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The Single Supervisory Mechanism - Panacea or Quack Banking Regulation? Preliminary assessment of the evolving regime for the prudential supervision of banks with ECB involvement

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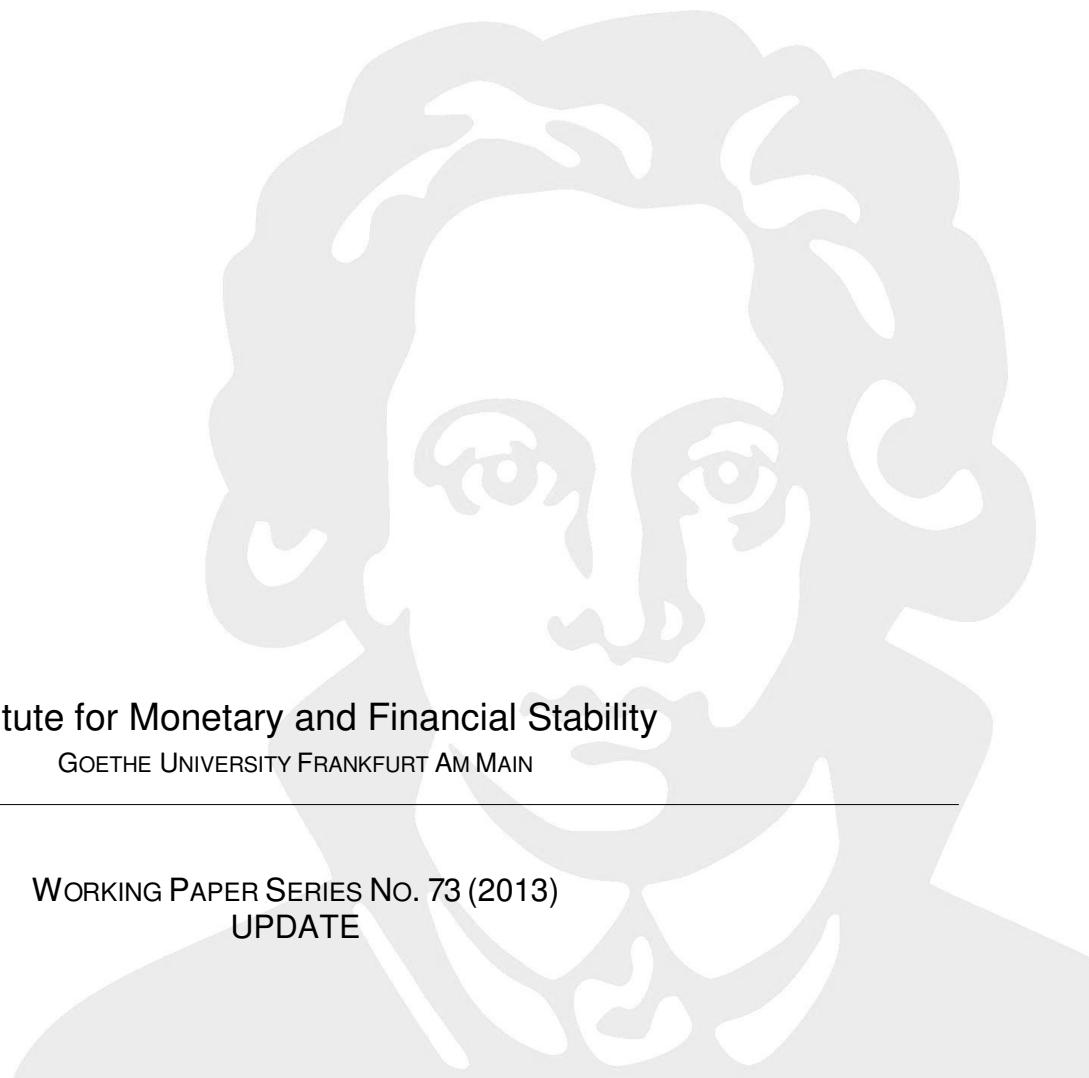
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TOBIAS H. TRÖGER

The Single Supervisory Mechanism –
Panacea or Quack Banking Regulation?

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The Single Supervisory Mechanism – Panacea or Quack Banking Regulation?

PRELIMINARY ASSESSMENT OF THE NEW REGIME FOR THE PRUDENTIAL SUPERVISION OF BANKS WITH ECB INVOLVEMENT

(original draft: August 16, 2013; this draft: October 19, 2013)

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Abstract: This paper analyzes the recently established architecture for the prudential supervision of banks in the euro area. It is primarily concerned with the likely effectiveness of the SSM as a regime that intends to bolster financial stability in the steady state.

By using insights from the political economy of bureaucracy it finds that the SSM is overly focused on sharp tools to discipline captured national supervisors and thus under-incentivizes their top-level personnel to voluntarily contribute to rigid supervision. The success of the SSM in this regard will hinge on establishing a common supervisory culture that provides positive incentives for national supervisors. In this regard, the internal decision making structure of the ECB in supervisory matters provides some integrative elements. Yet, the complex procedures also impede swift decision making and do not solve the problem adequately. Ultimately, a careful design and animation of the ECB-defined supervisory framework and the development of inter-agency career opportunities will be critical.

The ECB will become a *de facto* standard setter that competes with the EBA. A likely standoff in the EBA's Board of Supervisors will lead to a growing gap in regulatory integration between SSM-participants and other EU Member States.

Joining the SSM as a non-euro area Member State is unattractive because the legal framework grants no voting rights in the ECB's ultimate decision making body. It also does not supply a credible commitment opportunity for Member States who seek to bond to high quality supervision.

JEL classification: G21, G28, H77, K22, K23, L22.

Keywords: prudential supervision, banking union, regulatory capture, political economy of bureaucracy, Single Supervisory Mechanism (SSM), European Central Bank (ECB), European Banking Authority (EBA)

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I EUROPE’S HAMILTONIAN MOMENT?

The sovereign debt crisis in the euro area has been regarded as an event that could prompt closer fiscal integration in the E.U. that would potentially resemble Alexander Hamilton’s debt assumption plan of 1790.¹ In fact, the impetus to retroactively cure a perceived defect of the European Monetary Union (EMU)² seems to be much stronger than the historical catalyst for the U.S. developments that started with Hamilton’s original proposal: the unsustainable debt burden of U.S. states at the time amounted to 13.39% of GDP, which is why its assumption raised prospective federal debt-levels to no more than 42.29% of GDP,³ whereas today, the Member States of the euro area alone owe an amount equivalent to 92.2% of GDP.⁴ Yet, precisely these staggering numbers also explain the reluctance of governments in fiscally rather strong E.U. Member States⁵ when it comes to confronting their electorate with bolder leaps towards an encompassing economic, fiscal and political integration of the euro area: *prima vista* they could be misrepresented as an unconditional bail-out of irresponsible foreigners, a view that would be oats for populist opposition parties. The political economy hence suggests that a pragmatic approach of

¹ The comparison originates with Thomas J. Sargent’s Nobel Lecture, Sargent (2012, p. 10-29). For an astute analysis *cf.* Henning and Kessler (2012).

² For pre-sovereign solvency crisis contributions that argued for adding a banking component to the EMU model Čihák and Decressin (2007, p. 7-12), Véron (2007, p. 4-6). The general theory of optimum currency areas that typically considers close fiscal integration with a common transfer mechanism an essential precondition for successful currency areas originates with Mundell (1961), McKinnon (1963) and Kenen (1969). For a survey of the literature see Bayoumi and Eichengreen (1996).

³ Sylla (2011, p. 67); Johnston and Williamson (2013).

⁴ eurostat (2013).

⁵ Although, in line with common sentiment the highest ratios of government debt to GDP at the end of the first quarter of 2013 were recorded in Greece (160.5%), Italy (130.3%), Portugal (127.2%) and Ireland (125.1%), it is worth noting that both France (91.9%) and Germany (81.2%) exhibit debt to GDP-ratios (eurostat, 2013) in the vicinity or even beyond the 90%-threshold that was regarded as a peril to long-term prosperity in an influential, yet contested contribution, *cf.* Reinhart and Rogoff (2010); but see also Herndon et al. (2013).

piecemeal integration is the most sensible real world option to progress in the current *mêlée*.⁶

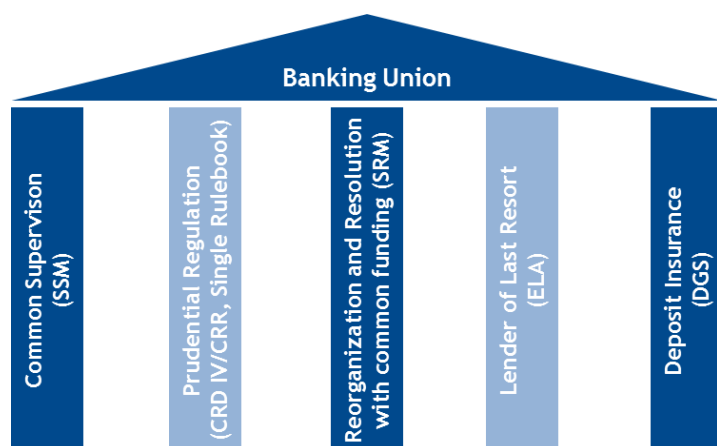


figure 1 - elements of banking union

Political leaders' pledge to establish a European banking union⁷ which would ensure an impartial and uniform implementation of a stringent regulatory and supervisory framework for all euro area banks could, if ultimately fulfilled, lead to a welcome contribution.⁸ Of course, a set of stringent substantive rules that govern banks' operations and risk-taking behavior, an effective and rigorously enforced

supervisory and resolution regime together with common safety nets (*i.e.* a reliable deposit guarantee scheme and clearly defined central bank lender of last resort obligations)⁹ arguably cannot do much to cure the current woes,¹⁰ but are apt to make

⁶ For an account of the broader political agenda of the European "four presidents" see Van Rompuy et al. (2012). On the dense intertwining of a successful banking union with reinforced fiscal and political integration in Europe, Pisani-Ferry et al. (2012, p. 15, 19); Véron (2012, p. 3-4).

⁷ The catchword refers to a centralization of pivotal instruments of banking policy on the supranational level which serves to preserve and advance the integration of the European (euro area) banking system, for an early proposal Fonteyne et al. (2010).

⁸ On the general desirability of a euro area banking union, see e.g. Goyal et al. (2013, p. 7-10); Pisani-Ferry et al. (2012, p. 3-4); Véron (2012, p. 2); for a skeptical assessment of the projects ultimate political feasibility, Elliot (2013, p. 45-6). To be sure, even beyond a common currency, the goal of market integration can militate in favor of a mutualization of banking policy among the 28 Member States of the E.U., for a discussion see Pisani-Ferry et al. (2012, p. 7).

⁹ For an analysis of the individual components an expedient banking union should feature (figure 1) Goyal et al. (2013, p. 7-8, 12-20), Pisani-Ferry et al. (2012, p. 6-15). Political statements are somewhat murky when it comes to DGS and don't even mention lender of last resort duties, European Commission (2012a, p. 7-8), Van Rompuy (2012, p. 4). In fact, as a reaction to predictable political headwind from certain Member States who fear a far-reaching mutualization of liabilities and the asymmetric sharing of costs, the creation of a common DGS is no longer a Council priority, cf. European Council (2012a, p. 4). Equivalent conflicts may delay enacting a resolution regime with common funding of backstops to combat systemic events. On the other hand, the harmonized set-up of substantive banking regulation has been adopted recently, cf. Directive 2013/36 of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 2013 O.J. (L 176) 338 [hereinafter: CRD IV] and Regulation 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, 2013 O.J. (L 176) 1 [hereinafter: CRR].

¹⁰ Some commentators see the banking union's potential contribution to ongoing crisis-management in the removal of tail-risks and contingent sovereign liabilities, e.g. Goyal et al. (2013, p. 5, 9-10, 20, 26). Yet, this depends on how the banking union relates to "legacy

future calamities less likely and limit their impact, if indeed all elements of the banking union depicted in figure 1 are ultimately introduced.

If regulatory intervention can indeed advance the goal of creating a more resilient financial system,¹¹ its foremost feature has to be its effectiveness as judged with particular regard to its stringent implementation and enforcement.¹² Only the latter will reaffirm lost confidence in the financial system's stability as the indispensable basis for sustainable credit-funded growth in the long run.¹³ The predicament of designing and launching the Single Supervisory Mechanism (SSM) as the first step¹⁴ towards a comprehensive banking union is that it potentially contributes to both combating the ongoing sovereign debt crisis¹⁵ as well as fostering the steady state in the long run.

This paper is primarily concerned with the evolving architecture's long-term prospects. In this context, increasing centralization must not always represent a value in itself, particularly so if it leads to hybrid forms that combine supranational dominance with persistent inter-agency cooperation. The evolving institutional framework has to exhibit plausible advantages over available alternatives. The spe-

assets", to wit whether direct ESM-recapitalizations will become available for balance sheet risks incurred under national supervision prior to the SSM becoming operational, *infra* note 43.

¹¹ For a recent skeptical view that emphasizes the detrimental impact of complex regulation which diminishes the importance of reputation and substitutes it for technical expertise without restraining behavior in an equivalent, meaningful way Macey (2013, p. 254-9). On the conventional rationale for prudential banking regulation and supervision Bhattacharya et al. (1998).

¹² Goyal et al. (2013, p. 8); Huertas (2012, p. 3); Wymeersch (2012, p. 4).

¹³ To be sure, the banking union cannot counter fears associated with a Member State's exit from the euro area that would impair deposits by way of re-denomination, Pisani-Ferry et al. (2012, p. 16). The ECB sought to address these anxieties revolving around the euro area's integrity in the announcement of its Outright Monetary Transaction (OMT) program, ECB (2012c).

¹⁴ On the optimal phasing-in of the banking union itself, Pisani-Ferry et al. (2012, p. 16-7); Goyal et al. (2013, 22-4).

