markets would become more fragmented and less competitive. Moreover, cross-border institutions would be forced to operate through a ‘constellation’ structure, including stand-alone and self-sufficient subsidiaries, each with autonomous management functions. Centralization of groups would thus be hindered, to the detriment of their efficient organization and functioning, while the relevant costs would be ultimately shifted to consumers. As shown by the economic literature, integrated financial groups support the integration of financial markets, with positive stabilization effects stemming from diversification and well-functioning internal capital markets.[20] Regulation should at least allow institutions to choose between a ‘constellation’ structure and a centralized one, on the basis of their business strategy.

Centralization of supervision reduces coordination problems by minimizing home and host-country biases. It also results in more effective risk management and reduces surveillance and compliance costs. As a consequence, multinational banks have better

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19 Ibid, at 26 - 27.

20 See M. Cremers, R. Huang, and Z. Sautner, ‘Internal Capital Markets and Corporate Politics in a Banking Group’, *The Review of Financial Studies*, 2011, 24, 358-401, finding that the internal capital market ‘provides an intertemporal insurance function against deposit shortfalls to its member banks’ and is ‘larger for more productive banks with better opportunities’; see also Kahn and Winton, 'Moral Hazard and Optimal Subsidiary Structure for Financial Institution' (2004) LIX (6), *Journal of Finance* 2531-75; Lòrànth and Morrison, 'Deposit Insurance, Capital Regulations and Financial Contagion in Multinational Banks' (2007) 34(5) and (6), *Journal of Business Finance and Accounting*, 917-49; Elsas, et al, 'The Anatomy of Bank Diversification' (2010) 34 (6) *Journal of Banking and Finance* 1274-87; Barba Navaretti, et al, 'Multinational Banking in Europe: Financial Stability and Regulatory Implications. Lessons from the Financial Crisis', *Economic Policy*, October 2010, vol. 25, 703-753; Haas and van Lelyveld, 'Internal capital markets and lending by multinational bank subsidiaries', *J. Finan. Intermediation*, 19, 2010.

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functioning internal capital markets, which enhance financial stability and risk diversification.[21] Indeed, proper centralization of group functions, such as risk and liquidity management, leads to more efficient resource allocation within a group, with positive stabilization effects.[22] Internal capital markets also operate as valuable crisis prevention tools by supporting subsidiaries in distress, given limited external funding in crisis situations.[23] No doubt, misuse of these markets by multinational groups could create instability, possibly spreading shocks across borders and amplifying contagion effects. However, integrated cross-border regulation and supervision should to some extent prevent similar abuses.

3. Centralizing crisis management

Effective cross-country coordination mechanisms are essential also in crisis situations. Supervisors should be backed by a set of early intervention and crisis

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21 For an assessment of the functioning of the internal capital market of multinational banks and the related positive effects in terms of risk diversification and financial stability, see de Haas and van Lelyveld, *supra* note 20; Cremers, et al, *supra* note 20; Barba Navaretti, et al, *supra* note 20.

22 See Cremers, et al, *supra* note 20; de Haas and van Lelyveld, *supra* note 20. A well-functioning internal capital market determines at least the following positive effects: (i) substitution or integration, where needed, of external funding ('more money effect'); (ii) better distribution of available funds to the most profitable investment opportunities ('smarter money effect').

23 See de Haas and van Lelyveld, *supra* note 20, at 21, for a proof of support effects by parent companies to distressed subsidiaries also during the recent financial crisis. Asset transferability and the establishment of a 'framework for intra-group liquidity management' are considered as possible preventative measures in crisis situations. See the European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank: An EU Framework for Crisis Management in the Financial Sector' (COM(2010) 579 final), 6, available at <http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf> (accessed September 2011).

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management tools applicable across borders to banking groups.[24] Similar measures reduce the systemic impact of cross-border institutions providing credible alternatives to their bailout. Moreover, they diminish the intrinsic moral hazard of banks' shareholders and managers, which is more pronounced in systemically relevant banks. Indeed, due to their specificities, banks experience increased agency problems between managers, shareholders, and creditors. In particular, opacity and asset substitutability make banks more vulnerable to managers engaging in excessively risky activities in order to extract private benefits.

Supervisory action is particularly sensitive at the beginning of a crisis, when early intervention measures could require shareholders to be expropriated, in order to avoid excessively risky gambling.[25] When authorities from different countries are involved, however, coordination is particularly difficult. Incentives of supervisors are misaligned due to their national accountability and there is a risk of regulatory forbearance. In fact, home country authorities are not responsible for the financial stability of host countries and home country taxpayers may not be prepared or willing to pay for negative cross-border externalities of a bank failure.[26] Furthermore, 'in addition to contributing to the stability of their financial system, supervisory authorities have an implicit—and

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[24] For a detailed analysis of possible crisis management tools currently debated at European level, see European Commission, 'Consultation on Technical Details of a possible European Crisis Management Framework' (6 January 2011), the consultation text and the relevant answers are available at <http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm>; and FSB 'Consultation Document on Effective Resolution Framework for Financial Institutions' (19 July 2011), available at: <http://www.financialstabilityboard.org/publications/r_110719.pdf> (both accessed September 2011). See also Basel Committee (2009), *supra* note 7, and the European Commission's Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (COM(2012) 280/3), available at <http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf>.

[25] See C. Goodhart, "The Regulatory Response to the Financial Crisis", EE, 2010, at 47.

[26] See Schoenmaker and Oosterloo, *supra* note 4, at 14.

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sometimes explicit—task of defending and promoting their industry within an integrated international financial market'.[27]

As a result, home and host authorities have conflicting interests in the supervision of multinational banks, especially with regard to closure decisions.[28] This, in turn, leads them not to share detailed information voluntarily, so as to exploit information asymmetries and influence regulatory action: 'the better aligned the interests of the countries are, the more detailed information can be exchanged in equilibrium. The joint welfare of the two countries [home and host] depends thus negatively on the divergence of interests'.[29] The European supervisory bodies, EBA in particular, help in the alignment of national supervisors' incentives by enhancing coordination mechanisms, also through moral suasion or binding mediation of possible conflicts. However, emergency situations are more sensitive. In fact, lack of time hampers effective coordination, while governments' concerns for domestic financial stability and potential fiscal responsibilities make cooperation less likely. Therefore, early intervention and resolution powers should be assigned to a central authority, rather than cross-country coordination between authorities.

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27 L. Bini Smaghi, 'A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market' CFS-IMF Conference, Frankfurt am Main (26 September 2008), available at <http://www.ecb.int/press/key/date/2008/html/sp080926.en.html> (accessed September 2011).

28 See R. Herring, 'Conflicts between Home and Host Country Prudential Supervisors', Working Paper (2007), available at: <http://fic.wharton.upenn.edu/fic/papers/07/0733.pdf> (accessed September 2011).

29 See Holthausen and Rønde, 'Cooperation in International Banking Supervision', ECB Working paper No 316 (2005), available at SSRN <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=301961>, at 34.

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4. Why a Banking Union?

The recent financial and sovereign debt crisis has once more highlighted the vulnerability of the European banking system and shown how the difficulties of an individual bank can quickly spread to other banks in the same or different countries, endangering the stability of the entire banking system and the role of the single currency. Since 2008, in particular, there has been a strong correlation between banks' finances and Member States' debts. This correlation goes in both directions creating a vicious cycle between bank risks and sovereign risks.

In countries where the domestic supervisor proved overly permissive towards national champions,[30] the national responsibility for crisis resolution meant that the difficulties of banks were passed on to public finances, which inevitably deteriorated.[31] Examples are offered by Ireland and Spain, where the rescue of ailing banks drew huge amounts of public resources.[32] In other countries, such as Greece and to a lesser extent

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[30] For an overview see E. Wymeersch, 'The European Banking Union, a first analysis', available at SSRN <http://ssrn.com/abstract=2171785> and L. F. Signorini 'Audizione presso il Senato della Repubblica 24 ottobre 2012' available at <http://www.bancaditalia.it/interventi/altri_int/2012/unione_bancaria_signorini.pdf>. In order to promote the local banking systems, some supervisors did not adequately counter risky behaviors of intermediaries, such as granting credit to certain sectors of the economy like real estate.

[31] See J. Pisani-Ferry, A. Sapir, N. Véron and G. B. Wolff, 'What kind of European Banking Union', available at <www.bruegel.org> emphasizing that banks that were European in ordinary circumstances have become national in crisis times, as they depend on national governments for support.

[32] See D. Elliott, 'Key issues on European Banking Union', available at <http://www.brookings.edu/~/media/research/files/papers/2012/11/european%20banking%20union%20elliott/11%20european%20banking%20union%20elliott.pdf > , noting that in Ireland and Spain, failing banks added massive liabilities to the balance sheets of the sovereigns, weighing them down.

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Italy, causality initially went in the opposite direction.[33] Huge public debts plagued domestic banks as a result of the strong domestic component of their bond portfolios.[34]

Moreover, national politicians and public authorities tried to avoid the risk of making taxpayers pay for the consequences of credits extended by national banks across borders.[35] In a similar context, banks and national supervisors have restricted the circulation of liquidity across borders, including transfers of capital within cross-border banking groups. As a result, the interbank markets ceased to function for intermediaries rather allocate their liquidity to non-interest bearing deposits at the European Central Bank. In addition, there has been a significant flight of funds from peripheral countries to central ones, even though the interest rates offered by the latter produce negative returns in real terms.[36]

In a similar context, the mechanisms of monetary policy have stopped working, showing that the single currency requires financial integration.[37] Moreover, the financial

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33 See D. Elliott, *supra* note 32.

34 See B. Coeuré, 'Why the euro needs a Banking union' available at <http://www.ecb.int/press/key/date/2012/html/sp121008_1.en.html> noting that this has also been the case for credit default swaps. A CDS is a financial swaps agreement that the seller of the CDS will compensate the buyer in the event of a loan default or other credit event. The buyer of the CDS makes a series of payments (the CDS "fee" or "spread") to the seller and, in exchange, receives a payoff if the loan defaults.

35 See J. Pisani-Ferry, A. Sapir, N. Véron and G. B. Wolff, *supra* note 31, arguing that banks have been encouraged by national authorities to cut cross-border lending, which is understandable from a national viewpoint. However, the pursuit of national policies to fight the crisis has not led to financial stability.

36 See D. Elliott, *supra* note 32, stating that fears about default on national debts and/or withdrawal from the euro motivate banks to move their founds out of troubled countries.

