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The European Banking Union: integrating supervisory approaches

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European Banking Union:

Integrating supervisory approaches

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1. Introduction

European integration is a long and yet uncompleted trip. The first event in which European politicians formally discussed the idea of integrating European countries was the Hague Congress on 7-11 May 1948, in which delegates from some 20 European countries proposed a 'European assembly'. Later on, Belgium, France, Germany (Federal Republic), Italy, Luxembourg, and the Netherlands signed in the Paris Treaty establishing the European Coal and Steel Community on April 18, 1951. A few years later, the same six countries signed the treaties establishing the European Economic Community and the European Atomic Energy Community on March 25, 1957. During the following decades, the European Economic Community was extended to almost all Western European Countries. On June 19, 1990, the Schengen Agreement was signed to abolish border controls among member states of the European Communities. In 1992, the Treaty on European Union was signed in Maastricht by members of the European Economic Community: this lays the basis for a common foreign and security policy, closer cooperation on justice and home affairs, and the creation of an economic and monetary union, including a single currency. The European Economic Community was replaced by the European Union (EU), and the single European Market was created on January 1, 1993.

A very (probably, the most) important event in European integration is the creation of a single currency (labeled as the Euro) that replaced national currencies: in May 1998, 11 EU member states (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) formalized the decision to move to a single currency. Then, on January 1, 1999, the Euro was launched and the European Central Bank (ECB) took responsibility for the EU's monetary policy. In the following years, various other countries joined the Euro and, currently, the Euro-area includes 19 countries (Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovenia, Slovakia, and Spain).

The global financial crisis stimulated EU countries to integrate their regulatory and supervisory frameworks further. Specifically, the Global Financial Crisis (GFC) of 2007–2009 and the following sovereign debt crises (when investors started to differentiate among the credit risk of different European countries, spurred by the very high level of sovereign debt in some countries) forced EU governments to approve a massive amount of state aid (€1.49 trillion in capitalization and asset relief programs; €4.3 trillion in guarantees and liquidity measures) towards the banking systems between the beginning of 2008 and October 2014. These crises showed the weakness of the European regulatory and supervisory framework. Thus, European institutions started a long reform process labeled European Banking Union (EBU). The EBU is structured in two[1] pillars to foster orderly banking crisis management.

The EBU's first pillar focuses on harmonizing banking supervision. Specifically, EU countries moved from a decentralized system (based on the home-country control) to a centralized system labeled Single Supervisory Mechanism (SSM). The second pillar aims to establish a common European regulatory framework to manage bank crisis events orderly: this is labeled as Single Resolution Mechanism (SRM).

The operationalization of the EBU has taken some time to complete (Figure 1) due to the radical changes it requires. Nevertheless, the EBU led European banks

[1] The EBU project originally consisted of three pillars: the harmonization of EU banking supervision through the creation of the Single Supervisory Mechanism (SSM), the harmonization of EU banking resolution procedures through the establishment of the Single Resolution Mechanism (SRM), and the harmonization of the deposit insurance in EU through the formalization of the European Deposit Insurance Scheme (EDIS). We omit considering the third pillar since it still needs to be completed. Today, EDIS (comprising national deposit guarantee schemes and a European deposit insurance fund) will be built in three stages. In the first stage (until 2020), EDIS would provide a specified amount of liquidity assistance and absorb a specified amount of the final loss of the national scheme in the event of a pay-out or resolution procedure. In the second stage (4 years until 2024), a national scheme would only have to be exhausted after accessing EDIS. EDIS would absorb a progressively more significant share of any losses over the four years in the event of a pay-out or resolution procedure. In the final stage (from 2024), EDIS will be 'full insurance': EDIS will completely replace the national schemes and be the sole insurance scheme for deposits in euro-area banks.

to have a unified regulatory framework for supervision (SSM) from November 04, 2014, and resolution (SRM) from August 19, 2014.

< Insert Figure 1 >

The remainder of the chapter summarises the current features of SSM (section 2) and SRM (Section 3). Finally, section 4 concludes the chapter.

