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The European Banking Union, a first analysis

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Abstract

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Eddy Wymeersch[*]

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Banking Union, European Central bank, euro area, Single Supervisory Mechanism, prudential supervision, home host relations

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Preliminary

The Proposal to centralise banking supervision in the euro area is one of the most significant steps in the creation of an internal market for financial services. The proposal is part of a three pronged initiative designated as the "Banking Union", of which the part dealing with prudential supervision is called the Single Supervisory Mechanism. The two other parts relate to the deposit guarantee systems and the recovery and resolution schemes, two subjects about which the Commission has previously tabled proposals that are under discussion in the legislative bodies. They will not be commented on in the present analysis. The Banking Union is also part of a longer term policy reflexion developed by Council President Van Rompuy in his 26 June 2012 speech "Towards a Genuine Economic and Monetary Union" where he identified the Banking Union, the Fiscal Union, a Competitiveness Union and a Political Union[1].

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[1] http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf. These plans may at a later stage, call for a change of the Treaty. See for an analysis: J. Pisani-Ferry, A. Sapir, N. Véron, G.B. Wolff, "What kind of European banking union?", *Bruegel Policy Contribution* 2012/12.

According to the official documents proposing the SSM identify several reasons for introducing a banking union have been mentioned[2]. The core objective is to restore confidence in the financial markets as confidence has been badly affected after the crisis that in a first stage caused huge losses in the banking sector but in a second stage is now undermining confidence in sovereign debtors as well, creating a negative loopback to the banking sector. Indeed one of the important lessons of this crisis is that private, in this case mostly banking debt, easily becomes sovereign debt where lack of confidence in the financial system spills over in the ultimate guarantor, the state. One of the objectives of the Banking Union consists of breaking this link between private and public debt by on the one hand ensuring that the public debt would not come again under the dependency of private debt, while the latter is kept under better control[3]. In order to achieve these objectives, the banking system has to be more strongly regulated, supervised[4] and even restructured in depth [5] while the spill-over effect has to be stopped by providing adequate recovery and resolution regimes, protecting the state from the need to bail out private banks. Moral hazard should cease to exist in the financial sector and all parties should keep this clearly in mind.

Linked to this first objective is the concern, voiced by the ECB and other bodies that the crisis is increasingly breaking up the internal market, putting the role of the euro as the single currency in danger. The ECB sees the banking Union as a complement to the monetary union. It draws attention to the dependence of the banking system on the sovereign's creditworthiness, while growing fragmentation of the financial markets[6] has a negative affect on the credit supply but also creates tensions with the single currency. In order to cut the links of the banking system with the sovereigns, a fully integrated banking system strengthened with sufficient capital ratio's is needed. The transmission channels for the monetary policy are functioning in a suboptimal way, leading to significant differences in the funding cost depending on the interrelated position of the sovereign debtor and his related banks.

At present banking supervision in he EU is fragmented: in each of the 27 member States, supervisors are at work, on the basis of harmonised but far from identical regulations. The system results in considerable differences, both in supervisory strictness, authority and methodology making the exchange of views and cooperation of supervisors sometimes quite difficult. If all states practised comparable supervision this would certainly contribute to support confidence, but would still be imperfect. It would not reduce the risk of regulatory arbitrage and of national bias, two forces that have lead to considerable structural consequences in the European banking system. Several of the banks that faltered have indeed showed some weaknesses due to laxity in their supervision, due to many factors among weaknesses in the supervisory processes, but also the support given by national supervisors to so-called "national champions", including the perceived willingness to support banks that constitute important players in their national economies. In some cases, banks that were

[2] These are the proposed regulation on the SSM (conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions; Com (2012) 511 Final) and a proposed regulation amending the EBA regulation (Com (2012) 512 Final)
[3] See B. Coeuré, Why the Euro needs a Banking Union, Speech, 8 Oct 2012.
[4] See the Commission introductory statement see 19 July 2012; see further Commission, A Roadmap towards a Banking Union, COM(2012) 510 final, 12 September 2012.
[5] See the Liikanen proposals: High-level Expert Group on reforming the structure of the EU banking sector, 2 October 2012 http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.
[6] See for details ECB, indicated that not only activity has considerably been reduced due to deleveraging and reduction of positions eg in derivatives, but also as a consequence of discontinuing cross-border activities. This tendency negatively affects the effectiveness of monetary policy decisions.

closely associated with the political world have been addressed with more flexibility, illustrating some form of moral hazard that is rarely highlighted. A single supervisor would at least be able to apply the rules in a more distant and neutral way, with the same strictness avoiding national champions to be privileged and put an end to the possibility to play on the differences between the national supervisory regimes. In supervision like in taxes, there are some "regulatory heavens" that are actively used by the financial groups.

As an immediate link to the recent decision making process, the introduction of the banking union conditions the bail-out of the Spanish banking system as its adoption preconditions the call on the European Stability Mechanism for the recapitalisation of the Spanish banks[7]. This aspect explains the urgency with which this proposal is planned to be adopted

1. The regulatory objectives of a Single Supervisory Mechanism or SSM

The present regime of banking or prudential supervision is based on an increasingly detailed harmonisation of the prudential rules with the application of these rules taking place at the level of the local supervisory agencies. This leads to a considerable diversity among the Member States, preventing the internal financial market to be realised[8].
Regulation, as adopted at the level of the European Union usually takes the form of directives that have to be transposed by the Member States in their national legal system. Not only the text of the directive itself gives rise to sometimes considerable differences in formulation[9], the more so as 22 languages are used, and as we all know , *"tradutore, traditore."* Moreover in the transposition into national law, quite a number of differences are introduced, some made necessary to the overall legal system, others due to more fortuitous factors. Most particularly older directives however leave quite an amount of flexibility for national rules to be adapted to local or specific circumstances. The European Commission verifies the adequate character of this implementation and obliges Member States to adapt their legislation if the discrepancy with the directive is too significant. As a consequence, harmonisation as conceived at the EU level reveals relatively important differences of outcomes. In recent times, the EU has moved increasingly to "maximum harmonisation" and to "regulations", especially in the securities field: these are directly applicable in the national systems, do no call for any transposition, and can therefore be expected to lead to the same application and interpretation, the latter being ultimately unified at the level of the European Court of Justice.

It will not astonish that the system as described results in substantial differences when one compares the actual supervisory practices: each national supervisor has its own methods, traditions, formulas, you name it, leading to often quite substantial differences in terms of outcomes. In some cases, significant regulatory arbitrage is the consequence; it does not only occur in the smaller Member States. Efforts are made to better coordinate national supervisory practices particularly within the colleges of supervisors for cross border groups. The European Supervisory Authorities are expected to play a significant role in this field, without being able to substitute themselves to the national supervisors[10]. This leaves a considerable

[7] See Conclusions of the European Council, 18 October 2012, pt 12.
[8] See ECB, Financial Integration In Europe, May 2012, http://www.ecb.int/pub/pdf/other/financialintegrationineurope201204en.pdf.
[9] According to constant case law of the ECJ, no particular language has precedence but the meaning has to be derived from the comparison of the different versions: for a recent example in an insider trading case, see ECJ, 28.6.2012, C-19/11.
[10] See eg. art. 31 of the ESMA regulation; for an analysis see Wymeersch: The European Financial Supervisory Authorities, in *Financial Regulation and Supervision, A post-Crisis Analysis* (Wymeersch, Hopt, Ferrarini), Oxford University Press, 2012.

leeway for divergent or specific supervisory practices. In the crisis, it also appears that national supervisors – who are primarily responsible and accountable before their national political bodies, have a tendency to take strong account of national interests, and sometimes have showed some flexibility in addressing strong measures to their domestic banks. As a consequence banking supervision has remained a patchwork of different practices, based on a common general framework, but far from reflecting the needs of an integrated financial market. In the crucial field of assessing risks, one has witnessed in some jurisdiction a certain leniency not to take potential losses into the accounts, resulting in a strong confidence crisis the moment the markets started to doubt about their health. It cannot be denied that this state of affairs does not support confidence in the quality of the banks, leading to fragmentation of the European financial market, and reducing the volume of cross border transactions and ultimately endangering the integrated market, one of the lead objectives of the European Treaties. Moreover this evolution has systemic consequences as due to a lack of confidence the interbank and other short term liquidity markets have at times fully dried up. The sovereign debt crisis has further exacerbated these developments.

The proposal of the Commission aims at putting an end to this diversity by centralising prudential supervision in the hands of one authority that will be able to secure that the rules are applied in all cases and in the same way[11]. Regulatory arbitrage and national champions should disappear, while strictness in supervisory practices is likely to restore confidence in the banking system. Moreover, the proposal, by providing for a larger level playing field, aims at reversing the trend for financial institutions to contribute to the disintegration of the EU financial market by making the conditions for cross-border activity more effectively equivalent.