37 See V. Constancio , 'Towards a European Banking Union', available at <http://www.ecb.int/press/key/date/2012/html/sp120907.en.html>, arguing that a high degree of financial integration, where financial institutions diversify their assets and liabilities across Eurozone countries, is essential for an effective transmission of monetary policy. Imperfect financial integration complicates the task of the central bank in a currency union making it more difficult to achieve a uniform impact in the transmission of monetary policy and ensure uniform levels of interest rates across countries. It is therefore essential to reverse this fragmentation and restore the proper transmission mechanism of monetary policy. See also EBC, "Financial

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system of the Eurozone has fragmented along national borders[38] leading to the formation of severe macroeconomic imbalances.[39] In some countries, the supply of credit has fallen dramatically, while the remuneration of bank deposits and the interest rates paid on bank loans diverge considerably between countries.[40] Despite the same level of reference rate for monetary policy set by the European Central Bank, the costs of credit to households and businesses are presently different across the eurozone countries, the highest being where the economic conditions are the weakest. Therefore, it is plausible that, rather than a single currency, there are today as many 'euros' as countries in the monetary union.

The need for centralization through a Banking Union, under the terms that will be analysed below in section IV, therefore emerged as a remedy to the crisis of the single currency and as a key factor to complete the monetary union, which presently lacks a financial component.[41] Even though the need to rethink bank surveillance in Europe was often highlighted before the recent crisis, most countries, including the euro-countries,

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Integration in Europe" April 2009, available at <http://www.ecb.eu/pub/pdf/other/financialintegrationineurope200904en.pdf>. A. Uhde and U. Heimeshoff, "Consolidation in Banking and Financial Stability in Europe: Empirical Evidence" (2009) 33(7) Journal of banking and Finance 1274-87.

[38] See EBC, "Financial Integration in Europe" April 2012, available at <http://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201204en.pdf>.

[39] See V. Constancio , *supra* note 37. The natural bias of national supervision, both in lender and borrowing countries, allowed the creation of large macro imbalances in several segments of the euro area. Indeed, a major lesson of the crisis is that financial supervision lagged behind financial integration contributing to the build-up of macroeconomics imbalances.

[40] See E. Wymeersch, *supra* note 30, arguing that the transmission channels for monetary policy are functioning in a suboptimal way leading to significant differences in funding costs which depend on the interrelated position of the sovereign debtor and his related banks.

[41] See J. Pisani-Ferry, A.Sapir, N. Véron and G. B. Wolff, *supra* note 31, arguing that Europe's Economic and Monetary Union (EMU) was constructed on the basis of two pillars: a monetary pillar with the independent and price-stability oriented European Central Bank, and a fiscal pillar oriented towards fiscal discipline with a modicum of coordination. EMU has no financial policy component apart from the ban on capital controls and the promotion of a single market for financial services, both of which apply to the whole EU, and it has no banking component, apart from those arising from the operation of monetary policy and the common banking regulation and common standards on deposit insurance. The ECB itself has few financial stability competences.

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were reluctant to transfer further sovereignty to the European institutions in this crucial sector.[42] After the sovereign debt crisis, what was already widely supported amongst scholars came to be accepted also in practice, while national self-interest was put aside.[43] Consequently, the Banking Union, with its three main components - namely, the SSM, the common guarantee of deposits and the joint management of crises – was seen as the main remedy to break the vicious circle between banks and sovereigns and reactivate the channels for the transmission of monetary policy.[44]

42 See T. Padoa-Schioppa, ‘EMU and banking supervision’ available at <https://www.ecb.int/press/key/date/1999/html/sp990224.en.html> already pointing out in 1999 the contradiction between the desire to create an integrated Europe-wide financial market with the persistence of national supervisory systems.

43 See D. Elliott, *supra* note 32, arguing that the crisis provides the impetus to overcome parochial interests and organize European banking more intelligently.

44 See E. Wymeersch, *supra* note 30.

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III. Weak centralization in the EU

In this section, we study the scope and models of supervisory centralization focusing on the general framework of banking supervision in the EU while leaving the Banking Union aside for special treatment in the following section. Firstly, we describe the three main models of centralization and discuss, in particular, the two of them (enhanced cooperation and lead supervision) that have been traditionally in force in the EU and were recently amended in various directions as a result of the financial crisis (para. 1). We then analyse the current European supervisory architecture that was recommended by the de Larosière Group and consists of a European System of Financial Supervision (ESFS), which is made-up of a European Systemic Risk Board (ESRB) and three European Supervisory Authorities (ESAs), including the European Banking Authority (EBA), each coordinating a network of financial supervisors (para. 2). Subsequently, we critically assess this supervisory architecture in the light of the arguments supporting centralization, as developed in this section and the preceding one. We show, in particular, that the present framework - based on delegation of powers to the lead (consolidating) supervisor and cooperation amongst competent authorities – carries relevant costs and is likely to fail in crisis situations as a result of misaligned incentives between national supervisors (para. 3).

1. Models of centralization

A centralized approach to supervision can be achieved along three different routes: (i) cooperation and coordination amongst authorities in different Member States;

(ii) lead home (or consolidating) supervisor; (iii) supranational authority.[45] These three models significantly differ as to their effectiveness and political feasibility. Requiring cooperation does not need substantial changes in the allocation of powers and responsibilities amongst national supervisors, but the effectiveness of this model may be constrained by national biases and misalignment of incentives of the authorities concerned. The lead supervisor model (under which a national supervisor is delegated by the other supervisors of a cross-border bank or banking group) is difficult to accept politically and possibly also ineffective, to the extent that misalignment of incentives and lack of trust negatively affect the delegation of powers between national supervisors. The third model (single supervisor) is fit to overcome most of the incentive compatibility problems between national supervisors, but is politically difficult to accept, as it involves deep institutional changes.

The three models can be combined one with another and form two-tier systems, consisting of a national and a supranational level. In the first model, the addition of a supranational authority tasked with mediation and conflict resolution may enhance coordination and cooperation amongst authorities. In the second model, the addition of a similar authority may help containing the lead supervisor's overreach. In the third one, the central authority could supervise cross-border groups directly, in addition to coordinating the supervision of domestic banks by local authorities.

(a) *Supervisory cooperation in the EU*

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[45] See Ferrarini and Chiodini, *supra* note 1.

The current European framework for cross-border supervision[46] is mainly based on cooperation. Directive 2009/111 (CRD II) has amended Directive 2006/48 (CRD) as to cross-border supervision, enhancing coordination mechanisms amongst supervisors. Moreover, it has promoted the lead coordinating role of the home and consolidating supervisor.[47] Cooperation mechanisms include information exchange and consultation between home and host supervisors; joint decisions under the consolidating supervisor; written cooperation agreements (Memoranda of Understanding or MoUs) and colleges of supervisors; action in crisis situations.

However, MoUs are not legally binding and enforceable, while colleges of supervisors lack the powers and political influence to perform effective coordination of national supervisors, particularly in times of crisis. In the recent turmoil, MoUs did not prevent ring-fencing and the break up of cross-border groups along national borders.[48] Indeed, voluntary cooperation and coordination mechanisms tend to fail when national

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46 The current European supervisory framework includes a newly established ESFS, consisting of the new ESRB in charge of macro-prudential supervision and of three ESAs, namely the EBA, the EIOPA, and the ESMA, in charge of micro-prudential supervision. The relevant regulations were adopted on 24 November 2010 and entered into force on 1 January 2011. In this chapter we will focus mainly on the EBA. The relevant legislation is available at <http://www.eba.europa.eu/Aboutus/Legal-texts.aspx> (accessed September 2011).

47 See Art 1.2(c) of the Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 (hereafter CRD II), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>, which adds to Art 4 of the Directive 2006/48/CE of the European Parliament and of the Council of 30 June 2009 (hereafter CRD) the definition of 'consolidating supervisor' as 'the competent authority responsible for the exercise of supervision on a consolidated basis of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies'.

48 See E. Huepkes, 'Insolvecy—Why a Special Regime for Banks?' in *Current Developments in Monetary and Financial Law*, vol 3 (International Monetary Fund, Washington DC, 2003). The A. points out that 'while such memoranda provide an adequate framework for cooperation in normal times, in a crisis situation they may not ensure that all necessary information is exchanged on a timely basis and that action is coordinated accordingly'. This was confirmed in the cases of Fortis and Dexia.

financial stability and taxpayers money are at risk. Due to a collective action problem, similar to that found in the prisoner's dilemma, the national mandate and the consequent misalignment of incentives of supervisory authorities prevent the same from seeking cooperative solutions, even if more efficient. Nationalist and protectionist solutions tend to prevail, with ring-fencing as a consequence.

The CRD II also strengthened the framework for cooperation and coordination in emergency situations, including adverse developments either in financial markets, which might jeopardize market liquidity and the stability of the financial system, or in individual institutions. When the consolidating supervisor has notice of similar adverse developments in the financial markets of any Member State, where a subsidiary or a systemically significant branch is located, it shall promptly communicate all relevant information to the competent authority.[49] Moreover, consistently with the possible macro-prudential impact of similar adverse developments, Member States shall allow competent authorities, where necessary, to hand such information to central banks of the ESCB[50] and to 'other departments of their central government administrations responsible for legislation on the supervision of credit institutions'.[51]

Furthermore, in the case of adverse developments regarding either financial markets or individual credit institutions, the consolidating supervisor shall plan and coordinate supervisory activities in cooperation with the competent authorities involved, and if necessary with central banks.[52] This can result in exceptional measures being taken under Art 132.3, like joint assessments, implementation of contingency plans, and

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[49] See new Art 130.1 of the CRD.
[50] See new Art 49.2 of the CRD.
[51] See new Art 50.2 of the CRD.
[52] See new Art 129.1(c) of the CRD.

communication to the public. However, according to Art 129.1(c), the consolidating supervisor shall, where possible, use ‘existing defined channels of communication for facilitating crisis management’. These ‘channels’, although not defined by the CRD II, may be the ‘written arrangements’ required by Art 131 of the CRD and colleges of supervisors.

(b) *Lead supervisor and mutual recognition*

The lead supervisor model consists of a single authority with supervisory powers over the whole cross-border group, irrespective of whether operating through branches or subsidiaries. It avoids duplication of regulatory requirements and reduces compliance and enforcement costs. The home authority is the lead supervisor, retaining responsibility for consolidated supervision over the banking group and its individual entities. A variant of this model keeps host authorities involved, so as to ensure supervisors’ proximity to cross-border establishments and allow local conditions to be sufficiently taken into account.[53] Delegation of supervisory tasks to host authorities, for example as to local gathering of information and inspections, increases the efficiency and effectiveness of supervision. Moreover, colleges of supervisors, comprising authorities of each country where subsidiaries or significant branches are located, enhance cooperation and exchange of information. However, colleges ‘advise the lead supervisor and discuss proposals of

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[53] See EFR, ‘On the Lead Supervisor Model and the Future of Financial Supervision in the EU’ (2005), at 30, available at <http://www.efr.be/documents/publication/22676EFRlsvfinal-June2005.pdf>; and ‘Monitoring Progress in EU Prudential Supervision’ (2007), available at <http://www.efr.be/documents/publication/97338EFR-september2007%20(final).pdf> (both accessed September 2011).

involved local supervisors but would not have the power to delay decisions of the lead supervisor'.[54]

In a similar model of multiple players, conflicts between authorities can be solved through mediation, with host authorities entitled to appeal against the lead supervisor's decisions. However, both mediation and appeal are likely based on moral suasion and reputational sanctions, so that it is doubtful that they would be an effective counterbalance to supervisors' home country bias and domestic accountability.[55] Non-cooperative strategies might also characterize host authorities' behaviour. Rather than cooperating with the home (lead) supervisor, host authorities might respond to national interest.

