(Dis)uniting the Diversity: The European Banking Union and the Non-Eurozone EU Member States

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Abstract

The European Banking Union (EBU) has introduced many important features of banking governance and contributed to restoration of confidence in European banking. However, two institutional pillars of the EBU, the Single Supervisory Mechanism and the Single Resolution Mechanism, were designed as mandatory for the Member States using the Euro as their currency, but optional for all other Member States. The majority of them have chosen to decline participation, while a handful have joined. A number of important components of the EBU are consequently unavailable or inapplicable to the non-participating States.

This thesis uncovers the reasons why the majority of non-Euro States are not participating, analysing the legal reasons for such choice, as well as national economic and banking sector predispositions of potential signatories. Its findings reveal that a significant number of States are likely to permanently opt-out of the EBU. Moreover, it argues that in the absence of solutions to the problems discouraging participation, the long-term non-participating States are likely to grow increasingly distant from the institutional components of the EBU and the Eurozone, which will deepen the fractures in the EU Single Market. As an answer to this conundrum, this thesis seeks to provide potential solutions for bridging the gap between the two groups of Member States and two banking supervision and resolution systems that have emerged. This thesis is the most detailed and multifaceted interdisciplinary study on all non-Eurozone EU Member States to date. It involves qualitative and quantitative research, blending the methodologies of legal research, data analysis and political economy.

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Dedicated to my wife, without whom this thesis would have never been finished, and my children, without whom it would have been finished two years earlier.

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Abbreviations

ABR: Administrative Board of Review
BRRD: Bank Recovery and Resolution Directive
CCA: Close Cooperation Agreement
CRD: Capital Requirements Directive
CRR: Capital Requirements Regulation
DGD: Deposit Guarantee Directive
EBA: European Banking Authority
EBU: European Banking Union
ECB: European Central Bank
EHM: Extended Home Market
EOFS: European Organisation for Financial Supervision
ESCB: European System of Central Banks
ESA: European Supervisory Authority
ESFS: European System of Financial Supervision
ESM: European Stability Mechanism
ESRB: European Systemic Risk Board
EU: European Union
FCA: Financial Conduct Authority
FSAP: Financial Services Action Plan
FSB: Financial Stability Board
FSOC: Financial Stability Oversight Council
FST: Financial Stability Trilemma
GFC: Great Financial Crisis
NCA: National Competent Authority
NRA: National Resolution Authority
NRF: National Resolution Fund
NoPS: Non-Participating Member State
PRA: Prudential Regulation Authority
PRR: Prudential Requirements Regulation
SRB: Single Resolution Board
SRF: Single Resolution Fund
SRM: Single Resolution Mechanism
SSM: Single Supervisory Mechanism
SSMR: SSM Regulation
SSMFR: SSM Framework Regulation
TEU: Treaty on European Union
TFEU: Treaty on the Functioning of the European Union

Introduction:
Thesis Structure, Themes and Methods Employed

A. General presentation of this work

The term 'European Banking Union' (EBU) generally refers to the gradual harmonisation and centralisation of banking policy, resolution, and supervision, involving a gradual transfer of powers from the Member States to the supranational European Union level. This thesis discusses the EBU from an unusual perspective – focusing on the EU Member States, which have chosen *not to* participate in it.

The EBU as we know it today was built around the Single Supervisory Mechanism (SSM), which is mainly about bank prudential supervision, the Single Resolution Mechanism (SRM), which deals with the resolution of banks, the Single Banking Rulebook ('the Rulebook'), a body of legislation governing the banking oversight in the EU, and the final, partly established, pillar – the single European Deposit Insurance scheme (EDIS).

The SSM and the SRM are known as the institutional pillars (or components) of the EBU. That is because they each comprise a governing EU level body and a system of national authorities, working together under complex arrangements, stipulated by EU legislation. Both of them are subject to a complication – they do not cover the entire European Union, but rather the Eurozone (Member States which have adopted the Euro as their single currency), and the States that voluntarily chose to join via a separate agreement.

The States choosing to exercise or not exercise that option are the focal group of this thesis. The aim is to explore the legal, political, structural and economic reasons why the majority of non-Eurozone Member States, remain unwilling to participate in the institutional components of the EBU. The thesis also offers insights into how the resulting fragmentation in European banking oversight might affect European financial stability and the integrity of the EU as a whole.

This work therefore chooses four angles of focus: 1) the non-Participating States (NoPS),[1] as the primary research interest 2) law, as the pivotal discipline of research, due to

[1] The term originally first used by PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, (Kluwer 2016). It refers to EU Member States which have not joined the institutional components of the European Banking Union. At the time of writing there are 6 NoPS: Czechia, Denmark, Hungary, Poland, Romania, and Sweden. In

its fundamental role in shaping the pre-conditions for non-participation, as well as the conditions for participation 3) the Single Supervisory Mechanism, as this pillar ultimately drew a sharp legal distinction between Eurozone and non-Eurozone States, and its primary statute governs the terms of optional participation, and 4) interdisciplinary research methodology, as a pre-requisite for a novel and comprehensive analysis of this multifaceted topic.

The work employs methodologies including legal analysis, political economy analysis, qualitative regulation analysis, and quantitative data analysis, in order to uncover and present a detailed and nuanced answer to the research problematic.

This introductory Chapter firstly seeks to outline the purpose and context of this thesis, which is done in section B. Section C provides an overview of the themes and scope of individual chapters making up this thesis. Research methodology is summarised in Section D, briefly introducing the theoretical and empirical foundations the thesis findings are based on. Section E highlights the aspects of the thesis which make an original contribution to the scholarly knowledge in the fields of European banking law and political economy.

B. Context and purpose of this research

The first institutional component of the EBU, the SSM, was created by the landmark Council Regulation (EU) No 1024/2013 (SSMR), which conferred on the European Central Bank a number of important tasks concerning prudential supervision. Due to constitutional limitations, which burdened the enactment of this Regulation,[2] only members of the European Monetary Union (EMU or 'Eurozone'), are compelled to participate in the SSM. The membership of the Single Resolution Mechanism (SRM) mirrors the membership of the SSM. Thus, the consequences of the SSM's geographical limits stretched way beyond the SSM, drawing a distinction between the EMU and non-EMU states in relation to not one, but two EBU pillars. Moreover, the constitutional limitations and EBU design choices made the participation terms available to EMU and non-EMU States drastically different.[3]

As a consequence of such development, a sub-group of EU Member States, known as the non-participating States or 'NoPS', emerged. Due to the significance of such States,

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some cases the definition includes former NoPS – the UK (now non-EU) and Lithuania (now Eurozone and EBU), and most recent EBU members – Bulgaria and Croatia.

[2] See Chapter 2 of this thesis

[3] See Chapter 3

which originally also included the UK and Lithuania, a number of legal adjustments needed to be made, ranging from special cooperation agreements and memoranda of understanding as part of the SSM framework, to significant adjustments in the voting mechanics in the European Banking Authority (EBA). These states are far from a monolithic bloc, as this thesis uncovers. Moreover, as if to make matters more complex, over the course of less than a decade, a number of States changed their relationship to the Union. That included leaving the EU altogether (UK), joining the Eurozone (Lithuania), joining the SSM and SRM (Croatia, Bulgaria), strictly opting-out (Sweden, Czechia), constantly revising the position (Denmark, Romania) or opting out with a possibility of joining in the future (Poland, Hungary).

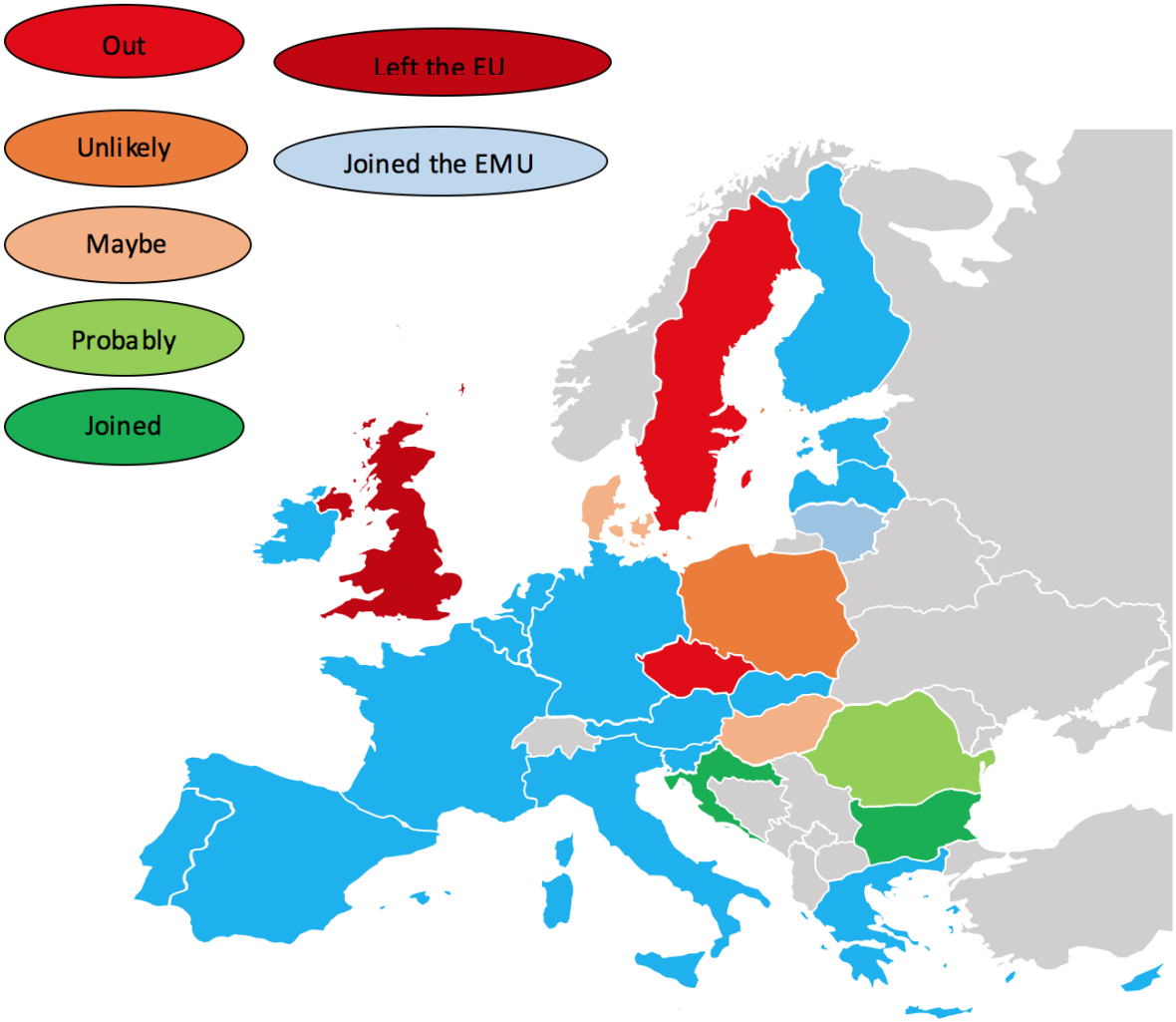

Fig.0.1 Map of recent decisions and declared intentions towards SSM and SRM, own research, updated April 2021

The decisions and positions of the States were drastically different, while the legal framework offered to them was the same. The research leading up to this thesis revealed that political and economic considerations eventually tilted the balance.

What is more, the findings in this thesis indicate that the EBU has amplified some integration and disintegration processes, which collide, pull at one another, and result in outcomes which are often operationally sub-optimal, costly, and inefficient. Ultimately, the political economy of the EBU has shaped many aspects of legal development, but the outcomes of these legal developments subsequently shaped the politics and the economics in their own right. The need to reflect and assess these processes resulted in the interdisciplinary methodology employed, seeking to provide answers to key questions, undistorted by the limitations and biases of a single discipline.

The aim of the thesis is to ask and answer two fundamental questions: 1) 'What factors lead to participation or non-participation of the non-EMU Member States?' and 2) 'What role has the law played in the past and could play in the future, in shaping the division in banking oversight between the NoPS and the participating States?' The answers to these questions can serve three functions: inform the EU policy debate, provide broader context for domestic considerations in relation to potential participation, and contribute to the debate on the theorisation of the consequences of the EBU on the dynamics of European (dis)integration.

C. Chapter overview

This thesis explores the problematic introduced above in six Chapters. The first five Chapters are dedicated to exploring the situation of the NoPS from five different perspectives, whereas the final Chapter suggests a number of legal changes, which could facilitate banking oversight convergence in the EU in ways that would be acceptable to the NoPS.

Chapter 1 explores the positioning of the EBU in the historical and theoretical context of European financial integration. That includes the discussion of integration processes that preceded the EBU, dire economic circumstances that led to its creation, the differentiated integration processes, and the broader theoretical conceptualisations applied to EU regulatory reforms. I argue that the EBU has an important and distinct place in all of these narratives, and the situation of the NoPS epitomises many struggles that the broader EU integration is facing. In particular, I examine the roles that the EMU and the 2007-2009 Great Financial Crisis (GFC) played in shaping the EBU. These two influences created the concurrent

narratives of continuity and urgency, which placed the Union on an unstable footing. I subsequently employ a more theoretical approach and analyse deeper implications of the Banking Union on EU's geopolitical and constitutional development, applying the theories of the Financial Stability Trilemma, the Inconsistent Quartet, and the Path Dependency Hypothesis. This discussion illustrates how differentiated integration can twist the EBU into a differentiation-deepening force, threatening the integrity of the Single Market.

Chapter 2 outlines the legal and institutional structure of the EBU, highlighting the most important features and shortcomings. Particular emphasis is put on the SSM, as the pillar which created the sub-group of States that this thesis focuses on. I discuss the factors which led to the SSM being forged the way it was and how two different levels – European and national - are designed to function together. I also analyse how the institutional arrangements of the SSM decision-making, particularly those relating to the ECB as the centerpiece, have made the participation terms fundamentally unequal. I argue that this inequality has spilled over into the other pillars of the EBU, especially the SRM. Furthermore, the increasing centralisation of European banking oversight has raised the stakes for the States taking part in these reforms, which makes unequal distribution of powers and consequences within the EBU pillars particularly problematic.

Chapter 3 analyses the mechanics of participation, as well as the alternative backstop arrangements meant to ensure a degree of regulatory harmonisation, if participation agreement is not reached. Particular attention is paid to the technical details of the Close Cooperation Agreements (CCAs) – binding documents through which the NoPS can become part of the institutional components of the EBU. I highlight the fundamental shortcomings of these agreements, which partly explain their unpopularity among the majority of NoPS. The exclusion of the non-EMU States from the Governing Council of the ECB results in an inherently disadvantaged position that these States end up in. In order to mitigate this problem, the EBU legislation foresees a number of alterations to the decision making mechanics in other bodies, as well as a termination clause, which allows the CCA States to leave the SSM and the SRM. However, my research reveals that these concessions can in effect be a poisoned chalice. The small print of the alleged concessions puts the non-EMU States in a position of even greater disadvantage, largely due aggravation of problems linked to the distributive consequences of the SRM. The alternative legal and institutional arrangements, on the other hand, do not facilitate the degree of regulatory convergence that was expected from the EBU.

Chapter 4 begins to unravel the underlying political economy reasons for different

participation choices. I discuss three geographical regions, which encompass all seven non-participating States and both CCA States, analysing individual circumstances and concerns of these Member States. I discuss the South-Eastern States (Bulgaria, Romania and Croatia), Visegrad states (Czechia, Hungary and Poland) and the Nordic-Baltic market (including Denmark and Sweden).

The Nordic-Baltic banking market is also chosen as a case study and a microcosmic illustration of Europe-wide problems. This market comprises of EEA, EU and Eurozone states, with different supervisory arrangements, which collectively form a fully integrated regional banking market. Despite it being one of the most financially stable and fiscally responsible regions in Europe, differentiated integration still has an effect on harmonious and consistent application of rules in this region. This research analyses the effects and influence of non-Eurozone and non-EU states, which nevertheless form part of integrated regional markets, alongside participating EU Member States. Such States have substantial credit sector presence across the EU, significantly influence banking in individual Eurozone states, and can (under certain circumstances) have unintentionally destabilising impact. This interconnectedness explains why, the pan-European arrangements might need to stretch beyond the Eurozone, to achieve their goals.

In Chapter 5, the thesis turns to answer a crucial question: why some countries agreed to sign the Close Cooperation Agreement while others have rejected it, despite both groups sharing very similar concerns, regarding the legal structures, loss of regulatory autonomy and distributive consequences of the SRM. I seek to fully uncover the remaining elements of the reasoning patterns. It becomes clear that many factors influencing the decision originate from outside the law. This chapter offers answers by using a mixed methodology, drawing on insights from a range of disciplines, including economics, political science and quantitative data analysis. I analyse a set of structural characteristics of domestic banking sectors of all non-EMU EU States and compare them against their willingness to participate. Such characteristics include *inter alia* banking sector concentration, banking sector internationalisation, exposure to certain States, and the level of non-performing loans. I find compelling evidence that structural factors can influence the decision at least as much as legal and political considerations. It also becomes clear that non-participation has pushed some NoPS to develop alternative contingency plans, in order to mitigate the threats that the participating States guard themselves against through the EBU. This underappreciated point is important, since it fuels the disintegration dynamics and confirms the path-dependency hypothesis, one of the hypotheses put forward in Chapter 1.

Chapter 6 draws conclusions from the analyses provided in the preceding chapters and moves onto concrete suggestions for legal reforms and improvements. It presents various solutions for harmonising banking supervision suggested in past publications and policy papers and discovered through this research, assesses their viability and offers several novel approaches. That includes, *inter alia*, discussions on Treaty change, enhanced role of supervisory colleges, clear stipulation of negotiation process for CCA accessions, further expansion of the remit of the institutional components beyond the EU, additional safeguards against disproportionate influence of the Governing Council of the ECB, EU-level legislation setting the baseline for supervisory practices, and creation of market incentives for further increased integration, leading to greater regulatory convergence.

D. Research methods

The set of research methods employed mainly comprises of legal analysis, law in context, law and economics, and political economy methodologies. Two methodological strands of thinking are developed throughout the thesis.

The legal analysis strand, which is largely qualitative, focuses on the substance of the Banking Union legislation and case law clarifying it, seeking to identify issues which are (or could be) of particular concern to non-Eurozone Member States. This analysis is supplemented by testing established hypotheses in political science, EU constitutional law, financial law, and economic theory, against the reality of the EBU. The methodological framework for this aspect of my research is detailed in Chapter 1 of this thesis.

The second strand of this research is more quantitative and (in legal research terms) empirical, and employs political economy research methods, quantitative data collection, data analysis, and qualitative assessment of quantitative data. The methodological framework for this aspect of my research is detailed in Chapter 5 of this thesis. The research process is generally centered around collection of quantitative data on various banking sector characteristics and comparing the unveiled trends against the Member State's willingness to participate.

My methods could be simplistically divided into two broad categories:

i) Qualitative legal research methods of normative assessment, and the evaluation of the findings against established theories of legal, political and economic development;

ii) Quantitative methods focused on a particular hypothesis or assumption, seeking to empirically assess the validity of that hypothesis and ascertain the breadth of its application;

This mixed methodology was necessary in order to provide answers to the questions the thesis set out to tackle. While it is (and will undoubtedly remain) unquestionable that legal scholars are the most capable of providing adequate analysis of legally complex issues, the legal literature on the issues examined in this thesis did not offer necessary analytical tools and methods for the assessment of underlying variables affecting the legal development. Most importantly, legal analyses failed to comprehensively answer why some Member States opted into the legal regime in question, while others opted out. It is thus necessary to adopt varied methodology, in order understand and address practical concerns and implications.

E. Contribution to existing knowledge

This thesis contributes to the existing body of literature in several ways. Firstly, it examines the non-participating States (NoPS) as a specific group in the EBU context in exceptional detail, going further than any other research on the topic to date. Secondly, it provides a blended legal and political economy analysis of the NoPS, exploring the finer nuances of the situation of each NoPS, also providing a number of multidisciplinary findings on their impact on the European financial (dis)integration processes. Thirdly, the thesis contributes to the existing literature by offering multiple normative suggestions as to how the concerns of non-participating States can be addressed, encouraging participation, and thus allowing for geographical expansion and increased effectiveness of the EBU's institutional pillars.

The empirical quantitative study of NoPS' banking sector structural characteristics provided in this work is more detailed than other research papers to date. Moreover, this research employed observation of changes in statistical indicators over periods of time, reflecting the dynamism of economic indicators, and thus avoiding point of observation bias. The full potential of such observations has not been fully utilised in existing literature. Furthermore, these changes were analysed in the light of legal and political developments, which happened during these periods, allowing for an informative qualitative discussion backed by quantitative indicators. The findings were assessed against legal, constitutional, and economic theories of European integration and disintegration, seeking to determine the

real world effects of legal factors and banking sector structural characteristics.

Consequently, the thesis uncovers fundamental overriding patterns, joining the narratives of individual NoPS, which allows for a comprehensive and conjunctive analysis, necessary for informed policy decisions and deeper scholarly understanding. Ultimately, this thesis produces a detailed answer why some States chose to join the SSM and SRM, while others stayed outside.

Chapter 1

The European Banking Union in the Broader Context of European Financial Integration

Introduction

The legal and institutional architecture of the bodies overseeing European banking is a complex system, built on several overlapping lines of thinking: 'ever-closer union' integration ideals, the need to accommodate pre-existing structures, lessons learned from past mistakes, uneasy political compromises, and sub-optimal constitutional foundations. Much like the Royal Ontario Museum (Fig.1.1), this institutional architecture would not look the way it does, if it was built from the ground up; but it is nevertheless a truly impressive blend of vastly different components.

The European Banking Union (EBU) is a major part of this architecture. It is a cornerstone of the European banking law, which is one of the branches of the European financial law, falling within the broader scholarly field of economic law.[4] The importance of the EBU notably stretches far beyond law, as its creation marked a major politico-economic shift in EU market integration. It was also the biggest reactionary move in the EU's history.

Fig.1.1 *Photo by Javen/Shutterstock*

The Banking Union was established following the global financial crisis (GFC) of 2007-2009 and the resulting sovereign debt crisis, which hit the Eurozone in late 2009.[5] No other EU reform of this magnitude has been so firmly linked to one particular event.

This chapter begins our journey through the complex world of EU banking regulation, discussing the way towards the Banking Union and offering crucial historical, theoretical and economic context, within which the technical details of the EBU should be considered. These

[4] Ch Gortsos, *The Evolution of European (EU) Banking Law under the Influence of (Public) International Banking Law: A Comprehensive Overview*, 3rd edition, National and Kapodistrian University of Athens 2020, p.127

[5] Often referred to jointly as the Great Financial Crisis or the 'GFC'.

discussions reveal the multifaceted nature of the EBU, as well as the complexity of its origins. The narratives of the EBU development lead into the discussion of the integration and disintegration dynamics. In this chapter I provide the core conceptual frameworks employed for the analysis of such dynamics, which will be used to summarise the findings presented in other chapters.

The chapter is structured as follows. Section A covers key events of the historical development of financial markets integration, regulatory integration, and supervisory centralisation. I identify the conditions the EBU was meant to depart from, that is, in other words, the modes of thinking and structural approaches that were meant to be left behind. I also explain why the EBU can be seen as a continuation of increasing integration of European financial services markets, and how it is linked to the European Monetary Union (EMU). These historical narratives form part of the neofunctionalist explanation of the EBU. Section B discusses the importance of the role of the crises, which altered the pace, depth and expediency of EU reforms. It explains how the crisis experience, the need to protect the EMU, and the linear progression towards deeper integration have further joined the EBU and EMU narratives, thus exposing the reform to the dangers posed by previous differentiated integration. Section C employs a more theoretical approach and analyses deeper implications of the Banking Union on the EU's geopolitical and constitutional development, employing the theories of the Financial Stability Trilemma, the Inconsistent Quartet and the path dependency hypothesis. I also explore the application of neofunctionalist and intergovernmentalist theories to the EBU. I argue that neither of these two theories can fully explain the integration and disintegration mechanics. Instead, they are reflections of different standpoints, adopted by different actors shaping the EBU. The ideational conflicts between them partly explain the difficulties in reaching a consensus that would allow the institutional pillars of the EBU to cover the entire European Union.

A. Brief history of European financial integration

This section provides the historical context for the Banking Union, highlighting the most important aspects of the financial markets integration, gradually moving onto the account of regulatory integration and supervisory centralisation. I indicate why the EBU, despite its links to the systemic shock of the crisis, is also a natural instalment in the broader European financial integration process. With that being said, this account also reveals how, despite trying to mirror the increasing integration of the European Single Market, financial

regulation lagged a few steps behind market realities. This tendency manifested even when integration was meticulously planned and facilitated by political decisions and legislative initiatives. This raises the question whether, through shock-induced decisiveness and urgency, the EBU managed to change that tendency and finally keep up with the marketplace it oversees.

The section starts by highlighting the complexity of the European banking market, resulting from the diversity of the banking systems that permeate it. It then proceeds to overview the historical evolution of European financial integration, as one of the natural historical paradigms in the evolution of the Single Market, leading to the EBU. Subsection 3 briefly summarises the importance of the Financial Services Action Plan and the role of banking supervision in this broader EU strategy for financial services. Subsection 4 covers a notable pre-crisis attempt to harmonise the EU banking supervision, based on the so-called Lamfalussy report, and its fundamental shortcomings. Subsection 5 highlights important crisis-time and post crisis developments, which completes the coverage of the banking oversight reforms up to the pivotal moment in the narrative of this thesis – the EBU. Subsection 6 discusses the links and parallels between the EBU and the EMU and highlights their importance for EBU legal development and consequent differentiation in integration.

1. Diversity and regulatory integration

The difficulty of integration efforts in the European finance is rooted in the astonishing diversity among the States. Banking is the most prominent example, since this industry is old, archaic, and deeply rooted in the national societies. The integration-focused reforms, which I will discuss in this section, effectively tried to join together individual markets, all of which developed separately, following unique narratives and timelines. The EBU is arguably the most ambitious installment in this decades-long endeavour.

The EU has always (at least formally) celebrated diversity among the Member States,[6] ultimately even carrying this rhetoric into the EBU legislation.[7] However, the diversity among the States, often allowed – or even facilitated - by EU legislation, also shaped the uneven edifice the EBU had to be placed on, making the reform more difficult. Even as cross-border banking approached full integration, the national banking markets and the underlying structures of credit institutions differed vastly.

The differentiation stemmed from uneven distribution of several factors: national

[6] E.g. Art 167 TFEU
[7] E.g. SSMR Rec.17, Rec.79

preferences, different compliance processes, coordination issues, autonomy costs, power of supranational actors, extent of ideational consensus, degree of international interdependences, etc.[8] Historically speaking, the EU Member States did not have a shared philosophy of banking and finance. For example, the UK, Ireland and many of the Eastern EU States adopted the so-called Washington consensus policies – hyper liberal, market-driven financial infrastructure models. This contrasts with the more cautions Scandinavian banking, or the complex, intricate, and unique German and Italian systems.[9] As I will explore throughout this thesis, a further problem for the EBU development is that financial services markets are not fragmented along the same lines as the European organisational mamberships. The NoPS and the Eurozone States have adapted their banking sectors to this complex maze, created by pre-existing differences and subsequent differentiated integration, and managed to form fully integrated regional banking markets, which operate smoothly despite glaring differences between the States, as illustrated in Chapter 4.

The national regulatory structures overseeing this landscape also differ vastly. According to Stubb such differentiation "can be categorised according to […] temporal, territorial or sectorial scope."[10] In the banking context, Elliot saw three fundamental ways in which regulatory structures differ across Europe: different choices about the particular institutions acting as supervisors, different degrees of centralisation, and different divisions of authority between supervisory discretion and legal procedures.[11] Europe never achieved full intellectual consensus regarding the optimal supervisory structure, and arguably – central banking as such. The ECB was modelled largely on the Bundesbank[12] and there are countries in Europe that intentionally chose a different approach to central banking. Some of them are NoPS. Not all of the central banks of the Member States are the main supervisors of credit institutions. In a quarter of the States central banks have no supervisory responsibilities. Some of these are NoPS. Historically, central banks mainly existed as public entities responsible for specific designated functions, highly independent, and not involved in application of law, which makes them somewhat unusual actors in international law.[13] Even

[8] See D Leuffen, B Rittberger, F Schimmelfennig, *Differentiated integration: Explaining variation in the European Union*, Palgrave Macmillan, 2013
[9] See N Veron, *Banking Regulation in the Euro Area: Germany is Different*, Peterson Institute, May 11, 2020
[10] ACG Stubb, *A Categorization of Differentiated Integration*, Journal of Common Market Studies, vol.34:2, 1996, p.283
[11] DJ Elliot, *Key Issues on European Banking Union; Trade-offs and some recommendations*, Global Economy and Development, Brookings, 2012, p.22
[12] DW Arner, MA Panton, P Lejot, *Central Banks and Central Bank Cooperation in the Global Financial System*, 23 Pac. McGeorge Global Bus. & Dev. L.J.1 2010-2011, p.11
[13] Ibid. p.2

in the States with central banks acting as supervisors, other bodies have various supervisory functions, and some of these bodies do not have direct equivalents in other States. Therefore, finding a single form of oversight for vastly different elements is a very difficult task. As Elliott expressed it, "supervisory choices that are right for Germany might be wrong for Greece, and vice versa."[14]

2. *Early Stages of Financial Integration*

A popular view in the literature is that the EBU was a response to the 2007-2009 (banking) and 2010 (sovereign debt) crises.[15] While, the impact of the crises is undeniable, the EBU can also be seen more broadly, as an extension of continuous financial markets integration process, predating and outlasting the EBU reforms.

