LUISS Guido Carli
LIBERA UNIVERSITÀ INTERNAZIONALE DEGLI STUDI SOCIALI

Department of Business and Management *Chair of M&A and Investment Banking*

The EU financial supervision in the aftermath of the financial crisis.

Focus on the banking industry: toward a European Banking Union"

SUPERVISOR

Prof. Luigi De Vecchi

CANDIDATE

Antonio Caruso

643011

CO-SUPERVISOR

Prof. Francesco Cerri

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Abstract

The US financial crisis of 2007, then propagated in Europe, has had harmful consequences on the real economy, considerably impacting the proper functioning of the European Single Market, affecting the financial sector, notably the banking sector and subsequently the European sovereign bond market. A series of unfavourable circumstances, primarily resulting from the lack of a solid European institutional framework, especially as regards to financial supervision, created the propitious conditions for the establishment of a vicious circle between banks and sovereigns. This has ultimately hampered the proper monetary policy transmission and has exacerbated the financial fragmentation process already in place for several years. This link between the private sector (banks) and the public sector (sovereigns) has highlighted the significant weaknesses, largely demonstrated during these five years of crisis, of the Europe-system, underlining the need of long-run reforms aimed at safeguarding and strengthening the Economic and Monetary Union (EMU), in order to prevent, or at least mitigate, the effects of future crises. For these reasons, the last five years have been characterized by a strong political ferment at the European level, aimed at addressing the several challenges raised by the crisis.

This thesis focuses on the evolution of the financial supervision in the European Union in the aftermath of the financial crisis. Conceptually, it is possible to divide the financial crisis in two main waves. The first was mainly characterized by the negative spillover effects stemming from the US subprime crisis that infected the old continent. The second wave instead was an evolution of the existing crisis that, in a context of political instability, banks weakness and increasing financial fragmentation in the EU,

resulted in a bank crisis, which in turn hit also sovereign's borrowing capacity, becoming a real sovereign debt crisis and then a generalized crisis of confidence toward Europe as a whole.

Consistently with the evolution of the financial crisis, the thesis is divided in two main blocks. The first block (chapters 1 and 2) analyses what was the role of the European regulators and supervisors during the first wave of the crisis. Starting from what have been the main shortcomings in regulation and supervision that contributed to the intensification of the crisis, it is analysed the reform following the De Larosiére report (2009), that led to the creation of a European System of Financial Supervisors (ESFS). This comprised the establishment of a new European body in charge of macro-prudential supervision, that is the European Systemic Risk Board (ESRB), and to the creation (or better the update of the previous three Lamfalussy committees: CEBS, CEIOPS and CESR) of three European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

Keeping as Ariadne's thread the evolution of the financial crisis and the resulting evolution in the European supervisory architecture, the second block (chapter 3 and 4) specifically addresses the banking sector supervision. The forthcoming establishment of a Single Supervisory Mechanism (the vote is presumably in September 2013 and the entry into force as October 2014), is part of the broader European Banking Union project, that is also based on a common resolution system and a common deposit guarantee scheme. However, a detailed analysis is provided only for the Single Supervisory Mechanism, as firstly the goal of this thesis is to analyse the evolution of financial supervision in the EU, and secondly because currently the discussions regarding both resolution and deposit guarantee are at a stalemate being very delicate political subjects as they could involve large money transfers between Member States (the next September there will be the German election and the next year the renewal of the European Parliament).

Finally, in the light of the recent ESFS review launched by the European Commission, the final part, making the point of what actually done by the ESRB and the ESAs, analyses what implications may have the SSM on the ESFS and what challenges the creation of such a mechanism places.

1. Background

1.1 Incipit

Most of the literature in the last five years focused the attention on the “financial crisis”. Rivers of ink have been spilled and millions of pages have been written in the attempt to address this matter and understand, clearly, what were the causes and the direct effects of one of the most severe crisis, if not even the worst, experienced by mankind in the last century. In literature some authors have defined this crisis even worse than the Great Depression of the 1930s, although the economic fundamentals are definitely different. A few months after the outbreak of the crisis, the billionaire investor

George Soros during an interview said *"the world faces the worst crisis since the second World War"*[1] epitomizing the collective wisdom.

In the light of the above, terms that until recently were totally unknown to the common people, but unfortunately also to many politicians, have gained notoriety. Terms like "subprime", "rating", "default", "spread" and many others, have become part of the common parlance, although sometimes are used without knowing the meaning. The media have literally bombarded the community with messages that, the most of times, have been proved incomprehensible to ordinary people with the unique effect of building up a climate of tensions and panic, reaching sometimes unsustainable levels. Such a situation seems to have become the norm during the last five years. Every day we hear about sovereign states in troubles, financial scandals, toxic assets, probability of default, etc. People have lost confidence in the financial sector, particularly in the banking system, perceiving a strange form of insecurity that should not be present in a sound financial system.

The Lehman Brothers crash determines the outbreak of a global financial crisis. Images like that of Lehman's employees leaving the workplace have become a cult and are now part of the popular imagination. Shortly after, the crisis has spread globally flowing to the real economy bringing the western world in a new phase of recession. The world GDP fell down for the first time after the Second World War and in this difficult situation the intervention of both central banks and governments was aimed at avoiding that the liquidity crisis would lead to failure banks and financial institutions. The

[1] Interview with the Austrian daily *Standard,* January 22, 2008.

primary goal was to safeguard the existence of the financial sector itself, fundamental condition to avoid the collapse of the global economic system. If from one hand the expansive monetary policy of central banks contributed to stabilize the financial system, on the other hand the banks retained all the liquidity injected. So when the crisis has worsened, the governments were required to intervene bailing out banks under financial distress, mindful of the impact of Lehman Brothers collapse. This has led to a vicious circle between banks and sovereign states that reached unsustainable levels with the evolution of the European sovereign debt crisis.

The official starting date of the EU sovereign debt crisis coincides with the announcement of the newly elected Greek Prime Minister George Papandreou that the government had systemically lied about the required Maastricht parameters. From this point onwards the way of mistrust, together with the growing financial speculation, has decisively undermined the very foundations of the European Union itself. In several occasions the default of a sovereign Member State was feared, and if this would have happened it would mean the collapse of the Economic and Monetary Union.

Shortly after the outbreak of the Greek situation, the crisis has spread firstly to some peripheral countries of the euro area, becoming then systemic worsening the precarious economic situation already faced. If we add the increasing political instability meandering throughout Europe and the sharp rise of anti-European sentiments, we realize how challenging is the task for European regulators to safeguard the integrity of the Economic and Monetary Union.

However, a crisis is an opportunity to address long overdue problems in a major way, since usually a crisis revives old issues and raises new ones. As the President Obama's chief of staff Rahm Emanuel observed, *"You never want a serious crisis to go to waste"*[2].

The main goal of this thesis is not to analyze causes and effects of both the financial crisis of 2007 and of the European sovereign debt crisis. A lot, perhaps too much, has been written about. Rather, the aim is to depict a complete overview of how the financial supervision in the European Union has been reformed in response to the crisis, both following the De Larosiére report (2009) addressing the main regulatory and supervisory shortcomings of the "first" part of the financial crisis, and then focusing on the current reforms affecting the banking industry as policy responses to the European sovereign debt crisis. Therefore, this first introductory chapter provides an overview of the evolution of the financial crisis began in 2007. It is not an exhaustive analysis, but rather a background analysis to provide us with the necessary understanding to then deal with the supervisory shortcomings and the subsequent architectural reform of the European financial supervisory framework following the De Larosière report (2009). The latter will be the core of the second chapter. The third chapter, after having provided a brief overview of the crisis developments in Europe, discusses the concept of a European Banking Union. In addition it contains two insights, respectively on the EU Banking Sector and on the Bank-Sovereign Link. Finally, the fourth chapter deals with

[2] Interview to the Wall Street Journal, November 19, 2008

the establishment of a Single Supervisory Mechanism (SSM), first fundamental pillar of the broader concept of a European Banking Union.

1.2. The evolution of the financial crisis

"When the United States sneezes it means the Western world has a cold"[3]

The above common saying perfectly epitomizes the current European economic and financial situation, considering that the majority of European Member States are still facing one of the most severe crises in their history, probably the worst one. This crisis, began thousands of kilometres away, has reached a global level: from private debt crisis to sovereign debt one, from financial and real estate crisis it became industrial crisis and labour market crisis hitting the real economy. However, in order to understand the current situation and how regulators faced and are facing the issues raised by the crisis, it is needed to retrace the key steps in its evolution.

It all begins in the summer of 2007. Until that there was a common feeling of well-being in the US, the monetary policies were expansive with abundant liquidity, low

[3] Harold Callender, *"Europe Wonders How Long U.S. Vote Will Hamstring It"*, New York Times, November 9, 1952.

rates of inflation and low interest rates and nobody, both inside and outside the financial sector, suspected what would happen in a short time. Credit volume grew rapidly and, as consumer inflation remained low, central banks felt no need to tight monetary policy conditions. Risk aversion was at very low levels and therefore investors and institutions continued to bear ever-increasing amount of risk. Phenomena like the deregulation, the financial innovations, the diffusion of Information and Communications Technology (ICT) and the global financial markets integration, allowed in underestimating the total exposure of the entire financial system towards the various risk factors. This period was characterized by a general feeling of laissez-faire.

From the castle built on securitization and subprime loans, it seemed everybody benefited, but slowly more and more imbalances were arising in global financial markets. According to Kindleberger (2000), *"financial crises are typically a result of extended accumulation of imbalances preceded by certain exogenous shock, or structural changes in the financial system. The examples are in the changes in the political environment, new regulations and financial innovations. These changes create new possibilities, but also, uncertainties and lack of awareness of potential risks"*[4].

The roots of the crisis are traced in the accumulation process of excessive leverage by banks and in the unsustainability of maturity mismatches in balance sheets,

[4] Charles P. Kindleberger , "Manias, Panics and Crashes: A History of Financial Crises", fourth edition, 2000.

mainly concentrated in the so-called "Shadow Banking system" (SBS)[5], characterized by elusion in accounting and prudential requirements and negligible capital[6].

Prominently, the financial innovation led to structural changes. The best example was the shift in the banking business model[7]. From an "originate-to-hold" model, i.e. banks used deposits to fund loans that they then kept on their balance sheets until maturity, to an "originate-to-distribute" model, since over time banks began expanding their funding sources to include bond financing, commercial paper financing, and repurchase agreement funding. Banks then started to sell or securitize the credits

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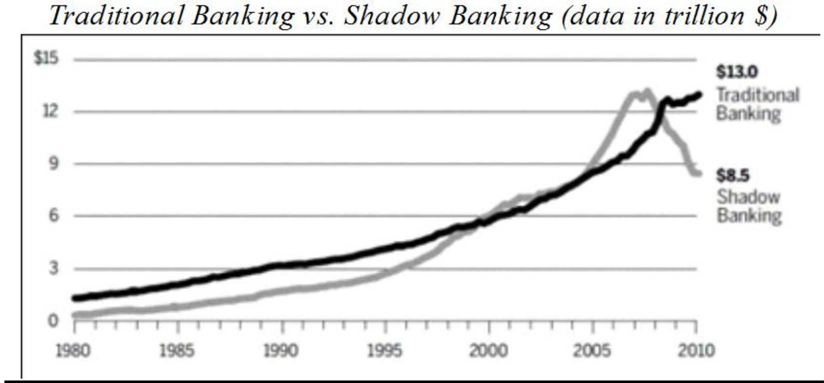
[5] The shadow banking system has been defined as "the system of credit intermediation that involves entities and activities outside the regular banking system". This definition implies the shadow banking system is based on two intertwined pillars. First, entities operating outside the regular banking system engaged in one of the following activities:

- accepting funding with deposit-like characteristics;
- performing maturity and/or liquidity transformation;
- undergoing credit risk transfer; and,
- using direct or indirect financial leverage.

Second, activities that could act as important sources of funding of non-bank entities. These activities include securitisation, securities lending and repurchase transactions ("repo"). (Source: FSB Report, Shadow Banking: Strengthening Oversight and Regulation, October 27, 2011)

[6] The chart below shows the rapid rise and subsequent decline in volumes handled by the SBS during the crisis. It is clear that the magnitude of the SBS in the United States has become of absolute relief.

Traditional Banking vs. Shadow Banking (data in trillion $)



Source: Financial Crisis Inquiry Report, 2011m p. 32

[7] Vitaly M. Bord and João A. C. Santos, "The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation", FRBNY Economic Policy Review - July 2012.

originated. This consisted in new possibilities for the financial system to broaden and manage risks and maturity mismatches. Some banks used this model as a primary source of financing of their activities, securitizing loans and then transferring the risk to others in a short period of time, in order to borrow again capital, sell the claim and benefit promptly. However it definitely lowered the lending standards[8].

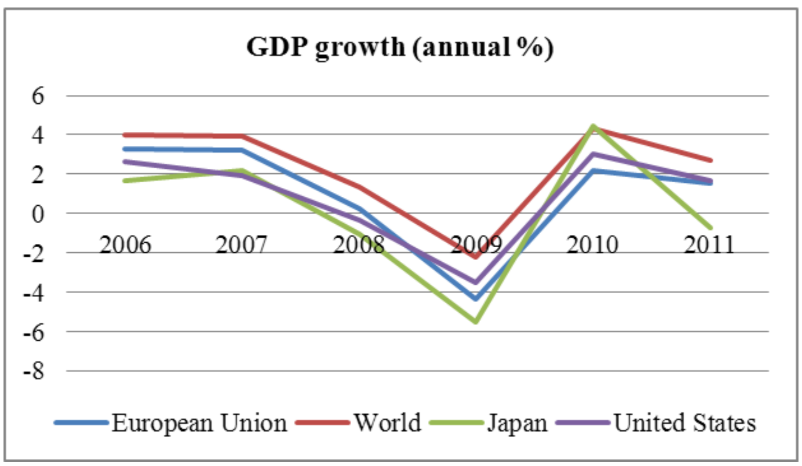
At the same time, in a low interest rates environment the housing bubble continued to inflate but, like every speculative bubble, sooner or later it would have bursted. The collapse of housing prices determined rising defaults on mortgages. The castle crumbles. The perceptions change and rapidly all the other market segments are infected by the growing mistrust. The securitization technique facilitated contagion[9] spreading the risks across the entire global financial system and, due to the complexity and opacity of such operation it was hard to assess the actual exposure to the so-called "toxic assets". In this climate of mistrust banks stopped to lending each other and the interbank market freezed.

The crisis peaked in the summer of 2008 when the American authorities decided not to bailout the Lehman Brothers due to the increasing disagreement among the American population following the bailing out of several financial institutions[10]. It was the panic. The default of Lehman Brothers changed the scope of the crisis, becoming global due to the international interconnections of this systemic institution, totally

[8] Petar Goshev, Speech at the International Economic Forum "Faster Towards the European Union", Ohrid, November 2, 2008.
[9] For example, the issuance of US Asset Backed Securities quadrupled from $337 billion in 2000 to over $1,250 billion in 2006.
[10] Like the two mortgage agencies "Fannie Mae" and "Freddie Mac", and the investment bank "Bear Sterns".

destabilizing the financial markets. In a short time the insurance company American International Group (AIG) has to be saved by the US authorities, two investment banks, Goldman Sachs and Morgan Stanley transform into commercial banks to be eligible for liquidity aid from the Federal Reserve (FED). However, even if the US Government tried to strengthen the US financial sector by launching for instance the Troubled Asset Relief Program (TARP)[11], a general crisis of confidence globally blazed and the western world fell into a recession. This was the first global recession since the Second World War. The chart (below) shows the GDP trend in the period 2006 – 2011.

Figure 1.1 - GDP annual % growth



Source: World Bank

[11] In order to strengthen the financial sector during the financial turmoil of 2008, on 3 October 2008 the US Government decided to launch the TARP program aimed at purchasing assets and equity from distressed financial institutions. The Tarp program initially allowed the US Department of Treasury to purchase or insure up to $700 billion (then reduced to approximately $475 billion) of "troubled assets", mainly Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs), from banks and other financial institutions.

The pressures grew also in Europe. The crisis began in the US as a private debt crisis, rapidly evolved and spread into a global economic shock. Similarly to the US, in Europe several financial institutions were bailed out by national governments to avoid bankrupts (see table 1.1).

The public intervention of governments and central banks was necessary in order to avoid stronger depressive effects. The degree of intervention varied significantly from one country to another, being largest in countries where the financial sector was big compared to the real economy such as in the UK.

The overall level of State aid by EU Member States almost quintupled in 2008 compared to 2007 and increased to 2.2% of GDP, almost exclusively as a result of crisis aid to the financial sector[12], reaching 3.6% of GDP in 2009[13]. Member states started to inject large amounts of aids into the banking sector to ensure that the lending to the economy could continue, considering the freezing of the inter-bank market from September 2008.

[12] State Aid Scoreboard – Report on State aid granted by the EU Member States – Autumn 2009 Update – COM (2009) 661 final
[13] State Aid Scoreboard – Report on State aid granted by the EU Member States – Autumn 2010 Update – COM (2010) 701 final

Table 1.1 - Main Bailouts in Europe

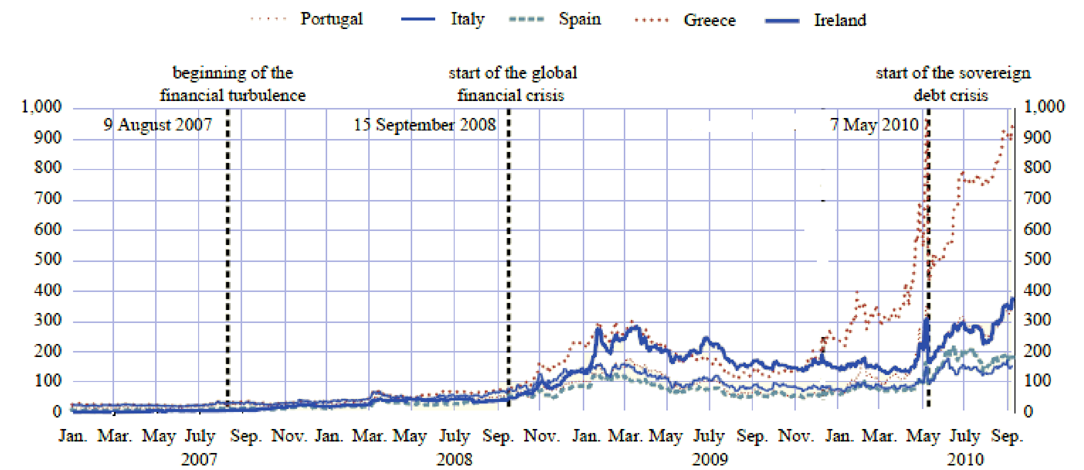
Date	Acquired Company	Acquiror
02/2008	Northern Rock (UK)	UK Government
07/2008	Alliance and Leicester (UK)	Grupo Santander
08/2008	Roskilde Bank (Denmark)	Danmarks Nationalbank
09/2008	HBOS (UK)	Lloyds TSB
09/2008	Bradford and Bingley (UK)	UK Government and Grupo Santander
09/2008	Fortis (Benelux)	Government of Netherlands and BNP Paribas
09/2008	Dexia (Belgium)	The Belgian, French and Luxembourg governments
10/2008	Landsbanki, Glitnir, Kaupthing bank (Iceland)	Icelandic Financial Supervisory Authority
01/2009	Anglo Irish Bank (Ireland)	Government of the Republic of Ireland
03/2009	Caja de Ahorros Castilla La Mancha (Spain)	Banco de Espana
05/2010	CajaSur (Spain)	Banco de Espana

Source: personal elaboration

Since the intensification of the crisis in September 2008, the long-term EU member states government bond yields relative to the German Bund have been rising after years of stability[14]. The crisis started to hit sovereign debts due to the increasing risk perception by international investors.

[14] ECB – "The ECB's response to the financial crisis", Monthly Bulletin, October 2010.

Figure 1.2 - Ten-year government bonds spreads relative to the German Bund



Source: ECB

In these circumstances, the crisis exposed a worrisome aspect of the Economic and Monetary Union, which is the interconnection between banking weaknesses and sovereign debt dynamics, with national fiscal and banking problems feeding each other being two faces of the same medal.

Initially the Europe's policy response to this situation was weak, both in terms of cooperation between national supervisors and between public authorities. However, the impact of the financial crisis and the economic downturn underlined the need for coordinated interventions. The European Central Bank (ECB) reacted swiftly by providing liquidity to the frozen inter-bank market. One of the main problems was the absence of a common framework for crisis management that led Member States to react individually, especially to avoid the default of larger financial institutions, creating sometimes negative spill-over effects on other Member States.

1.3. The EU's response

After the default of the investment bank Lehman Brothers, the financial crisis escalated and many systemically important European financial institutions were faced with severe liquidity problems and massive asset write downs. In this emergency situation, both confidence in and the proper functioning of the financial system declined[15]. As in the other parts of the world, governments in the euro area adopted several emergency measures to stabilize the financial sector and to cushion the negative consequences for the real economy. However, the impact of the financial crisis and the subsequent severe economic downturn underlined the need for coordinated interventions. At the international level, the G7[16] countries agreed on 10 October 2008[17] to use all available tools to prevent the default of systemically important financial institutions (the so-called "too big to fail" institutions), to unlock credit and money markets, to ensure that banks can raise sufficient capital from both public and private sources and to ensure that national deposit insurance and guarantee programmes continue to support confidence in the safety of the deposits. Then, at the G20[18]

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[15] European Central Bank – Occasional Paper Series, "Euro Area Fiscal Policies and the Crisis", N. 109/April 2010, Editor Ad van Riet.

[16] The G7 is an international finance group consisting of the finance ministers from seven largest and wealthiest (not intended as GDP, but global net wealth) industrialized nations on earth: the US, UK, France, Germany, Italy, Canada, and Japan.

[17] G7 Finance Ministers and Central Bank Governors – *Plan of Action* – Washington DC, October 10, 2008.

[18] The G20 was created in 1999 in response to the financial crisis that hit emerging countries in the 1990s (the Asian Crisis). The G20 is a group of finance ministers and central bank governors from 20 major economies. Its members are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, UK, USA, European Union (which is represented by the President of the European Council and the European Central Bank). In 2008, the G20 was promoted to become the steering forum of the world economy, from now on at the level of the Heads of State and Government. With the G20 growing in stature after the 2008 Washington Summit, the G8 started to lose importance. Representing 85% of the world economy and 66% of the global population, the G20 better reflects the reality in the 21st century.

Washington Summit of 15 November 2008[19], the leaders agreed to continue to stabilize the global financial system and improve the international regulatory framework. The subsequent G20 summits[20] focused their attention on the need of coordination of national measures in order to limit the effects of the crisis, optimizing the policy response and avoiding free riding problems. During these summits a reform agenda for financial regulation and supervision was defined and the lending capacity of international financial institutions was increased[21]. Finally it was decided to reform the international institutions[22] to make them more effective. The basic principles set at the international level inspired the action plan undertaken in the European Union.

From a monetary standpoint, since the beginning of the financial tensions in the middle 2007, the ECB reacted swiftly and decisively to the deteriorating economic and financial circumstances with the aim of maintaining price stability. In addition to reducing interest rates, the Eurosystem implemented a number of non-standard monetary policy measures during the period of severe financial market tensions.

In order to ensure the proper transmission of the monetary policy and to preserve credit flows to the euro area economy beyond what could be achieved by reducing interest rates, the ECB's Governing Council adopted a number of non-standard measures in October 2008, subsequently referred to as "enhanced credit support". According to

[19] G20 Special Leaders' Summit on the Financial Situation - Washington DC, November 14-15, 2008.
[20] London in April 2009; Pittsburgh in September 2009; Toronto in June 2010; Seoul in November 2010;
[21] For example, the IMF's lending capacity before the crisis was 265 billion $. In April 2009, the G20 decided to triple this sum.
[22] Like the International Monetary Fund (IMF), the World Bank, the Financial Stability Board (FSB).

Trichet[23] "*enhanced credit support constitutes the special and primarily bank-based measures that are being taken to enhance the flow of credit above and beyond what could be achieved through policy interest rate reductions alone*".

These non-standard measures focused specifically on banks in the euro area and comprised the following elements:

- *Fixed rate full allotment*. The Eurosystem applied a fixed rate full allotment tender procedure in all refinancing operations, ensuring the provision of unlimited central bank liquidity to eligible euro area financial institutions at the main refinancing rate and against adequate collateral. This measure was designed to support the short-term funding needs of banks.
- *Extended list of assets accepted as collateral*. The extension of the list of assets accepted as eligible collateral for refinancing operations further facilitated the access to Eurosystem operations.
- *Long Term Refinancing Operations (LTRO)*. LTROs are open market operations to support European banks by improving liquidity in the market. The ECB announced its intention to implement additional longer-term refinancing operations with a maturity of up to six months. In May 2009 it also announced that such operations would be conducted with a maturity of one year. The longer maturities enabled banks to attenuate the mismatch between the investment side and the funding side of their balance sheet.

[23] Speech of Jean-Claude Trichet, President of the ECB, at the University of Munich – July 13, 2009.

Furthermore, the efforts taken by EU Member States with respect to fiscal consolidation and structural reforms, along with EU initiatives such as the Stability and Growth Pact[24] and the new European System of Financial Supervision[25] were crucial to create the necessary conditions for recovery, economic growth, job creation, improved competitiveness and so to help Europe in getting out from the crisis.

Starting from the assumption that sound and sustainable public finances are a prerequisite for a sustainable economic growth and a smooth functioning of the Economic and Monetary Union (EMU), there is no doubt that the exceptional fiscal policy measures and monetary policy reactions to the crisis helped in restoring confidence in the euro area. However, these measures implied a substantial budgetary loosening and therefore the fiscal exit from the crisis implied a process towards fiscal consolidation. The Stability and Growth Pact constitutes the basic mechanism to coordinate fiscal policies in Europe. Without any doubt, the crisis has given rise to big challenges for the rules-based EU fiscal framework.

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[24] The SGP is a rule-based framework for the coordination of national fiscal policies in the European Union. It was established in 1997 to foster sound government finances ahead of the introduction of the single currency. In 2011 the Six-Pack introduced fundamental changes. This reform addressed gaps and weaknesses in the framework emerged during the financial crisis, strengthening both the fiscal surveillance and the enforcement provisions of the SGP.

[25] See Chapter 2.

1.4. The role of Financial Regulation and Supervision during the crisis

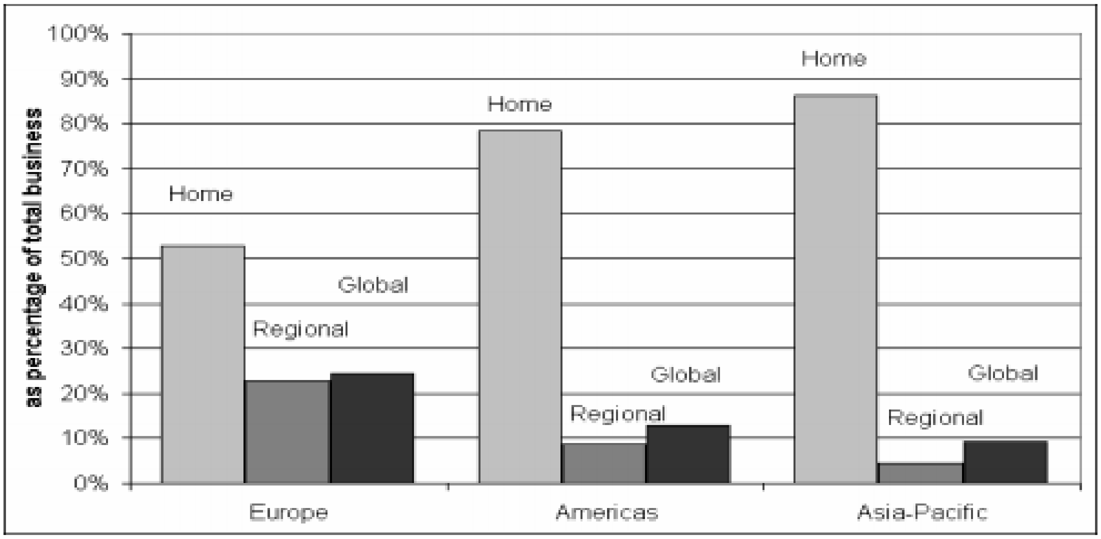
If from one hand the global financial crisis has been considered the direct result of macro-economic imbalances, on the other it was the consequence of the regulatory and supervisory framework inadequacy that led financial institutions to underestimate risks, to excessive risk taking and to systematically failing in risk assessment. The cumulative effect of these failures was the overestimation of the ability of financial institutions to manage their risks and this led to underestimate the capital they should hold. Despite their crucial role, both financial regulation and supervision failed in preventing the financial crisis. Moreover, if we consider the extreme complexity of structured financial products, the sudden freezing of the inter-bank market, the build-up of the Shadow Banking System and the perverse incentives created by the evolution of banking business model to the "originate to distribute" model with the excessive confidence placed on Credit Rating Agencies (CRAs), we can state, without any doubts, that the crisis was mainly the result of a failure of the regulatory and financial supervisory policies and practices, since they were not able to contain these pressures.