This possibility increases when approaching a crisis, as information asymmetries could be exploited to influence closure policies.[56] In similar situations, conflict resolution arrangements relying on moral suasion and reputational sanctions are likely ineffective. Binding mediation mechanisms appear as a more credible a solution, but they require a central authority to be established. Moreover, the time for mediation is presumably too long, with increased risk of negative externalities. As a result, those countries in particular where foreign-owned subsidiaries play a significant role in the domestic banking market generally reject the lead supervisor model.[57]

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54 See EFR (2004), see n 53, at 7. The establishment of colleges of supervisors should 'reduce the risk of externalities, i.e. the risk that the lead supervisor makes decisions, which would have unacceptable consequences in a host country'.

55 See Schoenmaker and Oosterloo, *supra* note 4.

56 Holthausen and Rønde, *supra* note 29, show that 'if the supervisors' preferences for closure do not coincide, the host country supervisor may have incentives to misreport its private information in order to obtain a preferable outcome'.

57 See J. Dermine, 'European Banking Integration: Don't Put the Cart Before the Horse' (2006) 15 *Financial Markets Institutions & Instruments*, pointing out that 'in most of the 10 NMS [New Member States], … foreign banks hold a very large market share: For instance, 97.5% in

The lead supervisor's model is reflected by the European principle of mutual recognition.[58] Indeed, the home supervisor has almost exclusive responsibility over branches established in other EEA (host) countries. However, mutual recognition only applies to cross-border branches, whereas 'solo' supervision of subsidiaries falls under the competence of the authorities of their state of incorporation. An exception regards consolidated supervision of the group as a whole, including subsidiaries, by the supervisor of the parent credit institution[59]. In particular, the model validation procedure described in the previous paragraph allows the consolidating authority to decide in a determinative way on the use of advanced risk modelling by a group, should the relevant supervisors not reach a joint decision. Moreover, the CRD II extends this procedure and the relevant role of the consolidating supervisor[60] to the group's risk management assessment, review and evaluation.

Besides this limited role as group lead supervisor, the consolidating supervisor has a primary role in the coordination of the authorities involved in the supervision of the

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Estonia, 83.3% in Hungary, 96% in the Czech Republic, and 67.8% in Poland. This situation is explained by the privatization programs that took place in those counties'. See also Pistor, *supra* note 13, pointing out how the powers of the home and host supervisor over foreign branches and subsidiaries respectively, are already excessively favouring home states, to the detriment, especially, of NMS and their financial stability.

[58] See E. Wymeersch, 'Delegation as an Instrument for Financial Supervision' (December 2006), 10, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952952> (accessed September 2011).

[59] Another exception to the competence of the subsidiary's home state was affirmed by the European Court of Justice in the *Caixa France* case, defining a banking group as a single (economic) unit for freedom of establishment purposes and treating subsidiaries like branches from a regulatory perspective. See the European Court of Justice, CaixaBank France v Ministère de l'Économie, des Finances et de l'Industrie (C-442/02), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62002CJ0442:EN:NOT>, where a French subsidiary of a Spanish group could avail itself of Art 43 of the EC Treaty (right of establishment) to be exempted from the prohibition to pay interest on sight deposits, applicable under French law, as a similar requirement was considered as a 'serious obstacle' to the operations of the group, disproportionately limiting freedom of establishment. See Wymeersch, *supra* note 58, at 3.

[60] See new Art 129(3) of the CRD.

banking group, being responsible for the gathering and dissemination of relevant or essential information regarding the group and its entities.[61] Moreover, the consolidating supervisor has a central role in colleges,[62] which are established and function according to written agreements determined by the consolidating supervisor after consultation with the relevant competent authorities[63]. The consolidating supervisor seems more focused on the coordination of other competent authorities for purposes of joint consolidated supervision, than on direct consolidated supervision.

2. The current European supervisory architecture

The legislation approved on 24 November 2010[64] to reform the European supervisory architecture represents a significant step towards regulatory convergence and

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61 Article 129 of the CRD.

62 Among a set of different policy options the one based on 'formal colleges of supervisors with involvement of CEBS [now EBA] and reinforced powers of consolidating supervisor' was preferred as it is deemed more effective with regard to the objective of reducing compliance burden. See the European Commission (COM(2008) 602 final), The European Commission (COM(2008) 602 final), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008PC0602:EN>, at 113.

63 The consolidating supervisor chairs the meetings of the college, decides which competent authorities shall take part in these meetings and is responsible for keeping member authorities fully and timely informed of actions and measures carried out by the college. See Art 131a of the CRD.

64 The relevant legislation includes: Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 establishing the new ESRB in charge of macro-prudential supervision; Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing the EBA, Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing the EIOPA, Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 and Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing the ESMA, in charge of micro-prudential supervision, respectively of the banking, insurance, and securities sectors. The regulations are available, among others, on the website of the EBA at <http://www.eba.europa.eu/>.

centralization of cross-border supervision.[65] Following the de Larosière Group's recommendations,[66] EU Regulations introduced an ESFS, assigning macro-prudential supervision to a newly established ESRB[67] and micro-prudential supervision to a network of national supervisors coordinated by the new European Supervisory Authorities, deriving from the transformation of pre-existing European Supervisory Committees.[68] The creation of a centrally coordinated network is aimed at enhancing effective cooperation between competent authorities in the supervision of cross-border financial institutions, while leaving day-to-day supervision to national authorities, in conformity with the principles of subsidiarity and proportionality laid down in Art 5 of the Treaty on

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65 See, for comments, F. Recine and P.G. Teixeira, 'Towards a New Regulatory Model for the Single European Financial Market' RTDF N. 4/2009; A Neergaard, 'European Supervisory Authorities: A New Model for the Exercise of Powers in the European Union?' EUREDIA 4/2009, 603 ff; Ferrarini and Chiodini, *supra* note 1; Ferran, "Understanding the New Institutional Architecture of EU Financial Market Supervision", in G Ferrarini, KJ Hopt and E Wymeersch (eds), *Financial Regulation: A Post Crisis Analysis*, Oxford University Press (2012). University of Cambridge Faculty of Law Research Paper (November 2010) 59. Available at SSRN: <http://ssrn.com/abstract=1701147> (last accessed December 2010).

66 The de Larosière Report is available at <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf>; for a comment, see Ferrarini and Chiodini, 'Regulating Cross-border Banks in Europe: A comment on the de Larosière Report and a Modest Proposal' (2009) *Capital Markets Law Journal* 123-40.

67 See the ESRB Regulation, *supra* note 64; and the 'Council Regulation (EU) No 1096/2010 of 17 November 2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board', available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0162:0164:EN:PDF>.

68 See *supra* note 64. For the purposes of this paragraph, we will refer mainly to Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing the European Banking Authority (hereafter EBA Regulation), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF>; see also 'Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority)' (P7_TA-PROV(2010)0336) (hereinafter 'Omnibus Directive'), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0120:0161:EN:PDF>.

the European Union.[69] As to bank supervision, the EBA has the tasks that we summarize below.

(a) *Uniform application of EU legislation*

The EBA Regulation provides for the adoption - where specifically set out by European legislation - [70] of (delegated) regulatory technical standards, aimed at ensuring harmonization of matters not requiring strategic decisions; and implementing technical standards, for the uniform application of EU legislation.[71] However, harmonized rules may not be sufficient to level the playing field if applied differently by national authorities. One of the EBA's tasks, therefore, is to ensure the consistent application of Community rules and standards by national supervisors.

The EBA may start investigations when informed that a competent authority does not correctly apply EU banking law, as specified by regulatory and implementing

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[69] The structure essentially corresponds to the one proposed by Schoenmaker and Oosterloo, *supra* note 4.

[70] This legislation (hereafter referred to as EU banking law) includes: credit and investment institutions' capital requirements and adequacy, financial conglomerates, money laundering, distance marketing of consumers financial services and deposit guarantee schemes. The Omnibus Directive, *supra* note 68, provides for the areas where the power to set technical standards is already conferred to the ESAs. Moreover, as noted by Ferran, *supra* note 65, 'the ESAs' powers in this respect will continue to expand', since recital 9 of the Omnibus Directive, 'identifies a first set of such areas and should be without prejudice to the inclusion of other areas in the future'. Furthermore, the EBA may also contribute to harmonization in areas other than technical standards through non-binding guidelines and recommendations, which national authorities or financial institutions may adopt on a 'comply or explain' basis. See Art 16 of the EBA Regulation.

[71] Both types of technical standards are endorsed by the Commission upon proposal of the EBA, which shall, where appropriate, conduct public consultations and cost-benefit analyses. The Commission decides on the endorsement of EBA's standards within three months from receipt of the same, and may refuse or endorse them with amendments only when required by Community interest and after proper consultation with the EBA. The endorsed standards are published in the Official Journal of the European Union and are legally binding. See Arts 10 to 15 of the EBA Regulation.

technical standards.[72] Within two months from the beginning of its investigation, the EBA shall recommend the actions that the national authority should take to comply with legislation. The latter shall inform the EBA of the measures adopted or to be adopted in conformity with the recommendation, within ten days of receipt. Should the authority fail to comply within one month from the recommendation's receipt, the Commission - acting on the EBA's request or on its own initiative, within three months (extendable to four) from the adoption of the recommendation - shall adopt a decision requiring the competent authority to comply with EU banking law provisions, save for the latter's right to be heard. Should the authority fail to comply with this decision[73] within a specified term,[74] the EBA shall adopt individual measures directly addressed to the financial institution(s) concerned, provided that the requirements set out in the relevant EU banking provisions are directly applicable[75] and that compliance is urgently required.[76]

(b) *Prompt supervisory action*

Prompt action in emergency situations is crucial to prevent the deepening of a crisis. The EBA Regulation, for the event of a crisis, empowers the EBA to issue binding decisions *vis-à-vis* national authorities, requiring the same to take measures in

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72 The EBA shall conduct investigations on the alleged breaches and acquire all relevant information by the authority concerned, either on request of the Commission or other competent authorities or upon its own initiative. See Art 17.2 of the EBA Regulation.