Although the present proposals undoubtedly are valuable contributions to the integration of the markets, one has to analyse them more in detail to determine whether, to what extent and in what circumstances this ambition can be pursued. Although these proposals constitute significant and necessary steps on the road to an integrated European market, they are not sufficient: many more steps have to be undertaken to achieve the full integration of the financial activity that can adequately support Europe’s economic and social development.

2. Supervision versus regulation

The scheme as proposed by the Commission is based on the fundamental division between regulation and supervision. Although the dividing line may in practice be less evident as would seem to flow from the distinctive terminology, it points to the significant features of the SSM.

The regulation of banks[12] remains essentially a national matter, showing distinct differences due to the regulatory technique. This national regulation is derived from the European directives, but offers quite some diversity, and this not only on points of detail. The future centralised supervision will have to take account of these “underlying” differences that are the national laws and regulations rules that are outside the remit of that supervisor, although not

[11] Nevertheless, some parties continue to insist that all banking supervision remains national, see German BVR, VOEB, Finanzgruppe Sparkassen und Giroverband, Gemeinsames Positionspapier zu einem einheitlichen Aufsichtsmechanismus fuer Kreditinstitute im Sinne der Gipfelerklaerung der Mitglieder des Euro-Waehrungsgebiet vom 29 June 2012.

[12] In the present paper the word “*banks*” will be preferred to “*credit institutions*” but only *brevitatis causa*. The precise scope of the proposed reform refers to credit institutions as defined in the directives.

outside his influence. The proposal takes due account of this double layered system that consists of national banking regulation in each of the jurisdictions involved, but applied by a supervisor that stands above the national level. Over time however the two levels are due to converge, and in result in what is usually referred to as the "European Single Rulebook'[13]. However the idea of having a common rulebook is a rather conceptual one, as it refers to a set of directives, regulation, implementing acts and even recommendations, guidance and other similar non binding instruments, that having been considered as a whole, will be better adjusted to each other, reflecting an integrated regulatory system. However this Rulebook is still far away and is likely to be opposed by the Member States that prefer to maintain their own practices, exceptions and ways of dealing. As long as regulation and supervision were national, these differences did not create internal tension, but led to significant cross- border friction, eg by way of regulatory arbitrage. In the future the opposite is likely to occur, affecting the effectiveness of supervision, as the single supervisor will be obliged to act on the basis of divergent "underlying" national regulations. Therefore one will have to engage in further streamlining the applicable regulation in the sense of more uniformity, or allow special, derogatory regimes only when the friction does not put the overall effectiveness in danger. By way of example, one can mention the differences as to the definition of "credit institution", defined in directive 2006/48 as "*an undertaking whose business it is to receive deposits or other repayable funds from the public and to grant credit for its own account*", some Member States include in their definition also institutions that do not receive deposits, or deposits from the public, but nevertheless grant credit. Should these be included in the ambit of the European supervisory regulation? The answer proposed in the new regulation is negative, what may create tension in terms of consolidated supervision. Over time and under the increased pressure of the SSM, this tension is likely to disappear.

The remit of the future supervisor will be limited to prudential supervision. Although the proposed regulation solves the difficulty of defining what constitutes "*prudential supervision*"[14] by referring to a relatively long list of supervisory activities, the question arises with matters that do not fit into this list. Indeed the list has obviously been conceived as limitative. There is language stating that matters of applying the rules on consumer credit, or on money laundering would not belong to the ambit of the ECB as prudential supervisor[15]. But the dividing line will be ambiguous: the application of the rules on money laundering reveals important prudential features as the confidence in the banking institution can be jeopardised due to too lax application of the AML rules. Will the ECB have to rely on the willingness of the national supervisor to adequately request these rules to be applied? Similar difficulties can be expected in the field of Mifid, with respect to the rules protecting securities clients: widespread misselling practices may in some cases lead to the perdition of the bank. In fact, the outcome would be largely as the situation that existed in Member States with a twin peaks system, with overlaps and some underlaps, what has been one of the reason for integrating supervision into one institution[16].

The creation of a multistate prudential supervisor will not put an end to the role of the existing national supervisory bodies: the explanatory memorandum to the proposals is

[13] See the Conclusions of the European Council of 18 October 2012, pt 7, stating that "*it is of paramount importance to establish a single rulebook underpinning the centralised supervision*."

[14] Art 4(1) enumerates the tasks that, for supervisory purposes, can be carried exclusively by the ECB.

[15] Preamble 22 referring to verifications mandated by the securities markets directives.

[16] See about this evolution, Wymeersch, E. The structure of Financial Supervision in Europe: about Single, Twin Peaks and Multiple Financial Supervisors, EBOR, 8:2, 2007, 239-306, ssrn 946695.

adamant in this respect in securing the role of the existing national authorities: they will maintain their competences in fields other than the prudential one, will be associated in several points of prudential decision making, share powers in the field of sanctioning.

This – and several others - features explain why the existing national supervisors, including the prudential supervisors will also be needed in the future, will be involved in non prudential supervisory activities, and this notwithstanding their role in the field of the interpretation and application of the existing national laws. Moreover, as will be explained later, if the new regime would be applied to all banks in the euro area, it will be indispensable to involve them actively in major parts of prudential supervision of at least the non-systemic banks, even if the supervisory activity is directed by and monitored from the ECB.

The application of the national legislation raises the issue of enforcement in the court, as the ECB will have to have the "locus standi" before the national jurisdiction to enforce its decisions, i.a. sanctioning decisions. As the regulation assimilates the ECB to a national supervisor, the proposed regulation allows the ECB to appear in a national court to obtain an authorisation for certain investigatory acts. The appreciation of the court is limited to the verification whether the proposed act is arbitrary or excessive. But the necessity of the action will not be put into doubt, as this can only be challenged before the ECJ[17]. The absence of the ECB having a right to sue in nationals court to have its decisions legally enforced seems a weakness in the regulation that should be clarified and if needed amended.

3. The choice for the ECB

The choice of the ECB as the institution best placed for exercising the SSM function is not a surprise. On the one hand the European Banking Authority could not be put in charge of actual supervision as tasks and responsibilities cannot be delegated to this body on the basis of the prevailing reading of European Law, more specifically on the basis of the Meroni doctrine[18]. Some eg in the European Parliament have proposed the creation of a special body in charge of banking supervision, but this would have required a change of the Treaty, not a winning proposition these days. The only body that could intervene without a change of the law is the ECB, as the Treaty – as modified by the Maastricht Treaty - already contains a provision allowing the ECB to exercise prudential responsibilities.

Under the overall heading "*monetary policy*", art. 127 (5) and (6) of the Treaty on the Functioning of the European Union or TFEU enumerates the basic tasks of the ESCB, the European System of Central banks, comprising the Central banks of the 27 members, or of the ECB stating:

(5) The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.
(6) The Council, acting by means of *regulations* in accordance with a special legislative procedure, may *unanimously*, and after consulting the European Parliament and the European Central Bank, confer specific *tasks* upon the European Central Bank concerning policies relating to the *prudential supervision* of credit institutions and other financial institutions with the exception of *insurance* undertakings.

While the first cited provisions refer essentially to activity in the field of formulation and conduct of policies for which the *ESCB* is put in charge, the second one addresses supervision

[17] See art. 12 of the proposed regulation.
[18] See for the Meroni doctrine as applied in this field, i.a. Wymeersch, nt. 9. § 9.102, Oxford University Press § 9.14 and the other contributions in the same work. There are numerous publications on the Meroni doctrine.

as such and allows the *ECB* to be put in charge of prudential supervision for banks. The phrasing is somewhat unclear as it mentions " *conferring tasks…. concerning policies relating to prudential supervision….*" but the overall analysis allows the ECB to take up activities ("tasks") provided these are related to or flowing from prudential policies. Some have put this interpretation in doubt stating that the ECB can only develop activities relating to policies, not to actual supervision. Ex absurdo, one could not reasonably consider this provision to have been inserted in the Treaty, with the specific guarantees it actually contains, as referring only to tasks relating to policies, such as the preparing studies or reports with a view of the adoption of prudential rules by other bodies. In fact the ECB does undertake such studies and presents them in several existing committees, such as the EFC or the ESA, where it takes part as an observer in an advisory capacity.

This Treaty provision has been very controversial when it was introduced, what explains the express provison that the key it contains could not be turned except with all Member States agreeing. The fear of the existing banking supervisors that the ECB might take over banking supervision was alleviated by this unanimity clause[19].

Strikingly the insurance sector was carved out as it was deemed that insurance companies could not directly affect monetary policy or financial stability. On the latter points, views have changed in the meantime: at least in terms of financial stability insurance companies are today also scrutinised by the financial stability institutions[20].