Financial markets integration is part and parcel of the EU's ambition to build a fully integrated internal market. While its ideological premises can be traced all the way to the very origins of the European Communities, the intensity and ambition of reforms gradually increased with time. In its early stages, the integration process was primarily based on long-term economic policy considerations. Such considerations became evident with 1966 Segré Report[16] and reached their aspirational apex with Jean Claude Juncker's initiative for the Capital Markets Union.[17] As Segré report put it "market mechanisms contribute best to economic growth and to the equilibrium of the economy when they operate within the framework of policies reflecting the long-term goals set for the economic and social systems."[18] The EC/EU spent many years building such environment. It is important to note, however, that the early considerations preceding the GFC, were very economic-benefit-oriented and neither foresaw potential crises or periods of stagnation of the kind witnessed in 2007-2010, nor detailed far-reaching regulatory or supervisory reforms. A good example of that is the Cecchini Report in 1988 advocating a fully integrated single market in financial services, but paying almost no attention to the oversight of such market.[19] By the late 90s and early 2000s the tensions had started growing, with increasing emphasis being placed on regulation and supervision. Markets in Financial Instruments Directive 2004/39/EC (MiFID)

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[14] Elliot 2012, p.22
[15] See section B below.
[16] C Segré, *Report by a Group of experts appointed by the EEC Commission, The development of a European capital market*, EU Commission 1966
[17] For overview see E Mourlon-Druol, *A Capital Markets Union for Europe, from Claudio Segré to Jean-Claude Juncker*, blog 2014
[18] Ibid.
[19] Unspecified, *Europe 1992: The Overall Challenge, Summary of the Cecchini Report*, SEC (88) 524 final, 13/04/1988

is a good example of the ensuing legislation, largely built with a purpose of shaping the market landscape.[20] These changes were legislation-focused and did not seek major institutional European-level centralisation. The following passage from a 2007 ECB report (also describing the early signs of the banking crisis as 'recent market turbulence'), aptly illustrates pre-crisis thinking:

> *"EU framework for prudential supervision should support the efficient functioning of cross-border banks. Cross-border banks are important drivers of banking integration, helping to address the relatively high degree of fragmentation of European retail banking markets. […] the supervisory framework should support the efficient functioning of cross-border banking as a channel for further financial integration, in view of its benefits for economic growth and competitiveness. […] differences in supervisory requirements and approaches and overlapping policy measures should be greatly reduced and eventually eliminated".*[21]

The agenda was primarily to create a level playing field, not avert a systemic shock. The market participants themselves were also expected to play an integration-deepening role, by establishing increased cross-border presence and developing systems of market self-regulation. Also, as the retail banking market was considered too fragmented, some level of prudential oversight fragmentation seemed somewhat proportionate.

3. The Financial Services Action Plan

a) Brief overview of FSAP

The Financial Services Action Plan (FSAP) neatly illustrates the integration strategy after the EMU. It consisted of a set of measures intended to fill gaps and remove the remaining barriers to the Single Market in financial services.[22] Market integration (notably neglecting regulatory harmonisation), was at the core of its agenda.[23] Integration was expected to "act as a catalyst for economic growth across all sectors of the economy, boost

[20] G Ferrarini, N Moloney, *Reshaping Order Execution in the EU and the Role of Interest Groups: From MiFID I to MiFID II*, European Business Organization Law Review, volume 13, 2012, p.581
[21] ECB, *Review of the Lamfalussy framework*, 2007, p.6
[22] European Commission, *The Financial Services Action Plan*, Cardiff, 06/1998, p.1
[23] HM Treasury, the Financial Services Authority, and the Bank of England, *The EU Financial Services Action Plan: a guide*, 2003, p.352

productivity and provide lower cost and better quality financial products for consumers, and enterprises, in particular - SMEs".[24]

The FSAP foresaw further harmonisation in many areas, many of which are beyond the scope of this work, including securities, insurance, accounts, corporate restructuring, various funds, retail payments, money laundering, etc.[25] Some measures with more obvious links to the topicality of this thesis concerned financial supervision, corporate insolvency, electronic money institutions, and cross-border savings. This reform, like its predecessors and early successors, was rules-focused and did not involve drastic institutional changes in areas directly concerning credit institutions. The adoption of the FSAP followed the standard EU legislative procedures and thus the ECB and financial markets regulators only served as consultants.

b) Place of banking in the FSAP

Although banking was considered a part of the Single Market for financial services programme, it was often put on the 'back burner', partly due to prevalent belief in sector resilience.[26] With that being said, the FSAP reforms had some banking-related features. Discussion of the majority of these aspects is beyond the scope of this thesis, but some of them serve as good illustration of a (slowly) growing focus on spill-over effects and banking operations in general. For example, the Bank Winding-up Directive in 2001[27] sought to ensure that credit institutions can be wound up and restructured in the EU as a single legal entity, which, had many cross-border banks not become too-big-to-fail by 2007, could be considered an important development. This Directive marked the first significant step towards consolidation and resolution harmonisation.

Another change with some relevance for this thesis was the Taxation of Savings Income Directive, designed to prevent cross-border tax evasion by individuals.[28] This is an illustrative attempt to harmonise oversight (albeit in one, individual respect) beyond the EU borders, touching upon Switzerland, something that I will return to in this thesis.[29]

These developments effectively demonstrate a pre-existing impetus towards rule

[24] Ibid, citing the conclusion of a discussion among Economy and Finance Ministers, the ECB President and Governors of National Central Banks, at informal ECOFIN meeting in Brussels in April 2002, discussing a report on Financial Integration, drawn up by a Working Group of the Economic and Financial Committee.
[25] European Commission, *The Financial Services Action Plan*, 1998, p.21-27
[26] For more detailed account of the state of affairs pre-2007 see RM Lastra, *Legal foundations of international monetary stability*, Oxford University Press, 2006, pp.324-328
[27] Directive 2001/24/EC
[28] Directive 2003/48/EC
[29] Chapters 4 and 6

harmonisation, predating the GFC. Such impetus was even more evident in the subsequent Lamfalussy report, discussed below.

c) Soft banking supervision measures

The limited attention paid to banking in the FSAP reforms is partly attributable to the existence of soft law measures and various enquiries, which created the illusion of 'something being done.' For example, following the Brouwer Report (gently indicating that the existing regulatory and supervisory structures in the EU might not be sufficient to safeguard financial stability),[30] a memorandum of understanding was agreed between the banking supervisors and central banks of the EU to that specific end - help ensure financial stability.[31] It included principles and procedures for cross-border cooperation between authorities in the event of a crisis of systemic proportions, affecting multiple States. These arrangements were further detailed by a 2005 memorandum to the same effect, also signed by the finance ministries of EU countries.[32] The memoranda concerned the identification of the authorities responsible for crisis management and cross-border information exchange. They also provided a framework for cross-border supervision infrastructure. Unfortunately, as the illusion of sincere and efficient cooperation was still prevalent, the political will to set up this (minimal) infrastructure was lacking. Moreover, even these soft law measures did not adequately address systemic risk assessment and management on pan-European level.

4. Lamfalussy Process

a) Goals and Accomplishments

A notable attempt to, *inter alia*, harmonise European financial supervision by increasing the coverage and quality of hard law instruments was the Lamfalussy process,[33] proposing a four level reform. At levels 1 and 2, the Lamfalussy process was based on the idea of differentiation between framework legislation and technical implementing measures, seeking to make the regulatory and supervisory framework more efficient, effective and

[30] H Brouwer, *Working Group of the Economic and Financial Committee, Report on financial stability, European Economy*, Economic Papers 143, May 2000. Brussels, p.32

[31] Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations 01/03/2003

[32] Memorandum of understanding on co-operation in financial crisis situations, 14/05/2005

[33] A Lamfalussy et al, *Regulation of European Securities Markets*, Final Report 15/2/2001; more information on the Lamfalussy process see EC website and D Alford, *The Lamfalussy Process and EU Bank Regulation: Another Step on the road to Pan-European Regulation?*, Annual Review of Banking and Financial Law, Vol.25:1, 2006, p.389

sufficiently flexible for market conditions of increasing integration.[34] In some (remote) sense this distribution has been adopted by the two-level SSM and SRM structures, discussed in Chapter 2. The particular focus on supervision at levels 3 and 4 of the Lamfalussy process was a significant novelty, attempting to mend the gaps left by the FSAP. Thus, the Lamfalussy reforms are said to have "laid the foundations for a network-based institutional governance system for the supervision of the EU financial system."[35] The purpose of such network was to ensure consistent transposition and application of legislation. Specifically, under the Lamfalussy process, representatives of national authorities, were brought together in EU-level committees: the Committee of European Securities Regulators (CESR), the Committee of European Insurance and Occupational Pensions Supervisors and, importantly, the Committee of European Banking Supervisors (CEBS).[36]

b) Systemic Shortcomings

In a somewhat prophetic paper called "Four Predictions about the Future of EU Securities Regulation", Hertig and Lee argued that the Lamfalussy process would not work, because of its failure to address two fundamental issues: national protectionism and bureaucratic inertia.[37] The later could also be described as 'bureaucratic sloth', as this passage from the preamble of Directive 2005/1/EC illustrates:

> *"The success of the Lamfalussy process depends more on the political will of the institutional partners [...] than on an acceleration... In addition, an overemphasis on the speed [...] could create significant problems with regard to the quality..."*[38]

Hertig and Lee also criticised the Lamfalussy process for effectively dealing with symptoms rather than causes and thereby creating preconditions for failure. That resulting failure was predicted to make increased harmonisation and some centralisation of supervision inevitable.[39] However, Hertig and Lee's paper received a mixed response. For example, Michael McKee, Executive Director, British Bankers' Association, presented opposing

[34] ECB, *Review of the Lamfalussy framework*, 2007, p.1
[35] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51:6, 2014, p.5
[36] On the committees see Ch Visscher, O Maisocq, F Varone, *The Lamfalussy reform in the EU securities markets: Fiduciary relationships, policy effectiveness, and the balance of power*, Journal of Public Policy, Vol. 28:1, 2008, p.19
[37] G Hertig, R Lee, *Four Predictions about the future of EU Securities Regulation*, 2003, pp.7-8
[38] Directive 2005/1/EC, Rec.12
[39] Hertig and Lee, 2003, p.7

conclusions.[40] The suspicion of a possible failure was present, but consensus on the magnitude, timing and likelihood was absent.

With hindsight, most Lamfalussy measures were moves in the right direction. However, they lacked firepower and operational stability, due to over-reliance on effective and sincere cooperation, reliability, and expertise of the national authorities (NCAs). The magnitude of the banking and sovereign debt crises exposed the shortcomings.[41] As Moloney observed, the "primary focus of Lamfalussy committees was regulatory and on supporting the Commission-led delegated rule-making process."[42] Moreover, while the Lamfalussy committees were designed to support supervisory co-ordination across the internal market, "they were hampered by their status as soft law actors", since they could not be empowered to adopt measures with binding effect.[43] Most importantly, the CEBS and the supervisory cooperation frameworks stemming from the Capital Requirements Directive (CRD) - the main piece of EU legislation in the banking sector at the time - were often not as effective in terms of enabling and supporting sincere cooperation and information sharing as believed. According to Avgouleas:

> "*Even regulators from (neighbouring) EU member states, who had also had established, via [CEBS], a good understanding with their counterparts, chose nevertheless, to follow a national approach when it came to dealing with distressed cross-border financial institutions, as in the Icelandic banks' and Fortis' cases*".[44]

Furthermore, as the example of Swedish bank rescue in the Baltics (discussed in Chapter 4 of this thesis) illustrates, even when the national authorities cooperated as intended and worked towards joint crises resolution, their cooperation framework had little to do with CEBS. In essence, banking - the financial sector with arguably greatest influence on the real

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[40] M McKee, *The unpredictable future of European securities regulation, A response to Four Predictions about the Future of EU Securities Regulation by Gerard Hertig & Ruben Lee*, April 2003

[41] On which see E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013; RM Lastra, *Banking union and Single Market: Conflict or companionship?*, Fordham International Law Journal, Volume 36, Issue 5, 2013, N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014

[42] Ibid. Moloney, p.5, on the role and limits of soft law institutional structures see K Alexander, E Ferran, *Can soft law bodies be effective? The special case of the European systemic risk board*, University of Cambridge Faculty of Law Research Paper No.36 2011

[43] Ibid.

[44] E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.264

economy - was not adequately covered by the reform, in terms of enforcement harmonisation and effective micro and macro prudential supervision.

Such situation stands in stark contrast with securities markets, where rules were more developed, and CESR played a bigger role in legislative development than CEBS did in banking legislation. Generally, the EU banking legislation was largely underdeveloped with only the CRD being in place, with the rest of the 'rulebook' still in its early stages. The ECB expressed concerns that CEBS was not sufficiently involved, due to unimplemented distinction between level 1 (principles) and 2 (technicalities) legislation.[45] The CRD acknowledged this differentiation only implicitly. As a result, the CEBS involvement in the drafting of most technical details was limited.[46] This is a striking issue, as it was not just the national central banks and NCAs, but also the ECB, arguably an institution with the greatest expertise in international banking in Europe, that was not meaningfully involved in the rule-making process. Reflecting on the state of affairs in 2006 Lastra wrote:

> "*decentralisation (national competence) is the principle that applies to financial supervision in Europe. The existence of a multiplicity of committees[…] cannot hide the fact that the locus of decision-making remains at the national level."*[47]

A contextually interesting (and sometimes forgotten) fact is that Lamfalussy process was not necessarily intended as a fixed and entirely permanent solution. Lamfalussy himself, as well as the other co-authors of the report understood the system's reliance on national competence and political will. The Committee recommended that its proposed regulatory structure should be reviewed, if sufficient progress was not achieved.[48] Also, if its approach 'did not have any prospect of success', a Treaty change, including 'the creation of a single EU regulatory authority for financial services was considered.[48] Following that thinking, EUROFI[49] published a report in 2002 suggesting that, to strengthen the Lamfalussy process, a European Regulatory and Supervisory System could be established.[50] It suggested that this system could use a common decision-making mechanism.[51] However, it also emphasised that

[45] ECB, *Review of the Lamfalussy framework*, 2007, p.9
[46] Ibid.
[47] RM Lastra, *Legal foundations of international monetary stability*, Oxford University Press, 2006, p.324
[48] A Lamfalussy et al, *Regulation of European Securities Markets*, Final Report 15/2/2001, pp.35, 41
[49] A high-profile think-tank, organising two annual events including policy-making representatives of multiple European and G20 states and distinguished experts.
[50] Eurofi, *The European Integrated Financial Market*, 2002, pp.24-25
[51] Ibid.

"the markets themselves should be given the freedom to develop and implement solutions."[52]

c) Lack of consensus

However, as subsequent documentation indicates, the process was assumed to be going well and meeting the targets. Just as the Lamfalussy Committee recommended, the EU institutions set up an Inter-Institutional Monitoring Group, consisting of representatives of the Council, Commission and the Parliament, to monitor the process.[53] This group – somewhat expectedly - did not include the ECB. The historically peculiar aspect is that the first Group's interim report on the operation of the Lamfalussy process drew largely positive conclusions.[54] Similar views were also prevalent in local settings and among market participants. Consistent with Lamfalussy, the Wicks Report recommended a market-risk-oriented approach, based on better implementation and enforcement of existing legislation, transparent consultations, less new legislation, and reports prepared by the market participants themselves, assessing the progress and the health of the Single Market.[55] This is a perfect example of the (then) prevalent belief in market self-regulation and industrial competence.

Lack of progress in the regulatory (especially supervisory) domain, can also be attributed to a notable lack of consensus on how the supervisory integration should look like. Lastra, for example, distinguished four different routes for European financial services centralisation that were considered: centralisation according to the model of a 'single supervisor', centralisation according to the model of 'multiple supervisors', centralisation of some supervisory functions, centralisation in one sector of the financial sector.[56] In many ways, the structures similar to the EBU or even one authority for the entire financial services sector was considered from the start, but only alongside other options. Generally, many opposed the creation of one, single European authority at the EU level on the grounds of excessive concentration of power and potential lack of accountability and transparency" and

[52] Ibid.
[53] Inter-Institutional Monitoring Group, *First Interim Report Monitoring the New Process for Regulating Securities Markets in Europe (The Lamfalussy Process)*, EC 2003
[54] Ibid.
[55] Wicks et al, *Creating a Single European Market for Financial Services: Discussion Paper produced by a working group in the City of London*, November 2002
[56] RM Lastra, *Legal foundations of international monetary stability*, Oxford University Press, 2006, p.324

said that it required "Treaty amendment and an in-depth discussion of the extent of its mandate."[57]

The Lamfalussy process was plagued by many problems, all of which have been analysed and assessed in multiple sources.[58] Many of such problems have been rectified by subsequent reforms. It remains uncertain, however, whether the lessons have truly been learned, as many of Lamfalussy era solutions re-emerge at the junctions where a consensus cannot be reached, and soft law measures and consultative bodies are employed as substitutes.

5. *De Larosière report and creation of ESFS*

The 2007-2010 financial crises painfully revealed important shortcomings in financial (most prominently – banking) supervision, on both: microprudential and macroprudential levels. The integrated and interconnected reality of European financial markets turned out to be significantly more sophisticated than the inter-institutional oversight arrangements overseeing that system. The crises exposed shortcomings in the areas of cooperation, coordination, consistent application of legislation, and trust between (and in) national supervisors. Consequently, the European Parliament instructed the Commission to fundamentally reform the supervisory structure of the Lamfalussy Committees including CEBS.[59] The Commission tasked a high-level group chaired by Jacques de Larosière to make recommendations on how to strengthen European supervisory arrangements and rebuild confidence in the financial system. In early 2009, the resulting 'de Larosière Report' on financial supervision in the EU set out a framework for a new regulatory agenda, strengthened coordinated supervision and crisis management procedures, laying the fundaments of the future EBU. The report concluded that the supervisory framework of the financial sector within the EU needed to be strengthened to reduce the risk and severity of future financial crises and highlighted the main problems that became evident.[60] The problems could be summarised as follows:

- Regulation was too micro-prudential and did not sufficiently address broader macro-prudential risks;

[57] Ibid.
[58] For a summary and literature review see E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.264
[59] European Parliament resolution 2008/2148
[60] J De Larosière, *High Level group on financial supervision*, EC 25/02/2009, Brussels

- The requirements set by prudential regulation were largely insufficient to ensure resilience;
- Lack of a systemic risk oversight body;
- Home-host supervision remained inadequate and lagged behind increasingly integrated market;
- The absence of common rules for resolving cross-border banks.

This report, notably, recommended *against* setting up supranational supervisory authorities at European level.[61] Instead, it prescribed 'far-reaching' reforms to the supervisory structure. Following these recommendation, the three European Supervisory Agencies (ESAs) were created. The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) thus formed the basis of the European System of Financial Supervision (ESFS), alongside the NCAs and the European Systemic Risk Board (ESRB).

This new architecture could be seen as a move away from Lamfalussy approach. Avgouleas comments that with this new architecture the EU effectively abolished "the last remnants of the principles of minimum harmonisation and mutual recognition in EU financial services regulation".[62] The ESAs also started playing a significant role in standard setting, which included drafting the regulatory standards. The EBA was entrusted with what came to be known as the 'Single Banking Rulebook'. Initially it was also the watchdog of consistent application of harmonised rules at the national level, but that was partly changed by the subsequent Banking Union reform.

Avgouleas argues that already at this stage "certain aspects of the supervision of cross-border groups have (implicitly) shifted from home country control to transnational supervisory structures comprising […] supervisory colleges and the new ESAs."[63] The reforms notably left out the resolution regime and institutional set-up at national level, while awaiting political, constitutional, fiscal and institutional prerequisites. Interestingly, the EBU had to smash through these obstacles, as most of these developments did not happen.

In summary, the de Larosière report could be seen as a hybrid process, the market-

[61] Ibid. para.218: "…[on] the unification of all supervisory activities for cross-border institutions at the pan-EU level, the Group considers that this matter could only be considered if there were irrefutable arguments in favour..."
[62] E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.265
[63] Ibid.

driven, playing-field-levelling approach coexisting with the early reaction to the shock of the crises. It could be seen as the start of the European Banking Union.

6. The impact of the EMU on the EBU

Even in the absence of the crises (and despite the mentioned resistance to the idea in the previous reforms) it would not be difficult to imagine an EBU-like structure, perhaps in a lighter form, eventually appearing as a natural outcome of legal, political and economic integration. Ideas for bodies that could spearhead greater cohesion in financial supervision were sprawling across Europe, with the most notable being the proposal for European Organisation for Financial Supervision, notably including a significance assessment, and elevation of the supervision of the most significant entities to European level.[64]

Arguably, the creation of the EMU put the EU on track to end up with a banking oversight consolidation reform, which further embedded the EBU in the broader narrative of EU financial integration. As Merino explained,

> *"it is the monetary relevance of the Banking Union that provides an immediate explanation to its creation. […] The implementation of monetary policy, that relies on the objective of price stability […] presupposes an economic policy founded on the obligation of budgetary stability as well as progressive convergence between the economies of Member States."*[65]

The ECB itself also saw the EBU as complementary to the EMU.[66] Barrett pointed out that the original draft plans for the EMU would have given to the ECB some regulatory and supervisory powers, and created the possibility of European-level bail-outs.[67] While this did not materialise immediately (or fully), multiple works written from both intergovernmentalist and neofunctionalist perspectives recognise the congruence between the EBU and the EMU.[68]

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[64] S Ingves, *Regulatory Challenges of Cross-Border Banking – Possible Ways Forward*, RBA Annual Conference 2007, pp.193-194, see also Chapter 4 of this thesis.
[65] A Merino, *European Banking Union, FIDE Congress Proceedings*, FIDE 2016, p.104
[66] ECB, *From Monetary Union to Banking Union, on the way to Capital Markets Union New opportunities for European integration*, 2015
[67] G Barrett, *The European Banking Union and the Economic and Monetary Union - A re-telling of Cinderella with an uncertain happy ever after?*, in Gianni Lo Schiavo (ed.), The European Banking Union and the Role of Law, Edward Elgar Publishing 2019 pp.11-12
[68] I will return to a more detailed discussion of these philosophies in section E. Notable works in both types of scholarship include: I Iaydjiev, *The Political Economy of Cross-Border Banking Regulation in Emerging*

This congruence is also evidenced by current participation levels, with only the States planning EMU accession in the near future joining the EBU. Moreover, parallels are evident in the intergovernmental power struggles between what Howarth and Quaglia described as 'follower countries' and the more influential States.[69] During the negotiations of both Unions, almost identical struggles occurred between French-led coalition of southern states, at the time facing a greater degree of instability, against the interests of German-led States facing lesser degree of instability.[70]

Most importantly, Eurozone membership results in a number of differences between the SSM and SRM participation terms available to the EMU and non-EMU States. Among those differences, explored in great detail in Chapters 2 and 3 of this thesis, we can find fundamental differentiation in terms of decision-making mechanics, voting, and withdrawal arrangements. As these terms are unfavourable to long-term EMU opt-outs, the dividing line between States participating and not participating in the EBU is essentially current or planned EMU membership. While, as I will explain in Chapter 5, it is not the only causal factor, EMU is nevertheless the most important *legal* factor. Thus, the EMU differentiation has de facto created much of the EBU differentiation. Schimmelfenning and Winzen attributed this situation to path-dependency – a boarder theory that "once the EU embarks on differentiation as a strategy to overcome heterogeneity-induced integration deadlocks, [differentiated integration] will not only harden into permanent divides among the member states, but also gain momentum."[71] In support of this conclusion Schimmelfenning analyses a number of features of the EMU and the EBU, convincingly arguing that the EBU was essentially built by the Eurozone, for the Eurozone, and the schism between participating EMU and non-EMU States has been etched into the very fabric of the legal texts. [72] A unique (and dangerous) aspect of the EBU is that in this instance the EU was unable to contain differentiated integration[73] within one policy area, which it had generally managed to achieve up to 2013.

Europe, 2004–2010, Cambridge University Press 2019; D Howarth, L Quaglia, *The Political Economy of European Banking Union*, Oxford University Press 2016, RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, RA Epstein, *When Do Foreign Banks 'cut and run'? Evidence from West European Bailouts and East European Markets*, Review of International Political Economy 21:4 2014, F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020

[69] Ibid. Howarth and Quaglia, p.10

[70] Ibid.p.23

[71] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.120

[72] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.484

[73] A term of many meanings, differentiated integration describes the basic idea of variation among states which pursue integration: some deciding to join in initiatives advancing integration of which others decide to abstain. In the context of the EBU, those latter Member States (NoPS) are not part of the institutional components of the

Therefore, a spillover has occurred from the differentiated EMU into (previously) undifferentiated financial market regulation.[74] Merino observed that "the monetary policy was designed as an exclusive competence of the Union, whereas the economic policy was designed as a mere policy of coordination between Member States." [75] Thus, the EBU joined two policy areas built on very different fundamental structures and allowed policy effects to diffuse freely across this (former) boundary.

It can therefore be argued that of all historical EU developments, the EMU had the biggest impact on the EBU. As I will explain in Chapters 2, 3 and 5, this is a major problem for the those seeking to optimise EU banking oversight.

B. How the crisis shaped the EBU

It is evident that the EBU can be seen, politically and historically speaking, as an extension of ongoing reforms broadly meant to strengthen the single market in financial services. However, the unprecedented speed, exceeding that of the previous reforms, determination to work around constitutional obstacles, alongside the fact that the EBU took a few steps further in most respects than any proposal before the crises, indicates a causal link to a trigger event; a significant and explosive one. According to Moloney the EBU was "forged in the crucible of the euro-area sovereign debt crisis."[76] Merino observed that "it was […] the sense of emergency that prompted the (r)evolution towards banking union", stemming from the Spanish crisis and insolvency of Bankia.[77] Gortsos similarly stated that the EU framework for financial regulation, supervision and oversight is a 'child of the crisis' or rather the child of two crises: the international financial crisis (2007-2009), and the fiscal crisis in the Eurozone (2010).[78]

This section firstly discusses the relationship between the EBU (including its character and goals) and the crises. Secondly, it addresses the vicious cycle between the sovereigns and banks that turned the financial crisis into the sovereign debt crisis, and was arguably the core

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EBU. See on this phenomenon A Kölliker, *Bringing Together or Driving Apart the Union: Towards a Theory of Differentiated Integration*, West European Politics, 24:4 2001, and D Leuffen, B Rittberger, F Schimmelfennig, *Differentiated Integration: Explaining Variation in the European Union*, Palgrave Macmillan 2013

[74] F Schimmelfenning, 2016, p.484

[75] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.105

[76] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1642

[77] A Merino, *European Banking Union, FIDE Congress Proceedings* 2016, p.106

[78] C Gortsos, *Crisis-based European Union Financial Regulatory Intervention: Are we on the top of the prudential wave?*, ERA Forum 16, p.89

problem the EBU sought to remedy. It further explains why this cycle has not been - fully - broken. Subsection 3 explains how the crises deepened the interdependence between the monetary policy and supervision, deepening the connection between the EMU and the EBU, shaping the later accordingly.

1. Impact of the crises on the character and goals of the EBU

As Aarma and Dubauskas observed, from the macroeconomic perspective, the decade preceding the financial crisis was an exceptionally favourable period, due to steady economic growth and low, non-volatile, inflation.[79] They further argue that "long-running successful macroeconomic situation promoted undue satisfaction with the existing trends and led to underestimation of the arising imbalances and implied risks."[80] According to Avgouleas and Arner, the build up to such combustible state started even earlier: for about fifty years industrial integration processes continued in an increasingly de-regulated market, but the regulatory standards and supervisory principles were not adjusted to such developments.[81] De-regulation in a variety of markets, lenient supervision, excessive risk-taking and over-leveraging affected banking institutions' balance sheet health.[82] That led to eventual decline in trust. The GFC, consequently, "resulted in partial disintegration of the internal market and […] caused splits along national lines of some segments of the single EU market for capital and financial services."[83] This was not only costly – it became symbolic, politically significant, and direction-defining.