73 Note that the EBA Regulation calls this decision a 'formal opinion'.

74 See Art 17.6 of the EBA Regulation.

75 This does not prejudice the right of the Commission to start an infringement procedure under Art 258 of the TFUE against the Member State of the addressed authority. See Art 17.6 of the EBA Regulation.

76 This additional requirement was introduced by the European Council, in Art 9.6 of the relevant Proposal (now Art 17.6 of the EBA Regulation), and allows for the adoption of individual decisions directly addressed to financial institutions 'where it is necessary to remedy in a timely manner the non compliance in order to maintain or restore neutral conditions of competition in the market or ensure the orderly functioning and integrity of the financial system'.

compliance with EU banking law provisions. Should the competent authorities fail to comply, within the time limit set out in the decisions, the EBA may address the measures in question directly to individual institutions, provided that the relevant requirements of EU banking law are directly applicable to the same. This procedure allows for a more rapid adoption of the relevant measures, but is conditional on the Council's deciding (on its own initiative or upon request of an ESA, the Commission or the ESRB) that an emergency situation exists 'which may seriously jeopardize the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union'[77].

In an area still related to emergency situations, the EBA shall ensure the proper follow-up of the ESRB's warnings and recommendations, which are per se non-binding.[78] When these are addressed directly to the EBA, its Board of Supervisors shall take the relevant measures in compliance with the relevant warning or recommendation. Otherwise, it shall explain the reasons for not doing so.[79] When the ESRB's decisions are addressed to national authorities and copied to the EBA, the latter shall ensure a timely follow-up, possibly using its powers under the EBA Regulation.[80] Moreover, it shall cooperate with the ESRB, in order to identify, measure, and respond to systemic risk, taking it into account when developing draft technical standards,[81] including the set up of

77 See Art 18.1 of the EBA Regulation.

78 See Art 36.3 of the EBA Regulation.

79 See Art 36.4 of the EBA Regulation.

80 Should the authority decide not to follow the ESRB's recommendation, the matter shall be discussed by the Board of Supervisors of the EBA. The relevant authority shall take the views expressed by this Board into account when informing the ESRB about the reasons for not conforming to the recommendation. See article 36.5 of the EBA Regulation.

81 Ibid, Arts 22 to 24.

recovery and resolution procedures[82] and the strengthening of a European system of deposit guarantee schemes.[83]

(c) *Colleges and mediation*

The EBA Regulation has significantly enhanced the role of colleges of supervisors in cross-border supervision. Tasks attributed to the EBA include the information collection and the coordination of Union-wide stress tests aimed at monitoring systemic risk and supervision by competent authorities on individual institutions, with the power to request further deliberations of a college where deemed appropriate.[84] Moreover, significant coordinating powers of the EBA relate to the development of recovery and resolution procedures, including, as mentioned above, the issuance of regulatory and implementing technical standards, the strengthening of the European System of national Deposit Guarantee Schemes, and the creation of a European System of Bank Resolution and funding arrangements.[85]

Finally, the EBA shall provide, on its own initiative or upon request, a mediating function by a procedure for the settlement of disagreements between authorities.[86] In

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82 Ibid, See Art 25.

83 Ibid, Art 26.

84 The EBA shall participate in colleges and 'lead in ensuring a consistent and coherent functioning of colleges of supervisors for cross-border institutions across the Union'. See Art 21 of the EBA Regulation. Coordination shall also involve macro-prudential supervision, as the ESRB must be notified without delay of any potential emergency and provided with all relevant information. See Art 36 of the EBA Regulation, which states that the EBA shall provide the ESRB will information necessary to perform its tasks on a regular basis in summary or collective form, while upon a reasoned request of the latter it shall deliver the data not in summary or collective form, according to Art 17 of the ESRB Regulation.

85 Ibid, Art 27.

86 Ibid, Art 19. Moreover, cooperation shall be facilitated by a common supervisory culture and consistent practices fostered by the EBA though the provision of opinions, the promotion of bilateral and multilateral exchange of information, training programmes and periodical peer

areas where EU banking law requires cooperation, coordination, or joint decision-making by authorities from different Member States, a competent authority disagreeing on the procedure or content of an action or inaction of another competent authority may request the EBA's assistance in reaching an agreement.[87] Should no agreement emerge, the EBA shall enjoin the competent authority to take or refrain from a specific action, in conformity with EU banking law.[88] Should the authority in question not comply with the EBA's request and should this result in a credit institution not complying with EU banking law, the EBA may (without prejudice to the Commission's infringement procedure under Art 258 of the TFEU) adopt an individual decision requiring the financial institution to comply with the requirements of EU banking law that are directly applicable.[89]

Any decision taken by the EBA may be appealed upon the Board of Appeal[90]. This shall take any measure and exercise any power within the competence of the EBA,

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review. The framework for enhanced cooperation shall allow for the delegation of tasks and responsibilities between authorities, either through bilateral or multilateral agreements. The EBA shall smooth the progress of delegation by identifying possible tasks and responsibilities which may be delegated or exercised jointly by competent authorities and by encouraging best practices. It shall be informed of any such agreement and possibly give an opinion on it within one month from being informed. Similar measures should further improve cooperation and best practices.

87 See Art 19 of the EBA Regulation. The EBA may assign the parties a deadline for conciliation, taking EU banking law into account, together with the complexity and urgency of the matter. A case in which the EBA can adopt measures to settle disagreements applying different time limits for conciliation depending on EU banking law is that of a joint decision on the designation as systemically significant of a branch between the home and the host supervisor, following Art 42a of the CRD. In this case, the time limit of two months where the competent authorities 'shall do everything within their power to reach a joint decision' shall also be deemed as a conciliation period for the purposes of the EBA Regulation. Similarly, the period of six months for the joint decision on the internal model validation according to Art 129.2, and the period of four months for the joint decision on group's risk assessment under Art 129.3 of the CRD, shall be considered as conciliation within the meaning of Art 19 of the EBA Regulation.

88 Ibid, Art 19.3.

89 Ibid, Art 19.4.

90 The appeal may be filed with the Board of Appeal through a reasoned written document within two months of the notification to the addressee or (in absence) the publication of the

or remit the case to the competent body for a new determination[91]. The EBA shall be bound to its decision. The decision of the Board of Appeal may be contested before the European Court of First Instance or the ECJ under Art 263 of the TFEU.[92] If an ESA fails to take a decision where it has an obligation to act, the relevant case may be filed before the European Court of First Instance or the ECJ, under Art 265 of the TFEU.[93]

Decisions included in the competence of ESAs may also be taken by the Commission or the ESRB, either on their own initiative or by request of national supervisors. In no case, however, will financial institutions be entitled to ask for similar actions. Moreover, no appeal may be filed in the absence of a decision by the ESA. Therefore, a claim before the European courts under Art 263 of the TFEU shall protect financial institutions in the case of European Supervisors' inaction.[94] Moreover, ESAs shall ensure that no decisions addressing emergency situations or settling disagreements between national supervisors impinge on fiscal responsibilities of Member States.[95]

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decision by the EBA. The Board of Appeal may decide within two further months. As a general rule, the appeal may not suspend the decision, but a suspension may be granted by the Board of Appeal when it deems that circumstances so require. See Art 60 of the EBA Regulation.

91 The composition of the Board of Appeal (two Members elected by each ESA) should guarantee high profile decisions, ensuring a broad vision of the financial system, from a cross-sector perspective. It remains to be seen whether the Board of Appeal will engage in technical details or leave them to competent authorities for (re)determination. In the latter case, the Board of Appeal should provide the authority concerned with binding guidelines. See Art 60.5, the rules of procedure are to be published by the Board of Appeal according to Art 60.6 of the EBA Regulation.

92 See Art 61.1 of the EBA Regulation or of the regulations establishing the EIOPA and the ESMA.

93 Ibid, Art 61.2.

94 In particular, Art 263.3 of the TFEU states that 'any natural or legal person may, under the conditions laid down in the preceding paragraphs, complain to the Court of Justice that an institution of the Community has failed to address to that person any act other than a recommendation or an opinion'.

95 See Art 38.1 of the EBA Regulation. As a safeguard, Member States may notify within two weeks the relevant European Supervisory Authority and the Commission that the decision pursuant to Art 19.3 will not be implemented by the competent national authority. Member States shall give clear reasons to demonstrate how the decision impinges on their fiscal responsibilities.

3. A critical assessment

The European supervisory framework just described substantially belongs to the first model of centralization examined above (enhanced cooperation), despite including some elements of the other two models. Firstly, the creation of the ESFS and the ESAs did not substantially change the allocation of powers and responsibilities amongst authorities, but enhanced coordination mechanisms. Secondly, the lead supervisor model remains confined to the supervision of branches and consolidated supervision of subsidiaries. However, some coordination mechanisms address the externalities that may derive from the exercise of the home supervisor's powers over foreign established branches. Indeed, upon the determination that a branch is systemically significant, host authorities have the right to take part in coordination mechanisms otherwise reserved to foreign-owned subsidiaries' supervisors. Moreover, the consolidating supervisor has enhanced coordination powers for consolidated supervision over the whole group (including its foreign subsidiaries). On the whole, the home supervisor's role on foreign

As a result, the decision of the European Supervisory Authority shall be suspended, and the latter shall inform the Member State within one month of the receipt of the notification, on whether it intends to maintain the relevant decision, to amend or revoke it. In the case that the ESA maintains its decision, the Council, acting by qualified majority, shall determine within two months whether the decision is to be maintained or revoked. The suspension of the decision shall be terminated if the Council decides to maintain the same or does not revoke it within two months. Decisions of ESAs taken as a reaction to emergency situations (under Art 18.3) are subject to similar safeguards. However, given the urgency, the procedure for determining whether the decisions impinge on the Member States' fiscal responsibility is significantly abbreviated: the Member State concerned shall notify the ESA, the Commission and the Council that the decision will not be implemented by the competent national authority within three working days of its notification or publication. The Council may revoke the decision within the following ten working days, otherwise the decision shall be deemed to be maintained and has to be enforced. See Art 38 of the EBA Regulation or the regulations establishing the EIOPA and ESMA.

established branches has been slightly reduced,[96] while the consolidating supervisor's role over foreign subsidiaries has been enhanced. Thirdly, the EBA represents a central pan-European authority, with a certain degree of binding powers. However, its role is limited to technical standards' setting; implementation of European banking law provisions; and coordination among national supervisory authorities. The EBA lacks direct supervisory powers either in normal times or in emergency situations.

The described framework, while clearly a step towards centralization and a considerable political compromise, is based on delegation of supervisory powers to the lead home (or consolidating supervisor)[97] and on cooperation among authorities. Both delegation and coordination carry relevant costs and are likely to fail in crisis situations, due to misalignment of incentives between national authorities. In addition, the current framework seems to lack the centralized mechanisms needed to solve these problems.

