Cross-border Banking and the SSM

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Abstract

In this article, I try to assess the likely impact of the Single Supervisory Mechanism (SSM) on cross-border banking in Europe. Firstly, I analyse the limits of the SSM, which is grounded on supervisory cooperation even though the ECB has powers of direction and substitution with respect to national supervisors. Indeed, the SSM represents a system of semi-strong centralisation, which may give rise to agency problems, particularly in the relationships with supervisors of non-euro area countries. Secondly, I examine the decoupling of supervision from regulation, which derives from the fact that the ECB lacks sufficient regulatory powers when acting as a supervisor of the Eurozone banking systems. The separation of regulation – which is harmonised at EU level – and supervision – which is centralised in the euro area – may create problems to the extent that the single supervisor cannot issue a prudential rulebook for the Eurozone but is subject to EU prudential regulation and national law provisions, often unduly limiting its supervisory discretion.

1. Introduction

Economists predict three types of positive effects of the Banking Union (Constâncio 2014; Véron 2015). Firstly, cross-border banking groups should function better, as they will be able to optimise their internal management of capital and li-

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quidity and reduce compliance costs. Unified supervision should also create greater trust among banks. Secondly, consolidation should occur in the European banking sector. Indeed, the weak profitability and excess capacity of this sector suggest that efficiency gains could derive from more consolidation. This and the repair of bank financial accounts should set the stage for a new phase of mergers and acquisitions. Thirdly, the role of capital markets should be enhanced. Corporate bond financing is becoming an important alternative to bank financing also in Europe. The shift towards more capital market-based intermediation should go forward, also considering regulatory incentives for banks to hold liquid instruments rather than loans. The European Commission pursues a strategy in this direction through the launch of a Capital Markets Union project (European Commission 2015).

In this article, I try to understand how likely it is that these predictions will be confirmed by future developments of the Banking Union. In particular, I assess the likely impact of the Single Supervisory Mechanism (SSM) on cross-border banking in the Eurozone by analysing possible shortcomings which may hinder the materialization of the Banking Union's positive effects highlighted above (Ferrarini and Chiodini, 2012 review the regulatory framework prior to the SSM). Firstly, I analyse the organization of the SSM, which is still grounded on supervisory cooperation even though the ECB has powers of direction and substitution with respect to national supervisors. Secondly, I examine the decoupling of supervision from regulation, which derives from the fact that the ECB lacks sufficient regulatory powers when acting as a supervisor of the Eurozone banking systems. The separation of regulation – which is harmonised at EU level – and supervision – which is centralised in the euro area – may create problems to the extent that the single supervisor cannot create a prudential rulebook for the Eurozone, but is subject to EU prudential regulation and national law provisions, often unduly limiting its supervisory discretion (Ferrarini 2015 and Ferrarini and Recine 2015 treat these topics more extensively).

2. The SSM in a Nutshell

The Single Supervisory Mechanism (SSM) is the first pillar of the European Banking Union, consisting of the European Central Bank (ECB) and the national supervisory authorities of the euro area. The tasks conferred on the ECB include

the following: to authorise credit institutions and withdraw their authorisations; to assess applications for the acquisition and disposal of qualifying holdings in credit institutions; to ensure compliance with prudential requirements on credit institutions (in areas like own funds requirements, large exposure limits, liquidity, leverage, etc.) and with requirements to have in place robust governance arrangements; to carry out supervisory reviews.

The ECB is provided with the same powers as those available to competent supervisory authorities under EU law. To the extent necessary to carry out its tasks the ECB may, by way of instructions, require national authorities to make use of their powers where the SSM Regulation does not confer such powers on the ECB. In addition, the ECB is vested with broad investigatory powers which include requiring credit institutions and other legal or natural persons to provide information; conducting all necessary investigation of any relevant person; and conducting all necessary on-site inspections at the business premises of the relevant legal persons (after being authorised by a judicial authority if national law so requires).

Moreover, the ECB is vested with specific supervisory powers for the exercise of which it is assisted by national authorities, in the areas of authorisation of credit institutions and assessment of acquisitions of qualifying holdings. Furthermore, the ECB is empowered to require institutions to hold funds in excess of capital requirements; to reinforce arrangements, processes, mechanisms and strategies; to present a plan to restore compliance with supervisory requirements; to apply a specific provisioning policy; to restrict or limit the business, operations or network of institutions; to limit variable remuneration; and to use net profits to strengthen own funds. The ECB is also provided with a sanctioning power, but only where institutions breach a requirement under directly applicable acts of Union law (and only with regard to legal persons). In other cases, the ECB – where necessary for carrying out the tasks conferred upon it by the Regulation – may require national competent authorities to open proceedings with a view to taking action in order to ensure that appropriate sanctions are imposed in accordance with relevant EU law and national legislation.