The attribution of supervisory powers to the ECB in the Treaty itself also solves a certain number of important issues: as the organisation of this function is put in the hands of the ECB, there can be no objection on the basis of a forbidden delegation of powers, as the powers have been directly conferred by the Treaty itself. It is then up to the ECB to organise this function, including the way the supervision will be organised, which internal bodies or persons will decide, and what will at the end have to be brought before the Executive Board or the Governing Council. The legal service of the Council, in an undisclosed document has considered that the Treaty does not allow this type of delegation[21]. Here the issue is not that of delegation, but of organisation of this function. In this respect the ECB enjoys a wide freedom of judgment, provided the ultimate responsibility lies with the governance bodies of the ECB. It is clear that the draftsmen of the proposed regulation were attentive to this issue when terming the scheme an SS-*mechanism*, and not an institution[22], thereby indicating that the mechanism does not call for a delegation to another body.

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[19] It has been argued that from the German side, the reference to policies was introduced to avoid the ECB being active in the field of prudential supervision. See: J. Carmassi, C. Di Noia and S. Micossi, Banking Union: A federal model for the European Union with prompt corrective action, Assonime, Note e Studi, 12/2012. However it then becomes unclear what means "tasks relating to policies" unless it would only – and unlikely - refer to the activities preparing a deliberation on policies.

[20] See IAIS, Proposed resolution of main issues from the comments on
Global Systemically Important Insurers (G-SIIs) Proposed Assessment Methodology

[21] The legal opinion has not been published, but several press publication discuss its content: See A. Barker, Leaked Legal opinion on Eurozone Banking, FT, 18 October 2012:
Juristische Fussangeln fuer die Europaeische Bankenaufsicht, NZZ, 19 October 2012; Juristische Bedenken gegen Euro-Bankenaufsicht wachsen, Handelsblatt 19 October 2012;
Further: K.C. Engelen, Die Bankenunion is eine Falle, Handelsblatt 19 December 2012.

[22] The creation of a separate institution would have been contrary to the present Treaty, and an unnecessary complication of the proposed supervisory system. Therefore also the SSM not being a separate institution but only a separate business line within the ECB, there can be no discussion about the issue of delegation to a separate body, as the entire organisation is internal to the ECB, see about this issue: A Baker, Leaked legal opinion on eurozone banking union, FT 18 October 2012 and Graham Bishop's comments: FT story on illegality

Another criticism that was voiced relates to the possibility for the regulation to decide about a matter which at the end belongs to the internal affairs of the ECB. By conferring tasks to the ECB, as stated in the Treaty, the Council, as the body conferring the tasks could also decide how they will effectively be carried out, especially as the organisation concerns a multiplicity of interests and of stakeholders, that go beyond the ECB. This is not changing the internal governance of the ECB, but putting conditions for the exercise of this new function.

In the same vein, the proposed regulation describes the involvement of national supervisors not in terms of contractual delegation parties, but as "*integral parts of the SSM*", again identifying the SSM as the way in which the internal function within the ECB will be structured with the involvement of the national supervisors, but not whether the national supervisors will be more or less autonomous players in the overall mechanism [23]. Whether a similar observation could be made about the non-euro area participating jurisdictions will be discussed later.

The decision to organise an SSM is adopted by the Council as part of a regulation, hence in a directly applicable instrument introducing the single supervisory system in all the Member States. The question can be raised whether the treaty provision allows for establishing the SSM only in the euro area states, and should not have made it mandatory to all EU states, in which cases it would never have been accepted by several governments. The Preamble of the regulation contains some general reference to the "*close links and interaction between Member states participating in the common currency, the banking union should apply at least to all Euro Member States*", stating the system would also be open to the participation of other Member States"[24].

It has been argued[25] that the Treaty does not allow the supervisory system to be limited to the euro area jurisdictions. Among the argument put forward is the reading of art 139 (2) (c) – transitional provisions - that does not include a reference to § 6[26]. Also is mentioned the Protocol nr. 15 relating to the UK and Northern Ireland[27]. This argument has to be taken seriously, as it also found support from certain market participants[28]. Arguments in favour of the Commission proposal point to the position of art 127(6) under the heading of monetary policy illustrating the close link of prudential supervision with the monetary policy, what is exactly the concern for which the present proposal has been drafted. The absence of a reference to art 127 (6) in the transitional provisions can be understood as unnecessary as the decision on the basis of that provision has to be unanimous in any case: an exception from a rule that is not applicable would not have added much value. The opt-in proposal for the

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of Banking Union proposals -Graham Bishop comments.

[23] 4.2.2. of the Explanatory memorandum.
[24] Preamble 9.
[25] See Carmassi, Di Noia and Micossi, nt. 17.
[26] "The following provisions of the Treaties shall not apply to Member States with a derogation: (c) the objectives and tasks of the ESCB (Article 127(1) to (3) and (5))"
[27] Point 4 of which reads as follows: "Articles 119, second paragraph, 126(1), (9) and (11), 127(1) to (5), 128, 130, 131, 132, 133, 138, 140(3), 219, 282(2), with the exception of the first and last sentences thereof, 282(5), and 283 of the Treaty on the Functioning of the European Union shall not apply to the United Kingdom. The same applies to article 121(2) of this Treaty as regards the adoption of the parts of the broad economic policy guidelines which concern the euro area generally. In these provisions references to the Union or the Member States shall not include the United Kingdom and references to national central banks shall not include the Bank of England".
[28] See German BVR, VOEB, Finanzgruppe Sparkassen und Giroverband, nt. 27.

participating non-euro states would also alleviate the concern: the system is entirely voluntary for all states that want to be involved, as each would have to accept the ECB's role.

It seems clear on the other hand that the proposal was not intended to base the SSM on the enhanced cooperation provisions of the Treaty of the European Union, although it does not seem that this approach would be prevented, even within the ambit of art. 127 (6) [29].

The consultation procedures have stirred some nervousness: that the ECB only has to be consulted and does not have to approve, is significant for the mind-set: it is not likely that it will object, as engaging more actively in prudential supervision has been - silently - on its agenda for many years.

The situation is different for the European Parliament, that already manifested its dissatisfaction for not being involved by way of an approval right. It has already expressed its fear that the proposal would lead to a two-speed union, and lead to a further splitting of the economic zone. It has also claimed to be involved in the appointment of the persons leading the supervisory board, in parallel with its privileges with respect to the appointment of the ECB's Executive Board members. From a general viewpoint of accountability, there can be no doubt that the EP's overall oversight should include the functioning of the SSM. Whether that should be done by separate decisions relating to the appointments or to the reports on the SSM, or is equally well achieved through the existing accountability and oversight instruments, can be doubted, as separate accountability procedures would lead to the conclusion that the Supervisory board of the SSM is a separate institution[30]. This issue can better be solved by providing that the present procedures on reporting and appointments would include the SSM aspects. More problematic is the Treaty provision that the EP only advises on the setting up of the Banking Union, and more specifically in its significant supervisory part, there where it will be involved in approving the regulations dealing with DGS and CRR. There are indications that the Council may voluntarily adopt a more flexible position[31].

The Treaty and the regulations make it clear that it is the ECB itself that is in charge, and not a separate body acting with the support of the ECB. One can ask oneself why no separate institution has been set up, as this would clearly evidence the separation between the monetary and the prudential functions. It seems that pursuing this line of reasoning would have been objectionable as art 127 (6) only allows to put the ECB in charge of prudential matters, and as delegation of such an important competence to a separate body would have called for a Treaty change. A similar discussion has been held at the moment of creating the ESA, and was decided by conferring minimal effective powers to the ESAs.

However, due to the primary responsibilities of the ECB in the monetary field, and the potential conflicts of interest between the two lines of business, it has been announced – and is very much welcomed - that the supervisory function will be located in a separate

[29] Art. 20, TEU.
[30] According to the conclusion of the European Council, "accountability takes place ate the level at which decisions are taken and implemented", Pt 7 of the European Council conclusions of 18 October 2012
[31] Graham Bishop considered that the EP could retain its approval of the EBA regulation amendments, and thereby maintain considerable leverage on the SSM proposal, FT story on illegality of Banking Union proposals - Graham Bishop comments, 18 October 2012

department, or in an internal body within the ECB[32]. It is important that this separate department is clearly separated from the overall monetary function, with a separate leadership, separate governance and management and with clear Chinese walls between the two aisles of the Bank. These ideas have been formulated in the text of the regulation providing that the different tasks of the ECB will have to be kept separate[33] and that the usual professional secrecy rules within the EU will apply[34] One can expect more specific rules on these points to be adopted by the ECB in its internal rulemaking process.