(a) *Agency costs of delegation*

Delegation gives rise to agency costs between the delegating authority (principal) and the delegated one (agent). These costs derive from information asymmetries and strategic behavior made possible by the misalignment of incentives. While coordination may reduce information asymmetries, supervisors' national mandate and accountability significantly impair their ability and willingness to effectively cooperate, notwithstanding coordination mechanisms.[98] The recent financial crisis showed how significant

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96 For a sceptical view as to the effectiveness of the designation of a branch as systemically significant in the host country, see Pistor, *supra* note 11, describing the relevant powers of the host as 'only nominal participation of affected member states in the colleges of supervisors' (p 30).

97 See Wymeersch, *supra* note 58, at 10.

98 Holthausen and Rønde, *supra* note 29.

externalities and spillovers deriving from supervisory failures of delegated authorities negatively impact the domestic financial systems of delegating authorities, jeopardizing their stability.[99] Voluntary delegation and cooperation were, therefore, abandoned during the crisis, whilst the host countries' powers over foreign-owned and regulated branches were seen as insufficient.[100] Also, the consolidating supervisors' powers over foreign established and regulated subsidiaries were seen as inadequate for effective consolidated supervision, due to non-cooperative solutions and ring-fencing by the relevant authorities. As argued throughout this paper, the different regulatory treatment of branches and subsidiaries did not match the operational practice of integrated multinational banks.

The CRD II narrowed the regulatory gap between branches and subsidiaries by enhancing both the role of the consolidating supervisor and that of the host authority of a systemically relevant branch.[101] The directive, however, failed to envisage a lead (consolidating) supervisor responsible for direct supervision over the group entities, irrespective of their legal form. The consolidating supervisor remains a coordinator of national authorities in the area of group supervision. Moreover, the enhanced role of host supervisors in the supervision of systemically relevant branches erodes the mutual recognition principle and the lead supervisor model incorporated in the same, rather reflecting the model of enhanced cooperation.

(b) *Limits of coordination*

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99 As shown by the Icelandic banks crises, *supra* note 10.

100 The problem was also raised by the Turner Report. See FSA (2009), see 'The Turner Review', *supra* note 9, pointing out the need for 'Gathering far more extensive information from banks and from home country supervisors on the whole bank liquidity of banks operating in the UK, including those operating as branches', p 99. See also Pistor, *supra* note 11.

101 See new Art 42a of the CRD.

In general, the new framework promotes coordination mechanisms aimed at fostering cooperation between authorities. Consultation and joint decisions (possibly via colleges) are generally preferred to lead supervision and delegation,[102] reflecting a lack of confidence and trust among supervisors. Also, the new supervisory architecture, rather than contemplating a centralized pan-European authority for direct bank supervision, enhances cross-border cooperation between national authorities, without affecting the allocation of supervisory powers and responsibilities. Supervision remains decentralized, while coordination mechanisms (including binding mediation and appeals) are centralized at European level. Coordination, however, is time-consuming and only workable in normal times. When a crisis occurs, the misalignment of incentives between national authorities becomes dramatic, given the threat to the relevant countries' financial stability and possible fiscal responsibilities. Moreover, the need for urgent regulatory action may not find an answer in inevitably slow coordination mechanisms. In fact, coordination arrangements, irrespective of their voluntary or mandatory nature, are incomplete contracts. Incentives of the relevant parties to effectively cooperate play, therefore, a crucial role. In crisis situations, when domestic financial stability and fiscal responsibilities are at stake, supervisors' national accountability will likely result in non-cooperative strategies. While cross-border cooperation could decently work for ongoing supervision on multinational groups, fully centralized crisis management seems to be the only way to prevent the national bias of local supervisors.

[102] For a distinction of delegation of supervisory tasks and decisions, and its implications, see Wymeersch, *supra* note 58.

IV. Strong centralization in the Eurozone?

In this section, we analyse the main aspects of common supervision in the Eurozone and ask to what extent the recent proposals for a Banking Union meet the centralization requirements addressed in the previous sections. First of all, we set the grounds for our analysis by illustrating the origins of the Banking Union in the current sovereign debt crisis. We then examine the main elements of the September 12, 2012 European Commission's proposal for a Council regulation on common supervision by the ECB,[103] which was modified by the December 14, 2012[104] agreement of the Council of the European Union (para. 2).[105] We subsequently ask to what extent the draft regulation satisfies the needs for supervisory centralization in the eurozone highlighted in other parts of this paper, showing that the relevant framework is to some extent seriously deficient and largely relies on cooperation between authorities and delegation (para. 3).

1. The concept of a Banking Union

As already argued under para. II.4, the Banking Union with its three main components is seen as the principal remedy to break the vicious circle between banks and sovereigns and reactivate the channels for the transmission of monetary policy.

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[103] The September 12, 2012 European Commission proposal is available at <http://register.consilium.europa.eu/pdf/en/12/st13/st13683.en12.pdf>, (hereafter 'Commission proposal').

[104] The December 14, 2012 agreement of the Council of the European Union is available at <http://register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf>, (hereafter 'draft regulation').

[105] For an overview of the Commission proposal and the Council agreement see the 'IMF technical background notes: A banking Union for the Euro Area', available at <http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301technt.pdf>.

Indeed, centralized supervision makes it possible to curb the national interest, which in the past has *inter alia* allowed for the accumulation of imbalances in the balance sheets of banks for the purpose of promoting national champions, with the consequences on public finances described above.[106] Moreover, common mechanisms for resolving banking crises[107] and a common guarantee of deposits[108] will contribute to cutting the link between banks and sovereigns. Clearly, however, the consent to provide these shared resources will be obtained only by preliminarily integrating regulation and supervision so as to prevent an increase in moral hazard.[109]

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106 See E. Wymeersch, *supra* note 30, arguing that a single supervisor would at least be able to apply the rules in a more distant and neutral way. In supervision, like in taxes, there are some "regulatory heavens" that are actively used by financial groups.

107 The current setup for bank resolution is established at the national level and many EU countries rely on general corporate insolvency law to deal with bank failures, an approach that can be very complex, lengthy and inefficient. The European Commission has taken several steps to harmonize and strengthen national resolution regimes. In June 2012, the Commission issued a draft directive for harmonized crisis management and a common resolution framework for all EU countries, which is expected to be adopted by the EU Parliament in 2013 (vote is scheduled on November 19, 2013). Furthermore, as announced in the EC blueprint of November 27, 2012, and reaffirmed in the December EU Council agreement, on July 10, 2013 the Commission has proposed a Single Resolution Mechanism, as a complement to the Single Supervisory Mechanism, in order to severe the negative feedback loop between banks and sovereigns. Under the proposal, a new agency called the Single Resolution Board shall recommend when to wind down failing banks and prepare their resolution in terms of tools and involvement of the European Resolution Fund. Upon the Board's recommendation, or on its own initiative, the Commission has the legal power to decide whether and when to place a failing bank into resolution and lay out the resolution's framework.

108 At the moment, deposit insurance schemes are national and remain diverse across EU countries. In particular they differ in terms of coverage, mandate, pay-out, and funding arrangements. After the 2008 crisis the EU harmonized the limit of deposit insurance to €100,000 per depositor and bank. However, the harmonization was not accompanied by clarification about how the new liabilities would be covered. Therefore in 2010, draft legislation at the EU level proposed further steps to harmonize national DGS, including shorter pay-out periods (that would be limited to seven working days) and funding arrangements, where the lack of common standards has allowed for diverging models of ex ante and ex post funding schemes. In the original Banking Union roadmap, the Commission expected the Directive to be adopted by end 2012. The December 14, 2012 conclusions of the EU Council have postponed the timeline for the adoption of the Directive for bank resolution to June 2013. At the end of July the Working Party will discuss on the state of play of the negotiations.

109 See B. Coeuré, *supra* note 34, arguing that there would no longer be a host or a home supervisor and this should ensure that cross-border allocation of capital and liquidity would be

The Banking Union should thus restore an effective transmission of monetary policy. As the crisis has shown, a monetary union can work only if an integrated banking system is in place.[110] By severing the link between banks' and sovereign balance sheets the Banking Union should stop the fragmentation process currently underway in the eurozone and lay the ground for renewed financial market integration,[111] which in turn will facilitate an effective transmission of monetary policy and ensure that credit supply meets the needs of the real economy.

However, the Banking Union is not the only mechanism deployed to solve the euro-crisis, the other main instruments being the European Stability Mechanism and the Fiscal Compact. The first is a permanent international financial institution that assists in preserving the financial stability of the European monetary union by providing temporary stability support to euro area member states. [112] The latter is an instrument designed to

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primarily driven by business considerations. A common resolution scheme would spread the burden of resolution rather than saddling any single sovereign with it. Finally, depositors would not need to consider shifting their funds across the continent in search of a safe haven, as all banks would offer the same insurance coverage

110 B. Coeuré, *supra* note 34, arguing that credit is the water of the economy, and for the economy to run smoothly it needs to reach all its parts in the same way.

111 See M. Draghi 'Speech at the 22nd Frankfurt European Banking Congress, 23 November 2012', available at <http://www.ecb.int/press/key/speaker/pres/html/index.en.html>, who emphasizes the need to break the loop between banks and sovereigns at national level by moving responsibility for financial stability to the European one. A financial union, in addition to improving investors' confidence, provides the most effective response to the fragmentation of European banking markets. Monetary stability, financial stability and defence of the Single market are all closely linked.

112 The ESM will issue bonds or other debt instruments on the financial markets to raise capital to provide assistance to Member States. Unlike its predecessor EFSF, which was based upon euro area Member State guarantees, the ESM has a total subscribed capital of 700 billion euro provided by euro area Member States - 80 billion in the form of paid-in capital with the remaining 620 billion as callable capital. This subscribed capital provides a lending capacity for the ESM of €500 billion. Financial assistance from the ESM is activated upon a request from a Member State to the Chairperson of the ESM's Board of Governors. Each instrument is linked to a Memorandum of Understanding that details the appropriate conditions a Member State has negotiated with the European Commission, in liaison with the European Central Bank, for financial support, as well as the monitoring and surveillance procedures to ensure a Member State

induce countries to pursue a balanced budget that is sustainable in the long-term. Compared to the ESM, however, it takes much longer before its benefits become visible.[113]

2. The Commission Proposal and the Council Agreement

On September 12, 2012 the Commission published a draft regulation conferring supervisory tasks on the ECB as part of a roadmap toward establishing the SSM in the eurozone. The proposal was based on Art. 127 (6) of the ESCB/ECB Statute[114] and provided a clear mandate and broad powers to the ECB to perform supervision on all e urozone banks, starting January 2013.[115] However, banks receiving or requesting public financial assistance would be targeted first, while systemically important banks should be subject to ECB supervision from July 2013 and all other credit institutions from January 2014.