¹⁵ In this regard, it would arguably contribute already, if the SSM was established, because it would affirm political leaders' commitment to do more to address the crisis than to present long-term visions, Pisani-Ferry et al. (2012, p. 15, 16). A more tangible advantage for crisis containment sometimes associated with the introduction of the SSM is contingent on the treatment of pre-existing debt overhangs (legacy liabilities), see *infra* note 43. Only if ECB-oversight also inaugurated the option to recapitalize those banks that accumulated their losses under national supervision directly with funds from the European Stability Mechanism (ESM), could the SSM redound to calming markets: it has been argued, that immediate mutualization of systemic risks allowed adequate provisioning of impaired assets, thus bought time for their value-preserving, post-crisis liquidation, an hence contributed to severing the bank-sovereign-link with its negative externalities Goyal et al. (2013, p. 9-10, 20-21, 26). Others have proposed a clean and neat separation-scheme that contemplates mutualization only in the exceptional case of legacy liabilities exceeding a sovereign's capacity and under the precondition of clear cost-sharing agreements, Pisani-Ferry et al. (2012, p. 16, 17). Some commentators have voiced fierce criticism with regard to the introduction of common backstops, albeit without addressing the macro-economic issues and pointing *inter alia* to the perils of common funded, indirect state financing instead, Schneider (2013, p. 453-4, 456-7).

cific set of rules introduced has to be the plausibly superior option at hand to promote the overall objectives.¹⁶

The recent promulgation of an operational set of rules for a SSM¹⁷ already raises doubts with regard to the effectiveness of the first pillar of the evolving regime. In fact, a closer look at both the events that triggered the legislative initiative (*infra* 2) and the distribution of competences between the European Central Bank (ECB) and national competent authorities (NCAs) within the SSM (*infra* 3) show that the new architecture was strongly influenced by availability heuristics and is thus more rooted in a mistrust *vis-à-vis* (captured)¹⁸ national supervisors than in the ambition to provide an integrative framework that optimizes effective transnational supervision. Against this background, it comes as no surprise that the SSM Regulation will be more concerned with providing sharp tools to discipline reneging national authorities but may prove problematic when it comes to inducing optimal cooperation between the ECB and non-opportunistic national supervisors. Yet, the latter remains vastly essential for the proper functioning of the new supervisory framework and requires a careful fine-tuning of incentive structures within the SSM that may militate against effective decision-making procedures. Moreover, the ECB's position within the SSM creates a *de facto* standard-setter alongside the European Banking Authority (EBA) which has the potential to countervail the goal of incrementally increasing the uniformity of actually observed supervisory practices in the E.U. as a critical component of the single market for financial services (*infra* 4). Finally, the reserved assessment is amplified if the attractiveness of the SSM is gauged from the vantage of non-euro area Member States who may thus abstain from joining the SSM although their participation is desirable to facilitate market integration in the E.U. (*infra* 5).

2 THE SUMMER OF 2012

It is long established that bank and sovereign debt crises constitute events that have the potential for mutual reinforcement.¹⁹ Against this background the banking union was explicitly initiated as a tool to “break the vicious cycle between banks and

¹⁶ Goyal et al. (2013, p. 22) acknowledge that an “incoherent banking union” could result in “an architecture that is inferior to the current national-based one.” See also Pisani-Ferry et al. (2012, p. 6) and *infra* 2.1.

¹⁷ The trilogue between Parliament, Commission and Council led to a compromise (cf. European Parliament, 2013a) that translated into the final proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions of July 1, 2013, Council Document 9044/13. <http://register.consilium.europa.eu/pdf/en/13/st09/st09044.en13.pdf> [hereinafter: SSM Regulation] recently endorsed by the Parliament (European Parliament, 2013b) and adopted by the Council on October 15, 2013 (European Council, 2013).

¹⁸ The concept describes how and when interest groups dominate regulatory decision processes Laffont and Tirole (1991); with a particular view to banking regulators Hardy (2006).

¹⁹ German Council of Economic Advisors (2011, p. 137-8); Tröger (2013, p. 189-90). For empirical evidence from the euro area see Gerlach, Schulz, and Wolff (2010) who identify an aggregate risk factor sensitive to both bail-out likelihood/magnitude and fiscal strength as main determinant of sovereign spreads.

sovereigns".²⁰ However, its specific design is best understood if the actual triggering events are scrutinized more closely.²¹

2.1 THE DISINTEGRATION OF THE EMU AND THE RE-FRAGMENTATION OF THE INTERNAL MARKET FOR FINANCIAL SERVICES

In fact, it was the reoccurrence of mutually reinforcing twin crises that ultimately overrode the political resistance against a more incisive centralization in banking regulation and supervision.²² The summer of 2012 saw increasing and persistent sovereign and private sector imbalances as a sign of a critical disintegration of the EMU. Return spreads for euro area government bonds widened and money and capital market rates incrementally diverged across the euro area.²³ These developments impeded the implementation of a uniform monetary policy within the EMU, as, for instance, slashes in monetary policy rates had little or no effect in certain Member States.²⁴ Banks' cost of doing business hinged partly upon their home Member State's fiscal strength and the consequential credibility of its backstops, thus establishing a pro-cyclically link between private and sovereign borrowing costs.²⁵

This observable loss of a level playing field for the provision of financial services in the internal market could be attributed to the general deterioration of confidence in the viability of the banking sector that brought Member States' bail-out capacity to the fore.²⁶ Leaving immediate crisis containment aside,²⁷ the long-term counterstrategy to revamp trust in financial institutions in the steady state required *inter alia* no more than effective prudential supervision and an operable resolution regime that would impede future build-ups of risk concentrations apt to undermine systemic stability. Put differently, recent events in the euroarea called for centralization only if and where the alternatives were *per se* less effective.²⁸ Clearly, tasking an

²⁰ European Council (2012b).

²¹ On the developments see also Elliot (2012, p. 6-7) who conceives the crisis as impetus "to overcome parochial interests and organize European banking more intelligently", *ibid.*, p. 9.

²² The E.U.'s immediate response to the shortcomings identified in the de Larosière Report as a in the run-up to the financial crisis had already lead to the creation of new supranational supervisory authorities. For critical assessments see Wymeersch (2010, p. 252-64); Moloney (2010, p. 1332-35, 1365-72); Ferrarini & Chiodini (2012, p. ■■■); Ferrarini & Chiarella (2013, p. 26-37).

²³ ECB (2012a, p. 17-28, 31-35).

²⁴ For the ECB's assessment see ECB (2012b). See also Goyal et al. (2013, p. 6 figures 2 and 3); Pisani-Ferry & Wolff (2012, p. 7-12).

²⁵ Goyal et al., (2013, p. 7).

²⁶ Angeloni and Wolff (2012).

²⁷ See *supra* note 43.

²⁸ Schneider (2013, p. 454) argues that pushing Member States to "implement efficient banking supervision" would have been the "right answer" to current problems and predicts negative impacts of centralization for countries with (allegedly) efficient supervision.

institution on the supranational level that is entirely unseasoned in pertinent regard does not provide an argument in itself.²⁹

It seems intuitive, though, that the incrementally transnational character of contemporary banking should be traced by an equivalent supervisory architecture, that minimizes negative cross-border externalities.³⁰ Cross-country comparisons, a broader information base, and the lower susceptibility to national preferences³¹ could constrain the build-up of excessive risk concentrations in good times.³² In times of crises, a transnational perspective would counter desires to cut foreign activities to stabilize the national banking system and would hence prevent the (re-)fragmentation of financial markets.³³

However, the desirability of more centralization remained a matter of dispute among European politicians, not least because a banking union as a crisis response has to be designed carefully with regard to its long-term ramifications for pan-European institutions. Ultimately, resistance crumbled only in light of the revelations during the flaring Spanish and Cypriot banking crises.

2.2 THE SPANISH (AND CYPRIOT) BANKING CRISIS AS THE STRAW THAT BROKE THE CAMEL'S BACK

After the first rumors of a private sector participation in the efforts to reduce the Greek sovereign debt load to sustainable proportions had corrupted the confidence in the viability of the European banking sector in July 2011,³⁴ the EBA conducted *inter alia* a capital exercise to calm the markets and gauged the overall need for additional own funds at the relevant Spanish banks at € 26.17 bn.³⁵ Yet, the bursting of the bubble in the residential construction market in May 2012 revealed that then nationalized Bankia S.A., the nation's largest mortgage lender, needed to be bailed-out with a capital infusion of € 19 bn, after the Spanish government had

²⁹ Ferran & Babis (2013, p. 11) point to the ECB's missing track-record as a supervisor and conclude that there is „absolutely no guarantee that the ECB will do a better job in supervision than many national supervisors“. On the other hand Ferrarini and Chiarella (2013, p. 42 note 115) see ECB-involvement as an asset.

³⁰ Pisany-Ferry et al. (2012, p. 3-4); Goyal et al. (2013, p. 7, 8, 14); with particular view to crisis management Ferrarini and Chiarella (2013, p. 6-19); for a general assessment of banks' risk-taking behavior under nationally fragmented supervision and resolution, Schoenmaker (2012, p. 53-4), Schoenmaker (2013, p. 69-89).

³¹ See also *infra* 3.3.2.

³² Clearly though, informational advantages of a supranational supervisor only accrue with regard to banks with sizable cross-border operations, Pisani-Ferry et al. (2012, p. 9). Of course, it is conceivable that parallel behavior and/or risk exposure of many small and medium sized, purely domestic institutions may pose systemic risks of wider proportions, Sapir et al. (2012, p. 3). Yet, such patterns can in principle also be identified by NCAs as the primary systemic risk occurs on domestic markets.

³³ SSM Regulation, art. 1(1) indeed explicitly deems preserving „the unity and integrity of the internal market“ a core aim of the SSM. For a discussion of this systemic approach that does not cater directly to individual depositors' interests, Wymeersch (2012, p. 14).

³⁴ Tröger (2013, p. 190-1).

³⁵ EBA (2011b).

converted an earlier € 4.5 bn rescue loan into voting stock.³⁶ Over time it was revealed that obscuring accounting practices (dynamic provisioning, a.k.a. “cookie jar-accounting”)³⁷ and dubious pre-insolvency debt restructurings (liquidity management exercises)³⁸, that were at least tolerated by the competent supervisor (Bank of Spain), had helped to disguise a problem that smoldered for years and ultimately required a massive reorganization of the troubled parts of the banking sector. Euro area Member States provided additional funds of up to € 100 bn to back the bail-outs,³⁹ with an initial transfer of € 39.5 bn from the European Stability Mechanism (ESM) occurring in December 2012.⁴⁰

It was the repeated pattern of insufficient and delayed information, the politically induced lax governance and oversight,⁴¹ and the evident moral hazard problems⁴² where an irresponsible national banking sector can rely on international aid,⁴³ that ultimately generated the political will to initiate a banking union among the euro area Member States at the end of June 2012.⁴⁴ However, the outcome of the legislative process establishing the banking union’s first pillar is not the comprehensive supranationalization of prudential supervision that was consistently endorsed by the Commission.⁴⁵ The political compromise for the SSM institutes the ECB as the *de iure* supreme overseer but relies *de facto* on NCAs to do the bulk of the daily supervisory work. In line with the incidents that eventually brought forth the SSM, the ECB will be more of a whipper-in for national supervisors than an operationally autonomous, supranational watchdog. The SSM is thus based on the premise that NCAs can’t be trusted and that the most pressing problem in designing an effective supervisory architecture lies in overcoming the forbearance NCAs may show *vis-à-vis* national champions (“home bias”).

³⁶ Bjork and House (2012); Stubbington and Roman (2012).

³⁷ For a critical review of these accounting practices, Mann and Michael (2002, p. 133).

³⁸ For a detailed description of the events at Bankia, Dübel (2013, p. 22-31)

³⁹ Forelle and Steinhauser (2012); Schaeffer Muñoz, Enrich, and Bjork (2012).

⁴⁰ Patnaude, A. (2012).

⁴¹ On the unholy alliance of politicians, board members, and supervisors Anonymus (2013).

⁴² Goyal et al. (2013, p. 12).

⁴³ It is an unresolved issue, how “legacy assets” will be treated once the SSM enters into force. SSM Regulation, art. 33(4), prescribes an entrance exam in which the ECB assesses at least those banks’ balance sheets that will henceforth fall under its direct supervision. However, despite the urgent case for transparency Pisani-Ferry et al. (2012, p. 15, 16), it is unclear how those risks that have been incurred under national supervision, will be eliminated or hedged once the ECB uncovers them in the SSM-entrance exam.

⁴⁴ European Council (2012b).

⁴⁵ European Commission (2012b, p. 5). Accordingly, the explanatory memorandum of the 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, p. 5 [hereinafter: Commission Proposal SSM Regulation] stated: “One of the key elements of the banking union should be a Single Supervisory Mechanism (SSM) with direct oversight of banks, to enforce prudential rules in a strict and impartial manner and perform effective oversight of cross border banking markets.”

The following part of this paper will make this point in more detail. It thus prepares the ground for an assessment of the SSM's probable operability and provides guidance for fine tuning some of its key features.

3 DISTRIBUTION OF COMPETENCES WITHIN THE SSM AND BEYOND

The institutional innovation the SSM will bring can be best understood if compared to the general European supervisory architecture. Financial institutions today typically operate across national borders.⁴⁶ As a consequence, their supervision raises specific challenges as sovereign authorities are bound to exchange information and cooperate closely. In the E.U. context, Member States banking laws that distribute competences among NCAs in cross-border scenarios are profoundly harmonized and accept some centralized decision-making power of the EBA (*infra* 3.1). For the euro area the SSM constitutes an island solution because it provides a degree of centralization on the supranational level unavailable elsewhere. Yet, even within the SSM NCAs will retain critical tasks in day-to-day supervision (*infra* 3.2). Hence, the overall assessment of the evolving regime turns out rather skeptical: the SSM is pervaded with cooperative elements in an essentially non-cooperative game without paying close attention to the acting public officers', i.e. bureaucrats' affirmative incentives that could induce much needed voluntary contribution and instead relies heavily on strong sanctioning powers. The direly needed elements to ameliorate the incentive structures partly contradict effective decision-making procedures (*infra* 3.3).

3.1 SHARED RESPONSIBILITIES IN CROSS-BORDER SUPERVISION

As table 1 indicates, the reformed CRD IV/CRR-framework for the prudential supervision of European banks⁴⁷ relies on responsibilities shared between host and home Member States⁴⁸ with a limited, albeit buttressed role for the EBA that has

⁴⁶ On the efficiency rationale Moskow (2006, p. 4-5); Fiechter et al. (2011, p. 5). For evidence on the potentially positive effects of internal capital markets in cross-border banking groups see also Haas and van Lelyveld (2010); Cremers et al. (2011).

⁴⁷ The pertinent European rules on prudential supervision cover mainly deposit-taking credit institutions (CRR, art. 4(1)(1)) and investment firms (CRR, art. 4(1)(2)) and European Parliament and Council Directive 2004/39 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, art. 4(1)(1), 2004 O.J. (L 145) 1 [hereinafter: MiFID]), yet only the authorization of credit institutions, cf. CRD IV, arts. 8, 49. With regard to their banking affiliates financial holding companies (CRR, art. 4(1)(20)), mixed financial holding companies (CRR, art. 4(1)(21)) and mixed-activity holding companies (CRR, art. 4(1)(22)) are included in consolidated supervision, cf. CRD IV, arts. 119 et seq. Financial firms that are included in national prudential bank regulation and supervision remain outside the E.U.'s regulatory grip.