In the European Union the mismatch between the financial sector and the supervisory framework further worsened the supervisory failings. As the following figure shows, by 2005[26] more than 20% of the banking activity in Europe was of a cross-

[26] SCHOENMAKER, D., VAN LAECKE, C., Current State of Cross-Border Banking, LSE Financial Markets Group Paper Series, Special Paper 168, November 2006, p. 8.

border nature, largely exceeding the levels in the American or Asian-Pacific financial sectors.

Figure 1.3 - Geographical Segmentation of Banks in 2005



Source: Schoenmaker and Van Laecke (2006)

However, despite this percentage of cross-border banking activity, the financial supervision in the European Union remained almost exclusively a prerogative of Member States. For these reasons, the asymmetry between the financial sector and its supervisors continued to increase, requiring even higher level of cooperation and coordination between national supervisors. This was one of the major shortcomings of the financial supervision during the crisis, or, when the circumstances required an EU-level intervention, the national responses prevailed due to the lack of coordination and sometimes the unwillingness to cooperate and share relevant information.

According to the De Larosière Report (2009)[27], regulators and supervisors focused too much on micro-prudential regulation of individual financial institutions and not sufficiently on the more general developments and systemic risks of contagion (macro-prudential supervision).

These supervisory failings led to a structural reform of the supervisory architecture in the European Union, started in October 2008 with the mandate conferred to Mr. Jacques De Larosière to chair an outstanding group of people to give advice on the future of European financial regulation and supervision. This resulted in a set of reforms and it was welcomed as a significant step toward the post-crisis recovery.

The reform of the EU financial supervisory architecture is the topic of the next chapter, where I discuss the former framework as well as its major shortcomings and the "new" system following the De Larosière recommendations.

[27] De Larosière Jacques, "*The high level group on financial supervision in the EU*", Brussels, February 25, 2009.

2. Financial Supervision in the European Union

2.1. Incipit

On Thursday 25 September 2008, speaking to an audience of some 4000 supporters in Toulon, France, the French President Nicolas Sarkozy said that the financial turmoil had highlighted the need to return to morality, business ethic, as well as to put in place a better supervisory and regulatory system. Quoting his words, *"The idea of the all-powerful market that must not be constrained by any rules, by any political intervention, was mad. The idea that markets were always right was mad .... Self-regulation as a way of solving all problems is finished. Laissez-faire is finished"*[1].

The Global financial crisis revealed the weaknesses of this under-regulated system, leading to a significant political mobilization both at the international and EU-

[1] Edward Cody, "Sarkozy advocates systemic change after crisis", The Washington Post, September 26, 2008

level in order to overcome the economic and financial crisis and prevent future ones by restoring confidence, repairing the financial system and strengthening financial regulatory and supervisory framework.

Changes in both the size and structure of the European and global financial systems have seriously tested regulators' ability to safeguard financial stability, with not worth mentioning results.

For a long time, financial sectors grew faster than the real economy, with many countries where total financial assets represented a multiple of their annual GDP[2]. This has led to a huge responsibility for the industry, supervisors and regulators. The financial crisis painfully revealed what can happen if basic checks and balances fail, if incentives are misaligned and if the system as a whole results under-regulated. Considering also the increasing complexity of financial systems, in terms of financial innovation and in the opacity of many structured financial products, the assessment of financial risks and vulnerabilities of the market became much more difficult.

As a result of this increasing complexity, financial systems became more interlinked and therefore exposition to contagion and systemic risks increased over time. In the EU, the emergence of large cross-border groups, in particular, posed substantial challenges, especially if we consider that some 40-45 large cross-border banking groups

[2] For instance the EU banking sector has grown significantly in the years prior to the crisis with the total balance sheet of EU monetary financial institutions (MFIs) reaching a total value of €43 trillion by 2008 or more than 350% of EU GDP. Source: Liikanen Report (2012).

accounted for almost 70% of all banking assets in Europe[3]. The following table compares the banking sector dimension in the EU, US and Japan.

Table 2.1 - Size of EU, US and Japanese banking sectors (2010)

	EU	**US**	**Japan**
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

Source: Liikanen Report (2012)

In the light of this increasing interconnection and complexity in the financial sector, the crisis underlined the inadequacy of the existing regulatory and supervisory framework both at international, EU and national level, demanding a profound reform for the finance industry in order to favour a return to business ethic, responsible government and with the aim to restore confidence among investors.

According to the London G20 summit of April 2009, *"Major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. Confidence will not be restored until we rebuild trust in our financial system. We will take action to build a stronger, more globally consistent, supervisory and*

[3] Liikanen Report (2012).

regulatory framework for the future financial sector, which will support sustainable global growth and serve the needs of business and citizens"[4].

The crisis has shed light on the fragmentation of financial supervision in the European Union, exposing serious failings in the cooperation, coordination, consistency and mutual confidence between national supervisors, undermining the integrity of the European financial markets[5]. In order to address these shortcomings, in October 2008, just after the crash of Lehman Brothers, the President of the European Commission, José Manuel Barroso, conferred to Mr Jacques de Larosière, a former Managing Director of the International Monetary Fund (IMF), the mandate to chair a high level group to give advices on the future of European financial regulation and supervision. The so-called "De Larosière Report" was presented on 25th February 2009.

This chapter discusses the European financial supervision system that came about in the wake of the post-crisis reforms, following the De Larosière recommendations. The chapter consists of five sections. The first section provides an overview of the former EU supervisory framework as well as its main shortcomings. Section two discusses the reform of the EU financial supervisory architecture following the De Larosière recommendations and the proposals made by the Commission in the autumn of 2009. Subsequently, the EU level supervision is detailed, both in terms of its macro-prudential arm (section 3) and its micro-prudential arm (section 4). Finally, the last section deals with the review process of the Europeans System of Financial

[4] London G-20 Summit - Leaders' Statement, April 2, 2009.
[5] As explained in the Communication from the Commission COM (2009) 252 final, "European financial Supervision", Brussels, May 27, 2009.

Supervisors (ESFS) in the light of the recent consultation launched by the European Commission on 26 April 2013, in order to assess the performance of this renewed system two years after its inception. Furthermore, the review will also address the potential impacts of the creation of a Single Supervisory Mechanism (SSM – the first pillar of the European Banking Union) on the ESFS, given the core role attributed to the European Central Bank (ECB) and will evaluate whether this necessitates further adaptations to the legal framework underpinning the ESFS.

2.2. The Former EU Financial Supervisory Framework: the supremacy of national supervision

The financial supervisory system that was in place at the outbreak of the financial crisis was the result of an evolution going on for decades[6]. It had been influenced by the integration of the EU's financial markets leading to an harmonization of the legal framework that equally required the definition of the responsible supervisor. This legal framework posed certain difficulties pertaining to the effectiveness of supervision and coordination between supervisors.

[6] A first Directive aiming at harmonising the EU financial sector was already adopted in 1973 (Directive 73/183/EEC). While, with regard to financial supervision, the Second Banking Directive introduces the home country supervision (Directive 89/646/EEC).

2.2.1 The former framework

In order to facilitate the dialogue between supervisors, limited supervisory cooperation arrangements have been put in place. However, despite these arrangements, financial supervision proved to be inadequate, as was demonstrated during the course of the financial crisis.

In order to discuss the legal framework governing the EU financial supervisory system, it is recommendable to separate the general legal framework applicable to the financial sector from the supervisory rules. The EU legal framework governing the financial sector has been characterized by two interrelated principles, namely, the minimum harmonization and the mutual recognition principles[7]. The former refers to a set of minimum requirements that apply to all financial institutions operating in the EU[8]. On the other hand, the mutual recognition principle, linked to the minimum harmonization, supports the free movement of goods and services in the EU, and for the financial sector it implies that a financial institution licensed and established in one Member State can freely provide its service in the rest of the EU[9].

The set of EU rules have important consequences for supervisory tasks. For example, the mutual recognition principle of financial institutions has resulted in the home country supervision control, implying that a financial institution is under the supervision of the competent authority of the Member State where it is licensed. This

[7] D. Schoenmaker (2011), Financial Supervision in the EU, Encyclopedia of Financial Globalization, p.5.
[8] For instance, these concern capital requirements and risk management.
[9] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, June 14, 2006.

includes the supervision of cross-border operations, as well as the operations of branches in other Member States[10]. The home country control largely reduced the supervisory role of the host competent authority[11].

In the light of the increasing integration of the European financial sector[12], the supervisory arrangements have become increasingly challenged, because a sector that operated cross-borders requires an encompassing supervisory perspective. In order to adjust supervision to the evolving trans-national nature of financial activity, the concept of consolidated supervision has been introduced[13]. Such consolidated supervision consists in designating a supervisor to oversee the financial institution as a whole. Moreover, supplementary supervision was introduced[14] to allow supervisors the cross-sectoral supervision of both banking and insurance firms. However, these supervisory arrangements have in no way scratched the supremacy of national supervision.

This led to a difficult situation where national supervisors had not a complete understanding of the financial institutions under their supervision. In these circumstances, to foster cooperation and coordination between supervisors, a series of supervisory cooperation arrangements were put in place, both among individual supervisors and at the EU-level.

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[10] For example, the Italian supervisory authority oversees an Italian bank's branch in France, as well as its cross-border operations in Spain.
[11] However, the situation is different when a financial institution sets up a separate legal entity in another Member State (i.e. subsidiary), because a subsidiary is supervised by the country in which it was established.
[12] See the Liikanen Report (2012) p. 30-31.
[13] Art. 125-126 of Directive 2006/48/EC.
[14] Directive 2002/87/EC of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

Regarding the cross-border cooperation, the EU rules stipulated that the home country supervisor should collaborate with the host authority and provides all the necessary information. However, while the rules expected cooperation between national supervisors, they did not alter the home country supervisor's competences, and in case of disagreement, the home country authority had always supremacy.

During the financial crisis, in order to foster supervision of cross-border financial institutions, more elaborate way of cooperation between national competent authorities were developed, notably the "colleges of supervisors"[15].

In addition, at the EU-level, the Treaty on the Functioning of the European Union (TFEU) attributes to the European System of Central Banks[16] (ESCB) a role in supervision. According to the TFEU[17], *"The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system"*. Nevertheless, this function was mainly exercised by the National Central Bank.

Notwithstanding this, in order to support national supervisors, a number of EU bodies have been created. For instance, in the European Central Bank, the Banking

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[15] The colleges of supervisors are likely to be one of the main innovations in financial supervision resulting from the financial crisis. Such college of supervisors brings together the different supervisors of the Member States in which a given financial institution operates. In these colleges, national supervisors are required to reach a consensus on supervisory decisions regarding a financial institution. As a result of the financial crisis, these colleges have become mandatory for multinational financial institutions. According to the "List of groups for which College of supervisors is in place" (CEIOPS, February 2010), by 2010, more than 100 supervisory colleges had been created in the European Economic Area.
[16] The ESCB groups the National central banks and the European Central Bank.
[17] Art. 127(5).

Supervision Committee (BSC) had been established[18]. The BSC assists central banks in the supervision of credit institutions and financial system stability, but as the BSC was only to provide a supporting role, it did not have any legally binding measures at its disposal.

In 2001 there was an important evolution in the EU financial supervision framework following the Lamfalussy Report[19]. It led to the creation of a four level structure to adopt and implement financial regulation. In this structure, the third level played a particular role with regard to financial supervision. At this level three sectoral committees were put in place, grouping respectively the national supervisors of the banking sector, the securities sector and the insurance and occupational pensions sectors. Notably, the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR). The tasks of the so-called "level-3 committees" expanded over the years. However, their main tasks were facilitating mediation between supervisors, contributing to the consistent implementation of EU directive, reviewing and converging supervisory practices and enhancing information exchange and supervisory coordination. The level-3 committees were required to pursue these tasks using non-binding measures, since they had only consultative powers and not the ability to take urgent decision. Therefore their major shortcomings consisted in their inability to cope with the differences in national supervisory practices and in forming a

[18] The BSC was established in 1998 and succeeded the Banking Supervisory sub-Committee, which had been created by the Committee of Governors in 1990. The BSC groups officials from the ECB, the National central banks and the banking supervisors.
[19] Lamfalussy Committee of Wise Men, Final Report on the Regulation of European Securities Markets, February 15, 2001.

common European supervisory culture. Moreover they were limited by the scarcity of resources available to them, severely hindering the work they could undertake and their speed of reaction. The basic reason of these problems was that these committees did not have the legal powers to take decisions and so they failed in develop the procedures needed to promptly address the emerging crisis.

If from one hand the European "arm" of supervision was without any real powers, on the other the regulation and supervision remained liability of the individual Member States, with a context where financial institutions increasingly grew in size having operations throughout the entire European Union, if not global. In these circumstances, with technical rules defined nationally and powers of supervisory authorities varying from one Member State to another, the result was a high degree of fragmentation in Europe with the consequent inability to coordinate and act in concert to overcome with the challenges imposed by the crisis.

2.2.2 Supervisory shortcomings

The crisis revealed a wide range of weaknesses in the global financial system, shedding light on the fragility of financial institutions and on the inadequacy of the regulatory and supervisory framework relative to the dimension and complexity of the financial sector at that time.

The primary objective of supervision is to ensure an adequate implementation of the rules applicable to the financial sector, in order to safeguard financial stability, foster confidence and provide sufficient protection for customers of the financial services. One of the main functions of supervision is to identify vulnerabilities at an early stage in order to prevent crises from occurring. However from time to time failures are unavoidable. If crises occur, then supervisors, together with central banks and finance ministries, must manage the crises to limit the damage to the economy and society as a whole.

Supervision should ensure that all supervised entities are subject to a minimum set of core standards, avoiding the emerging of distortions and regulatory arbitrage[20] stemming from different supervisory practices that are detrimental for the financial stability. Therefore, a level playing field is vital for the credibility of supervisory authorities, and this proves of utmost importance in the context of the Single Market[21]. Ultimately, supervision should encourage the smooth functioning of markets and the development of a competitive industry, in order to avoid market failures[22].

[20] A practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavourable regulation. Regulatory arbitrage opportunities may be accomplished by a variety of tactics, including restructuring transactions, financial engineering and geographic relocation. Regulatory arbitrage is difficult to prevent entirely, but it can be limited by resolving the most obvious loopholes and thus increasing the costs associated of circumventing the regulation for example.

[21] Built on the principles of undistorted competition, freedom of establishment and the free flow of capital.

[22] A market failure occurs when the private sector left to itself, so without government intervention, leads to a sub-optimal outcome. According to Goodhart *et al* (1998), there are three main reasons for government intervention in the financial sector:

1. Information asymmetry: when customers are less informed than financial institutions. Supervision aims to protect customers against this asymmetric information.
2. Externalities: when the failure of a financial institution may affect the stability of the financial system as a whole. Supervision aims to foster financial stability and to contain the effects of systemic failures:

The financial crises clearly revealed that the pre-crisis supervision and regulatory framework had considerable shortcomings. Supervision was unable to detect, signal or mitigate the crisis, failing in performing its core tasks from both a macro and micro-prudential standpoint. In addition, the existing regulatory framework in the EU lacked homogeneity, leading to a wide diversity of national transpositions in the enforcement of common directives and so giving rise to several regulatory inconsistencies. According to the De Larosière report, the following table summarizes the major regulatory inconsistencies existing during the financial crisis.

Table 2.2 - Existing regulatory inconsistencies in the EU

✓ Differences regarding sectoral extent of EU supervision
✓ Diversity in reporting obligations
✓ Diverse definition of core capitals from one Member State to another
✓ Different accounting practices for provisions related to pensions
✓ Divergence in transposition of the insurance mediation directive
✓ Differences in the definition of regulatory capital regarding financial institutions
✓ No single agreed methodology to validate risks assessment by financial institutions
✓ Substantial differences in the modalities related to deposit insurance
✓ No harmonisation for insurance guarantee schemes

Source: The De Larosière report (2009)

3. Market power: when financial institution and/or financial infrastructures may exert undue market power. In this case competition policy aims to protect customers against monopoly or oligopoly situations.

Goodhart *et al* (1998), Financial Regulation: Why, How and Where Now?, Routledge, London.

If from one hand regulation suffered several inconsistencies, on the other, each element of the supervisory process showed weaknesses during the financial crisis, both at a global and EU-level. The existing supervisory arrangements focused too much on the supervision of individual financial institutions, and too little on the macro-prudential side. The prevailing common belief was that market discipline and self-regulation would be enough to ensure financial stability. However, as the crisis painfully proved, healthy institutions do not necessarily imply a healthy financial system, whilst the analysis of systemic risks needs the attention deserved. In order to be effective the supervision must encompass all sectors and not be only confined to individual financial institutions.

Though sometimes macro-prudential risks were identified, there was a general lack of attention characterized by a laissez-faire behaviour. Several national and international entities[23] did evaluate the financial stability of the system as a whole and monitoring the evolution of systemic risks. At the EU-level, the European Central Bank (ECB) published bi-annual Financial Stability Review[24]. Notwithstanding this, too often the analyses of macro-financial stability drivers proved to be not in line with the evolution of the systemic risk. For example, the June 2007 ECB Financial Stability Review stated, at the dawn of the financial crisis, *"With the euro area financial system in a generally healthy condition and the economic outlook remaining favourable, the*

[23] Like National Central Banks with the publication of annual reports on financial stability, and the International Monetary Fund with the publication of the IMF Global Financial Stability Report.
[24] Since 2004 the ECB has published twice a year the Financial Stability Review which provides an overview of the possible sources of risk and vulnerability to financial stability in the euro area. The review aims to promote awareness of issues that are relevant for safeguarding the stability of the euro area financial system both within the financial industry and among the public at large. By providing an overview of the possible sources of risk and vulnerability to financial stability, the FSR also seeks to play a role in preventing financial crises. Source: www.ecb.int.

most likely prospect is that financial system stability will be maintained in the period ahead"[25]. This statement clearly epitomizes how difficult is the role of supervisors, that requires them to go against the tide and questioning the common belief trying to detect dangers but at the same time avoiding to generate unreasoned panic in the market.

On the other hand, even if supervisors issued warnings, correct or not they were, usually these warnings were insufficiently taken into account by policymakers since they were against their short-term interests concerning most of times core drivers of economic growth.

In the light of the increasing integration of the European financial sector, with already by 2005, 23% of all banking activity in Europe considered to be of a cross border nature[26], the supervision largely remained in the hand of individual Member States. This gave rise to several shortcomings in the supervision of cross-border institutions, since, according to the De Larosière report, the existing practices for challenging the decisions of national supervisors proved to be inadequate, relying extensively on the judgments and decisions of the home supervisor. In order to overcome to such problems, the supervisory cooperation between home and host authority was required. However, since the cooperation was of a voluntary nature, the most of times the home supervisor remained firmly in control, reducing the necessity for supervisory cooperation. In addition, the existing regulatory inconsistencies between Member States made the supervisory cooperation even more difficult. The lack of

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[25] ECB, Financial Stability Review, June 2007.
[26] See section 1.4

cooperation between supervisors hampered the exchange of information leading to an erosion of mutual confidence among them. The failure of supervisory cooperation became even more evident at the outbreak of the financial crisis, when, due to the non-binding nature of cooperation and the difficulties in taking a common decision, national supervisors preferred national responses. Ultimately, this resulted in the home country supervision problems, where, due to the ineffectiveness of supervisory cooperation, as the Governor of the Bank of England, Mervyn King said[27], global banking institutions are global in life, but national in death. Namely, when crises occur national central banks are required to provide lender-of-last-resort (LOLR[28]) support and national governments have to provide fiscal support to these rescue operations.

Last but not the least was the unsuitable level of resources available to the Lamfalussy level-3 committees (CEBS, CESR and CEIOPS). This severely limited their effectiveness and their speed of reaction. The following table summarizes the main shortcomings in supervision during the financial crisis according to the De Larosière report.

[27] FSA, The Turner Review: A regulatory response to the global banking crisis, March 2009.

[28] A lender of last resort (LOLR) is an institution willing to extend credit when no one else will. The term refers especially to a reserve financial institution, most often central banks, intended to avoid the default of banks or other institutions deemed systemically important or “too big to fail”.
A lender of last resort serves to protect depositors, prevent widespread panic, and otherwise avoid disruption in productive credit to the entire economy caused by the collapse of one or a handful of institutions.
In the EU the European Central Bank serves as the LOLR, in the US the Federal Reserve. Within other major world economies this role is undertaken by the Bank of England in the United Kingdom (the central bank of the UK), in Switzerland by the Swiss National Bank, in Japan by the Bank of Japan and in Russia by the Central Bank of Russia.

Table 2.3 - A multitude of Supervisory Shortcomings

- ✓ Lack of adequate macro-prudential supervision
- ✓ Ineffective early warning mechanisms
- ✓ Problems of competences
- ✓ Failure to challenge supervisory practices on a cross-border basis
- ✓ Lack of cooperation between supervisors
- ✓ Lack of consistent supervisory powers across Member States
- ✓ Lack of resources in the Lamfalussy level-3 committees
- ✓ No means for supervisors to take common decisions

Source: The De Larosière report (2009)

2.3. The "New" European financial supervisory framework

In the light of the above, it is clear that the crisis prevention function of financial supervisors, both at national and EU level, has not worked properly and that the EU's supervisory system proved to be difficult to manage. This ineffectiveness was incompatible with the well-functioning of the internal market. For these reasons, the high level group, chaired by Mr Jacques De Larosière, proposed a new structure to make European supervision more effective and so improving financial stability in the European Union.

2.3.1 From De Larosière onward

The so-called "De Larosière Report" was published on 25th February 2009. In the Communication "Driving European Recovery" of 4 March 2009, the European Commission welcomed and supported the recommendations proposed, setting out an action plan for reforming the way European financial markets were regulated and supervised[29]. Then, on 27 May 2009 in the Communication "European Financial Supervision", the Commission sets out the basic architecture for a new European financial supervisory framework composed of two new pillars: 1) an European Systemic Risk Council or Board (ESRB) in charge of macro-prudential supervision[30]; 2) an European System of Financial Supervisors (ESFS) consisting of a robust network of national supervisors working in tandem with three new European Supervisory Authorities (ESAs) [31] replacing the existing three Lamfalussy level-3 committees (CEPS, CESR and CEIOPS), in charge of micro-prudential supervision[32]. At the ECOFIN[33] meeting of 9 June 2009 the recommendations proposed by the high level

[29] Commission Communication to the Spring European Council, "Driving European Recovery" - COM (2009) 114 – March 4, 2009.
[30] The objective of macro prudential supervision is to limit the distress of the financial system in order to safeguard the overall economy.
[31] The European Banking Authority (EBA) based in London, the European Insurance and Occupational Authority (EIOPA) based in Frankfurt, the European Securities and Markets Authority (ESMA) based in Paris.
[32] Micro prudential supervision aims to supervise and limit the distress of individual financial institutions, considering that by preventing the failure of individual institutions it is possible to prevent or at least mitigate the risk of contagion and the negative externalities in terms of confidence in the financial system. For these reasons it has traditionally been the centre of attention of supervisors.
[33] The Economic and Financial Affairs Council is, together with the Agriculture Council and the General Affairs Council, one of the oldest configurations of the Council. It is commonly known as the Ecofin Council, or simply "ECOFIN" and is composed of the Economics and Finance Ministers of the Member States, as well as Budget Ministers when budgetary issues are discussed. It meets once a month. The Ecofin Council covers EU policy in a number of areas including: economic policy coordination, economic surveillance, monitoring of Member States' budgetary policy and public finances, the euro (legal, practical and international aspects), financial markets and capital movements and economic relations with third

group were broadly confirmed. The Ecofin Council stated in its conclusions that *"financial stability, regulation and supervision in Member States and in the EU must be enhanced in an ambitious way ensuring trust, efficiency, accountability and consistency with the allocation of responsibilities for financial stability*[34]*".* Subsequently, the European Council, on the 18-19 June meeting, broadly confirmed and implemented the recommendations proposed.

On the basis of the De Larosière recommendations, the Commission elaborated several legislative proposals for the establishment of a new European System of Financial Supervision[35]. Finally, on 22 September 2010 the European Parliament gave green light to a new financial supervisory architecture approving the Commission proposals[36]. Then, on 17th November 2010, the Council of Ministers adopted the legal

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countries. It decides mainly by qualified majority, in consultation or co-decision with the European Parliament, with the exception of fiscal matters which are decided by unanimity. Source: www.consilium.europa.eu

[34] Council conclusions on Strengthening EU financial supervision – Luxembourg, June 9, 2009.

[35] During September-October 2009, the Commission released several legislative proposals aimed at reforming the European Financial Supervision System. These are:

- Proposal for a Regulation on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board – COM (2009) 499 final – Brussels, September 23, 2009.
- Proposal for a Council Decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board – COM(2009) 500 final – Brussels, September 23, 2009.
- Proposal for a Regulation establishing a European Banking Authority – COM (2009) 501 final – Brussels, September 23, 2009.
- Proposal for a Regulation establishing a European Insurance and Occupational Pensions Authority – COM(2009) 502 final – Brussels, September 23, 2009.
- Proposal for a Regulation establishing a European Securities and Markets Authority – COM (2009) 503 final – Brussels, September 23, 2009.
- Proposal for a Directive 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 Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority – COM (2009) 576 final – Brussels, October 26, 2009.

[36] Press conference with the rapporteurs of the law that set down a rigorous new framework for the supervision of financial markets in the EU – Strasbourg – September 22, 2010

texts establishing the European Systemic Risk Board (ESRB) and the three new European Supervisory Authorities (ESAs)[37]. The following table summarizes the main steps in the creation of this new framework.

Table 2.4 - Main steps in the establishment of the ESFS

- ✓ **October 2008**: the EC mandate Mr. De Larosière
- ✓ **February 2009**: publication of the De Larosière report containing the recommendations
- ✓ **March 2009**: the EC communication "Driving European Recovery" welcomes and supports the recommendations proposed
- ✓ **May 2009**: the EC communication "European Financial Supervision" sets the basis for the architecture of the new ESFS
- ✓ **June 2009**: The ECOFIN Council of 9 June and the European Council of 18-19 June agree with the Commission's suggestions
- ✓ **September 2009**: the Commission adopts legislative proposals regarding the ESRB and the three new European Supervisory Authorities (ESAs)
- ✓ **September to November 2010**: the legislation is adopted by the EP on 22 September and by the Council on 17 November
- ✓ **December 2010**: the legislation is published in the Official Journal of the EU and enters into force on 16 December 2010
- ✓ **January 2011**: the new framework starts to work
- ✓ **January 2011**: the Commission adopts legislative proposals further clarifying the powers of the new ESAs

Source: personal elaboration

The new framework started to work as from January 1, 2011 replacing the old level-3 supervisory committees. Quoting the words of the Commissioner Michel Barnier, *"Europe is learning the lessons from the crisis and that is why today, it is giving itself a new apparatus of surveillance and supervision. To detect problems early*

[37] Council of the EU – Financial Supervision: Council adopts legal texts establishing the European Systemic Board and three new supervisory authorities – 16452/10 PRESSE 303 – Brussels, November 17, 2010.