2. The Single Supervisory Mechanism

The first EBU pillar, labeled as Single Supervisory Mechanism (SSM), is a historical event in worldwide banking. It was surprisingly completed relatively quickly, especially considering its importance (see Table 1 for a summary of its steps). It was mentioned for the first time on September 7, 2012, in the ECB vice-president's speech at the Duisenberg School of Finance on "Toward a European banking union". On December 14, 2012, the ECOFIN council reached a landmark agreement on establishing the SSM ECOFIN and disclosed the criteria adopted by ECB to identify significant banks. Less than two years later, SSM started on November 4, 2014.

< Insert Table 1>

SSM involves centralizing at the European level the regulatory and institutional framework responsible for safeguarding the robustness and stability of the banking industry. Accordingly, SSM has three complementary aims: (i) ensuring the safety and soundness of the European banking system, ii) ensuring consistent supervision, iii) increasing financial integration and stability.

The centralization of banking supervision involved all euro-area, but not all EU, countries (i.e., Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain). In addition, Bulgaria and Croatia voluntarily participated in European banking supervision through close cooperation in October 2020.

Although SSM is a unique system of banking supervision, it is organized on two levels based on a close collaboration between the ECB and National Supervisory Authorities (NSAs). The first level is based on the direct supervision of the primary banks (labeled as "Significant Banks") by the European Central Bank. A bank operating in the Euro area is classified as "Significant" if one of the following conditions is met: (i) the value of their total assets exceeded €30bn or 20% of national GDP (unless the value of total assets was below €5bn); (ii) it was one of the three largest institutions established in a member state; and (iii) the ratio of its cross-border liabilities in more than one other participating member state to its total assets was above 20% (unless the value of total assets was below €5bn). If a bank does not meet any of these criteria and is not subjectively selected by the ECB (e.g., in case of crisis), a bank is classified as Less-Significant: in this case, the National Competent Authority (usually, the Central Bank of the country that granted the license to the bank) directly supervises it in strict collaboration with the ECB. At its launch (November 2014), the number of significant banks was 130 banks, and they were located in 19 countries representing assets worth €22 trillion, i.e., 82% of total banking assets in the Eurozone. As of January 01, 2022, the number of Significant banks is 115 at the consolidated level and 935 at the individual level, while the number of Less-Significant banks is 2,192 at the consolidated level and 2,465 at the individual level.[2].

A supervised bank in the SSM can be one of the following entities: 1) credit institutions established in participating Member States; 2) financial holding companies established in participating Member States; 3) mixed financial holding companies established in participating Member States, and 4) branches established in participating Member States by credit institutions established in non-participating Member States.

ECB has various supervisory activities: a) conducting supervisory reviews, on-site inspections, and investigations; b) granting or withdrawing banking licenses;

[2] Source of data: ECB (2021) Significance Assessment: 2021 at a glance – moving to 2022

c) assessing banks' acquisition and disposal of qualifying holdings; d) ensuring compliance with EU prudential rules; and e) setting higher capital requirements ("buffers") to counter any financial risks.

To deal with the new supervisory role, The ECB quickly ramped up its supervisory and technical expertise ahead of the transition. By 2014, 1,070 new staff were hired through a competitive process that implied a substantial wage increase over national supervisors. In addition, ECB carried out the ongoing supervision of significant banks through Joint Supervisory Teams (JSTs). Specifically, a dedicated team composed of staff from both ECB staff and NSAs (but also including the competent authorities of the countries in which credit institutions, banking subsidiaries, or significant cross-border branches of a given banking group are established) is assigned to each of the significant banks. The JST has a fixed composition with a coordinator, national sub-coordinators, and a team of experts. The coordinator is a staff member from ECB (appointed for three to five years and generally from somewhere other than the country where the supervised bank is located) who leads the team and steers its supervisory activities. While the structure is fixed, a JST's size, composition, and organization change are tailored to the supervised bank's size, risk profile, and business model.