⁴⁸ CRD IV, art. 3(1) subpara. 39, CRR, art. 4(1) subpara. 43 define the home Member State as that in which a financial institution was authorized. CRD IV, art. 3(1) subpara. 40, CRR, art. 4(1) subpara. 44 define the host Member State as that in which a financial institution has branches or provides services. Hence, strictly speaking, the home/host-terminology is restricted to branch-structures. Under a subsidiary-structure the (host) supervisor responsible for the incorporated group-affiliates is referred to as "competent authority" whereas

gained momentum to settle—upon reference from a dissenting NCA—disputes that arise among home and host Member States’ supervisors.⁴⁹ Moreover, the regime still depends critically on banks’ organizational choices, to wit, whether they conduct their foreign activities through a branch⁵⁰ (legally dependent satellite) or a subsidiary⁵¹ (legally independent affiliate).⁵²

	Home Member State	Host Member State	EBA
Subsidiary Structure	Authorization and supervision of parent, CRD IV, arts. 8(1), 49(1) Consolidating supervision of group, CRD IV arts. 49(2), 111(1)	Authorization and supervision of legally independent subsidiaries in cooperation with consolidating supervisor (parent home Member State authority), CRD IV arts. 8(1), 49(1), 112(1) Participation in consolidating supervision, CRD IV art. 113(1)(2)	Binding decision if (i) consolidating or host supervisor fail to carry out duties, CRD IV 112(2) (ii) consolidating and host supervisor cannot settle dispute, art. 113(3) CRD IV
Branch Structure	Authorization and supervision of bank, including foreign activities (onsite investigations, etc.), CRD IV art. 49(1), 33, 41(1), 52	No authorization (E.U. passport), CRD IV art. 17 Supervision of liquidity endowment in cooperation with home supervisor, CRD IV arts. 156, 50 (2)(3) Closer cooperation, particularly with regard to liquidity risks, with home supervisor if branch is significant, CRD IV art. 51(2)	Binding decision if (i) home supervisor does not ensure banks’ compliance with CRD IV/CRR, CRD IV, art. 41(2) (ii) host supervisor seeks to take measures opposed by home supervisor, CRD IV art. 50(4) (iii) home supervisor does not take operational steps required by CRD IV art. 86(11), CRD IV art. 51(2)

the (home) supervisor is termed “consolidating supervisor”, cf. *e.g.* CRD IV, art. 112. For simplicity, the home/host-terminology is used in a broader sense here and also encompasses Member States home to a parent institution and Member States hosting their subsidiaries.

⁴⁹ The EBA upon reference of disputes between home and host supervisors may ultimately compel NCAs to take specific actions/refrain from such actions see Regulation 1093/2010 of the European Parliament and of the Council establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, art. 19, 2010 O.J. (L 331) 12 [hereinafter: EBA Regulation].

⁵⁰ CRR, art. 4(1)(17).

⁵¹ CRR, art. 4(1)(16) and Seventh Council Directive 83/349/EEC of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts, art. 1, 1983 O.J. (L 193) 1.

⁵² For a detailed description of the pre-CRD IV/CRR legal framework (Directive 2006/48 of the European Parliament and the Council Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 2006 O.J. (L 177) 1 [hereinafter Banking Directive]) with particular regard to this pivotal distinction, see Tröger (2013, p. 202-13).

This regime will remain unaltered with regard to all banks established outside the euro area, including those chartered in E.U. Member States that do not expressly opt-in to the SSM.⁵³ In fact, in relation to non-participating Member States (and third countries) the ECB will only assume the role of host/home authority for branches and subsidiaries in the (consolidated) supervision of transnational banks under CRD IV/CRR, SSM Regulation, arts. 17, 4(1)(b), 4(1)(f), and 4(2).⁵⁴ It will carry relatively more weight in colleges of supervisors as it will represent a more sizeable portion of the transnational group.⁵⁵

Even though common supervision in the euro area by its very nature can only have a limited reach, the SSM could have at least provided for an island-solution that abolished both the distinction between branch/subsidiary-structures and the friction-prone cooperative elements. Yet, the SSM does neither level the differences entirely that arise from banks' organizational choices, nor adhere to a strong model of supranational centralization⁵⁶ that would expulse NCAs entirely from performing critical functions in prudential supervision.

3.2 THE SSM

In order to predict the effectiveness of the evolving regime and identify the mechanics that will prove important when it comes to fine-tuning the supervisory apparatus, this part scrutinizes relevant features of the SSM. With regard to supervision in the euro area, the ECB will become the predominant institution vested with broad powers to determine and oversee supervisory practices (*infra* 3.2.1). Yet, in day-to-day operations it will also depend in important respect on the input and commitment of NCAs (*infra* 3.2.2).⁵⁷ Furthermore, the ECB's power to shape supervisory practices cannot override the substantive differences in prudential regulation that continues to hinge on whether cross-border banking groups' operate through branches or subsidiaries and thus draws on a distinction that is partly unaligned with actual risk structures (*infra* 3.2.3).

3.2.1 THE ECB'S ROLE IN PRUDENTIAL SUPERVISION

Originally, the Commission intended to establish the ECB as an omnipotent supranational watchdog at least for euro area credit institutions. The compelling advantage of tasking the ECB with supervisory obligations is that it rests on a relatively

⁵³ SSM Regulation, art. 2(1). For the preconditions under which a "close cooperation between the ECB and the national competent authority" can be established for the prudential supervision none-euro area banks within the SSM see *id.*, art. 7(2) and *infra* 5.1.

⁵⁴ *Infra* 3.2.3.

⁵⁵ Wymeersch (2012, p. 25).

⁵⁶ Ferrarini and Chiarella (2013, p. 20-1, 50-60).

⁵⁷ The institutional structure of the SSM resembles that of the Eurosystem that consists of the ECB and national central banks (NCBs) of those Member States whose currency is the euro.

sound constitutional basis in the founding Treaty.⁵⁸ Moreover, vesting supervisory competences and powers with the ECB, instead of another supranational authority, will arguably create synergies with its mandate for monetary policy and lender of last resort duties.⁵⁹ Yet, this is ambivalent, as the ECB's dual mandate is also a source for difficult policy trade-offs (*infra* 6) that account for convoluted governance arrangements (*infra* 3.3.2.1).

From the outset, the SSM should not, and will not, cover all institutions subject to prudential regulation and supervision under CRD IV/CRR.⁶⁰ Despite the significantly broader scope of TFEU, art. 127(6) that also pertains to financial institutions,⁶¹ SSM supervision will be limited to credit institutions as defined in E.U. legislation.⁶² Furthermore, even those credit institutions' activities not covered by supranational prudential regulation will not fall within the remit of the SSM.⁶³ This contradicts lessons from the financial crisis of 2007/08 that exposed risks for financial stability that reside outside the traditional banking sector,⁶⁴ which led both the U.S. and the U.K. to more encompassing and flexible approaches in prudential supervision.⁶⁵ The SSM's constriction to deposit taking institutions may in part be attributed to the fact that it is primarily geared towards intercepting the European feedback loop between banks and sovereigns. The broader agenda of implementing a regulatory framework for sustainable finance that is attuned to the lessons of the global financial crisis is pursued in parallel and may correct some of the current architecture's shortcomings.⁶⁶

According to the Commission's concept, the ECB should be in charge of all the major tasks in prudential supervision, *i.e.* licensing and authorizing credit institutions, ensuring compliance with own funds requirements et al., monitoring internal capital adequacy assessment processes, verifying internal governance arrangements,⁶⁷ stress-testing etc.,⁶⁸ for all euro area banks. However, it was clear from the

⁵⁸ Treaty on the Functioning of the European Union, art. 127(6), 2010 O.J. (C 83) 47 [hereinafter: TFEU], Wymeersch (2012, p. 6-7, 8-9); Ferran and Babis (2013, p. 2-3); but see also Carmassi et al. (2012, p. 3-4); Wymeersch (2012, p. 24) who challenge the SSM's openness to non-euro area Member States on legal grounds.

⁵⁹ Pisani-Ferry et al. (2012, p. 11); Goyal et al. (2013, p. 14).

⁶⁰ *Supra* note 47. For a critical view Verhelst (2013, p. 15).

⁶¹ Although secondary legislation cannot bind the interpretation of the TFEU, it is indicative that CRR, art. 4(1) subpara. 26 defines the latter as "undertaking other than an institution, the principal activity of which is to acquire holdings or to pursue one or more of the" banking activities listed in CRD IV, Annex I, points 2 to 12 and 15.

⁶² SSM Regulation, art. 1 subpara. 2. Commentators have pointed to possible tensions in consolidated supervision where the remit of national prudential banking regulation also encompasses, for instance non-deposit taking institutions that grant credit, Wymeersch (2012, p. 5); Schneider (2013, p. 455).

⁶³ E.g. activities as central counterparties are explicitly exempt, SSM Regulation, art. 1 subpara. 2.

⁶⁴ Gorton (2009a, 2009b).

⁶⁵ Ferran and Babis (2013, p. 5-6); see also Wymeersch (2013, p. 17-8).

⁶⁶ For the initiatives regarding the shadow banking sector see European Commission (2012c); European Commission (2013).

⁶⁷ Sapir et al. (2012, p. 4) have argued that vesting the competence to supervise banks' internal governance structures will be critical for the SSM's overall effectiveness.

outset, that the ECB would be in no position to brave the gargantuan challenge of supervising the more than 6.000 banks in the euro area on a stand-alone basis.⁶⁹ Instead, the Commission Proposal acknowledged, that “within the SSM national supervisors are in many cases best placed to carry out such activities, due to their knowledge of national, regional and local banking markets, their significant existing resources and to locational and language considerations, and therefore enable[d] the ECB to rely on national authorities to a significant extent.”⁷⁰ Yet, with the ECB’s pervasive power to issue instructions *vis-à-vis* national competent authorities,⁷¹ the latter were basically relegated to providing auxiliary assistance,⁷² policing money laundering prohibitions, and enforcing consumer protections.⁷³

During the legislative process the ECB’s role in direct supervision was confined to the euro area’s most important financial institutions (table 2) and a stronger role for participating Member States’ competent authorities within the SSM was re-installed under a “hub and spokes”-arrangement for less significant banks.

characterization of financial institution	SSM Regulation	Precondition for direct ECB supervisory competence
significant	art. 6(4) subpara. 5	participating Member States’ three largest banks
significant	art. 6(4) subpara. 2	(alternatively) bank’s <ul style="list-style-type: none"> i. large size (presumed, if total assets > € 30 bn) ii. importance for EU/Member State’s economy (presumed if total assets to GDP-ratio > 20% and total assets > € 5 bn) iii. ECB confirmation of participating Member State notification indicating significance for

⁶⁸ Commission Proposal SSM Regulation, art. 4(1). Wymeersch (2012, p. 15) alludes to confusion if “matters will show up ... that are not in the remit of the ECB”. However, supervisory responsibilities and related powers not explicitly conferred on the ECB remain at NCAs, SSM Regulation, art. 1(5), and arguably do not require centralization. *E contrario*, where supervisory responsibilities are indeed conferred on the ECB, no such responsibilities and related powers under national law persist in parallel. Overlapping or duplicated competences, as assumed by Ferran and Babis (2013, p. 12), cannot occur as a matter of law, although disputes over the precise delineation of competences can certainly arise in practice. See also *infra* 3.3.1.2. Moreover, as a consequence, significant banks will have to deal with oversight from both the ECB (for the supervisory tasks falling in the remit of the SSM) and NCAs (for the remaining tasks), Schneider (2013, p. 455).

⁶⁹ But see also Goyal et al. (2013, p. 12) arguing that a banking union should aim at supranational supervision of *all* banks, “regardless of size, complexity and cross-border reach”; for an assessment, that advocates the centralized definition of baselines but allows differences in “size, activity and business model” to be accounted for in supervisory practices and competences Wymeersch (2012, p. 17).

⁷⁰ Commission Proposal SSM Regulation, Explanatory Memorandum, p. 5.

⁷¹ Commission Proposal SSM Regulation, art. 5(4).

⁷² For a detailed description cf. Wymeersch (2012, p. 13-4).

⁷³ Commission Proposal SSM Regulation, recital 22; Ferran and Babis (2013, p. 10). Wymeersch (2012, p. 5, 15-6) points to overlaps where aiding and abetting money laundering or pervasive misselling may imperil confidence in a bank.

		domestic economy
significant	art. 6(4) subpara. 3	ECB decision if bank has subsidiaries in at least two participating Member States and substantial cross-border activities (foreign to total assets/liability ratio)
significant	art. 6(4) subpara. 4	direct EFSF/ESM recapitalization
less significant	art. 6(5)(b)	ECB decision after consultation/on request of NCA if insufficient oversight (particularly, in case of indirect EFSF/ESM recapitalization)

table 2 – direct ECB supervisory competence according to SSM Regulation

Table 2 indicates that the rather nested manner in which the SSM Regulation distributes the supervisory competences within the SSM should not blur the ECB’s considerable pull as the primary supervisor: according to preliminary estimates that applied only the quantitative criteria laid down in SSM Regulation art. 6(4) subpara. 2 approximately 150 to 180 top financial institutions that account for 80 to 91% of the assets held by the industry in the euro area will fall under direct ECB supervision.⁷⁴ It is important to note, that the relevant criteria have to be applied at the highest level of consolidation, *i.e.* subsidiaries of a significant parent institution are automatically regarded as significant themselves and will thus fall indiscriminately under direct ECB supervision.⁷⁵

It is a consequence of the sub-optimally coordinated phasing-in of the banking union in a rugged political process that the adequacy of the criteria applied to categorize banks (table 2) cannot be judged conclusively at the current stage. The policy considerations that should drive the decision which banks to include in direct supranational oversight are largely dependent on the function and design of the other institutions of a banking union (resolution regime, deposit insurance, backstops).⁷⁶ Yet, it should be noted that the relevant criteria do not necessarily link direct ECB oversight to a bank’s significant cross-border operations, *i.e.* do not align it with comparative informational advantages a supranational supervisor necessarily has (*supra* 2.1), although of course, size can be regarded as a rough proxy for transnational operations and interconnectedness.

For all less significant banks, the system of NCAs’ shared responsibilities in prudential supervision under CRR/CRD IV (table 1) in principle remains untouched within the SSM.⁷⁷ Notably, both the authorization of credit institutions and the assessment of notifications of acquisitions and disposals of qualified holdings is conferred on the ECB regardless of an applicant’s or target’s significance.⁷⁸ Similarly, the

⁷⁴ Wolff and De Sousa (2012); Goyal et al. (2013, p. 15).

⁷⁵ SSM Regulation, art. 6(4) subpara. 1. See also *infra* 3.2.3.

⁷⁶ For a discussion see Pisani-Ferry et al. (2012, p. 9-10).

⁷⁷ SSM Regulation, art. 6(6).