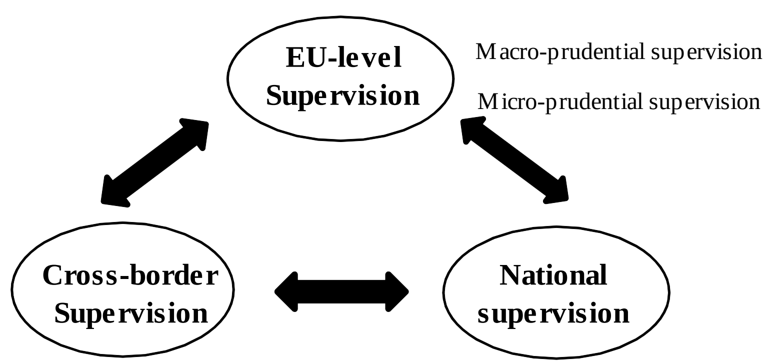
and to act in time in a coordinated and efficient way. These new structures are the control tower and the radar screens that the financial sector needs.[38] ”

Following the launch of the European Supervisory Authorities (ESAs), the Commission adopted legislative proposals[39] further clarifying their powers.

2.3.2 The resulting system

The renewed system consists of three levels of supervision: the EU, the cross-border and the national level. The following figure provides an overview.

Figure 2.1 - The EU financial supervision structure



Source: Egmont Paper (2011) p.18

The most important change regards the EU level supervision that has been assigned a bigger role than was previously the case with the level-3 committees. The

[38] Statement by Commissioner Michel Barnier, “The date of 1st January 2011 marks a turning point for the European financial sector” – Brussels, January 1, 2011

[39] “Omnibus II” Directive – COM(2011) 8 final – Brussels, January 19, 2011

renewed system consists of two pillars (figure 2.2), namely macro-prudential oversight and micro-prudential supervision.

Figure 2.2 - The European System of Financial Supervision

Micro-prudential supervision	**Macro-prudential oversight**
European Banking Authority (EBA)	European Systemic Risk Board (ESRB)
European Insurance and Occupational Pensions Authority (EIOPA)	
European Securities and Markets Authority (ESMA)	
Joint Committee of the ESAs	
National micro-prudential supervisory authorities	National macro-prudential supervisory authorities

Source: ESRB Annual Report 2011

Macro-prudential oversight is under the responsibility of the ESRB and the competent macro-prudential authorities in the EU Member States, while micro-prudential supervision is undertaken by the three new European Supervisory Authorities (ESAs), i.e. the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), by the Joint Committee of the ESAs and by the competent micro-prudential supervisory authorities in the EU Member States, as specified in the regulations establishing the ESAs[40].

[40] Regulations 1093/2010 (EBA), 1094/2010 (EIOPA), 1095/2010 (ESMA).

The ESRB Regulation[41], pursuant to the principle of sincere cooperation in accordance with Article 4(3) of the Treaty of the European Union, explicitly calls upon the parties to cooperate with trust and full mutual respect, in particular to ensure that appropriate and reliable information flows between them.

2.4. The Macro-prudential Arm: The ESRB

On 16 December 2010 the legislation[42] establishing the ESRB entered into force. The ESRB is an independent EU body whose purpose is to ensure supervision of the European Union's financial system. According to the ESRB Regulation, *"The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth*[43]*"*.

[41] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (the 'ESRB Regulation').
[42] Regulation (EU) No 1092/2010 and Regulation (EU) No 1096/2010.
[43] Art. 3 of Regulation (EU) 1092/2010.

Systemic risk is a broad concept, which the ESRB legislation defines as *"a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree"*[44]. This definition remains vague giving little details, but this ambiguity can allow the ESRB to adapt to future evolutions.

In order to prevent or mitigate systemic risk the ESRB determines, collects and analyses all the relevant and necessary information, identifying and prioritizing systemic risks dangerous for the financial system as a whole.

2.4.1 Structure

The institutional framework of the ESRB comprises the General Board, the Steering Committee, the Advisory Scientific Committee (ASC), the Advisory Technical Committee (ATC) and a Secretariat[45]. The following figure provides an overview of this structure.

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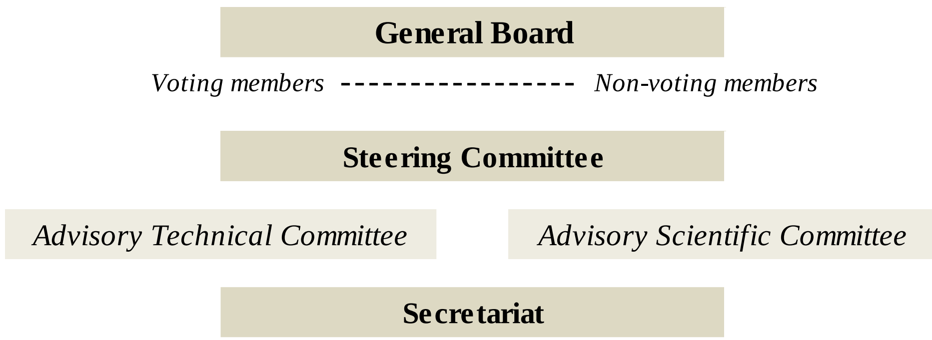
[44] Art. 2(c) of ibidem.
[45] Art. 4 of ibidem.

Figure 2.3 - Institutional set-up of the ESRB



Source: ESRB Regulation 1092/2010

The General Board[46] is the main decision-making body of the ESRB and is chaired by the President of the ECB[47]. It has 65 members[48], which can be seen as considerably large, but it ensures that all the relevant parties are properly involved and that the ESRB's assessment of systemic risk is based on a wide range of views and a broad set of information.

The Steering Committee[49] comprises 14 members of the General Board and is tasked with assisting in the decision-making process of the ESRB by preparing the meetings of the General Board, reviewing the documents to be discussed and monitoring the progress of the ESRB's ongoing work.

[46] Art. 6 of ibidem.

[47] For the first five years of its existence, the President of the ECB is the Chair of the ESRB. However, the review of the ESRB Regulation scheduled for this year, should reflect on the arrangements for the designation or election of the Chair of the ESRB. Art. 5 of ibidem.

[48]Of which 37 voting and 28 non-voting. The voting members include: the President and Vice-President of the ECB; the governors of the national central banks of the EU Member States; the Chairs if the three ESAs; a member of the European Commission; the Chair and the two Vice-Chairs of the ASC and the Chair of the ATC. The non-voting members are: the President of the Economic and Financial Committee and one high-level representative per EU Member State from the competent national supervisory authorities.

[49] Art. 11 of ibidem.

The two advisory committees, the Advisory Scientific Committee[50] and the Advisory Technical Committee[51] ATC, are tasked with providing advices on issues of relevance to the ESRB at the request of the Chair.

Finally, a Secretariat[52] is to support the ESRB in its day-to-day business. This secretariat is financed and staffed by the ECB that provides it with analytical, statistical, logistical and administrative support.

2.4.2 Tasks

To perform its challenging mission, the ESRB is expected to carry out the following tasks[53]: 1) supervision of the financial system through the collection and analysis of all relevant and necessary information; 2) identification and prioritization of systemic risks and the consequent issuing of warnings and recommendations; 3) provide follow-up on its recommendations and 4) report of the results and interaction with other public bodies.

1. *Supervision*: the prime task of the ESRB is to supervise and detect potential systemic risk in the financial system. This includes risk monitoring, in the course of which the ESRB gathers and analyses information, using, for example, financial stability indicators and early warning indicators. These activities

[50] Art. 12 of ibidem.
[51] Art. 13 of ibidem.
[52] Art. 3 of Council Regulation (EU) 1096/2010.
[53] Art. 3 of Regulation 1092/2010

require an extensive amount of information, collected in accordance with the relevant provisions stipulated in the ESRB regulation[54].

2. ***Warnings and Recommendations***: based on the information available and following its risk analysis, the ESRB can issue warnings and recommendations[55]. Warnings are intended to shed light on systemic risk sources, while recommendations focus on the policy actions needed in order to mitigate a systemic risk. These can be addressed to the EU as whole, as well as to one or more ESAs, national supervisors of individual Member States. Warnings and recommendations cannot be addressed directly to individual financial institutions. A clear limitation consists in the "soft" nature of such instruments, i.e. its recommendations are not legally binding. However the ESRB can decide to make them public[56]. In taking such a decision, the ESRB has to balance between the need to be transparent and accountable and the need to preserve confidentiality[57].

3. ***Follow-up:*** the monitoring of compliance with a recommendation is based on an "act or explain" mechanism, where those subject to recommendations should communicate to the ESRB the actions they have undertaken, providing adequate

[54] According to art. 15 of ibidem, the ESRB is not allowed to demand information directly from individual financial institutions. It relies completely on data collected by external sources following a strict hierarchy. Firstly, the ESRB is required to use existing statistic available at the EU-level. If this information is not satisfactory, it can request data from the ESAs and subsequently form central banks, national supervisors or national statistic authorities. Ultimately, if this does not result in the needed information, the ESRB can request information from Member States. In addition, the information provided to the ESRB is to be summarized, so that it does not allow for the identification of individual financial institutions.
[55] Art. 16 of ibidem.
[56] Art. 18 of ibidem.
[57] Five public recommendations have been issued since the inception of the ESRB.
See http://www.esrb.europa.eu/pub/recommendations/html/index.en.html

justification for any inaction[58]. If it judges that insufficient measures have been taken in response to a recommendation, the ESRB informs the appropriate bodies, i.e. the addressee, the Council and the ESA concerned. In contrast to recommendations, no formal follow-up is expected for warnings.

4. *Reporting:* as an independent body responsible for the macro-prudential oversight of the EU financial system, the ESRB is to report on its activities, both to the public and to the EU institutions[59]. To this end, the Chair of the ESRB is invited regularly to hearings before the ECON Committee of the European Parliament. These hearings are public and can be followed on the ESRB's website[60]. The ESRB is also expected to publish an annual report containing an analysis of financial stability. Furthermore, it is required to interact with other supervisors, such as the ESAs in the EU, and with relevant international and third country supervisory bodies outside the EU[61].

2.4.3. Limits

Despite its importance, the ESRB faces several limits that could undermine its effectiveness. A clear limitation consists in the "soft" nature of its warnings and recommendations, i.e. they are not legally binding. Even if the ESRB follows an "act or

[58] Art. 17 of ibidem.
[59] Art. 19 of ibidem.
[60] In addition, in the website the Chair's introductory statements are also published.
[61] Art. 3 of ibidem.

explain" approach, this lack of coercive power leads the ESRB to rely mainly on its reputation.

Another limit resides in the size of the General Board that makes the work of the ESRB even more complicated. In addition, along with the dimension of the board, the ESRB's membership relies strongly on central banks. Therefore, the role attributed to the non-central bank supervisors, i.e. sectoral experts, is very limited. The lack of sectoral representation can hamper the ESRB's ability to prevent and mitigate systemic risks, by detecting and responding to them.

2.5. The Micro-prudential arm: The ESFS

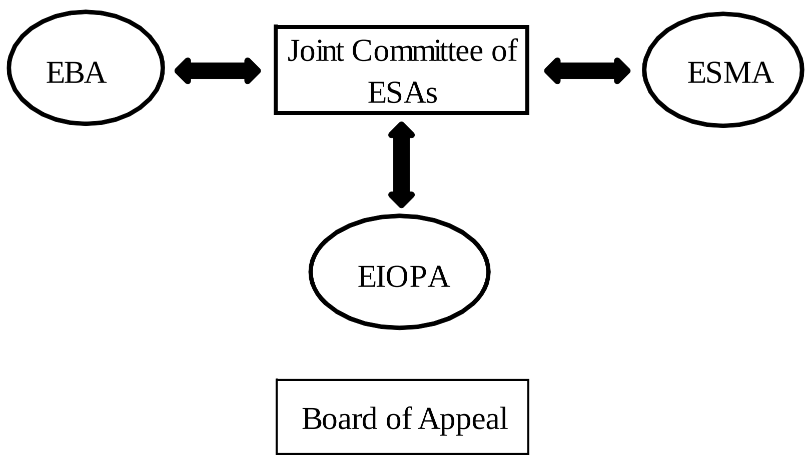
On 1st January 2011 the three new European Supervisory Authorities (ESAs) start their work, replacing the former Lamfalussy "level-3 committees". Although the macro-prudential supervision is an important aspect of supervision, it cannot replace the micro-prudential supervision, since the latter is the first line of defence against any financial sector difficulties.

In order to understand how the micro-prudential supervision at the EU-level works, we need to look at its overall structure, its tasks and then highlighting its limits.

2.5.1 Structure

The EU micro-prudential supervision is carried out by the three new European Supervisory Authorities (ESAs), a Joint Committee of ESAs and a Board of Appeal. The following figure provides an overview.

Figure 2.4 - Structure of EU micro-prudential supervision



Source: ESAs Regulations

The three ESAs represent the most important elements of this new structure. Each of them deals with a specific subset of the financial sector.

a) EBA

The European Banking Authority, established by Regulation (EC) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010, has taken over all existing and ongoing tasks and responsibilities from the Committee of European Banking Supervisors (CEBS). The primary objective of EBA is to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses[62]. Therefore, the EBA acts as a hub and spoke network[63] of EU and national authorities to safeguard the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors.

The EBA has some quite broad competences, including preventing regulatory arbitrage, improving the functioning of the internal market, ensuring the integrity, transparency, efficiency and orderly functioning of financial markets guaranteeing a level playing field, strengthening international supervisory coordination, promoting supervisory convergence and providing advice to the EU institutions in the areas of banking, payments and e-money regulation as well as on issues related to corporate governance, auditing and financial reporting.

b) EIOPA

The European Insurance and Occupational Pensions Authority, established by Regulation (EC) No. 1094/2010 of the European Parliament and of the Council of 24 November 2010, has taken over all existing and ongoing tasks and responsibilities from the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The Authority acts in the field of activities of insurance undertakings, reinsurance undertakings, financial conglomerates, institutions for occupational

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[62] Art. 5 of Regulation 1093/2010.
[63] See the EBA website - http://www.eba.europa.eu/

retirement provision and insurance intermediaries[64]. The EIOPA aims to protect consumers, rebuilding trust in the financial system and ensuring an effective and consistent level of regulation and supervision taking in account of the varying interests of all Member States and the different nature of financial institutions promoting a greater harmonisation and coherent application of rules for financial institutions and markets across the European Union.

c) ESMA

The European Securities and Markets Authority, established by Regulation (EC) No. 1095/2010 of the European Parliament and of the Council of 24 November 2010, has taken over all existing and ongoing tasks and responsibilities from the Committee of European Securities Regulators (CESR). ESMA contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection[65]. In particular, ESMA fosters supervisory convergence both amongst securities regulators, and across financial sectors working closely with the other ESAs. Its work on securities legislation contributes to the development of a single rulebook in Europe. Moreover, as part of its role in standard setting and reducing the scope of regulatory arbitrage, ESMA strengthens international cooperation on supervisory practices.

[64] Art. 1 of Regulation 1094/2010.
[65] Art. 1 of Regulation 1095/2010.

d) The Joint Committee

The Joint Committee (JC) serves as a forum where the authorities cooperate regularly dealing with cross-sectoral issues, as well as financial conglomerates[66]. In particular it plays an important role in interacting with the ESRB performing micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability and through a proper information exchange. The JC consists of the Chairpersons of the ESAs and is chaired on an annual rotation basis by the ESAs' Chairs. The JC has no legal personality and decisions are considered to be taken by the individual ESAs. However, the JC ensures that common decisions are taken by the ESAs. Furthermore, the JC established four Sub-Committees: the Sub-Committee on Financial Conglomerate, the Sub-Committee on Cross Sectoral Developments, Risks and Vulnerabilities, the Sub-Committee on Anti-Money Laundering and the Sub-Committee on Consumer Protection and Financial Innovation.

e) The Board of Appeal

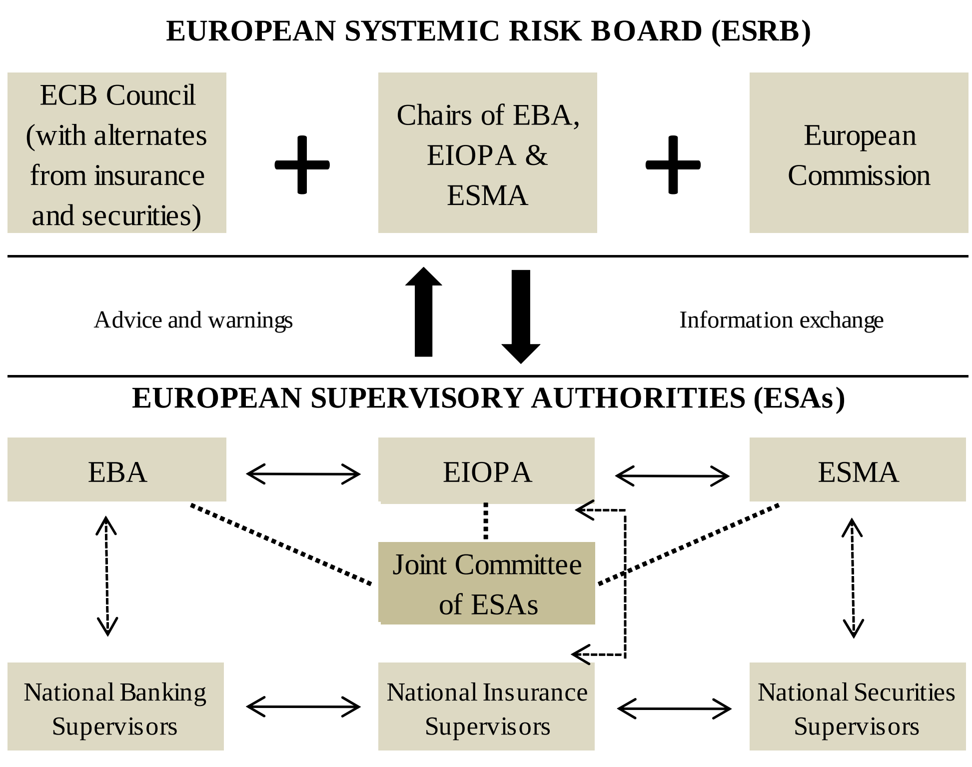
The Board of Appeal (BoA) serves to allow for a contestation of an ESA decision[67]. It is composed of six members and six alternates, who are individuals of high repute with a proven record of relevant knowledge and professional experience, including supervisory experience in the fields of banking, insurance, occupational pensions, securities markets or other financial services. Each ESA nominates two members and two alternates from a short-list proposed by the Commission.

[66] Art. 54 of Regulations 1093/2010, 1094/2010, 1095/2010 (from now "ESAs Regulations).
[67] Art. 58 of ESAs Regulations.

Regarding the appeals, any natural or legal person, including competent authorities may appeal against a decision of the ESAs. The BoA can subsequently confirm or invalidate such decision. Further, the decisions made by the BoA may be brought before the Court of Justice of the European Union, in accordance with article 263 TFEU[68].

The following figure provides an overview of the new European System of Financial Supervisors (ESFS).

Figure 2.6 - European System of Financial Supervision (ESFS)



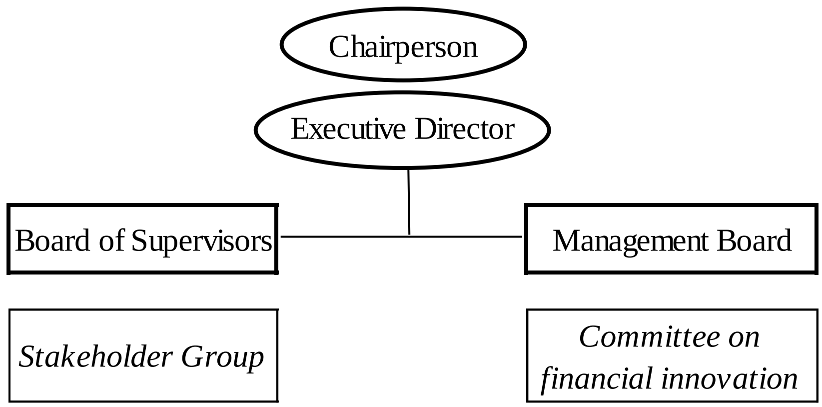
Source: personal elaboration

[68] According to article 263 of TFEU, "The Court of Justice of the European Union shall review the legality of legislative acts, of acts of the Council, of the Commission and of the European Central Bank, other than recommendations and opinions, and of acts of the European Parliament and of the European Council intended to produce legal effects vis-à-vis third parties. It shall also review the legality of acts of bodies, offices or agencies of the Union intended to produce legal effects vis-à-vis third parties".

2.5.1.1 Internal Organisation of the ESAs

The internal structure of the three ESAs is identical. It comprises a Board of Supervisors, a Management Board, a Chairperson, an Executive Director, a Committee on financial innovation and a Stakeholder Group[69]. The following figure provides an overview.

Figure 2.5 - Internal Organisation of the ESAs



Source: personal elaboration

The Chairperson[70] is to be a full-time independent professional, implying that he or she cannot combine this function with any other supervisory or industry function. The Chairperson heads the meetings of the Board of Supervisors and the Management Board.

The Executive Director[71] is in charge of the management of the Authority and prepares the work of the Management Board. He is also responsible for implementing

[69] Whilst EBA and ESMA have only one Stakeholder Group, EIOPA has two Stakeholder Groups (Article 37 of EIOPA Regulation) namely: the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group.
[70] Art. 48 of ESAs Regulations.

the annual work programme of the Authority under the guidelines of the Board of Supervisors and under the control of the Management Board, and for designing and implementing the ESA's budget. Like the Chairperson, the Executive Director is to be a full-time independent professional.

Each ESA has two decision making bodies: the Board of Supervisors and the Management Board.

The main decision-making body is the Board of Supervisors[72] which is, among other things, responsible for the adoption of draft technical standards, opinions, recommendations and decisions. It is composed of the Chairperson of the respective ESA, who chairs the meeting, the heads of the relevant national supervisors[73], a representative of the Commission, of the ESRB and of the other two ESAs[74]. In addition, the Board of Supervisors can also decide to admit observers, i.e. representatives of Member States of the European Economic Area.

The second decision making body is the Management Board[75] which ensures that the Authority carries out its mission and performs the tasks assigned to it. It is composed of the Chairperson and six other members of the Board of Supervisors. The Executive

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[71] Art. 51 of ibidem.
[72] Art. 40-44 of ibidem.
[73] In Member States where more than one authority is responsible for the supervision according to this Regulation, those authorities shall agree on a common representative.
[74] The voting-members are the heads of the national public authority competent for the supervision of financial institutions in each Member States. The representatives of the ESRB, the Commission and the other two ESAs have no voting rights.
[75] Art. 45-47 of ibidem.

Director and a representative of the Commission participate in the meetings of the Board but without voting rights.

Each ESA has a Committee on financial innovation[76] that comprises representatives of all relevant national supervisory authorities, with a view to achieve a coordinated approach to the regulatory and supervisory treatment of new or innovative financial activities.

Finally, the Stakeholder Group[77] serves to facilitate consultation with interested parties in areas relevant to the tasks of the Authority. The EBA and the ESMA each have one Stakeholder Group at their disposal, while EIOPA has two.

2.5.2. Tasks

According to the ESAs Regulations the three authorities have an almost identical wide range of tasks to fulfil[78]. However it is likely that the ESA's role will diverge over time to better address the problems relative to the specific subset of the financial sector they deal with.

[76] Art. 9(4) of ibidem.
[77] Art. 37 of ibidem.
[78] Art. 8-9 of ibidem.

Precisely, the three authorities are not mandated to carry out day-to-day supervision of financial institutions[79], which is the sole responsibility of national competent supervisors[80].

2.5.2.1 Supervision

Although the ESAs are not in charge of day-to-day supervision, they have some supervisory tasks. They are to monitor and assess market developments in the area of its competence and where necessary they are to inform the other ESAs, the ESRB and the European Parliament, the Council and the Commission about the relevant micro-prudential trends, potential risks and vulnerabilities. Keeping an eye on systemic risk, the authorities are to include in its assessments an economic analysis of the financial sector they deal with and an assessment of the impact of potential market developments. In addition, the ESAs, in cooperation with the ESRB, have the important task to initiate and coordinate stress tests to assess the resilience of financial institutions to adverse market developments and evaluate the potential systemic risk[81]. However, the role of the

[79] Rec. 9 of EBA and ESMA Regulations, and Rec.8 of EIOPA Regulation.
[80] With the exception of ESMA, that since 1 July 2011 is the responsible body regarding the registration and supervision of credit rating agencies (CRAs) in the European Union. Following the entry into force of the European Market Infrastructure Regulation (EMIR) N. 648/2012 of 4 July 2012, ESMA is expected to assume responsibilities in the area of post-trading including direct supervision of trade depositories.
[81] Art. 23 of ibidem.

ESAs is limited to coordination, while tests themselves are carried out at the national level[82].

In order to carry out the duties assigned to them, the ESAs firstly are to take into account the information available at the EU-level, then they can request data from the competent authorities of the Member States, and if the information is not available the ESAs can request information to other Member States public bodies, i.e. the ministry responsible for finance. Ultimately, the authorities may address a duly justified and reasoned request directly to the individual financial institutions[83].

2.5.2.2. Single Rulebook

As the European Council stated in its conclusions of 9 June 2009, a major goal of the ESAs is to establish a European single rulebook applicable to all financial institutions active in the internal market, in order to foster the smooth functioning of the Single Market and prevent regulatory arbitrage, leading to a less divergent financial legislation across Member States and creating a level-playing field across the Union. According to the ESAs Regulations, in order to achieve these objectives, they can

[82] So far, only EBA and EIOPA have initiated and coordinated stress tests, in the banking and insurance sector respectively. Furthermore, EBA carried out a recapitalization exercise in 2011/2012 (see the next chapter) to restore confidence in the EU banking sector. ESMA will contribute to supervisory stress testing in 2013 by developing a stress test framework for Investment Managers, Exchanges and Central Counterparties (CCPs).
[83] Art. 35 of ibidem.

develop draft regulatory technical standards[84] and develop guidelines and recommendations[85].

Guidelines and recommendations are non-binding and the monitoring of compliance with them is based on an "act or explain" mechanism, where if an addressee, i.e. supervisors or financial institutions, does not comply, it has to provide an adequate justification. On the other hand the regulatory technical standards, following the endorsement of the Commission, become legally binding instruments and are directly applicable. Therefore, the regulatory technical standards play a bigger role in the harmonisation process, and so in the building up of the single rulebook, than the guidelines and recommendations.

2.5.2.3. Enforcement of EU rules

The ESAs play a substantial role in enforcing EU rules by counteracting breaches of EU law[86] and by settling disagreements between competent authorities in cross-border situations[87]. For the first case, the ESAs regulations provide a specific procedure. Firstly the authority may investigate the alleged breach or non-application of Union law and then address a recommendation to the competent national authority concerned setting out the action necessary to comply with EU law. In case of non-

[84] Art. 10-15 of ibidem.
[85] Art. 16 of ibidem.
[86] Art. 17 of ibidem.
[87] Art. 19 of ibidem.

compliance the Commission, after having been informed by the Authority, can issue formal opinion on the matter. If the national competent authority's actions are still considered to be insufficient, the ESA can directly require financial institution to act[88].