The sudden shift in macroeconomic conditions during the crisis altered the (arguably ongoing) reforms' processes and spirit. While the impetus towards harmonisation and integration was by no means new, the particular shape and speed of the EBU were a result of the banking and sovereign debt crises. This is evident from four fundamental aspects of EBU origin. Firstly, the focus of the reform was on banking – the financial Trojan horse of the late 2000's. Secondly, as Moloney described it, the EBU was "a reshaping of the EU's traditional harmonization-driven liberalization-focused, and rules-based approach to financial system governance" as "an executive and institutional reform."[84] According to Tridimas, this "shift

[79] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.4
[80] Ibid.
[81] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.19
[82] See Chapter 4E for concrete examples of such processes in individual banking markets.
[83] ECB, *Financial Integration in Europe*, 2012, p.87
[84] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1612

from a rules-based approach towards executive and institutional reforms disrupts the normal direction of power flows" in the EU.[85] Given the previous unwillingness to make drastic changes, evidenced by the Lamfalussy reforms, such shift was only politically possible due to dire and far-reaching consequences of the crises. Thirdly and consequently, EBU represented a fundamental shift in terms of the Financial Stability Trilemma priorities;[86] which is only possible at major historical junctions. Fourthly, and perhaps most importantly, the EBU could be seen as a reform furthering market integration by restriction and protection, not liberalisation and playing-field levelling. It is a reform built on the narrative of a cautionary tale, atypical for the EU, which usually tries to build its ever closer union with forward-looking enthusiasm. As Moloney observed, for the "first time […] internal market construction and support have not been, at least directly, the dominant objectives of a major reform to EU financial system governance".[87] In that respect, for the first time in modern EU history, a major EU integration event adopted hindsight, not future-orientation, as the dominant perspective.

This is evident from the declared goals of the EBU. According to Baglioni, these goals can be put into three broad groups:[88]

- ✓ Achieving supervisory and resolution convergence among the European countries.
- ✓ Breaking the vicious circle between bank and sovereign risks;
- ✓ Reducing the fiscal cost of crises by establishing the requisite institutional framework;

The goals reflect the perceived causes of the banking crisis and the sovereign debt crisis respectively. Notably, the crises can also be seen as a junction point allowing the EU institutions pursue their agenda, by forcing through changes that were previously perceived as too grand, costly or politically contentious. Epstein and Rhodes took neofunctionalist view and concluded that "Europe's supranational institutions have taken advantage of the crisis to push through reforms that fundamentally contradict the perceived interests of many

[85] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.46

[86] A trilemma between national autonomy, integrated markets and financial stability, discussed in detail in section C.

[87] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1611

[88] A Baglioni, *The European Banking Union*, Palgrave Macmillan, 2016, p.7. See pp.7-29 for detailed discussion.

member states."[89] They specifically highlight the fact that the Commission and the ECB have managed to limit the impact of German national interests, securing assent to controversial measures.[90] It could be argued that technocratic neofunctionalist agenda needed more political firepower borrowed from the intergovernmental level, which was only possible since the governments themselves felt threatened by the sovereign debt crisis.[91] Such reasoning reflects the complexity of the dual nature of the Banking Union: simultaneously flowing from historical tendencies of further integration and also ground-breaking, in its swiftness and magnitude. This coexistence of intergovernmental retrospectivity and neofunctionalist future orientation created conflicting tensions, to which I will return in section C of this Chapter.

2. *De-linking sovereigns and banks*

The national governments felt the urgency to act since the crises showed "Europe's banks and national governments to be locked in a vicious cycle with weak banks dragging down governments, while weak governments [were] dragging down their nations' banks."[92] As was stated by the House of Lords European Union Committee, the "fundamental problem […] was the systemic link between struggling banks and an indebted sovereign state."[93]

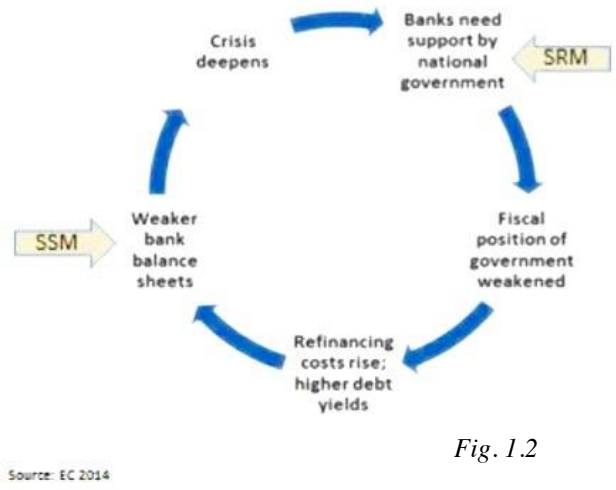

Fig. 1.2

Merino further highlights "a clear connection between the triad of banking, public budget and monetary policy. […] Member States are vulnerable to their banks; banks are vulnerable to their Member States."[94] Therefore, according to Grundmann, the foremost aim of creating a European Banking Union was to break the link between state budgets (funds)

[89] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.6
[90] Ibid. p.3
[91] For discussion of the interplay between neofunctionalism and intergovernmentalism in the EBU see section C of this chapter.
[92] P Coy, *A Way to Break Out of Europe's 'Doom Loop'*, Bloomberg 26/06/2012
[93] House of Lords EU Committee, 25th report, HL260, paras.21–3
[94] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.105

and bank funds […] which proved to be a vicious spiral in the financial and then the Euro crisis."[95]

The liquidity shortage, decline in trust and resulting risk aversion during the GFC naturally increased credit institution funding costs. That increased the borrowing costs for the States, within which these credit institutions operate. That increased the cost of sovereign and interbank lending, as investors lost confidence and government bonds started shedding value. That caused a sovereign debt crisis in multiple Member States and (in some sense) the Eurozone as a whole. The banking crisis and the sovereign debt crisis effectively aggravated each other. Under such conditions any attempts to restore fiscal sustainability felt increasingly futile. This in turn undermined trust even further, and increased fragmentation in the EU banking market, even along the borders of Eurozone States.

Moreover, some actions that the banks and States resorted to in the run up to the crisis and during its outbreak made matters worse. Merino pointed out situations where banks were "exposed to the creditworthiness of their governments, on account of substantial amount of public debt of their own country that they hold."[96] Such relationship magnifies the effects of the downward spiral: the more troubled the state, the more likely it is to have to pressure and incentivise its banks to purchase its debt. The banks do not have the luxury to resist such pressures, since during a systemic crisis reliable debt instruments are scarce. That aggravates the two factors that are harming both parties: the states become increasingly dependent on domestic bank funding and the banks become increasingly exposed to their troubled states. At the peak of the sovereign debt crisis, around 70% of all EU government bonds were held by domestic banks, with the numbers reaching staggering 99% in Greece and more than 90% in many other troubled economies.[97] The creditworthiness problems of these States effectively caused divergence in bank funding and lending conditions at national levels. Moreover, the panic in government bond markets broke the monetary policy transmission channels. It created a self-fulfilling crisis, in which countries whose debt outlook in other circumstances was perfectly sustainable were threatened.[98] It is clearly evident from the language and the agenda of all post-crisis EU banking legislation that the EBU was built with these threats in mind.[99]

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[95] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Bloomsbury 2019, p.106
[96] Ibid.
[97] Ibid.
[98] H Van Rompuy, *Speech at the Brussels Economic Forum*, 10 June 2014
[99] E.g. Rec.6 SSMR

In 2012 the ECB suggested that the SSM should contribute to restoring confidence in the banking sector and to reviving interbank lending and cross-border credit flows through independent, integrated supervision.[100] This was carried into the EBU legislative proposals. The objective[101] was to restore "confidence in the financial markets as confidence […was] badly affected after the crisis that in a first stage caused huge losses in the banking sector […and] in a second stage [undermined] confidence in sovereign debtors, creating a negative loopback to the banking sector."[102] From the supervisory perspective, a single supervisor was expected (not unduly, as it turned out) to rebuild depositor and investor confidence, as it was less likely to be suspected of national bias and supervisory forbearance.[103] Pre-GFC supervisors were often lenient towards the so called 'national champions', largest domestic institutions with lots of influence, as the supervisors were often constrained by their mandates or by other national pressures.[104] Moreover, the banking crisis revealed a degree of cynicism (mixed with national interests) of the national regulators, which manifested in actions like siding with troubled banks in hiding information from the public, delaying loss recognition, postponing corrective action and consequently magnifying losses.[105] As Grundman observed, the resulting "negative external effects on the (common) currency caused by supervisory failure were so disastrous that […] any other solution than centralisation seemed unconceivable."[106] Centralising supervision was expected to minimise supervisory forbearance and counter the causes of market fragmentation. It was also promised that a European supervisor would not insist on national asset and liability matching, which can increase fragmentation.[107] Effective supranational resolution regime, in turn, allows for timely and effective bank resolutions, uninhibited by national interests. Thus, SRM also had a role to play in breaking the doom loop: it limited rising funding costs and thus the risk of

[100] ECB, Opinion on the SSM proposal, 27 Oct. 2012 (COM(2012)96), para.2
[101] First formulated in this wording in proposed regulation on the SSM, Com (2012) 511) and the proposed regulation amending the EBA regulation (Com (2012) 512) and carried into the final texts of SSMR, EBAR and SSMFR.
[102] EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.2
[103] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.11
[104] See Chapter 4(D) for examples
[105] J Carmassi, C Di Noia, S Micossi, *Banking Union in the Eurozone and the European Union*, CEPS 2012 p.6
[106] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Bloomsbury 2019, p.106
[107] Y Mersch, speech, *Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis*, 2013

bank bail-outs by national governments, as it became more common to resolve banks rather than save them.[108]

Generally, one of the major achievements of the EBU is that sovereign influence has been limited, at least in the Eurozone. However, it has not been *eliminated*. It is important to note that the SSM and SRM, are equipped with tools to prevent a banking crisis spiralling out of control, but not necessarily prevent the crisis *as such*. Purfield and Rosenberg observed that some of the key drivers in the pre-crisis bubble were (historically speaking) bank lending and a corresponding acceleration of domestic demand. [109] Prudential regulation, in itself does not guarantee responsible lending, nor do counter-cyclical buffers safeguard against macroeconomic bubbles, which, on a side note, makes post-GFC and Covid-19 monetary, credit, and fiscal policy very concerning.

Moreover, there are limits to what supervision and resolution can do in a politically charged, structurally difficult landscape shaped by differentiated integration, as well as national and commercial interests. Problems stemming from limited institutional and geographical scope are aggravated by incomplete structures and missing components.

The absence of a European Deposit Insurance Scheme (EDIS), which would join all national deposit schemes together, and which was originally included in the EBU plans, arguably limits what the SSM and SRM can achieve in terms of breaking the vicious cycle in crisis situations. Huertas sees the (not-yet-built) EDIS and the (already built) SSM/SRM as two distinct, separate and equally important, parts of the equation. The SSM is supposed to reduce the probability that banks will fail and the SRM is meant to reduce the bail-out likelihood.[110] However, he argues that the mentioned dependence of banks on governments has not been sufficiently reduced.[111] In addition to the mentioned government debt that the banks hold, banks are disproportionately exposed to governments, in terms of credit and 'climate'.[112] Neither the SSM nor the SRM can solve the problems caused by the fact that national governments shape the legal and economic environment.

Sovereign risk thus remains a factor. As the Greek Bailout Referendum demonstrated, there is a risk that the government of a Eurozone State would change the currency in which the depositors' accounts is denominated. Huertas argued that in such cases EDIS could

[108] Ibid.
[109] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.4
[110] TF Huertas, *Banking Union: The Way Forward*, 2015, pp.1-2 also in David Mayes, Geoffrey E. Wood and Juan Castaneda, (eds.) *European Banking Union: Challenges and Prospects*, Routledge 2016
[111] Ibid.
[112] Ibid.

ensure that a Euro deposit in one Member State is as good as a Euro deposit in any other Member State.[113] Obviously, such goal could also be partially achieved through fiscal harmonisation, but that is not on the cards. Even the fiscal backstop for resolution has not been agreed upon.[114]

Guaranteeing against sovereign risk, or at least mitigating it, is even more difficult with States outside of the Eurozone, joining via Close Cooperation, discussed in Chapter 3. On the other hand, non-participation of the NoPS increases other risks, including those of systemic proportions.[115] Such risks partly stem from the fact that with the SSM and SRM being absent in the NoPS, the effects of legislation and arrangements seeking to delink the sovereigns and banks are weaker.

3. Differentiation, the Crisis, and the EMU

As discussed in section A, it is clear that a historical and jurisdictional link exists between the EMU and the EBU. It could also be seen as a triangular relationship between the crises, the EBU and the EMU. Tridimas observed that "the origins of the Banking Union lie [in] the Eurozone crisis which undermined financial stability in the Eurozone and posed an existentialist threat to EMU."[116] Merino thus concluded that even the very existence of the EMU was threatened by both: the budgetary distress of States and evident instability of the banking system, which serves "as conduit of monetary policy to the real economy".[117]

The EBU's relationship with the EMU is thus twofold. On the one hand, the interconnectedness between the two Unions exposed the EBU to differentiated integration – largely a by-product of the EMU. On the other hand, the experience of the crises that threatened the EMU, provided the narrative the EBU was shaped by, and chained that narrative to the goal of protecting the EMU. Quite possibly, the EBU and its supervisory and resolution bodies would have been shaped differently, under different circumstances.

The need to protect the EMU inevitably resulted in the EBU being primarily *for* the EMU. Micklitz argued that the ECB's Outright Monetary Transactions program, primarily designed to save the Eurozone, required political legitimisation in the form of the EBU.[118]

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[113] Ibid.
[114] See Chapter 2 of this thesis
[115] as discussed in Chapter 4
[116] T Tridimas, *European Banking Union, FIDE Congress Proceedings*, 2016, p.60
[117] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.105
[118] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.272

Reportedly, the States approved such an extensive bond purchase programme precisely because the Single Resolution Fund and the Single Supervisor were put in place to ensure that future bail-outs and recapitalisations of the banking sector could be avoided.[119]

As a consequence, the EBU was simultaneously built on a fragmented footing and placed in a position of a 'wedge', where it could easily deepen that fragmentation. Merino sees the EBU as a construct of dual nature, "a two-sided construction, with a foot in the internal market and another one in the monetary union." [120] The internal market foot continues to follow the path of pre-crisis reforms, albeit at significantly greater pace and with a more distant destination. The EMU foot, however, was given a new function – to *preserve* and *safeguard* the EMU. Unfortunately, placing two feet on two distinct uneven surfaces, moving at different speeds, is not a comfortable way to stand, be it move forward. As will become evident throughout this thesis, the elements aimed at the Single Market can be threatened or stifled by differentiation, while the elements aimed at the Eurozone are deepening differentiation, which, at its extreme, can result in fragmentation. It is therefore in the deep interest of the EU, the Eurozone and the Single Market to ensure that banking supervision and resolution differentiation is curbed before it reaches the level of irreversible fragmentation. That interest is not necessarily shared by the NoPS.

C. Theoretical conceptualisations and (ir)reversible choices of the EBU

The differences in EBU participation levels and conditions are, of course, not a result of an intellectual consensus to deliberately opt for such differences. They rest upon a long history of differentiated integration and national differences between the Member States. This has resulted in the so called graded membership, which, according to Schimmelfennig and Winzen, "emerges from a sequence of decisions on the deepening and widening of an organization." [121] Typically, differentiation and graded membership is not what is intended by the proposal for deeper integration - it comes up as a (sub-optimal) option during the negotiations or after their failure.[122] In EU integration processes, this outcome is often linked to one of the two things: 1) fundamental ideational disagreement between parties, driven by their own self-interest, agendas, and philosophies or 2) lack of agreement on the potential

[119] Ibid.p.273
[120] Ibid.
[121] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.157
[122] Ibid.

sacrifices, when the need to make such sacrifices emerges due to the traditional conflict between centralising reforms and national autonomy.

This section thus discusses the main conceptualisations of such schisms and the constitutional and economic law theories trying to explain them. Subsection 1 discusses the classic philosophies of EU integration analysis, and lays the foundations for assessing the EBU in their context later in this work. Subsection 2 discusses the theories analysing the relationships between mutually exclusive factors, framing the choices the EU States have to make in terms of the EBU. Subsection 3 provides the core considerations for assessing the significance of the EBU and its ability to affect future EU legal, economic, constitutional and political development.

1. Theories of EU integration

Much like most EU reforms pursuing deeper integration, the EBU can be seen through the lenses of two main integration theories: neofunctionalism and intergovernmentalism. With different actors pursuing their agendas, driven by different philosophies, the resulting tensions deepen fragmentation in the EU, as differentiation spills over from the legal and economic domains, into geopolitics and EU constitutionalism.

a) Neofunctionalism

Neofunctionalism,[123] generally holds that political and economic integration in Europe tends to deepen over time, driven by Union institutions seeking to simultaneously achieve the best possible outcomes for the EU as a whole and to consolidate their own power. In the banking context, this theory tends to highlight a struggle between the EU and national interests, in which the former typically prevails.[124] When it only prevails in some States, but not others, centripetal, fragmentation-deepening, effects can be generated, contributing to differentiated integration, graded membership, and path-dependency. At its very dawn, Ernst B. Hass's theory anticipated a gradual decline of the national element of the EU in favour of greater integration at the supranational level.[125] He expected policy spill-overs between areas

[123] Originally: EB Haas, *The Uniting of Europe: Political, Social and Economic Forces, 1950–57*, University of Notre Dame Press 1958
[124] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.6
[125] Haas 1958, pp.319-324

(particularly in economy), gradual transfer of domestic allegiances, and technocratic automaticity to propel this process forward with increasing intensity.[126]

At least two out of these three processes, namely technocratic automaticity (and the general rise of technocracy), and the spill-overs can be identified in the EBU developments. They are blatantly obvious in a variety of aspects ranging from the rationale for the EBU and market integration in general, to the very mechanics of the functioning of the institutional EBU pillars.

Sandholtz and Stone Sweet posited that "in policy areas where the number and value of cross-border transactions rose, so did the supply of EU-level rules."[127] This was the case with the EU banking markets integration leading up to the EBU, as is evidenced by the events described in Section A. According to the neofunctionalist theory, these legal developments are preceded by a broader consensus that separate national legal regimes hinder effective cross-border financial interactions.[128] Again, this tendency is reflected in the rhetoric of the legislation shaping the EBU.

Following the neofunctionalist line of reasoning further, upon embarking on the reforms to facilitate cross-border trade (and also to oversee it), the EU and the Member States generally need to introduce some level of autonomous supranational control.[129] As a consequence, some level of control, previously held by the States, needs to be surrendered to these supranational bodies. The more operational efficiency is desired, the more autonomous the supranational institutions need to become. In that respect neofunctionalism "accounts for the migration of rule-making authority from national governments to the European Union."[130] This theorisation basically describes the elevation of decision-making (SSM, SRM) and even rule-making capacity (ECB, EBA), to the European level, mostly facilitated by the EBU. I will provide further evidence of this in Chapter 2.

When the EU bodies exercise their autonomy, their agenda can diverge from the perceived best interests of at least some States. In fact, as a matter of neofunctionalist theory, supranational governance routinely produces outcomes that conflict with the preferences of

[126] Ibid. pp.291-292
[127] W Sandholtz, A Stone Sweet, *Neofunctionalism and Supranational Governance*, Oxford University Press 2010, p.11
[128] Ibid.pp.10-11
[129] P Pierson, *The Path to European Integration: A Historical Institutionalist Perspective*, Comparative Political Studies, 1996, p.130
[130] W Sandholtz, A Stone Sweet, *Neofunctionalism and Supranational Governance*, Oxford University Press 2010, p.5

the most powerful states.[131] Epstein and Rhodes argued this to be the case in the specific case of the EBU.[132] A number of unintentional factors can contribute to this divergence, including overload and spill-over resulting from high issue density and complexity, or systemic crises, requiring a swift action.[133] In the EBU context such factors were 'supplied' by the crises, thus allowing neofunctionalist agenda to take hold.

Under this theory, resulting consolidation of powers tends to be accompanied by a spill-over, when EU actors realise that the objectives of supranational policies can be better achieved by extending supranational policy-making to additional, functionally related domains.[134] These spill-overs can be economic and/or political and happen from previous stage of integration into a new one, or from one policy area into another.[135] As mentioned, this phenomenon has been observed in the EBU, as a spill-over from monetary policy into financial market regulation.[136] This could be attributed to the symbiosis between the EMU and the EBU, but such symbiosis in its own right is argued to be a sign of path dependency and thus a part of the neofunctionalist narrative.

The neofunctionalist theory would indicate that the European courts then tend to uphold this adjusted power balance, which favours supranationalism. As I will illustrate in Chapter 2, this has particularly been the case in the SSM context, but also in EU financial regulation in general. National courts, notably, do not necessarily share the same sentiment.

This is linked to possible push back on behalf of Member States. Under such circumstances "institutional reversal – an unwinding of supranational rules – is possible but difficult."[137] In principle, States' governments could correct the divergences, as the high contracting parties of the Treaties. Such correction would, however, require consensus, as Treaty changes require unanimity. Even standard legislative reforms generally need substantial qualitative majorities. Moreover, as Schimmelfenning noted, "by the time the member state governments consider policy reversal, the integrated policy may already have

[131] Ibid. p.19
[132] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.6
[133] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.486
[134] Sandholtz and Stone Sweet, 2010, p.8
[135] D Howarth, L Quaglia, *The political economy of European Banking Union*, Oxford University Press 2016, p.9
[136] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.105 and Schimmelfenning, 2016, p.484
[137] Sandholtz and Stone Sweet, 2010, p.17

created endogenous interdependence as well as sunk costs and exit costs." [138] Such costs are explored in more detail in Chapter 3. Furthermore, by that point the supranational structure is, in all likelihood, already shaping interest groups among the Member States. That usually happens by deepening the interdependences of the actors participating in the integrated policy, and resulting (sometimes unintentional) solidarity emerging among those not participating in the integrated policy.

Rosamond argued that as a consequence of such interdependencies in core economic policy areas and their spill-overs, deeper political integration might become inevitable.[139] The problem with the EBU and EMU is, that they constitute an additional interdependency between the participating States, but not one that would cover the entire single market. Hence the danger of further differentiation along the lines of participation, which would be in line with the path dependency hypothesis, discussed hereinafter. In such case the EMU and EBU differentiation would continue to spill over into the political domain.

Of course, neofunctionalism does not explain all the aspects of the EBU, while the EBU events do not necessarily reflect all the elements of this theory. For example, neofunctionalism predicts that interest groups and market participants would transfer their allegiances away from national institutions, towards the supranational European institutions. While some institutions intentionally moved to participating States (e.g. Nordea), many other banks (e.g. L-Bank) fight tooth and nail to stay *with* the national authorities, which is reported to be the main tendency.[140] Moreover, the States forming part of the EBU often try to resist the Commission's and the ECB's (perceived) neofunctionalist agenda on the legal and political levels.

b) Intergovernmentalism

It is therefore reasonable to look for some explanations in the theory of intergovernmentalism. Intergovernmentalism rests on the idea that integration necessitated by cross-border activity is primarily shaped by national governments, which create European rules.[141] The key feature of this principle "is the focus on national interests and the decision-

[138] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.486
[139] B Rosamond, *The uniting of Europe and the foundation of EU studies: revisiting the neofunctionalism of Ernst B. Haas*, Journal of European Public Policy 12:2, 2005, p.245
[140] See K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.2
[141] A Moravcsik, *Liberal Intergovernmentalism and Integration: A Rejoinder*, Journal of Common Market Studies, 1995, pp.616, 621

making power of national governments negotiating."[142] In furtherance of this theory Moravcsik argued that EU integration should be understood as a series of choices made by national leaders, and that these choices are *inter alia* driven by economic interests and asymmetrical interdependence.[143]

Where Member States fail to negotiate a consensus, or where national interests are too different, rifts can occur. That forms the crux of the intergovernmentalist explanation for differentiated integration and consequent graded membership. According to this theory, in the banking context States are also expected to pursue policies that benefit their domestic financial sector.[144] Partly for assessing the validity of this hypothesis, a banking-sector-structural-characteristics-based research has emerged in the scholarly field of political economy. It is particularly attractive due to quantitative simplicity of relevant indicators. Chapter 5 of this thesis provides an analysis based on this methodology. My research, in this field confirms that the States have not abandoned their national positions, which continue to play a part in decision-making process. There are even signs of a pushback against perceived power creep of the SSM and ECB in particular, in the form of seeking to exclude certain entities from its domain, through political pressure and legislative acts. Moreover, Howarth and Quaglia provide an account, partly based on intergovernmentalist theorisation, of how both the EMU and the EBU were shaped by outright power struggles between groups of States with conflicting economic interests.[145]

With many aspects of the EBU fitting within this theory there are also many that do not. Firstly, the intergovernmentalist explanation has been criticised for failing to account for the events following the reform in question.[146] Particularly, intergovernmentalists are sceptical about many neofunctionalist paradigms, including the spill-over argument, which, while its magnitude and importance can be debated, is (at least in the EBU context) basically a historical fact. Moreover, they disagree with the fundamental idea that EU bodies, in their own right, can have political influence exceeding that of individual States. As my analysis of the ECB in Chapters 2 and 3 indicates, that does not withstand empirical scrutiny.

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[142] D Howarth, L Quaglia, *The Political Economy of European Banking Union*, Oxford University Press 2016, p.10
[143] A Moravcsik, *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht*, Routledge 1998, p.18
[144] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.132
[145] D Howarth, L Quaglia, *The Political Economy of European Banking Union*, Oxford University Press 2016, p.10, 23
[146] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.486

c) *Standpoints, not explanations*

Neither neofunctionalism, nor intergovernmentalism can fully explain the EBU. Alternative theories seem to have even less of an explanatory value, at least within the confines of this chapter. Two additional theories – constructivism and federalism – can also be discussed in this context. Constructivism is rooted in the "explanatory power assigned to ideas or 'policy paradigms', defined as a set of causal beliefs concerning a certain policy area, rather than material (mostly economic) interests."[147] Due to its largely unempirical and 'uneconomic' character, constructivism is notably not the best theory for the analysis of the EBU, within the framework of this thesis. Its further exploration would, notably, be an interesting strand for further qualitative research on the subject. By contrast, the theories of European federalism and federalisation[148] are sometimes applied to the EBU.[149] However, they are more useful in explaining the power dynamics *within* the institutional components of the EBU, than the choices made in the EBU's creation or subsequent accession decisions made by the NoPS. I will return to these theories in Section E of Chapter 2.

It appears that while integration theories do not present an explanation for the EBU in its entirety, they do explain the ideational positions the States and the EU proceed *from*. Such positions create conflicts, where different philosophies render different conclusions on the optimal course of action or desired limits to the powers of supranational institutions. Tridimas lists a number of constitutional tensions appearing in the EBU, with two of them being of particular importance here. Namely, ones between "technocracy and politicisation" and between "Economic and Monetary Union (EMU) and the internal market."[150]

These tensions suggest a narrative in which neofunctionalism and intergovernmentalism are not explaining the EBU integration, but rather shaping it. The EU institutions can be argued to pursue neofunctionalist agenda, seeking to amass power necessary (or thought to be necessary) to achieve the goals of the EBU, as well as broader market integration. However, due to their inability to eliminate fragmentation and national

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[147] Howarth and Quaglia, 2016, p.10

[148] See A Mills, *Federalism in the European Union and the United States: Subsidiarity, Private Law and the Conflict of Laws*, University of Pennsylvania Journal of International Law, Vol.32, No.2, 2011; R Schütze, *From Dual To Cooperative Federalism: The Changing Structure of European Law*, Oxford University Press 2009

[149] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012; T Tridimas, *EU Financial Regulation: From Harmonisation to the Birth of EU Federal Financial Law*, EUI 2010, pp.3, 5-9, 16 implying that even the creation of the EBA could be seen as a sign of federalisation of EU financial law

[150] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.27

autonomy, they cannot control the wild card – national interests. In the absence of a mechanism that would compel or push the NoPS to participate, their politico-economic interests take hold. Such interests can diverge from the EU's interests. The NoPS therefore behave in an entirely intergovernmentalist fashion towards the EBU and the EMU, basing their decisions on primarily national interests.

This interplay has given rise to the so called realist philosophy, blending the elements of intergovernmentalism and neofunctionalism. It is argued that despite the neofunctionalist push from EU institutions, the magnitude of the change brought by the EBU was reduced by national interests.[151] Donnelly recounts that many member states like Germany, Finland, and the Netherlands insisted on institutionally reinforcing national autonomy and other States "accepted these demands as the price for modest increases in emergency loans that stave off collapse."[152] He argues that "stronger countries will successfully upload their preferences at the expense of other national preferences, and that the obligation on national governments to implement those standards remains weakly institutionalized in deference to the principle of national sovereignty."[153] In contrast to Donnelly, the findings of Epstein and Rhodes can be presented, who argued that, firstly, there was no internal 'German consensus' on the EBU and, secondly, that despite some notable attempts, Germany was unable to dictate the terms of a 'consensus' to other Eurozone countries or EU institutions, and only achieved *some* of the changes it advocated.[154] The same could be said for some NoPS, like Poland and Denmark, who could not get what they wanted in the EBU negotiations, and thus opted out.