It should be avoided that one part be seen to be driven by the objectives pursued by the other, or even that an appearance of this sort be created. The effects on the monetary policy might be very negative and the market would reflect the wrong signals. The risks of leaks influencing decision making in one or the other department should be very strictly prevented and adequate safeguards provided, as an infringement of this rule might undermine the public confidence in both supervision and monetary decisions.

On the other hand even the tightest internal organisation should not hide that the central decision making powers - both monetary and prudential - in the euro area are exercised by the ECB as the central financial authority. The question will therefore be to clearly delineate the subject matters that have been attributed to one part of the Bank, to define the bridges that can exist between the two, and to specify the role the ultimate bodies of the Bank will play in this process. The present proposals are still somewhat short on these topics and do not identify the circumstances – preferably very restrictively defined - when on an on-going basis prudential matters will have to be escalated to the ultimate decision making bodies, the Governing Council or its Management board. The involvement of these bodies can not be avoided as the ultimate responsibility lies with them.

It has rightly been remarked that the regulation should usefully introduce a specific name for this new function of the ECB; this would avoid confusion with its monetary tasks, and facilitate and clarify reference to the prudential activities. It was proposed to call it "*European Banking Supervision*", close to European Banking Authority. However this title could give the impression that this function is independent from the ECB, therefore it seems preferable to call it ECB-S, or ECB Supervision, or some similar designation. Once more, this may be an internal matter for the ECB, as it is the only addressee of the treaty provision.

The financing of the ECB's supervisory activity will be ensured by separate supervisory fees, that are expect to be "*proportionate and take account of the risk profile*". There will be a separate budget, different from that of the ECB and in principle there will be no cross financing. Whether that budget will relate to all supervisory expenses both at the ECB level and at the national level, is not clear, as one may expect that national levies will continue to exist for the activities that have not been transferred to the ECB. On the other hand if national supervisors will be exercising supervisory activities on behalf of the ECB, it is logical that the financing will be ensured by the ECB, on the basis of the agreement of the latter with the national supervisor, thereby avoiding disparity in the level of supervision.

3. The governance of the ECB as a prudential supervisor

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[32] This structure is not different from the one followed in the Federal Reserve.
[33] Art. 18 of the Regulation.
[34] Art. 20 (1) of the Regulation refers to art. 37 of protocol nr 4 and in relevant acts of the Union, referring here to the provision on secrecy in the directives on prudential supervision.

The Treaty mandates the prudential supervision to be exercised by the ECB: hence its governing bodies will as a rule be in charge and responsible for the prudential supervision in the euro area. This includes the duty to organise the supervision, to install the necessary internal bodies, develop the appropriate administrative structures and procedures and to ensure the adequate follow up with the euro area member banks and the non-central bank supervisors, all in accordance with the conferring of the tasks mentioned in article 127 (6)[35]. Several provisions of the regulation point to this ultimate role of the ECB and its governance bodies[36].

For several reasons it seems obvious that this organisational task cannot be exercised by the existing bodies of the ECB and that separate structures will have to be created. Notwithstanding the ultimate powers of the ECB's Governing Council, the regulation provides for a separate internal management structure, called the *Supervisory Board*. This designation may not well cover its activities that probably go beyond mere supervision; nor it is clear who is supervised.

The composition of the Supervisory Board is described in some detail:

- Members related to the ECB
    - The chair is a member of the Executive Board of the ECB, elected by the Governing Council for a 5 year non-renewable mandate
    - The Vice-Chair is elected by and from the members of the Governing Council, ie from the Eurosystem Central banks
    - Four members will be appointed by the Executive Board as representatives of the ECB.

- Members representing the national prudential supervisors: each can delegate one member. Strikingly these are not representatives of the states

- Representatives of the "closely cooperating" Member States have been provided for, but their position is not very clear as it will have to be determined by the conditions of "close cooperation" in "compliance with the statute of the ESCB[37] and the ECB". The latter provision is unclear.

- Finally, observers of the EBA and the European Commission will be invited.

- A steering committee may be set up providing support to the activities of the Board and preparing its meetings.

In the relationship of the ECB to the Supervisory board, the regulation designates the latter as an "internal" body, but in charge, of "clearly defined supervisory tasks and related decisions regarding individual or a set of identifiable credit institutions, financial holding companies or

[35] As mentioned above, this is not a "delegation"- what would have been objectionable -, as seems to have been referred to in the Council legal opinion, but the organisation of tasks that have been conferred to the ECB; see the Council legal opinion as referred to in A. Barker, nt 20; on delegation in general, see, Wymeersch, "Delegation as an Instrument for Financial Supervision", *Rev Trim Droit financier* 2007, 71; http://ssrn.com/abstract=952952.
[36] See art. 21(4) of the Regulation eg; the cost of supervision will be borne by the ECB (art. 22), but recouped on the supervised entities by a levy (art. 4) proportionate to importance (volume?) and risk profile, implying a classification by risk.
[37] The European System of Central Banks is composed of the ECB and the 27 national central banks.

mixed financial holding companies"[38] subject to the oversight and responsibility of the Governing Council. Its decisions will be attributed to the ECB, and should be declared enforceable as any other ECB decision, but than at the behest of the Supervisory Board. Even today not all decisions – and certainly no operational decisions – are adopted by the ECB's statutory bodies. Therefore the contention that all supervisory decisions have to be adopted by one of the ECB's statutory bodies does not recognise the ECB's right to organise itself, within the limits stated in the regulation. Nor is there any provision dealing with appeal against decisions of the Supervisory Board: would these to only be appealable before the ECJ[39].

This provision makes it once more clear that the Governing Council remains fully in charge, and that the delegation is if not relating to individual acts, at least is to be narrowly formulated. Interesting is the reference to individual credit institutions, clarifying the draftsmen's intention to allow the Governing Council to take decisions relating to individual institutions, per hypothesis important ones and probably only in a crisis situation. There may also be a question whether this delegation – rather attribution of competences- would be revocable, unless in cases of serious dysfunction. In these cases, the limits on the separation of the different ECB's functions will come under stress.

Although nothing is mentioned in the proposed regulation, this functional separation will likely lead to the organisation of a separate department within the ECB, with dedicated staff and a separate organisational structure. The relations of the Supervisory Board and this department have not been detailed in the regulation, and there is no mention that it can address itself to the prudential department, but one can presume that while the department will remain integral part of the ECB, the relationship with the Supervisory Board is to be clarified in the organisation agreement, putting the Supervisory Board in charge of "*clearly defined supervisory tasks and decisions*". On the basis of the proposed regulation it is rather unclear what will be the role of the Supervisory Board and to what extent it will be in control of the supervisory processes and could steer the action undertaken by the supervisory department. There is a risk that this board may be a mere advisory body, devoid of any real power. This might lead many issues to be ultimately submitted to the Executive Board or to the Governing Council, what cannot not have been the intention, and is not compatible with the idea of a separation of function

Many of these issues should be further clarified in the internal rules of procedure to which the regulation refers.[40]

With respect to accountability, as the supervisory activity belongs to the overall tasks of the ECB, it is up to the ECB to finally account for its action in the supervisory field as well[41]. It will report annually to the European Parliament and the Council, but the spokesman will be the chair of the Supervisory Board[42]. It is mentioned that accountability with respect to the choice of the chair will be realised through the vetting process for the members of the Executive Board, of which the chair will have to be a member. But on questions posed by these political bodies, it would be the ECB that will be in control: the Supervisory board is not mentioned, what may create contradictory answers.

[38] Art. 19, (3) of the Regulation, where the figure is erroneously in our view designated as based on a delegation.
[39] Art. 12(2) in fine of the Regulation; in any case due process has to be respected: Preamble 33.
[40] Art. 19 (7) of the Regulation.
[41] Art. 17 of the Regulation.
[42] Also present the representatives of the national supervisors of the "participating" "Non-euro-area countries: art 21(2) of the Regulation.

4. The relationship of the ECB with the national prudential supervisors.

The proposal makes it clear that if the ECB will be in charge of prudential supervision of all the banks in the euro area[43], the national prudential supervisors will not be out of business. On the one hand they will contribute to the activities for the matters that have not been transferred to the ECB – regulatory matters, non-prudential fields of supervision – and on the other hand the ECB intends – and will in fact be obliged – to entrust a significant package of supervisory tasks to the national supervisors. In that sense the future system will work as a "hub and spoke" system, a well known process in network industries.