Another mean of enforcing EU rules is the ESAs' role in settling disagreements between national competent authorities. In settling a disagreement, the Authority firstly act as a mediator pushing for a conciliation, but if after this phase there is still disagreement between the competent authorities concerned, then the Authority may take decisions that bind national authorities. Where the national authorities still do not comply, the Authority is empowered to adopt and individual decision addressed to a financial institution requiring the necessary action to comply with its obligation under EU law. These decisions prevail over any previous decision adopted by other supervisors[89].

2.5.2.4. Dealing with distressed situations

The ESAs have the competences to handle moments of financial distress in order to avoid the lack of supervisory cooperation as occurred during the financial crisis. These consist in the role played by the ESAs in contingency planning[90], when the

[88] So far, the ESAs have not addressed any recommendations to National authorities nor addressed individual decisions to financial institutions. However, the ESAs have made use of "soft" informal measures to bring about conformity of EU law.
[89] So far, the ESAs have not used these powers.
[90] Art. 25-27 of ibidem.

Council declares an emergency situation[91] and with the power conferred to the ESAs to temporarily restrict or ban financial activities posing a threat to the financial system[92]. Firstly, contingency planning includes recovery and resolution procedures and funding arrangements, in dealing with the failure of financial institution without impacting financial stability. However, the ESAs have not the power to set out the basic rules, as this shall be done in the form of a legislative act. Once the legislative act is adopted, the ESAs will be able to review arrangements and adopt draft technical standards on the matter. For instance, currently EBA is working on draft technical standards regarding the Bank Recovery and Resolution Directive[93].

Secondly, in case of adverse developments which may seriously jeopardise the proper functioning and the integrity of financial markets, the Council can declare an emergency situation, during which the ESAs are conferred with supplementary powers. In such situations the ESAs are empowered to require actions by national supervisors and in case of non-compliance the ESAs can adopt decisions addressed to individual financial institutions, prevailing over any previous decisions adopted by other supervisors[94].

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[91] Art. 18 of ibidem.
[92] Art. 9(5) of ibidem.
[93] On 6 June 2012, the Commission adopted a legislative proposal for bank recovery and resolution. The proposed framework sets out the necessary steps and powers to ensure that bank failures across the EU are managed in a way which avoids financial instability and minimizes costs for taxpayers.
COM (2012) 280 final - Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.
[94] So far, no emergency situation has been declared. However, the ESAs have undertaken significant preparative work to ensure their capability to act efficiently in case an emergency action was declared.

Finally, the ESAs are able to temporarily restrict or ban financial activities if these pose a threat to the financial system or its markets[95].

2.5.2.5. *Fostering supervisory cooperation and convergence*

The Authorities play an active role in building a common EU supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and coherent approaches throughout the EU[96]. The contribution of the ESAs towards a common supervisory culture however is hindered by the non-binding nature of the instruments at their disposals, i.e. providing opinions, promoting multilateral exchange of information between national authorities and other convergence tools. Moreover, the Authorities are able to organize and conduct periodical peer reviews[97] of some or all of the activities of competent authorities, to further strengthen consistency in supervisory outcomes. Equally, the ESAs play a coordination role[98] between competent authorities, although they have binding power if the mediation fails[99].

[95] This is the case for example of the powers conferred to ESMA to temporarily restrict short selling, credit default swaps and other related activities if necessary to deal with specific threat for financial stability. See the Regulation (EU) N. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.
[96] Art. 29 of ESAs Regulations.
[97] Art. 30 of ibidem.
[98] Art. 31 of ibidem.
[99] Art. 19 of ibidem.

Finally, the ESAs have the task to stimulate and facilitate the delegation of tasks and responsibilities[100] between national supervisors by identifying those tasks and responsibilities that can be delegated or jointly exercised by promoting best practices.

2.5.2.6. Consumer protection

The ESAs take a leading role in the consumer protection dealing with financial products, promoting transparency, simplicity and fairness in the market for consumer financial products or services[101]. To pursue this goal, the ESAs have a broad range of possibilities, including the collection, analysis and report on consumer trends, the coordination of financial education initiatives, the development of training standards for the industry and the contributing to the development of common disclosure rules. During its monitoring activity, the ESAs can adopt guidelines and recommendations as well as issue warnings in the event that a financial activity poses a serious threat to the public interest[102].

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[100] Art. 28 of ibidem.
[101] Art. 9 of ibidem.
[102] So far, only the ESMA has issued warnings, notably:

- 5/12/2011, on investing in foreign exchange (Forex);
- 10/09/2012, on retail investors about the pitfalls of online investing;
- 18/04/2013, on contracts for differences (CFDs);

In addition, ESMA has issued two guidelines, namely:

- 06/07/2012, MiFID guidelines to enhance investor protection;
- 19/10/2012, guide to investing;

See www.esma.europa.eu

In addition, the ESAs have been attributed a role with regard to national deposit guarantee schemes[103]. The Authorities will contribute to strengthening the European system of national deposit guarantee schemes by ensuring the correct application of future rules concerning this matter[104].

2.5.2.7. Reporting and relationship with other entities

As for the ESRB, the ESAs' regulations specify reporting[105] and interaction duties[106] with other supervisory bodies.

Firstly, the ESAs are required to publish an annual public report[107] on their activities, providing information on the subset of the financial industry they deal with, including if any guidelines or recommendations have been issued and the level of compliance by the Member States. In addition, the annual report must detail which national competent authorities have not complied to counter breaches of EU law.

Secondly, the ESAs are to report to the European Institutions. The European Parliament and the Council may, at any time, request a statement by an ESA's Chairperson. The latter is to answer to any questions of the Members of the European Parliament.

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[103] Art. 26 of ESAs Regulations.
[104] See the European Commission proposal for a Directive …/…/EU of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], COM(2010) 369, SEC(2010) 835, SEC(2010) 824.
[105] Art. 50 of ibidem.
[106] Art. 36-37 of ibidem.
[107] Art. 53(7) of ibidem.

Regarding the interaction with other entities, the relationship with the ESRB is of utmost importance. The ESAs are to warn the ESRB on potential threats to financial stability, while they need to act upon warnings and recommendations given by the ESRB. Finally, the ESAs are required to consult with interest parties. In order to facilitate such consultation, a Stakeholder Group has been formalized for each ESA[108].

2.5.3. Limits

Despite the ESAs are to carry out several tasks, most of them of a complex nature, there exist some limits that threat the role played by the Authorities and may hinder their future evolution.

Starting from a mere financial standpoint, while the ESRB is financed and staffed by the ECB[109], the three ESAs have their own budget. The Authorities are financed 40% from the EU funds[110] and 60% through contributions from Member States. In addition, the EU legislators can require financial institutions to pay fees, which are then added to the ESA's budget. This is the case for ESMA that receives contribution from the Credit Rating Agencies (CRAs). The following table provides a comparison between the budget of the three ESAs, the British Financial Supervisory Authority (FSA) and the Italian Commissione Nazionale per le Società e la Borsa (Consob), for the year 2011, 2012 and 2013.

[108] EBA and ESMA have only one Stakeholder Group, while EIOPA has two Stakeholder Groups.
[109] Art. 3 of Council Regulation 1096/2010.
[110] These subsidies enter in the General Budget of the European Union.

Figure 2.7 - Budget comparison

	2011	2012	2013
EBA	€ 12.683.000	€ 20.747.000	€ 25.967.360
EIOPA	€ 10.667.000	€ 15.655.000	€ 18.767.470
ESMA	€ 16.962.000	€ 20.279.000	€ 28.235.000
Total	€ 40.312.000	€ 56.681.000	€ 72.969.830
FSA	£ 492.000.000	£ 543.500.000	£ 675.000.000
exchange rate	0,867884 *(2011 average)*	0,810871 *(2012 average)*	0,832709 *(1/2013 average)*
	€ 566.896.037	€ 670.266.911	€ 810.607.307
Consob	€ 132.650.000	€ 125.310.000	€ 121.070.000

Note: since 2013 the FSA has been divided into the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)

Source: Bank of Italy; EBA, EIOPA, ESMA,FSA and Consob annual reports and business plans

As the figure shows, the ESAs face a severe budget constraint that also leads to a staff constraint. This hinders the proper fulfilment of the tasks they are expected to perform. Even if EUR 73 million for the year 2013 might seem impressive, if it is compared with the FSA's budget for the same year it is approximately eleven times lower. Certainly, this kind of comparison is not very precise, since the EU and national level have diverse tasks. However it highlights the supremacy of national supervisors over EU-level ones.

Regarding the supervision, the ESAs' role remains limited. As said before, they are not empowered to conduct day-by-day supervision[111], but they can only collect information and monitor market developments. Even if they detect a problem, they can

[111] Except for ESMA that since 1 July 2011, is the responsible body regarding the registration and supervision of Credit Rating Agencies in the European Union. Additionally, new EU regulations have added future direct supervisory powers to ESMA's remit regarding trade repositories.

only act by forcing national supervisors or financial institutions, and only if there have been breaches in EU law or if the Council has declared an emergency situation. Therefore it is very difficult for the ESAs to seriously exert influence over financial markets.

Furthermore, even if the ESAs have been endowed with several binding competences, their role remains restricted due to the lengthy process and/or their subordination to an EU Institution. The following table provides an overview of these procedural constraints.

Table 2.5 - Procedural constraints

Task	Constraint
✓ *Adopting regulatory technical standards*	These are drafts; they need to be endorsed by the Commission . Furthermore, the European Parliament and the Council may reject them
✓ *Issuing guidelines and recommendations*	These are non-binding and are based on an "act or explain" mechanism.
✓ *Enforcement of EU rules*	The ESAs' action power is subordinated to the adoption by the Commission of a formal opinion
✓ *Settling disagreements*	The ESAs act as a mediator in the conciliation phase which can take considerable time
✓ *Dealing with distressed situations*	The ESAs can use their emergency powers only if the Council has declared an emergency situation

Source: personal elaboration

In the light of what previously said, it is likely that these powers are to be used scarcely[112]. As a consequence it seems that although the subordination to the Commission, the task of adopting draft regulatory technical standards will be the most prominent competence of the ESAs.

Finally, the ESAs' activities are limited by the presence of a fiscal safeguard clause. The vote of the European Parliament of 22 September 2010 was preceded by a protracted phase of disagreement with the Council[113] due to some Member States' reluctance to transfer powers to the EU level. The insertion of the fiscal safeguard clause was the consequence of the political agreement reached[114]. According to the safeguard clause[115], the ESAs are to ensure that no decision adopted in relation to an emergency situation or in settling a disagreement between national supervisors impinges in any way on the fiscal responsibilities of Member States, thus limiting the pecuniary repercussions of the ESAs' decisions. The following figure provides an overview of how the safeguard clause works.

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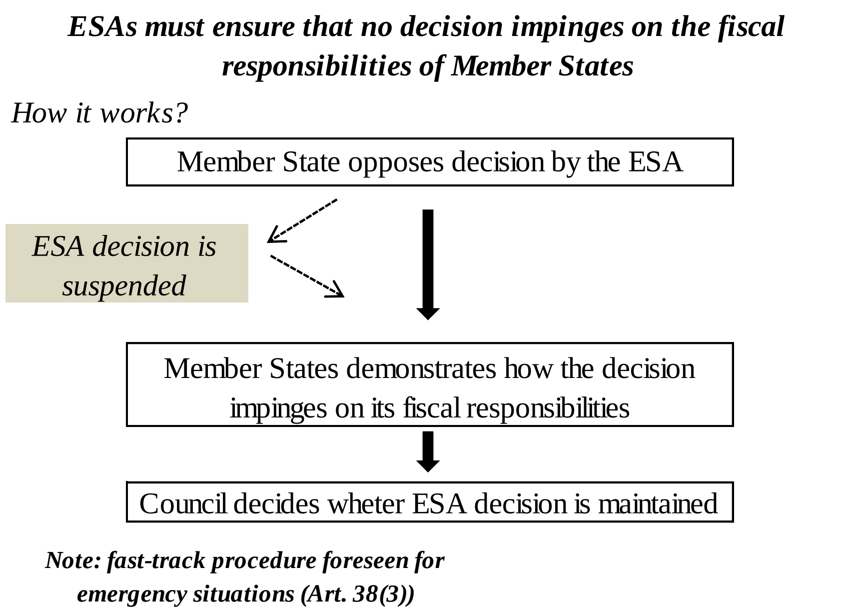
[112] From their inception the ESAs have never used their powers in the settlement of disagreements between national supervisors. In addressing breaches in EU law, the ESAs have not addressed any recommendations to national authorities nor addressed individual decisions to financial institutions; they have made use of only “soft” informal measures to bring about conformity of EU law. Regarding their supplementary powers in case of emergency, as so far no emergency situation has been declared by the Council, the ESAs have not made use of these powers; however, the ESAs have undertaken significant preparative work to ensure their capability to act efficiently in case an emergency situation will be declared. In order to ensure consumer protection, so far the only the ESMA has issued three warnings published on the relevant website (see www.esma.europa.eu).

[113] See the Council conclusions on Strengthening EU financial supervision, June 9, 2009, paragraph 9.

[114] The main points of disagreements between the Council and the EC were solved by introducing a "fiscal safeguard clause"; by granting to ESAs the final decision making power when different National supervisors overseeing an EU-wide operating financial firm are in disagreement; by empowering the ESAs with direct action towards National supervisors and in case of non-compliance directly to the financial institutions, but leaving to the Council the final power to declare an emergency; by designing the chair of the ECB as chairperson of the ESRB in order to guarantee some status of independence.

[115] Art. 38 of ESAs Regulations.

Figure 2.8 - Safeguard Clause



Source: Art.38 of ESAs Regulations

2.6. Review of the ESFS

The ESFS regulations provide for a review process by the Commission of the European Systemic Risk Board (ESRB) by 17 December 2013[116] and of the European Supervisory Authorities (ESAs) by 2 January 2014[117] and every three years thereafter. For the ESAs, the Commission is required to publish a general report on the experience acquired as a result of the operations and procedures of the Authorities. This review will

[116] Art. 8 of the ESRB Regulation 1096/2010.
[117] Art. 81 of ESAs Regulations.

require the Commission to assess, inter alia, the level of convergence in supervisory practices reached by competent authorities; the progress achieved in the fields of crisis prevention, management and resolution; the role played by ESAs in dealing with systemic risk; the application of the safeguard clause as well as the role played as mediator in settling disagreements between national supervisors. Furthermore, the Commission in its review is to evaluate whether it would be appropriate to simplify the ESFS, in particular, to enhance the coherence between the macro and the micro-prudential level, whether the evolution of the ESFS is in line with the global market development and finally if the financial and human resources of the ESAs are adequate to carry out their responsibilities. Then, the report is to be forwarded to the European Parliament and to the Council, together with any accompanying proposals, as appropriate.

A similar review is expected for the ESRB, where the European Parliament and the Council are to examine the Regulations establishing the ESRB on the basis of a report prepared by the Commission, in order to determine whether the mission and organisation of the ESRB need to be reviewed as well as the modalities for the designation or election of the Chair of the ESRB.

In order to perform this assessment process, the Commission issued a public consultation on 26 April 2013, to gather responses from a wide audience, comprising citizens, organizations and public authorities to inform the review. Of course, when carrying out the review, the Commission takes into account that the necessary legislation is not yet fully in place. Therefore the review is without prejudice to ongoing work on several legislative proposals (i.e. proposal on bank recovery and resolution, MiFID, etc.).

The review will also address the potential impact of the creation of a Single Supervisory Mechanism (SSM) on the ESFS, given the core role attributed to the ECB and, therefore, the Commission will assess whether this involves further adaptations to the legal framework underpinning the ESFS.

The Commission's legislative proposals of September 2012 on establishing a Single Supervisory Mechanism (SSM) constitute a first step towards a European Banking Union.

The next chapter, after having provided a narrative of the crisis developments in Europe, will deal with the process towards the establishment of a European Banking union, analyzing the concept and its rationale. Furthermore, it provides two insights on the EU banking sector and on the bank-sovereign link respectively.

3. Towards a European Banking Union

3.1. Incipit

In 2010, while the world tried to shake off the real and financial consequences of the global crisis, a new hotbed emerged in the Euro area. After the financial turmoil of 2007-2008 and a temporary improvement in the market climate afterward, characterized by the supportive measures undertaken by central banks and governments, new tensions emerged in late 2009.

The financial instability of Greece triggered a new wave of mistrust among international investors, directed this time towards the euro area sovereign bond markets.

Since then, the sovereign spreads rose sharply for many of the EU Member States, representing one of the biggest challenges for the European Monetary Union (EMU) since its creation. Raising investor concerns about sovereign risk, had adverse effects on banks and financial markets, due to the link between debt-burdened governments and troubled banks, where each side negatively impacted on the other, resulting in a vicious circle that threatened the stability of the "single market" in the European banking sector.

The situation was even most severe in some euro area countries, i.e. Greece and Ireland, with their credit ratings lowered several notches and a sizeable increase in sovereign debt spreads. In addition, through diverse transmission channels, this new wave of mistrust infected most of the European Member States, notably the southern countries, even if they presented different structural deficiencies compared to countries like Greece or Ireland. This was mainly due to the increasing interconnection of the European banking sector, where although banks remained under the supervision of the home country, they increased their cross-border activities and cross-holdings of sovereign debts. Through these channels the contagion founded easy ways of transmission.

Following the financial crisis of 2007 the EU supervisory framework already underwent a comprehensive reform[1], aimed at ensuring a stable, reliable and robust single market for financial services through the establishment of the European Systemic Risk Board (ESRB) in charge of macro-prudential supervision, and the creation of three new European Supervisory Authorities (ESAs), namely EBA, EIOPA and ESMA

[1] See Chapter 2.

charged with micro-prudential tasks. However, it changed a little from the former supervisory framework, since it simply provided more tools, used rarely, at the EU-level to exert power on national supervisors. Certainly, this new framework for financial supervision was a step in the right direction. However, the design as coordination framework means that national authorities have substantially retained competence for most decisions.

In the light of what has happened, and it is still happening, it is clear that the existing institutional framework of the European Monetary Union (EMU) based on the two building blocks of national competence and cooperation, it is not more a viable choice. Certainly, when it was created in the 1990s, with the most of banking activity confined to national markets, it was a right choice. However, the internationalization process of euro area banks plus the increasing interconnections of the banking system, posed new challenges to the existing framework, which failed to evolve in line with the industry. Nowadays, there is the need to move towards a more European solution for both banking supervision and crisis resolution at the EMU-level in order to preserve the proper functioning of the "single market" avoiding, or at least preventing, future crisis from occurring.

For the above reasons, the concept of a banking union has been revived during the last year. Built on a common single rulebook, it includes in the first place a fully integrated banking supervision for the euro area, with a competent supervisory institution, notably the ECB, being responsible for micro-prudential supervision with investigative powers. The creation of an integrated euro area Single Supervisory

Mechanism (SSM) will have obvious advantages compared with the status quo. With integrated supervision, for example, all relevant data for euro area banks would be made available in an aggregate form, allowing the single supervisor to identify all the financial links between Member States, as well as concentrations and therefore possible arising threats. Furthermore, a single supervisor will be more independent when dealing with the so-called "national champions", being in charge of safeguarding the interest of the EU as a whole rather than the specific national interests.

Although the SSM constitutes a major step towards a more integrated financial framework, in order for it to work properly it is essential that both deposit insurance and resolution schemes are reformed and implemented at EU-level. The former will strengthen the credibility of the banking sector by ensuring that eligible deposits of all credit institutions will be sufficiently assured. The latter will permit an orderly winding-down of non-viable institutions and thereby protecting tax payer funds. In the light of the recent Cypriot crisis, these arguments result particularly relevant.

This chapter discusses the crisis's developments in Europe (Section 1), highlighting the vicious circle instituted between banks and sovereigns. Section 2 deals with the concept of a banking union, retracing the main steps toward its creation. Although it seems to be a new concept, this idea dates back to the preparation of the Maastricht Treaty. Section 3 discusses the rationale behind the establishment of a banking union in the EU, analysing the main conjunctural and structural factors leading toward the revival of such a concept. Finally, section 4, provides a brief overview on how far we are towards completing the banking union in Europe.

In addition, this chapter contains two different insights, respectively on the EU banking sector and on the bank-sovereign link.

3.2. Crisis developments in Europe

After a "black year" characterized by massive bailouts on both sides of the Atlantic, 2009 was a relatively calm year in the financial markets. In terms of financial performance, it was a rebound year, with a price recovery that helped banks to repair their balance sheet and allowed them to return, in some cases, to profitability[2]. However, the situation was completely different for the real economy and the public finances, hardly impacted by the large stimulus packages approved by all major countries around the world in order to prevent the world economy from falling into a global depression. While these fiscal efforts had a considerable positive short-term effect, their long-term impact was uncertain. The stimulus spending plus the cost of state aid measures had a considerable effect on the level of sovereign debt.

From an international standpoint, the sovereign debt level of the euro area[3] is comparable to the level of the United States and significantly lower than that of the

[2] For instance, Deutsche Bank recorded a Net Income of €4,958 billion in 2009 as opposed to a loss of €3,896 billion in 2008 (Source: Deutsche Bank Annual Report 2009).
[3] In 2011 it amounted to EUR 8.3 trillion or around 87% of EU GDP.

Japan. Based on this comparison it would seem to be manageable. However, the euro area is not a fiscal union and the debt level differs across Member States.

When in November 2009 the Greek Prime Minister Papandreou revealed the true size of the country's deficit and debt, the sovereign risk became the main concern for investors spreading turbulence in the financial markets.

On 2nd May 2010, after lengthy negotiations, the Eurogroup and the International Monetary Fund (IMF) agreed upon a rescue package for Greece worth €110 billion to allow the refinancing of its debt out to 2014[4]. Furthermore, in order to address the ongoing emergency situation faced by EU Member States, a set of financial support and intervention instruments were established, cushioning the impact of the crisis and avoiding worse outcomes.

Simultaneously, at the extraordinary Ecofin Council of 9-10 May 2010[5], two new instruments were established, notably the European Financial Stabilization Mechanism (EFSM)[6] and the European Financial Stability Facility (EFSF)[7], to address the contagion

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[4] Statement of the Eurogroup – Brussels, May 2, 2010.

[5] Council of the European Union – Press Release N. 9596/10 (Presse 108).

[6] The EFSM established by the Council Regulation (EU) No. 407/2010 of May 11, 2010, is an emergency funding mechanism autonomously administered by the European Commission that provides financial assistance to EU Member States in financial difficulties. Through the EFSM the Commission is allowed to borrow up to €60 billion from financial markets on behalf of the Union and under an implicit EU budget guarantee. The EFSM may act through a loan or a credit line established for Member States. This particular lending arrangement implies that there is no debt-servicing cost for the Union. Interests and loan principal are repaid by the beneficiary via the Commission and in case of default by the borrower; the EU budget guarantees the repayment of the bonds.

[7] The EFSF is a temporary rescue mechanism based on bilateral lending between European Member States in partnership with the International Monetary Fund. Its mandate is to safeguard financial stability in Europe by providing financial assistance to euro area Member States within the Framework of a macro-economic adjustment program. To fulfil its mission, the EFSF issues bonds or other debt instruments on capital markets, allowing funding up to €440 billion backed by guarantees of the shareholder Member States. These guarantees total €780 billion. The EFSF is also authorized to intervene in the primary and

issue resulting from the Greek crisis. These instruments were designed to finance, through lending, the European Member States in financial distress. In the following months the EFSM was activated for Ireland[8] and Portugal[9], for a total amount up to €48.5 billion (up to €22.5 billion for Ireland and €26 billion for Portugal).

In addition to EU initiatives, the involvement of some Member States' banks in the financial crisis in Greece and Ireland led them to introduce national bailout measures to avoid the collapse of their national banking systems.

In the light of the sustained sovereign tensions and the ongoing economic and financial difficulties, the EU policy-makers decided that a permanent resolution mechanism, able to provide financial stability support, would be needed to address those critical situations where euro area Member States were facing difficulties and their financial instability could have posed a threat to the stability of the European Union as a whole. So, in February 2011, the Eurozone Finance Ministers set up a permanent bailout fund, or the European Stability Mechanism (ESM)[10], worth about EUR 500 billion[11].

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secondary bond markets and it may funds recapitalizations of financial institutions through loans to governments.

[8] For further information see http://ec.europa.eu/economy_finance/assistance_eu_ms/ireland/index_en.htm

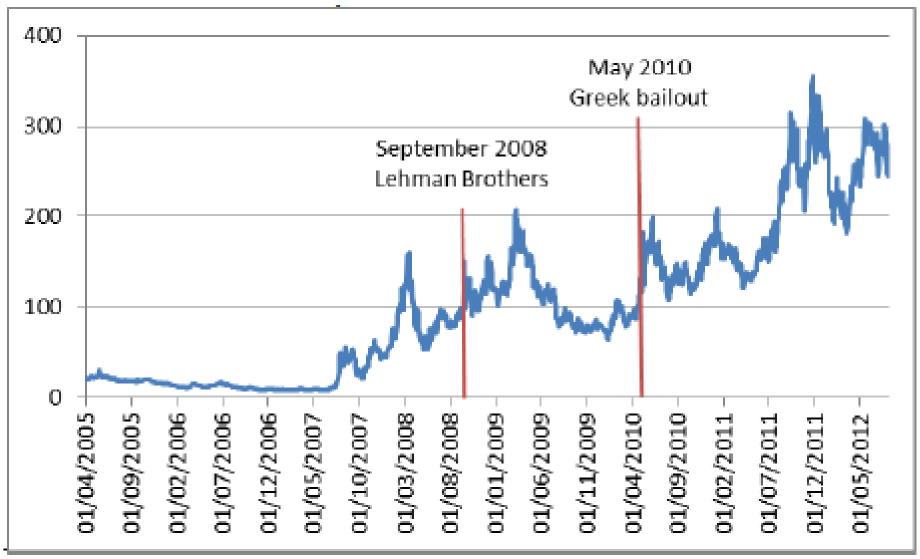
[9] For further information see http://ec.europa.eu/economy_finance/assistance_eu_ms/portugal/index_en.htm

[10] The Treaty establishing the ESM was signed on 2nd February 2012, establishing the ESM as an intergovernmental organization under public international law. The ESM was inaugurated on 8 October 2012 after the completion of the ratification process by the participating euro area Member States. From this point onward, the ESM is the primary support mechanism to euro area Member States. Like its predecessor – the temporary European Financial Stability Facility (EFSF) – the ESM provides financial assistance to euro area Member States experiencing or threatened by financing difficulties. The two institutions, ESM and EFSF, will function concurrently until mid-2013, after which the EFSF will not enter into any new programmes.

[11] Eurogroup meeting – Brussels, February 14, 2011 – Press conference by Jean-Claude JUNCKER, President of the Eurogroup and Commissioner for Economic and Monetary Affairs Olli REHN

These actions, if from one hand averted worse direct outcomes, on the other imposed significant costs on the European banking sector, since many investors were reluctant to invest in European banks, considering them too complex, insufficiently transparent and with uncertain future. As a consequence the access to debt capital market started to close for the majority of European banks, because investors began to require higher risk premia.

Figure 3.1 - iTraxx 5y CDS spreads of European Financials



Source: Liikanen (2012)

As the above figure shows, the 5-year iTraxx[12] CDS spreads of European Financials, by May 2010 were already higher than after the collapse of Lehman, rising to even higher levels in 2011 and 2012.