The tasks performed by JST are fundamental for bank supervision. First, a JST assesses the risks banks face and checks that banks are equipped to manage those risks properly in a process labeled Supervisory Review and Evaluation Process (SREP). Also, a JST proposes the supervisory examination program, including a plan for on-site inspections, implements the approved supervisory examination program and any supervisory decisions, ensures coordination with the on-site inspection teams, and liaises with the national supervisors.

The SSM represented a tightening of bank supervision in Europe. Various reasons explain why banks believed the launch of the SSM would lead to stricter supervisory standards. First, the motivation to establish a supranational authority was to implement single and strict supervisory standards across countries. From the beginning, the ECB's supervisory arm focused on three strategic directions that suggest more stringent supervision: achieving a sounder capital base, reducing credit risks, and harmonizing supervisory standards. The newly established ECB's supervisory arm prioritized rebuilding confidence in the banking sector and addressing its weaknesses (Draghi, 2014). Indeed, an essential part of the preparation for the SSM was the Comprehensive Assessment (CA) stress test initiated to clarify which banks will be subject to the ECB's direct supervision. The Comprehensive Assessment focused on evaluating banks' credit risk6 and ensuring sound capitalization of the Significant banks. Compared with other stress-test exercises conducted in Europe or the US, the CA is unique because it was set up as a preliminary step for the SSM implementation. Second, banks could also anticipate that local supervisors would be easier to negotiate with, given the cultural familiarity and political influence. Agarwal et al. (2014) find systematic differences among different supervisors in their intensity of supervision in the same bank. They find that switching from a local (state) to a central (federal) supervisor implies stricter supervision, suggesting that geographical proximity to the bank is associated with more lenient supervision. Third, large banks are complex organizations; thus, efficiencies of scale and learning arise when a single larger organization conducts supervision. Therefore, a supranational supervisor is expected to be more technically prepared and less subject to political and cultural influences than national supervisors. The supervision of each Significant bank is entrusted to a Joint Supervisory Team (JST) that has a pan-European perspective and combines staff from different nationalities.

The launch of the SSM provides researchers with an exogenous and unexpected shock that various papers have exploited to study the effect of stricter supervision. The SSM created two separate supervisory strands in euro area banking that varied in intensity and costs for participants that influenced banks' behavior. There is extensive and consistent evidence in US banking that banks strategically chose to stay small to remain below thresholds (Kisin and Manela, 2016; Bouwman, Hu, and Johnson, 2018; Ballew, Iselin, and Nicoletti, 2022; Alvero, Sakai, and Kairong, 2022) and this was also shown to be the case of SSM (Fiordelisi et al., 2017). SSM also impacted stock prices: its announcement led to large movements in financial asset prices in which significant banks were adversely affected (Carboni, Fiordelisi, Ricci, and Stentella-Lopes, 2017). Recently, Cerulli et al. (2023) argue that, in practical terms, the change to a new supervisor was perceived as costly by banks: (i) ECB has the power to impose additional capital requirements (so-called pillar II add-ons) in case of weaknesses in the measurement of risks to capital. Thus, significant banks would be subject to higher costs to enhance their analytical skills and, potentially, to onerous additional capital demands; ii) the JST supervision is less accommodating to the interests of supervised banks than national supervisors; iii) the far more prominent size and capabilities of the newly created supervisor allow ECB to undertake more analytically and technically demanding supervision. Thus, Cerulli et al. (2023) estimate the change in banks' profitability to just below the €30bn threshold relative to a stylized counterfactual from a comparable group of banks. The main finding is that banks right below the threshold experienced lower profitability overall than banks right above: banks around the cutoff wanted to keep their local (and familiar) supervisor and thus managed their scale of operations to remain below the threshold, which has a material cost. For banks right below the threshold, the SSM thus resulted in lower profits by up to a third for banks just below the threshold.