It could then be argued that neofunctionalist agenda becomes dominant, as it is shared not just by EU institutions, but also a number of States. That effectively weakens the position of predominantly intergovernmentalist States, which are more cautious about the EBU and particularly the ECB's powers within it. From the perspective of the Single Market, this is dangerous. It creates a plethora of internal tensions. That effectively 'sharpens' the edges of the participation decision for the NoPS, and forces them into clearly defined, distinct choices, which can increase path-dependency.

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[151] S Donnelly, *Power Politics and the Undersupply of Financial Stability in Europe*, Review of International Political Economy 21:4 2014, p.981
[152] Ibid.
[153] Ibid. p.985
[154] RA Epstein, M Rhodes, *The political dynamics behind Europe's new banking union*, West European Politics, 39:3, 2016, pp.418, 423

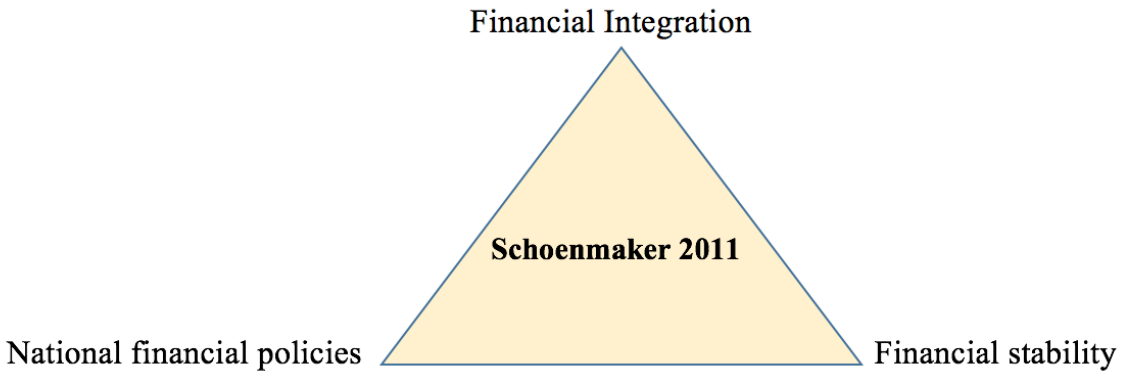
2. *The financial stability trilemma and path-dependency*

A detailed picture of the consequences of such sharp and distinct choices can be revealed by adopting a dynamic framework, which reflects the continuous attempts to balance conflicting pressures and priorities. I thus explore several frameworks particularly fitting for (or previously applied to) international banking.

a) The Financial Stability Trilemma

The first conceptualisation employed for my analysis is the Financial Stability Trilemma (FST). Dirk Schoenmaker's hypothesis holds that financial stability, financial integration and national financial policies form a trilemma.[155] Any two of the three objectives can be compatible, but not all three.[156] As he further elaborated, "the trilemma boils down to the issue of sovereignty. At one extreme, policy makers can hand over part of their sovereignty to foster global banking and global financial stability. At the other extreme, policy-makers can choose to impose restrictions on cross-border banking to preserve their full sovereignty."[157]

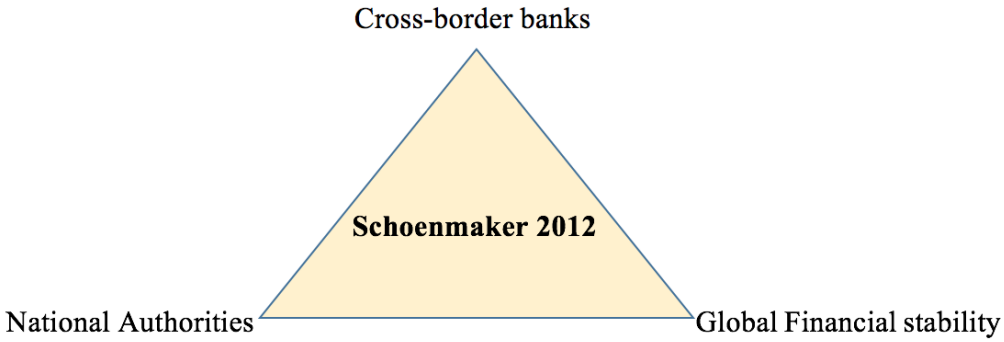
Fig.1.3 The Financial Stability Trilemma, Schoenmaker 2011, retextured original visualisation



Schoenmaker subsequently applied the trilemma to international banking, from the global macroeconomic perspective:[158]

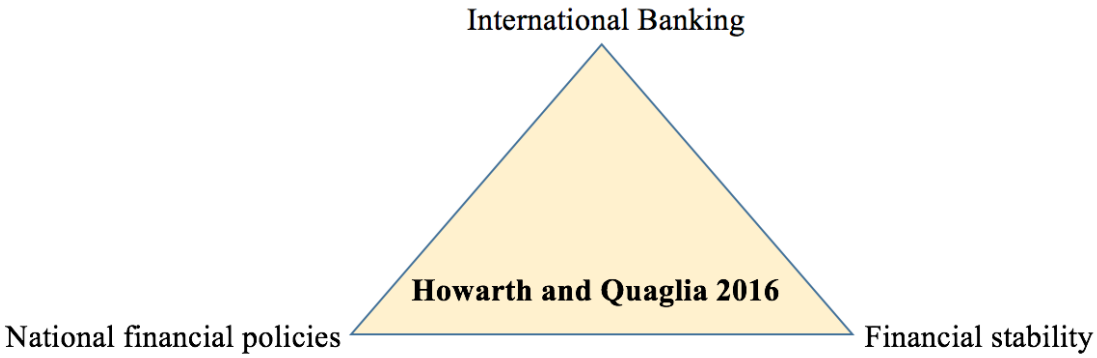
[155] See D Schoenmaker, *The financial trilemma*, Economics Letters 111:1 2011, pp.57–59
[156] Ibid.
[157] D Schoenmaker, *Banking Supervision and Resolution: The European Dimension*, Law and Financial Markets Review Vol.6 2012, p.5
[158] Ibid.

Fig.1.4 The Financial Stability Trilemma in International Banking, Schoenmaker 2012, visualisation is mine



Howarth and Quaglia adjusted the trilemma for the analysis of national perspectives on international banking, to include the components of financial stability, international banking, and national financial policies.[159]

Fig.1.5 International Banking Trilemma, Howarth and Quaglia 2016, visualisation is mine



While this theory is attractively simple, an important question needs to be answered: would prioritising international banking and financial stability really mean the sacrifice of national financial policies (Howarth and Quaglia) or national authorities (Schoenmaker)? The question boils down to whether the country joining the SSM and SRM would actually suffer a major loss of autonomy in bank supervision, resolution, and banking policies in general. There seems to be a degree of consensus that it would. Epstein and Rhodes argued that the creation of common SSM amounts to a significant loss of national control over credit institutions.[160] De Rynck observed that "centralizing supervision and harmonizing standards

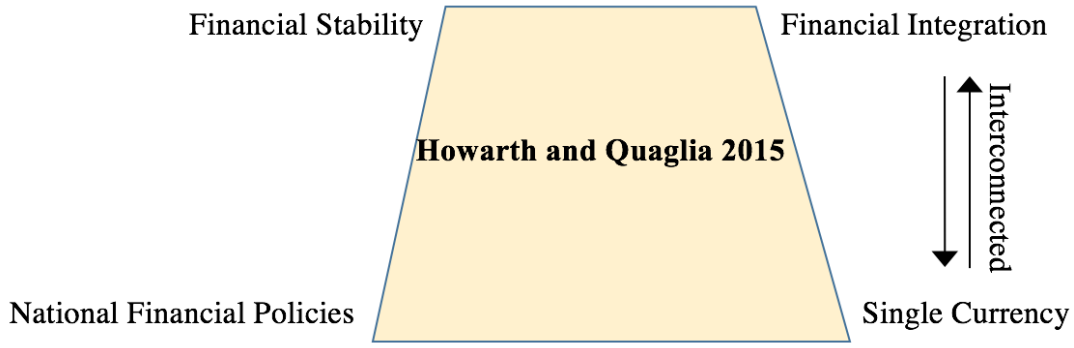
[159] D Howarth, L Quaglia, *The Political Economy of European Banking Union*, Oxford University Press 2016, p.18

[160] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking*

are a rupture with the past", which introduces a novel policy model. [161] Moloney concluded that the NCAs operate within a legal infrastructure which privileges the position of the ECB and thus "the loss of control by the Member States […] is real."[162] Binder and Gortsos therefore described the EBU as the most significant step towards financial integration in Europe since the creation of the Monetary Union".[163] Merino argued that by joining the SSM and the SRM participating States transfer responsibilities and powers to the European bodies to the extent *comparable to* the EMU, not just *complementing* it.[164] In depth analysis of the technical aspects of the SSM, SRM and the mechanics of opting-in, which I will conduct throughout this thesis, confirms these conclusions. If participation constitutes a significant transfer of power, it also constitutes a clear choice within the confines of the Trilemma. The choice of financial stability and financial integration *over* national policies.

For the NoPS the SSM/SRM constitute a choice rather than a necessity, and that is because of their non-participation in the EMU. By contrast, as Howarth and Quaglia argued, the Eurozone States faced the 'financial inconsistent quartet' (Fig.1.6), struggling to simultaneously manage financial stability, financial integration, national financial policies, *and* the single currency.[165]

Fig.1.6 Financial Inconsistent Quartet, Howarth and Quaglia 2015, visualisation is mine



Simplistically, for an EMU State, sacrificing financial integration is not an option, since it uses the Single Currency, which exposes it to the broader financial health of the Eurozone.

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union, KFG 2014, and D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015

[161] S DeRyck, *Banking on the Union: the Politics of Changing Eurozone Supervision*, Journal of European Public Policy 23:1 2016, p.120

[162] Ibid.

[163] JH Binder, Ch Gortsos, *European Banking Union: A Compendium*, CH Beck, Nomos, Hart 2016, p.V

[164] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.105

[165] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.3

Trying to 'disconnect' their banking system would thus be painful and possibly futile. Since sacrificing financial stability is not an appealing prospect, national financial policies meet the sacrificial knife. Howarth and Quaglia reasoned that the NoPS do not face the inconsistent quartet and thus all that they are wrestling with is the Trilemma, which leaves them the (limited) flexibility to make any choice within its confines.

b) The Path Dependency Hypothesis

Since the NoPS retain their ability to choose, it is important to understand where different choices can take them, and how that affects the EU as a whole. For that purpose I adopted Schimmelfenning's path-dependency hypothesis. [166] Simplistically, the hypothesis holds that previous integration choices dictate future choices in interconnected policy areas. Therefore, it is believed that differentiation adopted as a strategy to overcome heterogeneity-induced integration deadlocks, hardens into permanent divides among the Member States, which in turn condition future differentiation.[167] Schimmelfenning argued that the EBU "was designed to meet the deficits" of the Eurozone and thus "its institutional setup reinforced the original reasons why Non-Eurozone states decided to abstain from the euro area." [168] As a result, the Banking Union "not only reaffirms the original differentiation" but also "widens the institutional gap between the euro area and the rest of the EU". [169] The crisis event can thus be seen as an acceleration or an amplification of the path-dependent differentiation outside of the EMU and path-dependent (albeit sometimes reluctant) integration within it. Fabbrini and Guidi observed that while the "crisis opened a critical juncture where it was possible to redefine the institutional and policy features of the EU, its dramatic and accelerated impact has ended up reinforcing the path-dependent logic generated by the previous constitutional settlement."[170]

Schimmelfennig and Winzen listed the following reasons why these processes are likely to continue:[171]

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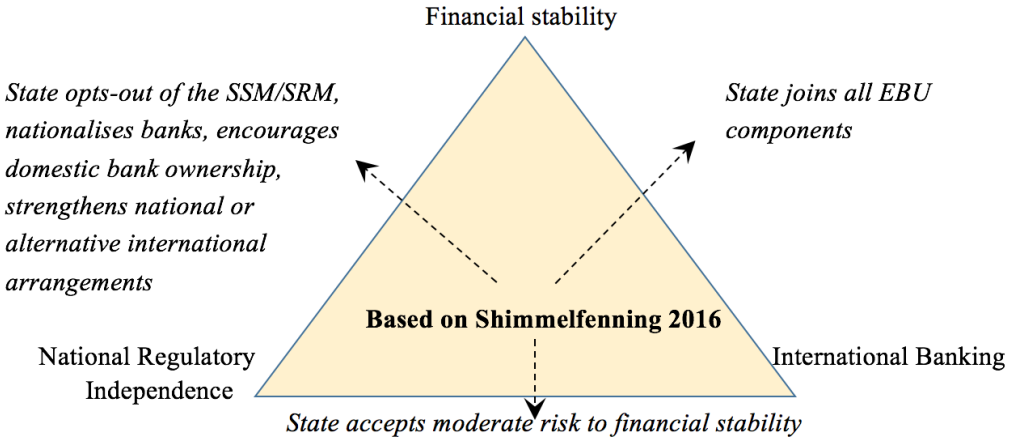
[166] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.492
[167] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.120
[168] Ibid.
[169] Ibid.
[170] S Fabbrini, M Guidi, *The European Banking Union: A Case of Tempered Supranationalism?* In S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.237-238
[171] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.121

- Removal of the most Eurosceptic states from the most advanced integration schemes and consequent circumvention of their veto on future integration decisions;
- Support for normative legitimacy of future differentiation;
- Weakened supranational actors tasked with uniform integration (e.g. the EBA) and strengthening of supranational actors created by the insider group (e.g. SRB, ECB Governing Council);
- Reinforced endogenous interdependence among the most integrated states,
- Facilitation of future agreement on more integration among the insiders, thereby widening the gap between insiders and outsiders and making it increasingly difficult to catch up.

They conclude that the increasing distance between the EU's 'core' and 'periphery' is evident from recent treaties and legislation. [172] As my political economy research in Chapter 5 reveals, this phenomenon is further evidenced by the arrangements made by the most reluctant NoPS, to mitigate the dangers and difficulties presented by non-participation.

If this hypothesis is correct, the NoPS with no plans to join the EMU will naturally diverge further away from it, as well as the EBU. Those States which intend to eventually adopt the Single Currency, should then opt to join the EBU, seeking to avoid further divergence. To illustrate this theorisation, I merged the path dependency hypothesis and the financial stability trilemma into a single illustration in Fig.1.7.

Fig.1.7. Path dependency and the financial trilemma



[172] Ibid. p.121

It is highly likely that the choices made in terms of the FST could harden into permanent positions. Such hardening would be in line established scholarship on integration and disintegration mechanics. There is a rich body of knowledge on the causal relationships between integration and differentiation, particularly on whether differentiated arrangements have centripetal or centrifugal effects on undecided states.[173] If the path dependency is correct, differentiation at this junction would create a centripetal effect for those states that wish to join the EMU and centrifugal effect for those that do not. As Ferran observed, this can lead to three possible outcomes: dynamic of integration, dynamic of disintegration, or lasting divisions within the Union.[174] The next four chapters of this thesis will discuss how these dynamics manifest and the legal and politico-economic reasons creating such dynamics.

D. Conclusions

The aim of this Chapter was to chart the way towards the Banking Union and offer a contextual framework for more technical legal and politico-economic discussions. Sections A and B took a historical perspective and showed that the Banking Union could be viewed from two perspectives: on the one hand, as a logical continuation of political and macroeconomic agenda of creating a fully integrated market for financial services, on the other - a reaction to the 2007-2009 financial crisis and the 2010 sovereign debt crisis. Both origin stories ultimately intersect at their linkages to the European Monetary Union. That creates a number of concerns relating to the States which do not participate in the EBU and therefore might have different national interests. Section C introduced a set of conceptual frameworks reflecting integration and disintegration dynamics, and broad-stroked the basis for underlying legal, political and economic challenges and concerns that stem from the Financial Stability Trilemma and path dependency. In particular, it highlighted the danger that many of the non-participating States could potentially drift further away from the Eurozone and the EBU, which could in turn threaten to further fracture the single market and undermine the broader goals of systemic stability.

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[173] For the literature review on which see E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.4. See also F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, K Dyson A Sepos (eds), *Which Europe? The politics of differentiated integration*, Palgrave Macmillan 2010

[174] Ibid. Ferran, 2014

Chapter 2

The Legal Structure of the European Banking Union and the Defining Role of the Single Supervisory Mechanism

Introduction

This Chapter discusses the core legal structures that collectively make up the European Banking Union and the constitutional origins of the schism that appeared between the participating and non-participating States, which is the main topic of this thesis.

The EBU as we know it today was built around the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Single Banking Rulebook ('the Rulebook'). Through this reform the ECB became the sole supervisor for significant credit institutions and groups of such institutions in the participating States, while the SRM, and the Single Resolution Board (SRB) as its governing organ, took charge of resolution. The European Deposit Insurance Scheme – the intended third pillar of the EBU – has not been completed on the institutional level. However, this area was still touched upon by legislative reforms.

The SSM was the first institutional pillar of the Banking Union, based on Council Regulation 1024/2013 ('SSMR') which transferred bank prudential supervision tasks to the ECB and governs its interactions with the other main 'constituency' in the SSM: the National Competent Authorities (NCAs). This pillar is also the most significant for the discussion in this thesis, as it drew a fundamental distinction between three groups of EU Member States: the Eurozone States which have to participate in the SSM, the States in close cooperation, which voluntarily opt into participation, subject to (problematic) limitations,[175] and the non-participating States (NoPS). The participation in the SSM also determines the participation in the SRM, as the two mechanisms have identical membership – one cannot be joined without joining the other. Therefore, the SSM will be discussed in greater detail than other components of the EBU.

The purpose of this Chapter is to discuss and analyse the most important features of the EBU legal and institutional architecture, highlighting the main legal, constitutional, and political tensions and implications. It will be argued that the centralisation of decision-

[175] See Chapter 3, Section B

making and standard setting powers, have sharpened the edges of the choice that the NoPS have to make in terms of the Financial Stability Trilemma.[176] as the power balance within the EBU's instructional pillars, especially the SSM, is strongly tilted towards supranationalism and neofunctionalism.

The Chapter is structured as follows. Section A briefly summarises the legal architecture of the EBU. Section B introduces the set of legislation underpinning the EBU – the Single Rulebook. Section C provides a detailed discussion on the pillar that created the distinction between the NoPS and the participating States – the SSM. Section D discusses the second institutional component of the EBU – the SRM. Section E discusses the tensions between the EBU and national levels, which lays groundwork for deeper discussion of the reasons for non-participation in the remaining chapters of this thesis. The final section concludes.

A. Brief overview of the EBU legal structure

The European Banking Union legal structure is considered to consist of two layers: 1) the set of common rules under which banks operate and the EU, and 2) intergovernmental agreements and EU legislation conferring a set of powers to control banking activities in the participating States upon EU bodies, assisted by national competent authorities (NCAs).[177]

The first layer of EU legislation can also be described as the 'non-institutional components' of the EBU. The core element of this layer, binding the entire EBU legal structure together, is the Single Rulebook, which is often considered a pillar of the EBU in its own right. Unlike the institutional pillars, the Single Rulebook does not have a single constitutional basis, nor does it form a single document, as illustrated in table 2.1 below. Instead, each of the core pieces of legislation forming the Rulebook have their own constitutional basis, corresponding to the area of EBU that they govern.

[176] See Chapter 1, section C
[177] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.103

Table.2.1 Key Legal Provisions and Constitutional Basis of EBU Components

	Supervision	**Resolution**	**Deposits**
Mechanisms	SSM Regulation 1024/2013 SSM Framework Regulation 468/2014	SRM Regulation 806/2014 SRF Intergovernmental Agreement 2014	
Rulebook Provisions	CR Regulation 575/2013 CR Directive IV 2013/36/EU	BRR Directive 2014/59/EU	DG Directive 2014/49/EU
Constitutional Basis	Art. 127(6) TFEU	Art. 114 TFEU Intergovernmental Agreement 2014	Art.53(1) TFEU

The second layer of EBU legal structure created the institutional components of the EBU. The two existing institutional components of the EBU are based on the SSM Regulation[178] (SSMR) and the SRM Regulation (SRMR).[179] The SSMR was complemented by the SSM Framework Regulation (SSMFR). The core SRM legal architecture was completed by an Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund (SRF).[180] The Intergovernmental Agreement has the status of an international Treaty and was signed by all EU Member States except Sweden and the UK. This legislation was further refined through delegated acts, decisions and other legal instruments.

The EDIS has not been completed on the institutional level, but some work has been done in this field through legislative harmonisation, particularly via the Deposit Guarantee Directive 2014/49/EU (DGD). Some light on how the EDIS could look like was shed in late 2015, when the Commission proposed the framework for the scheme.[181] The proposal was, however, met with resistance and not implemented. There have been a few attempts to push it

[178] Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions
[179] Regulation (EU) No 806/2014 of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund
[180] Intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund, 2014
[181] Final Communication to the European Parliament, The Council, The ECB, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union, COM (2017) 592

forward. In 2017 the central bank governors and vice governors of Finland, Spain, Lithuania and France urged other EU governments to create EDIS. The effort failed largely due to German opposition. However, in her Commission presidency candidate speech, Ursula Von Der Leyen emphasised the need to complete the Banking Union, including pushing ahead with EDIS, as well as completing a common backstop to the SRF, and strengthening the bank resolution and insolvency frameworks.[182]

The differences between State positions can be explained adopting an intergovernmentalist line of reasoning, which in turn indicates that the (dis)integration drivers, discussed in Chapter 1, continue to play a role in the EBU development. Spain, Lithuania and France had significant problems during the GFC and deposit coverage came to the forefront. The German banks are, however, cautious about financing banks in troubled economies, as they hold large amounts of liquid assets. As I will discuss in Chapter 4, the prospect of EDIS is also unnerving for some NoPSs sharing structural characteristics with Germany, which are concerned about becoming primary contributors (e.g. Denmark, Sweden, Hungary). Such differences also reflect the difficulty with which all of the existing pillars of the EBU were built, and the delicate balancing of consensuses and concessions that was required.

B. The Single Rulebook

The Single Rulebook could be considered the first pillar of the EBU, since the CRD IV preceded the SSMR (June and October 2013 respectively). [183] Babis called the Single Rulebook "the most important body of legislation, as far as supervision and prudential regulation is concerned."[184] This section seeks to define the Rulebook for the purposes of this thesis and to highlight its relevance for the institutional components of the EBU. Subsection 1 clarifies the definition of the Single Rulebook for the purposes of this thesis. Subsection 2 highlights the biggest improvements brought by the Rulebook. Subsection 3 indicates some of the remaining dangers posed by lack of harmonisation in interpretation and enforcement,

[182] U von der Leyen, *A Union that strives for more: My agenda for Europe, political guidelines for the next European Commission 2019-2024*, p.9

[183] The BRRD and SRM were confirmed and voted on alongside the SSM in April 2014. On the significance of these timings see H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.278

[184] V Babis, *Single rulebook for prudential regulation of banks: Mission accomplished?*, University of Cambridge Faculty of Law Research Paper No.37 2014, p.1

as well as those created by flexibility allowed by the Rulebook provisions. Subsection 4 discusses the role of the EBA in trying to ensure pan-European harmonisation in the application of the Rulebook. Subsection 5 covers the problems presented by plurality of sources of hard and soft law coexisting with the Single Rulebook.

1. Definition and contours of the Single Rulebook

The term 'single banking rule-book' has a number of similar yet not identical definitions and purpose statements. According to Moloney, the term generally refers to "the array of binding legislative and non-legislative rules which govern the banking market." [185] It became a formal EU legal and political term in 2009 and reflects the "aim of a unified regulatory framework for the EU financial sector that would complete the single market in financial services." [186] According to the Commission, the Rulebook has two primary goals – consistent application of EU banking legislation through removal of transposition risks, and construction of a harmonised set of core standards.[187] According to the EBA, the rulebook is meant to ensure uniform application of Basel III accords in all Member States, close regulatory loopholes and thus contribute to a more effective functioning of the Single Market.[188] Fundamentally, all EU legislation enacted to the effect of fulfilment of these goals could be considered to be a part of the Rulebook. For the purposes of this thesis, I adopt Moloney's more technical definition as "rules governing the prudential regulation of deposit-taking institutions in support of the EBU. […] [B]inding legislative and non-legislative (delegated (Art.290 TFEU) and implementing (Art.291 TFEU)) harmonised rules which govern the EU financial system."[189] The focus of this section is, however, narrower – the CRR/ CRDIV package,[190] which, according to Babis is the core of the Rulebook.[184] This legislation will also be addressed as part of broader discussion of the EBU's resolution regime in section D of this Chapter.

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[185] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1610, n.4
[186] EBA website
[187] European Commission, *European supervisory authorities proposals impact assessment*, SEC/2009/1234, p.8
[188] EBA website
[189] Moloney 2014, p.1610
[190] Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

2. *Achievements*

The CRD IV and the CRR which deal with bank capital requirements in the EU, facilitated significant improvements. The Rulebook managed to (generally) ensure that the same definitions of legal concepts and tests are applied throughout the EU. In relation to prudential regulation that meant harmonisation of methodologies for capital ratio calculation, liquidity level assessment, exposures, cross-border presence, etc. Moreover, the Rulebook achieved a considerable degree of harmonisation in authorisation and right of establishment in the Single Market procedures, micro-prudential supervision, and micro and macro prudential regulation, which was a significant novelty in the EU legal order. Furthermore, the BRRD[191] was the first major EU legislation in the field of recovery and resolution.

The BRRD, the CRR, and CRD IV are not limited to banks and can apply to investment firms, which avoids artificial separation between entities engaging in the same activities. As I will illustrate in section C, that is not the case with the institutional components of the EBU. Most importantly, many important rules were laid out in the CRR – an EU Regulation - which is directly applicable, less prone to interpretations and thus provides a sturdy basis for the CRD.[192] This is an important improvement, compared to the pre-Rulebook framework, discussed below, which was directives-based and thus more vulnerable to differentiation. Generally, the Single Rulebook, alongside the supervisory handbook, which I will discuss hereinafter, have been described as "cross-cutting all [the] areas [and] aimed at achieving a truly uniform supervisory and administrative practice with regard to credit institutions."[193]

3. *Lack of harmonised enforcement and interpretation*

An important shortcoming of pre-EBU banking legislation was that it was based on loosely harmonised rules, with the application of these rules overseen by the NCAs, at the national level. Harmonisation efforts often took the form of Directives and, where political will and consensus were lacking, occasionally defaulted to recommendations. Moreover, as Howarth and Quaglia observed, such Directives, notably including the CRD and the four 'Lamfalussy directives', were "often based on a minimum common denominator, resulting from convoluted compromises and trade-offs during the negotiation process."[194] Following

[191] Bank Recovery and Resolution Directive 2014/59/EU
[192] See e.g.CRR Art.147
[193] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Hart Publishing 2019, p.91
[194] D Howarth, L Quaglia, *The political economy of European Banking Union*, Oxford University Press 2016, p.27

their enactment such Directives needed to be transposed by the States into their respective legal systems, subject to national formulation, interpretation, and linguistics of different languages.[195] The 'common' meaning of terms was only ever really ascertained when legal disputes arose, due to EU law's preference for the Preliminary Reference procedure over other forms of challenging EU legislation. This led to a considerable diversity among the States.[196] Such diversity often created room regulatory arbitrage, but also – on rare yet significant instances - had a major impact on the banking businesses operating in different countries. The second banking Directive,[197] exemplified how a European banking rule enacted at the EU level can result in very different outcomes within the States. The German way of implementing this Directive allowed the State to retain its three-layer banking system, whereas most Italian mutual banks were demutualised, partly as a consequence of the legislation implementing the Directive. As mentioned, the Single Rulebook has gone quite far in curbing this diversity, but only to an extent.

The CRR,[198] important as it, is the only Regulation in the main Single Rulebook ensemble. The BRRD and the CRD are both Directives. Although the Rulebook is built around a set of legal instruments with EEA relevance and pan-EU application, divergences are possible as long as fragmentation along the Eurozone, SSM/SRM and EU borders remains.

While some divergences might appear due to the type of legislation employed, others stem from the flexibility allowed by the provisions themselves. Babis provides a detailed account on how the Rulebook can leave room for national divergences even within the SSM/SRM area.[199] The flexibility allowed under the CRR/CRD IV could open opportunities for arbitrage and regulatory competition among the States, thus undermining the goals and purposes of the Rulebook.[200] The list of exposures which NCAs can exempt from the large exposures limit is particularly problematic.[201] This list includes asset items constituting claims on governments, central banks, public sector entities, and intra-group exposures.[202] This makes a big difference, as otherwise credit institutions are prohibited from creating exposures exceeding 25% of their capital to a single counterparty or a group of

[195] No EU language has automatic precedence, see *Markus Geltl v Daimler AG* CJEU, 28/6/2012, C-19/11
[196] See ECB, *Financial Integration in Europe*, 2012
[197] Directive 89/646/EEC
[198] Capital Requirements Regulation (EU) No.575/2013 (CRR)
[199] V Babis, *Single rulebook for prudential regulation of banks: Mission accomplished?*, University of Cambridge Faculty of Law Research Paper No.37 2014, pp.9-15
[200] Ibid.p.9
[201] Ibid.p.10
[202] Art.400(1) CRR

counterparties.[203] While to be exempted such exposures need to be 0% risk weighted, the effectiveness of the risk profiling is questionable, since it is based on internal ratings, which means it is not immune to national and market pressures, as well as not fully harmonised.[204] Such flexibility can obstruct the efforts to break the viscous circle between the States and the banks, while also distorting competition. This is particularly dangerous in relation to smaller banks and institutions located in the NoPS, which avoid direct ECB oversight. 25% is a massive exposure, and it is questionable whether *any* such exposure can be justified. Moreover, in the absence of such exemptions, banks would be forced to look into government-backed claims in other Member States, which would deepen market integration and create common interest between the States.