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is progressing towards financial stability. The assistance provided by the ESM is not rerouted to Member States in public finance statistics.

Euro area leaders also agreed that when an effective SSM – central pillar of a Banking Union – will be established under the ECB, the ESM could, in compliance with a regular decision, recapitalize eurozone banks directly. However there are deep reservations in some Member States about using the eurozone's bailout fund for direct bank recapitalization, which will make it very difficult to find an agreement that would need unanimous backing.

113 See B. Coeuré, note 33, stating that these instruments, when operational, would effectively sever the link between banks and sovereigns, and support the functioning of the EMU.

114 Art. 127 (6) of the ESCB/ECB Statute states: 'The 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'.

115 Given its extensive expertise in macroeconomic and financial stability issues, the ECB is well placed to carry out supervisory tasks with a focus on protecting the stability of Europe's financial system. Its supervision should enhance transparency and strengthen confidence in the European banking system. Indeed, the ECB is the *de facto* lender of last resort and has already provided ample liquidity to support European banks despite not receiving the necessary information from national supervisors who, in some cases, were in denial of their problems. In its new role as a common supervisor the ECB will be in possession of more information. Moreover, the SSM does not require a Treaty revision, thus speeding up the whole process.

The Commission also announced that the draft EU legislation which will contribute to creating a single rule book (CRR/CRD IV)[116] and to harmonizing and strengthening national resolution regimes and deposit guarantee schemes should be adopted by the end of 2012. The Commission announced plans for the proposal of a single resolution mechanism, and confirmed its views on the powers of the EBA to harmonize technical standards for regulation and supervision and act as a non-binding mediator for cross-border supervision and resolution in the EU.[117] However, the

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116 The draft Capital Requirements Regulation and Directive, available at <http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm>, will strengthen supervision (e.g. through supervisory plans, onsite inspections, more robust and intrusive supervisory assessments) and harmonize sanctions to ensure uniform application of Basel II and III by limiting national options and discretions. The CRR also tightens large exposure limits, liquidity ratios, and public disclosure requirements, and introduces an indicative leverage ratio. Ensuring full consistency of rules is a natural policy response to the high degree of financial and monetary integration in the EU in general and in the euro area in particular. The EU Council version of the CRR/CRD IV, the so-called Danish compromise, approved in May 2012 and being considered by the EU Parliament, acknowledges that financial stability risks differ across jurisdictions and institutions, and provides national authorities with the flexibility to impose stricter standards to respond to macroprudential concerns. Under the draft legislation, Common Equity Tier 1 capital ratios can be increased by up to 3 percent (systemic risk buffer) on all exposures or up to 5 percent on domestic or non-EU exposures without the Commission's pre-approval. For higher buffers, pre-approval is required. The draft regulation allows member states to impose temporarily (for up to two years, but extendable) some stricter prudential requirements for domestically licensed financial institutions. The drafts maintain the national authorities' capacity to require Pillar 2 capital add-ons for individual institutions, based on their risk profile. For example, sectoral risk weights up to 25 percent beyond what will be established in the common rulebook for real estate and financial sector exposures, as well as stricter large exposure limits (up to 15 percent), public disclosure requirements and liquidity requirements.

117 See Art. 4.1.3 of the Commission proposal: 'The ECB will carry out its tasks within in the framework of the European System of Financial Supervision and will closely cooperate with the three European supervisory Authorities. The EBA will keep its powers and tasks to further develop the single rulebook and ensure convergence and consistency of supervisory practice. The ECB will not take over any tasks of the EBA and the exercise of its regulatory powers in accordance with Article 132 TFEU will be limited to areas which are necessary for the proper exercise of the tasks conferred on the ECB by this regulation'.

The composition of the board of supervisors of the EBA will remain unaffected and representatives from national competent authorities will continue to shape decision-making in the EBA. However, to reflect the ECB's supervisory responsibilities, representatives from competent authorities from participating Member States shall coordinate and express, for matters falling in the competences of the ECB, a common position'.

Commission did not specify how common safety nets and backstops for deposit insurance and resolution funding will be established.

The December 14, 2012 conclusions of the EU Council postponed the timeline for the adoption of the draft directives on bank recovery and resolution and on harmonization of deposit guarantee schemes.[118] Adoption of the CRR/CRD IV was described as a priority so as to develop a single rulebook.[119]

The EU Council conclusions also called for an operational framework to be in place before June 2013 that would allow the ESM to directly recapitalize banks when an effective SSM is established.[120] Overall, the draft regulation agreed upon in December confirmed the Commission proposal providing clear tasks[121] and strong supervisory powers[122] to the ECB over all credit institutions authorized in the euro area.

The Council agreed that the SSM would come into operation in March 2014, or one year after the legislation enters into force, whichever is later. The agreement

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118 See para. (8) of the 13-14 December 2012 European Council conclusions, available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134353.pdf>: 'The European Council urges the co-legislators to agree on the proposals for a Recovery and Resolution Directive and for a Deposit Guarantee Scheme Directive; once adopted, these Directives should be implemented by the Member States as a matter of priority'.

119 See para. (7) of the 13-14 December, 2012 European Council conclusions: 'The Single Supervisory Mechanism constitutes a major qualitative step towards a more integrated financial framework. The European Council welcomes the agreement reached within the Council on 13 December and calls on the co-legislators to rapidly agree so as to allow its implementation as soon as possible. It also reiterates the importance of the new rules on capital requirements for banks (CRR/CRD), which are of the utmost priority so as to develop a single rule book, and calls on all parties to work towards their agreement and rapid adoption'.

120 See para. (10) of the 13-14 December, 2012 European Council conclusions: 'It is imperative to break the vicious circle between banks and sovereigns. Further to the June 2012 euro area Summit statement and the October 2012 European Council conclusions, an operational framework, including the definition of legacy assets, should be agreed as soon as possible in the first semester of 2013, so that when an effective single supervisory mechanism is established, the European Stability Mechanism will, following a regular decision, have the possibility to recapitalise banks directly. This will be done in full compliance with the Single Market'.

121 See Art. 4 (Tasks conferred on the ECB) of the draft regulation.

122 See Art. 8 -12 of the draft regulation.

provided that when the ESM requests the ECB to take over direct supervision of a credit institution as a precondition for direct recapitalization, the ECB may immediately assume its supervisory duties concerning this bank, regardless of the starting date of the SSM.[123]

(a) *ECB and SSM*

The tasks conferred on the ECB include the following: to authorise credit institutions and withdraw authorisations of the same; to assess applications for the acquisition and disposal of qualifying holdings in credit institutions; to ensure compliance with prudential requirements on credit institutions (in areas like own funds requirements, large exposure limits, liquidity, leverage, etc.) and with requirements to have in place robust governance arrangements, including 'fit and proper' requirements for bank managers, risk management processes, internal control mechanisms, remuneration policies, etc.; to carry out supervisory reviews, including stress tests, and other supervisory tasks concerning recovery plans and early intervention.[124]

In view of carrying out these tasks and ensuring high standards of supervision, the ECB shall apply all relevant Union law and where the latter consists of Directives the national legislation transposing the same. To that effect, the ECB shall adopt guidelines and recommendations, and take decisions subject to and in compliance with the relevant Union law. The ECB may also adopt regulations, but only to the extent necessary to organize or specify the modalities for carrying out those tasks.[125]

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123 See Art. 27 of the draft regulation.

124 See Art. 4 (1) of the draft regulation.

125 Before adopting a regulation with regard to matters having a substantial impact on credit institutions, the ECB shall conduct open public consultations and analyze the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the

According to Art. 5 (1) of the draft regulation, the ECB shall carry out its tasks within a single supervisory mechanism (SSM) composed of the ECB and national competent authorities and the ECB shall be responsible for the effective and consistent functioning of the same. Art. 5 (2) specifies that the ECB and national competent authorities shall be subject to a duty of cooperation in good faith and an obligation to exchange information. Art. 5 (3) further adds that national authorities shall be responsible for assisting the ECB with the preparation and implementation of any acts relating to the tasks conferred on the ECB by the draft regulation.

The SSM will cover – either directly or indirectly – all credit institutions established in participating countries, although most tasks related to the supervision of those institutions that are considered as less significant would be normally carried out by the national authorities.[126] The criteria under which banks will be under the direct supervision of the ECB include size, importance for the economy of the EU or of a member state, and significance of cross-border activities.

Under the criteria specified in Art 5 (4), banks accounting for about 80 percent of euro area banking assets will be under the direct supervision of the ECB.[127] A bank will be directly supervised by the ECB if any of the following conditions is met: (i) assets of the bank exceeding €30 billion, (ii) ratio of total assets to GDP of the home member state exceeding 20 percent, or (iii) national competent authorities defining the institution as

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scope and impact of the regulations concerned or in relation to the particular urgency of the matter, in which case the ECB shall justify the urgencySee Art. 4(3) of the draft regulation.

126 See Art. 1 of the draft regulation. The regulation is without prejudice to the responsibilities and related powers of the competent authorities of the participating Member States to carry out supervisory tasks not conferred on the ECB by the same. As to the tasks of national authorities, see also Art. 5 (6).

127 See G.B. Wolff, C. De Sousa, "A banking union of 180 or 81%?", available at <www.bruegel.org/nc/blog/detail/article/965-a-abanking-union- of-180-91-percent.USX4lh03hWI>.

significant. An institution may also be considered as significant by the ECB if it has significant cross-border assets or liabilities, relies upon ESM financial assistance, or is among the three largest institutions in its home member state (which will determine direct supervision of largest banks in smaller countries). The ECB retains the power to bring any bank under its direct supervision, if deemed necessary.[128]

The responsibilities for credit institutions indirectly supervised by the ECB are shared between the latter and the national authorities according to the criteria stated in Art. 5 (5) and (6). The ECB shall issue regulations, guidelines or general instructions to national competent authorities, according to which the latter perform the supervisory tasks conferred upon the former. When necessary to ensure consistent application of high supervisory standards, the ECB may decide to exercise directly all the relevant powers for one or more credit institutions. Moreover, the ECB shall exercise oversight over the functioning of the system, may at any time make use of its investigatory powers, and may request information from the national competent authorities on the performance of the tasks carried out by them.

National competent authorities, on their turn, shall carry out and be responsible for the tasks conferred upon the ECB by Art. 4 and shall adopt all relevant supervisory decisions within the framework and procedures referred to in Art. 5 (7). They shall report to the ECB on a regular basis on the performance of the supervisory activities performed. They will remain exclusively responsible for consumer protection and anti-money-laundering tasks, receiving notifications from credit institutions related to the

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128 According to Art. 5 (4) of the draft regulation the ECB may also, on its own initiative, consider an institution to be of significant relevance where it has established banking subsidiaries in more than one participating Member States and its cross-border assets or liabilities represent a significant part of its total assets or liabilities subject to the conditions laid down in the methodology.

right of establishment, supervising activities of third countries credit institutions' branches, and supervising payment services.[129]

(b) *ECB and national authorities*

The ECB is provided with the same powers as those available to competent supervisory authorities under EU law.[130] To the extent necessary to carry out its tasks under the new regulation, the ECB may require, by way of instructions, national authorities to make use of their powers where the regulation does not confer the same on the ECB.[131] Art. 8 (2a) specifies that in the exercise of their respective supervisory and investigatory powers, the ECB and national competent authorities shall cooperate closely.