The SSM covers - either directly or indirectly - all credit institutions established in participating countries. The criteria under which banks fall under the direct supervision of the ECB include size, importance for the economy of the

EU or of a Member State, and significance of cross-border activities. In practice, 122 banking groups (possibly 130 next year) are subject to direct supervision, with balance sheets accounting for €25 trillion euro in assets (Nouy 2015).

The SSM is largely grounded on delegation to national authorities and supervisory cooperation. Indeed, the ECB performs its supervisory tasks within the SSM, which is also comprised of national competent authorities. Both the ECB and these authorities are subject to a duty of cooperation and a duty to exchange information. However, this model is not simply one of enhanced cooperation between supervisors, given that the ECB has responsibility for the system, together with powers of direction and substitution with respect to national supervisors.

An architecture based on cooperation and delegation under the direction and control of a central authority is to some extent unavoidable, given that more than 6000 banks are based in the euro area, of which the top 150 groups cover 80 per cent of banking assets. The largest institutions (and the ones to be identified according to special criteria) are under direct ECB supervision. However, national authorities provide the latter with all information necessary and assist it in the preparation and implementation of acts relating to its supervisory tasks. The remaining institutions are supervised by the national authorities and only indirectly by the ECB. Reference to national authorities was dictated by resource constraints and political expediency, but also by the existence in the Eurozone of different legal, accounting and taxation frameworks, as well as of many languages and business contexts. Full centralisation was not an option, even with regard to cross-border banks, given that supervisory resources are mainly national and firm proximity is important in supervision. However, decentralisation should not reduce the role of the single supervisor to the mere validation of decisions taken locally, given the need for supervisory consistency with respect to the entire banking system of the euro area.

3. Semi-strong Supervisory Centralisation

Whether this complex model of delegation and cooperation will work in practice is early to assess. Nevertheless, I would argue that the SSM, despite being a remarkable step towards a single supervisor model, still represents a

semi-strong form of centralisation for it still relies, to some extent, on supervisory cooperation. Cooperation mechanisms tend to fail in case of a crisis, as supervisors pursue their national interest rather than the European one, while delegation allows the delegated authority to exploit its informational advantage. Cooperation and information duties are insufficient to counter such difficulties, for the national supervisors' incentives often go in the opposite direction, particularly when facing a crisis. Moreover, the ECB's direction and substitution powers may be impaired by the non-cooperation of local supervisors, including non-compliance with their information duties. In addition, enforcement of national legislation against credit institutions may be difficult to the extent that the ECB lacks *locus standi* before the national courts. While recourse to the European Court of Justice may be too slow for effective enforcement, the alternative of the ECB asking national supervisors to bring the relevant claims in national courts may encounter procedural difficulties, in addition to creating agency problems in the relationship between the central and the delegated supervisor.

Similar comments also apply to the regime included in the SSM Regulation with respect to administrative sanctions. From an organisational perspective, it would be difficult for the ECB to run proceedings for the imposition of administrative sanctions under the different domestic laws that may be applicable in individual cases. From a legal perspective, the ECB's sanctioning power under national law and its *locus standi* in national courts would appear to be problematic. This explains the recourse in the Regulation to two different sanctioning regimes, depending on whether the relevant breaches refer to EU law or to national law. However, the limits of the choice made are obvious, for the delegation to national authorities carries agency problems that might impair the effectiveness of enforcement, particularly considering that these authorities would run the relevant proceedings under their own responsibility and would be free not to impose sanctions as a result.

An additional and difficult question is whether the national authorities keep their power of initiative in relation to sanctioning proceedings, so as to be able to impose sanctions even if not required by the ECB. Art. 18(5) does not exclude this possibility, which would, however, run against the logic of the SSM and the responsibilities of the ECB, at least in the case of banks that are directly supervised by the latter.