These flexible exposure provisions should be considered in conjunction with the fact that the ECB can also grant approvals, permissions, derogations, or exemptions to the rules relating to capital, liquidity, leverage and other requirements, which might make the playing field even 'bumpier'.[205]

Concerns regarding uneven playing field are not limited to the requirements themselves. The devil might be in the interpretation of requirements. A particularly problematic issue is the principle of recognition of prudential requirements between home and host authorities. Member States can recognise the macroprudential measures in another State with regard to a bank's exposures there.[206]As Babis rightly observed, the calculation of a credit institution's total Counter-Cyclical Capital Buffer includes the buffers set by all Member States where the institution in question has exposures.[207] She points to the risk that the recognising (home) State and the setting (host) State may apply these measures in different ways.[208] For example, this would be the case if the recognising State applies different definitions of eligible capital or different methodologies for the calculation of prudential requirements.[209]

The Single Rulebook generally leaves the States the flexibility to impose stricter requirements, but market pressures might result in a race to the 'Rulebook bottom', which could at particular points be lower in the NoPS, as they seek to gain competitive advantage in attracting business. It is therefore crucial for the attainment of the goals of the EBU to ensure

[203] Art.395(1) CRR
[204] Babis, 2014, p.10, see Part Three, Title II, Chapter 3 CRR
[205] SSMR Rec.23
[206] CRD IV Art.134, CRR Art.458(5)-(6)
[207] Babis, 2014, p.14
[208] Ibid. See also CRD IV Art.137
[209] Babis, 2014, p.14

that the baseline requirements are sufficiently robust, as well as strictly enforced.

4. Further harmonisation and the role of the EBA

In an attempt to reinforce this baseline, the EBA – a pre-existing ESA - was entrusted with the duty to be the primary 'guardian' of the Rulebook; as opposed to, for example, the ECB.[210] This decision might seem somewhat questionable in terms of legal capacity, since the ECB is a more powerful EU institution listed in Art.13 TEU. As an ESA, the EBA does not have legislative powers and is limited to drafting binding technical standards (acts specifying particular aspects of a Directive or Regulation forming part of the rulebook), which are subsequently adopted by the Commission in the form of regulations or decisions.[211] Despite such limitations, the EBA was preferable to the ECB, due to the restrictions of the ECB's reach, which I will discuss in Section C. The choice of a less powerful pan-European body over a more powerful Eurozone body reflects long term impetus towards expansion and convergence beyond the Eurozone. Arguably, the involvement of the Commission also helps the Rulebook development retain broader Single Market focus.[212]

EBA was also subsequently given the task to develop the European Supervisory Handbook.[213] This handbook is meant to harmonise methodologies for identifying and measuring credit institutions' risks, defining corrective action, provide a framework within which supervisors exercise their judgment, and ensure consistency of outcomes.[214] Thus, the Handbook "sets out supervisory best practices for methodologies and processes" for all EU NCAs, the ECB and the EBA itself.[215]

5. Distortion introduced by the ECB

The launch of the SSM has somewhat complicated this system. The ECB within the SSM is subject to the EBA-developed technical standards, EBA's guidelines and recommendations, and the Supervisory Handbook; all while monitoring compliance with the

[210] European Council, 11225/2/09 Rev 2, para.20
[211] Arts.8(2)(a), 10-15, EBA Regulation
[212] E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.312
[213] Art.8(1)(a) EBA Regulation, as amended by the European Parliament on 22/05/2013
[214] A Enria, *Initial statement, ECON committee public hearing on banking supervision and resolution, next steps*, EBA 2012, also European Commission communication, *On a road map towards Banking Union*, 2012, p.5
[215] EBA Regulation Arts.8, 29(2)

single rulebook itself.[216] At the same time, the ECB is in charge of the so-called 'supervisory manual' – a non-binding document covering various aspects of the SSM functioning, not otherwise stipulated in the SSMR or SMMFR.[217] A large proportion of this text is based on the EBA's Supervisory Handbook, which could be considered an unnecessary duplication. Some aspects differ, and thus can create divergences. Although the provisions of the manual are not binding and even the ECB itself is free to deviate from them, this is yet another 'rulebook' and it does not apply to the NoPS, while the EBA's books do, which could, in some limited instances, result in differentiation. In the early stages of the EBU there was also some confusion in the SSM countries as to which handbook will be valid in which situation.[218] This has been solved by giving the ECB's manual non-binding status, but that effectively raises questions about its necessity on the one hand, and effectiveness on the other. If the Supervisory Handbook and the ECB's manual remain similar – what is the purpose of such duality? On the other hand - if they diverge – the schism between the SSM states and the NoPS deepens. Such situation is sub-optimal. As Avgouleas and Arner observed,

> "*Different supervisory handbooks and supervisory approaches between the Member States participating in the [SSM] and the other Member States pose a risk of fragmentation of the single market, as banks could exploit the differences to pursue regulatory arbitrage*."[219]

It is evident that in the absence of unifying institutional structures, more room for divergences would exist between the NoPS and the SSM/SRM, as well as among the NoPS. One of the reasons why divergences remain is lack of clarity in terms of rule-making capacity and hierarchy of institutions involved in that process. Arguably, even in the absence of conflict between the rule-makers themselves, dangers on the practical level remain, where credit institutions can find opportunities for regulatory arbitrage or deliberately search for alleged conflicts in overlapping provisions.

Harmonisation through the ECB's deeper involvement in rule making could partly solve this problem, but would also introduce a plethora of new ones. As will become

[216] Art.4(3) SSMR
[217] ECB, *SSM Supervisory Manual*
[218] European Court of Auditors, *Special Report European banking supervision taking shape — EBA and its changing context*, 2014, p.35
[219] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.42

increasingly clear throughout this thesis, the more involved the ECB is in an EBU pillar, the more concerns that raises, due to its institutional architecture, discussed below. The ECB can already influence the content of the Rulebook provisions, which allows for further spill-overs of the power dynamics from the SSM into the Rulebook, much to the dissatisfaction of non-EMU Member States.[220] If such influence increases, that might make participation even more undesirable.

C. The SSM

The aim of this section is to analyse the first institutional component of the EBU, the European Single Supervisory Mechanism, which is the most important pillar for the purposes of this thesis. As Merino pointed out, the political agreement on the transfer of prudential competences from the States to the EU marked the moment of birth of the Banking Union.[221] The SSM's particular relevance is also rooted in its constitutional foundations, which effectively created the division between the Eurozone and non-Eurozone States on two levels. Firstly, the non-Eurozone States could not be compelled to participate in SSM. Secondly, the membership conditions for those that chose to participate voluntarily were fundamentally different.

This section thus highlights the most important constitutional peculiarities of the SSM, and their consequences. That is done in subsections 2-5, following a brief discussion of the goals, purposes and institutional structure of the SSM in Subsection 1. Subsection 6 concentrates on the role of the ECB as the centrepiece of the SSM and the functions that flow from such position. Subsection 7 discusses the role of the National Competent Authorities (NCAs) and their responsibilities.

1. The SSM overview

a) Goals and purpose

Perhaps the most important goal of the SSM is to eliminate national bias in supervision by transferring bank prudential supervisory competence from the national to the EU level. As discussed in Chapter 1, the attainment of that goal would remove one of the pre-conditions for the occurrence of 'doom loops' in crisis situations, while also contributing to the

[220] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Hart 2019, p.120

[221] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.107

improvement of market conditions under normal circumstances.

Positioned at the centre of the SSM stands the ECB, joined by the NCAs, which are also part of the SSM. The functions and competences of the ECB and the NCAs will be examined later in this Chapter. For now, suffices to say that the adoption of the SSMR changed the profile of the ECB's activities significantly, while also subtly altering its goals and field of responsibility. Under Art.1 SSMR, the ECB's prudential supervision tasks were conferred upon it, with a view to "contributing to the safety and soundness of credit institutions" and the "stability of the financial system". Previously, the only significant power for safeguarding the stability of the banking system that the ECB was entrusted with, was last-resort lending to *solvent* banks facing illiquidity problems.[222] In that sense, the conferral of SSM powers marked a fundamental ideational and functional shift. As one would expect, the ECB was vested, in its new role as bank prudential supervisor within the Banking Union space, with a new legislative mandate.

b) Institutional set-up

The supervisory decisions in the SSM are made by various organs of the ECB, as well as by the NCAs. This institutional architecture is supported by review and mediation mechanisms. All of these organs will be discussed at some length throughout this thesis. This subsection thus only serves as a brief introduction.

The majority of day-to-day supervisory decisions in relation to the less-significant banks are made by the NCAs. The majority of supervisory decisions regarding *significant* credit institutions are made by the Supervisory Board. The Supervisory Board of the SSM comprises of its Chair, Vice Chair, four representatives of the ECB, and one representative from the NCA of each participating State.[223] Eurozone and participating non-Eurozone States are represented on more or less equal terms. Notably, the Board members have to "*act independently and objectively in the* ***interest of the Union as a whole*** *and […] neither seek nor take instructions from the institutions or bodies of the Union [or] from any government of a Member State*…"[224] That principle, at least in theory, applies to the State representatives.

While most of the supervisory decisions are taken by the Supervisory Board, the highest ranking organ is nevertheless the Governing Council of the ECB. Non-EMU States

[222] Ch Gortsos, *The single supervisory mechanism: a major building-block towards a European Banking Union (the full europeanisation of the 'bank safety net')*, ECEFIL 2013, p.11, the emphasis is mine.
[223] SSMR Art.26
[224] Art.19(1) SSMR

are excluded from it, due to constitutional limits discussed in Subsection 3.[225] The Governing Council retains the ultimate responsibility for all actions of the ECB and has a number of veto powers over other organs, and serves as an appellate body. Notably, the Governing Council representativeness was already a sensitive topic, even within the EMU. For example, Lithuania's EMU accession triggered a system under which national central bank governors take turns holding voting rights on the Governing Council, meaning that not all States are always represented.[226] This problem will be aggravated by subsequent accessions of Croatia, Bulgaria, and other future users of the Euro.

A lot of ECB's decisions, including those relating to regulatory activities, are made by the Executive Board, comprising of six permanent members.[227] That is also a concern for the non-EMU States, as Art.139(2)(h) TFEU, excludes them from the appointment of the Executive Board.

In order to mitigate these imbalances, the ECB has established and Mediation Panel, which resolves differences of views expressed by the NCAs of all participating States concerned regarding a disagreement between the Supervisory Board, where the non-EMU participating States are represented and the Governing Council, where non-EMU participating States are not represented.[228]

Another important organ is the Administrative Board of Review, entrusted with reviewing the decisions taken by the ECB in the exercise of SSM powers.[229] The Administrative Board of Review is "composed of five individuals of high repute, from Member States." Current employees of the ECB and NCAs are barred from holding positions on the Board, which is also expected to act independently.[230] I will return to the discussion of the appellate organs in Chapter 3.

2. Choosing the (best?) banking supervisor

Choosing the central institution for the SSM was essentially an elimination process, with the ECB not being everyone's preference. However, given the need to have a solid legal basis and the ability to act swiftly under difficult circumstances, the ECB was better positioned to undertake such functions than any of the alternatives.

The EU legal system is largely based on the principle of conferred powers. Under this

[225] Art.129 TFEU
[226] On which see ECB website
[227] the President, the Vice-President and four other members
[228] Art.25(5), Rec.73 SSMR
[229] Art.24(1), (2) SSMR
[230] Ibid.

principle, the EU can only act if the Treaties provide a legal basis for its actions.[231] Such basis needed to be found for the central institution of the SSM. Among possible legal bases that were initially contemplated was Art.114 TFEU, an internal market Treaty basis, on which EU agencies, such as EBA, can be founded. However, Art.114 was rejected,[232] and so was the choice in favour of establishing an EU agency at the heart of the SSM, which would have faced additional complications because of the *Meroni* doctrine, setting limitations on the powers that can be delegated to an agency.[233] Thus, at the time it was believed that entrusting the EBA with direct micro-prudential supervision would amount to improper delegation. To be sure, subsequent case law – the *short-selling* decision[234] in particular – has made this assumption somewhat questionable. Even if the EBA could have undertaken some of the functions the ECB was subsequently given, it would face many of the limitations the SRB is now facing, as well as cumbersome decision-making procedures, discussed in section D, below. Theoretically, the nuclear option of Art.352 TFEU was also available as a possible constitutional basis, but the use of it would have been too problematic politically. The ambiguity of this article would have made the constitutional limits of the powers of the new European banking supervisor unclear; a position which would doubtlessly be considered unacceptable by a number of EU States, including most NoPS. Ultimately, the body that could most easily act as a banking supervisor was the ECB, since it is allowed to exercise prudential competences under Art.127(6), which provided a 'constitutionally secure' option.[235]

The justifying logic is that the supervisory functions are being conferred on the ECB as "pre-requisites for ensuring price stability and effective performance of other monetary functions."[236] Wymeerch used this logic to justify many features of the SSM, highlighting the position of Art.127(6) under the broader heading of monetary policy, which points to the symbiosis between the EBU and the EMU, discussed in Chapter 1, section A(5).[237] This reasoning appears equally justified from the operational and empirical standpoint. Micklitz argued that the "integration of financial markets represents an essential goal of the EBU and

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[231] See further discussion in section E of this chapter.
[232] See A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.109
[233] *Meroni v High Authority* [1957/1958] ECR 133.
[234] Case C-270/12, *UK* v.*Council and Parliament*, judgment of 22/01/2014
[235] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1659
[236] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.12
[237] See EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.8

at the same time, a pre-requisite for the monetary policy of the ECB." [238] Peek et al. presented empirical evidence that supervisory knowledge can increase the ability to forecast variables informing monetary policy.[239] Lastra also emphasises the ECBs 'money printing' capacity, which is a useful perk for a lender of last resort, especially one which is also the supervisor.[240] Since these functions complement each other, from the operational effectiveness standpoint, it is somewhat unfortunate that the two capacities of the ECB needed to be separated, thus limiting the potential benefits. I will return to this issue later in this Chapter.

Importantly, the ECB itself was far from neutral in this process and actively sought to expand its powers into the supervisory domain. This can be traced to the pledge of the (then) ECB president Mario Draghi "to do whatever it takes to preserve the euro."[241] That, notably, makes the EBU even more targeted at the Eurozone. Furthermore, Micklitz argued the SSM, with the ECB at the centre, to be a "direct reversal of the Internal Market programme […] built around the supervisory authority – the Single Supervisory Board – rather than substantive provisions."[242] He further stressed the importance of the fact that the ECB is an EU institution, effectively entrusted with centralised decision-making powers, which has significant political and constitutional implications, discussed in section E.[243]

3. Problems with Article 127(6) TFEU

Obviously, being the only feasible option and having *some* advantages does not make Art.127(6) an ideal legal basis. There are several suggested interpretations that make this provision seem like an inherently problematic source of legitimacy. While such interpretations have largely been brushed aside in order to swiftly facilitate the reform, it is important to highlight the most important ones, as they illustrate the imperfections of the SSM's constitutional basis. Most importantly, Art.127 drew a fundamental distinction between the Eurozone and non-Eurozone States in the EBU framework, creating numerous complications. The problematic aspects of the SSM's constitutional basis can be divided into two broad groups: uncertainties and differentiation catalysts.

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[238] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.273
[239] J Peek, E Rosengren, G Tootell, *Is Bank Supervision Central to Central Banking?*, 1997, pp.2-3, 31-35
[240] see RM Lastra, *Banking union and Single Market: Conflict or Companionship?*, Fordham International Law Journal, Volume 36, Issue 5, 2013, p.1218
[241] M Draghi, *Verbatim of the remarks made by Mario Draghi*, 26 July 2012
[242] Micklitz 2019, p.278
[243] Ibid. p.286

a) Uncertainties and ambiguities

Art.127(6) permits the conferral on the ECB of *specific* tasks concerning *prudential* supervision. The reference to 'specific' has been interpreted in different ways. Tridimas points to the allegations of inadequacy of Art.127(6) as the constitutional basis of the SSM based on the word 'specific', and a (notably unsuccessful) challenge in front of the German Constitutional Court,[244] where it was argued that Art.127(6) only allows the conferral of 'specific' powers to the ECB and cannot be the basis for making the ECB the single supervisor.[245]

Some commentators have also claimed that pursuant to Art.127(6) the ECB can develop activities relating to policies, but not actual supervision. In other words, that its reach should not be much greater than that of the EBA. Gortsos for example points out that when the TFEU was enacted:

> *"[c]ontrary to what was established with regard to the definition and implementation of the single monetary [...] policy, which became supranational, the ECB did not shift into a supranational supervisory authority for the financial system [...], given that relevant competencies remained at national level*.[246]

In this context, reference is also made to Art.127(5),[247] which stipulates that the ESCB, not the ECB separately, is responsible for *"supervision of credit institutions and the stability of the financial system".* Allegedly, the relevant competence which lies with the ECB is only to submit opinions, in accordance with Art.127(4) TFEU, within the limits set out in Decision 98/415/EC of the Council.[248]

Meanwhile, the reference to 'prudential supervision' raises questions about the limits of the concept of such supervision, as well as the very meaning of it. Ferran and Babis suggest that the answers to these questions should be determined by reference to the capital

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[244] Az 2 Bvr 16 186/14

[245] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, pp.36-37

[246] Ch Gortsos, *The single supervisory mechanism: a major building-block towards a European Banking Union (the full europeanisation of the 'bank safety net')*, ECEFIL 2013, p.10

[247] Carried over verbatim to Article 3.3 of the Statute of the European System of Central Banks and the ECB. Carmassi et al, 2012, notably, argued the opposite - that the Treaty does not allow the supervisory system to be limited to the Eurozone jurisdictions.

[248] Gortsos, 2013, p.10

requirements legislation of the Single Rulebook.[249] Unfortunately, neither CRR nor CRDIV include a precise definition of prudential supervision. They can, however, inform the overall view of what supervision entails. Art.4(1)(47) of the CRR seems to imply that prudential supervision is ensuring compliance with the Rulebook and using all necessary powers conferred in the legislation. A more detailed and precise definition would be desirable for future development, specifically in drawing a clear line between supervision and regulation. On the other hand, unnecessarily strict definition could draw artificial and unhelpful distinctions between supervision, early intervention and resolution, making the processes more difficult and lengthier, as the legitimacy of actions of different authorities could be constantly challenged as encroaching upon the domain of another body and thus illegitimate.

b) Differentiation between Member States

These ambiguities, problematic as they may be, seem unlikely to materially affect the stability of the SSM in the long run. By contrast, the significance of unnecessary differentiation between Member States cannot be overstated. Such differentiation is linked to constitutional complications in relation to the participation of the non-EMU States. At the dawn of the SSM this issue raised a variety of questions.

Initially there was some speculation that Art.127(6) could not apply to non-Eurozone States.[250] According to Wymeersch, this argument found support among market participants.[251] The current set up of the SSM presumes that Art.127(6) *can* apply to all EU States, but that requires a separate close cooperation agreement for each individual non-Eurozone State. Other Treaty provisions justify this interpretation. Art.139(2)(c) TFEU lists the objectives and tasks of the ESCB under Art.127, which do not apply to States 'in derogation' (i.e. non-Eurozone),[252] but clearly emits para.6 from that list. Protocol 15, point 4 relating specifically to the UK excluded paragraphs 1-5, but not 6. While Brexit made this provision redundant, it is still an important indication of legislative intent. However, as is evident from a number of Treaty provisions, including Art.139(2)(e) TFEU, for the SSM to extend beyond the Eurozone *automatically*, without a separate agreement, an alternative to the ECB would need to be found to serve as the main institution, which, as mentioned, would

[249] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.6
[250] Ibid. p.22 with reference to EO Wymeersch, T*he European Banking Union, a First Analysis*, 06/2012 (Original version, all references to this text elsewhere are to the updated text)
[251] EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.8
[252] Art.139(1) TFEU

have been very difficult.

The biggest problem is that even when the non-Eurozone States participate in the SSM and SRM on voluntary basis, constitutional restrictions prevent that participation from being truly equal. In essence, under Art.129 TFEU the Governing Council of the ECB is the ultimate decision-maker of the ECB and consequently bares the ultimate responsibility for the ECB's actions.[253] That, in principle, has not been changed by the creation of the Supervisory Board of the SSM. Non-Eurozone states are not – and cannot be - represented in the Governing Council and cannot participate in the decision-making of this organ. This problem stands as a major stumbling block for new SSM/SRM accessions. It has far-reaching consequences, affecting numerous aspects of the SSM and even seeping into the SRM. This problem is partly the legacy of the legislative framework designed for the ECB with only the monetary capacity. For that reason, Art.139(2)(h) also excludes non-EMU States from participating in the appointment of the ECB's Executive Board which is, inter alia, in charge of day-to-day business of the ECB, implementation of monetary policy and includes some of the highest-ranking ECB officials, including the President.

4. The 'mechanism' status

a*) The delegation issue and the dominance of the Governing Council*

The biggest difference between the SSM and alternative ideas and proposals for European supervisory centralisation is that it is a *mechanism*, not an institution. The reasons for such choice are of particular relevance for this thesis. Once it became clear that the ECB, as the single supervisor, could not realistically become the *only* supervisor, at least not within the timeframe required, the involvement of the NCAs became a necessity. As we will see later, the ECB even relies on the NCAs for the exercise of its tasks under the SSMR. As each NCA was given a seat at the Supervisory Board and entrusted with important tasks in day-to-day supervision (even for significant banks), the legality of such arrangement was questioned. Wymeersch's research reveals that the legal service of the Council, in an unpublished document, concluded that the TFEU does not allow direct delegation to any other institution, including NCAs or other institutions 'subordinate' to the ECB.[254] In this context Ferran and Babis[255] explore the thorny issue of delegation of discretionary powers

[253] As argued by Baglioni, supra, p.33
[254] E Wymeersch, *The Single Supervisory Mechanism or 'SSM', Part One of the Banking Union*, National Bank of Belgium Working Paper No.255 2014, p.21
[255] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.11

under EU law, which the critics of the SSM might point to. They point to *Tralli v ECB*[256], where, considering the application of *Meroni v High Authority* to the ECB, the Court held that an EU body is entitled to lay down measures of organisational nature, delegating powers to its own internal decision-making organs.[257]

The way around this obstacle was found by naming the SSM a *mechanism*, not an institution. With the SSM being a mechanism, rather than an institution, the issue of delegation does not arise, as the arrangement effectively makes NCAs the ECB's 'executive',[258] as the case is in relation to the implementation of the monetary policy.[259] As far as internal organisation goes, the EU institutions have a considerable amount of discretion, and distribution of tasks within those confines does not constitute delegation.[260]

The problem with this reasoning is that the SSM does not actually merge the NCAs into the ECB, even if they sit on the Supervisory Board. They are, *de facto* and *de jure*, separate bodies and those challenging the SSM legitimacy could argue that leaving the NCAs decision-making powers involves external delegation rather than internal organisation.[261] The mentioned opinion of the legal service of the Council therefore insisted that the only way to make it 'internal' was to put the ultimate responsibility for the SSM's decisions on the Governing Council.[262] This is also in line with the established reading of Art.129(1) TFEU. Therefore, in a bid to comply with Art.129, as well as avoid improper delegation allegations, the SSM had to have the Governing Council placed at the top of its organisational hierarchy. Making the NCAs part of the Supervisory Board, which is technically a part of the ECB, notably also gave the ECB the ability to influence the status and role given of the NCAs, thus indirectly making the Governing Council even more dominant. [263]

b) The resulting coordination problems

While the status of a mechanism as opposed to an institution largely solved the delegation problem, it has come at considerable practical and operational costs. The primary

[256] C-301/02 P Tralli v ECB [2005] ECR I-4071, para.42
[257] *Meroni v High Authority* [1958] ECR 133
[258] see Art.6 SSMR
[259] Ch Gortsos, *The single supervisory mechanism: a major building-block towards a European Banking Union (the full europeanisation of the 'bank safety net')*, ECEFIL 2013, p.23
[260] *Meroni* paras.59-60
[261] Ferran and Babis, 2013, p.11
[262] Mechanics of that are set out in Art.26(8) SSMR
[263] See E Chiti, F Recine, *The Single Supervisory Mechanism in Action: Institutional Adjustment and the Reinforcement of the ECB Position*, European Public Law Volume 24:1 2018, p.124

problem is said to be reliance on coordination between central and national elements.[264] Moloney points to the fact that the ESAs have faced many difficulties in the past, especially when directing the NCAs, in relation to *inter alia* binding mediation between NCAs or compliance with ESA guidelines.[265] It did not take long for this problem to manifest in the SSM context. The ESAs, the ECB and the Italian government did not coordinate well in relation the problems of Monte dei Paschi di Siena and failed to trigger early intervention and resolution processes, partly due to its status as the country's 'national champion' and impeding Italy's constitutional referendum in late 2016.[266] The story of this banking failure is eerily similar to the one of Lehman Brothers at the wake of the GFC, with various attempts at private and public sector solutions taking an entire year, and the final request for a private sector solution eventually rejected by the ECB. The speed and efficiency promised by the EBU had not turned into reality. Generally, the SSM has been described as 'vulnerable' due to the split of competence between centralised and decentralised elements, 'as co-ordination risks arise from the mechanism-based operating model'.[267] Moreover, it could be argued that the delegation issue has not been solved but rather neutralised and the fine line of the *Meroni, Tralli* and *Short Selling* rulings always needs to be kept in mind, which effectively burdens decision-making.

5. Business type limitations

Art.127(6) confers the mentioned *"*specific tasks" upon the ECB "relating to the prudential supervision of *credit institutions* and other financial institutions *with the exception of insurance undertakings."* (emphasis added) This wording effectively limited the scope of the SSMR to banks, which is arguably sub-optimal.[268] The GFC showed that non-bank financial institutions can also be systemically dangerous.[269] The companies that needed support included juggernauts like AIG and AEGON. Moloney thus argued that a wider scope

[264] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1645
[265] Ibid.
[266] B Braun, *Two sides of the same coin? Independence and Accountability of the European Central Bank*, Transparency International EU 2017.p.23
[267] N Moloney, 2014. p.1645
[268] see EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.7 and K Alexander, *House of Lords EU Committee on Economic and Financial Affairs Inquiry into reform of the EU banking sector*, House of Lords 2012
[269] E Avgouleas, C Goodhart, D Schoenmaker, *Bank Resolution Plans as a Catalyst for Global Financial Reform, Journal of Financial Stability*, Journal of Financial Stability vol. 9, issue 2 2013, p.6

could have "supported the holistic, cross-sectoral, functional approach to supervision which the crisis exposed as being necessary."[270]

Due to the constitutional restrictions and subsequent political compromises, discussed in subsection 7 below, the SSM regime does not apply to large market segments, including many institutions performing maturity transformations. Such limitations might be leaving room for regulatory arbitrage and creating uneven playing field. Moreover, if seen from a comparative perspective, these restrictions limit the SSM structure to the extent not found in most interconnected jurisdictions. The US Financial Stability Oversight Council can designate systemically important (roughly equivalent to what is known in the SSM jargon as 'significant entities' – see below) non-bank financial entities and financial market utilities to be supervised by the Federal Reserve, which automatically triggers application of enhanced prudential requirements.[271] Similarly, in the UK the PRA can designate investment firms for its supervision.[272]

That said, the scope of ECB supervision is still an improvement over the original SSM proposals. The coverage was expanded moving from the initial proposals onto the final SMMR text; which acknowledges that "risks for the safety and soundness of a credit institution" can arise "both at the level of an individual credit institution and at the level of a banking group or of a financial conglomerate".[273] Thus, in addition to supervision of individual credit institutions, the ECB's tasks include supervision at the consolidated level, supplementary supervision, supervision of financial holding companies and supervision of mixed financial holding companies.[274] These were meaningful additions to the ECB's competences compared to the initial proposals, which were assumed not to include financial holding companies and conglomerates.[275]

6. *Competencies of the ECB*

Even with some exemptions and exceptions, the list of ECB competencies is obviously vast. Following the establishment of the SSM, the central banking and supervisory competencies of the ECB could be simplistically listed as follows:

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[270] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1658
[271] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.12
[272] Financial Services and Markets Act 2000 s.22A
[273] SSMR Rec.26
[274] Defined in point 15 of Art.2 Directive 2002/87/EC
[275] EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.7

- setting and implementing the monetary policy;[276]
- issuance of euro banknotes and coins;[277]
- macro-prudential oversight as part of the ESRB; [278]
- micro-prudential supervision as part of the SSM.