⁷⁸ SSM Regulation, arts. 4(1)(a) and (c), 6(6). The ECB will grant bank licenses as proposed by NCAs in a “no objection” procedure, SSM Regulation, art. 14(2). It can withdraw authorizations on a proposal from the NCA or on its own initiative, SSM Regulation, art. 14(5). In the latter case, as long as no SRM is in operation, NCAs can object to the ECB withdrawal-decision, if a delay is necessary to orderly resolve the institution or/and main-

ECB, as a consequence of its mandate and expertise in financial stability issues, will have the power to deploy macroprudential tools (capital buffers) with regard to all euro area banks even against NCAs' objections.⁷⁹

However, even where no primary ECB-competence is established, ECB-coordination and oversight is supposed to ensure enhanced consistency and integration of supervisory practices, *i.e.* in relation to the NCAs the ECB shall safeguard the implementation of the supervisory approach that itself observes in direct supervision.⁸⁰ To that end, the ECB will be empowered to issue regulations, guidelines, or general instructions to NCAs.⁸¹ Hence, it will have extraordinary clout to shape NCAs' actual supervisory practices in great detail.⁸² The ECB-formulated framework will compel NCAs to notify the ECB in advance of any material supervisory procedure, further assess these procedures if the ECB so requests, and forward draft supervisory decisions for comments to the ECB.⁸³ As a matter of law, the ECB will thus be able to control and influence supervisory practices virtually at the grass-roots level. Moreover, it will have to make exhaustive use of these competences, as monitoring of the SSM's proper operation will be one of the core tasks conferred on the ECB under TFEU art. 127(6).⁸⁴ To facilitate this assignment, the ECB can not only react to *ex ante*-approaches from NCAs, but also proactively request information concerning the performance of their supervisory tasks.⁸⁵ Furthermore, it can verify or complement the information received by using its investigatory powers *vis-à-vis* euro area banks that allow *inter alia* information requests, general investigations, offsite diligence and (judicially authorized) onsite inspections.⁸⁶

Finally, NCAs will also be coerced to cautiously maneuver within the ECB-set framework for the prudential supervision of the euro area's less significant banks, as they will face the permanent and pervasive threat of being ousted as competent supervisor by the ECB. SSM Regulation art. 6(5)(b) vests power with the ECB to assume at any time on its own initiative the competence to directly supervise less sig-

tain financial stability, SSM Regulation, art. 14(6). Similarly, the ECB ultimately decides on whether to oppose a share acquisition after an extensive review by NCAs on the grounds of their proposal, SSM Regulation, art. 15.

⁷⁹ SSM Regulation, art. 5(2), (4). For a critical assessment of such a centralization that contradicts NCAs' idiosyncratic expertise in judging local markets, Véron (2012, p. 6). The concerns, that the ECB may henceforth assume an even more dominant position within the decision making process of the European Systemic Risk Board (ESRB), Ferran and Babis (2013, p. 28-9), are unrelated to the ECB's macroprudential tools as they simply follow from the ECB's position in the ESRB's General Board and participating Member States' NCBs' plausible tendency to follow the ECB in lockstep once the SSM is operable (*see also infra* 4.2).

⁸⁰ Ferran and Babis (2013, p. 10).

⁸¹ SSM Regulation, art. 6(5)(a).

⁸² Ferran and Babis (2013, p. 11) observe that if the ECB-defined framework takes the form of "a very prescriptive supervisory handbook" it will annul most of the leeway to supervise in a judgment-led manner that accounts for local idiosyncrasies.

⁸³ SSM Regulation, art. 6(7)(c).

⁸⁴ SSM Regulation art. 6(5)(c).

⁸⁵ SSM Regulation art. 6(5)(e).

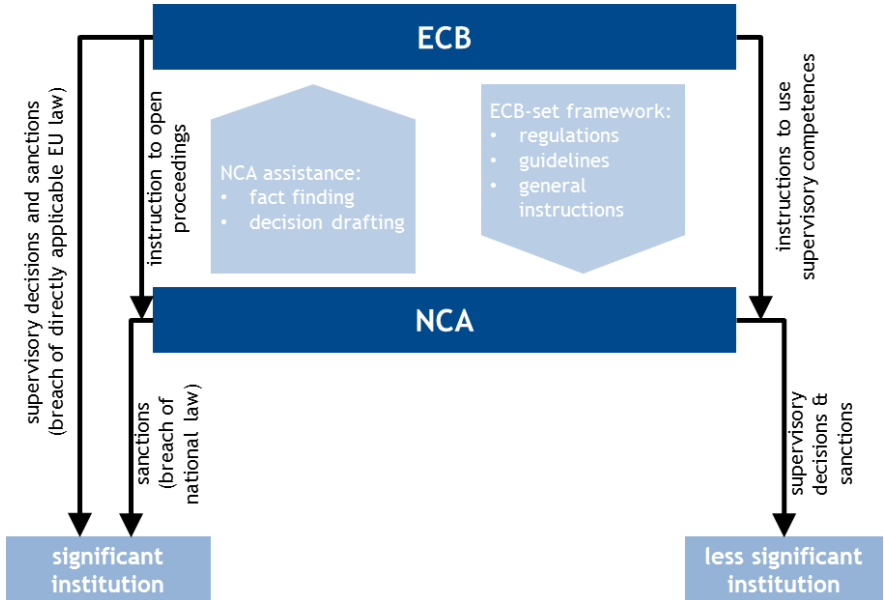
⁸⁶ SSM Regulation, arts. 6(5)(d), 10-13.

nificant banks if their supervision falls short of the consistent high supervisory-standards the SSM is supposed to adhere to, particularly where these institutions benefit from indirect recapitalizations with funds from supranational coffers.⁸⁷ Of course, this may prove an empty threat if the ECB does not have sufficient resources at its disposal that enable it to actually supplant ailing NCAs and take over all their tasks immediately.⁸⁸ Yet, neglecting shaky banks’ monetary restrictions, at least retrieving the pertinent costs will be possible: The ECB will levy cost-covering annual fees from supervised credit institutions⁸⁹ and can thus recover expenditures incurred from preempting a NCA in the supervision of less significant banks.

Yet, the pertinent feature of the legal set-up adds to the overall picture that sees the ECB as the sole guarantor of the consistent, impartial and stringent supervision of euro area financial institutions and exhibits a general mistrust towards NCAs as a direct function of the events that brought about the sweeping institutional reforms (*supra* 2.2). In sum, the ECB as the SSM’s primary supervisor will be provided with heavy sticks, yet the carrots for NCAs seems missing.

3.2.2 INTERPLAY WITH NCAS

Even though the humongous challenge the Commission’s proposal of direct ECB supervision of all euro area banks (*supra* 3.2.1) would have meant has been superseded by a more modest concept in the politically consented SSM Regulation, the size-



able responsibilities conferred on the ECB suggest that much of the supervisory legwork will have to be performed “close to the ground”. It is at least comprehensible that the forthcoming supervisory architecture seeks to integrate NCAs in order to

⁸⁷ The wording of SSM Regulation, art. 6(5)(b) could be interpreted as empowering the ECB to exercise supervisory powers in individual incidents. Yet, to ensure the proper functioning of the SSM **figure 2** - ECB/NCA interplay within the SSM

instruct NCAs to make use of their powers under national law, SSM Regulation, art. 7(1) subpara. 3 (*infra* 3.2.2). Hence, the provision should be read as a broad power and obligation to preempt NCAs completely.

⁸⁸ According to SSM Regulation, art. 28, the ECB will be responsible for devoting the necessary financial and human resources to exercise its supervisory functions. With regard to SSM Regulation, art. 6(5)(b) this could mean that the ECB has to hold available *inter alia* a buffer of qualified personnel that enables it to take over the supervision of less significant banks without delay that would otherwise result from hiring ad hoc.

⁸⁹ SSM Regulation, art. 30.

capitalize on their knowledge of national, regional and local banking markets, their longstanding expertise particularly with regard to the interpretation and application of (harmonized) national banking regulation,⁹⁰ and their advantages with regard to location and language-skills. As a consequence, the ECB is tasked with devising a general “framework to organise the practical modalities” of the interplay between itself and the NCAs not only with regard to the supervision of less significant institutions (*supra* 3.2.1) but also with regard to that of the euro area’s biggest banks that fall under its direct oversight.⁹¹ Hence, NCAs will also be tightly involved in the supervision of significant institutions, starting with uncovering the factual bases for various ad hoc or ongoing supervisory measures (e.g. onsite-verifications, evaluation of internal risk models),⁹² up to and including drafting decisions for the ECB.⁹³ Moreover, the ECB will have to rely on NCAs when it comes to enforcing prudential regulation as it can impose administrative sanctions autonomously only if banks breach directly applicable E.U.-law,⁹⁴ *i.e.* violate regulations (TFEU, art. 288(2)), but can only require NCAs to open proceedings if banks violate (harmonized) national law thereby coercing reluctant NCAs into quasi-representative actions.⁹⁵

More generally, the ECB can always push NCAs to take the actions necessary to carry out the tasks conferred on it by issuing instructions.⁹⁶ However, any form of such “compelled cooperation” makes daily operations arduous and thus raises doubts with regard to the effectiveness of the new regime. The latter can hardly be dispelled by reference to the anemic legal obligation to cooperate within the SSM.⁹⁷

3.2.3 SUBSIDIARIES AND BRANCHES

It has been argued elsewhere that the distinction between subsidiaries and branches is unaligned with the actual risk structures in transnational financial institutions and that the considerable differences in the supervisory framework that fol-

⁹⁰ See also *infra* 3.3.1.1.

⁹¹ SSM Regulation, art. 6(7).

⁹² It is this involvement of NCAs which – if it was effective – could largely mute concerns that ECB supervision would be “too distant”, *cf.* Schneider (2013, p. 454).

⁹³ SSM Regulation, art. 6(7)(b). The literature has voiced concerns that even tasking NCAs with preparatory work for ECB supervisory decisions may constitute an impermissible delegation of discretionary powers, Ferran and Babis (2013, p. 11) pointing to ECJ, Case 9/56, *Meroni v. High Authority*, 1958 E.C.R. 133. Yet, this seems debatable; for a very generous approach *see also* Wymeersch (2012, p. 7, 10, 11 note 35, 12). The tight grip of the ECB on NCAs’ auxiliary services and its unfettered competence to render the final supervisory decision warrant to doubt that the issue does pertain to NCAs’ discretionary powers. Moreover, it is not an exercise of hair-splitting that the competences NCAs *retain* as circumscribed in the SSM Regulation have never been conferred on the ECB by a regulation under TFEU, art. 127(6), *i.e.* no administrative (re-)delegation occurs.

⁹⁴ SSM Regulation, art. 18(1) allows for a punitive disgorgement of actual or estimated profits.

⁹⁵ SSM Regulation, art. 18(5). For a pessimistic assessment Ferrarini and Chiarella (2013, p. 57).

⁹⁶ SSM Regulation, art. 9(1) subpara. 3.

⁹⁷ SSM Regulation, art. 6(2) subpara 1. For an optimistic view Ferrarini and Chiarella (2013, p. 54).

low from it should be leveled.⁹⁸ The SSM cannot remedy these shortfalls entirely because it provides only a discrete distribution of supervisory competences within the euro area but does not alter the pertinent substantive regulation.⁹⁹

If a significant institution from a participating Member State branches into another participating Member State, the ECB will be the sole supervisor, *i.e.* it will not only carry out the tasks of the home but also those of the host supervisor (*supra* 3.1 table 1).¹⁰⁰ The supervisory tasks to be performed under the roof of the ECB, however, remain unaltered and thus diverge from those to be observed if a transnational bank conducts its foreign operations under a subsidiary structure. Furthermore, the ECB will be the competent host supervisor if an institution from a non-participating Member State branches into the euro area,¹⁰¹ *i.e.* there will be a single host supervisor even if branches are established in different participating Member States. Finally, the ECB will serve as the home supervisor, if a significant institution from a participating Member State branches into a non-participating Member State.¹⁰²

The ECB will serve as both the consolidating supervisor and the competent authority in a subsidiary structure if the parent institution authorized in a participating Member State is significant.¹⁰³ It is a consequence of determining whether a bank is significant at the highest level of consolidation,¹⁰⁴ that if a significant parent establishes a subsidiary that would in itself be regarded as less significant, the ECB not only assumes the role of the consolidating supervisor but also directly supervises the subsidiary. Thus, contrary to the procedures laid out in CRD IV (*supra* 3.1 table 1), the ECB does not cooperate with NCAs in the consolidated supervision of significant institutions. The ECB also participates as the competent authority in the consolidated supervision of significant subsidiaries, if the parent institution is authorized in a non-participating Member State.¹⁰⁵

In sum, European banks will benefit to a significant degree from a centralization of competences as the mere reduction of supervisory points of reference they have to turn to lowers their costs of compliance. Yet, from the policy maker's point of view, a pivotal drawback of the regulatory regime survives: the supervisory tasks, methodologies and processes as determined by substantive banking regulation will

⁹⁸ Tröger (2013 p. 199-200 and 220-1).

⁹⁹ For other areas where the traditional distinctions based on organizational form will persist, Wymeersch (2012, p. 19).

¹⁰⁰ SSM Regulation, art. 17(1).

¹⁰¹ SSM Regulation, art. 4(2).

¹⁰² SSM Regulation, art. 4(1)(b).

¹⁰³ SSM Regulation, art. 17(2).

¹⁰⁴ *Supra* 3.2.1 at note 74.

¹⁰⁵ SSM Regulation, art. 4(1)(g).

continue to differ depending on the banking groups' organizational structures and will not necessarily accord with banks' actual risk structure.¹⁰⁶

3.3 ASSESSMENT

The literature that seeks to evaluate the evolving supervisory structures generally dwells on the tacit assumption, that the specific supervisory tasks will be performed seamlessly along the lines of competence defined by the SSM Regulation. However, experience with national supervision teaches that in reality frictions occur where inter-agency cooperation is required and that interfaces between hub and spokes constitute potential fault-lines. To conceptualize expected losses in the systems overall effectiveness, it is useful to draw lessons from the political economy of administration and look at top-level bureaucrats' incentives,¹⁰⁷ particularly of those in NCAs (*infra* 3.3.1). From this perspective, it is important that the supervisory architecture provides not only sticks but also carrots. The SSM certainly provides a heavy club for the ECB to discipline NCAs. Yet, the perks that could integrate their top personnel in order to induce optimal voluntary efforts are less pronounced and ultimately hinge on developing a common organizational culture within the SSM. Moreover, integrative elements partly have the potential to hamper swift supervisory decision making (*infra* 3.3.2).

3.3.1 LESSONS FROM THE POLITICAL ECONOMY OF ADMINISTRATION: BUREAUCRATS' INCENTIVES

3.3.1.1 RELEVANCE OF NCAs' CONTRIBUTIONS

NCAs will perform at least preparatory or auxiliary services in establishing the factual grounds for supervisory decision making (direct ECB-supervision) or they will execute prudential supervision for less significant banks within the ECB-defined supervisory framework, under the permanent threat to be ousted (indirect ECB-supervision).¹⁰⁸ Obviously, the critical proposition underpinning such an institutional framework is that national supervision is generally more hospitable towards detrimental domestic interests, and that hence the ECB has to be established primarily as a "whipper-in" for NCAs who are seen with inherent mistrust.¹⁰⁹

It has been suggested here that the emphasize on strong powers for the hub *vis-à-vis* the SSM's spokes is explicable by availability heuristics that look mainly at

¹⁰⁶ For a similar assessment see Schoenmaker and Oosterloo (2005, p. 8); Schoenmaker and Oosterloo (2007, p. 275-7); Hüpkes (2009, p. 374-5); Ferrarini and Chiodini (2012, p. ■■■).