[12] iTraxx, Bloomberg code 'ITRX', is the brand name for the family of CDS index products covering regions of Europe, Australia, Japan and non-Japan Asia. The indices are constructed on a set of rules with the overriding criterion being that of liquidity of the underlying Credit Default Swaps (CDS). The iTraxx suite of indices are owned, managed, compiled and published by Markit. The most widely traded of the

Moreover, these interventions had the adverse outcome of transferring the insolvency risks from the private sector to the public finances, further strengthening the nexus between banks and national governments, being two faces of the same medal.

Regulatory efforts to restore confidence in the European banking sector proved insufficient. Although many banks passed the EU-wide stress test conducted in early 2010 by the Committee of European Banking Supervisors (CEBS)[13], the market was not convinced that these results truly reflected the situations faced by European banks.

Summing up, 2010 was a year characterized by the increasing pressure of high sovereign debt levels that led to trust erosion in the European banking system, due to the common belief that European banks held large portfolios of sovereign debt on their balance sheets.

During the first half of 2011 the anxiety continued to pervade financial markets, as, while Eurozone Ministers insisted upon new austerity measures for Greece[14], rumours of contingency plans for a Greek exit from the euro area started to circulate. It became evident that Greece would have not been able to meet the budgetary targets set by the Troika[15]. Consequently in June 2011 Standard & Poor's decided to downgrade

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indices is the iTraxx Europe index, also known simply as 'The Main', composed of the most liquid 125 CDS referencing European investment grade credits. (Source: www.markit.com).

[13] CEBS – 2010 stress tests results – July 23, 2010. (Source: www.eba.europa.eu).

[14] Statement of the Eurogroup – June 20, 2011.

[15] The Troika refers to the European Commission, the European Central Bank and the International Monetary Fund.

Greece's sovereign debt to CCC. After lengthy negotiations, a second rescue package[16] worth €109 billion was approved in July 2011[17].

Shortly after, in order to stabilize financial markets, on 7 August 2011, the ECB announces its Securities Markets Programme (SMP)[18], by which it was committed to buy Italian and Spanish government bonds[19].

Furthermore, a second EU-wide stress test, organised by the new established European Banking Authority (EBA) tried to address the sovereign debt exposures of European banks[20]. The stress test's results showed that eight banks had failed while sixteen were in the danger zone[21].

The mistrust on financial markets' resilience continued to rise, and the summer of 2011 brought additional financial tensions on the sovereign markets of Spain and Italy. However the change in their respective governments in the autumn of 2011 mitigated the situation.

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[16] This package included a swap for private debt holders, who would exchange their existing securities for partially collateralized papers with longer maturities and lower coupons, similar to the "Brady Bonds" used to resolve the Latin America debt crisis.

[17] European Council Conclusions – Brussels, July 21, 2011.

[18] The SMP consisted in interventions by the Eurosystem in public and private debt securities markets in the euro area to ensure depth and liquidity in those market segments that were dysfunctional. The objective was to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented towards price stability in the medium term. The impact of these interventions was sterilised through specific operations to re-absorb the liquidity injected and thereby ensure that the monetary policy stance was not affected. (Source: ECB website)

[19] Statement by the President of the ECB – August 7, 2011.

[20] EBA – 2011 stress tests results – July 15, 2011. (Source: www.eba.europa.eu).

[21] According to EBA press release of 15 July 2011, eight banks fell below the capital threshold of 5% CT1R over the two-year time horizon, with an overall CT1 shortfall of EUR2.5 billion, while sixteen banks displayed a CT1R of between 5% and 6%.

The EU enhanced the existing crisis mechanism available to Member States, namely the European Financial Stability Fund, EFSF, and made progress toward the establishment of a permanent mechanism, namely the European Stability Mechanism, ESM[22].

In this context, it was clear that most of European Banks needed to be recapitalized to cope with the increasing tensions in the sovereign debt market. On 27 August 2011, speaking at the Jackson Hole, Christine Lagarde, managing director of the IMF, said: *"(..) Banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereign and weak growth. This is key to cutting the chains of contagion"*[23].

In addition, in October 2011 the struggling Franco-Belgian bank Dexia received a huge bailout package, and one week later the European Commission President José Manuel Barroso further stressed that European banks needed to be recapitalized, but that Member States were responsible for that[24].

On its side the European Central Bank (ECB) unveiled new emergency loan measures to help banks, aimed at limiting market turbulence and avoid further national bailouts.

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[22] European Council Conclusions – Brussels, July 21, 2011.

[23] Lagarde Christine, speech: "Global risks are rising, but there is a path to recovery" – Jackson Hole, August 27, 2011.

[24] Live interview with YouTube/Euronews of October 6, 2011. Barroso said individual countries were responsible for the recapitalisation of their banks through markets, but admitted that in specific case more could be done.

In December 2011 the EBA published the recommendations and final results of its bank recapitalization exercise, carried as part of coordinated measures to restore confidence in the banking sector, showing that European banks needed to further strengthen their capital positions by building up an exceptional and temporary capital buffer against sovereign debt exposures[25].

Shortly after the ECB launched its first three-year Long Term Refinancing Operation (LTRO) in order to support European banks by improving liquidity in the market[26], followed by a second LTRO in early 2012 for a total of EUR 1.1 trillion (gross) liquidity injected into the European banking system. The two 3-years LTROs had an impressive impact on sovereign bond markets, since benefitting banks, and via the strong bank-sovereign nexus, they triggered a downward trend of the sovereign spreads in the more vulnerable Member States.

However, the recovery experienced at the beginning of 2012 remained short lived. Neither the huge amount of liquidity injected through the ECB's operations, nor the EBA efforts to improve transparency of bank's capital position or to foster the build-up of additional capital buffers led to a durable return to normality in financial markets, with banks licensed in vulnerable Member States that remained heavily reliant on ECB funding. Consequently, the negative market sentiment remounted and the crisis evolved into a crisis of confidence in Europe.

[25] EBA – 2011 capital exercise final results – December 8, 2011. (Source: www.eba.europa.eu).
[26] In this LTRO the ECB injected €489.19 billion.

This climate of instability, fuelled by the market participants' pessimism about the ability of Member States to reach their fiscal target for 2012, and by the increasing unsustainable public debt levels, gave rise to "flight-to-quality"[27] episodes also outside the Euro Area's borders, affecting other sovereigns such as Norway, Sweden and Switzerland. These, in turn, led to increasing differences between Member States' sovereign interest rates. For instance, for shorter maturities of German government securities, investors were even accepting zero or negative yields[28].

Despite signs of improvement after the two 3-years LTROs, the functioning of the euro money market remained somewhat impaired. Concerns on the counterparty credit risk regarding European banks licensed in vulnerable Member States, plus an environment of excess liquidity continued to depress market activity. Funding costs continued to diverge according to the geographic origin of both the counterparty and the collateral thereby hampering the uniform transmission of monetary policy throughout the euro area. In order to alleviate such concerns, the ECB's Governing Council took further measures to strengthen the transmission of monetary policy, pursuing the main objective of price stability in the euro area. On 6 September 2012, the ECB's Governing Council announced the preparation of Outright Monetary Transactions (OMTs), involving unlimited purchases on the secondary market of bonds of governments that seek bailout assistance from the EU's EFSF/ESM. In addition, it decided to suspend the

[27] It consists in upward jumps in the demand for low risk assets due to the uncertainty about asset payoffs and/or about the macroeconomic outlook.
[28] Also for Belgium, France, The Netherlands, Austria and Finland.

application of the minimum credit rating threshold requirement for assets issued or guaranteed by the governments of countries eligible for OMTs[29].

In this context, in September, the European Commission published two proposals[30] for conferring specific tasks on the ECB concerning the prudential supervision of credit institutions, in the light of the "Four Presidents" report[31] and the European Council conclusions of June 2012[32].

The Outright Monetary Transactions (OMTs) and the progresses with banking union left a clear trace in bank funding markets in the second half of 2012 and early 2013. Most indicators of risk sentiment improved, as the spiral of reinforcing upward trends in risk premia on sovereigns and banks, encountered during the sovereign debt crisis, were reversed. As a consequence of the improvements in the sovereign bond market, the funding costs of banks on debt security market fell, with a declining in banks' CDS also. Several EU banks returned to finance themselves through the markets, and also banks from vulnerable Member States were again able to issue substantial amount of debt securities.

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[29] ECB – Press release, September 6, 2012. (Source: www.ecb.int).

[30] European Commission – Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions – COM (2012) 511 final – Brussels, September 9, 2012.

European Commission – Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions – COM (2012) 512 final – Brussels, September 9, 2012.

[31] European Council – "Towards a Genuine Economic and Monetary Union", report by the President of the European Council Herman Van Rompuy, EUCO 120/12 (Presse 296) – Brussels, June 26, 2012.

[32] Euro Area Summit Statement – Brussels, June 29, 2012.

3.3. The need for a new regulatory and supervisory framework

The crisis demonstrated the rapidness with which financial distress spreads from one institution to another and to sovereigns, particularly in a highly complex and interconnected financial system such as the European. In addition, the presence of a strong linkage between the sovereign and the banking sector even threatened the financial stability of the euro area as a whole. From one hand Member States were individually responsible for rescuing banks licensed in their jurisdiction, being highly vulnerable to the cost of banking crises, especially in those situations where they were home to banks with significant cross-border activities. On the other, banks have been exposed to their own governments through their holding of debt securities[33]. This implied that whenever the sovereign was in a precarious situation, banks have been weakened as a consequence. Markets realized that such distortion was a source of significant vulnerability and, therefore, started to price the risk that governments would go further into debt, or even in default, as a consequence of bank weaknesses, or that banks would incur heavy losses as a consequence of sovereign bonds market turbulence.

In order to stabilize the financial system, weaken the destabilizing link between banks and sovereigns, and reverse the process of financial market fragmentation resulting from the retrenchment behind national borders to curtail contagion, the euro area needed to strengthen its supervisory and regulatory framework, creating a new one

[33] See Focus 3.2. – The bank-sovereign link.

bringing incentives in line with an internal market for banking services supported by a monetary union.

In this context the concept of a banking union was put forward by the President of the European Commission Barroso at the informal European Council, which took place on 23 May 2012. Since this meeting, the idea of a European banking union has attracted a lot of attention in the political debate, being even more often one of the hottest topics of discussion at the EU level during the last year.

3.3.1. What is a banking union?

As part of the comprehensive EU policy response to the crisis, during the last year, the Euro area leaders committed themselves to move quickly toward a banking union. The concept of a banking union represents an analogy of the monetary union and the political union. But, whilst, the former already exists, the latter is still an ambitious idea toward which many Member States strive.

Building on a single rulebook, a banking union refers to a structure under which participating Member States coordinate their banking systems along at least three main ways.

The first pillar consists in a common supervisory framework. Integrated supervision is essential to ensure the effective application of prudential rules, risk control and crisis prevention throughout the EU. This leads to an architectural reform towards a single European banking supervisory system, formed of a European and a national level, with the EU-level having the ultimate responsibility. However, national competent authorities may retain substantial powers, delegated from the EU-level supervisor and subject to its intervention. The EU-level micro-prudential supervision may be limited to the systemically important banks, with smaller banks remaining under the responsibility of national authorities. Notwithstanding this, the EU-level supervisor retains pre-emptive intervention powers applicable to all banks. Such a system would ensure that the supervision of banks throughout the EU is equally effective in reducing the probability of bank failures and preventing the need of intervention by joint deposit guarantee schemes or resolution funds.

Secondly, a common management of the resolution process for troubled banks is complementary to the EU-level supervision. When a bank is at risk of insolvency, the problem may be resolved through a restructuring process that includes several forms of aid, i.e. liquidity assistance and capital injections. However, in the event of actual insolvency, decisions need to be made on how the losses are to be allocated among investors, creditors, and other parties. Authorities may also decide to manage the bankruptcy procedure if necessary to safeguard the financial system. In Europe, this is a matter of concerns, since although banks are operative cross-borders, being pan-European rather than national, the resolution process remains essentially in the hands of individual Member States, with only some cross-border cooperation for international banks. In a banking union, these difficulties are resolved through the establishment of a Single Resolution Mechanism (SRM) managed by a single resolution authority.

Lastly, to be effective, a banking union necessitates a European deposit insurance scheme to introduce a European dimension to national deposit guarantee schemes for banks supervised at EU-level. Currently, deposit guarantee funds are purely national. Furthermore, the rules on how protection is provided differ considerably across countries. A banking union would be incomplete without a common guarantee fund or at least a fund that guarantees the national guarantors, so that depositors would no longer need to be concerned about whether their deposits are safe or not. It would strengthen the credibility of the existing arrangements and would serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured.

In addition, the EU-level resolution and the deposit guarantee schemes should be set up under the control of a common resolution authority. Nevertheless, the credibility of any deposit guarantee scheme requires access to a solid financial backstop. Therefore, as regards to the euro area, the European Stability Mechanism (ESM) is expected to act as a fiscal backstop to the resolution and deposit guarantee authority.

3.3.2. Banking union: an older idea than it seems

Although the idea of a banking union seems to be a new initiative borne out as a consequence of the crisis, actually it is based on an older debate. During the preparations of the Maastricht Treaty, in the early 1990s, there was already the strong conviction that a European system of banking supervision was a key element in the construction of the monetary union. One of the foremost proponent of this view was Brian Quinn, a Bank of England official, who chaired the preparatory sub-committee on banking supervision[34].

This conviction was based on the logical observation that, since the single currency would have deepened financial interdependence in Europe, the latter would have required an integrated system of financial supervision. Although, at the end, a different view prevailed, the force of this conviction explains why the Treaty on the Functioning of the European Union (TFEU) states at the Article 127(6) : *"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"*. Therefore, the Treaty left open the possibility to establish a single system of banking supervision.

Already in 1999, Tommaso Padoa-Schioppa[35] underlined that the Treaty allows the reconsideration of the institutional framework without recurring to the very heavy treaty amendment procedure[36]. This is a highly significant indication that the drafters of the Treaty clearly understood the anomaly of the double separation between central

[34] Constancio, Vitor – Speech, "The nature and significance of Banking Union", London – March 1, 2013.
[35] During a lecture held at the London School of Economics on 24 February 1999, on the topic "EMU and banking supervision".
[36] Such procedure requires an intergovernmental conference, ratification by National parliaments and sometimes even a National referendum.

banking and banking supervision and saw the potential difficulties arising from that. According to Padoa-Schioppa, this simplified procedure can be interpreted as a "last resort clause" provided in the case the cooperation between the Eurosystem[37] and national supervisory authorities, turned out not to work effectively. In addressing the future developments of the banking industry in Europe, he said, *"I am convinced that in the future the needs will change and the multilateral mode will have to deepen substantially. Over time such a mode will have to be structured at the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the euro area to be as prompt and effective as it is within a single nation"*[38].

Again, when the first signs of the global financial crisis had just begun to appear, whilst the prevailing mood in Europe was still one of confidence, Padoa-Schioppa, at that time the Italian Finance Minister, was among the few to grasp the full implications of those events for the monetary union and for the European institutions. He firmly believed that the crisis would give rise to the opportunity and need to reform the financial architecture in Europe. He argued that Europe should react to the crisis by creating a unified regulatory and supervisory framework, notably a banking union to complete and support the still unfinished and fragile monetary union. He proposed this

[37] The Eurosystem consists of the European Central Bank and the central banks of the member states that belong to the Eurozone. The Eurosystem is distinct from the European System of Central Banks, which is the group of central banks that includes the ECB and the central banks of all European Union member states, including those countries not included in the Eurozone.
[38] Padoa-Schioppa, Tommaso – Lecture; "Emu and banking supervision", London School of Economics – February 24, 1999.

vision several times, i.e. at the Ecofin informal meeting of Porto in September 2007. However he always received virtually no support from his European peers[39].

This is noteworthy, considering that Padoa-Schioppa could have not imagined what would have been the consequences of the financial crisis. Five years on, views have totally changed, with the forthcoming establishment of the Single Supervisory Mechanism (SSM) as a first step towards a European banking union.

3.3.3. What have been to date the steps toward a banking union?

The Report "Towards a Genuine Economic and Monetary Union"[40], commonly known as the "Four Presidents Report"[41], represents a milestone in the process of European integration. It officially introduced the concept of a Banking Union, being one of the four essential building blocks[42] envisaged to complete the European architecture for long-term stability and prosperity of the Economic and Monetary Union (EMU). About that, in the report, the President Herman Van Rompuy affirmed: *"An integrated*

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[39] Angeloni, Ignazio – "Towards a European Banking Union", CESifo Forum, April 2012.

[40] European Council – "Towards a Genuine Economic and Monetary Union", report by the President of the European Council Herman Van Rompuy, EUCO 120/12 (Presse 296) – Brussels, June 26, 2012.

[41] Because it was the result of the collaboration between the President of the European Council, the President of the European Commission, the Chair of the Eurogroup and the President of the European Central Bank.

[42] These are:

1. An integrated financial framework;
2. An integrated budgetary framework;
3. An integrated economic policy framework;
4. Ensuring the necessary democratic legitimacy and accountability of decision-making within the EMU;

financial framework to ensure financial stability in particular in the euro area and minimize the cost of bank failures to European citizens. Such a framework elevates the responsibility for supervision to the European level, and provides for common mechanisms to resolve banks and guarantee customer deposits"[43].

Following this report, on 29 June 2012, the euro area heads of state and government agreed to move toward a banking union, with an initial emphasis on the establishment of a Single Supervisory Mechanism (SSM), involving the ECB on the basis of the article 127 (6) of the TFEU that allows the ECB to take on supervisory powers on banks. Moreover, it was noted that the establishment of the SSM would open up the possibility of the ESM direct recapitalization of banks, rather than by funding national governments that would then fund their own banks at their own risk[44].

This was further stressed by the president Barroso during a speech held before the European Parliament, saying *"The banking union will be designed to fully address the structural shortcomings in the institutional framework for financial stability. (..) I believe a banking union is an indispensable step"*[45].

Contextually, the European Commission was mandated to present proposals for the single supervisory mechanism and the European Council was requested to consider

[43] European Council – "Towards a Genuine Economic and Monetary Union", report by the President of the European Council Herman Van Rompuy, EUCO 120/12 (Presse 296) – Brussels, June 26, 2012 – pag.3.
[44] Euro Area Summit Statement – Brussels, June 29, 2012.
[45] Barroso, Josè Manuel – Speech at the European Parliament Plenary Debate on the European Council of 28-29 June 2012.

these proposals as a matter of urgency by the end of 2012[46], by inviting the President of European Council to develop, collaborating closely with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound roadmap for the achievement of a genuine Economic and Monetary Union.

In September the European Commission offered its proposals[47] for a Single Supervisory Mechanism and published an accompanying communication outlining the roadmap towards a banking union[48]. Precisely, the European Commission offered two legislative proposals, respectively for the setting up of a SSM by conferring tasks on the ECB concerning policies relating to the prudential supervision of credit institutions and for adaptations to the Regulation setting up the European Banking Authority (EBA). These first proposals called for a new body within the ECB to take on overall supervisory authority for all Eurozone banks and those of other EU countries which reach agreement with the ECB about inclusion. In addition, national authorities would continue to be the main day-to-day supervisors, but the ECB would have ultimate responsibility and could take over day-to-day supervision to whatever extent chosen for those banks where it would felt this to be necessary. Regarding the EBA, the proposals

[46] Euro Area Summit Statement – Brussels, June 29, 2012.

[47] European Commission – Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions – COM (2012) 511 final – Brussels, September 9, 2012.
European Commission – Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions – COM (2012) 512 final – Brussels, September 9, 2012.

[48] European Commission – Communication, "A Roadmap towards a Banking Union", COM(2012) 510 final – Brussels, September 9, 2012.

authorized it to create a “single supervisory handbook” which would apply across the EU and which the ECB would be required to follow.

On 12 October, the European Council issued the interim version of the report “Towards a Genuine Economic and Monetary Union”[49]. This interim report was largely based on ideas and proposals that were expressed during a series of bilateral meetings in September with all EU Member States and with the European Parliament and its President. The aim of this report was to highlight points of convergence and to outline areas that would have required further work.

The European Council Summit of 18 October 2012 reached a series of conclusions on banking union. Stressing the need to move towards an integrated financial framework, open to the extent possible to all Member States wishing to participate, the European Council invited the legislators to proceed with work on the legislative proposals on the SSM as a matter of priority[50]. Furthermore, the Eurogroup was called to draw up the exact operational criteria for direct bank recapitalization by the ESM[51], in full respect of the 29 June 2012 euro area Summit statement. The Council stressed the need to break the vicious circle between banks and sovereigns and noted the Commission’s intention to propose a Single Resolution Mechanism for Member States participating in the SSM once the proposals for a Recovery and Resolution Directive[52]

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[49] European Council – “Towards a Genuine Economic and Monetary Union”, interim report – Brussels, October 12, 2012.
[50] EU Council – Conclusions on completing EMU – Brussels, October 18, 2012. Point 2, 4-9.
[51] EU Council – Conclusions on completing EMU – Brussels, October 18, 2012. Point 10.
[52] Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives

and for a Deposit Guarantee Scheme Directive[53] would be adopted. Overall, these summit conclusions generally supported the Commission's proposal, but leaved room for further modifications and compromises.

On 28 November 2012, the European Commission adopted a blueprint for a deep and genuine Economic and Monetary Union, which provided a vision for a strong and stable architecture in the financial, fiscal, economic and political domains[54]. The Blueprint is the Commission's contribution to the "Four Presidents" report, a final version of which was being prepared for discussion at the European Council of 13-14 December. Commenting on the Blueprint, José Manuel Barroso, President of the European Commission said: *"We need a deep and genuine Economic and Monetary Union in order to overcome the crisis of confidence that is hurting our economies and our citizens' livelihoods. We must give tangible proof of the willingness of Europeans to stick together and move forward decisively to strengthen the architecture in the financial, fiscal, economic and political domains that underpins the stability of the Euro and our Union as a whole"*[55]. The Blueprint set out the path to a deep and genuine EMU, involving incremental measures to be taken over the short, medium and longer term.

77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 – COM (2012) 280/3.

[53] Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast] – COM (2010) 368 final.

[54] European Commission – Communication, "A Blueprint for a deep and genuine economic and monetary union – Launching a European Debate", COM (2012) 777 final – Brussels, November 11, 2012.

[55] European Commission press release IP/12/1272 – Brussels, November 28, 2012.

On 3 December 2012, the European Parliament's ECON Committee published reports[56] tabled for the plenary session. These documents included amendments to European Commission's proposals.

On 5 December 2012, the European Council published the final report "Towards a Genuine Economic and Monetary Union"[57], based on the former interim report and the EU Council's conclusions of October 2012. This final report provided the background to the roadmap presented at the December 2012 European Council. It suggested a timeframe and a stage-based process towards the completion of the Economic and Monetary Union (EMU) covering all the essential building blocks identified in the report presented at the June European Council, incorporating valuable inputs provided by the Commission's Blueprint.

On 14 December 2012, the European Council agreed on a roadmap for the completion of the EMU[58], stressing that in a context where bank supervision is effectively moved to a Single Supervisory Mechanism, a Single Resolution Mechanism will be required, with the necessary powers to ensure that any bank in participating Member States can be resolved with the appropriate tools. Furthermore, at the extraordinary meeting of the Economic and Financial Affairs, the Council set out its position on the two proposals aimed at establishing a SSM for the oversight of credit

[56] Committee report on the proposal for a Council Regulation and a Committee report on the proposal for a Regulation of the EP and of the Council.
[57] European Council – "Towards a Genuine Economic and Monetary Union", final report – Brussels, December 5, 2012.
[58] European Council Conclusions EUCO 205/12 – Brussels, December 14, 2012.

institutions. Two compromise text were published, namely a consolidated text[59] on the proposal for a Council Regulation conferring specific tasks on the ECB conferring policies relating to the prudential supervision of credit institutions, and a General approach[60] on the proposal for a Regulation amending the Regulation establishing the EBA as regards to its interaction with the SSM.

The President Barroso further stressed this exciting result, saying: *“"I warmly welcome this exceptionally important agreement on the Single Supervisory Mechanism reached by the Council. Based on the proposal tabled by the Commission on 12 September, this is a crucial and very substantive step towards completion of the banking union and a timely step forward in the integration of financial supervision for the euro area. (..) I want to underline that in four months we have moved from a Commission proposal to political agreement by the Council, which demonstrates once again that the European Union has the political will and capacity to act quickly on momentous issues"*[61].

[59] European Council – Interinstitutional file 2012/0242(CNS) – ECOFIN 1080, EF 316 – Brussels, December 14, 2012.
[60] European Council – Interinstitutional file 2012/0244(COD) – ECOFIN 1081, EF 317, CODEC 3057 – Brussels, December 14, 2012.
[61] Barroso, Josè Manuel – Written Statement, Brussels, December 13, 2012.

3.4. Why a banking union?

In an integrated currency area, financial stability is a matter of collective responsibility. The sovereign debt crisis and the contagion effect, made it clear the necessity to speed up the economic and financial unification process in the euro area.

At the basis of the banking union concept, there are both conjunctural and structural factors (table 3.1). Those conjunctural are direct consequences of the financial crisis, notably of the European sovereign debt crisis, while the structural ones are related to the deficiencies showed by the European institutional framework during the crisis.

Table 3.1 - Why a banking union?

Conjunctural factors	Structural factors
✓ Bank-sovereign link	✓ Financial integration vs. national supervision
✓ Financial fragmentation	✓ Monetary policy transmission
✓ Restore credibility of the financial sector	✓ Reduce "ring-fencing"
✓ Preserve tax payers' money	

Source: personal elaboration

3.4.1. Conjunctural factors

The conjunctural factors that foster towards the establishment of a banking union are mainly recognized in the need to break the vicious circle between Member States and their banking sector, to address the financial fragmentation in times of crisis, to restore credibility of the financial sector and to preserve tax payers' money.

3.4.1.1. Break the link between banks and sovereigns[62]

The crisis was partially caused by national banking crises. In countries like Ireland and Spain, failing banks added huge amount of liabilities to the sovereigns' balance sheets, while in others, like Greece, the problems of sovereigns endangered the banking sector through various transmission channels.

In this context, the correlation between the funding costs of euro area banks and those of their respective sovereigns have increased, notably in the peripheral economies. This divergence in bank funding conditions at national level, in turn, gave rise to cross-country differences. In addition, with the lack of countries' ability to control local interest rate conditions, the existing architecture strengthened the link between banking sector and sovereign's public finances.

This link goes in both directions. Firstly, from banks to sovereigns, particularly in those countries where financial supervision has not worked properly, where the deficiencies of some banking systems have determined a rapid deterioration in the public finance conditions. This posed the basis for the sovereign debt crisis and for the consequent contagion effect. In order to prevent this from happening again, a European

[62] For insights see Focus 3.2.

integrated system of financial supervision is necessary to break the vicious link between banks and sovereign. Firstly, its constitution will favour the adoption of the supervisory best practices. Secondly, a common supervisory framework will attenuate national interests, i.e. in safeguarding the so-called “national champions”.

As for the second direction, from sovereign risk to banks, in countries where the health status of public finances is impaired, the banks’ conditions are closely dependent on those of sovereign. This happens, because the instability of the public sector undermines the market participants’ perceptions on the sovereign’s ability to successfully activate national resolution mechanism. This sentiment negatively impacts the banking sector stability, through for example the downgrading of financial institutions or the increase in the cost of funding they have to bear. Ultimately, this impacts on the competitiveness of banks operating in the single market. Moreover, the constitution of a European mechanism for crisis resolution will help in breaking this link.

3.4.1.2. Financial fragmentation

Growing pressures in funding and lending markets during the crisis have led to a fragmentation of the euro area banking system along national lines. Banks were more often unwilling to lend to banks in other countries, being in contrast with the pre-crisis period when there was a very active cross-border market. National authorities revealed unduly favourable toward their national banking systems, regardless of outward negative spillovers, so exacerbating the fragmentation in financial markets. This disintegration of the European banking market also destroyed many of the advantages envisioned when the EU moved to create a unified financial market. In this context it is nearly impossible to have an integrated market when funding costs and credit availability significantly vary across Member States.