The competency at the centre of this thesis – micro-prudential supervision - includes organisation of supervision, development of administrative bodies and structures and even a limited degree of rule-making.[279] The ECB is made exclusively competent (although not expected) to prudentially supervise (directly or indirectly, permanently or optionally) all credit institutions established in the participating States.[280]

In this subsection I will discuss the division of tasks between the NCAs and the ECB, and overview the responsibilities of both levels of the SSM. First, however, I will begin by highlighting a key change in how the ECB as an institution operates - that is, the principle of a separation between banking supervision and monetary policy.

a) Separation between the EMU and the EBU

The supervisory competencies of the ECB are operationally and, to an extent, institutionally, separated from its monetary ones. This is done "in order to avoid conflicts of interests and to ensure that each function is exercised in accordance with the applicable objectives."[281] An example of such conflict of interest could be a situation where a decision to increase interest rates - a monetary policy decision - hurts financial intermediaries, performing maturity transformations.[282] Baglioni argued that a central bank, responsible for both monetary policy and prudential supervision, would have an incentive to delay the interest rate decision, wary of the side effects on the stability of the banking system. [283]

The ECB thus has to ensure that the Governing Council operates in a differentiated manner regarding monetary and supervisory functions, including strictly separated meetings and agendas.[284] According to Alexander, this arrangement was insisted on by Germany.[285]

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[276] Arts.127(1) and (2) TFEU
[277] Art.128 TFEU
[278] Pursuant to Council Regulation 1096/2010, also based on Art.127(6) TFEU
[279] Listed in Art.4 SSMR
[280] On the discussion of the ECB's discretion to make choice of institutions to be supervised by it see section E below.
[281] SSMR Rec.65, Art.25
[282] Baglioni, *supra*, p.35
[283] Ibid.
[284] SSMR Rec.65, Art.25

From the operational perspective, there seems to be a lack of consensus on whether such separation, sometimes called a 'Chinese Wall', is optimal. Prior to the GFC, the ECB itself suggested that arguments for rigid separation between prudential supervision and central banking were losing strength in the Eurozone.[286] At an even earlier stage of EU financial integration, when the conceptual framework of the ECB was being developed, Goodhart and Schoenmaker argued that separation between the two responsibilities is sub-optimal and the risk of conflict of interest can be dealt with internally, without any 'Chinese wall' building.[287] They argued that the ECB, as the lender of last resort, has to deal with immediate consequences of systemic failures and thus should be able to unapologetically engage in supervision. Moreover, as the same authors stated in a different publication, even in normal times "the integrity and reliability of a payment system is essentially dependent on the quality of the participants, the specific clearing and settlement arrangements, and the possible backing by a Central Bank", so artificially separating such agendas might be an overkill.[288]

Such thinking is not unwarranted. The stated mission of the ECB includes ensuring the safety and soundness of credit institutions, stability of the financial systems of the EU and individual States, the unity and integrity of the internal market, protection of depositors and improving the functioning of the internal market, in accordance with the Single Rulebook.[289] The breadth of this mission might effectively mean that only an institution with both – central banking and supervisory – capacities could be up to the task, and the 'wall' between the two – if actually existent and functioning – needs to be repeatedly climbed over. Baglioni has further criticised separation, stating that it 'does not rely on solid economic arguments'.[290] He mentions examples when the monetary and supervisory duties might need to be coordinated, like for mitigating pro-cyclical effects of capital requirement adjustments.[291]

It would seem that eventual demolition of the wall might be desirable. However, in the absence of a Treaty change that remains unlikely, as long as the current system for close cooperation with the NoPS remains in place.[292] One of the reasons for the erection of the

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[285] K Alexander, *European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism*, European Law Review Vol.40 2015, p.165
[286] ECB, The Role of Central Banks in Prudential Supervision, Press Release, 22 March 2001, see also TFEU Art.127(5) and ECB Statute, Art.3(3)
[287] C Goodhart, D Schoenmaker, *Should the functions of monetary policy and banking supervision be separated?*, Oxford Economic Papers 1995, p.558
[288] C Goodhart, D Schoenmaker, *Institutional Separation Between Supervisory and Monetary Agencies*, LSE 1993, p.19
[289] SSMR Rec.30
[290] Baglioni, *supra*, p.34
[291] Ibid. p.36
[292] For detailed discussion see Chapter 3 of this thesis.

'Chinese wall' was that non-Eurozone States obviously do not participate in the monetary policy considerations and thus would find themselves at an inherent disadvantage, when the monetary and supervisory interests of the ECB need to be balanced, even when they do not conflict.

b) Directly supervised institutions

Supervision is based on a distinction between significant and less significant institutions. Generally, the ECB is in charge of the biggest or particularly systemically or domestically important entities, which effectively amounts to roughly 120 banks, whereas the NCAs are in charge of the rest of the market.

i) Rules for determining the supervisor

One of the most fundamental changes introduced by the EBU is that, via the SSM, the ECB directly supervises institutions, which are "significant on a consolidated basis."[293] Pursuant to Art.6(4) SSMR, an institution is considered significant and therefore falls within the ECB's direct supervisory domain under at least one of the following circumstances:

- the total value of its assets exceeds 30 billion euros;[294]
- the ratio of its total assets over the GDP of the participating State exceeds 20%, unless the total value of its assets is below 5 billion;[295]
- upon a notification[296] by the NCA that it considers such institution significant to the domestic economy and a resulting ECB's comprehensive assessment;[297]
- ECB decision where the institution has established subsidiaries in more than one participating State and its cross-border assets or liabilities represent a significant part of its portfolio;
- it is one of the three most significant credit institutions in a participating State;[298]
- any institution that directly receives or requests ESM assistance.[299]

[293] Note the difference in the language employed: SSMR uses the term "systemically important institutions" significantly less, compared to the proposals and mostly refers to them as "significant institutions". The previous term is still used for non-Eurozone banks, e.g.Art.3(6).
[294] Art.6(4)(i)
[295] Art.6(4)(ii)
[296] Art.6(4)(iii)
[297] Including a balance-sheet assessment.
[298] Art.6(4), last paragraph
[299] Or received previously from the European Financial Stability Facility

It is apparent that the interpretation of some of these criteria allows for more discretion than for others. A distinction can be drawn between the 'hard' (30 bln, GDP ratio, top 3 in the State) and 'soft' (NCA notification, subsidiaries in a NoPS) criteria. For example, for the third criterion (NCA notification) the ECB is expected to take into account all relevant circumstances, including level-playing field considerations, the weighting of which leaves a margin of discretion.[300]

Credit institutions that do not meet one of the above criteria – so-called 'less significant' entities – generally continue to be supervised by NCAs. This distinction between significant entities which are directly supervised by the ECB, and less significant entities, which continue to be supervised by NCAs, is a key feature of the SSM and, as I will illustrate hereinafter has become a point of legal contention, when 'borderline' entities seek to be classified in a particular way.

ii) The particular circumstances clause and its judicial interpretation

Besides setting out the above criteria, Art.6(4) includes an important discretion for the ECB. It foresees that in case of 'particular circumstances', the ECB can 'reclassify' a significant credit institution as less significant. This possibility is further fleshed out in the SSM Framework Regulation (SSMFR).[301] Pursuant to Art.70(1) of the SSMFR, particular circumstances exist where:

> '*there are specific and factual circumstances that make the classification of a supervised entity as significant inappropriate, taking into account the objectives and principles of the SSM Regulation and, in particular, the need to ensure the consistent application of high supervisory standards*'.[302]

If the ECB decides to make use of this provision, the reclassified credit institution will be supervised by NCAs. However, generally, the use of the 'particular circumstances' clause appears to be limited. The SSMFR states that the term must be interpreted strictly.[303] Moreover, the 'particular circumstances' that would allow classifying an otherwise significant entity as less significant are to be determined on a case-by-case basis and "specifically for the supervised entity or supervised group concerned, but not for categories

[300] SSMR Rec.41
[301] Art.6(4) sub-para.2 SSMR; Arts.70-71 SSMFR
[302] Art.70 SSMFR
[303] Art.70(2) SSMFR

of supervised entities."[304] As the case law suggests, the onus of proof seems to be on the institution (possibly also the NCA) to prove that the SSMR objectives can be better attained by putting a significant institution under the direct supervision of the NCA.[305]

These provisions on 'particular circumstances' came under scrutiny in the *L-Bank* case.[306] In this case *Landeskreditbank Baden-Württemberg – Förderbank* (L-Bank), a German bank wholly owned by the Land of Baden-Württemberg, received a notification from the ECB that "on account of its size it was subject solely to its supervision rather than shared supervision under the [SSM]."[307] L-Bank disagreed, invoking the 'particular circumstances' clause of Art.6(4) SSMR and Arts.70-71 SSMFR.[308] The Administrative Board of Review of the ECB – a body which, as mentioned in section C(1), carries out internal administrative reviews of the ECB's supervisory decisions – found the ECB's decision lawful. The final verdict was that "the applicant's classification as a significant entity was not in contradiction with the objectives of the [SSMR]".[309]

L-Bank challenged the decision of the ECB, including the ECB's interpretation of the term 'particular circumstances', before the General Court (EGC). However, the EGC agreed with the ECB. Referring to Art.70(1) SSMFR, which fleshes out the meaning of 'particular circumstances', it held that it had to be understood as:

> *"referring solely to specific factual circumstances entailing that direct prudential supervision by the national authorities is better able to attain the objectives and the principles of the [SSM Regulation], in particular the need to guarantee consistent application of high prudential supervisory standards."*[310]

It went on to confirm that the ECB was right when deciding in essence that a reclassification of L-Bank was only justified "if it was demonstrated that direct prudential supervision by the German authorities would be better able to ensure attainment of the

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[304] Art.71(1) SSMFR
[305] C-450/17 P, para.59 and T-122/15 para.75
[306] Landesbank Baden-Württemberg is a parent company controlling three commercial banks and the Landesbank for some Federal States of Germany; Germany's biggest state-backed landesbank lender.
[307] *Landeskreditbank Baden-Württemberg v. ECB* Case T-122/15 Para.2
[308] Under Art.70 SSMFR "Particular circumstances […] make the classification of a supervised entity as significant inappropriate, taking into account the objectives and principles of the SSM Regulation and, in particular, the need to ensure the consistent application of high supervisory standards." Under Art. 71 such determination is to be made on case by case basis.
[309] ECB/SSM/15/1, para.2
[310] *Landeskreditbank Baden-Württemberg v. ECB* Case T-122/15 Para.80

objectives of the [SSMR] than supervision by the ECB."[311] EGC also ruled that under Art.6(4) "the ECB has exclusive competence for determining the 'particular circumstances' in which direct supervision of an entity which should fall solely under its supervision might instead be under the supervision of a national authority."[312] L-Bank appealed the decision of the EGC, but on appeal, the Court of Justice (CJEU) confirmed the decision.[313]

The CJEU notably did not close the door to such challenges completely, remarking that in principle there was nothing in either regulation, which "would make it impossible for the Landeskreditbank to argue that there are 'particular circumstances' within the meaning of those provisions, and to adduce proof of their existence," [314] and that a stronger argument presented in claiming 'particular circumstances' could be more fruitful.[315] Notably, the ECB has exercised its discretion not to supervise with respect to several banks, on grounds including preservation of national supervisory system, and the bank being otherwise too small.[316] However, this is still an instance of the ECB exercising its discretion, and seeing an exercise of discretion as a limitation to discretion would be erroneous.

This case also set precedent as to how the principle of proportionality is to be interpreted in the SSM (potentially EBU as a whole) jurisprudence. The CJEU stated that "the principle of proportionality was taken into consideration by the EU legislature, and that the ECB is not required […] to determine case-by-case whether, despite the application of the criteria set out in the second subparagraph of Article 6(4) […], a significant institution should come under the direct supervision of the national authorities on the ground that they are better able to attain the objectives of that regulation.[317] The justifying logic seems to be that as long as the credit institution satisfies one of the 'hard' criteria of classification (i.e. top 3 in the country, 30 billion, etc.,) the proportionality test is automatically considered to be satisfied, as that is how the system was envisaged by the legislature. It is not unforeseeable that, should the institution be classified as significant based on more discretionary criteria, the approach could be more lenient, but that is not confirmed.

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[311] Ibid. para.81
[312] Ibid. para.54
[313] *Landeskreditbank Baden-Württemberg v. ECB,* Case C-450/17 P
[314] C-450/17 P, para.63
[315] Ibid. para.71
[316] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1646, with reference to Third 2014 SSM Quarterly Report, p.6
[317] Case T-122/15 para.59, also para.75 of Case C-450/17 P

iii) Consequences of differentiation by significance

The arrangement based on significance assessment, while effectively utilising an existing infrastructural base, also has some drawbacks. Firstly, such arrangement still necessitates the existence of the NCAs in their full pre-EBU capacity, corresponding budgets and payrolls. Secondly, small institutions can also turn out to have systemic implications within (and as a result of) their particular operating environments.[318] The well-known problems of 'cajas de ahorro' in Spain are illustrative of this problem. Thirdly, the credit institutions themselves clearly do not see the two regimes as being equivalent, and are willing to 'shop' for the one that suits them better, which has multiple negative effects.

In the light of such concerns, the Commission initially proposed that all banks in participating States should be supervised by the ECB. However, this proposal crashed against a wall of national interests. Germany, the Netherlands, and Finland prominently argued that smaller institutions with no major cross-border activities should continue to be supervised by the NCAs.[319] Two pragmatic factors also came together in shaping this system: the ECB itself was being reformed and facing constitutional limitations; the NCAs were already in place to do the job.

This represents a broader theme of the EBU reforms where old and new architecture had to be modified and merged together, as discussed in Chapter 1. This is not, in and of itself, a problem. Concerns appear where, as Moloney expressed it "the proxies can be shaped by political interests rather than disinterested assessments of optimal scope."[320] As I will illustrate,[321] the numerous EBU/SSM limitations, divisions, exemptions, discretions, and exclusions have been shaped by many distinct and sometimes conflicting interests. It becomes hard to find their underlying logic. In order to effectively function in this environment, the ECB was given the discretion in *interpreting* the significance criteria, but that resulted in a whole new set of political and constitutional problems, discussed in section E.

c) Functions and powers of the ECB within the SSM

Following prolonged wrestling with constitutional limitations, legal challenges and political pressures, the ECB nevertheless ended up with a list of significant supervisory tasks.

[318] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1645, see SSMR Rec.16
[319] Ibid.
[320] Ibid.
[321] Subsection 7, below.

In this subsection I will touch upon the most important aspects, including some of the more contentious ones.

i) **authorising and withdrawing the authorisation** of all credit institutions established in a participating State irrespective of their significance.[322] The SSMR justifies this consolidation of authority by emphasising the need to ensure that only "an organisation capable of dealing with the specific risks inherent to deposit taking and credit provision, and suitable directors carry out those activities."[323] NCAs nevertheless participate in the authorisation process, since it is up to them to propose to the ECB to grant authorisation.[324] As Moloney summarised, NCAs are "responsible for data collection and assessment of compliance; […] the ECB in effect endorses the NCA decision but is the *de jure* authorizing actor, albeit with limited operational control." [325] NCAs can outright reject an application for authorisation, if the requirements for authorisation under national law are not met.[326] They can also propose to withdraw the authorisation of a credit institution pursuant to EU or national law.[327] Thus, the ECB has to carry out its tasks with regard to withdrawal of authorisations in cases of non-compliance with national law.[328] In such cases the ECB, a pan-European, non-judicial body, effectively enforces national law of participating States and shows deference to their requirements and procedures.

ii) To conduct or participate in **cross border supervision**, when at least one State involved participates in the SSM.[329] That includes carrying out the tasks of the home State NCA in case of a credit institution established in a participating State, which wants to establish a branch or provide cross-border services in a NoPS,[330] supervision of credit institutions' parents established in a participating State,[331] and participation in supervision on a consolidated basis in relation to parents not established in one of the participating States.[332]

The ECB acts as either the home or the host authority where the credit institution is established *across* the SSM borders. This essentially happens in accordance with the old

[322] Arts.4(1)(a) and 14 SSMR
[323] Rec.20 SSMR
[324] They can also propose to the ECB to withdraw an authorization under Art.14(5)
[325] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1648
[326] Art.75 SSMFR
[327] Art.4(1)(a), Rec.20 SSMR
[328] Art.14(5) SSMR
[329] Art.4(1)(b) and (g), Art.6(4) SSMR
[330] Art.4(1)(b)
[331] Art 4(1)(g)
[332] Ibid.

home-host principle, discussed in Chapter 3(A)(1) of this thesis, but with the ECB stepping into the shoes of the relevant NCA. The ECB has, pursuant to Art.9 SSMR, all the powers that competent authorities have under EU law (e.g. the CRD), unless otherwise provided.[333] Importantly, the ECB can also require NCAs to make use of their powers stemming from national law, where the SSMR does not confer such powers on the ECB.[334] As discussed in detail in Chapter 3, with regard to credit institutions established in non-Eurozone *participating* States, the ECB exercises its powers via Close Cooperation agreements.[335] By virtue of such agreements the States partly surrender their NCAs and national legal banking supervision powers to the ECB. This modified SSM arrangement seeks to ensure that the supervision of the ECB does not allow any spill-overs from the Eurozone and delivers on the promise to act in the interest of the EU as a whole. It follows a broader pattern of the EBU whereby the more cross-border the business is, the more supranational oversight it attracts.

iii) The ECB **assesses acquisitions and disposals of qualifying holdings in credit institutions,** except resolutions.[336] The SSMR states that "an assessment of the suitability of any new owner […] is an indispensable tool for ensuring the continuous suitability and financial soundness of credit institutions' owners." [337] Merger and acquisition issues came to the forefront during and shortly before the GFC. From the failed attempts to organise the last hope takeover of Lehman Brothers, to the story of RBS, which brought ABN AMRO's subprime mortgages onto their books just before the crash - these events had dire consequences.

Banking mergers often have strong political undertones, which does not always result in the best outcomes. Political pressures and obstacles, particularly in crisis situations, can result in unnecessary delays, which can prevent a timely acquisition and result in outright failure of the troubled bank.[338] On the other hand, unchecked business interest of systemically important entities can result in destabilising mergers. With the SSM system in place, harmful mergers are more likely to be prevented, thanks to the ECB's greater expertise and more resources for assessment, while locally less favoured (but necessary on the European scale) mergers are easier to force through.

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[333] SSMR Rec.45
[334] Art.9(1) para.3
[335] For detailed discussion of Close Cooperation Agreements see Chapter 3.
[336] Art.15 SSMR
[337] Rec.22
[338] for specific examples see S Deo, C Franz, C Gandrud, M Hallerberg, *Preventing German Banks Failures: Federalism and Decisions to Save Troubled Banks*, Politische Vierteljahresschrift, PVS, 56 2015, p.168

While under Art.15 SSMR the initial assessors of acquisition applications are the NCAs, the ECB can essentially veto such acquisition on the basis of EU law. According to Gortsos, with mergers and acquisitions of businesses in the banking sector being subject to approval by the ECB, the European banking landscape will be shaped at supranational level for decades.[339] There is little doubt that the ECB as an EU institution, is well placed to carry out such an assessment, arguably without imposing undue restrictions on the internal market,[340] but this also raises questions as to where prudential supervision ends and direct market regulation begins.

iv) The line between supervision and regulation is also blurred in relation to the assessment of **suitability of directors**, which is obviously is a huge power, as a matter of principle *and* practice.[341] Even in federal states like the USA, Switzerland or Russia such powers can only exercised by the federal authority under limited circumstances, and the ECB does not (*sensu stricto*) wear the mantle of the sovereign in the EU. Art.93(2) SSMFR gives the ECB all powers the relevant NCA has for such matters. Additional related provisions expand it beyond, including the removal provisions of Art.16(2)(m) SSMR, which includes removals on the basis of EU and national law transposing Directives.[342] Grundmann sees this as a fundamental change with consequences stretching far beyond banking law.[343] He argues that the organisational requirements of banking supervision, including acquisition and disposal of holdings and suitability of directors, will at some point inevitably clash with the goal of increasing the shareholder value, which could alter the private law equilibrium, especially in company law, "with the ensuing need for a detailed readjustment of rules on duties of directors (their ultimate goal no longer being shareholder or also stakeholder welfare)."[344]

v)The main function of the ECB in the SSM is of course to **ensure compliance with relevant prudential requirements and governance requirements.**[345] In ensuring

[339] Ch Gortsos, *The single supervisory mechanism: a major building-block towards a European Banking Union (the full europeanisation of the 'bank safety net')*, ECEFIL 2013, p.34
[340] Ibid.
[341] SSMR Rec.20 and Art.16 SSMFR Arts.93-94
[342] See Art.4(3) SSMR
[343] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Hart 2019, p.114
[344] Ibid.
[345] Art.4(1)(d) and (e)

compliance, the ECB applies Union law (e.g. the CRR), but not only. Indeed, the SSMR also tasks the ECB with applying *national* law where the relevant Union requirements are set out in an EU directive (e.g. the CRD). Directives require implementation into national law and accordingly the ECB must apply the law that transposes the Union law into national law. To be sure, EU regulations are different. They do not require implementation into national law and the ECB can apply them directly. Nonetheless, these regulations can still include 'options' for Member States. Accordingly, the SSMR also requires the ECB, when exercising its tasks, to apply relevant national laws which exercise these options.

Clearly this arrangement, where the ECB – as an EU institution – is required to apply national law is a constitutional peculiarity and one that was hotly debated during the negotiations of the SSMR. Such arrangement has broader implications which will be discussed in section E. For now suffices to say that this arrangement is an unusual deviation from the general EU line of reasoning, where national implementing measures and national laws applying options are out of an EU body's reach. In general, any kind of direct law application of EU bodies is unusual. Previously, similar centralised decision-making procedure combined with law application only existed in competition law.[346] Based on Art.103 TFEU, the Commission was entrusted with the competence to enforce EU law via Regulation 17/1962.[347]

Arguably, such arrangement was necessary and in line with the broader SSM logic. Given that much EU legislation is still adopted in the form of directives, it was a necessary arrangement. This is all the more so, since directives lack horizontal direct effect and accordingly, the ECB would not (generally) be able to rely on Directives against credit institutions (which are private parties).

vi) The ECB performs **supervisory reviews and stress tests** in order to determine whether the arrangements of credit institutions and the own funds held by them ensure a sound management and coverage of risks.[348] On the basis of supervisory reviews, the ECB can impose specific additional funds, publication and liquidity requirements, as well as take other measures.[349] The ECB monitors whether the banks hold certain levels of capital against risks inherent to the business, limit the size of their exposures to individual counterparties in

[346] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart 2019, p.286
[347] Ibid.
[348] SSMR Art.4(1)(f), including in coordination with EBA.
[349] where those measures are specifically made available to the competent authorities.

accordance to the (notably rather flexible) Single Rulebook provisions, and disclose information on their financial situation, as well as dispose of sufficient liquid assets to withstand situations of market stress, and limit their leverage.[350]

vii) The ECB **participates in supplementary supervision of a financial conglomerate** in relation to the credit institutions included in it, and assumes the tasks of a coordinator, where appointed.[351] As discussed, supervision of conglomerates, as well as inclusion of financial holding companies and mixed financial holding companies are significant improvements, which expanded the ECB's remit significantly. On the other hand, their inclusion makes the exclusions of other 'bank-like' entities and their groups even harder to justify, as I will discuss in subsection 7 below.

viii) A particularly contentious aspect of the SSM arrangement is that the ECB performs **supervisory tasks relating to recovery plans and early intervention** where a credit institution or a group does not meet or is likely to breach the prudential requirements. That includes a number of powers relating to fundamental aspects of business operations. As Donnelly observed, these powers "are controversial enough within a country, but are un-precedented within the EU. All of these measures require strong regulatory authority to intervene in the property rights of companies, shareholders and creditors."[352] The ECB can also implement structural changes required to prevent financial stress or failure. Such powers notably do not (or at least *should* not) amount to outright resolution. The resolution plans are also mainly the responsibility of the Single Resolution Board, discussed in Section D, although the dividing line is not clear. According to Baglioni, the SSM lacks a clear distinction between early intervention measures, resolution powers, and day-to-day supervision.[353] That has further reaching consequences of particular relevance for the problematic assessed in this thesis, as the involvement of the ECB in the activities forming part of other pillars of the EBU brings the representation issues of the SSM into these other pillars.

[350] SSMR Rec.23
[351] in accordance with the criteria set out in relevant EU law
[352] S Donnelly, *Power Politics and the Undersupply of Financial Stability in Europe*, Review of International Political Economy 21:4 2014, p.983
[353] Baglioni, *supra*, p.95

ix) Another instance where the ECB operates on the border of the competence of another EU body is **contribution to the development of draft regulatory technical standards or implementing technical standards**.[354] The adoption of those standards is within the purview of the EBA and not part of the tasks of the ECB. The role of the ECB is to contribute in a 'participating role' to their development, or to draw the attention of EBA to the need for such standards. Moreover, the ECB itself is subject to the regulatory and implementing technical standards drafted by EBA in accordance with Arts.10-15 and 16 of Regulation 1093/2010, and to the provisions of the European supervisory handbook, also developed by EBA.[355] The intricacy of these relationships is discussed in section B of this Chapter.

x) The ECB's involvement in rule making also extends to **adopting regulations for the arrangement of SSM tasks**.[356] Before adopting a regulation, the ECB conducts public consultations unless that is disproportionate or the matter is urgent.[357] Moloney observes that the ECB has considerable rule-making powers, not just under Art.4(3) SSMR, but also Art.132 TFEU, which, *inter alia*, allowed for the ECB's investigatory and enforcement powers and its operational framework, to be partly governed through ECB-made rules.[358]

xi) The range of the **ECB's investigatory powers** is vast. That includes institution investigations and on-site inspections.[359] To that end the ECB exercises all the investigatory powers the NCAs would have under EU law and can request the NCAs to use their power existing solely under national law.[360] Moreover, the ECB can ask national courts to have its orders enforced in case of a refusal of an on-site inspection,[361] and has the power to *request* the assistance of the relevant NCA.[362]

xii) The ECB also has far reaching direct and indirect **sanctioning powers**, including fines and penalties for failure to comply with obligations under its regulations and decisions,

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[354] Art.4(3)
[355] Ibid.para.2
[356] Ibid.
[357] Ibid.
[358] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1643
[359] SSMR Rec.47, Arts.9-14
[360] Art.9(1) para.3 SSMR
[361] Art.13(1) SSMR
[362] Art.12(5) SSMR

rooted in the mentioned Art.132(3) TFEU.[363] *Inter alia*, that includes pecuniary penalties up to twice the amount of the profits gained or losses avoided because of the breach.[364] NCAs are able to apply penalties in case of failure to comply with obligations stemming from national law, including such law enacted in transposition of Directives. Importantly, under Art.18(5) the ECB can direct NCAs to open proceedings imposing penalties for breaches of both, EU acts and national legislation, including national legislation conferring powers, which are not stipulated by EU law. In this respect the ECB's sanctioning powers stretch even beyond the powers of courts.

xiii) Besides its micro-prudential tasks, the ECB also has certain tasks in the **macro-prudential area**. Macro-prudential supervision concerns systemic risks to the banking system as a whole. The toolkit of macro-prudential supervisors includes, *inter alia*, the ability to adjust capital buffers, exposure limits, etc. Specifically, under Art.5 SSMR, the ECB can apply higher requirements for capital buffers and 'more stringent measures aimed at addressing systemic or macro-prudential risks' than those that are applied by macro-prudential actors of participating States.[365] The fact that ECB can only apply higher requirements or more stringent measures underscores that the ECB's role in the macro-prudential field is only secondary. Schammo rightly observes in this context that the SSMR "does not vest exclusive macro-prudential competence in the ECB. The ECB's power under Art.5(2) is an intervention power. National actors continue to be the primary holders of macro-prudential competence."[366] Nevertheless, he also points out that – the ECB's secondary role notwithstanding - the ECB takes the view that it can exercise its macro-prudential powers 'even if no measures have been applied at the national level.'[367] He refers to Art.102 SSMFR, according to which the failure of a national authority to set a buffer rate 'does not prevent the ECB from setting a buffer requirement.' However, actual macro-prudential powers, albeit limited, are somewhat unusual among the SSM's mostly micro-prudential provisions. Many NoPS consider this overreaching and it is one of the many issues that concern them.

xiv) This list featured several mentions of the ECB **applying national law**. That is a

[363] Arts.17-18, Rec.36
[364] Art.18(1)
[365] Details with respect to rules and procedures are found in the CRD and CRR.
[366] PJE Schammo, *Inaction in Macro-prudential Supervision: Assessing the EU's Response*, Journal of Financial Regulation Vol.5:1 2019, p.18
[367] Ibid.

part of a broader arrangement whereby the ECB can utilise national legal systems in pursuit of the declared goals of the SSM. It could be considered part of the effort to combat inaction bias, giving national legislation additional enforcement capacity.[368] On the other hand, by engaging in application of national law, the ECB arguably bypasses the NCAs, taking part of their mandate stemming from national democracies.