¹⁰⁷ The underlying assumption is that the internal organization of public authorities allows motivating the rank and file to act—by and large—in accordance with the agencies general policies as determined by its top executives. In any case, optimizing the internal governance and incentive structures does not pose a problem unique to the context of inter-agency cooperation.

¹⁰⁸ *Supra* 3.2.1, 3.2.2, and figure 2.

¹⁰⁹ For this rationale for centralization on the supranational level *supra* 2.1. But see also *infra* 3.3.1.2 and 6.

the most recent events that triggered the reform efforts and indeed exhibit egregious cases of captured and thus forebearing NCAs.¹¹⁰ Understandably, this focus becomes even more pronounced, as direct supranational recapitalizations through the ESM will be made expressly available,¹¹¹ because the move arguably contributes to calming markets,¹¹² but also exacerbates the potential for moral hazard. Yet, it could also be asked, if learning would have improved national supervision or whether lax oversight is indeed necessarily associated with it. After all, in light of the severe economic and social problems that currently shake, for instance Spain, Ireland, and Iceland, with hindsight, lenience towards national champions may not have been such a great idea—and may not be seen as such by the electorate in particular. Moreover, it was particularly the Bank of Spain that did well in discouraging massive CDO investments of the country’s largest cross-border banking groups who did thus comparably well in the crisis of 2008/09.¹¹³

These general policy considerations don’t have to be explored in detail as political leaders have determinedly embarked on a trajectory of more centralization in prudential supervision. However, it should be kept in mind that the evolving structure of semi-strong centralization with (critical) NCA-involvement has the potential for problems that may not only cancel out some of the advantages of centralization but also make its key advantage, forestalling forbearance of captured NCAs, partly unachievable.

Both legislators¹¹⁴ and scholars¹¹⁵ recognize that taping local knowledge about domestic markets, administrative practices, law etc. that resides in NCAs is important. If indeed the contribution of NCAs is vital for the SSM’s overall effectiveness, the query becomes whether public officers at NCAs, *i.e.* agents who actually discharge the duties vested with their supervisory authorities, who either offer or refuse to exchange information and to collaborate with due diligence, are sufficiently incentivized to contribute to high-quality supervision.¹¹⁶

3.3.1.2 BUREAUCRATS’ INCENTIVES

To posit, that the success of the SSM depends on the incentives of (top-level) bureaucrats in charge at the competent authorities dwells on the realistic assumption, that the public agencies involved should not be treated as black boxes that generate flawless output in implementing policy goals. From this perspective, it is important to remember the motivating forces identified in the line of research that applies methodologies from organizational theory to the political and administrative

¹¹⁰ *Supra* 2.2.

¹¹¹ On the ESM’s recently approved direct bank recapitalization instrument see Eurogroup (2013); ESM (2013).

¹¹² *Supra* note 15.

¹¹³ See Scott (2008).

¹¹⁴ *Supra* note 70.

¹¹⁵ Sapir et al. (2012, p. 3); Goyal et al. (2013, p. 15); Ferran and Babis (2013, p. 11).

¹¹⁶ Goyal et al. (2013, p. 14) recognize the importance of “incentive compatibility” between the ECB and NCAs.

process.¹¹⁷ Methodologically, the object of investigation can be scuritized by using the analytical inventory of agency-theory: bureaucrats constitute agents who not only have some discretion that allows them to adapt to unforeseen contingencies,¹¹⁸ but also grants them leeway to take hidden action and pursue their own interest, because bounded rationality of principals—ultimate (citizens) or intermediate (legislators)—prevents the writing of complete contingent constitutions and laws that would secure the untainted pursuit of the common good.¹¹⁹ In fact, the intrinsic motives that are commonly identified as driving agency personnel in their exercise of office account for actions that serve the principals’ interest only sub-optimally.¹²⁰

According to standard analysis bureaucrats are driven by a desire to increase their personal power and to augment their prestige.¹²¹ They thus seek to enlarge their agency’s size, competence, and right to intervene in the affairs of those falling within the scope of its mandate. They will discharge their duties in a way that allows them to acquire a favorable reputation among their peers, in the general public, and in the media. Moreover, opportunities to advance their future career in administration, politics, or the private sector motivate their behavior, which makes them prone to promoting the interests of those who offer the most desirable job opportunities in the long term and can result in regulatory capture.¹²² Finally, agency personnel seek to avoid liability for false actions or forbearance and will consequentially have a proclivity to follow approved practices that can be verified in any review, even if new developments occur.

To be sure, these observed preferences do not necessarily warrant a pessimistic perception of bureaucrats’ effectiveness,¹²³ but they highlight that these individuals are not robots that are automatically programmed to serve the public interest by quasi-mechanically enforcing prudential regulation, along the lines of legally devised competences, and free of self-interest.

Analyzed from this vantage, the incentives to contribute to supervisory efforts within the SSM are potentially suboptimal, particularly from the perspective of „subordinate“ NCAs. Both, the preparatory and information-gathering services in direct ECB-supervision, and the ECB-framed oversight over less significant credit institutions represents anything but a gain in power or prestige for thus far independent NCAs —particularly as they will be deprived of the competence to supervise

¹¹⁷ Programmatic contributions include Tullock (1965), Weingast and Marshall (1988), and Moe (1991).

¹¹⁸ On the positive aspect of “adaptive efficiency” North (1990, p. 80-1).

¹¹⁹ For an overview of various political agency models see Besley (2006, p. 98-172).

¹²⁰ See generally Stigler (1971); Prendergast (2007). For the role of cognitive biases that tend to aggravate the deviation from desirable outcomes see Choi and Pritchard (2003). For an analysis with a particular view to the governance of financial supervisors see Enriques and Hertig (2011).

¹²¹ Niskanen, Jr. (1971, p. 36-42).

¹²² Supra note 18.

¹²³ For at least ambiguous assessments of the complex web of incentives and its inherent trade-offs, see Levine and Forrence (1990); Tullock (1984).

systemic institutions.¹²⁴ Ceding ground to the ECB may occur only reluctantly, turf wars loom large.¹²⁵ Moreover, professional and/or political upward mobility on the national level is rather unlikely to result from good „auxiliary services“ discharged in the background. *Vice versa*, it may not constitute the most attractive or career-boosting task that ECB-bureaucrats will perform with utmost diligence, to supervise a tiny euro area Member State’s three largest banks.

In sum, incentives to voluntarily contribute with ample commitment to ECB-led, high-quality supervision are not immediately apparent. To be sure, the problem will not be an open blockade or outright sabotage of the ECB’s efforts, but a lack of incentives to do more than work-to-rule and go the extra mile instead certainly impends. Proposals for an effect-based regulation, that aligns supervisory competences as closely as possible with bureaucrats’ incentives as long as political realities do not allow to avoid the thickets of inter-agency cooperation altogether, have sought to address precisely the lurking lack of positive motivations.¹²⁶ They are based on the insight that improving the supervisory architecture does not only hinge on devising clear responsibilities and hierarchies to compel close cooperation and dense exchange of information by law.¹²⁷ To be sure, the ECB can rely on a set of tough enforcement tools in relation to NCAs¹²⁸ and does not have to put its hope in informal institutions that normally provide the only available sanctions for non-cooperative behavior in transnational contexts.¹²⁹ But they only can be brought to bear where the ECB has detected or suspects deficits in a NCA’s supervisory practice. If bureaucrats in NCAs are not positively incentivized to voluntarily unveil deficits that their idiosyncratic know-how allows them to detect, even the most plausible advantage of supranational supervision, forestalling forbearance as a function of NCA’s “home bias”, is endangered, because the ECB will simply lack the resources to generally investigate daily supervisory practices of NCAs.¹³⁰

3.3.2 INTEGRATIVE PROSPECTS OF INTERNAL DECISION MAKING PROCEDURES, ECB-SET FRAMEWORK, AND NCA-ECB CAREER PATHS

Organizational theory has long embraced the importance of the top level’s benign reputation for respecting the legitimate concerns of subordinates as a center-

¹²⁴ Tröger (2013, p. 218).

¹²⁵ It is indicative in this respect, that the Bundesbank—that participates in banking supervision in Germany—stresses that the SSM is based on the “principle of decentralization” (!) and points to its network character, and thus, at least rhetorically, augments the position of NCAs, Bundesbank (2013, p. 16).

¹²⁶ Pistor (2010); Tröger (2013, p. 220-1). See also Financial Services Authority (2009, p. 99) and the “lead supervisor model” as developed in European Financial Services Roundtable (2005, p. 26-28).

¹²⁷ But see Goyal et al. (2013, p. 14, 15) who focus exclusively on “clear responsibilities”, “strong oversight and accountabilities” of NCA’s and argue that ECB early intervention powers “provide incentives for cooperation” (id., p. 23), again relying exclusively on the stick for motivation.

¹²⁸ Supra 3.2.1 and 3.2.2.

¹²⁹ For an account of the self-enforcing mechanisms that international law normally has to rely on Guzman (2008, p. 33-48).

¹³⁰ Ferran and Babis (2013, p. 11).

piece in inducing optimal commitments and efforts of a firm's employees.¹³¹ Translated into the SSM-context, the ECB's legally defined lead role within the SSM requires complements that integrate NCAs and lead to a commonly embraced supervisory identity within the SSM.

3.3.2.1 INTERNAL DECISION MAKING PROCEDURES

An important aspect of the integrative prospects that help achieve the goal of providing positive incentives for NCAs to contribute voluntarily to optimal supervisory efforts within the SSM may flow from their representation in SSM-decision making bodies, most importantly the ECB Supervisory Board.¹³² This newly established body will plan and execute the ECB's supervisory tasks¹³³ and will be composed of a Chair (external candidate) and a Vice-Chair (Member of ECB Executive board),¹³⁴ four ECB-representatives not directly involved in monetary tasks, and one representative from each participating Member State's NCA.¹³⁵ This composition makes for an overweight of NCAs in the Supervisory Board, because at least 17 of the 23 full members of the Supervisory Board will be delegates from Member States' supervisors. It translates into a NCA-dominance of the Board's decision making. Although voting weights had been favored for all Board decisions during the legislative process,¹³⁶ the inclusive and simple solution prevailed: decisions will be taken with simple majority under a one member one vote-rule with a casting vote for the Chair in case of a draw.¹³⁷ A weighted voting process only applies under SSM Regulation, art. 26(7), where regulations are to be adopted.¹³⁸ Quite importantly, ECB-representatives on the Board will have a voting capacity equal to the median of NCA-representatives and will hence not be in a position to command decisions.¹³⁹ Furthermore, a Steering Committee with ten members and up to seven NCA-

¹³¹ Kreps (1990, p. 93, 125).

¹³² Its creation is owed to legislators' vow to strictly separate monetary policy and supervisory functions of the ECB, SSM Regulation, recital 65 and 73, art. 25. In the same vein, the ECB is obliged to pursue only the objectives set out in SSM-Regulation, art. 1(1) (safety and soundness of credit institutions, stability of the financial system, and unity and integrity of the internal market), when carrying out supervisory tasks. On the ECB's determination to effectively implement the separation in its internal procedures, Constâncio (2013).

¹³³ SSM Regulation, art. 26(1).

¹³⁴ SSM Regulation, art. 26(1), (3). The goal is to further separate supervisory and monetary policy functions by limiting overlaps in top-personnel, cf. SSM Regulation, recital 66; Ferran and Babis (2013, p. 13). Commission Proposal SSM Regulation, art. 19(2) prescribed the Chair be selected from the Executive Board, accepting a far larger intersection with monetary policy functions.

¹³⁵ SSM Regulation, art. 26(1), (5). Where the NCA is not the central bank, a central bank representative can also be brought to Supervisory Board meetings. However, such twin-attendance does not impact on voting rights, SSM Regulation, art. 26(1) subpara. 1.

¹³⁶ Voting weights had been favored by some Member States during the legislative process to reflect sizes of national banking sectors, Barker et al. (2012).

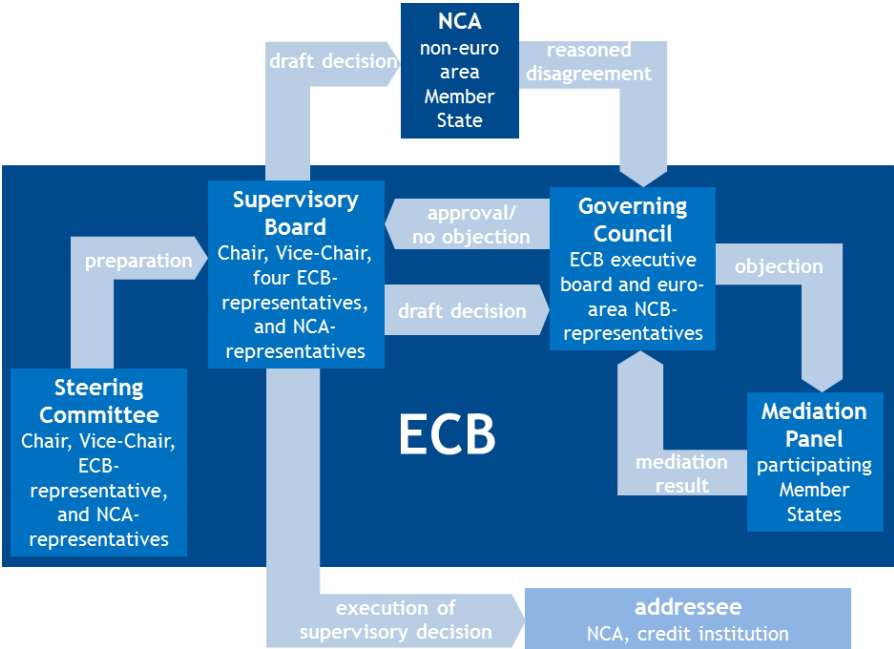
¹³⁷ SSM Regulation, art. 26(6).

¹³⁸ SSM Regulation, art. 4(3) subpara. 2 allows the ECB to adopt regulations "only to the extent necessary to organize or specify the arrangements for carrying out of the tasks conferred on it" by the SSM Regulation.

¹³⁹ SSM Regulation, art. 26(7).

representatives will technically prepare Supervisory Board decisions, *i.e.* draft the drafts etc.¹⁴⁰

In sum, despite the allocation of the most important supervisory powers at the ECB, the decision making process of the newly created Supervisory Board makes ECB-led supervision essentially a common activity of Member States. At first glance, this gives it significant integrative potential that could induce voluntary collaboration within the SSM. Yet, at least for bureaucrats from those NCAs that thus far supervised a significant banking sector autonomously, the mere participation in the decision making process on the supranational level arguably does not compensate the visual loss in power and prestige, despite the larger geographic scope of the new activities. Moreover, even the feeble integrative



moment comes at the price of a rather bloated size of the Supervisory Council which raises doubts regarding its ability to act in a swift and determined manner.¹⁴¹

However, the integrative capacity of internal decision making procedures is also attenuated, as constitutional concerns arguably compel Governing Council involvement in each and every ECB supervisory decision.¹⁴² This follows from the Governing Council’s character as the ECB’s ultimately responsible decision making body.¹⁴³ The political compromise has not subscribed to the view that the relation

¹⁴⁰ SSM Regulation, art. 26(10). The Committee will consist of the Supervisory Board’s Chair, its Vice Chair, one more ECB representative and up to seven NCA representatives, according to a rotation scheme to be determined by the Supervisory Board.