Being more conscious of cross-country spillovers than national supervisors, an integrated system of financial supervision would correct the financial institutions' trend to increasingly focus on their national home markets in times of crisis. In turn, this will even support provision of services by financial institutions across Member States, particularly ensuring an efficient deployment and allocation of capital across the euro area and the EU as a whole. The institution of a banking union is intended to restore confidence in banks all across the Eurozone, allowing a freely cross-border funds flowing.

3.4.1.3. Restore credibility of the financial sector

The establishment of a European system for banking supervision will enable a supervision of the highest quality, unfettered by other non-prudential considerations, i.e. political assessments when dealing with a "national champions" or free riding problems when dealing with the resolution of cross-border financial institution. The institution of a banking union will benchmark and foster good practices among European banks and will help in changing the sadly common belief that banks are European in life, but national in death.

3.4.1.4. Preserve tax payers' money

The amount of approved funds to rescue financial institutions during the crisis has been unprecedented[63]. In order to preserve tax payers' money, the institution of a banking union, notably of a single recovery and resolution mechanism, will equip national authorities with tools to force the orderly restructuring of banks in danger of insolvency with a view to preserving components that are considered systemically important from a financial stability standpoint. The financial burden will be put first, and foremost, on shareholder and creditors, not on taxpayers, known as "bailing-in" instead of "bailing-out" banks.

3.4.2. Structural factor

Of no less importance are the structural factors, namely the incomplete institutional architecture of the EU with the contradiction "financial integration versus

[63] See Focus 3.1 – The EU banking sector.

national supervision", the ineffective monetary policy transmission throughout the EU, and the Member States "ring-fencing" tendency.

3.4.2.1. Financial integration vs. national supervision

Although the euro area is characterized by a dense network of cross-border financial institutions, the existing architecture is based largely on national competences regarding supervision, resolution and deposit guarantee schemes.

Even before the financial crisis, Tommaso Padoa-Schioppa underlined the contradiction of having an integrated financial area with supervisory tasks at national level[64]. The increasing interconnection between markets and intermediaries, notably for those with cross-border operations, revealed how rapid the risks transmit throughout the market, infecting all financial institutions regardless of their home country and negatively impacting on the financial stability of the EU as a whole. It is no more affordable for an integrated market to have each country acting on its own regarding crisis management. This because national policies usually aim at maximizing the internal welfare, not considering the possible negative externalities they create.

The institution of a banking union, with a single EU-level authority in charge of supervision, will better identify, monitor and assess the arising vulnerabilities, rather than through cross-border cooperation arrangements.

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[64] Padoa-Schioppa, Tommaso – Lecture; "Emu and banking supervision", London School of Economics – February 24, 1999.

3.4.2.2. Monetary policy transmission

The financial crisis determined a market fragmentation along national borders, due to an increasing perception of intermediaries' counterparty risk, caused also by a general wave of mistrust on both banks' health status and public finances. During the crisis "flight-to-quality" episodes caused an outflow of capitals from peripheral countries to those considered most solid. The low diversification and high exposure toward sovereigns of financial institutions hampered the proper monetary policy transmission, determining an uneven distribution of the level of long-term interest rates among European Member States. Compared with the same reference rate set by the ECB monetary policy, credit costs diverged between euro area countries, being higher in those Member States characterized by weaker economic conditions. A single system of banking supervision would favour the effective transmission of monetary policy.

3.4.2.3. Reduce "ring-fencing" practices

The crisis was characterized by a lack of common supervisory practices in dealing with cross-border financial institutions that gave rise to several inefficiencies. One of these was the Member States tendency to protect national financial borders, namely "ring-fencing". A unified system of banking supervision would reduce these ring-fencing practices, favouring the proper functioning of the single market. This in turn would foster the economic growth and therefore the recovery process.

3.5. How far are we towards completing a Banking Union?

On the main elements of a genuine banking union, progress is currently positive on all fronts, but it is also uneven.

First, the single rulebook, that to a large extent already exists, will be complemented by the agreement on the CRD4 (Capital Requirements Directive IV) expected in the near future. This will contribute significantly towards making the banking sector in Europe more stable by creating a level playing field.

Regarding the common resolution framework, a proposal for the establishment of a Single Resolution Mechanism (SRM) should be presented by the European Commission in the second half of this year. In the meantime, the Bank Recovery and Resolution (BRR) Directive should be adopted. This in turn will provide a better framework for coordinating resolution of cross-borders financial institutions providing national authorities with new resolution powers, i.e. writing down capital instruments and bailing-in creditors. The adoption of the BRR Directive will help to protect taxpayers by ensuring that the financial sector will bear the burden of any future bank resolution.

The creation of a common financial backstop in already underway with the possibility for the European Stability Mechanism (ESM) to directly recapitalise banks being currently one of the most important topic of discussion. However, only those banks joining the SSM will be able to apply for it. In the short-term this will help to weaken the bank-sovereign nexus, while in the longer-term the ESM could act as fiscal backstop to the resolution and deposit guarantee authority.

With regards to the establishment of a common system of deposit protection, the adoption of the Commission's proposal of 2010 on deposit guarantee schemes is expected in the second half of this year. This will in turn help to restore confidence in the national schemes, by providing a harmonized framework at the EU-level.

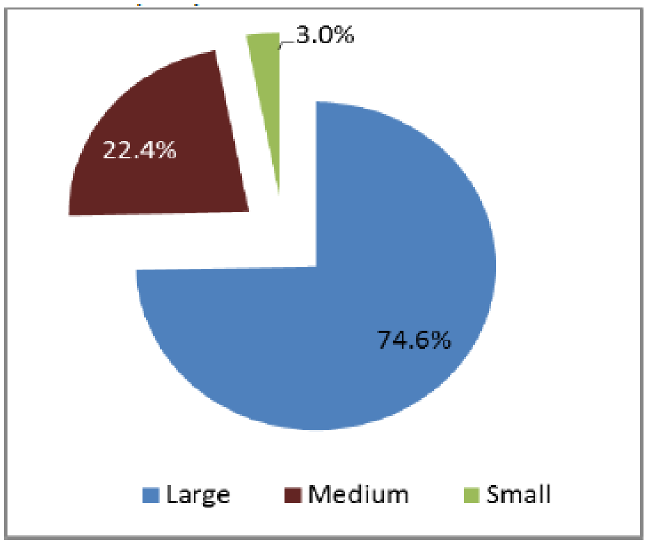
Finally, the progresses on the Single Supervisory Mechanism are already well advanced. The two regulations setting up the SSM have already been approved the last December by the Council. In March the Council published two final compromise texts that are now being discussed by the European Parliament. The latter partially approved the draft legislative texts at its Strasbourg plenary session on 22 May 2013. The final vote is expected to take place on the next September plenary session.

The following chapter provides a detailed analysis of the Single Supervisory Mechanism, in the light of the Commission's proposals of September 2012 and of the final compromise texts of March 2013.

Focus 3.1. The EU banking sector

In the EU there are approximately 8000 credit institutions[1]. In order to determine the close relationship between the developments in the financial sector and the fiscal condition of sovereigns in Europe, the most important factor is the size European banks have achieved over time. According to Schoenmaker (2011)[2] the European banks can be split in relation to their size, forming three groups.

Figure 3.2 - Assets held by large, medium and small EU banks (2011)



Source: Liikanen (2012)

A first very large group consists of small banks operating regionally. For example, this is the case in particular for Germany and Austria that have many small savings and cooperative banks most of which having assets less than €1 billion. A

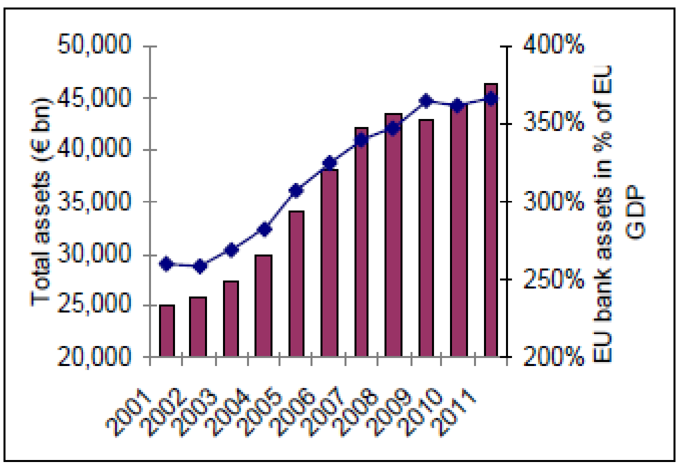
[1] European Commission – "European Financial Stability and Integration Report 2012", April 2013, pag.20.

[2] Schoenmaker, D. (2011), "The European banking landscape after the crisis", Duisenberg School of Finance Policy Paper No. 12.

second group consists of medium banks often operating on a nation-wide scale with assets ranging from €1 billion to €100 billion. Finally, the third group consists of the large banks usually operating on an international basis, and having assets that exceed €100 billion. However, as the figure 3.2 shows, the large banks group make up about three-quarters of total banks assets in the EU.

Looking at the size growth of the European banking sector in the years leading up to the financial crisis, it is evident the increased role of financial intermediation. As the following figure shows, total assets of MFIs[3] in the EU reached €43 trillion by 2008 or about 350% of EU GDP.

Figure 3.3 - Total assets of MFIs



Note: Bar charts show total assets, dotted line shows assets in % of GDP.

Source: Liikanen (2012)

[3] "Monetary Financial Institutions" (MFIs) is the term used by the ECB. MFIs include credit institutions as defined in Community law, and other financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account, to grant credits and/or make investments in securities. Also money markets funds are classified as MFIs.

On an international comparison, for example, in the US the banking sector accounts for 78% of US GDP, while in Japan for 174% of GDP (figure 3.4).

Figure 3.4 - Size of EU, US and Japanese banking sectors (2010)

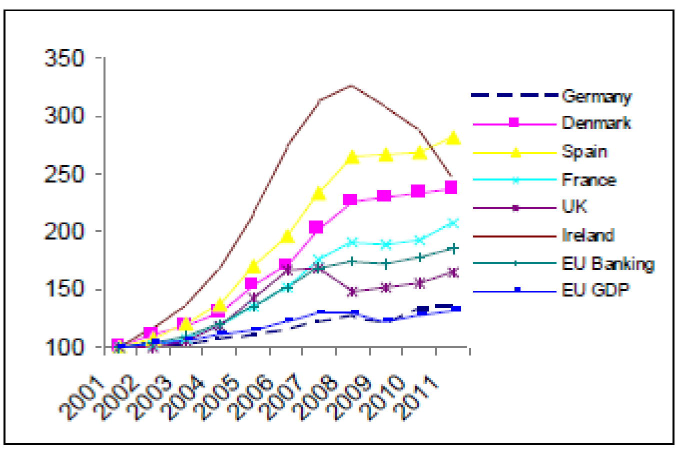
	EU	USA	Japan
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

Notes: Top 6 banks for Japan.

Source: Liikanen (2012)

These are risk factors that cannot be ignored, although they also reflect the greater dependence of the European economy on bank financing than elsewhere. However, the aggregate data mask the significant differences existing between Member States. As the following figure shows, countries like Spain and Ireland experienced the highest growth MFI assets between 2001 and 2008, while other Member States grew less in the year preceding the crisis.

Figure 3.5 - Total MFI assets

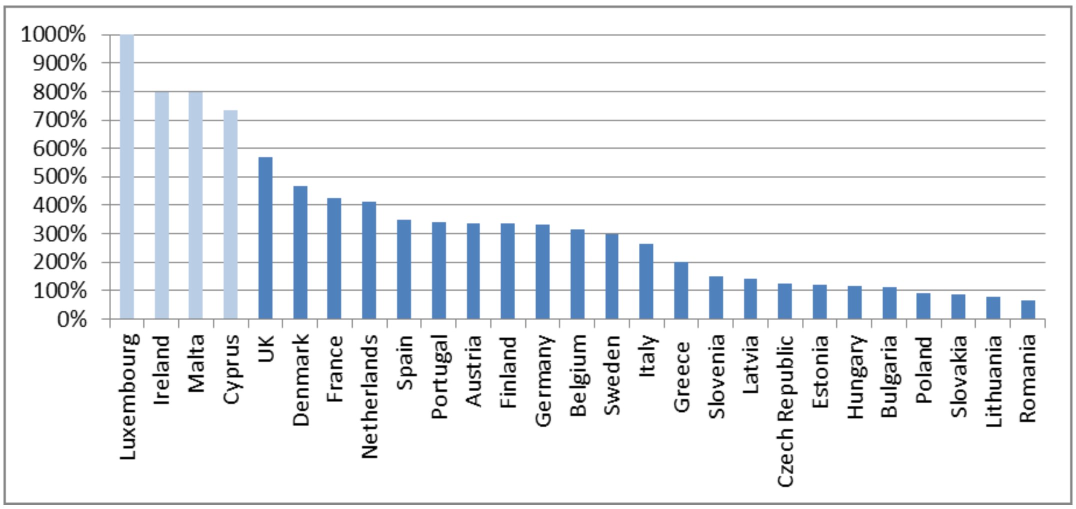


Note: index, 2001 = 100

Source: Liikanen (2012)

The European banking sector is also characterised by a significant variation in the industry size amongst the European countries. In absolute terms the United Kingdom, Germany and France has the largest banking sector[4]. As figure 3.6 shows, in relative terms (in % of national GDP), the MFIs assets are the largest in Luxembourg, Ireland, Malta and Cyprus.

Figure 3.6 - Total assets of MFIs in the EU, by country (in % of national GDP)



Source: Liikanen (2012)

Another important feature of the European banking landscape is the relative size of its top ten banks. As figure 3.7 shows, at the end of 2011 the European top-ten banks held assets worth around €15 trillion or 122% of EU GDP.

[4] With total assets of MFIs amounting to €9.93 trillion, €8.52 trillion and €8.42 trillion respectively.

Figure 3.7 - Large EU banks (2011)

Bank	Country	Total assets (€ million)	Total assets/ national GDP (%)	Total assets/ EU GDP (%)
Deutsche Bank	DE	2,164,103	84.8	17.4
HSBC	UK	1,967,796	119.8	15.8
BNP Paribas	FR	1,965,283	99.8	15.8
Crédit Agricole Group	FR	1,879,536	95.4	15.1
Barclays	UK	1,871,469	113.9	15.0
RBS	UK	1,803,649	109.8	14.5
Santander	ES	1,251,525	118.2	10.1
Société Générale	FR	1,181,372	60.0	9.5
Lloyds Banking Group	UK	1,161,698	70.7	9.3
Groupe BPCE	FR	1,138,395	57.8	9.1

Source: Liikanen (2012)

During the financial crisis, in the absence of corrective measures, the EU governments potentially had to backstop very large financial institutions. Banking sector restructuring, since the beginning of the crisis, has been very slow, with only few bank liquidations. This was mainly due to the lack of a common resolution framework.

According to the Commission's 2012 State Aid Scoreboard[5], between October 2008 and December 2011, the amount of national support used by banks amounted to roughly €1.6 trillion (or 12.3´% of EU GDP). Liquidity support accounted for the largest parts amounting to roughly €1.27 trillion (9.3% of EU GDP) in the form of state guarantees and other short-term liquidity support measures. Support to bank solvency

[5] European Commission, COM (2012) 778 final, State Aid Scoreboard – Report on state aid granted by the EU Member States – Autumn 2012 Update

amounted to roughly € 0.4 trillion (3.5% of EU GDP) in recapitalisation measures and sorting out the impaired assets.

It is noteworthy to underline that three EU Member State accounted for nearly 60% of the total aid used, notably the United Kingdom (19%), Ireland (16%) and Germany (16%). In addition, the top three beneficiaries in the former two countries received more than 80% of all aid, while those in Germany received more than half[6].

[6] For further information see the Commission staff working document – Facts and figures on State aid in the EU Member States – 2012 Update, accompanying the EC document COM(2012) 778 final.

Focus 3.2. The bank-sovereign link

Since the beginning of the European sovereign debt crisis, the strong linkage between banks and sovereigns has been frequently emphasized, underlying the need to break this vicious circle in order to restore confidence in the financial sector, notably in the banking sector, posing the basis for recovery from the crisis.

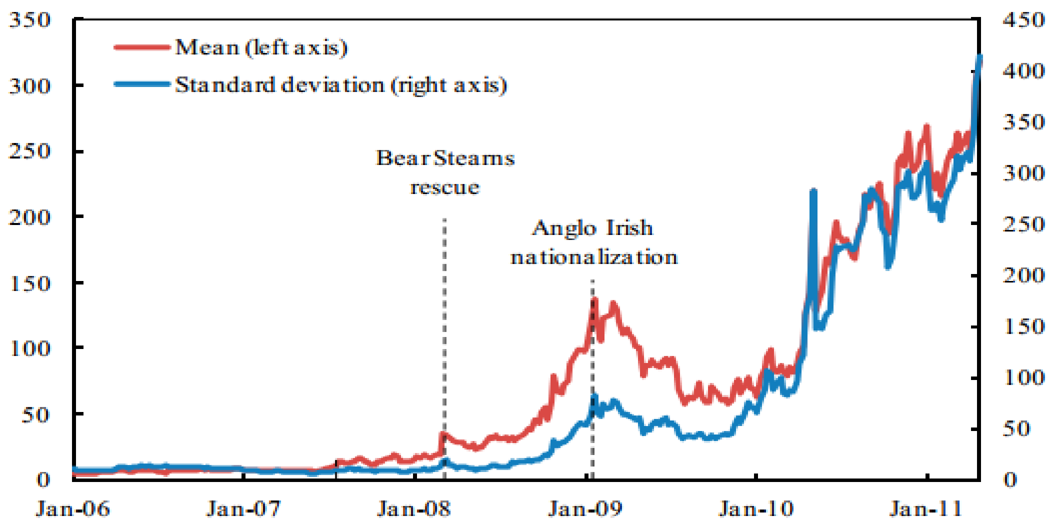
The financial crisis and the consequent global recession caused a sharp deterioration in the public finances across advanced economies, notably in the euro area, where the concerns about sovereign risk led some countries to see their credit ratings downgrading and their funding costs rising sharply. This adversely affected the banking sector, deteriorating the funding opportunities, raising the costs and in some cases even threatening the very existence of banks. The impact on banks was in line with the perceived deterioration in the creditworthiness of the home sovereign, suggesting that investors were focusing on banks' jurisdictions as well as their creditworthiness.

According to Mody (2009)[1], the roots of this vicious circle can be recognized in two main events, namely the rescue of Bear Sterns in January 2008 and the Anglo Irish nationalization of January 2009. Before them, the spreads of European sovereign bonds moved randomly in a narrow range with only modest differentiation across countries. This stability was also considered a hallmark of successful financial integration within the euro area.

[1] Mody A. (2009) "From Bear Sterns to Anglo Irish: How Eurozone Sovereign Spreads Related to Financial Sector Vulnerabilities", IMF Working Paper WP/09/108, International Monetary Fund.

As figure 3.8 shows, after the rescue of Bear Sterns and the Anglo Irish nationalization, the sovereigns' spreads began to increasingly respond to the weaknesses of their own financial sector.

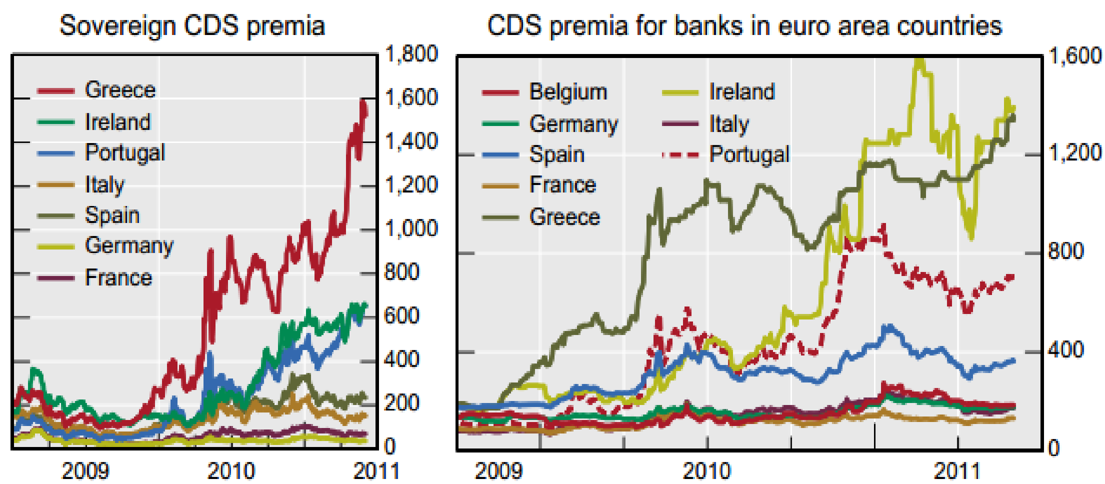
Figure 3.8 - Increase and dispersion of Eurozone sovereign spreads



Source: Mody and Sandri (2011)

The crisis evolved, being characterized by highly intertwined financial and sovereign shocks, with the transmission of shock going in both directions, and not as it was at the beginning, when only the financial sector stress raised sovereign spreads. This results are even clearer if we look (figure 3.9) at the CDS premia of sovereign and banks in the euro area in the period 2009-2011.

Figure 3.9 - Comparison of sovereign and banks CDS in the Euro area



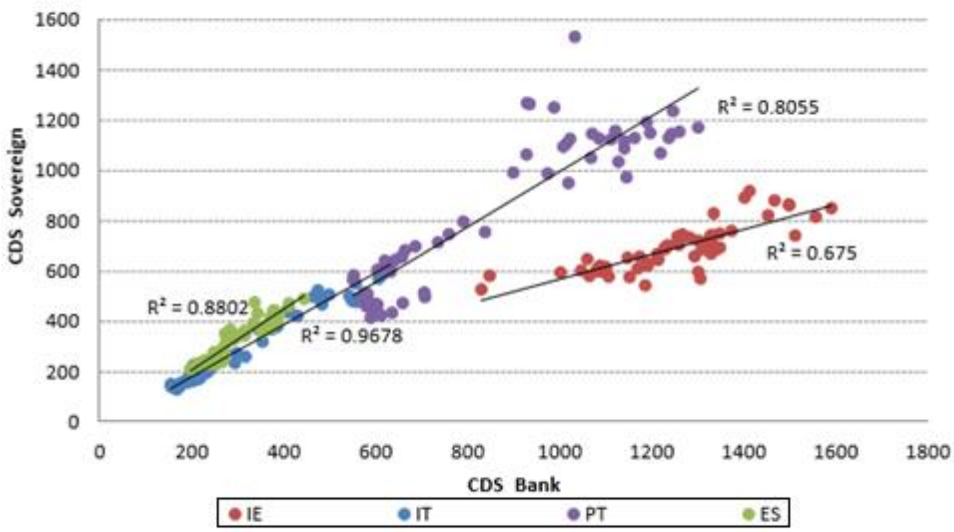
Source: BIS (2011)

Undoubtedly, as the crisis worsened in Europe affecting sovereign debts, the interdependency between banks and sovereigns played a central role, with a destabilizing effect for the whole financial system by posing real threats to the existence of the Economic and Monetary Union itself.

The increasing correlation between sovereign and banking CDS in the last years (figure 3.10), sheds light on the need of further regulatory and supervisory reform, in order to cope with this situation that is really threatening the basis of the Economic and Monetary Union[2].

[2] Angeloni and Wolff (2012), "Are Banks affected by their Holdings of Government Debt?", Bruegel Working Paper 2012/07, March 2012.

Figure 3.10 - Correlation between sovereing and banking CDS



Source: Angeloni and Wolff (2012)

In order to understand how the contagion of one sector to the other transmits, several authors have analysed the spillovers from banks to sovereign and vice versa, founding diverse channel of transmissions. For example, Mody and Sandri (2011)[3] recognized that sovereign spreads mirror the domestic vulnerabilities of national banking sectors and that financial shocks have a more severe impact on sovereign spreads where public debt-to-GDP ratios are higher. Gerlach, Schulz and Wolff (2010)[4] showed that the size of the banking sector balance sheet matters for the assessment of the European sovereign risk, measured through the spread to the German Bund. In particular, they demonstrated that in period of financial instability the size of the banking sector is a positive determinant of a country's yield spread, providing empirical

[3] Mody A. and Sandri D. (2011), "The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip, IMF Working Paper WP/11/269, International Monetary Fund
[4] Gerlach, Schulz and Wolff (2010), "Banking and Sovereign Risk in the euro area", CEPR DP 7833

evidence that the effect of banking sectors on sovereign spreads is related to their relative vulnerability.

Furthermore, in 2011, the Bank of International Settlement (BIS) commissioned a study[5] aimed at examining the relationship between sovereign credit risk and bank funding conditions. The study recognised four main channels through which the deterioration in the creditworthiness of a sovereign can have an impact in the banking system.

Firstly, losses on banks' sovereign portfolios have a negative impact on banks' balance sheets, making funding more costly. Secondly, higher sovereign risk reduces the value of the collateral that banks can post to obtain liquidity from the central bank. Thirdly, sovereign rating downgrades normally translate into lower ratings for domestic banks, as banks are more likely than other sectors to be affected by sovereign distress. This pushes up wholesale funding costs and reduces the market access. Finally, the deterioration in the creditworthiness of the sovereign reduces the funding benefits that banks derive from implicit and explicit government guarantees. In addition, the authors examined other channels of contagion, but their effects are more difficult to assess. These includes for example a decrease in the risk appetite of investors for bank securities due to weak public finance conditions, or the adverse impact of a deterioration of sovereign risk on banks' fee and trading income.

[5] Bank for International Settlement (BIS) (2011), "The impact of sovereign credit risk on bank funding conditions", CGFS Papers No 43.

4. The Single Supervisory Mechanism (SSM)

4.1. Incipit

In the time span of less than one year, the Single Supervisory Mechanism, part of the European Banking Union broader project, moved from being a simple idea formulated in the June 2012 "Four Presidents" report[1], to Commission proposals[2] (just three months after), to a political agreement by the European Council[3] to finally land to

[1] European Council – "Towards a Genuine Economic and Monetary Union", report by the President of the European Council Herman Van Rompuy, EUCO 120/12 (Presse 296) – Brussels, June 26, 2012.
[2] European Commission – Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions – COM (2012) 511 final – Brussels, September 9, 2012.
European Commission – Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (EU) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions – COM (2012) 512 final – Brussels, September 9, 2012.
[3] European Council – Interinstitutional file 2012/0242(CNS) – ECOFIN 1080, EF 316 – Brussels, December 14, 2012.
European Council – Interinstitutional file 2012/0244(COD) – ECOFIN 1081, EF 317, CODEC 3057 – Brussels, December 14, 2012.

the partial approval by the European Parliament on 22 May 2013 Strasbourg plenary session[4].

It is noteworthy to underline the pace at which the establishment process of the SSM run, as it demonstrates once again that the European Union has the political will and capacity to act quickly in dealing with potential common threats affecting the single market, in order to preserve and strengthen the overall European project during this ongoing severe financial and economic crisis.

In normal times, a proper sequencing toward the establishment of a European Banking Union, would firstly implied the harmonization of rules at national level, a process that however would take several years as EU Directives need to be fully adopted. This would be gradually followed by the creation of new authorities in charge of supervision and resolution at the EU-level. The process would end up in a full banking union based on integrated EU-level supervision, a single resolution authority, a common resolution and deposit guarantee scheme, and a common fiscal backstop. What is now being discussed in Brussels, would require more time, in order to properly design all the main features and to address in the bud all the possible shortcomings arising from a so complex project.