4. Cooperation with Other Authorities

The SSM focus on the Eurozone determines the need for the ECB to cooperate with other authorities in the EU. These are, first of all, the European Supervisory Authorities (ESAs) forming the European System of Financial Supervisors (ESFS), including the European Banking Authority (EBA). The amended EBA Regulation effects 'a rebalancing' of the position of EBA vis-à-vis the ECB, strengthening EBA in an effort to avoid 'centrifugal forces'. Firstly, the Regulation establishing EBA has been modified to ensure that EBA can carry out its tasks in relation to the ECB by clarifying that the notion of 'competent authorities' also includes the latter. Secondly, the amended Regulation confirms EBA's powers to harmonise technical standards for regulation and supervision. Thirdly, EBA's governance has been changed in order to effect a rebalancing of powers between member States. An independent panel will make proposals to the Supervisory Board, whose decisions will be taken by a majority including a simple majority of its members from participating member States and a simple majority of its members from non-participating member States. The ECB shall continue to participate in EBA's Board of Supervisors through a non-voting representative. It also participates in colleges of supervisors without prejudice to the involvement of national competent authorities of participating Member States in these colleges.

With reference to the Member States not participating in the single currency, the ECB and the competent authorities of those Member States may enter into cooperation through a memorandum of understanding that outlines the terms for their collaboration in carrying out their respective supervisory duties under Union law (the 'close cooperation' regime of Art. 7 SSMR).

As a result, the SSM does not substantially modify the general framework of EU banking supervision, save for what provided with respect to EBA's position vis-à-vis the ECB. Indeed, the introduction of the SSM does not affect the models of enhanced cooperation and lead supervision on which the EU general framework is based. These models still characterise bank supervision in Europe, while a model of semi-strong centralisation is in place for Eurozone countries. Of course, this picture could change substantially if a sufficient number of non-euro countries adhere to the system of 'close cooperation' foreseen by the Regulation. By opting into close cooperation with the ECB, a non-euro country shall become a participating Member State and will be subject to a regime sim-

ilar to that applicable to euro countries. Assuming that the great majority of EU Member States participate in the SSM, as a result of many non-euro countries opting in, the problems of cooperation with EBA and the competent authorities of non-participating countries would be substantially reduced.

However, the incentives for a non-euro country to participate in the Banking Union are unclear. No doubt, extending common supervision to all EU countries would work in the interest of systemic stability, as argued throughout this paper. However, the theoretical soundness of this argument will not necessarily determine its acceptance in practice. Indeed, by participating in the SSM, a Member State will give up most of its supervisory powers in favour of the ECB. The incentives for politicians to proceed along a similar route are doubtful. While the loss of sovereignty is clearly visible, the gains in terms of systemic stability and financial integration would be difficult to explain to the average voter. Moreover, these benefits will depend on a sufficient number of non-euro countries opting in. If this number is low, the incentive to participate will be modest, pointing to a collective action problem which is not easily solved. Furthermore, non-participating Member States shall enjoy some voting power within EBA's Supervisory Board, which might create a sufficient incentive not to join the SSM. Therefore, recent efforts to rebalance the voting power within EBA's Supervisory Board – which are officially justified by reference to the need to protect the financial interests of the Union – paradoxically reduce the incentives for non-euro countries to participate in the SSM.

5. The Single Rulebook and the SSM

The new CRD/CRR package brought about two important innovations for EU prudential rule-making. Firstly, despite being rather detailed, the CRR and CRD foresee that further provisions will be adopted at Level 2 through regulatory and implementing technical standards. Secondly, a large part of the new prudential requirements have, for the first time, been enacted through a EU regulation (CRR), i.e., an instrument that is directly applicable in the Member States. Moreover, the whole package was inspired by the principle of maximum harmonisation, so as to avoid uneven implementation by Member States, which has been considered as a key ingredient in the run-up to the crisis.

However, the EU regulatory arena today sees many players acting under often unclear and overlapping mandates. In addition, reforms of the EU regulatory framework have produced several layers of rules, with no clear accountability for the final output. At Level 1, the EU institutions set out the main rules. These rules were originally conceived as high-level principles, but today they tend to be very detailed, mainly pursuing a maximum harmonisation approach. At Level 2, the Commission and EBA make rules on the basis of mandates, which are set out in Level 1 directives and regulations and provide for the issuance of delegated acts and regulatory technical standards under 'comitology' procedures. When directives are adopted at either level, Member States provide for their implementation through national rules which are adopted by parliaments, governments or regulators. At Level 3, EBA issues guidelines and recommendations specifying the rules set at the other two levels.