If national law confers on the NCAs powers which are not required by EU law, including certain early intervention and precautionary powers, the ECB can require NCAs in the participating States to use those powers.[369] Notably, as a general rule, the ECB can only issue such instructions where the SSMR does not confer equivalent powers on the ECB, but this is not a significant limitation in this context.[370] This raises two broader concerns. On the one hand, the ECB takes over many powers that were entrusted to the NCAs by their sovereigns, through delicate and politically contentious processes. On the other hand, even though the ECB (by working through NCAs and applying national law) shows some deference to subsidiarity, long term such system can create bumps in the playing field. As Mills put it, "diversity of state laws" can lead to "an anachronistic fracturing of regulation, facilitating forum shopping."[371] For example, the aforementioned application of local sanctioning powers brings up harmonisation issues, meaning that the playing field concerns, conflicts of interest and unequal application of precedent might occur. Moreover, Tridimas discussed a number of complications, which could arise through the ECB applying national law and noted that the ECB would have to interpret national law in order to apply it. [372] The question is whether the ECB would be bound by the interpretation of the national courts, or, alternatively, if it would be obliged to disregard such interpretation if it conflicts with EU law.[373] Micklitz questions the ability of the ECB, as an enforcement authority, to hold the vast body of EU and national rules together, to reach the national public officials in charge, and to do so more efficiently than the NCAs (or courts) do in the NoPS.[374] Furthermore, there is little practical guidance on how the ECB is to apply the rules of precedent or

[368] For commentary on inaction bias see Ibid. pp.1–28
[369] Rec.35, Art.9(1) para.3 SSMR
[370] Ibid.
[371] A Mills, *Federalism in the European Union and the United States: Subsidiarity, Private Law and the Conflict of Laws*, University of Pennsylvania Journal of International Law, Vol.32, No.2, 2011, p.420
[372] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.33
[373] Ibid.
[374] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.291

even whether it is bound by precedent in the first place.

7. Competences of the NCAs

Despite the central position of the ECB, the NCAs are a major integral part of the SSM.[375] Schammo described the SSM model as "based on an 'uploading' and 'unloading' of supervisory tasks: 'uploading' because the ECB […] directly supervise[s] credit institutions as a result of the establishment of the SSM;[376] 'unloading' because the ECB in its role as prudential supervisor [relies] on the expertise and work of national authorities."[377] In short, the SSM recognises the expertise of the NCAs within their jurisdictional, economic, organisational and cultural domains.[378]

This subsection briefly examines the main functions of NCAs, some of which were already touched upon in the previous subsection. It shows that NCAs play an important role within the SSM, but also continue to do so outside the SSM. This section does not provide a complete list of the NCAs' powers, as such powers differ in different States. Therefore, a detailed account would be outside of the scope of this research. This subsection merely seeks to highlight the most important aspects of the institutionally dual-layered nature of the SSM, before analysing the deeper implications of the power balance between the two levels in section E.

a) NCAs' role with respect to significant entities

While the significant entities are supervised by the ECB, at the operational level, NCAs have an important role.

Firstly, they participate in 'joint supervisory teams' (JSTs).[379] Each of such teams are composed of staff members of the ECB and the NCAs, but presided by a member of ECB staff – JST Coordinator.[380] Such teams engage in most aspects of day-to-day supervision of a significant entity, including supervisory review and evaluation process, the preparation of a supervisory examination programme and implementation of such programme.[381] Under Art.5(1) SSMFR, staff of national central banks, which are not the designated NCAs in their

[375] Art.6(1) SSMR
[376] Arts.4-5 SSMR
[377] PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, (Kluwer 2016), p.5
[378] SSMR Rec.37
[379] Art.3 SSMFR
[380] Arts.3(1) and 6 SSMFR
[381] Art.3(2) SSMFR

countries can also join the supervisory team. That arguably deepens the cultural symbiosis between central banking and bank supervision across the SSM.

Secondly, the NCAs assist the ECB with the preparation and implementation of acts relating to the tasks referred to in Art.4 SSMR, discussed above.[382] That includes the preparation and implementation of acts relating to the ECB's supervisory tasks, including the day-to-day assessment, on-site verifications, and assisting the ECB in enforcement of decisions.[383] Both the ECB and NCAs have an obligation to exchange information.[384] The NCAs and the ECB also 'share' sanctioning, authorisation and assessment of qualifying holdings powers discussed in subsection 6, above. Generally, in the areas where the powers of the ECB and the NCAs intersect, the general principle is that the NCAs can do more, but almost never – less.[385] That particularly applies to their powers in the macro-prudential field, to which I will return shortly.

b) NCAs' role with respect to less significant entities

Pursuant to Art.6(6) SSMR, the NCAs are responsible for the supervision of less significant banks and, in the absence of the ECB interference, generally have the same competences the ECB does for the significant entities. However, the role of NCAs with respect to less significant entities must now be seen in light of the aforementioned *L-Bank* decision. This case established that the NCAs carry out their tasks with respect to NCAs only as a result of a decentralised implementation of an ECB *exclusive* competence.[386]

The ECB also benefits from important powers over NCAs under Art.6(5) SSMR. Under Art.6(5)(a) the ECB issues regulations, guidelines, and general instructions to NCAs, according to which they complete their supervisory tasks. If that does not suffice in ensuring "consistent application of high supervisory standards", the ECB can decide to exercise directly all the relevant powers.[387] As discussed in section E, this provision is particularly contentious. That is linked to the ECBs exercise of oversight over the functioning of supervisory system as a whole.[388] The ECB can also at any point request information[389] and seek judicial authorisation for its actions via national institutions, even if that means

[382] Art.6(3)
[383] Arts.90-91 SSMFR
[384] Art.6(2) SSMR
[385] See on this issue E Chiti, F Recine, *The Single Supervisory Mechanism in Action: Institutional Adjustment and the Reinforcement of the ECB Position*, European Public Law Volume 24:1 2018, pp.122-123
[386] *Landeskreditbank Baden-Württemberg v. ECB* Case T-122/15, para.72
[387] Art.6(5)(b)
[388] Art.6(5)(c)
[389] Art.6(5)(d)-(e)

bypassing the NCA.[390] Moreover, under Art.31(2) SSMR, the ECB can order a supervisory team that does not involve the ECB's staff to include a member of any other participating State's NCA. In summary the NCAs retain a considerable number of tasks and a degree of operational autonomy in relation to the non-significant entities, but that autonomy can be removed by the ECB.

c) NCAs' role with respect to entities falling outside of the scope of the SSM

Outside the scope of the SSM the NCAs have retained their powers and responsibilities.[391] That includes some functions intertwined with the SSM supervision, but not forming part of it, like receiving right of establishment and free provision of services notifications, and day-to-day verifications of credit institutions.[392] Micro-prudential supervision of (technically) non-banking financial businesses also remains the exclusive responsibility of the NCAs. The list of such businesses includes, *inter alia*, all entities excluded by Art.1(2) SSMR (to which I will return hereinafter) and insurance and reinsurance undertakings excluded by Art.127(6) TFEU. Other notable businesses performing bank-like functions which remained with the NCAs include electronic money institutions, payment processors (including deposit-taking ones), UCITS, investment firms and funds, etc. Importantly, the Member States are free to diverge from the EU law definition of credit institutions to some extent, and designate some of these bodies as credit institutions under *national* law and have their NCAs supervise them as such. That would not bring them into the ECB's domain. Importantly, the NCAs also supervise credit institutions from third countries establishing a branch or providing cross-border services in the EU.[393] NCA's also retained all of their competences in non-prudential supervision.[394]

The underlying logic is that the NCAs retain all competencies that are not necessary to for implementation of EU policy in the area of banking supervision.[395] Questions, remain, however, as to whether all entities excluded from the scope of the SSM would fit under the umbrella of such justification.

[390] Art.6(5)(d)
[391] SSRM Rec.28
[392] Ibid.
[393] Ibid.
[394] EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.5
[395] SSRM Rec.15

d) Entities excluded from ECB supervision by the SSMR

As discussed in Chapter 1, it is widely believed that the surrender of national powers, particularly the powers of the NCAs, in the SSM area is quite significant. It is therefore unsurprising that many States deliberately sought to exclude certain entities not just from the SSM remit, but also from the remit of the CRD, and thus many other Single Rulebook provisions. As mentioned, all such entities are supervised by the NCAs.

I have discussed the exclusions resulting from Art.127(6) TFEU in Section C(5). Quantitatively, constitutional limits are not the primary source of exclusions from the ECB supervision. Further exceptions were made due to political pressures. Some of these excluded entities are, simplistically speaking, very similar to banks in terms of business profile, and engage in deposit taking and lending. Art.1(2) SSMR explicitly excludes institutions referred to in Art.2(5) of Directive 2013/36/EU (CRD)[396] from the supervisory tasks conferred on the ECB. That list is lengthy and includes *inter alia* investment firms,[397] Italian, French and Portuguese deposit taking funds, Croatian, Lithuanian and Irish credit unions, and many others. Whilst the exclusion of some institutions appears fully reasonable, due to their specific character and links to smaller regional economies within their States, the exclusion of credit unions and deposit-taking funds is less convincing. Often there is little practical difference between these institutions and credit institutions to which the SSM system applies, just like there is often little practical difference between similar entities excluded in one State but not excluded in another. A further problem is that excluded entities usually have particular links to the State or a region within it, which means that the problem of interconnectedness between the State and these institutions is particularly deep.

It is a reflection of a number of uneasy political compromises and the legacy of the GFC. Germany (in)famously lobbied for Sparkassen and Landeskreditbanken to be excluded.[398] That could have potentially given these gigantic entities, which are - by most measures - retail banks, a number of privileges. Germany even managed to get Poland - a determined NoPS - to come out in support of German exclusions. Lithuania, still not an EMU member at the time, also supported Germany, as well as all credit union exceptions, in order to set precedent for the exclusion of its own credit unions, when it joined the EMU shortly

[396] Amended to include Croatian and Bulgarian entities and modify the lists of other national exemptions by Directive 2019/878.
[397] As long as they fall within the scope of Directive 2004/39/EC
[398] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.12, see G Steinhauser, *L Stevens, German Savings Banks Flex Political Muscle: Sparkassen Have Punched Loopholes Into Europe's Post-crisis Banking Laws*, WSJ, 2013

after. Notably, Germany eventually reluctantly agreed to submit these entities to the SSM framework, in exchange for other concessions.

It is important to note, that the EU chose to use the CRD as a proxy for adjusting the exemptions, rather than simply listing them in the SSMR. Using a Directive, rather than a regulation for that purpose allowed for easier additions of exclusions, when negotiating participation with NoPS.

However, such flexibility comes at a cost. Due to the exclusions, the SSM regime does not apply to significant market segments, including institutions performing maturity transformations. Such limitations might be leaving room for regulatory arbitrage and tilting the playing field, as liquidity, especially toxic and otherwise suspicious assets, might gravitate towards alternative deposit taking institutions, including shadow banking entities, partly hiding them from regulatory oversight.

It can also drive further differentiation.[399] As discussed in Chapter 1(A), the national banking systems of the EU States are very diverse, due to their separate evolution, flexible - directives-based - EU legislation, and different economic philosophies. Veron uses the example of Germany, illustrating how the different layers of its banking system have effectively created a sub-strata of banks, which "are subject to a different supervisory, state-aid, and accounting framework [which] raises the possibility of competitive distortions" and a possible return of the "bank-sovereign vicious circles."[400] The Art.1(2) SSMR exclusions have the potential to aggravate such risks and draw further divisions between regulatory systems, not only between the Member States, but also within them.

Furthermore, Art.2(5) CRD has become a political battle ground, used by the States to resist the perceived power creep of the ECB and EU in general.[401] As this provision easily lends itself to amendments, such power struggle expressed through an almost annually amended legal provision inevitably conflicts with the goal of legal certainty.

e) NCA's role in the macroprudential field

As pointed out above, NCAs continue to be the primary actors within the macro-prudential field. Their powers stem from both, EU and national law. [402] However, even

[399] Stubb recognised territorial and sectorial scope as types of differentiated integration; ACG Stubb, *A categorization of differentiated integration*, Journal of Common Market Studies, vol.34:2 1996, p.283
[400] N Veron, *Banking regulation in the euro area: Germany is different*, Peterson Institute, May 11, 2020
[401] See section E(4) of this Chapter.
[402] SSMR Art.1 para.6 states "[t]his Regulation is also without prejudice to the responsibilities and related powers of the competent or designated authorities of the participating Member States to apply macroprudential tools not provided for in relevant acts of Union law", see also Rec.28

though macroprudential supervision continues in the main to be a national competence, the SSMR does impose some obligations on NCAs that wish to make use of certain macro-prudential tools. Specifically, if an NCA wishes to use one of the macro-prudential tools listed in Art.5 SSMR (e.g. impose a counter-cyclical buffer), it has to notify the ECB of this intention. The ECB can object, stating its reasons. The NCA has to 'duly consider' the ECB's reasons before proceeding with the decision, but retains the freedom to push ahead. The same principle broadly applies in the opposite scenario. The ECB can also apply higher requirements at its discretion, has to listen to the opinion of the relevant NCAs, but is capable of proceeding despite the possible objection.[403]

This is in line with Schammo's observation that, generally, the relations between the NCAs and the ECB are less hierarchical in macro-prudential supervision than in micro-prudential supervision.[404] In some cases, the NCAs can even utilise the firepower of the ECB to deal with particular national or regional concerns. For example, under SSMR Art.5(3), an NCA can propose to the ECB to raise capital buffers, seeking to address a specific situation in its State or regional setting. The language of Art.5(2) and (3) does not necessitate the causal factors arising from the financial industry itself. That effectively means that macro-prudential tools at the ECB's disposal could be used to address broader country or region specific concerns, as long as they do not fall too far from the SSMR's remit.

D. The Single Resolution Mechanism

A bank resolution is a process by which a failing bank is wound down or restructured, when it "cannot go through normal insolvency proceedings without harming public interest and causing financial instability."[405] This process allows the resolution authorities to use a plethora of intervention powers, reaching as far as suspension of creditor or shareholder rights.

Resolution, albeit preferable to outright insolvency, is obviously still an undesirable outcome. Therefore, it is normally preceded by a recovery attempt. That needs to take place when the bank still retains its recovery capacity - the capability to restore its financial position following a significant deterioration *before* reaching the point of potential

[403] Art.5(2) and (4) SSMR
[404] PJE Schammo, *Inaction in Macro-prudential Supervision: Assessing the EU's Response*, Journal of Financial Regulation, Volume 5, Issue 1 2019, pp.3, 18
[405] Europa website

insolvency.[406] When that point is reached, the resolution arrangements kick in. In the EBU this process is handled by the second institutional pillar – the Single Resolution Mechanism (SRM). In this section I will briefly introduce the functions and structure of the SRM and proceed to highlight the aspects of it that are of particular relevance for this thesis.

1. Membership and purpose of the SRM

The Member States participating in the SSM automatically participate in the SRM and vice versa.[407] As I will explain in detail in Chapter 3, for those States that opt into these arrangements and retain the ability to withdraw, withdrawal from one Mechanism would automatically expel them from the other one.[408] Such clauses do not apply to the EMU States, which participate in both mechanisms automatically.

The SRM primarily seeks to strengthen enforcement of the BRRD – the Bank Resolution and Recovery Directive - provisions in the participating States, by countering contagion and other systemic consequences of bank failures, as well as trying to prevent such failures in the first place.[409]

As discussed in Chapter 1, banking sector contagion effects often resulted from using public funds for bail-outs and interconnectedness between the credit institutions and states. According to the SRMR, these problems were partly attributable to divergences between national resolution rules, practices, and decision-making processes.[410] Thus the rectification of such issues was necessary to restore and retain confidence and market stability, as well as mitigate moral hazard.[411] As Moloney observed,

> "*the financial crisis has starkly illustrated how aggressively banking market damage and risk can be transmitted across the internal market. Containment of risk in one part of the internal market through the SRM should mitigate the extent to which risk spreads in crisis conditions*."[412]

[406] Art.2(1)(1) BRRD
[407] Art.4 SRMR
[408] Following the procedure stipulated in Art.4(3) SRMR
[409] BRRD Rec.1-3
[410] SRMR Rec.2
[411] Ibid.
[412] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1657

The SRM also seeks to continue the work started by the BRRD in strengthening market discipline, even in non-critical times. Before the SRM came into play, the BRRD bail-in mechanism had already placed the burden of bank losses onto shareholders and creditors before using the public funds, with a primary purpose of protecting the interests of taxpayers and mitigating moral hazard.[413] As Avgouleas and Goodhart observed, "turning unsecured debt into bail-in-able debt [can in itself] incentivize creditors to resume a monitoring function, thereby helping to restore market discipline".[414]

Although the SRM came in as an enforcement mechanism for the BRRD regime, it also effectively strengthens the SSM. A good way to ensure adequate prudential behaviour of financial institutions is the fear of ultimate failure. On that note Huertas argued that the SRM "can create a credible threat that the ECB could put a bank into resolution without cost to the taxpayer and without wreaking havoc on the economy at large."[415] Generally speaking, delinking the sovereigns from troubled too-big-to-fail banks and producing deterrent effects on the banking industry has potential to make the market more disciplined in and of itself. In that sense harmonised resolution can strengthen supervision.

2. The Single Resolution Board

With some exceptions, the SRM institutional infrastructure mirrors the SSM, in the sense that there is a division of responsibilities between the European and national levels.[416] The core institutional structure of the SRM is the Single Resolution Board (SRB), an EU agency established pursuant to the SRMR. In relation to significant banks, the SRB essentially assumes the tasks and powers of the relevant national resolution authorities (NRAs), like the ECB does for supervisory purposes.[417] That involves preparation of resolution plans and making resolution decisions.[418] Somewhat contrary to the name, the SRB's function is not just dealing with resolution; the role is proactive, focusing on resolution planning and preparation, seeking to *avoid* banking failures.[419] The NRAs of participating States retain the authority for smaller institutions and 'non-bank' entities,

[413] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.574
[414] C Goodhart, E Avgouleas, *Critical Reflections on Bank Bail-ins*, BIS 2015, p.4
[415] TF Huertas, *Banking Union: The Way Forward*, 2014, p.8, also in David Mayes, Geoffrey E. Wood and Juan Castaneda, (eds.) *European Banking Union: Challenges and Prospects*, Routledge 2016 see also SSMR Art.4(1)(i)
[416] Art.7 SRMR
[417] Art.7(2) SRMR
[418] Procedure detailed in Art.8 SRMR
[419] SRB mission statement on its website

including those specifically excluded by the SSMR/CRD, as discussed in section C, above.[420]

The SRB's mandate stems from Art.114 TFEU (the main legal basis for ESAs and EU financial regulation) which has historically been problematic.[421] As Moloney observed, Art.114 "does not confer a general competence to regulate the internal market, but requires that a measure must genuinely improve the conditions for the establishment and functioning of the internal market".[422] This was one of the reasons why the establishment of the Single Resolution Fund (SRF), imperative for the SRM's functioning, required a separate international treaty. I will return to the SRF in Subsection 4, below.

The SRB is comprised of a Chair, four full-time members, and members delegated by each participating State. Unlike in the SSM, no distinction is made between the representatives of EMU and non-EMU participating States. The full time members are appointed on the basis of merit.[423] The permanent members, including the Chair, are to act in the interest of the Union and a whole and in most respects are reminded to take into account the interests of the NoPS.[424] The ECB and the Commission also delegate permanent observers.[425]

The SRB does not always sit in the same composition. Under Art.43(5) SRMR, the composition varies between executive and plenary sessions, both of which have different tasks. The executive session includes the Chair, the four permanent members, and the two permanent observers. When the executive session is considering a resolution of a particular bank, these members are joined by the SRB members representing all the NRAs involved with that entity.[426] The membership of the executive session is therefore more restricted than that of the plenary session, which involves all members of the SRB. Under Art.53(1) SRMR, the SRB, in its executive session, can also, on *ad hoc* basis, invite additional observers, including a representative of EBA and the NRAs of NoPS, when deliberating on a group that has presence in them. The wording of the provision seems to suggest that the NoPS representatives are to be invited every time such situation emerges and that the SRB does not have discretion on the matter.[427] Moreover, under Art.83(3) SRMR the NoPS' NRA representatives can participate in joint resolution teams as observers.

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[420] Arts.1, 7 SRMR
[421] See Case C-376/98, *Germany v. Parliament and Commission (Tobacco Advertising)*, [2000] ECR I-8419
[422] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1653
[423] SRMR Art.56(4)
[424] E.g.Art.10(10) or Rec.32 SRMR
[425] Art.43(3) SRMR
[426] SRMR Rec.32
[427] Note the use of the word 'shall' for NoPS NRAs and 'may' for EBA.

In most other respects the cooperation between the SRB and the NoPS NRAs is limited to memoranda of understanding, which are non-binding soft law instruments.[428] I will return to their shortcomings in Chapter 3. Nevertheless, the flexible design of the SRB has been praised as "more dynamic and variable" than that of the ECB's Supervisory Board.[429]

Despite its smaller composition, the executive session has major powers, including preparing all the decisions to be adopted by the plenary session, preparation and approval of resolution plans, determining own funds and eligible liabilities requirements and even making significant decisions in relation to the SRF (generally those falling bellow 5bln Euro threshold).[430] The plenary session retains the decision-making superiority on using the SRF above the threshold and the investments that the Fund makes.[431] It also sets the vast body of rules, the executive session and the NRAs have to follow.[432]

3. Dealing with a troubled bank

The SRB's powers include use of a number of powerful resolution tools: the sale of business tool, the bridge institution tool, asset separation, the bail-in, etc.[433] The NRAs retain the same powers for all other banks, if the SRF is not being used. In any situation, the NRAs have to inform the SRB of their actions and coordinate with it, submit the resolution plans to the SRB and inform the SRB on the progress of a particular resolution.[434] Finally, the SRB can directly exercise the resolution powers with regard to any Eurozone credit institution, thus replacing the relevant NRA.[435]

Being more similar to an ESA than a Union institution, in terms of its mandate, the SRB has notable advantages and disadvantages compared to the Single Supervisory Board and the ECB. The biggest advantage is that the SRB's mandate, while broadly similar to that of the ECB's, can stretch further. For example, under Art.7(2)(b) SRMR, the SRB is in charge of all cross-border groups, regardless of their status in the SSM. It is argued that the SRM's 'significance test' design in this sense is more sensitive to cross-border and internal

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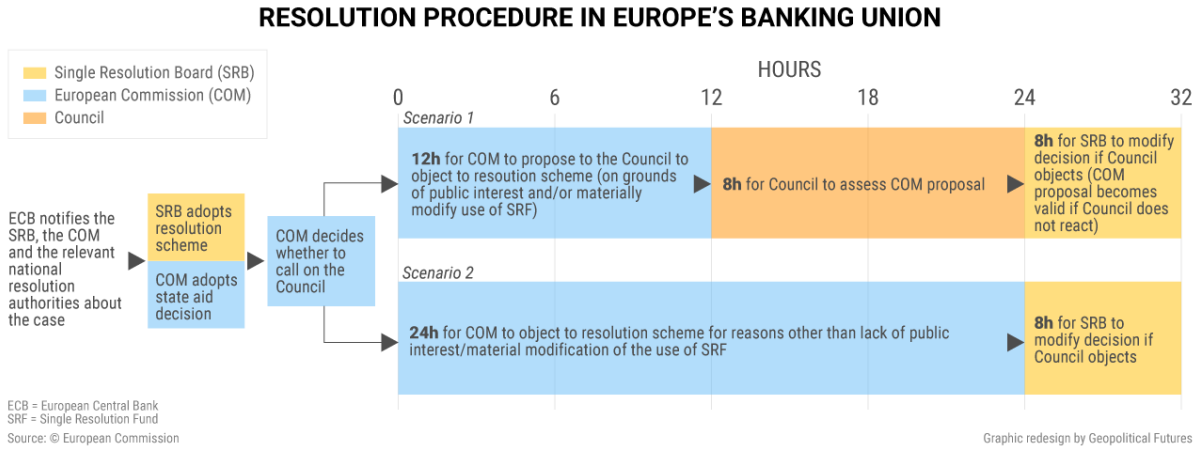
[428] Art.32 SRMR
[429] A Smoleńska, *Single Resolution Board: Lost and found in the thicket of EU bank regulation*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.177
[430] Art.54 SRMR
[431] Art.50(1) SRMR
[432] Ibid.
[433] Arts.23-27 SRMR
[434] Art.28 SRMR
[435] Art.7(4)(b)

market bank activities than the SSM's.[436] The mentioned institutional flexibility and equal representation for all participating States are also considerable advantages.

However, SRB also has a notable limitation: it needs to rely on the firepower of institutional actors to enforce its decisions. Particularly the NRAs are put in charge of the implementation of decisions regarding individual banks and use their powers under the Single Rulebook and national law to that end.[437] Moreover, the doctrines of delegation and conferral often require additional competence of an EU institution for implementation and enforcement. For that reason the Commission is heavily involved.[438] The scenarios involving different actors are illustrated in Fig.3.1 below.

Fig.3.1 Resolution Procedure in the EBU



A particularly problematic aspect is the ECBs involvement. As mentioned in section C above and explored in detail in Chapter 3, the conditions for participation in the SSM are not equal between the EMU and non-EMU states, which discourages most NoPS. That is mostly rooted in the exclusion of the opt-ins from the Governing Council of the ECB. Therefore, heavy involvement of the ECB in resolution processes risks undoing the good done by ensuring equal representation for the non-Euro participating States in the SRM. Simplistically, the more involved the ECB is in resolution, the more problems it brings over from the SSM.

The ECB is involved in the SRM on multiple levels. As discussed in section C, the

[436] A Smoleńska, *Single Resolution Board: Lost and found in the thicket of EU bank regulation*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.177
[437] Art.29 SRMR
[438] For summary of involvement of EU institutions see Rec.24 SRMR

early intervention powers are held by the ECB, for significant credit institutions.[439] Intuitively, the early intervention seems more like an activity falling within the resolution domain, rather than supervision. However, since the SRB is not equipped with full discretionary direct action powers, the involvement of a Union institution – the ECB - was necessary to ensure speed and swiftness of intervention. Otherwise the EBU bodies would struggle to intervene at a stage that could still be described as early, due to above-mentioned complexities of decision-making and enforcement. While the SSMR Art.4(1)(i) explicitly excludes resolution powers from the ECB's domain, other provisions indicate that the dividing line is far from obvious. The same provision gives the ECB the ability to instruct structural changes to the credit institution and the duty to participate in recovery planning. These powers in relation structural changes and requirements are certainly far-reaching, including additional funds requirements and restrictions to business operations.[440] Moreover, Art.12(1) SRMR requires the SRB to consult the ECB on the minimum requirement for own funds and eligible liabilities, which the ECB can then enforce pursuant to the aforementioned SSM legislation. While these are borderline powers falling somewhere between supervision, resolution and regulation, in one respect the ECB's involvement is particularly significant: the ECB can declare a significant bank 'failing or likely to fail', thus setting in motion all the resolution processes, as illustrated in Fig.2.2 below.

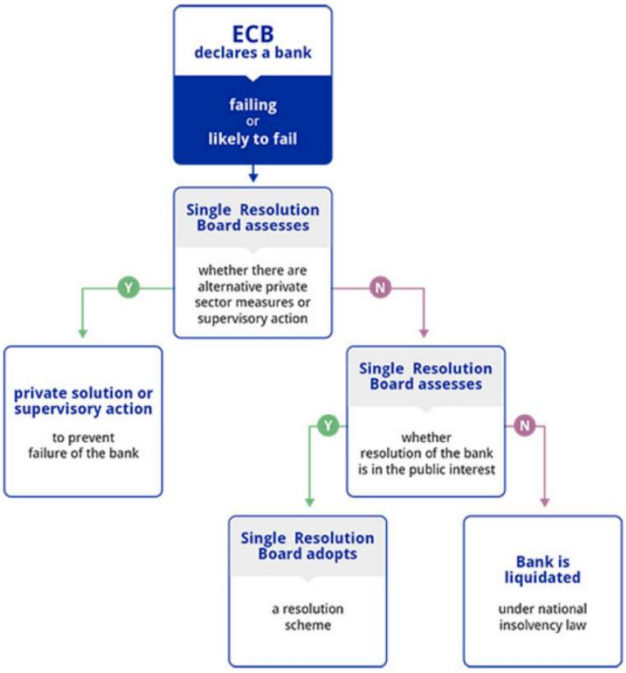


Fig.2.2 Resolution Decision Points in the EBU[441]

All in all, it is plain that decision-making within the SRM is quite complicated. The road to the final decision to resolve can stretch through the SRB, the NRAs, the European Commission, the ECB, the EBA and the NCAs, where separate from the NRAs.