3. The integration of Single Resolution Mechanism

The second EBU pillar, labeled as Single Resolution Mechanism (SRM), focuses on resolution procedures for distressed European banks.

The SRM is introduced by the EU Regulation no. 806/2014 and provides the Bank Recovery and Resolution Directive, briefly BRRD (2014/59/EU) of the European Parliament and European Council establishing a common framework for the resolution of failing banks. Before its approval, the BRRD takes time: On June 06, 2012, the European Commission published the first draft of the BRRD, defining under which circumstances a credit institution is deemed to be failing or likely to fail. On August 28, 2013, European Finance Ministers backed BRRD to be presented in European Parliament. The European Parliament approved the final version of the BRRD on April 15, 2014, so the European Council on July 14, 2014, making the SRM effective since August 19, 2014. The other provisions of BRRD have been implemented into national law since January 01, 2015. In contrast, the section related to the bail-in tool has been implemented since January 01, 2016.

< Insert Table 2 >

The SRM mechanism creates a new responsible authority for resolving failing banks (the Single Resolution Board – SRB) and a Fund to support failing banks (the Single Resolution Fund – SRF).

The SRB decides on resolution procedures for distressed banks and is directly responsible for the EBU cross-border and large banks (it is responsible for all the resolution cases in Euro Area). The Single Resolution Fund is a fund at the supranational level financed by the Euro Area banks to support failing banks. Each member state must set up an ex-ante resolution fund financed by the banking sector. Banks' annual contributions are based on their liabilities and the risks they take. The aim is to reach, by 2023, at least 1% coverage for deposits of all banks operating in each country. The BRRD also regulates when this fund can be used: applying the bail-in tool is a precondition for accessing the fund.

The SRM functioning consists of different steps: (1) the European Central Bank notifies the SRB that a bank is failing or likely to fail; (2) the European Central Bank decides whether apply a private solution or apply a resolution in the public interest (in the first case the resolution will be under national insolvency law, in the second case the SRB adopts a resolution procedure; (3) the procedures adopted by the SRB entered into force the day after, after the approval by the European Commission (while, the European Council can amend the amount of the SRF to be used); (4) the SRB ensures that the national resolution authority takes the necessary resolution actions.

The BRRD aims to provide the SRB with efficient financial tools to deal with failing banks, ensure the continuity of the bank's critical functions, transfer losses to banks' investors, and enhance financial stability. The second pillar of EBU implies an orderly crisis management procedure, standard for all Euro Area banks. The BRRD provides four different financial tools to resolve credit institutions in financial troubles, limiting consequences on financial stability and minimizing the impact of banks' failures on public finances and, lastly, on taxpayers. The BRRD regulates the resolution procedure of a Euro Area bank via an early intervention (when the bank fails to meet its capital requirements) and via a resolution procedure common to all Euro Area banks when the first option is no longer viable. Within early interventions, the BRRD grants SRB the power to intervene before the bank's condition deteriorates until this becomes inoperative. According to the going concern principle, the SRB can require the bank to draw up a recovery plan, change the bank's management, and appoint temporary administrators. In the second case, when early interventions are no longer viable, the BRRD regulates the functioning of the resolution of such distressed banks.

There are four financial tools: the sale of a business, the bridge institution, the asset separation, and the bail-in. The first tool (sale of a company) enables the SRB to sell the whole business of the failing bank's financial, or parts of its business, to another bank without the consent of shareholders. The second (the bridge institution) tool gives the power to SRB to transfer shares, assets, and liabilities of the distressed bank to a bridge institution, which is temporary and partially or publicly owned. Third, the asset separation tool enables the SRB to separate good and bad assets to be transferred to a publicly-owned asset management vehicle (this financial tool must be combined with at least another resolution tool to maximize proceeds). Finally, the bail-in tool prescribes a hierarchy (also known as bail-in hierarchy) of the types of financial instruments to be converted into shares or written down, moving the burden of losses from taxpayers (bailout) to shareholders and creditors of the failing bank. All these resolution tools entered into force on January 01, 2015, except for the bail-in tool, which started one year later (January 01, 2016).