But times are not normal. There was, and there still is, the need to rapidly cope with the financial crisis, firstly through the establishment of a banking union in order to repair the financial sector, restore credibility among investors and weaken the vicious

[4] European Parliament – "Parliament backs EU banking supervisory system plans", Press release, Strasbourg, May 22, 2013.

link between banks and sovereigns which in the last years has been strengthened more and more hampering the proper monetary policy transmission and exacerbating the financial fragmentation in the EU[5]. Therefore, even hazarding to proceed to fast and so implementing this new framework in a non-exhaustive manner, the current circumstances require to move quickly, as the financial and economic crisis is still meandering throughout the EU, worsening day by day and even threatening the existence of the Single Market itself. Even if some divergences remain, mainly related to national political interests, EU policy-makers have recognised that such an extreme situation requires extreme efforts.

In order to better understand the urgency of such measures, it can be useful to compare the timing of previous reforms of such scope to the European Banking Union project. For instance, one of the most critical reforms, maybe the most important, was the monetary union. Well, a decade has passed between the idea to realize the monetary union in 1989 and the launch of the Euro in 1999. Certainly, the creation of a single currency for the EU implied several and diverse constraints and consequences for the participating Member States, but this comparison is useful to do out of the importance, in these current extreme and adverse times, of a European Banking Union. The EU needs to finally decide whether it wants to still be a sort of "incomplete" union, or to make progress toward a "real" Economic and Monetary Union.

In the light of the above, it seems that the efforts undertaken by EU regulators during the last year can be interpreted as a clear signal addressed to the participating

[5] See Focus 3.2. The bank-sovereign link

Member States, and not only, that there is the definite intention to evolve and to finally become a true Economic and Monetary Union.

The financial and economic crisis, then sovereign debt crisis, has hit Europe in its core, shedding light on the structural weaknesses of the EU's policy framework. This in turn gave rise to increasing anti-European sentiments throughout the EU, most of times manipulated by unwary politicians with the sole purpose of generating consensus in the population's segment most affected by the economic crisis. Well, now it is the time to decide for the future of the European Union.

The creation of the Single Supervisory Mechanism (SSM) is simply a first step in the broader revision of policies of the banking sector in Europe, and it will support and complement the institutional setting of a Genuine Economic and Monetary Union, as envisaged by the "Four Presidents" report. The SSM is expected to ensure homogenous standards of supervisory intensity across the euro area, by independently and autonomously assessing the European banking system and, in doing so, removing national distortions. This will be in turn decisive in restoring and safeguarding confidence in the banking sector, helping to reverse the trend towards financial fragmentation, on the basis of a system that involves the European Central Bank (ECB) and national supervisors. In this context, the SSM should be best placed to address systemic risk, by taking into account negative externalities and spillovers in a fully integrated economic area.

Currently, the future of the European Union itself seems hanging by a thread, and this has been recognised by EU policy-makers, that, during the last June euro area

Summit[6], stressed the peremptory necessity to move towards a stronger Economic and Monetary Union, based on integrated frameworks for the financial sector (i.e. the Banking Union), for budgetary matters and for economic policy, all surrounded by strengthened political legitimacy and accountability.

More than fifty years ago, John F. Kennedy during a speech in Indianapolis said: *"When written in Chinese, the word crisis is composed of two characters. One represents danger, and the other represents opportunity"*[7].

Well, the current economic and financial crisis is giving a huge opportunity to move toward "more Europe", laying the foundations for a prosperous future for all participating Member States, and therefore such crisis must not be wasted. The Europe does not need another crisis to be able to address its major structural shortcomings, but it needs to keep pace with the momentum now.

This chapter provides an analysis of the Single Supervisory Mechanism (SSM), based on the two final compromise texts of the Council of the European Union published on 25 March 2013. The final outcome of the SSM, expected to be definitively approved after the summer, is likely to differ from the agreement that was reached in certain aspects, although the overall design of the SSM will remain unchanged. As a background, section 1 briefly discusses the fundamental guiding principles presented by the Governing Council of the European Central Bank for establishing the SSM and section 2 presents the proposed SSM Regulation. Subsequently, the SSM is detailed in

[6] Euro Area Summit Statement – Brussels, June 29, 2012.
[7] John F. Kennedy – Speech, Indianapolis, April 12, 1959

terms of its scope (section 3), tasks and powers (section 4) and organizational structure (section 5). The sections 6 and 7 discuss respectively the accountability of the SSM and the need to separate the monetary policy functions from the supervisory tasks. Finally, the last section deals with the interaction of the SSM with the other relevant supervisory bodies.

4.2. Guiding principles

Following the Commission proposals of September 2012, the European Central Bank (ECB) was requested by the European Council to express its opinion on the proposed regulations. Since both texts related to the conferral of specific supervisory tasks on the ECB and the establishment of the Single Supervisory Mechanism (SSM), the ECB adopted a single opinion on the two proposals. In its opinion[8], the Governing Council of the European Central Bank (ECB) presented a set of guiding principles for establishing the SSM (see table 4.1).

[8] European Central Bank (ECB) – Opinion CON/2012/96, November 27, 2012.

Table 4.1 - Fundamental ECB principles

- ✓ Effective supervision without any risk to the ECB reputation
- ✓ The ECB should remain independent in carrying out all its tasks
- ✓ Strict separation between Supervisory and Monetary Policy tasks
- ✓ The ECB shouls have full recourse to the knowledge, expertise and operational resources of national supervisory authorities
- ✓ Consistency with the single market in financial services, so welcoming non-euro Member States in the SSM
- ✓ Compliance with the highest standards of accountability for the supervisory tasks

Source: ECB Opinion (2012)

First, to enable the SSM to conduct effective supervision, the SSM regulations entrusts the ECB with specific supervisory tasks associated with the necessary corresponding supervisory and investigatory powers and direct access to information. This is essential for the effective supervision the SSM is required to carry out. Moreover, the inclusion of all credit institutions under the scope of the SSM is important to preserve a level playing field among banks and prevent segmentation in the banking system.

Second, the ECB has to perform the tasks conferred on it by the SSM regulation without prejudice to the objectives of the European System of Central Banks (ESCB) as provided in article 127 of the Treaty. Under the Treaty and the Statute, the ECB enjoys full independence in executing its tasks, which includes any supervisory tasks conferred on it by virtue of Article 127(6) of the Treaty.

Third, it is essential to strictly separate monetary policy and supervisory tasks, to prevent potential conflicts of interest and ensure autonomous decision-making for the performance of these tasks. To that end, appropriate governance structures are needed to ensure a strict separation between these tasks, while allowing the overall structure to benefit from synergies.

Fourth, it is essential for the SSM to be able to exploit the competences of national supervisors in performing the new supervisory tasks. Through appropriate decentralized mechanisms, while preserving the integrity of the system and avoiding duplication, the SSM will be able to benefit from the closer proximity of national supervisors to the supervised entities and, at the same time, ensure the necessary continuity and consistency of supervision across participating Member States, both euro and non-euro countries.

Fifth, the SSM and EBA regulations must ensure that the new framework will be consistent with the Single Market for financial services. To that end, the SSM regulation allows Member States wishing to join the SSM to engage in appropriate close cooperation mechanisms. In addition, the conferral on the ECB of tasks concerning the prudential supervision of credit institutions for the euro area creates a new institutional framework which will require adjustments to the governance of the EBA, in particular by providing for equal treatment between the national supervisory authorities and the ECB, while safeguarding the ECB's independence.

Finally, democratic accountability is the natural counterbalance to independence. The ECB is already subject to accountability and reporting obligations, and building on these, separate and adequate forms of accountability are to be designed for the new supervisory tasks, while respecting the ECB's independence. Moreover, accountability should take place at the level at which decisions are taken and implemented, therefore, accountability mechanism should be primarily designed at the European-level, without prejudice to the existing accountability mechanisms of national supervisors.

4.3. The proposed SSM regulation

According to the proposed regulations, the SSM will be a mechanism composed of the ECB and national competent authorities of euro area countries, with the national competent authorities of non-euro area Member States being able to participate by establishing close cooperation with the ECB, whereby the responsibility for specific supervisory tasks will be conferred to the ECB[9].

The ECB will be responsible for the functioning of the SSM, and it will be charged of supervisory tasks in virtue of the Article 127(6) of the Treaty, that permits

[9] Rec. 29 of the Final Compromise Text of the proposal for a Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions – COM (2012) 511 final – Brussels, March 25, 2013 (from here onward it is referred as "the SSM Regulation").

the ECB to perform specific supervisory tasks, except for insurance undertakings, without recurring to the heavy Treaty amendment procedure.

Moreover, an essential element supportive to the effectiveness of the SSM, is the single rulebook, which substantially already exists and whose completion and implementation is overseen by the three European Supervisory Authorities (ESAs), in particular by the European Banking Authority (EBA)[10].

The conferral of supervisory tasks to a central bank is quite common. Indeed, in many Member States[11] central banks are already responsible for banking supervision, and the ECB, as the Euro area's central bank with extensive expertise in macroeconomic and financial stability issues, is best placed to carry out defined supervisory tasks with a focus on protecting the stability of Europe's financial system[12]. Therefore, the ECB will be conferred specific tasks concerning policies relating to the supervision of credit institutions within the participating Member States in the SSM.

In its supervisory function, the ECB will be assisted by national supervisors who have long-established expertise in the supervision of credit institutions within their territory and their economic, organisational and cultural specificities. The ECB will in turn benefit from the closer proximity of national supervisors to the supervised entities leveraging on their operational capabilities and resources, since these authorities have established a large body of dedicated and highly qualified staff for these purposes[13]. This

[10] See Section 2.4.2.2.
[11] For instance, in Italy the Bank of Italy is in charge of prudential supervision of credit institutions.
[12] Rec. 11 of the SSM Regulation.
[13] Rec. 28 of ibidem.

cooperation will include in particular the assistance of national competent authorities with the ongoing day-to-day assessment of a bank's situation and related on site verifications[14]. Furthermore, the ECB is required to closely cooperate with the three European Supervisory Authorities (ESAs), namely the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Systemic Risk Board (ESRB) within the framework of the European System of Financial Supervision (ESFS)[15] established in 2010[16]. Finally, the ECB, in carrying out its supervisory tasks, is expected to closely cooperate also with the national authorities empowered to resolve credit institutions and with the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM)[17].

The following sections discuss the specificities of the provisions of the proposed SSM Regulation, in terms of SSM's scope, supervisory tasks and powers conferred upon the ECB, structure and governance of the SSM, accountability requirements in the light of ensuring a strict separation between the monetary and supervisory functions, and the SSM's impact on the other relevant supervisory bodies.

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[14] Art. 5(3) of ibidem.
[15] See Chapter 2.
[16] Art. 3(1) of ibidem.
[17] Art. 3(4) of ibidem.

4.4. Scope of the SSM

The scope of the SSM under the proposed regulations is very broad, covering more than 6,000 credit institutions licensed in the eurozone[18]. The fact that all credit institutions established in the euro area fall within the scope of the SSM is a key element of the mechanism. Safety and soundness of large and systemically relevant cross-border banks is essential to ensure the stability of the financial system. However, the recent financial crisis has illustrated that not only larger banks can pose systemic risks[19]. As the experience of the Spanish Cajas has demonstrated, small banks with correlated risks can represent a serious threat for the sovereign and European financial stability[20]. In this context, the interconnectedness of banking sectors and the interlinkages between banks and sovereign, played a key role[21]. Even if covering only the so-called "systemic" banks, with difficulties arising from different views regarding systemic bank nomenclature, could be potentially easier in terms of technical and political implementation, it would only partially address these systemic risks. Therefore, the ECB should be able to exercise its supervisory tasks in relation to all credit institutions authorized in, and branches established in, participating Member States[22].

Certainly, when carrying out the supervisory tasks conferred on it, the ECB should have full regard to the diversity of credit institutions in terms of their size and

[18] International Monetary Fund (IMF) Staff Discussion Note – "A Banking Union for the Euro Area", February 2013.
[19] Rec. 13 of the SSM Regulation.
[20] For further information see Garicano Luis (2012), "Five lessons from the Spanish Cajas debacle for a new euro-wide supervisor", VoxEU.org, October 16, 2012.
[21] See Focus 3.2.
[22] Rec. 13 of the SSM Regulation.

business models, as well as the systemic benefits of diversity in the European Banking industry[23].

Although in the eurozone there are more than 6000 banks licensed (a similar magnitude as in the US as showed by Figure 4.2), approximately the 150 largest banks cover some 80% of banking assets[24].

Figure 4.2 - Banks under Supervision (US and Euro Area)

US FDIC insured	7246
# of banks regulated by:	
Federal Reserve	6027
of which assets > US$ 100 billion	26
Federal Deposit Insurance Corporation (FDIC)	4551
Office of the Comptroller of the Currency (OCC)	2036
National Credit Union Administration (NCUA)	7094
Euro Area Credit institutions	6180
of which assets > € 100 billion	>30

Source: IMF Staff Discussion Note (2013)

4.4.1. Coverage

The proposed SSM Regulation envisages a differentiated approach regarding the conduct of supervision for those credit institutions falling under the direct supervision of the ECB and those credit institutions that will primarily be subject to the supervision of

[23] Rec. 13a of ibidem.
[24] International Monetary Fund (IMF) Staff Discussion Note – "A Banking Union for the Euro Area", February 2013, p. 15.

national supervisors. It means that the ECB will directly supervise those financial institutions that are considered to be significant. The significance of a credit institution is defined on the basis of its size, importance for the economy of the EU or any participating Member State and significance of its cross-border activities. Moreover, the Regulation explicitly defines the size thresholds (on a consolidated basis) that determine whether a credit institution is significant or not[25]. Therefore, a financial institutions will be deemed significant if any one of the following conditions are met[26]:

1. The total value of its assets exceeds 30 billion euro; or
2. The ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20%, unless the total value of its assets is below 5 billion euro; or
3. Following a notification by its national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB takes a decision confirming such significance following a comprehensive assessment by the ECB, including a balance sheet assessment, of that credit institutions.

With a view of safeguarding the single market, the supervisory authorities of non-euro Member States will be able to participate in the SSM through the establishment of

[25] Art. 5(4) of the SSM Regulation.
[26] It is possible that these specific values will be altered before the final approval of the SSM Regulation, but the main criteria will most likely remain unaltered. However, a question that remains unsolved is whether the thresholds will be periodically adjusted to inflation, but currently this appears not to be the case.

close cooperation with the ECB[27]. Once close cooperation has been established, the ECB will conduct supervision of credit institutions established in a Member State whose currency is not the euro by means of instructions addressed to national competent authorities[28].

With regard to less significant credit institutions, these will be subject to national supervisors' decisions, and the ECB will issue regulations, guidelines or general instructions to the national competent authorities[29]. Notwithstanding this, if deemed necessary in ensuring the consistent application of high supervisory standards, the ECB may at any time, on its own initiative and after consulting with national authorities, or at the request of a national competent authority, decide to exercise direct supervision[30]. Furthermore, the ECB shall carry out the tasks conferred on it relating the prudential supervision in respect of the three most significant credit institutions in each of the participating Member States, unless justified by particular circumstances. In addition, the ECB may also consider an institution to be of significant relevance where it has

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[27] According to Art. 6(2) of the SSM Regulation, the close cooperation shall be established, by a decision adopted by the ECB, when the following conditions are met:

a. The Member State concerned notifies the other Member States, the Commission, the ECB and the EBA the request to enter into a close cooperation with the ECB in relation to the exercise of the tasks conferred by the SSM regulation on the ECB, with regards to all credit institutions established in the Member State concerned, in accordance with article 5;
b. In the notification, the Member State concerned undertakes:
   - To ensure that its national competent authority or national designate authority will abide by any guidelines or requests issued by the ECB;
   - To provide all information on the credit institutions established in that Member State that the ECB may require for the purpose of carrying out a comprehensive assessment of those credit institutions;
c. The Member State concerned has adopted relevant national legislation to ensure that its national competent authority will be obliged to adopt any measure in relation to credit institutions requested by the ECB;

[28] Art. 6(1) of ibidem.

[29] Art. 5(5)(a) of ibidem.

[30] Art. 5(5)(b) of ibidem.

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 and liabilities. Finally, the ECB will be in charge of direct supervision for those credit institutions for which public financial assistance has been requested or received directly from the EFSF or the ESM[31].

The following table provides an overview of the ECB prudential supervision coverage under the proposed SSM Regulation.

Table 4.3 - ECB coverage under the SSM

✓ Credit institutions falling within the thresholds outlined by the Article 5(4) of the SSM Regulation
✓ Credit institutions licensed in non-euro Member States that established a close cooperation with the ECB
✓ The three most important credit institutions of each of the participating Member States
✓ Credit institutions that have established subsidiaries in more than one participating Member States and with significant cross-border assets and liabilities
✓ Credit institutions that requested or received public financial assistance directly from the EFSF or the ESM
✓ Any other credit institution if deemed necessary by the ECB in order to preserve the financial stability

Source: SSM Regulation COM (512) final

[31] Art. 5(4) of ibidem.

Banks that do not meet the criteria mentioned in the above table are labelled "less significant". About 98% of credit institutions in the eurozone fall under this definition, and therefore they continue to be supervised at the national level. While these banks represents a small part of the total banking assets, it is clear that most supervisory operations in the SSM will still be carried out nationally[32].

4.4.2. Limits

As it is designed, the scope of the ECB's supervisory competences is essentially limited in three ways: geographically, in terms of coverage of the financial sector, and with regard to the tasks the ECB executes[33].

4.4.2.1. Geographical limits

The precise scope of the SSM still remains unclear since it will depend on the Member States' willingness to join it. Therefore, the SSM will not become the EU-level supervisor, as it will encompass only some of the EU Member States.

[32] International Monetary Fund (IMF) Staff Discussion Note – "A Banking Union for the Euro Area", February 2013.
[33] Verhelst Stijn (2013), "The Single Supervisory Mechanism: A Sound First Step in Europe's Banking Union?", Egmont Institute, March 2013, p. 5.

In order to shed light on the future scope of the SSM, it is essential to distinguish between eurozone and non-eurozone Member States. If from one hand those countries belonging to the eurozone have not choice, since for them the membership of the SSM is obligatory, on the other Member States whose currency is not the euro are free to join the SSM[34]. This differentiation is mainly due to a lack of political will in some non-eurozone countries, but it is also a direct consequence of some legal constraints. As it is designed, the SSM will be established inside the ECB according to article 127(6) of the Treaty. Well, even if this legal technicality allow to avoid the heavy Treaty amendment procedure, it limits the voice of non-eurozone countries in the SSM because the main decision body of the latter will be the Governing Council of the ECB, and according to the rules establishing the ECB, only the eurozone countries can participate in it and are empowered with voting right. Surely, this will require a future review, and indeed the proposed SSM Regulation provides for such review[35].

4.4.2.2. Financial sector coverage limits

A second element limiting the SSM's scope lies in the different definition of credit institutions in the different national legislations. According to the EU legislation, a credit institution is defined as : *"an undertaking whose business is to receive deposits or*

[34] Some of them made it clear that they will not join the SSM, notably the UK and Sweden. Other countries have shown willingness to join the SSM depending on the final outcome of the legislative negotiations.
[35] According to Art. 26 of the SSM Regulation, the first review will be by 31 December 2015, and subsequently every three years thereafter.

other repayable funds from the public and to grant credits for its own account"[36]. However, the EU definition partially covers the European financial sector. For instance it does not include investment firms (very active in the financial landscape performing many of the same tasks as traditional banks), hedge funds, pensions funds, central counterparties, asset managers and insurance firms. These types of financial institutions will continue to be supervised at the national level. In particular, with regard to insurance firms, the ECB is also constrained by the legal basis upon which the SSM will be established. The article 127(6) of the Treaty clearly affirms that the ECB can take specific supervisory tasks regarding credit institutions "except" of insurance undertakings. This differentiation is likely to result in sub-optimal situations, i.e. when the insurance arm of a financial institution will be supervised at the national level, while the banking arm of the same institution will be supervised by the ECB under the SSM.

4.4.2.3. ECB supervisory tasks limits

The proposed SSM Regulation endows the ECB with a specific set of supervisory tasks[37]. Consequently, the national competent authorities will continue to perform all supervisory tasks not deemed "essential" by the SSM Regulation. These competences can be seen as "non-essential" in the sense of being not strictly necessary to ensure the stability of the financial sector.

[36] Art. 4(1) of Directive 2006/48/EC.
[37] See the next section.

Within the limits outlined in the above, the ECB, under the SSM, will become the responsible EU-level financial supervisor.

4.5. Tasks and Powers

The proposed SSM Regulation clearly outlines the key supervisory tasks conferred upon the ECB necessary for carrying out the prudential supervision of credit institutions within the specific coverage set by article 5[38]. Notably, the ECB will be in charge of all the so-called "essential" tasks, while all the tasks not explicitly specified in the Regulation will remain under the national authorities competence, i.e. the supervision of credit institutions from third countries establishing a branch in the Member State and matters related to consumer protection, money laundering and payment services. Therefore, in the SSM framework, the ECB will be responsible for an extensive set of tasks ranging from the authorisation and withdrawal of authorisation of credit institutions to carrying out early interventions in the case of financial distress of an institution.

The ECB will be empowered of both macro and micro-prudential tasks in respect of the Treaty provision that allow conferring only specific supervisory tasks onto the

[38] See the previous section.

ECB[39]. Therefore, the list mentioned in the SSM Regulation is extensive and concerns the essential components of bank supervision[40].

The ECB will perform these supervisory tasks by adopting guidelines and recommendations. Furthermore, it will be subject to binding regulatory and implementing technical standards developed by the EBA and to the provisions of the European supervisory handbook that will be developed by the EBA in accordance to the SSM Regulation[41]. The ECB may also adopt regulations only to the extent necessary to organise or specify the modalities for the carrying out of its tasks[42].

In order to carry out its tasks effectively, the ECB will be able to require all necessary information[43], and to conduct investigations[44] and on-site inspections[45], where appropriate in cooperation with national competent authorities[46].

In addition, to ensure compliance with supervisory rules and decisions by credit institutions, the ECB has the power to impose effective, proportionate and dissuasive sanctions in case of breaches[47]. On the other hand, national authorities will remain able

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[39] Art. 127(6) of the Treaty.
[40] Art. 4(1) of the SSM Regulation.
[41] Art. 4(3) of ibidem.
[42] Before adopting a regulation, the ECB shall conduct open public consultation and analyse the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the 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 urgency.
[43] Art. 9 of ibidem.
[44] Art. 10 of ibidem.
[45] Art. 11 of ibidem.
[46] Rec. 31 of ibidem.
[47] Art. 15 of ibidem.

to apply sanctions in case of failure to comply with obligations stemming from national law transposing Union Directives[48].

4.5.1. Micro-prudential supervisory tasks

Once the SSM will enter into force, probably from 1st of October 2014, as the political debate at the EU-level is delaying negotiations, the ECB will be in charge of several micro-prudential supervisory tasks. These tasks notably cover[49]:

- ✓ Authorisation and withdrawal of authorisation of credit institutions;
- ✓ For credit institutions in participating Member States which wish to establish a branch or provide cross-border services in a non-participating Member State, the ECB shall act as home authority, by carrying out the tasks the national competent authority would have under national legislation;
- ✓ Assessing applications for the acquisition and disposal of qualifying holdings in credit institutions, except in the case of bank resolution;
- ✓ Ensuring compliance with prudential requirements imposed on credit institutions in the areas of own funds requirements, securitisation, large exposure limits, liquidity, leverage, and reporting and public disclosure of information on those matters;

[48] Rec. 27 of ibidem.
[49] Art. 4(1) of ibidem.

- ✓ Ensuring compliance with requirements imposed on credit institutions to have in place robust governance arrangements, including the fit and proper requirements for risk management processes, internal control mechanisms, remuneration policies and practice and effective internal capital adequacy assessment process (ICAAP), including internal ratings based (IRB) models;
- ✓ Carrying out supervisory reviews, including stress tests in coordination with the EBA, in order to determine whether the arrangements, strategies, processes and mechanisms put in place by credit institutions and the own funds held ensure a sound management and coverage of their risks. On the basis of the review the ECB will be able to impose specific additional own funds requirements, publication requirements, liquidity requirements and other measures.
- ✓ Carrying out supervision on a consolidated basis of credit institutions' parents established in one of the participating Member States, including over financial holding companies and mixed financial holding companies, and participating in colleges of supervisors. (in nota definition of financial holding etc..);
- ✓ Participating in supplementary supervision of a financial conglomerate (nota) in relation to the credit institutions in it assuming the role of a coordinator in accordance with the criteria set out in the relevant Union law.
- ✓ Carrying out supervisory tasks in relation to recovery plans, and early intervention where a credit institution does not meet or is likely to breach the applicable prudential requirements, structural changes required from credit institutions to prevent financial stress or failure, excluding any resolution powers.

4.5.2. Macro-prudential supervisory tasks

Regarding macro-prudential tasks and tools, the SSM Regulation states that, in addition to the competences of national competent authorities in this field, the ECB may apply certain measures addressing systemic or macro-prudential issues. Therefore, when the SSM will come into force, both the ECB and the national competent authorities will be able to apply such measures.

In particular the ECB will be empowered to apply higher requirements for capital buffers, notably counter-cyclical buffer rates[50], surcharges differentiated across banks according to their contribution to systemic risk and liquidity and leverage requirements[51]. When employing such instruments, the ECB will be required to take into account the specific situation of the financial system, economic situation and the economic cycle in individual Member States[52]. However, macro-prudential instruments which are not specified in the Union law, i.e. loan-to-income and loan-to-value ratios, will remain the exclusive responsibility of national competent authorities.

The proposed conferral of both macro and micro-prudential powers on the ECB will allow it to coordinate the use of macro and micro-prudential policies. This will be of vital importance since, as the financial crisis has shown, macro and micro-prudential risks can be mutually reinforcing leading to worse outcomes. This configuration should therefore help in mitigating the impact of future crisis.

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[50] Art. 4a(2) of ibidem.
[51] Rec. 18 of ibidem.
[52] Art. 4a(3) of ibidem.

The national competent authorities will be able either to act on their own initiative when applying macro-prudential tools or to request that the ECB act in order to address the specific situation of the financial system and the economy in their countries[53]. On the other hand, the ECB may also act on its own initiative by applying more stringent macro-prudential tools in consultation with the relevant competent authority in each participating Member State[54].

Since the macro-prudential tools are conferred both at the European and national level, the ECB and the national supervisors will be subject to a "mutual consultation" obligation[55] and close collaboration on these issues. This flexible framework will allow the SSM to ensure a level playing field, and will address financial stability concerns at the relevant level they will arise: sub-national, national or European[56].

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[53] Art. 4a(1) and 4a(2a) of ibidem.

[54] Art. 4a(2) of ibidem.

[55] Both the National authorities and the ECB must inform each other of their intentions ten working days prior to taking action and duly consider possible related objections in reply, before proceeding with the decision.

[56] European Central Bank (ECB) Report, "Financial Integration in Europe", April 2013, p.42.

4.6. The SSM’s organisational structure and governance

The proposed SSM Regulation provides a proper organisational setup to be put in place in order to allow the ECB to perform the supervisory tasks conferred on it under the SSM framework.

The EU Treaties clearly specifies rules concerning the decision-making power of the ECB. However, these rules were designed with the idea of the ECB being in charge only of monetary policy issues and not relating to prudential supervision of credit institutions. Therefore, as the ultimate decision-making body of the ECB is the Governing Council, only the eurozone Countries will be empowered to express their voice regarding prudential supervision matters. In order to reach a balance between eurozone and non-eurozone participating Member States in the SSM, a procedure has been devised, that while respecting the Treaty’s wording, it makes the non-eurozone countries equal partners in decision-making regarding prudential supervision of credit institutions.