The hub, thus the ECB will adopt the supervisory decisions, and these will be- according to the proposal at least – applicable to all banks: the national supervisors will be tasked with applying these decisions and thereby must follow in a precise way the instructions given by the ECB[44]. The spokes, the national supervisors, will implement these instructions on the request of the ECB, within the framework and according to the conditions set by the ECB[45]. This would include the powers to undertake investigations, on site inspection and other similar interventions directed to individual banks: although the national supervisors can be tasked with undertaking some of these tasks, the regulation makes it clear that the primary competence lies with the ECB, and therefore that it can at any moment step in itself[46] The national supervisors should receive notification about cross border establishment of branches or proposals to provide services[47] Contrary to present practices, the national supervisor does not have to be involved in these procedures, eg in on site inspections, as they will "actively assist the ECB inspectors, but only on the latter's request[48]. And if needed, the ECB could call on the local judiciary for having is orders enforced in case of a refusal of an on-site inspection[49], if needed with the assistance of the national supervisor[50].

This short analysis leads to the conclusion that the ECB will be fully in charge of the prudential supervision and will only allow the national supervisors to intervene to the extent that it deems it is useful, but without granting any privilege for the national supervisor to be involved, nor any co-decision at least as far as the regulation is concerned.
There are some - apparent -exceptions to this high degree of centralisation:

- with respect to processing a request for authorisation of a bank, the case will first be investigated by the local supervisor as it has to determine whether the request conforms to the local banking regulations. On that basis, it will advice the ECB to grant the authorisation, provided the conditions set out in Union law are met[51]. The second verification related not to national banking law, but to Union law, what may allow to remove some restrictive national conditions.
- with respect to withdrawing the authorisation of a bank the ECB does not have to take the advice of the national supervisor: it can act on the latter's – non binding - proposal, or on its own initiative.

[43] Art. 4 (1) of the Regulation.
[44] Art. 5 (4) of the Regulation.
[45] Art. 5 (3) of the Regulation.
[46] Art. 8 (2) and 10 of the Regulation.
[47] Preamble 22. It is unclear why this information is stored at the national supervisor and not at the ECB.
[48] Art. 11 (4); see Preamble 28.
[49] Art. 12 (1) of the Regulation.
[50] Art. 11(5) of the Regulation.
[51] Art. 13 (1), 2nd § of the Regulation.

- the ECB is empowered to impose sanctions on its own in cases in which Union law would require that national supervisors have a directly applicable sanctioning power[52]. In other cases, the ECB can require the national authorities to undertake action with a view of having the conduct sanctioned: this can relate to sanctioning for violations of national law implementing Union law, but also for fully national provisions; in each case the action will have to be necessary for supporting the ECB's action, giving it a final right of appreciation[53].

The hub and spoke system as has been conceived by the regulation's draftsmen is based on strong centralisation of decisions and actions at the ECB, along with optional calls on the intervention of the local supervisors but only when the ECB deems it necessary. One can image that national supervisors will have some difficulty organising their role in the supervisory process and invest in setting up of highly expert supervisory teams if the basis for their intervention is as weak and transitory as the regulation at present provides. It seems advisable that when the national supervisors are tasked with certain supervisory activities, these have to be subject to a formal agreement, outlining the conditions of this type of outsourcing, including the remuneration and the conditions of termination.

5. The scope of the ECB tasks as a prudential supervisor

5.1 "Prudential supervision"

The ECB will be in charge of "*prudential supervision*", a concept that has not been defined in the proposal but is further detailed in a number of specific supervisory decisions or actions. The overall objective of this activity is spelled out in article 1 of the proposed regulation: it aims at "*promoting the safety and soundness of credit institutions and the stability of the financial system, with due regard for the unity and integrity of the internal market*". The objective of this type of supervision can therefore be described as insuring the safety and stability of the financial system, by ensuring the safety and soundness of the individual institutions. Referring to the concerns voiced by several European institutions, the unity and integrity of the internal markets have expressly been mentioned. Striking is the absence of any explicit reference to the protection of the users of bank services or to the safety of depositors or investors: the European system is it seems conceived more from a systemic approach, rather than with a view of protecting individual users or customers. The reference to the integrity of the internal – not the "financial" - market is a macro concept, alluding to the perceived risks of fragmentation of the internal market, but obviously not to the protection of the individual investor[54].

The ECB's tasks as a prudential supervisor have been listed in the proposed regulation. As a consequence, standard interpretation holds that no tasks and no decisions could be adopted

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[52] See art. 15 (1). Differently from the subject of rulemaking, there is a clear mandate in the regulation allowing the ECB to impose certain sanctions. However in this field also, the preamble introduces confusion as it refers to the sanctioning powers of the ECB on the basis of article 132 TFEU, while the latter essentially refers to monetary matters. It would seem that there is some weakness in the coordination of the two provisions, and that the preamble reflect a previous state of drafting.

[53] See preamble 27, according to which the national authorities will remain competent for sanctioning on the basis of national law transposing Union directives. It is clear that there is ample room for conflicts in this matter. Clarification is needed.

[54] In that sense the European regulation has been conceived in terms that follow closely the German approach where the Supreme Court has held that protection of individual investors was not in the remit of this legislation and hence individual investors could not claim.

that do not fit into one of the categories listed in the regulation. Although the list has been widely framed, it is likely that sooner or later matters will show up for which decisions have to be made but that are not in the remit of the ECB. In these cases national supervisors will take over, what may lead to confusion. It might have been indicated to introduce a mechanism allowing the remits of the ECB to expand to other tasks that are directly related to prudential supervision.

The regulation's definition of prudential tasks follows closely what is usually included in national regulation much of which is detailed in the Banking directives. These are merely summarised here:

- *authorisation* of banks, including the *withdrawal* of an authorisation: the ECB will take the final decision but on the basis of a proposal made by the national supervisor of the jurisdiction where the bank will be situated. The conditions for authorisation will be laid down in national law and may be stricter than the one laid down in the directive[55]. On withdrawal the ECB can be stricter and decide on its own initiative, whether or not to withdraw the authorisation even if invited to do so by a national supervisor.[56] In the same spirit it will decide on the fit and proper character of the shareholders of banks, referring both to acquisitions and to disposals**.** One can presume that this includes the fit and proper test for bank directors and top management[57]**.**
- ensure the application of the *prudential requirements* laid down in the Union legislation, such as the rules relating to capital, liquidity, disclosure etc. More importantly is the power to require additional own funds including countercyclical buffers, or any other measures for combating systemic risk, all powers to be exercised in accordance with Union acts.
- *governance* also belongs to its remit, referring to arrangements, processes and mechanisms, but here no reference is made to Union acts, leaving obviously more discretion than in the previously mentioned fields.
- *risk management*, possibly leading to demands for additional own funds or liquidity provision;
- carry out *stress test* that may result in additional requirements
- *group supervision*, both on a consolidated basis, or for conglomerates where supplementary supervision applies.
- *emergency intervention* dealing with recovery actions and with intra group financial support arrangements, when applicable in coordination with the national resolution authorities.**[58]**

As the national supervisor will further remain in charge of non-prudential forms of supervision, it will be necessary to further clarify the dividing line of prudential supervision with other types of supervision, as the latter, especially if they create risks will be prudentially relevant: the verification whether the "know-your-customer" rules under Mifid have been followed is a matter usually considered in the hands of the securities supervisors, but clearly has consequences in the prudential field. The interaction is even stronger in the case of

[55] Preamble 15.
[56] Art. 13 (2) of the Regulation.
[57] In that sense, Preamble 14.
[58] See Preamble 21, putting the ECB in charge of the coordination of national authorities, pending the creation of a European resolution body; see on this topic: ECB, *The Role of Central banks in Prudential Supervision*, http://www.ecb.int/pub/pdf/other/prudentialsupcbrole_en.pdf

money-laundering regulation. There is a clear need to delimitate the fields that are covered by the notion of prudential supervision, taking the CRD IV as the most advanced source of information in this respect.[59] Here appropriate agreements will have to be negotiated with the securities or other supervisors: the Joint Committee that is organised in the ESA structure will be an appropriate platform to define the rules for this new type of cooperation[60]of the European Supervisory Authorities .

A special mention deserves the involvement of the ECB in resolution matters. These will normally be attributed to the national resolution authorities, separate from the prudential supervisor. This structure will continue to apply with the ECB. In the recovery phase the ECB further intervenes for the supervisory work, in coordination with the resolution authorities or authority [61].

5.2. Supervision on "credit institutions"

The SSM will supervise the banks located in the 17 Member States that are part of the euro area. According to the Banking directive these banks have their registered office and also their principal place of business in the countries that belong to the euro area[62]. The banks especially the subsidiaries located in other EU or non EU states are not directly included, but -and to a limited extent- , only on the basis of the rules on consolidated supervision[63].

As referred to in the Treaty, the SSM would apply to banks – more precisely "credit institutions"- to be understood in the sense used in the directives, meaning "*an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account*"[64]. It would not include the investment firms that are subject to the MIFID, what may trigger certain concerns of regulatory competition.