¹⁴¹ Goyal et al., 2013, p. 29; Ferran and Babis, 2013, p. 14.

¹⁴² Commission Proposal SSM Regulation, art. 19(3) allowed the Governing Council to „delegate clearly defined supervisory tasks and related decisions regarding individual or a **figure 3** - ECB supervisory decision making is was deleted to reflect and the ESCB and ECB Statute, *infra* note 145.

¹⁴³ The latter has constitutional status as it is codified in TFEU, arts. 129(1), 283(1) and the related Protocol (No. 4) on the Statute of the European System of Central Banks and of the European Central Bank, arts. 9(3), 10(1), 2012 O.J. (C 326) 320 [hereinafter: ESCB and ECB Statute]. For a detailed discussion of the resulting conflict between well-designed supervisory institutions and Treaty pre-settings that largely override expediency considerations, Ferran and Babis (2013, p. 14-5); Véron (2012, p. 6-7).

between the Supervisory Board and the Governing Council is a matter of the ECB's internal organization and thus grants leeway to limit the decisions that have to be brought before the Council.¹⁴⁴ SSM Regulation, art. 26(8) provides for a procedure that seeks to uphold the separation of monetary policy and supervisory functions but also reflect the constitutional requirements. It demands of the Governing Council to object explicitly to the draft decisions submitted by the Supervisory Board in writing, stating in particular monetary policy concerns, within ten days during normal times and 48 hours in crisis situations.¹⁴⁵ If the Council objects, a mediation panel will try to resolve the diverging views among participating Member States, SSM Regulation, art. 25(5). However, regardless of the outcome of the mediation, ultimately the Governing Council's decision will prevail, *i.e.* in order to reach a supervisory decision the result of the mediation has to be adopted by the Governing Council (figure 3).

Of course, at least euro area Member States¹⁴⁶ also dominate the Council.¹⁴⁷ Yet, it is not NCAs and their top-level bureaucrats who are representing their Member States, even where prudential banking supervision is vested with NCBs, because the Governing Council assembles the heads of NCBs' monetary policy arms. Hence, the invariable involvement of the Governing Council weakens both the integrative potential that the internal decision making process holds, the speed and resoluteness of decision making in the multi-layer governance arrangement,¹⁴⁸ and the supervisory expertise that ultimately flows into supervisory decisions.¹⁴⁹

The critical aspect is that the internal decision making process both holds integrative potential, as it provides for a broad and meaningful involvement of representatives from all participating Member States' NCAs. Yet, this—together with the invariable requirement of Governing Council approval—makes arriving at an outcome quite cumbersome. In any case, at least from the perspective of large Member States with a significant banking sector, a perceptible loss of relevance for their NCA persists.

¹⁴⁴ Wymeersch (2012, p. 7, 10, 11 note 35, 12).

¹⁴⁵ The Governing Council can only approve or object to Supervisory Boards draft decisions, *i.e.* it cannot amend and shape them according to own perceptions.

¹⁴⁶ On the situation of participating Member States whose currency is not the euro see *infra* 5.2.

¹⁴⁷ Again, the relation is 6 to 17, *i.e.* the President, the Vice-President and four other Members of the Executive Board on the ECB-side, together with the 17 governors of NCBs, TFEU, art. 283(1), (2) and ESCB and ECB Statute, arts. 10(1) and 11(1).

¹⁴⁸ The process becomes even more complicated, where participating Member States whose currency is not the euro disagree with draft decision of the Supervisory Board. For a detailed description of the applicable procedure cf. *infra* 5.2 and figure 4.

¹⁴⁹ Ferran and Babis (2013, p. 14). Commentators have expressed concerns that the Supervisory Board will be a practically powerless advisory body, Wymeersch (2012, p. 12). Yet, this need not be true. Some of the weaknesses in the governance structure may be "corrected" in practice: as the supervisory expertise will reside in the Supervisory Board and its working-level staff, *i.e.* the ECB's supervisory department, benefits from specialization and routinization may accrue, if the Governing Council's ultimate responsibility is executed by rubber-stamping draft supervisory decisions in normal times.

3.3.2.2 ECB-SET FRAMEWORK, AND NCA-ECB CAREER PATHS

The SSM's capacity to integrate NCAs and provide proper incentives for their bureaucrats ultimately depends on the ECB-set framework for the cooperation between ECB and national competent authorities and particularly how it is animated in day-to-day supervisory practice. It is a good sign, that the pertinent regulation which will be the backbone of the organization of common supervision, is currently prepared by joint ECB/NCA committees and working groups. Furthermore, mixed teams¹⁵⁰ may provide an excellent opportunity to incentivize NCAs adequately and induce them to feed their expertise into common supervision.¹⁵¹ To achieve that goal, they have to be set up in a way, that NCA-representatives not only serve as drudges for the ECB gentry.

In a similar vein, the exchange and secondment of staff could,¹⁵² if carefully designed, provide career-opportunities for NCA-bureaucrats inducing them to cooperate. More generally, career paths should be designed in a way that good supervisory performances at NCAs may translate into upward mobility to the ECB, turning the SSM into a true unit for promotion purposes. As long as NCA-bureaucrats' can procure their next job within the public sector only from their domestic minister of finance, it is clear where their loyalties lie and that the latter may not militate in favor of stringent supervisory practices where national champions are targeted.

4 COEXISTING STANDARD SETTERS - A EUROPE À DEUX VITESSE IN BANKING SUPERVISION?

The amendments to the European supervisory architecture also affect the EBA's role, both directly and indirectly.¹⁵³ The London-based authority will also receive more clout as an operational supervisor. It will henceforth be able to request relevant information directly from financial institutions¹⁵⁴ and will no longer have to rely on data provided by NCAs, particular to conduct stress tests on a sound factual basis.¹⁵⁵ Quite importantly, the EBA retains the power to require competent authori-

¹⁵⁰ SSM Regulation, art. 31(2) provides for an ECB arranged, mixed composition of supervisory teams.

¹⁵¹ Goyal et al. (2013, p. 15, 27).

¹⁵² SSM Regulation, art. 31(1).

¹⁵³ In accordance with the provisions of the Joint Declaration on practical arrangements for the codecision procedure (2007 OJ (C 145) 5), the European Parliament reached an agreement at first reading that was adopted by the Council on October 15, 2013 (European Council, 2013), resulting in the 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, PE CONS 22/13, <http://register.consilium.europa.eu/pdf/en/13/pe00/pe00022.en13.pdf> [hereinafter: EBA Amendment Regulation].

¹⁵⁴ EBA Amendment Regulation, art. 1(18)(b) amending EBA Regulation, art. 35(6).

¹⁵⁵ The EBA conducted a stress test involving Europe's 90 largest banks immediately before the severe repercussions that the Greek sovereign debt crisis had in the European banking sector became visible during the summer of 2011 (Tröger, 2013, p. 190-1) and con-

ties to take supervisory actions in emergency situations¹⁵⁶ and ultimately act in place of the competent supervisory authority,¹⁵⁷ which also applies if the latter does not remedy a breach of immediately applicable Union law,¹⁵⁸ also in relation to the ECB,¹⁵⁹ after the Commission's plan to partly insulate the ECB from direct EBA-interference was not carried forward in the political compromise.¹⁶⁰ However, as matter of practice it seems unlikely that the EBA—clearly under-resourced for this purpose—will meddle with day-to-day supervisory activities both within and outside the SSM.¹⁶¹ Hence, the most important development seems to be related to the EBA's core task as E.U.-wide standard setter. In this capacity, it will be confronted with a *de facto* rivaling institution (*infra* 4.1). At the same time its internal decision making procedures will become more cumbersome and thus conjure up the peril of a standoff between rivaling blocks of NCAs (*infra* 4.2).

cluded that the bulk of participating institutions was sufficiently resilient due to high tier-one capital ratios, EBA (2011a). Among other things, this experience shows that NCAs tend to report data to the supranational stress tester in a way that supports a strong performance of “their” national banks, see also Véron (2012, p. 6).

¹⁵⁶ EBA Amendment Regulation, art. 1(7)(b) amending EBA Regulation, art. 18(3). The amendment (“competent authorities” instead of “national authorities”, see *infra* note 159) clarifies that it is also the need for coordination between NCAs and the ECB in emergency situations that warrants EBA intervention.

¹⁵⁷ The EBA may adopt individual decisions addressed directly to financial institutions if the competent authority does not take required actions in emergency situations, EBA Regulation, art 18(4).

¹⁵⁸ EBA Regulation, art. 17(6) requires that the NCA does not remedy the breach after receiving a formal Commission opinion that takes the EBA recommendation into account.

¹⁵⁹ For purposes of the application of the EBA Regulation, the ECB in its supervisory capacity will be regarded as a competent authority treated indiscriminately like an NCA, EBA Amendment Regulation, art. 1(2) amending EBA Regulation, art. 2(2)(f).

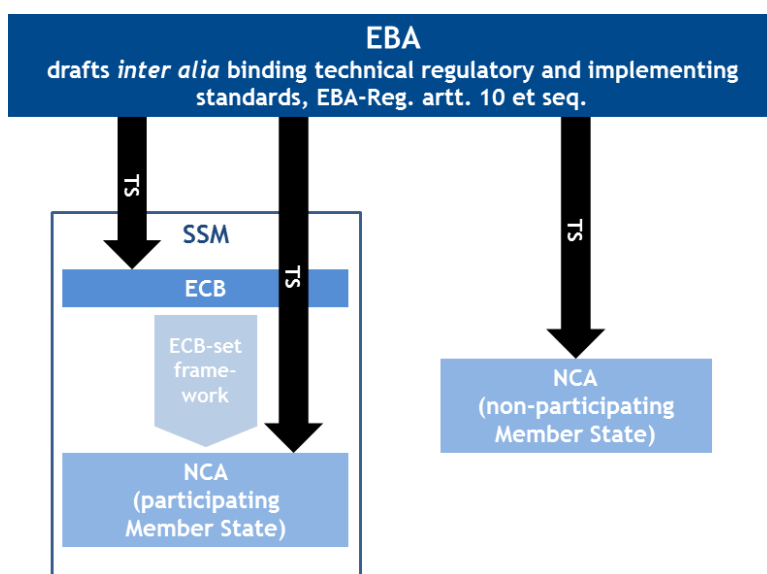
¹⁶⁰ The Commission sought to allow the ECB an explained non-compliance with EBA-opinions in emergency situations and disputes with NCAs, Commission Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (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, arts. 18(3a), 19(3a), COM(2012) 512 final [hereinafter: Commission Proposal EBA Amendment Regulation]. The rationale was seen in the ECB's independent status—flowing from its role as central bank responsible for monetary policy—that prohibits *inter alia* subordination to other E.U. bodies, TFEU art. 130, ESCB and ECB Statute, art. 7. After all, E.U. legislation subscribed to a bolder interpretation of the constitutional framework that limits the unconfined independence requirement to the ECB's monetary policy mandate. For a discussion see Ferran and Babis (2013, p. 24).

¹⁶¹ The EBA will also have the competence to ultimately decide quarrels between NCAs and the ECB in accordance with the procedure laid down in EBA Regulation, art. 19(3), *supra* note 49 and table 1, as these provisions remain unchanged by the EBA Amendment Regulation. Yet, as the ECB assumes the role of home and host competent authority within the SSM (*supra* 3.2.3), relevant disputes may occur only in relation to non-participating Member States' NCAs. EBA Regulation, art. 19(1) requires an explicit referral to the provision in Union law for the EBA to receive decision-making power. As such referral is lacking in the SSM Regulation, disagreement of NCAs with ECB measures within the SSM cannot be brought before the EBA.

4.1 EBA-RULEMAKING AND ECB-SUPERVISION COMPARED

Another source of potential frictions in the new supervisory architecture results from the ECB's relation to other institutions within the European System of Financial Supervision (ESFS), in particular to the EBA in its capacity as gap-filling rulemaker. At the outset, ECB (SSM) and EBA pursue different ends. The ECB and the NCAs enforce supranational and (harmonized) national banking regulation in the participating Member States, whereas the EBA devises binding regulatory and implementing technical standards (TS) to be adopted by the Commission that clarify and fill gaps in E.U. banking regulation,¹⁶² a task which is still critical for integrating actual supervisory practices despite the increasing harmonization of substantive banking regulation.¹⁶³

SSM Regulation art. 4(3) subpara. 2 stipulates explicitly¹⁶⁴ that the ECB in carrying out its supervisory tasks will be bound by the TS, have to consider EBA guidelines and recommendations in accordance with EBA Regulation, art. 16, and be subject to a European supervisory handbook that will describe best practices in supervisory methodologies and processes.



However, the query pertains to the *de facto* relation of the ECB-defined supervisory framework (*supra* 3.2.2) and the EBA-drafted technical standards, its guidelines and recommendations and the European supervisory handbook. Although the further does not generally have the quality of a source of law,¹⁶⁵ it will practically shape the application of the pertinent E.U.-Regulations and harmonized national laws within the SSM, i.e. determine the law in action, event though not that on the books: the ECB will compel compliance with its own interpretation of supranational legislation by forcing NCAs to adopt its own position and construe national implementing acts in conformity with it. This prediction does not neglect the fundamental difference between regulation and supervision. Yet, it posits that—

¹⁶² EBA Regulation, arts. 10-15.

¹⁶³ For a bleak account of differences in supervisory practices, regulatory arbitrage and “home bias” that could be of figure 4 - EBA and ECB channels to integrate supervisory standards

¹⁶⁴ The clarification is owed to the controversy surrounding the scope of the ECB's independence, *see supra* note 160.

¹⁶⁵ This is only the case where the ECB is entitled to promulgate regulations (TFEU, art. 288(2)) as part of its supervisory framework, SSM Regulation, art. 4(3) subpara. 2 and *supra* 3.3.2.2 .

as a matter of practice— the ECB will be significantly less encumbered in integrating supervisory standards than some commentators have argued,¹⁶⁶ even where substantive banking regulation remains (harmonized) national law. This is even more likely, as the ECB can not only rely on pure fiat but also on the adjudication of the European Court of Justice (ECJ) that consistently holds that Member States' courts and administrative agencies have an obligation to interpret domestic legislation in a way that it conforms with E.U. law, both primary¹⁶⁷ and secondary.¹⁶⁸ As a consequence, the actual impact of the ECB-defined supervisory framework is very similar to that of the EBA's TS, guidelines and recommendations and the European supervisory handbook (figure 4).¹⁶⁹ In fact, it goes even further as the ECB has sweeping powers to cram its interpretations down on NCAs (*supra* 3.2.1 and 3.2.2). This observation makes the ECB a *de facto* more powerful standard-setter than the EBA, because in relation to NCAs it can dictate the interpretation of harmonized banking regulation, at least as long as no challenge of its position is brought before the ECJ.¹⁷⁰

Of course, the ECB will not blatantly renege against EBA-set supervisory standards. However, it can go further and proceed more rapidly in its efforts to integrate supervisory practices. Where binding TS have thus far not been proposed by the EBA it can prescribe the use of common methodologies or processes in the framework it has to devise for the SSM. This road may become even more attractive, if the EBA's capability to expedite the integration of supervisory practices becomes constricted as a result of amendments to the rules governing its decision making process in regulatory matters.