The bail-in resolution tool represents the most significant change in European legislation concerning the resolution procedures of credit institutions.

3.1 The Bail-in Tool

The bail-in is the most crucial resolution tool since it transfers the burden of bank losses from the taxpayers (via liquidity injections by the Governments) to the banks' investors. From 2008 to 2014, half of the European GDP was directed into State aid programs for banks, and consequently, sovereign debt levels increased of the several bailouts implemented after the 2007–2009 financial crisis. The bail-in tool aims, among other things, to stop the sovereign debt nexus.

The new European Resolution framework establishes a creditors' hierarchy (Figure 2) for banks' liabilities falling within the bail-in scope. In case of resolution, the first level of instruments to be called to cover the losses is the Common Equity Tier 1, followed by Additional Tier 1 and Tier 2. Finally, if these instruments are insufficient to cover the losses, losses are covered by calling subordinated debt and senior unsecured debt[3].

< Insert Figure 2 >

At the bottom of the creditors' hierarchy are eligible customer deposits greater than €100'000. Customer deposits smaller than €100'000 are fully protected by national deposit insurance. Applying the bail-in tool in case of failing banks, banks' investors burden with the cost of failure. On the one hand, bail-in limits the use of public finances to resolve failing banks (which use increases sovereign debt). On the other hand, the bail-in restricts the number of people who bear the cost of failure, generating significant losses for the bank's investors. This procedure increases the likelihood of bank panic and bank runs hindering financial stability

[3] In compliance with the principle of "no creditors worse off" set by the BRRD, four countries (Germany, France, Italy, and Spain) decided to integrate the BRRD into their national legislation with a further sub-classification of the category "senior unsecured debt" (Pigrum et al., 2016).

(Carboni and Scardozzi, 2021). Financial stability is the first policymakers aim in creating the EBU.

The BRRD does not forbid the use of public finances. Specifically, the BRRD establishes that the costs will be borne by banks' investors, according to the bail-in tool hierarchy, and, only at that point, financed from the SRF. The resolution fund can be used only after the bail-in of shareholders and creditors for a minimum of 8% of a bank's total liabilities. It can finance up to 5% of the bank's total liabilities. Only in extraordinary cases when an extensive bail-in might hinder financial stability, the SRB might recourse to public support, eventually approved by the European Commission.

To apply the bail-in, the regulators require a framework to make the burden of bank losses feasible by banks' investors rather than using public finances. The failing bank should have enough equity and debt to cover bank losses. The BRRD introduces such a requirement: the Minimum Requirement for Eligible Liabilities (MREL). MREL allows the application of the bail-in tool by the SRB by enhancing that the Euro Area banks have enough assets to be used in case of resolution. The MREL provision will enter into force in 2024.

The introduction of the bail-in generates important effects on the EU banking system (Maddaloni and Scardozzi, 2023). Another objective of the bail-in is to improve market discipline. Restoring market discipline is necessary because of the benefits of implicit guarantees previously granted to European banks, especially those considered Too Big To Fail. The removal of the implicit guarantee seeks to restore market discipline in the banking system. Moreover, the crystal-clear definition of all the financial instruments issued by banks eligible for bail-in, provided by the BRRD, fosters financial stability through a greater awareness by the bank creditors about the instruments' level of risk. Policymakers aimed to increase such awareness to remedy mis-selling, a phenomenon: retail investors should not retain risky instruments, and, at the same time, the cross-holdings of bank bonds hinder financial stability through a contagion effect (Maddaloni and Scardozzi, 2022).

The implementation and application of the bail-in application may have several consequences for the economy. An increase in the bank cost of funding: the banks' liabilities become riskier after the introduction of the bail-in. Hence, banks' creditors require higher returns for their investments, increasing the bank's cost of funding. This increase follows the bail-in hierarchy: subordinated bondholders, more exposed in case of bail-in, require greater returns than senior bondholders. Consequently, banks might change their funding strategies for the European banking sector (Fiordelisi and Scardozzi, 2022).