The proposed regulation contains a list of institutions or persons that are attracted into the supervisory purview, but this is not the list of the supervised institutions[65]. It only defines the list of bodies or persons from which the ECB can request information, where it can undertake investigations including on-site inspections, and this with a view of carrying on its prudential tasks.

There has been a debate about whether the SSM would apply only to the 25 to 27 systemic institutions, or include all banks. Some states, especially Germany voiced concern about the latter option also invoking the impossibility of supervising all 6000 to 7000 bank in the Euro zone. This argument is somewhat misleading as it goes without saying that all these banks cannot possibly be supervised out of Frankfurt. In any case the local banking supervisors will have to continue to be involved in the supervision of banks in their jurisdictions, e.g. of the subsidiaries of the foreign banks. This issue therefore raises the question of the model of supervision that has been worked out (see supra nr 4).

[59] See CRD IV art. 99 e.s. on Supervisory measures.
[60] Preamble 24, referring to the Joint Committee of the ESFS, what is technically not correct
[61] Art 4 (1)(k) of the Regulation.
[62] See art. 11(2) directive 2006/48.
[63] See on consolidated supervision art 1, directive 2006/48 26.
[64] Art. 4(1), see art. 2(3) of the proposed regulation.
[65] See art. 9 of the proposed regulation.

On the other hand there are strong arguments to extend the SSM to all banks, so as to avoid competitive distortions, or to let uncontrolled risk pockets to develop in non-systemic institutions as this risk may spread throughout the system. Reference is often made to the regional banks in Germany or in Spain or to the Northern Rock case that triggered an important confidence crisis[66]. Therefore a system has to be introduced that – at the level of principle - allows all banks to be supervised in accordance with the same basic standards but at the same time making allowance for differences in size, activity and business model. This analysis does not mean however that all banks have to be supervised the same way, nor by the same body.

It seems reasonable that only the most important banks, usually the systemic institutions are supervised directly by the ECB. They are the most complex, have the widest worldwide or international ramifications, call for extensive international contacts, and would cause the greatest calamities in case of a loss of confidence. It is also with respect to these banking groups that the more complex recovery and resolution systems will have to be put in place, what requires strong cross border expertise and experience, and much coordination. All this can best be achieved if all efforts are centralised in one institution. The message to be given is that the strictest standards will be applicable to them.

For different reasons, the banks that have received state support should also be put in the first wave: the problems are still far from resolved and the intensive care treatment needs to apply until they are finally cured, or otherwise disposed off.

It would be preferable that the non-systemic banks would than remain under the direct supervision of the local banking supervisors. However in this case and in order to secure a sufficiently level playing field, the ECB should fix measurable parameters within which these local entities can exercise their supervisory function and be able to verify ex post whether these parameters have been respected. If there is no need to direct everything from Frankfurt, what would not be realistic for several reasons, (such as overload, language issues, cultural differences and so on), there are imperative reasons to avoid the national banking regulators to engage in a new round of regulatory arbitrage or forbearance and weaken the confidence in the overall banking system. Safeguards have
to be installed to avoid that supervisory weakness or political influence would steer these institutions away from strict supervisory standards.

The existing national banking supervisors might be designated as "delegated" supervisors acting on behalf of the ECB. However this formulation might raise legal objections, as delegation is restricted according to European law. It would therefore be preferable to formulate that the supervision is exercised by the ECB but with the assistance of the national prudential supervisors[67]. The freedom these supervisors will enjoy can then be determined whether in a general ECB regulation or depending on the structure of the national banking system – e.g. a system largely composed of subsidiaries of systemic banks – by individual arrangement.

Certain financial institutions that do not qualify as credit institutions should nevertheless be usefully included in the supervisory purview. This is the case for central counterparties active

[66] See Preamble 13 of the Regulation.
[67] See Exp memo 4.2.2 stating that national supervisors intervene "as an integral part of the SSM."

in the clearing for both securities and derivatives[68], for central securities depositaries, some major broker-dealers, and even some major asset managers. Not all of these institutions have the bank status although some have been qualified as systemic. Additional work is needed to ensure the system to be coherent and to avoid major gaps in the prudential network[69].

5.3. The changed home-host relationship

One of the most significant aspects of the proposed reform is the effect it will have on home-host issues. To briefly summarise the present situation:

- In principle all banks are supervised by the supervisor of the place where they are domiciled, and where their principal place of business has to be located; therefore subsidiaries of foreign banks are nevertheless supervised by the supervisor where the subsidiary is located (host supervisor);
- Branches are part of the overall bank and are supervised by the home supervisor, with limited supervisory rights of the host supervisor;

- Multistate groups of banks are supervised by the home supervisor of the parent, on a consolidated basis for specific supervisory matters; this supervision takes place with the "support" of the host supervisors, meeting in the college of supervisors of all, or the most significant host supervisors.

- For financial conglomerates, a special regime applies, as supervision will involve banking and insurance supervision.

The proposed regime will extend the ECB's supervision over all euro area banks, and hence would include all subsidiaries and all branches in the euro area. Hence, and as far as prudential supervision is concerned, the differentiation between branches and subsidiaries will loose much of its meaning and the colleges of supervisors for intra-euro area groups and consolidated supervision will disappear [70]. As a consequence the home and host qualification will be subject to a new definition. In that sense all matters will be "home", and there will be no need for authorisation or notifications[71]. As to liquidity requirements that until later measures will remain a host competence, these will evidently become a competence of the ECB.

The freedom of establishment will therefore be further supported, as no additional requirements should apply in case of establishing a branch in another Euro-area state. Therefore one can expect some subsidiaries be converted into branches.

For activities outside the euro area, subsidiaries will be supervised by the local supervisor, while branches and services come under the supervision of the home supervisor. Hence in these cases there may be a need to organise a college of supervisors. The reverse also applies:

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[68] According to EMIR Regulation (Regulation 648/2012,of 4 July 2012),the CCP should be supervised by the securities supervisors under the coordination of ESMA, see art. 18, EMIR. However the competent authority is determined by the Member State where the CCP is established

[69] See Commission consultation on: A Possible Recovery and Resolution Framework for Financial Institutions other than banks.

[70] Art. 14(2) of the Regulation.

[71] Explanatory Memorandum 4.3.2

subsidiaries of non-euro area banks will be supervised by the ECB, where applicable the latter being part of the college, while branches will fall outside the scope of the ECB.

The differentiation between home and host will however not disappear entirely, at least not at the present juncture. Indeed the new regime only applies to prudential supervision, meaning that other forms of supervision will remain under the authority of the local supervisor in accordance with the rules spelled out above. Moreover, the basic regulatory regime will remain national as the basic laws remain national, and for these aspects the national supervisor will remain competent[72]. The prudential supervisor will necessarily have to take account of these differences leading to some odd results: the financial institution that is subject to prudential supervision of the ACP in France but does not receive deposits from the public will not be subject to the ECB's direct supervision, as not being a bank, but nevertheless further subject to national supervision and to ECB's consolidated supervision if it has a systemic parent.
The SSM will only affect banks although indirectly it may also affect firms that deliver services to banks as these may influence the operational risks in the bank. Service providers like IT firms may therefore also feel the new supervisory regime.

With respect to the non-euro participating states, according to the proposed regulation, the situation would not be different from that of the euro area states, with however a possible exception for liquidity matters that are related to the monetary sovereignty of these states.

As to the non participating Member States, the situation would seem unchanged, in that subsidiaries will continue to be supervised by the host state, while branches and services come under the authority of the home states, be it the ECB or any other EU banking supervisor. Changes will essentially affect the colleges of supervisors. In cases of financial conglomerates, the ECB will replace the existing supervisor and will sit alongside the local banking and the insurance supervisors.

6. The relationship to other financial regulatory bodies

Although belonging to the ECB, it is worthwhile to briefly analyse how the relationship of the ECB as a prudential supervisor with other public bodies in the financial field has been conceived.

(i) The role of the European System of Financial Supervision ESFS

The proposed regulation situates the ECB among the participants in the ESFS, a cooperation arrangement that was first mentioned in the ESA regulations. It is composed of the ECB, the ESRB, the three ESAs and their Joint Committee and the national supervisors. Under the ESA regulations, the members of the ESFS are bound to "cooperate with trust and full mutual respect, in particular in ensuring the flow of appropriate and reliable information between them"[73]. In the corresponding article of the SSM regulation, the national supervisors have not been mentioned, what is rather puzzling as the ECB in its supervisory capacity ranks in the class of the national supervisors. Another message can be read in the Explanatory Memorandum where it is stated that the ECB will "*carry out its tasks within the ESFS and*

[72] Art. 14 (1) of the Regulation.
[73] Art. 2 (4) of the ESMA regulation.

cooperate closely with national supervisors and the EBA"[74]. This last reading is probably the right one. Cooperation will be organised with all national bodies if appropriate.