4.2 EURO-AREA DOMINANCE OF EBA DECISION MAKING OR STANDOFF?

The creation of the SSM also provides for a looming euro area-dominance of the EBA Board of Supervisors, *i.e.* the decision making body responsible amongst others for EBA-rulemaking. To be sure, representatives of the NCAs will remain the sole voting-members of the Board reflecting its character as a common institution for all 28 Member States.¹⁷¹ However, Commission Proposal SSM Regulation art. 4(1)(l) commissioned the ECB to „coordinate and express“ a common position of euro area Member States in the EBA Board of Supervisors (and its Management Board) for

¹⁶⁶ Wymeersch (2012, p. 5) and Ferrarini and Chiarella (2013, p. 52-3) identify the necessity to apply harmonized national law as a source of frictions that could compromise effective supervision. For a similar account, that assumes that the ECB will indeed take out to respect any idiosyncracies of national legal systems, Schneider (2013, p. 455).

¹⁶⁷ Case 157/86, *Murphy v. Bord Telecom Eireann*, 1988 E.C.R. 673; Case 322/88, *Salvatore Grimaldi v. Fonds des maladies professionnelles*, 1989 ECR I-4407.

¹⁶⁸ Case C-106/89, *Marleasing SA v La Comercial Internacional de Alimentacion SA*, 1990 E.C.R. I-4135; Joined Cases C-397/01 to C-403/01, *Pfeiffer and others v. Deutsches Rotes Kreuz, Kreisverband Waldshut e.V.*, 2004 E.C.R. I-8878 para 115 et seq.; Case C-555/07, *Kücükdeveci v. Swedex GmbH & Co. KG*, 2010 E.C.R I-365 para 49 et seq.

¹⁶⁹ For a similar assessment see Schneider (2013, p. 456).

¹⁷⁰ *Cf.* SSM Regulation, art. 24(11).

¹⁷¹ As to date, the ECB will only be represented by a non-voting member, nominated by the Supervisory Board, EBA Regulation, art. 40(1)(d) as amended by EBA Amendment Regulation, art. 1(21)(b).

“issues relating to the tasks conferred on the ECB by this regulation”. It is quite plausible that prudential regulation *relates* to the supervisory tasks conferred on the ECB and that SSM-participants thus were expected to be ECB-synchronized in EBA-drafting of TF etc.¹⁷²

However, the Commission proposed no substantive change to EBA Regulation art. 44(1) subpara. 2 that requires a qualified majority for the adoption of draft TS and other regulatory measures.¹⁷³ Yet, to prevent a walkover of non-participating Member States, the majority requirements for the pertinent Board of Supervisors’ decisions may have to be adapted accordingly. Hence, Parliament¹⁷⁴ successfully proposed to tighten the relevant thresholds by stipulating a double-majority requirement in addition to the qualified majority vote.¹⁷⁵

Commission Proposal SSM Regulation art. 4(1)(l) was discarded in the political compromise. But even without an explicit mandate for the ECB to coordinate a common position, a proclivity of participating Member States to vote *en-bloc* may exist and be amplified over time with supervisory methodologies and procedures incrementally converging thanks to ECB coordination.¹⁷⁶ Hence, the amendment championed by Parliament arguably balances a looming euro group-dominance.¹⁷⁷ Indeed, it will quite effectively counter the peril that draft TS, guidelines and recommendations etc. were adopted that would be perceived as entirely heteronomous from the perspective of non-participating Member States.

¹⁷² Wymeersch (2012, p. 21). For a narrower interpretation of Commission Proposal, SSM Regulation, art. 4(1)(l) Ferran and Babis (2013, p. 27 note 169).

¹⁷³ Commission Proposal EBA Amendment Regulation, art. 1(7) amending EBA Regulation art. 44(1) subpara. 2.

¹⁷⁴ Conferring supervisory tasks on the ECB pursuant TFEU, art. 127(6) requires only the consultation of Parliament in a special legislative procedure (TFEU, art. 289(2)), whereas the concurring amendment of the EBA Regulation will find its legal basis in TFEU, art. 114, and thus requires parliamentary consent in the ordinary legislative procedure (TFEU, art. 294).

¹⁷⁵ EBA Amendment Regulation, art. 1 (24)(a) amending EBA Regulation, art. 44(1) subpara. 2.

¹⁷⁶ Ferran and Babis (2013, p. 27); Véron (2012, p. 8).

¹⁷⁷ This observation also explains the double-majority requirements for adopting supervisory decisions in emergency situations, EBA Regulation, art. 44(1) subpara. 7 as amended by EBA Amendment Regulation, art. 1(24)(a), and in matters pertaining to breaches of directly applicable E.U. law or cross-border disputes that apply in the latter cases as long as at least four Member States do not participate in the SSM, EBA Regulation, art. 44(1) subpara. 3 and subpara. 4 as amended by EBA Amendment Regulation, art. 1(24)(a) and that allows non-participating Member States to effectively block decision making. Moreover, in matters pertaining to breaches of directly applicable E.U. law, EBA Regulation, art. 17, and cross-border disputes, EBA Regulation, art. 19, EBA decisions will be drafted by an independent panel that is composed of the Board of Supervisor’s chairperson and six disinterested representatives from competent authorities, EBA Amendment Regulation, art. 1(22) amending EBA Regulation, art. 41. Ultimately, the double-majority requirement feeds concerns surrounding the EBA’s capacity as a decision maker in supervisory matters similar to those scrutinized *infra* for its rulemaking function. For a discussion see Ferran and Babis (2013, p. 26); on the (unintended) consequences of Commission Proposal EBA Amendment Regulation, art. 1(7) amending EBA Regulation art. 44(1) subpara. 3, that made it very hard for non participating Member States to veto decisions, Wymeersch (2012, p. 23).

It need not be decided here whether it necessarily created negative externalities if participating Member States—with sometimes relatively small banking sectors¹⁷⁸—could impose their views on adequate prudential banking regulation on dissenters. Euro area Member States may favor a different style of regulation, but there is no convincing evidence that their approach is inexpedient or even inimical. After all, the Commission was deliberately put in the position to weed out such outlandish regulatory blunders should they come out of the EBA.¹⁷⁹ With that in mind, one is tempted to ask, if it was not the logic of the *De Larosière*-architecture with bolstered European Supervisory Agencies (ESAs), that individual Member States would have to accept majority decisions in order to achieve greater uniformity in regulation and its enforcement.¹⁸⁰ To be sure, the situation with coordinated and hence rather stable majorities poses a largely unanticipated scenario and the geographical distribution of Europe's financial services industry is such that the control of EBA-rulemaking would be external from the perspective of Europe's foremost financial center.¹⁸¹

Still, however, the focus on devising an institutional setup that primarily seeks to prevent coalitions from prevailing with their preferences in EBA decisions may be misguided. The promulgated double majority-requirement will also abet a paralysis of the Board of Supervisors and thus weakens the EBA's capacity to integrate supervisory standards through TFs etc.¹⁸² The EBA's ability to act will be severely encumbered, if no decision can be taken against either the ECB-orchestrated opposition of participating Member States or the resistance of non-participating Member States led by the Bank of England and its Prudential Regulation Authority. A plausible outcome will be that EBA rulemaking will attempt to paper over unresolvable conflicts by proposing rather vague TS etc. that allow implementing diverse supervisory approaches while being in full compliance with supranational regulation.¹⁸³ As a consequence, an incremental integration of supervisory practices under the auspices of the EBA may fall prey to this lurking standoff, whereas the ECB may proceed rapidly down this road by devising an ever tighter framework for the SSM.

5 NON-PARTICIPATING MEMBER STATES

¹⁷⁸ In June 2013, the aggregated balance sheet of U.K. monetary financial institutions accounted for 20.90% in the E.U., that of euro area MFIs for 72.15%, that in other E.U. Member States for 6.95%, ECB (2013). Véron (2012, p. 5) reports similar numbers, but overstates the U.K. share in his obviously flawed aggregation (total of 93.1%). Ferran and Babis (2013, p. 22) posit that the U.K. is „the location for almost 50 per cent of E.U. financial services business“.

¹⁷⁹ The Commission can decide not to endorse or to amend a draft TS that exhibit severe defects, particularly if they contradict “fundamental principles of the internal market for financial services”, EBA Regulation, recital 23 with arts. 10(5)-(7) and 15(5)-(7).

¹⁸⁰ High Level Group on Financial Supervision in the EU (2009, p. 46-8).

¹⁸¹ See *supra* note 178. It is this indisputable situation which puts concerns into perspective that point to the double majority requirement's tendency to give non-participating Member States disproportionate influence in relation to their number, population and economic weight, Bundesbank (2013, p. 29). The latter indicators are simply less important than the relative size of the regulated industry which proxys a jurisdiction's affectedness far more precisely.

¹⁸² For a similar assessment see Ferran and Babis (2013, p. 27).

¹⁸³ Ferran and Babis (2013, p. 27).

The SSM represents an island-solution that is initially limited to Member States whose currency is the euro. As a consequence, the U.K. will not fall immediately within the remit of the SSM. Hence, the banking activities in Europe's foremost financial center¹⁸⁴ are fed into the transnational supervisory efforts only along the traditional lines of shared competences (*supra* 3.1). Obviously, on a micro-level, the stated goal of common supervision, to implement more uniform and integrated high-standard supervisory practices and the general rationale for supranationalizing prudential banking supervision (*supra* 2.1) speak strongly in favor of casting the net wide. On a macro-level, preserving the integrity of a single market where capital and services flow unimpeded across national borders is pivotal for the financial services industry and the prosperity of European polities.¹⁸⁵ Hence, the SSM in principle is rightfully hospitable towards new entrants as it offers an arrangement of close cooperation non-euro area Member States can opt-into (*infra* 5.1). Of course, an assessment of likely candidates for such a close cooperation cannot be limited to the attractiveness of the legal package,¹⁸⁶ yet the limited participation rights in ECB supervisory decision making suggest, that it is rather unalluring to submit to the euro area's supervisory architecture without adopting its currency (*infra* 5.2). What's more, the broad exit options for Member States in close cooperation prohibit the SSM from serving as an institutional device that allowed to signal a credible commitment to high quality supervision to markets (*infra* 5.3). All in all, the prospects of a broad participation of non-euro area countries are dim (*infra* 5.4).

5.1 CLOSE COOPERATION

Despite doubts relating to the lack of a sound legal basis for non-EMU participation,¹⁸⁷ Member States outside the euro area shall have the option to seek a „close cooperation“ and thus opt into the SSM as full-fledged partners.¹⁸⁸ On request of the Member State the ECB will decide whether the preconditions for such a close cooperation are met, to wit, if the domestic legal framework allows the ECB to function as the primary supervisor in relation to the pertinent NCA.¹⁸⁹ The Member State commits for a three year period from the ECB's decision and can request the termination of the close cooperation anytime thereafter.¹⁹⁰ The ECB can suspend or terminate the close cooperation if a procedure to remedy deficits fails, particularly if the Member State does not ensure, even after receiving a precise warning, its NCA's

¹⁸⁴ *Supra* note 178.

¹⁸⁵ Ferran and Babis (2013, p. 22).

¹⁸⁶ For a comprehensive discussion see Darvas and Wolff (2013, p. 6-10).

¹⁸⁷ Carmassi et al. (2012, p. 3-4); Wymeersch (2012, p. 24).

¹⁸⁸ Commission Proposal SSM Regulation, arts. 6(3), 19(5) conditioned the representation of non-euro area Member States in the Supervisory Board on the ECB's decision establishing the close cooperation. For a discussion of this position of non-euro area participating Member States, Ferran and Babis (2013, p. 20).

¹⁸⁹ SSM Regulation, art. 7(2).

¹⁹⁰ SSM Regulation, art. 7(6).

compliance with the ECB-set supervisory framework.¹⁹¹ Once again, the ECB is equipped with strong tools to reign-in insubordinate NCAs.

5.2 SECOND-CLASS SSM-PARTICIPATION: NO ULTIMATE SAY IN ECB-DECISION MAKING

The key aspect that makes entering into a close cooperation relatively unattractive for Member States who do not—at least in medium term—aspire to introduce the euro could follow from the ECB’s character as an institution of euro area Member States.

Participating Member States whose currency is not the euro will not be directly involved in ECB-decision making at the level of the Governing Council.¹⁹² Hence, even though non-euro area SSM-participants are fully represented in the decision making process of the newly established Supervisory Board,¹⁹³ they will not take part in the Governing Council’s ultimate determination whether supervisory decisions will be adopted or dropped (*supra* 3.3.2.1 and figure 3). Non-euro area Member States in close cooperation who disagree with a draft decision of the Supervisory Board only have a right to articulate their reasoned disagreement in order not to be bound by the pertinent decision if the Governing Council does not confirm the non-euro area Member State’s objection.¹⁹⁴ If the Governing Council does not honor the Member State’s concerns, the only remaining resort lies, however, in the immediate termination of the close cooperation on the affected Member State’s request.¹⁹⁵ If, on the other hand, the non-euro area participant is opposed to an objection of the Governing Council that led to a change of the Supervisory Board’s draft decision, it can submit its reasoned disagreement to the Council that will consider withdrawing or confirming its original objection within thirty days.¹⁹⁶ In case of a confirmation, the participating Member State has the option to avoid being bound by the ultimate decision, albeit at the risk of the ECB terminating or suspending the close cooperation.¹⁹⁷ In light of the incisive consequences of such a kick-out from the SSM, it has been suggested that the decision should be taken on the highest political (European

¹⁹¹ SSM Regulation, art. 7(5).

¹⁹² This follows from the Governing Council’s function as the ultimately responsible decision making body of the euro area’s monetary policy maker, defined in the TFEU and the ESCB and ECB Statute, *supra* note 143; Darvas and Wolff, (2013, p. 3). For a discussion of the—largely unpromising—routes to redress the problems without a Treaty change see Ferran and Babis (2013, p. 21-2).

¹⁹³ SSM Regulation, art. 26(1) assigns a representative from each participating Member State’s NCA full membership in the Supervisory Board. In light of the definitions in SSM Regulation, art. 2(1), (2), Member States that have opted for a close cooperation are thus put on equal footing with euro area members (*see also* SSM Regulation, art. 26(12) on the equal treatment of all participating Member States in the Supervisory Board’s rules of procedure), as has been urged by the European Council (2012c, p. 7). For a discussion of the evolution of the rule *see* Ferran and Babis (2013, p. 20-1).