Finally, the procedure's implementation should be credible for the bail-in to generate the benefits previously highlighted – enhancing market discipline, reducing moral hazard, mitigating mis-selling, and strengthening financial stability. Market participants should believe in its applicability in case of a bank failure. The literature has deemed the tool not credible enough, especially if the failure involves Too Big To Fail banks (Volz and Wedow, 2011).

4. Conclusion

The European Banking Union is a historical event. In a few years, the European banking supervision and resolution mechanism moved from a decentralized system at the domestic country level to a centralized approach at the European level to avoid the repetition of events, such as those that took place during the Global Financial Crisis and the sovereign debt crisis.

This process was realized in two steps: the supervision of banks in normal times (Single Supervisory Mechanism) and the supervision of banks in distress (Single Resolution Mechanism). Both reforms were announced in 2012, became effective a few years later, and represent a milestone in the banking regulatory framework. On the one hand, these reforms have entirely modified the role and powers of National Central Banks. But on the other hand, they have assigned new responsibilities and powers to the European Central Bank and created new bodies (such as the Single Resolution Boards) to foster orderly crisis management.

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Figure 1 - Timeline of the European Banking Union

This figure summarises the main steps of the European Banking Union project. Source: Authors' own

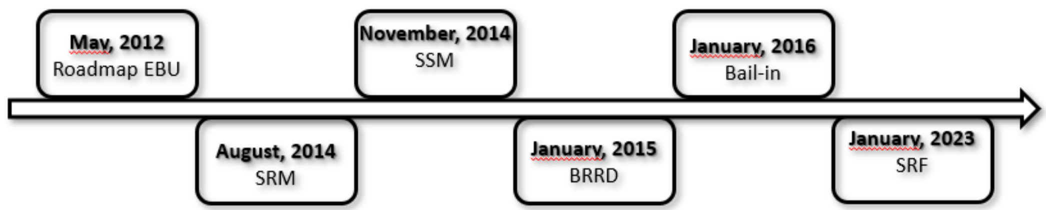

Figure 2 – The Bail-in hierarchy

The figure reports the order of security callout by the bail-in tool in case of resolution. At the top of the hierarchy, we have the equity instruments (CET1, AT1, T2), bonds (subordinated and senior), and the bottom of the bail-in hierarchy are the customer deposits, the latter to be called to cover bank losses. The national deposit insurance scheme ensures customer deposits under 100,000 euros. Source: Authors' own