In any case the substantive role of the ESFS is very limited and does only relate to the exchange of information among the different participants, a matter that is dealt with in other provisions of this regulation. Therefore one could consider this reference to the ESFS as not very material.

(ii) ESRB

The relationship of the ESRB with this new supervisory line of business has not been mentioned in the proposed regulation. As the ESRB is a member of the ESFS[75], it seems logical that the provisions applicable to the national supervisors would equally apply to the ECB in its supervisory mode. In practice with respect to communicating information to the other ESRB members, the ECB will have to balance the interests of the supervised entities and its related obligation of secrecy with the public interest, which is the core element in its mission "*to contribute to the prevention or mitigation of systemic risks to financial stability in the Union*"[76]. More detailed guidelines would be welcome in this field.

It is striking that in its prudential mode the ECB has expressly been charged with:

> " imposing capital buffers … including the setting of countercyclical buffers rates and any other measure aimed at addressing systemic or macro-prudential risks in the cases specifically set out in Union acts"[77]

Some have considered that there is contradiction with the ECB's role in systemic matters, eg in the ESRB. However, on the basis of the quoted provision the ECB will impose actual conditions and requirements, and not be limited to general recommendations as is the case under the ESCB regulation. It would moreover be odd that there would be a contradiction between the two sets of requirements.

(iii) The relationship with the EBA

One of the more delicate points in the proposal concerns the relationship with the European Banking Authority. The explanatory memorandum to the proposal pays ample attention to the role of EBA and its continuing existence without change in composition and tasks. It has clearly not been the option of the proposal to reduce or modify the role of the EBA and its draftsmen have gone great lengths to do away with any uneasiness about the continuing existence of the EBA as a regulatory and coordinating agency. According to the European Council "*the EBA should retain its existing powers and responsibilities*"[78].

However, some might have thought that it would have been logical to entrust the prudential supervision to the EBA, as the latter has started its activities only in 2011, and was put in charge i.a. of "*contributing to (a) improving the functioning of the internal market, including*

[74] Explanatory Memorandum to the Regulation 4.1.1
[75] See art. 1 of the ESRB regulation.
[76] Art. 3 ESRB regulation.
[77] Art. 4 (1) (e) of the Regulation; see Preamble 12, referring to "macro-prudential stability".
[78] Council conclusions, 18 October 2012, pt 8.

in particular, a sound, effective and consistent level of regulation and supervision"[79]. There are serious impediments to putting the EBA in charge: the EBA incorporates the cooperation of the 27 national regulators, and not only the 17 euro area supervisors, its activities are mainly related to regulating and standard setting, not to supervision that cannot be widely delegated to an agency. One can expect EBA to continue to exercise these functions, ensuring that the regulation remains applicable to the 27 Member States, and therefore does not end up in splitting the Internal Market, a fear that has been vividly expressed in the Parliament. In the future the regulatory work will therefore be prepared in the EBA, including the somewhat mythical European Rulebook and the development of common regulatory practices with the participation of the 27 national authorities. The ECB will be participating in the EBA Board of Supervisors in its own right, expressing the common position of the competent authorities that take part in the SSM. The ECB will beforehand coordinate the common position of these authorities, but this only with respect to the tasks conferred to the ECB by this regulation[80]. There is no doubt that the 27 authorities will continue to participate and exchange views on regulatory matters, but with respect to subjects within its remit only the ECB will speak. It not clear whether that only concerns matters of supervisory practice, also dealing with individual cases, or also the regulatory treatment of the issues that have appeared from supervisory practice. But the ECB will not be participating in decisions that relate to regulation in general, otherwise than as an observer.

Although as the SSM will now be the supervisor for the 17 euro area Member States, it will not take part in the EBA meeting as a full voting member as its remit is limited to supervisory issues, not extending to regulation. In the opposite case, ECB would represent the 17 Member States, and these would not be entitled to vote. As will be explained later, the decision making procedure within the EBA will have to be adapted to make sure that the decisions reached reflect objectivity and balance.

The EBA is not only in charge of preparing regulations, it also intervenes in dispute resolution between national supervisors[81]. This function will remain necessary in the future with respect to differences of opinion between the ECB and the national supervisors, the latter e.g. considering that their interpretation of national laws is to be preferred. Supervisory practice may also be the subject of a conflict resolution procedure with supervisors that do not take part in the SSM[82], but not with the participating states as their prudential supervisory powers will be incorporated in the ECB.

There might be situations where a conflict may escalate in the sense that the EBA would be obliged to take a decision that is directly applicable to the bank situated in the jurisdiction of the supervisor that has not rightly implemented Union law or that has not taken the necessary measures to implement a conflict settling decision [83]. In these cases the EBA takes directly applicable decisions, addressed to an individual market participant. However the room for discretion in the EBA's decision is very limited: the action can only relate to provisions that are directly applicable, indicating that these are rules that would be applicable in any case, but where the unwillingness of a national supervisor to enforce them stands in the way of effective application. It also means that the ESA is not applying additional rules, but merely holds the

[79] See EBA regulation, art. 1 (5)(a).
[80] Art. 4 (l) of the SSM Regulation; also Explanatory Memorandum 4 2 1.
[81] On the basis of art. 19 of the EBA regulation.
[82] Although the participating non-Euro MS could also discuss about the conditions for their participating.
[83] Art. 17 (6) for cases of Breach of Union Law. Art. 19 (4) for conflict cases.

financial institutions to the existing, and already applicable rules[84]. Technically, there may be differences of opinion, in which case the ECB will be held to the EBA's decision including that of its Board of Appeal.

Provided the necessary safeguards have been applied there is no reason to derogate from the EBA regulation for these cases. This idea is strongly expressed in the modified EBA regulation where it is stated that the ECB shall comply with it or provide within 48 hours an appropriate justification for its non-compliance[85]. A similar addition is provided in the provision on conflict resolution.

In both cases of Breach of Union Law and Conflict Resolution, decisions will be adopted by the Board of Supervisors acting on the basis of an opinion of a Panel, composed by the Board, by consensus, and consisting of the Chairman and two non-conflicted members. If no consensus can be found a ¾ majority will be needed.

The Provisions in the EBA regulation dealing with emergency situations are proposed to be adapted. Indeed, to the extent that in crisis or other emergencies an important role will be exercised by the ECB, the presence of the SSM in the emergency procedures may create ambiguity. Moreover emergency measures are not part of the "prudential " package that has been put in the hands of the SSM. The national supervisors will continue to exercise their powers in emergency cases and the SSM will be invited to take part in their meetings but than as an observer.

The importance of the adapted decision making procedure should be highlighted. The EBA regulation provides that decisions are in principle adopted by the board of Supervisors, i.e. by the 27 national regulators by simple majority. The ECB is as observer not entitled to vote. This rule will be maintained in the future, meaning therefore that the ECB may have to face a negative vote if some of the national supervisors that are part of the SSM vote against a certain motion it supports.

The qualified majority rules for decisions under the Regulatory act and the prohibition of certain financial products and services have not been changed[86].

A complex system is proposed for decisions in the field of emergency measures and for conflict resolution matter: in the original EBA regulation these were decided by simple majority. In the future, the non-euro area states have requested additional guarantees.

The simple majority that applied for these cases will now be replaced by an adapted simple majority: the motion is adopted unless it is rejected by simple majority, what in fact means that it can be adopted by a very small number of Member States, and not necessarily by a majority if there is no clear opposition. This formulation deserves to be clarified. More important is the additional condition posed for the opposing votes: a simple majority of opponents (14 out of 27) is not sufficient, it should contain at least three votes of SSM participants, and three votes of non-participants or non-euro area states, whether states adopting close cooperation or states that will stay out of the SSM. The arithmetic of all this is interesting: although the euro area states would have a sufficient majority to oppose (17/27)

[84] see Wymeersch, The European Financial Supervisory Authorities, in 232 Financial Regulation and Supervision, A post-Crisis Analysis, OUP, 2012. § 9.102, Oxford University Press.
[85] EBA 2 Draft regulation, art. 18 new para 3 a.
[86] See for details Wymeersch, nt 84 § 9.141

nor do non-euro area countries (10/27). An alliance between the two groups can only block if at least three non-euro area countries oppose, but in that case, at least 15 euro area countries should join the opponents. A majority of all non-euro area states could block provided at least 4 euro area members join the opposition ((10+4)/27). Practically, this scheme makes it clear that it will be very difficult to effectively oppose a motion on the basis of these articles. It is therefore controversial whether the non-euro area states will accept this scheme.