¹⁹⁴ SSM Regulation, arts. 7(8), 26(8).

¹⁹⁵ SSM Regulation, art. 7(8).

¹⁹⁶ SSM Regulation, art. 7(7), 26(8).

¹⁹⁷ SSM Regulation, art. 7(7) subpara. 2-4.

Council) rather than on the more technocratic level (ECB).¹⁹⁸ Yet, the proposition was not seized during the legislative process, arguably because the decision is certainly primarily one of supervisory expedience and is thus wisely assigned to the highest decision making body within the SSM.

Even if concerns over a pervasive discrimination of non-euro area participating Member States may be unwarranted, also because they are prohibited as a matter of law,¹⁹⁹ it is a significant difference, if a representative of the affected Member State can participate actively in the Governing Council's deliberations or if the Member State has to rely *dégagé* on the benevolent consideration of a position articulated *ex ante*. This may be a bitter pill to swallow for those E.U. Member States who indeed wish to signal their good will to further the common cause as part of their quest to join the euro-club. Yet, it may well prove unacceptable for others.

5.3 SSM IS NO "LOBSTER TRAP"

Moreover, the SSM does not provide a credible bonding option for those Member States whose currency is not the euro if they seek to credibly commit to high quality supervision of their banking sector.²⁰⁰ For institutional choice to serve as a positive signal to markets it is indispensable that opportunistic changes to the original decision *ex post* are ruled out. The issue is to overcome a commitment problem that otherwise exists for Member States whose currency is not the euro if it was not for the support by pertinent institutions.²⁰¹

As the option to leave exists for those Member States whose currency is not the euro, especially if they are discontent with hard supervisory decisions, and—even more importantly—participating Member States who fail to live up to the SSM's supervisory standards may be expelled,²⁰² the SSM is not the proverbial lobster trap required for credible bonding by submitting to stringent institutions.²⁰³ It thus does not allow reaping the welfare benefits that would accrue in the form of lower financing costs for more stable banks and consequentially cheaper access to credit if such bonding was available.

5.4 CANDIDATES FOR CLOSE COOPERATION?

¹⁹⁸ Véron (2012, p. 5).

¹⁹⁹ SSM Regulation, arts. 1(4), 26(12).

²⁰⁰ The literature has discussed and advocated choice-based approaches where either jurisdictions, Hertig et al. (2010, p. 181–89, 194–210), or individual banks, Mortimer-Schutts (2005); Čihák and Decressin (2007), could opt-into a European regime of banking regulation and supervision.

²⁰¹ See generally North and Weingast (1989).

²⁰² Darvas and Wolff (2013, p. 6 note 10) also point to the "very special status" of non-euro area countries that favor "purely national interests".

²⁰³ For a theory comparing irrevocable commitments to high regulatory standards (mandatory disclosure rules) with a lobster trap Rock (2002).

It was indeed a strong incentive to join the SSM, if the opt-in offered risk-sharing and least-cost bank resolution through ESM backing.²⁰⁴ Yet this seems hardly an option, as the ESM was established by an intergovernmental Treaty of the seventeen euro area Member States outside of the E.U. framework and is thus not immediately available for non-euro area participating Member States²⁰⁵

Obviously, benefits associated with an opt-in can follow from higher supervisory quality and restrictions on regulatory arbitrage, reduced compliance costs for transnational financial institutions, and the termination of home/host-coordination requirements. The latter aspect is not straight forward though and very much depends on how (subsidiary or branch) and where (participating or non-participating Member State) foreign assets are held, because there is no direct ECB supervision of subsidiaries in non-participating Member States regardless of whether the group's home Member State is in close cooperation or not.²⁰⁶ However, these advantages largely accruing in the private sector may not compel governments to cease sovereign rights. Hence, it will ultimately hinge on a non-euro area Member State's individual situation, if the option to join the SSM will be exercised.

The case seems stronger for Central European Member States who have pegged their currency to the euro and have a financial sector largely dominated by subsidiaries of foreign banks,²⁰⁷ although of course joining the SSM would entail a significant seizure of sovereign rights in supervising these subsidiaries.²⁰⁸ Supranationalizing supervision potentially counters the preference of consolidating home supervisors to push for downsizing foreign lending in a situation of domestic crisis.²⁰⁹ To a certain degree, even non-participating Member States will benefit as free-riders from a dilution of the pertinent preference, if the banking group's parent is a significant institution authorized in a participating Member State and thus falls within the remit of direct ECB supervision.²¹⁰ The ECB's motivation to compel a deleveraging in foreign jurisdictions may be less strong as it does not only serve the clearly defined national interests of the group's home Member State.²¹¹ Yet, the non-participating Member State will still remain an "outsider" *vis-à-vis* the consolidating supervisor and may, at least at the margin, improve its position by joining the club as a full member with participation rights.

²⁰⁴ Goyal et al. (2013, p. 29).

²⁰⁵ See Treaty Establishing the European Stability Mechanism (ESM) and ECJ Case C-370/12, *Pringle v Government of Ireland, Ireland and The Attorney General*, 2012 E.C.R. I-■■■.

²⁰⁶ See supra 3.2.1, 3.2.3. Darvas and Wolff (2013, p. 6) present case studies for a Danish and a Hungarian banking group.

²⁰⁷ Wymeersch (2012, p. 23).

²⁰⁸ See supra 3.1 and table 1. Darvas and Wolff (2013, p. 5, 14-5) show that if central and eastern European countries entered into close cooperation direct ECB supervision would cover primarily foreign subsidiaries in these jurisdictions.

²⁰⁹ Generally on the conflicting preferences of home and host supervisors, Herring (2007); Fiechter et al. (2011, p. 18); see also Ferrarini and Chiarella (2013, 8-10, 14 f.).

²¹⁰ *Supra* 3.2.1.

²¹¹ In principle, the ECB cannot discriminate against non-participating Member States whose currency is not the euro, SSM Regulation, art. 1(4).

For political reasons it is hard to imagine that the U.K. will dare moving in a direction that may be perceived as approaching the EMU. However, it has to be kept in mind that the City of London has to swallow the bulk of centralized banking policy output anyway, for instance in the form of the comprehensively harmonized banking regulation (CRD IV/CRR)²¹² that will bring, amongst others, bonus caps for bank personnel²¹³ that are very unpopular in the City. In medium term, its choice will most likely depend on how its interests will be affected by the SSM, even though it stays on the sidelines.²¹⁴ Despite the legal obligation to abstain from any discrimination against non-participating Member States whose currency is not the euro,²¹⁵ the described mode in which the ECB-driven, closer integration of supervisory practices among participating Member States will operate (*supra* 4), suggests that widening gaps do neither conform with the rationale of a single market for banking services,²¹⁶ nor make life easier for the City's cross-border banks who might ultimately push for a pragmatic accession to the SSM.

6 CONCLUDING REMARKS (ALSO) ON THE BIGGER PICTURE

The assessment provided here is primarily concerned with the likely effectiveness of the SSM as a supervisory regime to improve steady state financial stability, *i.e.* the adequacy of the institutional arrangement for normal times-supervision. It hence does not look at (important) concerns regarding the ECB's accountability as a supervisor²¹⁷ or the legitimacy issues regarding the special review process involving the newly created Administrative Board of Review.²¹⁸ Furthermore, it is analytically indifferent with regard to the ramifications it has that a central bank will serve as the primary supervisor, *i.e.* it does not take into immediate account negative spillover effects for the ECB's monetary policy function that could add to the doubts.²¹⁹ The institutional combination of supervisory and monetary policy under one roof puts the central bank in a position to avoid hard supervisory decisions, potentially even cover own deficient oversight, by easing monetary policy and thus modifying the focus on the inflation objective; it can also provide liquidity to banks despite their insolvency to secure price stability; it can refrain from withdrawing bank licenses if it

²¹² Darvas and Wolff (2013, p. 4) argue that there will be "no material difference between countries in the SSM and those outside the-SSM" with regard to prudential regulation once CRD IV/CRR will be implemented. But see also those commentators that posit the persistence of significant divergences in national banking laws *supra* note 166.

²¹³ CRD IV, art. 94.

²¹⁴ However, it is clear that the practical modalities of the operation of the SSM will be shaped during the first months, thus giving "stragglers" only limited influence in this regard.

²¹⁵ SSM Regulation, art. 1(4).

²¹⁶ For a similar view, Ferran and Babis, 2013, p. 22.

²¹⁷ SSM Regulation, arts. 20, 21. For an extensive discussion of these issues Ferran and Babis (2013, p. 16-9).

²¹⁸ SSM Regulation, art. 24.

²¹⁹ For a general discussion of the issue *see* Goodhart and Schoenmaker (1995); with a special view to the EMU, ECB (2001); for an optimistic view of an insider Constâncio (2013).

faces losses as a bank creditor.²²⁰ In fact, the ECB—without having a lender of last resort mandate²²¹—has, at various stages during the ongoing sovereign debt crisis provided quasi-backstops to ailing banking systems through its instruments of monetary policy, e.g. by broadening the definition for eligible collateral against which it lends to banks, lowering the minimum credit rating for this collateral, reducing the haircut/increasing the advance rate for collateral banks presented, easing borrowing terms and conditions.²²² It is only the safeguards against such negative spillovers that influence the analysis as the attempts to separate the ECB’s monetary policy function from its supervisory tasks complicates its decision making process (*supra* 3.3.2.1).

Other papers focus on the SSM’s capacity to attenuate the current instabilities. As a consequence, these analyses evaluate the SSM essentially as a necessary precondition for direct ESM-recapitalizations. The latter arguably represents the cost-minimizing mechanism for the orderly reorganization of Europe’s troubled banks.²²³ However, if seen from that vantage, the SSM may actually exacerbate the too-big-to-fail problem in the long run, as larger bail-out capacities tend to produce correspondingly larger institutions whose growth may or may not be adequately controlled by structural prescriptions how banks should separate their business lines.²²⁴

The evaluation of the SSM ultimately depends on where the most virulent problems impeding effective prudential supervision are seen, to wit whether it is indeed the avoidance of regulatory forbearance triggered by NCAs’ “home bias” that should shape the institutions of normal times-supervision. In this regard, the view that sees the SSM as a panacea²²⁵ seems to be influenced by availability heuristics. However, even if avoiding capture is key, the SSM’s institutional set-up seems suboptimal (*supra* 3.3.1.2) and requires carefully designed integrative elements that provide the carrots to complement the sticks (*supra* 3.3.2). Moreover, it has to be kept in mind that it obviously becomes harder for local interests to capture a supra-local supervisor.²²⁶ Yet, this doesn’t say much for instances where the interests of agents themselves are broader and may thus lead to potentially more devastating capture on a higher level.²²⁷

²²⁰ Pisani-Ferry et al. (2012, p. 11); Goyal et al., (2013, p. 14).

²²¹ Aglietta (2000, p. 47); Wyplosz (2012, p. 19-21) perceive this as a deficit of the EMU.

²²² For a chronology of the relevant measures see ECB (2011, p. I-IV) and the assessment of Schoenmaker (2012, p. 56).

²²³ Goyal et al. (2013, p. 9-10, 20-21, 26). Already *supra* note 15.

²²⁴ High Level Expert Group on reforming the structure of the EU banking sector (2012).

²²⁵ E.g. Ferrarini and Chiarella (2013, p. 40).

²²⁶ Agarwal et al. (2012) show that U.S. federal supervisors observe more stringent supervisory practices than state authorities.

²²⁷ See e.g. Macey (2013, p. 231-250) for a deeply pessimistic account of the SEC being captured by Wall Street.

The effectiveness of common supervision also depends critically on the interplay with the resolution regime, particularly with the institutions of the SRM. Ultimately, only the credible option to close down a bank without limit systemic consequences lends momentum to supervisory authorities.²²⁸ Moreover, as long as resolution and the pertinent safety net (backstop) remain national, Member States would still have to bear (in part) the fiscal consequences of the decisions of foreign/external supervisory authorities. Any arrangement without a symmetric burden-sharing mechanism obviously drives a wedge between participating Member States incentives and the social optimum.²²⁹ In fact, the query becomes, whether SSM-participation without concurring SRM-membership will indeed remain impossible as is provided in the Commission Proposal for an SRM Regulation.²³⁰

The latter is just evolving,²³¹ the outcome of the legislative process far from clear. The ECB has sound reasons not to become involved in resolution that will always tend to have fiscal implications (bail-out). Yet, if for that matter, resolution powers will not be vested with the ECB, the separate resolution authority should also have to have partly parallel supervisory powers necessary to facilitate early intervention, orderly reorganization, and resolution.²³² It is hard to imagine that the envisioned participation of the Chair of the European Resolution Authority in the Supervisory Board's meetings²³³ will solve all the looming coordination problems: the ECB will be tasked with early intervention,²³⁴ and will be in the position to pull the plug.²³⁵ It is also competent to oversee recovery planning.²³⁶ Yet, the precise scope of its involvement in resolution planning remains unclear as the latter will mainly fall in the domain of the Resolution Board,²³⁷ *i.e.* there is no clear-cut division of labor with resolution authorities, leaving a critical challenge to be worked-out in the future.

²²⁸ Sapir et al. (2012, p. 2, 5-6) who point to the post Lehman-experience where authorities refrained from closing down banks for lack of operable resolution regimes that would limit contagion and provide for adequate loss allocation and burden sharing; *see also* Goyal et al. (2013 p. 12); Ferran and Babis (2013, p. 8-9).

²²⁹ Goyal et al. (2013 p. 12, 22).

²³⁰ Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council, arts. 2(a), 4, COM 2013(512) final.

²³¹ This sequence adds to the complexity of the determination of Member States whose currency is not the euro whether to join the SSM: if SSM membership remains firmly linked to SRM participation (*supra* note 230), the Outs currently don't know for sure what they are buying with an opt-in.

²³² Pisani-Ferry et al. (2012, p. 11). Commission Proposal SRM Regulation, art.11 prescribes the exchange of information between the EZB/NZBs and the Resolution Board once the ECB takes measures of early intervention pursuant SSM Regulation, art. 16.

²³³ SSM Regulation, recital 70.

²³⁴ SSM Regulation, art. 4(1)(i), 16(1).

²³⁵ SSM Regulation, art. 4(1)(a), 14(5).

²³⁶ SSM Regulation, art. 4(1)(h).

²³⁷ Commission Proposal SRM Regulation, arts. 7 et seq.

In sum, the institutional design of the SSM suffers from severe structural shortcomings that probably will not all be entirely solvable in supervisory practice once the system becomes operational. Generally, an improved institutional arrangement requires the much dreaded change of the TFEU²³⁸ that would open up political accountabilities of a different kind. However, in its current state, the SSM will certainly not be the much longed for panacea for Europe's current woes. To become more than a quack policy maker's initiative to display problem solving capacity, substantial efforts to ultimately achieve what arguably could not be accomplished under conceived time-pressure in the first round will remain inevitable.

²³⁸ See also Schneider (2013, p. 454) citing *Jeroen Dijsselblom* and hinting that the banking union was introduced accepting breaches of EU law.

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