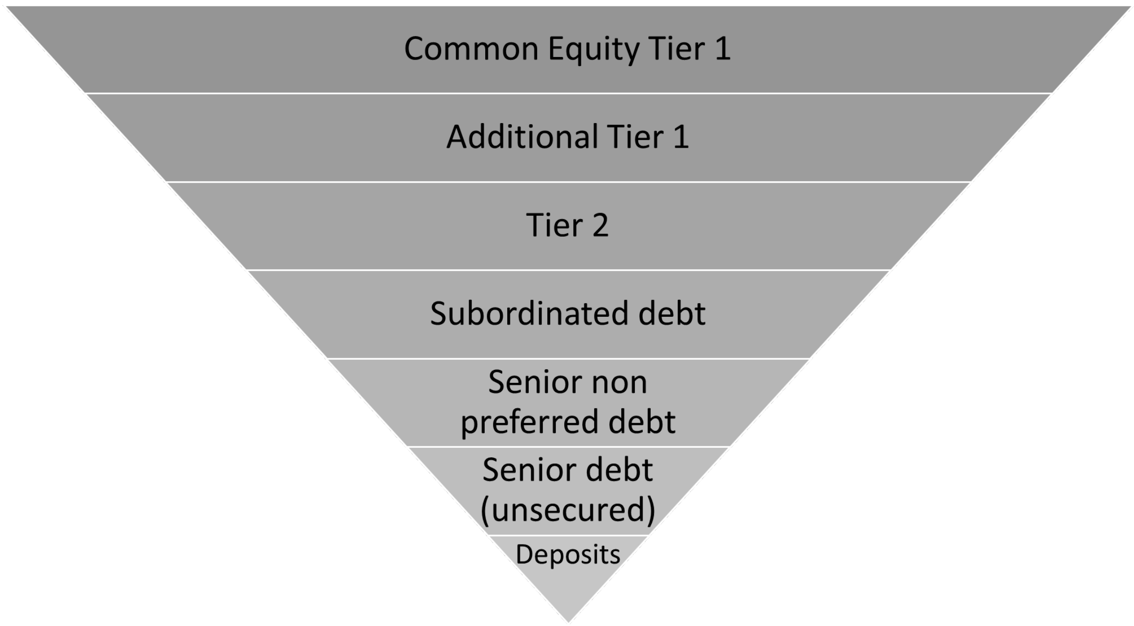

Table 1 - The pivotal moments of the Single Supervisory Mechanism (SSM) launch

This table summarises the main steps of the Single Supervisory Mechanism project.

September 07, 2012	ECB vice-president's speech at the Duisenberg School of Finance on "Toward a European banking union".
September 12, 2012.	The European Commission adopted two proposals for establishing a Single Supervisor Mechanism (SSM) for banks led by the European Central Bank (ECB).
December 14, 2012	ECOFIN council reached a landmark agreement on the establishment of the SSM ECOFIN in Disclosure of the criteria adopted by the ECB to identify significant banks
February 12, 2013	ECB Vice-President's speech at the Warwick Economics Summit on "Financial stability risks, monetary policy and the need for macro-prudential policy".
September 12, 2013.	ECB welcomes the European Parliament vote to create single supervisory mechanism
October 23, 2013	ECB starts comprehensive assessment in advance of supervisory role
December 16, 2013	Danièle Nouy appointed as Chair of the Supervisory Board
January 09, 2014	New Directors General for supervision appointed. Four new Directors General to take up positions in early 2014
January 22, 2014	ECB proposes a candidate for Vice-Chair of the SSM Supervisory Board
February 03, 2014	ECB makes progress with asset quality review and confirms stress test parameters for a comprehensive assessment
February 07, 2014	ECB launches public consultation on draft ECB SSM Framework Regulation
March 07, 2014	Supervisory board members appointed
March 11, 2014	ECB publishes manual for asset quality review
April 25, 2014	ECB publishes SSM Framework Regulation
April 29, 2014	ECB to give banks six to nine months to cover capital shortfalls following comprehensive assessment
May 27, 2014	ECB launches public consultation on draft ECB regulation on supervisory fees
July 17, 2014	ECB publishes disclosure process for the comprehensive assessment
July 23, 2014	Lithuania to join euro area and Single Supervisory Mechanism (SSM) on January 01, 2015
September 04, 2014	ECB publishes final list of significant credit institutions
September 08, 2014	Members of the Administrative Board of Review appointed
October 10, 2014	ECB to disclose the final results of the comprehensive assessment
October 22, 2014	Statement about media reports ahead of the comprehensive assessment results
October 23, 2014	ECB launches public consultation on draft Regulation on reporting of supervisory financial information
October 26, 2014	ECB's in-depth review shows banks need to take further action
November 04, 2014	SSM starts

Table 2 - The pivotal moments of the Single Resolution Mechanism (SRM) launch

This table summarises the main steps of the Single Resolution Mechanism project.

June 2012	The European Commission proposed the first draft of BRRD
August 2013	The European Finance ministers back the BRRD to be presented in European Parliament
April 2014	The European Parliament approved the BRRD
July 2014	The European Council approved the BRRD
August 2014	The SRM entered into force
January 2015	The BRRD entered into force (except for the bail-in provision)
January 2016	The bail-in entered into force
January 2023	SRF equals at least 1% coverage for deposits of all EU banks.
January 2024	MREL provision enters into force