Moreover, the ECB is vested with broad investigatory powers which include requiring credit institutions and other legal or natural persons to provide information; conducting all necessary investigation of any relevant person; conducting all necessary on-site inspections at the business premises of the relevant legal persons (after being authorised by a judicial authority if national law so requires).[132] The ECB is also vested with specific supervisory powers for the exercise of which it will be assisted by national authorities, in the areas of authorisation of credit institutions and assessment of

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129 See 22nd considerandum of the draft regulation.

130 According to Art. 8 (1) of the draft regulation, 'for the exclusive purpose of carrying out the tasks conferred upon it by Article 4 (1), (2) and 4a (2), the ECB shall be considered, as appropriate, the competent authority or the designated authority in the participating Member States as established by the relevant Union law. For the same exclusive purpose, the ECB shall have all the powers and obligations set out in this Regulation. It shall also have all the powers and obligations, which competent and designated authorities shall have under the relevant Union law, unless otherwise provided for by this Regulation. In particular, the ECB shall have the powers listed in Sections 1 and 2 of this Chapter'.

131 See Art. 8 (1), last period, of the draft regulation.

132 See Art. 9 – 12 of the draft regulation.

acquisitions of qualifying holdings.[133] Furthermore, the ECB is empowered to require institutions to hold funds in excess of capital requirements; to reinforce arrangements, processes, mechanisms and strategies; to present a plan to restore compliance with supervisory requirements; to apply a specific provisioning policy; to restrict or limit the business, operations or network of institutions; to limit variable remuneration; to use net profits to strengthen own funds; etc.[134]

The ECB is also provided with a sanctioning power, but only where institutions breach a requirement under directly applicable acts of Union law.[135] In other cases, the ECB – where necessary for carrying out the tasks conferred upon it by the regulation – may require national competent authorities to open proceedings with a view to taking action in order to ensure that appropriate sanctions are imposed in accordance with relevant EU law and national legislation.[136]

Non-participating member states whose currency is not the euro will be able to enter into close cooperation with the ECB, under the condition that the national authority will abide by the ECB guidelines and requests, and provide all necessary information that the ECB may require[137]. The ECB is tasked to coordinate and express a common position

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133 See Art. 13 and 13a of the draft regulation.

134 See Art. 13b (2) of the draft regulation.

135 Art. 15 (1) of the draft regulation states that the ECB may impose administrative pecuniary sanction of up to twice the amount of the profits gained or losses avoided because of the breach where those can be determined; or up to 10% of the total annual turnover of a legal person in the preceding business year. Art. 15 (7a) specifies that nothing in the regulation shall confer on the ECB the power to impose sanctions on natural persons.

136 See Art. 15 (5) of the draft regulation, further stating that this provision shall be applicable in particular to any administrative sanctions or measures to be imposed on members of the management board of an institution who under relevant national legislation are responsible for a breach.

137 In particular, under these agreements supervisory tasks remain to local supervisors. Therefore the ECB has no direct binding power.

of euro area national supervisors at the Board of Supervisors and at Management of the EBA for issues relating to the supervisory tasks conferred on the ECB.[138]

(c) *Supervisory Board: role and composition*

A Supervisory Board (aided by a Steering Committee) will be created to achieve appropriate governance and facilitate timely supervisory decision making by, or subject to the oversight and responsibility of, the Governing Council. According to Art. 19 (1) of the draft regulation, the Supervisory Board is an internal body composed of its Chair and Vice Chair, four representatives of the ECB and one representative of the national authority competent for the supervision of credit institutions in each participating member state. This provision further specifies that all members of the Supervisory Board shall act in the interest of the Union as a whole.

The Council agreement strengthened the governance arrangements of the Commission proposal reflecting concerns related to the separation between monetary policy and prudential supervision, so as to minimize conflicts of interest between the two functions and ensure that non-euro area countries have a voice in the SSM (since non-euro area "opt-ins" are not represented on the ECB's Governing Council).[139] Strict differentiation between monetary policy and supervision shall apply, including strengthening the powers of the Supervisory Board by a complex voting procedure that ensures representation of the non-euro area members.[140] Draft decisions of the Supervisory Board will follow a silence procedure, i.e. they will be deemed to have been

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138 See Art. 3 (4bis) and Art. 6 of the draft regulation.

139 See Art. 19 of the draft regulation.

140 See Art. 18 of the draft regulation.

adopted unless the Governing Council objects to them within a short period (10 days in normal times, and 2 days in stressful times).

A mediation panel and a Steering Committee shall be created to help resolving disagreements and aiding decisions. In practice, it will be important to balance the representation of national interests and public officials from the ECB in the governance structure of the SSM. It will also be important to ensure that the complexity of the setup does not undermine effective and prompt supervisory decision-making.

The Governing Council, and in particular the Chair of the Supervisory Board, is accountable to the Eurogroup and the EU Parliament through, among other things, an annual report on the execution of the ECB's supervisory tasks and transparency of its supervisory budget. Moreover, the ECB is subject to internal and external audits, also by the EU Court of Auditors, and judicial scrutiny by the EU Court of Justice.[141]

3. A semi-strong framework

We pass on to identify potential weaknesses in the proposed scheme of common supervision in the Eurozone. We critically examine, in particular, the limits to common supervision deriving from (a) the current absence of a common rule-book for the supervised entities; (b) the extensive reliance on cooperation amongst supervisors and delegation from the central supervisor to the national ones; (c) the focus on the eurozone and the need for the ECB to cooperate with other authorities, including the EBA; (d) the current incompleteness of the Banking Union.

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141 See Art. 17 of the draft regulation.

(a) *Absence of a common rule-book*

While supervision will be (to some extent) centralized, regulation will largely remain in the national responsibility.[142] Under Art 4(3) of the draft regulation, in order to carry out its tasks, the ECB is entitled to apply all relevant Union law and, where Union law consists of directives, the national laws transposing the same. However, Member States often enjoy considerable discretion in the transposition of directives, so that the single supervisor will perform its tasks under partially diverging laws and regulations. Only over time a single European rulebook will emerge – also as a result of the EBA's work - consisting of EU regulations, directives, implementing acts and also recommendations, guiding principles and other non-binding instruments. Nonetheless, a similar rulebook will likely find some resistance from Member States preferring to stick to their legal traditions and supervisory practices.

To the extent that regulation and supervision are national, cross-border differences in regulation create international frictions and give rise to regulatory arbitrage, but are not necessarily problematic for supervisors. Once supervision is centralized, the ECB will find that divergent national regulations may be an obstacle to effective cross-border supervision. On one side, they determine information costs for the single supervisor, who must rely on national authorities for advice on applicable rules. On the other, interpretation problems may arise with regard to the scope of EU directives and of the relevant implementing provisions.

An example taken from the CRD treatment of large exposures will clarify this issue. Art. 111 (1) of the CRD provides that a credit institution may not incur an exposure to a client or group of connected clients the value of which exceed 25 % of its own funds.

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142 For an analysis, see E. Wymeersch, *supra* note 30.

Article 111 (2) further provides: ‘Where that client or group of connected clients is the parent undertaking or subsidiary of the credit institution and/or one or more subsidiaries of that parent undertaking, the percentage laid down in paragraph 1 shall be reduced to 20 %. Member States may, however, exempt the exposures incurred to such clients from the 20 % limit if they provide for specific monitoring of such exposures by other measures or procedures’. Art. 113 (1) specifies, however, that member States may impose limits more stringent than those laid down in Article 111.

As a result, in a given Member State there can be one of three possible regimes for large exposures to a parent undertaking and subsidiaries of the same: 20% limit; no limit (but specific monitoring of the relevant exposures); a limit lower than 20%. Possibly, also a higher limit (of say 40%) could be foreseen by national legislation, increasing the scope for possible divergence. Assuming that a Member State adopts one of the alternatives to the 20% limit – for instance, no limit, but specific provisions on risk management as to the relevant exposures – the question could arise whether compliance with the national rules falls under the SSM. The national supervisor could in theory claim to have exclusive competence, on the basis of the argument that the national rules at issue do not strictly implement any of the directive provisions. However, a broader (and, in our opinion, preferable) interpretation could be followed, according to which the full subject of large exposures, including those to related parties, is subject to the SSM under the draft regulation. This example is sufficient to show the kind of disputes that might arise and endanger the effectiveness of common supervision in the eurozone.

(b) *Reliance on supervisory cooperation and delegation*

The SSM is largely grounded on delegation to national authorities and supervisory cooperation, despite strong powers conferred on the ECB. Indeed, the latter will perform its tasks within the SSM, which is also composed of national competent authorities. Both the ECB and these authorities are subject to a duty of cooperation and to one to exchange information (Art. 5 (1) and (2). These duties should prevent, at least in part, information asymmetries between the periphery and the centre of the SSM. However, this model is not simply one of enhanced cooperation, given that the ECB has responsibility for the system, together with powers of direction and substitution with respect to national supervisors.

The recourse to this multifaceted architecture was, to some extent, unavoidable. As already stated, more than 6000 banks are based in the eurozone, of which the top 150 cover 80 percent of banking assets.[143] The largest institutions (as well as those which will be identified according to the criteria analysed in the previous paragraph) will be under direct ECB supervision; however, national authorities will provide the ECB with all information necessary and will assist the same with the preparation and implementation of acts relating to its supervisory tasks (Art. 5 (2) and (3)). The other (less relevant) institutions will be supervised by the national authorities and indirectly by the ECB.

Reference to national authorities was dictated by resource constraints and political expediency, but also by the existence in the eurozone of different legal, accounting and taxation frameworks, as well as of many languages and business contexts. Full centralization was not an option even with regard to cross-border banks, given that

143 See the IMF staff discussion note 'A Banking Union for the Euro Area', available at <http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf>.

supervisory resources are mainly national and firm proximity is important in supervision. However, decentralisation should not reduce the role of the single supervisor to the mere validation of decisions taken locally, given the need for supervisory consistency with respect to the entire banking system of the eurozone.[144]

In essence, a balance must be struck between centralization and delegation, also taking into account the size of banks and their domestic or cross-border nature. Delegation is more justified in the case of domestic institutions, but the ECB is rightly empowered to instruct national authorities and also to replace the same in the supervision of one or more institutions (Art. 5 (5)). However, delegation is needed also in the case of cross-border banks, even though the ECB will keep a more direct hold on their supervision.