Art. 4(3), first paragraph, of the SSM Regulation states that, for the purpose of carrying out its supervisory tasks, the ECB shall apply all relevant Union law and, where Union law is composed of directives, the national legislation transposing them. Where the relevant Union law is composed of regulations and those regulations explicitly grant options to Member States, the ECB shall also apply the national legislation providing for those options. However, as specified by Recital 34 of the SSM Regulation, "such options should be construed as excluding options available only to competent or designated authorities". The question therefore arises (and is briefly analysed in the following section) whether similar options should be exercised by the national competent authorities or by the ECB, at least with respect to institutions directly supervised by the same.

The ECB has only limited rule-making powers as to prudential supervision. According to Art. 4(3), second paragraph, the ECB shall adopt guidelines and recommendations, and take decisions subject to and in compliance with the relevant Union law. It shall in particular be subject to binding regulatory and implementing technical standards developed by EBA and adopted by the Commission in accordance with the EBA Regulation, and to that Regulation's provisions on the European supervisory handbook developed by EBA. The ECB may also adopt regulations, but only to the extent necessary to organise or specify the arrangements for carrying out the tasks conferred on it by the SSM

Regulation. Before adopting a regulation, the ECB shall conduct open public consultations and analyse the potential related costs and benefits. In addition, the ECB should 'exercise powers to adopt regulations in accordance with Art. 132 of the Treaty on the Functioning of the European Union (TFEU) and in compliance with Union acts adopted by the Commission on the basis of drafts developed by EBA and subject to Art. 16 of Regulation (EU) No 1093/2010'.

6. The consultation on O&Ds

Interesting developments are taking place with the ECB consultation on the options and discretions (O&Ds) which are granted to supervisors by the Capital Requirements Regulation (CRR) and by the Commission Delegated Regulation on the Liquidity Coverage Ratio (LCR Delegated Act). Some of these O&Ds are applied in a general manner, while some are applied following a case-by-case approach. The Explanatory Memorandum clarifies that "for general O&Ds, the decision of the supervisor applies to all banks, whereas for case-by-case O&Ds supervisory decisions are bank specific" (ECB 2015a). Accordingly, the ECB is consulting on two related documents: a draft ECB regulation on the exercise of 35 general O&Ds (ECB 2015b) and a draft ECB Guide on the exercise of 82 case-by-case O&Ds (ECB 2015c).

The ECB's power to issue guidelines for specific O&Ds derives from Article 4(3), second paragraph, of the SSM Regulation, providing that the ECB can adopt guidelines for the purpose of carrying out its tasks. The power to issue a regulation on general O&Ds is not specifically mentioned in the SSM Regulation, which on the contrary states that the ECB can adopt regulations only to the extent necessary to organise or specify the arrangements for carrying out the tasks conferred on it by the Regulation.

However, the ECB seems to rely on Article 9 (1) of the SSM Regulation stating in its first paragraph that, for the purpose of carrying out its supervisory tasks, the ECB shall be considered, as appropriate, the competent authority or the designated authority in the participating member States as established by the relevant Union law. Art. 9(1), second paragraph, further specifies: "For the same exclusive purpose, the ECB shall have all the powers and obligations set out in this Regulation. It shall also have all the powers and obligations,

which competent and designated authorities shall have under the relevant Union law, unless otherwise provided for by this Regulation. In particular, the ECB shall have the powers listed in sections 1 and 2 of this Chapter." These are the investigatory powers and other specific supervisory powers.

Indeed, the ECB Explanatory Memorandum to the current Consultation indicates the legal basis for the draft ECB Regulation and the draft ECB Guide as follows: "Since becoming the competent authority for the significant institutions within the euro area on 4 November 2014, the ECB has had the power to determine the most appropriate way to exercise the supervisory O&Ds for the institutions under its direct supervision. Recital 2 of the SSM Regulation states that it is essential to intensify the integration of banking supervision in order to bolster the Union, restore financial stability and lay the basis for economic recovery ... In addition, the ECB has the mandate to ensure the consistent functioning of the SSM (Article 6 of the SSM Regulation)".

The Preamble of the draft ECB Regulation further specifies that the O&Ds granted by a regulation for which the ECB should apply the national implementing legislation (Article 4 (1) SSM Regulation) "do not include those available only to competent authorities, which the ECB is solely competent to exercise and should exercise as appropriate" (Recital 7). Furthermore, "in exercising options and discretions, the ECB, as the competent authority, should take account of the general principles of Union law, in particular equal treatment, proportionality and the legitimate expectations of supervised credit institutions" (Recital 8).