(iv) Rulemaking power

Although the EBA is the primary body to be involved in rulemaking, proposing or advising on the European commission acts aimed at the implementation of the directives or regulation, the SSM regulation provides for a rulemaking power of the ECB in its supervisory activity**.**

There is some ambiguity as to the legal basis and the purport of this power. On the one hand the SSM regulation empowers the ECB to adopt regulations, recommendations and decisions that implement or apply Union law. This competence applies "*subject to and in compliance with any relevant Union law rule*"[87]. This can be read as not conferring independent rulemaking power, but only within the limits of a higher level provision, a legislative act, or an implementing act.

On the other hand, the preamble states that the ECB shall have rulemaking powers, on the basis of article 132 TFEU, but only when "Union acts do not deal with the subject matter, ….. or not in sufficient detail.[88] Here the rulemaking power has a default character. Art 132 however grants rulemaking power, but essentially in the monetary field[89]. To the extent that the text of the regulation has primacy over the preamble, it would seem that the ECB will not be entitled to independent rulemaking, i.e. rulemaking that is not based on an explicit delegation by a higher instrument, even in a default mode. There seems to be a contradiction between the two cited texts.

7. The external dimension

Per hypothesis the proposed SSM only applies to the euro area countries, but is likely to affect also the non-Euro European Union states, and third countries as well. To determine these lateral effects, a more detailed analysis is needed.

(i) The "participating" non Euro states

The proposed regulation contains a provision allowing non-Euro states to opt in into the SSM: these are called "participating Member States" working in "close cooperation" with the ECB. Some Member-States may have in interest in seeing their banks, mostly subsidiaries of larger European group, submitted to the same regime of supervision as applicable to the parent company, what is already the case to a certain extent. And of course subsidiaries, branches and services offered by euro zone banks in non euro,

[87] Art 4 (3).
[88] Preamble 26.
[89] The reference in art. 132 to the Statute of the ESCB and the ECB to the articles 19 (1), 22 and 25.2 cannot constitute a basis for regulation in the field of supervision, as art. 19 (1) deals with mandatory reserves for monetary policy reasons, while art. 22 deals with clearing and payment systems. Art. 25.2 is a mere reference to art. 127 (6).

participating states, these will fall under the supervision of the ECB, on the basis of the local laws or on the law of the head office. Here again conversion into branches may become more attractive.

The conditions for such a choice are quite onerous: the non-Euro state should transfer all prudential supervisory powers to the ECB and this with respect to all banks located in its jurisdiction[90]. Preliminary conditions are that a close cooperation should have been established beforehand - what is not very clear in the initial stage - while the home state will have to adopt all relevant banking legislation if it has not done so. It will have to adhere to the instructions and requests of the ECB, and may be expelled if it does not follow these up. These provisions seem to indicate that there will still be a role for the local supervisor in administering the prudential regime for the account of the ECB as is the case for the Euro area states. It is not clear what is the difference between the latter regime and the "close cooperation" that seems to be the framework for this type of transfer of supervisory powers. Also there is no provision on ending the cooperation: would it have to be considered irreversible?

The national supervisor will obtain a seat on the Supervisory Board of the SSM, but this according to the provisions adopted in the close cooperation agreement. The ECB will replace the local supervisor, but only for purposes of prudential supervision[91]. However the latter will remain in place for matters of regulation, or for representation in coordination bodies such as the European Banking Authority. This division may create the same tension as has been mentioned above[92].

In fact these rules would reduce the local supervisor to an advisory and ancillary role. It should not astonish that these strong conditions have raised objections from several Member States, eg. Sweden and Poland to name those that have directly voiced their opposition. Some states will prefer to continue to coordinate their supervisory activities under the present rules and procedures, in which case the ECB will take the place of the national supervisors of the euro area.

It seems likely that this opt-in regime will have to be further refined by proposing a more balanced system, allowing for involvement of the local supervisor in important decisions. The idea of "close cooperation" should be worked out in detail, possibly following specific rules on delegation not only of tasks but also of responsibilities and competences. The Treaty system of "enhanced cooperation" therefore does not need to be applied[93]. But the issue of the legal power remains: art. 127 (6) cannot not be applied to non euro states. The mere willingness of the non-euro states to adhere to the SSM is not enough to constitute a valid and legally enforceable basis for their participation in the SSM, there more as there are institutional questions. Art. 352 TFEU can play the role of deus ex machina. Unless one considers that the hypothesis relates to Member states delegating to the ECB the supervisory tasks that it has organised under an agreement that would include rules on decision making, limits to powers and approval by the national supervisor, termination and similar matters.

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[90] Art. 4(2).
[91] See the language used in Preamble 29 "*involvement to the greatest extent possible*".
[92] See nr. 2 supra.
[93] See art. 20 of the TEU.

Under the conglomerates regime a specific issue arises, as the treaty does not allow extending the SSM to insurance companies. Hence they will remain under national supervision but, as made clear in the preamble[94], the supplementary conglomerate supervision could, if normal criteria lead to that conclusion, be exercised by the ECB. A transitory provision provides that the ECB will exercise the tasks of supervisor of credit institutions in a conglomerate or of coordinator from the entry into force of the regulation[95].

Technically, there is no provision allowing a subsidiary to opt for the ECB supervisory regime. However, by converting the subsidiary into a branch, this result can easily be achieved and has in fact already been practiced in some Member States where subsidiaries have opted for becoming branches.

(ii) The non-participating states

The Member States that do not use the Euro have not been separately addressed: they remain under the present regime, meaning that European legislative and regulatory provisions will be applicable to them and that the existing directive provisions on cooperation will remain in place. But changes in the euro area will necessary have an effect in the non-participating states: the European Council has stressed the need to ensure the level playing field between the two groups of states, in "full respect of the integrity of the single (financial) market"[96]. With respect to branches and subsidiaries of banking groups located in the euro area, the present system of establishment, home country supervision and consolidated supervision will remain applicable, whereby the ECB will replace the national supervisors in the colleges of supervisors sitting at the table with the supervisors of the non-participating states. If the ECB is the lead supervisor of a banking group, its relative weight will of course increase substantially, representing a larger part of the supervised group.

With respect to subsidiaries, branches and services offered by euro zone banks in non participating states, the applicable regime will be the same as today.

As mentioned above, the proposed regulation contains some provisions ensuring these states to be protected in the decision making process within the EBA.

(iii) Third countries

The regulation contains no provisions on the effect of the SSM on third countries: the logical consequence is that the relations of the ECB to supervisors in these countries will be the same as before between the national supervisors and the supervisors in the third country. For supervisory matters, colleges of supervisors will therefore consist of the ECB and the third country supervisor, without participation of the euro area national supervisors. The same applies for the "participating" Member States. In non-supervisory matters, the ECB will not be involved, although one would expect it normally will attend as in observer for subjects that

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[94] Point 3 of the preamble.
[95] See art. 27 (5).
[96] See pt 8, Council conclusions of 18 October 2012. This last sentence may reflect of fear of regulatory arbitrage.

may impinge on its supervisory functions. In practice, one can expect the ECB to play a more prominent role in these cases, due to its competence for a large part of the Euro zone, and its involvement in other related fields (financial stability, monetary).

Financial institutions from third country jurisdictions will remain subject to the applicable national regulations and be supervised by the competent national supervisors, unless the activities of the latter are exercised by the ECB under the "participating" regime (see supra i)

Conclusion

The centralised system of financial supervision, as proposed, contains essential elements allowing banking supervision to be put on firmer footing within the euro area. The overall concept is quite convincing and meets the requirements of the present supervisory situation. The approval of this scheme will be a significant step in the direction of a consolidation of the financial system in Europe. Of course there a certain number of detailed items that need further clarification, such as the governance of the Mechanism, while some questions – such as the regime of the non-euro participating states will deserve further analysis. Also the overall accountability needs to be strengthened, especially with respect to the role of the European Parliament. But all in all, this proposal indicates the right way forward[97].

At the moment of writing, the European Council has decided to approve the present proposal subject to some refinements to be worked out at the Eurogroup level. It was also decided that the new system of supervision will be adopted before the end 2012 and rolled out during 2013, once the regulations have been adopted. Transitional measures as provided in the regulation will also have to be adopted[98]

The work is far from over: although the SSM will offer taxpayers a stronger shield against failure of the banks, other pieces have to be put in place. Differently from the national supervisors who have been mandated by their governments and parliaments, there is no taxpayer behind the ECB. Therefore it is essential that fast progress is made in the two other parts of the banking Union, the deposit guarantee systems and the crisis recovery and resolution systems.

[97] In the same general sense, N.Véron, Europe's Single Supervisory Mechanism and the Long Journey Towards Banking Union Bruegel, 4 October 2012

[98] Art. 27. Some considered the pace of work too fast: see EU Summit 18/19 October: Graham Bishop comments, stating that this was putting the cart before the horse, and that a five year period of preparation is needed.

Financial Law Institute

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