Whether this complex model of delegation and cooperation will work in practice is difficult to predict. In light of the analysis made in the previous section with regard to EU banking supervision in general, we would argue that the SSM, despite being a remarkable step towards a single supervisor's model, still represents a semi-strong form of centralization. As already argued, cooperation mechanisms tend to fail in case of a crisis, for supervisors pursue their national interest rather than the European one, while delegation suffers from information asymmetries which allow the delegated authority to exploit its informational advantage. Cooperation and information duties are insufficient to counter similar difficulties, for the national supervisors' incentives often go in the opposite direction, particularly when facing a crisis.

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144 See the 'IMF technical background notes: A banking Union for the Euro Area', *supra* note 105.

Moreover, the direction and substitution powers of the ECB, which are aimed to prevent failures in the supervisory system, may be impaired by the non-cooperation of local supervisors, including non-compliance with their information duties. In addition, enforcement of national legislation against credit institutions may be difficult to the extent that the ECB lacks *locus standi* before the national courts. While recourse to the European Court of Justice may be too slow for effective enforcement, the alternative of the ECB asking national supervisors to bring the relevant claims in national courts may encounter procedural difficulties, in addition to creating agency problems in the relationship between the central and the delegated supervisor.

Similar comments apply to the regime included in the draft regulation with respect to administrative sanctions. The ECB is empowered to impose these sanctions only for breaches of requirements deriving from directly applicable acts of Union law and only with regard to legal persons. In all other cases the ECB may require national competent authorities to open proceedings in order to ensure that effective, proportionate and dissuasive sanctions are imposed (Art. 15 (1) and (5)). A similar regime is justified on at least two grounds. From an organizational perspective, it would be difficult for the ECB to run proceedings for the imposition of administrative sanctions under all the different domestic laws which may apply in individual cases. From a legal perspective, the sanctioning power of the ECB under national law and the *locus standi* of the same in national courts would appear to be problematic.

This explains the recourse in the draft regulation to two different sanctioning regimes, depending on whether the relevant breaches refer to EU law or national law. However, the limits of the choice made are obvious, for the delegation to national authorities carries agency problems that might impair the effectiveness of enforcement, particularly considering that these authorities would run the relevant proceedings under their own responsibility and would be free not to impose sanctions as a result of the same.

An additional and difficult question is whether, once the regulation is in force, the national authorities will keep their power of initiative in relation to sanctioning proceedings, so as to be able to impose sanctions even if not required by the ECB. Art. 15 (5) does not exclude this possibility, which would however run against the logic of the SSM and the responsibilities of the ECB, at least in the case of banks which are directly supervised by the latter.

(c) *Focus on the eurozone and need for supervisory cooperation*

The SSM focus on the eurozone will determine the need for the ECB to cooperate with other authorities. These are, first of all, the ESAs forming the ESFS, including the European Banking Authority. The tasks and responsibilities of the EBA (already described in section III.2) will remain essentially unchanged.[145] The ECB shall participate in the Board of Supervisors of the EBA, where it will coordinate and express a common position of the euro area Member States for matters falling under its tasks. It will also participate in colleges of supervisors without prejudice to the participation of national competent authorities of participating Member States in these colleges.

However, the EBA Regulation will be amended to ensure that the EBA can carry out its tasks in relation to the ECB by clarifying that the notion of 'competent authorities'

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[145] The draft regulation confirmed its views on EBA's powers to harmonize technical standards for regulation and supervision and to act as a non-binding mediator. Therefore, the EBA will be responsible for the single rule-book applicable to all banks in the EU. In addition, it will prepare a single supervisory handbook – a "how to do it" manual for supervision across the EU.

includes also the latter.[146] Under the proposed amending regulation,[147] the EBA's powers to resolve a cross-border disagreement between supervisors and to require action in an emergency situation will be amended in the sense that EBA could request the ECB to follow its decision, but not require the same to do so. The ECB will have either to comply or to provide adequate justification for non-compliance. In addition, considering that the ECB will coordinate the position of the euro area Member States, the voting modalities currently provided for in the EBA regulation will be reviewed, so as to ensure that EBA decisions are taken in a more balanced way.[148]

As to non-participating Member States, the ECB and the competent authorities of these States shall conclude a memorandum of understanding describing in general terms how they will cooperate with one another in the performance of their supervisory task under Union law. As a result, the SSM shall not modify substantially the general framework of EU banking regulation and supervision, save for what provided with respect to the EBA's position *vis-à-vis* the ECB. Indeed, the introduction of the SSM

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146 See the European Commission Proposal for a Regulation amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), available at <http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-512_en.pdf>, (hereafter 'Commission Proposal for a Regulation amending EBA').

147 See Art. 1 (2) of the Commission Proposal for a Regultion amending EBA.

148 Currently under the EBA Regulation, decisions concerning regulatory matters as well as budgetary matters (Chapter VI) are taken by the Board of Supervisors on the basis of a qualified majority of its members, as defined in Article 16(4) TEU and Article 3 of the Protocol No 36 on transitional provisions. Decisions on other issues (e.g. on breach of law according to Article 17, on settlement of disagreement under Article 19, on the election of Management Board) are adopted by the Board of Supervisors by simple majority of the voting members according to the rule "one man one vote". If voting rights remained unchanged, decisions taken by simple majority would not always represent the interests of the Union as a whole, for Eurozone countries would likely act as a block. Therefore, stronger decision-making powers will be given to an independent panel which would include at least one member from a non-participating Member State. The decision of the panel would be considered as adopted by the EBA Board of Supervisors, unless it was rejected by a simple majority, which would be required to include at least three votes from participating Member States and at least three votes from Member States that are neither participating nor have entered into close cooperation arrangements with the ECB.

shall not affect the models of enhanced cooperation and lead supervision on which the EU general framework is based. These models still characterise bank supervision in Europe, while a model of semi-strong centralization will be in place for Eurozone countries.

Of course, the picture just drawn could change substantially if a sufficient number of non-euro countries adhere to the system of 'close cooperation' foreseen by the draft regulation (Art. 6). By opting into close cooperation with the ECB, a non-euro country shall become a participating Member State (Art. 2 (1) and will be subject to a regime similar to that applicable to euro countries. Assuming that the great majority of EU member States participated in the SSM, as a result of many non-euro countries opting-in, the problems of cooperation with the EBA and the competent authorities of non-participating countries would be substantially reduced.

However, the incentives for a non-euro country to participate in the Banking Union are unclear. No doubt, extending common supervision to all EU countries and banks based in the same would work in the interest of systemic stability, as argued throughout this paper. However, the theoretical soundness of this argument will not necessarily determine its acceptance in practice. Indeed, by participating to the SSM a member State will give up most of its supervisory powers in favour of the ECB. The incentives for politicians to proceed along a similar route are doubtful. While the loss of sovereignty would be clearly visible, the gains in terms of systemic stability and financial integration shall be difficult to explain to the average voter.

Moreover, these benefits will depend on a sufficient number of non-euro countries opting-in. If this number is low, the incentive to participate will be modest, determining a collective action problem which is not easily solved. Furthermore, non-participating member States shall enjoy some voting power within the EBA's Supervisory Board, which might create a sufficient incentive not to join the SSM. Therefore, recent efforts to rebalance the voting power within the EBA Supervisory Board – which are officially justified by reference to the need to protect the financial interests of the Union – paradoxically reduce the incentives for non-euro countries to participate to the SSM.

(d) *Current incompleteness of the Banking Union*

The SSM is one of the pillars on which the Banking Union will be grounded, the others being a single resolution authority and a joint deposit insurance scheme. Without these two pillars the SSM will not break the vicious circle between sovereigns and banks. They are necessary also to limit the conflicts of interest of national authorities within the SSM. A single resolution authority, with clear ex ante burden-sharing mechanisms, should be empowered to either close or restructure banks and required to intervene well ahead of insolvency. A common resolution/insurance fund, sized to resolve small to medium bank failures, with access to common backstops for systemic situations, would add credibility and facilitate industry funding.

However, achieving the two additional pillars might prove problematic for political reasons. Presently, the possible outcome of relevant negotiations is uncertain, with the risk that some countries' obstructionism could lead to an incomplete framework. In the absence of centralized resolution, the SSM would face the difficult task of coordinating corrective actions and decisions to initiate resolution with many national resolution authorities. As a result, least cost resolution would be hard to achieve, while conflicts over the distribution of losses would arise amongst national authorities, with potential stability implications. Without an adequate common fiscal backstop and funding for resolution, the SSM may not obtain political buy-in, jeopardizing incentives within the delegated system of supervision if potential fiscal costs remain national. In a similar scenario, the ECB-centered SSM would face high reputational risks whenever supervisory decisions have direct fiscal implications.

V. Conclusions

In this paper we have analysed the different cases of supervisory centralization either implemented or proposed in Europe in the aftermath of the financial crisis and the sovereign debt crisis. Our central thesis is that supervisory fragmentation is a cause of systemic risks, for cooperation amongst national authorities is bound to fail in crisis situations, while the absence of common resolution mechanisms and common deposit guarantee schemes aggravates the costs of a banking crisis and increases the chances of a bailout.

We have argued, in particular, that the current new European supervisory architecture introduced in 2010 substantially belongs to the model of 'enhanced' cooperation, despite including elements of the other two models (lead supervisor and single supervisor), and is the outcome of a political compromise. Indeed, member States resisted losing their share of sovereignty on the financial sector, while financial institutions, including large banks, preferred the proximity to domestic regulators which allows them to extract rents more easily. As a result, the new European supervisory authorities, including EBA, coordinate the national ones, rather than supervising financial firms directly. National authorities cooperate in a network (the ESFS) under local mandates and are therefore prone to domestic biases, particularly in crisis situations.

The situation will be different under the Banking Union, where the single supervisory mechanism (SSM) essentially belongs to the third model of centralization (single supervisor). We have argued, however, that the SSM includes elements of cooperation and delegation, which will help the ECB to perform its tasks as a central supervisor, but will also give rise to conflicts of interest and information asymmetries which could endanger the effectiveness of the system. Moreover, the SSM will be limited to the Eurozone, so that the enhanced cooperation and lead supervisor's models will nevertheless apply in the relationships with other countries. The ECB will also have to cooperate with EBA that will keep its regulatory and mediation tasks, as already provided by the 2010 reforms. As a result, cross-border banking groups will often be subject to substantial supervisory fragmentation.

The seriousness of these weaknesses could be tempered by an extension of the Banking Union to a sufficient number of non-euro countries under the regime of close cooperation. However, we have shown in the last section of this paper that the incentives for these countries to opt into a similar regime are modest and that there could be greater incentives to stay out of the SSM and exploit the voting power of non-euro countries within the EBA's Supervisory Board.

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