However, the provisions of the SSM Regulation cited in the Preamble do not specifically refer to a regulatory power of the ECB for the implementation of general O&Ds. In particular, Article 4 (3) constrains the ECB regulatory power to organizational matters, so that the power to regulate prudential matters is in principle excluded. Moreover, Article 9 (1) clearly refers to supervisory powers, which are different from rule-making ones (although the policies relating to prudential supervision could include rule-making, as argued in the following section). Presumably in order to overcome similar difficulties, the Explanatory Memorandum makes recourse to a functional reading of the SSM Regulation, arguing that the ECB regulatory power is needed for the proper functioning of the SSM. Which is true on policy grounds, as I explain below, but is a thin legal basis for the ECB's regulatory power.

7. A Single Rulebook for the Eurozone?

There is clearly an asymmetry between the ECB's monetary and supervisory roles. On the one hand, the ECB is a fully fledged EU institution with exclusive competence regarding monetary policy and strong regulatory powers in its area of competence. On the other hand, it is a prudential supervisor replacing national authorities on the basis of a delegation by EU institutions. As a banking supervisor, the ECB enjoys limited regulatory powers, being subject to both Union law and national law. Moreover, the ECB is subject to the powers of EBA as to dispute settlement, emergency decisions and breach of EU law. In addition, it is subject to the procedures provided for by the CRR when implementing macro-prudential measures. In some cases, the ECB has an even more limited status than national authorities, lacking, e.g., voting rights within EBA's Board of Supervisors.

However, a proper reading of the Treaty would already allow the delegation of regulatory powers to the ECB in its role as a prudential supervisor. Indeed, Art. 127(6) of the TFEU states that specific tasks may be conferred upon the ECB 'concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings'. The notion of 'policies' could no doubt include some rule-making powers in the areas of prudential supervision that the Council could very well specify in its mandate to the ECB grounding the SSM.

The reasons supporting the current regulatory approach, including a single supervisor for the euro area without rule-making powers, are easily understood. Promoting the single market whilst assuring a level playing field requires a single set of rules across the EU. If the ECB became the rule-setter for all EU banks, non-euro Member States would clearly be concerned that bank regulation was biased to Eurozone banks. Nonetheless, the present decoupling of regulation (which is made at EU level) from supervision (which is performed at either national or Eurozone level) makes the ECB appear like Janus Bifrons, the Roman god whose head had two faces (one oriented to the future and the other to the past). Even assuming that the ECB's features as a central bank were rightly set aside when constructing the SSM, we should still consider whether the present approach, resulting from hard political compromises, leads to efficient and effective supervision. On the one

side, rule-making powers are generally considered as an important tool for supervisory authorities, which can regulate either the structure of firms or their conduct with a view to reducing the probability of bank failures and safeguarding financial stability. On the other side, regulatory independence, i.e., a high degree of autonomy of independent supervisors in rule-making, is a well-established international financial standard and crucially includes equipping supervisors with large discretion to set and change the rules flexibly. I wonder whether such an objective is fulfilled by the complex interaction between different layers of rules concerning the SSM, which make regulatory change a very cumbersome process involving several players.

To sum up, the present EU regime for prudential regulation – which is characterised by maximum harmonisation, several layers of regulation, multiple rule-makers and excessively detailed rules – may be suboptimal for the SSM and hinder its flexibility. Moreover, the countries participating in the SSM do not face the problem of regulatory competition, which maximum harmonisation is aimed to solve. Rather, the SSM will need a consistent and homogenous regulatory framework in order to make supervision uniform in the Eurozone. This is not to say that EU harmonisation will become irrelevant from the Banking Union perspective. Indeed, harmonisation will still be needed vis-à-vis the countries that do not participate in the SSM; furthermore, EU-wide banking groups clearly benefit from harmonisation of the rules in all countries where they are established.

8. Conclusions

In this paper, I have tried to assess the likely impact of the Banking Union and particularly of the SSM on cross-border banking. After briefly analysing the predictions made by economists and policy-makers with regard to the deeper integration of financial markets that may derive from the Banking Union, I highlighted the organizational limits of the Single Supervisory Mechanism. I argued, moreover, that the SSM could give rise to agency problems also in the relationship between the ECB and the supervisors of non-euro area countries. I then examined the decoupling of supervision from regulation within the Banking Union and the negative consequences which may derive from it in terms of efficiency and effectiveness of supervisory action. The lim-

its discussed in this paper with respect to the SSM and to the single rulebook help understanding the degree of uncertainty characterising the predictions commonly made by economists and policy-makers with respect to the impact of the Banking Union on cross-border banks.

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