4.6.1. The general decision-making procedure

Under the SSM, decision-making will centre around two ECB bodies, namely, the Supervisory Board, mainly composed of national supervisors, and the Governing Council, that is the ultimate ECB’s decision-making body.

Under the procedure envisaged, the Supervisory Board will draft the ECB's supervisory decisions, to be then submitted to the Governing Council that retains the ultimate decision-making power. In order to ensure an equal treatment between the eurozone and non-eurozone countries participating in the SSM, a draft decision by the Supervisory Board will be deemed adopted by the Governing Council, unless the latter objects due to particular circumstances[57]. This procedure is similar to the "reversed Qualified Majority Voting" [58], that is used for a number of economic governance decisions in the Council of Ministers[59].

In the light of the above, the Governing Council is the only body that can block a decision taken by the Supervisory Board. However, under normal circumstance, it will do so infrequently, and this will make the Supervisory Board the *de facto* decision-making body regarding prudential supervision matters.

4.6.2. Structure

Besides the Supervisory Board and the Governing Council, two specific bodies will deal with supervisory decision-making in the ECB: the Mediation Panel[60] and the

[57] Art. 19(3) of the SSM Regulation.
[58] Under the Reversed Qualified Majority Voting, the Commission make a proposal to the Council. That proposal is subsequently deemed adopted, unless the Council objects to that decision by a qualified majority within a limited timeframe, usually ten working days.
[59] Verhelst Stijn (2013), "The Single Supervisory Mechanism: A Sound First Step in Europe's Banking Union?", Egmont Institute, March 2013, p. 12.
[60] Art. 18(3b) and Rec. 36c of ibidem.

Administrative Board of Review[61]. These bodies enter into play when dispute arises on a supervisory decision. In particular the former, has been envisaged to take into account the possibility that difference in opinion may arise between the Governing Council and the Supervisory Board; in that case, a national supervisor can appeal to the Mediation Panel. However, its role is limited, as its decisions are in no way binding on the Governing Council, rather it is likely to have moral authority, making it difficult for the Council not to take it into account. On the other hand, the Administrative Board of Review will be established for the contestation of a decision by the Governing Council by private and legal persons, including banks. The Board will permit a timely challenging of supervisory decisions in order to avoid the lengthier procedures foreseen by the European Court of Justice. As for the Mediation Panel, the incidence of the Administrative Board of Review is limited as it has only moral authority and no binding powers on the Governing Council.

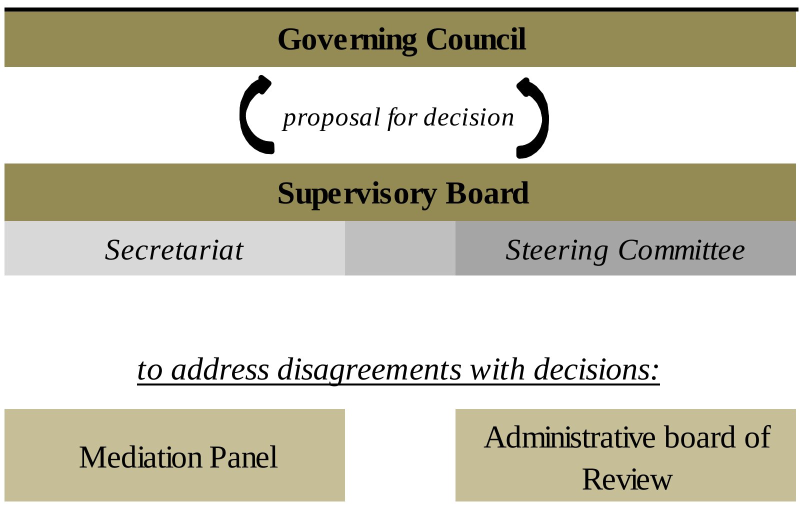
In addition, the SSM Regulation, provides for the establishment of a Secretariat that will support the activities of the Supervisory Board, including preparing its meetings[62].

Finally, a Steering Committee of the Supervisory Board, with no decision-making powers, will be in charge of preparatory tasks working in full transparency with

[61] Art. 17c and Rec. 34f of ibidem.
[62] Art. 19(4) of ibidem.

the Supervisory Board[63]. The following figure provides an overview of the organizational structure as envisaged by the proposed SSM Regulation.

Figure 4.1 - SSM's organizational structure



Source: Proposed SSM Regulation - March 2013

4.7. Accountability

When the ECB was created, much attention was given to its independence in order to properly perform the tasks conferred on it relating the monetary policy issues. However, with the creation of the SSM, the ECB needs to be accountable towards national governments and European institutions, since the prudential supervision of

[63] Art. 19(4a) of ibidem.

credit institutions call for a substantial level of accountability. This because supervisory decision-making is more prone to subjectivity than monetary policy and therefore the ECB needs to be open on the decisions it adopts and the reasons behind.

This higher level of democratic accountability should however not compromise the ECB's independence required for carrying out its monetary policy tasks. To this end, the ECB will be accountable to the European Parliament and to the Council of Ministers[64]. In addition, a somewhat indirect form of accountability consists of an annual report by the ECB on its supervisory operations, including information on the envisaged evolution of the structure and amount of supervisory fees[65]. This report is to be submitted to the European Parliament, the Council, the European Commission and the Eurogroup[66].

Beyond the annual report, a more direct form of accountability consists of the interaction between the ECB and other public bodies, mainly at the European level. The chair of the Supervisory Board is therefore obliged to appear in front of the European Parliament and the Eurogroup when these institutions request an ad-hoc hearing[67].

To a lesser extent, the ECB is also accountable toward national parliaments[68]. The latter may ask the ECB oral and written questions, but the ECB is not obliged to respond although it would be politically difficult not to do so. In addition, national

[64] Art. 17(1) of ibidem.
[65] According to Art. 24 of the SSM Regulation, the ECB will levy an annual supervisory fee on the credit institutions supervised in order to cover the expenditure incurred in relation to the prudential supervision the ECB will carry out.
[66] Art. 17(2) of ibidem.
[67] Art. 17(4-5) of ibidem.
[68] Art. 17aa of ibidem.

parliaments can also invite the ECB to appear in their parliament, but only in relation to the supervision of a credit institutions based in that Member State[69].

The accountability provisions of the proposed SSM Regulation lie essentially at the EU-level, consistently with the lift of bank prudential supervision to that level. This is in line with the "Four Presidents" report that states that *"democratic control and accountability should occur at the level at which the decisions are taken"*[70].

The need for more democratic accountability therefore demands additional efforts to increase the European Institutions' legitimacy towards its citizens.

4.8. Separation from monetary policy functions

During the last year political debate on conferring prudential supervisory tasks on to the ECB, a major concern was that these new competences might have potential negative effects on the ECB's monetary policy functions, because it was feared that supervisory and monetary responsibilities might conflict with each other, i.e. providing liquidity to distressed banks may stabilise the financial system, but it can also lead to higher inflation. Furthermore, mistakes in supervision can have a negative impact on the

[69] Art. 17aa(3) of ibidem.
[70] European Council, "Towards a Genuine Economic and Monetary Union", final report – Brussels, December 5, 2012, p.16.

reputation of the ECB in general and therefore also on its monetary reputation. For example, the recent problems in the Italian bank Monte dei Paschi di Siena illustrated the potential reputational risk. As the president of the ECB Mario Draghi was Governor of the Bank of Italy when some of the opaque operations took place, his track record come under fire. The criticism would have been even more extensive if the ECB would have been the competent supervisor at the time[71].

To prevent the emergence of conflicts of interest, the legislators aimed to fully separate monetary policy from prudential supervision decision-making. Quoting the German Finance Minister Wolfang Schäuble, the EU should create a “Chinese wall” between the two policies[72].

The proposed SSM Regulation states that the ECB is to separate its supervisory tasks from its monetary tasks, notably including an organisational separation of the staff involved in the different tasks and with separate reporting lines[73].

This separation principle is also reflected in the decision-making procedure[74], where the supervisory decisions are primarily the responsibility of the Supervisory Board with the Governing Council retaining a sort of “veto power”. In addition, with a view to ensuring separation between monetary policy and supervisory tasks, the ECB is

[71] Dixon Hugo, Mario Draghi’s poisoned banking chalice. Reuters, Opinion, February 4, 2013
[72] Schäuble Wolfang, How to protect EU taxpayers against bank failures, Financial Times, August 30, 2012.
[73] Art. 18(2) of the SSM Regulation.
[74] See Section 4.5.

required to set up a Mediation Panel. This panel is mainly meant to solve disagreements on the impact of a decision on monetary policy[75].

4.9. SSM interactions with other relevant supervisory bodies

The creation of the SSM will have an impact beyond the borders of its participating Member States. Being in charge of prudential supervision of credit institutions, the ECB will have to interact with the already in place European supervisory bodies and participate in the college of supervisors for the supervision of cross-border financial institutions.

4.9.1. Cross-border supervision

A cross-border supervisory college groups the different national supervisors of the main countries under which bank operates. Each college of supervisors therefore deals with only one specific cross-border institutions.

The impact of the SSM on these colleges will depend on whether the college deals with a banks that operates only in countries participating to the SSM, or with a

[75] Art. 18(3b) of ibidem.

bank that operates beyond the borders of the SSM. In the first case, the colleges of supervisors will lost much of their value, since the ECB will become the supervisors with final authority[76]. Whilst, for banks operating beyond SSM's borders, not much should change in principle. The ECB will participate in the colleges of supervisors, but this will not be to the detriment of the role played by national supervisors of countries participating in the SSM.

4.9.2. EU-level supervisory bodies

Regarding prudential supervision of credit institutions, two EU-level bodies play a substantial role. These are the European Banking Authority (EBA) dealing with micro-prudential supervision of banks, and the European Systemic Risk Board (ESRB) dealing with macro-prudential supervision[77]. Both bodies will be impacted by the creation of the SSM, but the EBA will undoubtedly be influenced the most as its functioning will be altered by the proposed Regulation COM(2012) 512, amending its establishing Regulation.

[76] Always within the limit of "essential" and "non-essential" supervisory tasks as outlined in article 4 of the proposed SSM Regulation.
[77] See Sections 2.3 and 2.4.

4.9.2.1. EBA

The EBA was created in the aftermath of the financial crisis and groups banks supervisors of all the Member States. It replaced the previous level-3 Lamfalussy Committee of European Banking Supervisors (CEBS).

The creation of the SSM will have a major impact on the governance of the EBA, notably regarding its voting rules. This because, as decisions in the EBA are taken by the national supervisors of all the Member States, the SSM non-participating countries feared to have little voice on EBA decision. This fear was based on the belief that, once the SSM will enter into force, the participating Member States would vote as a single entity in the EBA. In order to safeguard the voting rights of non participating Member States and accommodating their fears, additional safeguards in the EBA's decision-making have been included in the Regulation COM (512) final amending the Regulation EC 1093/2010 establishing the EBA. The major innovation is the double majority that will be necessary for the approval of several types of decisions. This implies that a decisions needs to be approved by both a majority of participating countries in the SSM and a majority of non-participating countries. A decision cannot be adopted if one of these majorities is lacking. However, this setup will allow few non-eurozone countries to gain a disproportionate say in the EBA decision-making, as they would easily be able to block any decisions . For these reasons, the EBA voting mechanism will be reviewed according to the future operational setup and performance of the SSM.

4.9.2.2. ESRB

Like the three European Supervisory Authorities (EBA, ESMA and EIOPA), the European Systemic Risk Board (ESRB) was created in a response to the financial crisis with the aim to address macro-prudential supervision and so dealing with systemic risks at the EU-level. In its current configuration, the ESRB is composed of 67 members of which 38 have voting rights.

At the time of writing, end of May 2013, no formal changes are envisaged to the functioning of the ESRB, even if, within the framework of the SSM, the ECB will be in charge of macro-prudential supervisory tasks.

The countries participating in the SSM and the ECB possibly will take frequently the same stance in the ESRB meetings. If this will be the case, the SSM countries will likely be the determining factor in the ESRB's decisions to the detriment of the other voting members. However, this risk seems to be exaggerated, because even if in the worst case the ERSB should be controlled by the SSM countries, ultimately the ESRB's decisions are non-binding.

Notwithstanding changes to the functioning of the ESRB are currently not foreseen, it is likely that the review launched at the end of April 2013 will involve the role of the ECB in the ESRB as well as the balance of power between participating and non-participating countries in the SSM.

Conclusions

The last five years have been characterized by a strong political ferment at the European level. The EU policy-makers multiplied their efforts to cope with the increasing challenges raised by the financial crisis in order to address the major shortcomings showed by the existing policy and regulatory European framework.

In this thesis I focused the attention on the evolution of the financial supervision in the European Union in the aftermath of the financial crisis, analysing the major innovative steps in the landscape of EU-level supervision, namely the creation of the European System of Financial Supervisors (ESFS) and the upcoming establishment of a Single Supervisory Mechanism (SSM) part of the broader concept of a European Banking Union.

Conceptually it is possible to divide the financial crisis in two main waves. The first was mainly characterized by the negative spillover effects stemming from the subprime crisis of 2007 that infected the European economy, while the second wave was an evolution of the existing crisis that, in a context of political instability, European banks weakness and increasing financial fragmentation in the EU, has resulted in a bank crisis. The financial turmoil then started to hit also sovereigns' borrowing capacity, even worsening the fragmentation in the EU single market and becoming a sovereign debt crisis. Well, these extreme circumstances required extreme policy efforts.

In the light of the above, the EU financial supervisory framework evolved accordingly. In a first stance, following the report of the high level group chaired by Mr. Jacques De Larosière, a new European System of Financial Supervisors (ESFS) was created. This comprised the establishment of three new European Supervisory Authorities (ESAs), notably the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), in charge of micro-prudential supervision. However, one of the most innovative concept brought by this reform was the creation of a new body in charge of macro-prudential supervision, namely the European Systemic Risk Board (ESRB). During the financial crisis too much attention was given to the health of individual financial institutions, by giving little or even no attention to threats stemming from systemic risks. The creation of the ESRB was a step in the right direction acknowledging that the analysis of the systemic risk sources needed the attention deserved, since, as the crisis painfully proved, healthy financial institutions do not necessarily imply a healthy financial system. Therefore, in order to be effective, supervision must encompass all sectors and not only be confined to individual financial institutions.

These new supervisory bodies started their work from 1st January 2011, and therefore it is still too early to perform a proper and exhaustive assessment of their actions. However, in the light of the upcoming Banking Union, a review of the ESFS will take place before the end of 2013 in order to assess their actions and to evaluate if the future interactions with the SSM would require further adjustments[1].

If from one hand a new European System of Financial Supervisors (ESFS) has been created, the other innovative step consists in the establishment of a European Banking Union. This is, after all, the most significant development in financial supervision in the history of the European Union.

The crisis demonstrated the rapidness with which financial distress spreads from one institution to another and to sovereigns, especially in a highly complex and interconnected financial system such as the European. In this context the concept of a Banking Union was put forward by the President of the European Commission José Manuel Barroso on May 2012. Such a Union should be based on three main pillars, namely a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Deposit Guarantee Schemes (DGS). Furthermore, it will be of utmost importance

[1] In this context on Friday 24 May 2013 there was a Commission's public hearing on the review of the ESFS aimed at gathering a broad view regarding the effectiveness of their first two years of existence.

the timely completion and implementation of a single rulebook, on which the three European Supervisory Authorities (ESAs) are already working.

However, a banking union is obviously not a panacea, but it can be pivotal in fighting the current crisis by weakening the vicious circle between banks and sovereigns, stabilizing the financial system, reversing the process of financial market fragmentation resulting from the retrenchment behind national borders in order to curtail contagion and restore the proper monetary policy transmission.

The ESFS: the first two years of activity

Almost two years and a half have passed from the establishment of the ESFS. This renewed financial supervisory system has substantially altered the way in which financial supervision is carried out. However, despite their increasing importance these new EU level bodies still face certain limitations. Let's deal with each of them separately.

The European Banking Authority (EBA) has overall performed very well in its first two years of operational activity. Although its first stress test of July 2011 saw negative market reactions, in the following months it gained a leadership role towards bank recapitalization issue. Regarding one of its most important tasks, that is the work on a common single rulebook, the work is ongoing, although at an inadequate pace. This is mainly due to staffing and resources constraints (common also to the other two European Supervisory Authorities). In addition, the too much national discretion in level-1 legislation even complicates the work to EBA to develop level-2 legislation (technical standards). However, despite these constraints, the EBA has achieved significant results and, with the upcoming Banking Union, it will continue to play a central role in EU financial supervision, although it will have to evolve.

The European Securities and Market Authority (ESMA) after only two years of work, has gained international notoriety mainly due to its overall very good performance. The authority has played a key role in contributing to the development of a single rulebook for financial services, drafting technical standards and providing advices to the European Commission. Considering the significant constraints, both in terms of staff and resources, the work already done is impressive. Just consider its commitment regarding for example the European Market Infrastructure Regulation (EMIR), the Credit Rating Agencies (CRAs) supervision, the Regulation on Short-Selling and Credit Default Swaps (CDS) and the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS). However, in order to keep this pace, it will be critical that ESMA, in addition to more resources and qualified personnel, will gain access to relevant data in order to conduct in-depth analysis including stress testing for systemic risk market institutions under its scope. Furthermore, ESMA is already directly responsible for registration and supervision of Credit Rating Agencies (CRAs) in the EU, but this matter is very complex and requires a strategic vision of the tasks and methodologies to be applied in supervising CRAs. Looking at the results achieved on its supervision function, it is possible that in the near future more competences will be attributed to the ESMA regarding the supervision of other market institutions, i.e. Central Counterparties (CCPs) and Central Securities Depositories (CSDs).

The European Insurance and Occupational Pensions Authority (EIOPA) faces a different situation. Contrary to EBA and ESMA, EIOPA has not yet been provided with a basic legislative package. This because, the Solvency II Directive[2], aimed at codifying and harmonising the EU insurance regulation has not been approved by the Members of the Union. For these reasons, in its first two years of existence, EIOPA devoted the most of its resources to the preparation of the Solvency II implementation, by helping national regulators, supervisors and insurance companies themselves, as this Directive, once entered into force, will require several changes in national legislations. Furthermore, EIOPA has contributed to the proper functioning of the colleges of supervisors when dealing with complex financial institutions containing also insurance activities.

Finally, the European Systemic Risk Board (ESRB), responsible of macro-prudential oversight was one of the most innovative concept in the response to the financial crisis. However, the work done in its first two years of existence is not in line with the expectations that were before its establishment. For instance, even if the ESRB's reports and recommendations are certainly well appreciated, they seems to be too general and not very useful in truly addressing the systemic risk's sources. This is mainly due to the fact that the ESRB was created in a period of financial turmoil and even if it should play a key role in "preventing" the crisis, it only tried, with poor results,

[2] Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance – "Solvency II", November 25, 2009.

to “mitigate” the current financial crisis. Furthermore, the inefficacy of the ESRB is also due to its very complex organizational structure. It is a very large body and therefore its actions are hindered by several constraints. In addition, it operates in an overcrowded environment, surrounded by several national macro-systemic board, that ultimately alter its operational efficiency. However, the present financial landscape provides several sources of systemic risk and therefore opportunities to reflect on them. In such an environment, with the clear objective to safeguard the EU financial stability, there is the need to have a unique, supra-national and non-political body in charge of macro-prudential oversight. Undoubtedly, there is not “one fit for all” solution, but if the present institutional organization of the ESRB seems too complex to be effective, or there is too much bureaucracy, it should be simply changed. After all, the current review is aimed at detecting the potential threats and weaknesses of the new ESFS and trying to cope with them.

The implication of the SSM on the ESFS

The SSM is still at an embryonic stage and it is yet not possible to accurately assess its future implications on the ESFS. In this phase the only possible answer is “it depends”. It depends because in principle the effectiveness of the SSM, and its impact on the ESFS, will be a function of how many Member States decide to participate. Naturally, the more Member States join, the better it will be for the efficiency of the SSM itself and for the functioning of the ESFS, as in a first stance, having as many as possible countries, both eurozone and non-eurozone, will probably reduce the scope for coordination failures. Furthermore, higher participation rate will permit to better safeguard the single market in financial services, increasing the consistency in the application of supervisory and regulatory practices. In addition, hoping that the Single Resolution Mechanism (SRM) will be as soon as possible established, a wide SSM membership could diminish the single market's distortions caused by the divergent fiscal positions of sovereigns, as countries that are part of the SSM will also have access to the SRM. However, at the time of writing the negotiations regarding the establishment of a resolution mechanism and a resolution authority seem at a stalemate.

Regarding its interactions with the ESFS, it is difficult to say how the latter will be affected by the SSM without knowing its exact composition. Surely, the SSM will have a great impact on the European Banking Authority (EBA) and to a lesser extent on the European Systemic Risk Board (ESRB).

The EBA will be affected in particular regarding its commitment toward the creation of a single rulebook. While the EBA will remain responsible for developing regulatory policy and technical standards that will form the basis for a single rulebook for credit institutions across Europe, the SSM will play a key role in improving coordination between different national supervisors supporting the accomplishment of the EBA's mandate. The upcoming SSM will also affect the EBA, as the latter will be responsible of drafting a supervisory handbook in order to encourage supervisory convergence in Europe. The existence of the SSM will facilitate the work of the EBA, as all countries joining the SSM will probably converge in their supervisory practices.

Again, the broader the participation to the SSM, the higher its efficacy. Finally, the EBA will be affected by the SSM regarding the conduct of stress tests. According to the proposed SSM Regulation, the ECB in carrying out its prudential supervision function, is to conduct a comprehensive assessment of the banks that then it will supervise directly. This assessment process will consists in a balance sheet assessment and in a forward-looking assessment of individual banks capital positions and provisioning levels in the form of a stress test. Well, these stress tests, and the future ones, undertaken as part of the SSM, will be conducted in close cooperation with the EBA. In the light of the above, the EBA is expected to evolve with the upcoming establishment of the Banking Union, although now it is too early to exactly envisage how it will evolve.

To a lesser extent, also the ESRB will be affected by the establishment of the SSM. Under the latter, the ECB will be in charge also of macro-prudential tasks, and therefore a close cooperation between the two bodies will be essential. In addition, as experience has showed, macro-prudential oversight can only work well if it is accompanied by good and strong micro-prudential supervision. Well, the creation of the SSM provides an opportunity in this regard. However, some concerns may arise again regarding the participation of Member States to the SSM, since with the upcoming banking union, the ECB could perform macro-prudential oversight for the participating Member States, while the other countries would it do nationally. This would be a grave mistake, because Europe needs, as a union, an independent body that looks behind its borders and is also concerned by possible contagious effects. Therefore, in the near future the ESRB must be reinforced, both in terms of resources and powers, as in its current setting it is only able to exert pressure having no “real” powers. In the light of a reinforced micro-prudential supervision (the SSM), also the macro-prudential oversight must be enhanced.

Finally, regarding the SSM’s interaction with ESMA and EIOPA, in the current framework it will have few implications, as, according to the Treaty, the ECB, under the SSM, may carry out prudential supervision toward “only” credit institutions. However, it is likely that in the future things will change and therefore these authorities will need to evolve accordingly.

Challenges ahead: establishing and complementing the SSM

Despite some delays, the SSM is on the right track and, even if the system may not be perfect due to several legal constraints, it is an essential step towards truly addressing the causes of the financial crisis.

The creation of the SSM, in the context of the broader concept of a Banking Union, raises several challenges. In the European financial landscape it is an epochal shift, a new frontier, even comparable to the creation of the European Monetary Union.

Will the ECB be able to take up effectively these supervisory tasks? If so, will this system prove better than the previous supervisory structures? In the nearest future the ECB will have a heavy agenda as, for instance, it has to swiftly develop supervisory competences and practical arrangements to deal with national competent authorities.

Furthermore, coordination between EU-level direct supervision of banks under the SSM and the national supervision of the rest of the financial sector could be a source of tension.

Another delicate issue consists in the non-eurozone countries' participation to the SSM. Even if they will participate, they will not be "full" members of the SSM, because only the eurozone countries have a voice in the decision-making body of the ECB, the Governing Council, and therefore non-eurozone countries will not have a say in its final decisions. To counterbalance this situation, the EBA functioning will be altered, but also in this case it will result in a sub-optimal outcome, as it will grant to non-eurozone countries disproportionate power regarding the EBA decisions due to the double majority voting rule.

The lack of non-eurozone full membership and the issue of voting rights are direct consequences of the Treaty constraints that have rendered the task of designing the SSM more difficult. Despite these limitations, the SSM has the prerequisites to function efficiently within the existing Treaty. However, changing the Treaty only for the SSM is not a viable choice, but, if in the future the Treaty would be changed for other reasons, the EU legislators would certainly take the opportunity to revise the Treaty provisions that impede a better design of the SSM.

Even if the overall design of the SSM is already been outlined, the political debate is still ongoing, with several aspects on which the MEPs (Members of the European Parliament) are requiring more clarity. In the following weeks the negotiations will focus their attention mainly on the required stronger accountability of the ECB, on the participation of non-Eurozone countries and on a stricter division between monetary policy and supervision roles inside the ECB. However, the most is already been done, and the SSM Regulations should be finally adopted in September 2013 and, therefore, it should enter into force from 1st October 2014.

In waiting a formal adoption, the ECB is already at work by organising the operational framework in order to be ready to effectively and efficiently assume the new responsibilities once the SSM will be operative.

Although the SSM represents a major step towards a more integrated financial framework, in order for it to suitably function it is essential that a Single Resolution Mechanism (SRM) is created. It is crucial that a framework for banks resolution is in place once the SSM will be operative, in order to avoid the risk of encouraging supervisory forbearance based on the expectation of the implicit guarantee provided by central banks, i.e. by providing liquidity in case of financial distress. Therefore, a SRM needs to be put in place to ensure that non-viable credit institutions are closed down and resolved. As for the SSM, the SRM requires a European dimension in order to be able to decide timely and impartially disregarding national political interests and preserving taxpayers' money. The creation of the SRM depends on the adoption of the Bank Recovery and Resolution Directive, that contains an harmonised toolkit of resolution powers. However, the precise framework of the SRM has yet to be defined and a proposal by the European Commission is expected to be submitted in the summer, even if, considering the delay in the SSM negotiations and the important political issues, mainly regarding to the financial consequences for Member States, it is likely to have a proposal for the SRM later this year, if not the next year.

The other fundamental pillar of the Banking Union, complementary to both the SSM and the SRM, is a common European deposit guarantee scheme. Currently, in the European Union, deposit guarantees are provided by each Member State separately, with certain common minimum requirements set at the EU-level[3]. In the light of the upcoming Banking Union, national-level deposit guarantees are not compatible with a EU-level supervision and resolution. This because, if a sovereign's financial health is under pressure, depositors could question the government's ability to guarantee their deposits and this would lead to national bank run, as it happened in Cyprus the last February. For this reason, a EU-level deposit guarantee scheme, at least for all SSM participating countries is deemed necessary, even if not urgent as the Single Resolution Mechanism. However, it is likely that in the near future the European deposit guarantee discussion will not be addressed, since there are more urgent issues to tackle, i.e. supervision and resolution. In addition, being a very delicate political subject as it could involve large money transfers between Member States, in the light of the upcoming September German elections and the next year renewal of the European Parliament, I think it is very unlikely that a political agreement is reached within the next 18 months.

As Rome wasn't built in a day, the European Banking Union is a very complex and delicate project and it will take time to get it up and running effectively. However, the continuous delays, due mainly to political issues and frictions between Member

[3] See Directive 94/19/EC on Deposit Guarantee Schemes – Consolidated Version.

States rather than technical points, could undermine the credibility of the overall project. This sort of procrastination policy seen until today sends wrong signals. Both the SSM and the SRM, but also the DGS, are the elementary pillars for the recovery and reintegration of the European banking system and therefore they must be implemented swiftly and decisively.

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