[439] Art.13 SRMR
[440] See Art.16(2) SSMR
[441] ECB, *What happens when a bank is failing or likely to fail?*, 2018

Baglioni describes the SRM governance structure and decision making mechanics as "by evidence too complex."[442] He points out that all the bodies involved need to "take complex decisions and interact with each other under very strict time deadlines."[443] This complexity is increased by a large number of consultation, observation and oversight procedures.[444] A lot of these procedures are put in place to promote convergence, but the number of stakeholders and variables is mind-boggling, which is considered a feature of sub-optimal design by the majority of NoPS.

4. The financing arrangements and the (almost) single resolution fund

As Tridimas observed, "although, consistently with its legal basis, the SRM Regulation stresses its internal market credentials, its centre of gravity lies with the substantive aim of pursuing financial stability through the establishment of burden-sharing arrangements."[445] Such burden sharing would be impossible without adequate funding, which necessitated the creation of the SRF. It is an industry-contributions-based fund, meant to ensure that the banking industry itself remains primarily responsible for its health and rescue. It is also one of the SRM's most contentious features.

Just like many other components of the SRM, it mirrors the provisions for national resolution funds in the BRRD. Baglioni argued that the SRMR "makes the national resolution funds introduced by the BRRD obsolete, since they have been substituted by the SRF."[446] Although this could be the case for the Eurozone states, the situation for the NoPS, wishing to join the SRM is – predictably - more complex. As I will explain in detail in the next Chapter, non-Eurozone countries can, unlike their Eurozone counterparts, withdraw from the SRM and thus the SRF.[447] This would result in a number of sudden an very drastic changes, including a recoupment being repaid to them,[448] and reinstatement of the national resolution fund (NRF), which would have to satisfy a lengthy list of criteria.[449] That would likely force some States opting for long-term non-EMU participation to stockpile cash in a separate NRF on top of the SRF.

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[442] As stated by Baglioni, *supra*, pp.96-97
[443] Ibid.
[444] SRMR Rec.35
[445] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.26
[446] Baglioni, *supra*, p.98
[447] Art.4 SRMR
[448] SRMR Art.4(3)
[449] Ibid.

The size of the completely mutualised SRF is expected to be at least 1% of the covered deposits of all credit institutions in the participating State, same as for the NRFs.[450] The mutualisation process is regulated by the Intergovernmental Agreement signed by all EU States except the UK[451] and Sweden. This derogation of the UK and Sweden, two largest national banking markets in the EU outside Eurozone, was an important political statement, to which I will return in Chapters 4 and 5. Each State has to transfer up to 12.5% of their annual *ex ante* contributions.[452] The general idea, as Baglioni explains, is that during the mutualisation process "the national compartment of the country where the bank is established […] will be first used", digging into the mutualised funds as the crisis deepens.[453]

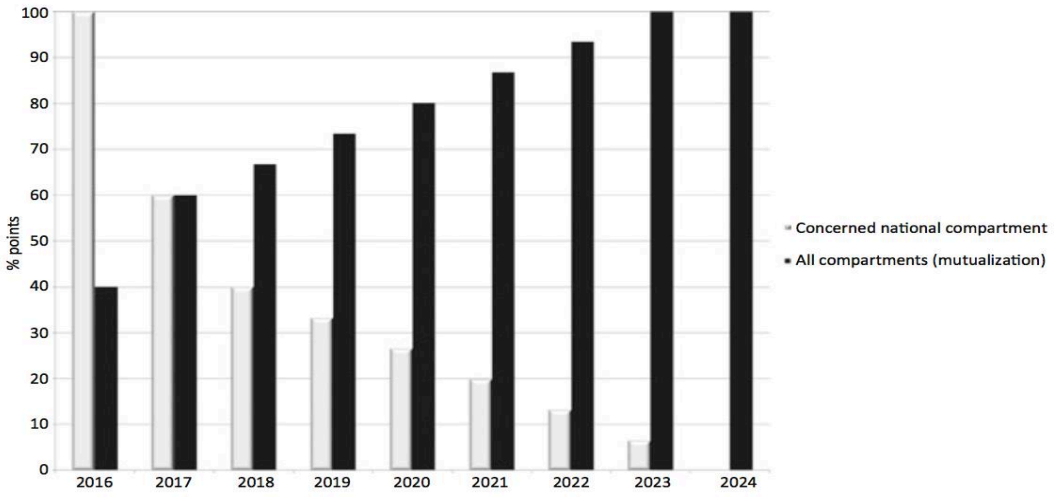

Fig.2.3. SRF mutualisation statistics and prediction. Source: Baglioni 2016[454]

The SRF Intergovernmental Agreement acknowledges the possibility of situations where "the means available in the Fund are not sufficient for a particular resolution action, and where the *ex post* contributions [need to be] raised."[455] The *ex post* contributions must not exceed three times the annual amount of *ex ante* contributions.[456] The possibility of a crisis situation similar to the GFC, where both types of SRF funding would not suffice needs to be considered. SRMR says that "under no circumstances shall the Union budget or the

[450] SRMR Art.69
[451] It was an EU Member State at the time
[452] SRMR Art.70(2)(b)
[453] Baglioni, *supra*, p.100
[454] Ibid. p.99
[455] SRF Intergovernmental Agreement para.13, For more on ex post contributions see JH Binder, Ch Gortsos, *European Banking Union: A Compendium*, CH Beck, Nomos, Hart 2016, p.66
[456] SRMR Art.71

national budgets be held liable for expenses or losses of the Fund."[457] The recovery plans also need to be drafted, avoiding any assumption of extraordinary public financial support.[458] That leaves two options. The first one is the Harmonised Loan Facility Agreement, signed by each SRM State with the SRB. Such agreement effectively provides a national individual credit line to the SRB to back its national compartment following resolution cases. Generally, this type of agreement means that a lender sets out the terms and conditions on which it is prepared to make a loan facility available to a borrower, an example of which is discussed in Chapter 4. That can be a time consuming process, not much faster than obtaining *ex post* contributions. The second option is the ESM. This option is also problematic as the ESM is limited to 700 billion euros (of which only 500 are available for lending) and operates in international law as an international treaty.[459] It is limited to the Eurozone, and non-Eurozone States, like Bulgaria and Croatia, could not accede to it when joining the EBU. Even for EMU States such process is not automatic, as the ESM is not linked to the SSM or SRM, and in that sense does not form part of the EBU. Furthermore, the ESM has its own eligibility criteria, which first need to be satisfied (which is also time-consuming), and even then the entire 500 billion would not be deployed to deal with the crisis in question. That is mostly because the ESM holds just 80 billion in capital, with 420 billion being callable. Moreover, it is worth noting that the ESM is an instrument of 'precautionary financial assistance' and is meant to recapitalise troubled banks, not bail out the failed ones, and thus serves a different function to that of the SRF.[460]

If these options fail and the SRF runs out of money, the responsibility to deal with the remainder of the shortfall would fall on the States housing the troubled credit institutions, even if that goes against the rhetoric of the SRMR. As Baglioni rightly observed, if this is the case, "the purpose of breaking the link between governments and the financial risk of their domestic banking sectors, which has been officially placed at the center of the European banking union project, seems to be seriously jeopardized."[461] Arguably this jeopardy would happen even at the stage of ESM application, as the ESM can purchase bonds of the beneficiary Member States and even issue its own, thus locking the ESM and the states in a loop.[462]

The use of the SRF for problem situations which do not amount to a crisis is also

[457] SRMR Art.67(2)
[458] BRRD Art.5(3)
[459] The Treaty Establishing the European Stability Mechanism, 2 February 2012
[460] See Art.14 ESM Treaty
[461] Supra, p.101
[462] Arts.17-18 ESM Treaty

restricted. As Huertas observed, "the BRRD allows the resolution authority to tap the resources of the fund to recapitalise a failing bank, provided creditors bear losses equal to at least 8% of the bank's liabilities and the assistance from the resolution fund is consistent with state-aid rules. [463]" Effectively that means that there is a *de minimis* threshold for magnitude of banking sector problems. Moreover, the funds available to individual states are even more limited.

Such limits and thresholds make perfect institutional sense, as the SRM is not envisaged as the main way of dealing with failing banks. It is expected that for most banks' liquidation can be achieved through the normal insolvency proceedings applicable to any company in the market, and only some credit institutions considered too systemically important and interconnected would be 'resolved'.[464]

It is largely for this reason that the SRF is often considered incomplete. Consequently, the creation of a backstop is being pursued by the Commission. Tridimas summarised the proposal as follows:

"The […] backstop would be used in combination with other resolution tools, namely, bail-in and the availability of the SRF and would include, for example, using common funding in combination with the ECB instruments to cover liquidity shortfalls and provide more time to look for the best buyer of a bank in a specific situation."[465]

Without going into too much detail of this proposal, as it is beyond the scope of this work and still incomplete, it is important to note that any deeper involvement of the ECB in the resolution process could make participation less appealing to NoPS in *de jure* or *de facto* permanent EMU derogation, and that needs to be taken into account.

E. Power struggle between the two levels of European banking oversight

As discussed in Chapter 1, following the Financial Stability Trilemma, it can be argued that opting into the SSM/SRM is effectively a choice of supranationalism over national

[463] TF Huertas, *Banking Union: The Way Forward*, 2014, p.8, also in David Mayes, Geoffrey E. Wood and Juan Castaneda, (eds.) *European Banking Union: Challenges and Prospects*, Routledge 2016
[464] See for example BRRD Art.42(5)(a), 32(5) Rec.14 and statement at: https://srb.europa.eu/en/content/what-bank-resolution
[465] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.26 with reference to European Commission, *Communication on Completing the Banking Union*, COM(2017)592

control. From the theoretical perspective, it could also be considered a choice of neofuctionalism over intergovernmentalism. Some have gone as far as to argue that it is in fact a choice of technocracy over democracy.[466] For that to be the case, however, mere legislative harmonisation is not enough. The institutional components of the EBU would need to exhibit clear supranational characteristics, as well as evident impetus towards further centralisation. It is therefore important to determine where the balance between the EBU institutional components and the national authorities has settled in terms of internal dynamics within these pillars. The acceptability of this settlement is a key consideration in the NoPS decision on participation. For the sake of clarity and brevity, I will mostly focus on the SSM, as it draws the sharpest distinction between the two levels, due to its differentiation between the EMU and non-EMU states, which is of particular significance for the topicality of this thesis. Moreover, with the ECB, an EU institution, as its centerpiece, the SSM is effectively the biggest recent leap towards greater direct control of a major policy area by the EU.

Subsection 1 starts with a brief discussion on the theory of federalism, often invoked in the SSM/SRM discussion, due to the two-level structure of these mechanisms. However, instead of attempting to answer whether the EBU institutional components fit into this theory, I take the theory apart and discuss how the SSM squares against the key balancing concepts that are employed in federalist assessment: the principle of conferral (Subsection 2), the principle of subsidiarity (3) and the level of centralization (4). Subsection 5 revisits the *L-Bank* case, and discusses the approach the European courts take in relation to the aforementioned key balancing concepts in the EBU context, as well as the political counter moves that the States employ in a bid to avert centralization.

1. Federalism

The division of the SSM and SRM into two (European and national) levels invoked the notions of federalism.[467] Tridimas described the EBU as "a force towards the federalisation of financial regulation."[468] Carmassi et al. even called it a 'federal model'.[469] In principle, division of power into two often characterises federalisation. To form a federation, as Alexis

[466] Ibid. Grundmann and Micklitz 2019
[467] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, and T Tridimas, *EU-Financial Regulation: From Harmonisation to the Birth of EU Federal Financial Law*, EUI 2010, pp.3, 14 who argued that even the creation of the EBU could be seen as a sign of federalisation of EU financial law.
[468] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.27
[469] J Carmassi at al, 2012 and T Tridimas, ibid.

de Tocqueville expressed it, is "to divide the sovereign authority into two parts."[470] There also seems to be a requirement of some sort of separation between two levels of governance, evidenced by 'physical' constitutional structures, as well as enumeration of (and limits to) the powers of the 'federal' body. [471] Using this as a yardstick, the SSM notably falls closer to the federal narrative than the SRM, due to the ECB's dominance and its status as an independent EU institution.[472]

The problem with this thinking is that there is no single definition of federalism in EU economic law, and the term has been employed very loosely. The meaning of federalisation in EU law, financial or otherwise, is far from uniform and is subject to numerous interpretations.[473] As Roobol observed, to the British 'to federate' may sound as 'to centralise', whereas to the Belgians it is more often understood as 'to decentralise.'[474] Therefore, calling a mechanism federal implies a division of authority into two parts, and suggests some conceptualisations concerning the power relationships that characterise federalism,[475] but does not suggest a sufficiently robust set of criteria for empirical analysis. This lack of clarity regarding the meaning of federalism persists in banking law. Grundman, discussing federalism in the specific EBU context, said that this theory "emphasises the main advantages of decentralised rule-setting, guided by the subsidiarity principle".[476] However, Tridimas deviates from this definition in a different chapter of the same book, and seems to imply that in this context federalisation means *greater* centralisation.[477]

With that being said, discussions on federalism, especially in the European context, almost universally involve the analysis of four variables: subsidiarity, conferral, centralisation, and balance of power. It is thus more meaningful to assess the features of the

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[470] A de Tocqueville, *Democracy in America*, Liberty Fund 1954, p.151
[471] Schütze, Robert, *Federalism as Constitutional Pluralism: Letter from America*, also in J Komarek, M Avbelj, (eds.), *Constitutional Pluralism in the European Union and Beyond*, Hart 2011, pp.30, 56
[472] See Rec.75, 77, Art.19 SSMR, Art.130 TFEU
[473] See S Deo, C Franz, C Gandrud, M Hallerberg, *Preventing German Banks Failures: Federalism and Decisions to Save Troubled Banks*, Politische Vierteljahresschrift, PVS, 56 2015, J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, A Mills, *Federalism in the European Union and the United States: Subsidiarity, Private Law and the Conflict of Laws*, University of Pennsylvania Journal of International Law, Vol.32, No.2, 2011, and R Schütze, *From Dual To Cooperative Federalism: The Changing Structure of European Law*, Oxford University Press 2009
[474] WH Roobol, *Draft Convention Preamble, Articles I-1, I-9 and I-17*, Cambridge University Press 2005, pp.87, 89
[475] See R Schütze, *From Dual To Cooperative Federalism: The Changing Structure of European Law*, Oxford University Press 2009, p.56
[476] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Bloomsbury 2019, p.100
[477] T Tridimas, *The Constitutional Dimension of Banking Union*, in Ibid. 2019, p.27

EBU in the context of these variables individually, as they each constitute a separate concern for the Member States.

2. *Conferral*

In the SSM, much like in the EU as a whole, the division of power is facilitated through the principle of conferral. The principle provides that "the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein," and "competences not conferred upon the Union in the Treaties remain with the Member States."[478] This is what the SSMR does: it *confers* specific supervisory tasks on the ECB. That is also a major difference between the SSM and the SRM. The SRM is not an instance of conferral of powers to an EU institution and thus its structure is less constitutionally problematic.

The significance of the SSM conferral of tasks cannot be overstated. The SSMR is the EU's formal recognition that, in principle, banking supervision is a Union competence, not only on the legislative, but also administrative and adjudicative levels. Grundmann argued that this is a "huge step taken conceptually – namely in that it is no longer only legislation (rule-setting) which is being transferred to the central EU level, but also its application/administration in the individual cases."[479] He sees it as a continuation of the Lamfalussy process, discussed in Chapter 1, in the form of a "move towards much "deeper unity in the application of law down into the single cases," but also a leap "towards much more intense 'real' uniformity in applied law – as compared to mere legislative harmonisation or even unification (even if combined with the possibility of preliminary reference)." [480] Arguably, the SSMR does not just confer new powers onto the ECB but also deepens such powers to an almost unprecedented extent. According to Micklitz, "the message is that banking is different from all other regulated markets – from telecom, energy, transport, but also from other financial services and insurance" and that special competence rules are "necessary for European institution building replacing national banking supervisory institutions."[481] To be clear, the ECB does not fully functionally replace the NCAs through the SSM/EBU, but it does, to a very large extent replace them in terms of the hierarchy of power. Grudmann thus alludes to the possibility that through this reform, the EU – mainly

[478] Art.5(2) TEU
[479] Grundmann, 2019, p.87
[480] Ibid., p.88
[481] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.278

through the ECB – will become in yet another area an independent supervisor of EU States and companies, like the Commission has become in competition law and state aid.[482]

3. Subsidiarity

The legitimacy of conferral of tasks in many ways rests upon the principle of subsidiarity, which is meant to ensure that powers are not elevated to the EU level unnecessarily. According to Carroza, subsidiarity is rooted in the fundamental "human need for both belonging and differentiation" and thus "demarcates a conceptual territory in which unity and plurality interact, pull at one another, and seek reconciliation."[483] As a legal principle, subsidiarity serves an important function – it counterbalances power consolidation.[484] In the TEU the principle is stated as follows:

"*…the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, […] but can rather, by reason of the scale or effects […], be better achieved at Union level*."[485]

Mills observed that, in respect to the principles of conferral and subsidiarity, an exclusive allocation of competence to the higher level "implicitly involves a determination that uniform regulation at that level is strongly necessary and justified" and "an exclusive allocation to the states implicitly involves a determination that regulation at the federal level is not necessary and cannot be justified."[486] This logic forms the basis of the formal justification for the establishment of the SSM, the objectives of which:

"cannot be sufficiently achieved at the Member State level and can therefore, by reason of the pan-Union structure of the banking market and the impact of failures of credit institutions on other Member States, be better achieved at the Union level…."[487]

Specifically, supervision and resolution of significant credit institutions is moved to the higher level due to the transnational character of their activities, while NCAs and NRAs remain responsible for smaller institutions, due to their particularities and connections to

[482] Grundmann, 2019, p.116
[483] PG Carozza, *Subsidiarity as a Structural Principle of International Human Rights Law*, 97 Am. J. Int'l L. 38 2003, p.52
[484] DJ Edwards, *Fearing Federalism's Failure: Subsidiarity in the European Union*, The American Journal of Comparative Law, Volume 44, Issue 4 1996, pp.537, 543
[485] Art.5(3) TEU
[486] A Mills, *Federalism in the European Union and the United States: Subsidiarity, Private Law and the Conflict of Laws*, University of Pennsylvania Journal of International Law, Vol.32, No.2, 2011, p.380
[487] SSMR Rec.87

smaller national and regional economies. This logic was also used in justifying the exclusions of certain entities from the scope of the EBU, as discussed in Section C(7)(d).

Historically, subsidiarity always gained importance at the moments of centralisation and consolidation of the EU institutions' powers. The added competencies of the ECB are an example of such centralisation. It can be recalled that the formal recognition of subsidiarity as a legal principle of EU law followed the expansion of the EU's powers by the Maastricht Treaty, the same Treaty that effectively created the EMU, which, in turn, the EBU was built to safeguard, as discussed in Chapter 1. This introduction of subsidiarity as a legal and political principle into the constitutional practice is understood in two ways: 1) as a reaction by States to the growing centralised power of the European community, 2) a methodology for ensuring balance between the EU and the States.[488] In reality it falls somewhere in between, with the assessment largely dependent on the assessor's political stance. Horst, for example, argued that subsidiarity as a principle is primarily playing a role in reducing the threat posed by the ECJ to the States' cultural diversity.[489] Bermann, also highlighted "the connection between subsidiarity and the expansion of the Community's powers," [490] but also considered its use to be a broader mechanism for balancing of power in the EU.[491] It is widely considered that subsidiarity adds moral and constitutional legitimacy to EU reforms, which is a particularly acute concern for the EBU.

Barber argued that subsidiarity "does not just embody a preference for smaller units over large ones: it allocates powers to the states containing the people who will be affected by the power."[492] Such interpretation of subsidiarity distils the "the function which the legal relationship involved fulfils in the economic […] life of any country."[493] The economic life is of course linked to political life, which thus makes subsidiarity politically sensitive. Deo et al. research shows that policy-makers' view of their financial system "varies based on the overlap between banks' activities and who politicians rely on for electoral support."[494] This is where the subsidiarity settlement manifests: it determines which officials have the power to influence the financial institutions (e.g. prevent bank failures), as well as which

[488] A Mills, 2011, p.393
[489] N Horst, *Creating an Ever Closer Union: The European Court of Justice and the Threat to Cultural Diversity*, 47 Colum. J. Transnat'l law 165, 2008
[490] GA Bermann, *Taking Subsidiarity Seriously: Federalism in the European Community and the United States*, Columbia Law School 1994, p.346
[491] Ibid. pp.386–90
[492] NW Barber, *The Limited Modesty of Subsidiarity*, Review of European Law in Context 2005, p.312
[493] M Guliano, P Lagarde, *Report on the Convention on the law applicable to contractual obligations*, European Council 1980, p.20
[494] S Deo, C Franz, C Gandrud, M Hallerberg, *Preventing German Banks Failures: Federalism and Decisions to Save Troubled Banks*, Politische Vierteljahresschrift, PVS, 56 2015, p.160

constituencies are important for politicians and officials to retain power.[495]

Consequently, the States are often reluctant to surrender such powers to supranational bodies, especially to a (more or less) autonomous EU institution, like the ECB. In such cases the States and some credit institutions tend to invoke doctrines capable of limiting centralisation, like subsidiarity, in order to maintain greater national control. Such considerations have particular practical implications, and play a role in the participation decisions of the NoPS. If the subsidiarity and centralisation questions are settled in a way that maintains a satisfactory balance between the NCAs and the ECB, the task of persuading the NoPS to join might become a little easier. However, if such settlement comes at the expense of operational stability, some of the practical incentives for joining might be lost. Moreover, it is not just the subsidiarity settlement that matters, but also the directions in which power flows *within* the EBU institutional pillars.

4. Centralisation and consolidation of power

The State contemplating participation in the SSM and SRM needs to factor in not one, but two levels of functional centralisation and power consolidation. Firstly, there is the static layer of centralisation, created by the EBU legislation itself. In a sense this settlement reflects the eventual consensus reached between neofunctionalism and intergovernmentalism during negotiations. Secondly, there is the dynamic layer, shaped by ongoing processes within the institutional pillars. Here, the ECB once again comes to the forefront, since being an EU institution and arguably the most powerful body in the EBU architecture, it could edge the overall construct towards greater centralisation and consolidation of power in its own hands. This would be very much in line with neofunctionalist theorisations.

The importance of the static allocation of power should not be understated. According to Carmassi et al. European banking governance centralisation did not necessitate that functions are always exercised at the central level for all banks and in all circumstances.[496] However, to achieve the intended goals, the arrangements needed to ensure that "the legal powers of supervisory decisions firmly reside at the supranational level."[497] Moloney wrote that the EBU "has re-ordered the balance of power between the Member States and the EU with respect to operational banking market governance and in so doing has placed some

[495] Ibid.
[496] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012 and T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019
[497] Ibid.

stress on the foundational Treaty settlement regarding the competence of the EU."[498] While it seems that the national regulatory autonomy aspect of the Financial Trilemma, discussed in Chapter 1, has been (partly) sacrificed, this might be the inevitable cost of having a banking union in the first place. Baglioni states that "on political grounds, the transfer of sovereignty related to the oversight over the banking system was a prerequisite to proceed toward the […] pillars of the banking union."[499] As discussed in Chapter 1, the imminent need to move away from the home-host principle was felt, and with it, the resulting need to partly move away from national oversight regimes.

The length, contentiousness and difficulty of negotiations, as well as the numerous compromises and exceptions discussed above, indicate that this transfer of (traditionally) sovereign powers, was not easy. Moloney's research revealed that the NCAs operate within a legal infrastructure which "privileges the position of the ECB" and thus "the loss of control by the Member States and NRAs/NCAs is real."[500] It is therefore unsurprising that the States might feel uneasy about the increases in powers and influence of the ECB - the most autonomous of the EBU institutions. This is of even greater concern for the NoPS, especially those unwilling to adopt the Euro, as they are, as mentioned, excluded form the ECB Governing Council. Any indication that the functioning of the SSM or SRM facilitates further consolidation of power in the hands of EU bodies, beyond the original legal settlement would be perceived as a major red flag.[501]

It appears that the ECB, supported by the Commission and the EU Courts, has been taking small incremental steps towards power consolidation, which forms the dynamic element of centralisation. Chiti and Recine's research revealed that while the ECB generally acted in a manner which is compatible with the rationale and text of the SSMR, "it has consolidated and promoted supranationalism within the SSM."[502] They point to a number of processes including, elaboration of the ECB's supervisory handbook, ideological prevalence of supranationalism, and gradual expansion of the ECB's powers, strengthening the functional prominence of the ECB in the SSM. [503] Crucially, Chiti and Recine consider the development of the SSMFR, in which the ECB played and important role, as part of this

[498] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1653
[499] Baglioni, *supra*, p.57
[500] https://www.palgrave.com/gp/book/9781137563132, p.1642
[501] See Chapter 4 of this thesis.
[502] E Chiti, F Recine, *The Single Supervisory Mechanism in Action: Institutional Adjustment and the Reinforcement of the ECB Position*, European Public Law, Volume 24:1 2018, p.124
[503] Ibid.

process. They argue that such activity of the ECB shapes the pattern of interaction between the ECB and the NCAs, and the nature of the supervisory powers wielded by the ECB. This dynamic is argued to be capable of conditioning future developments in the SSM.[504] This forms part of a broader narrative in which the decision-making allegedly moves away from coordination, towards centralisation.[505] According to Micklitz, when such fluctuation is possible, the power tends to flow predominantly in one direction - from the States to the EU.[506]

On a side note, this dynamic internal centralisation, which includes administrative centralisation, effectively prevents the SSM structure from being classed as federal. As Schütze argued, the powers of the federal body need to remain enumerated.[507] While some fluctuation is possible and natural, there needs to be a degree of separation, or at the very least the power balance needs to move back and forth between the two levels. Thus, the process of dynamic, one-directional flow of powers moves the construct from the federal 'middle ground' (between the national and international or between centralisation and coordination) into the territory of centralisation.[508]

My findings in this thesis confirm that this dynamic also affects the participation decisions of the NoPS. Through voluntary participation the NoPS would not only have to accept the subsidiarity settlement enshrined at the launch of the EBU, not only accept the clarification of this settlement provided by the CJEU, but also the fact that the ECB and - by extension - the EU is likely to gradually move (on the basis of policy *or* inertia) towards greater supranationalism, greater neofunctionalism, and thus also increasingly greater ECB dominance, *within* the limits permitted by that settlement. Tridimas expects institutional interaction, supervisory coordination, and the need to ensure the attainment of objectives, to lead to a high degree of normative harmonisation and supervisory convergence, through which ECB will become the dominant player.[509] He further reasoned that supervisory supremacy of the ECB is likely to lead to regulatory supremacy, due to unsustainability of

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[504] Ibid.
[505] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.285
[506] Ibid.
[507] R Schütze, *From Dual To Cooperative Federalism: The Changing Structure of European Law*, Oxford University Press 2009, p.56
[508] On the concept of federal middle ground see Ibid. p.58
[509] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.47

separation between regulation and supervision, and the institutional weight of the ECB.[510]

While there are many factors allowing the power within the SSM (and – by extension – the EBU) to consolidate in the hands of the ECB, perhaps the most obvious legal reason is that the SSM regime does create hard border between the competences of the ECB and the NCAs through Art.6(4) SSMR significance assessment. Furthermore, the congruence between the SSM and the SRM, as well as the ECB's involvement in the Single Rulebook rule-making thus allow for spill overs into other pillars of the EBU. Art.5(b) of the SSMR explicitly states that "when necessary to ensure consistent application of high supervisory standards, the ECB may at any time, on its own initiative […] decide to exercise directly itself all the relevant powers for one or more credit institutions [which are not deemed significant]." The ECB's ability to remove the bank form the NCA's domain, has been further enhanced by the formulation of the particular circumstances clauses in the SSMFR, the wording of which, as mentioned, has been influenced by the ECB itself. Rec.5 SSMFR says that the "NCAs are responsible for directly supervising the entities that are less significant, without prejudice to the *ECB's power to decide in specific cases to directly supervise such entities* where this is necessary for the consistent application of supervisory standards."[511] ECB's liberties extend to use of the NCA staff for supervisory teams at its full discretion.[512] Moreover, the NCAs do not *have* to be involved in some procedures like on-site inspections, but such involvement can be requested by the ECB.[513]

Most importantly, in line with neofunctionalist theories, the European courts have taken the ECB's side. Read in conjunction with the *L-Bank* judgment discussed in detail below, the SSMR and SSMFR provisions remove the ability for an NCA to be *exclusively* responsible for any credit institution in a legally demarcated way, bar specific exclusions via Art.1(2) SSMR.

5. The L-Bank case and the stance of the EU courts

a) Core message of the ruling

As discussed above, in the *L-Bank* case, *Landeskreditbank Baden-Württemberg – Förderbank*, received a notification from the ECB that it will be considered significant on account of its size.[514] L-Bank disagreed, invoking the aforementioned 'particular

[510] Ibid.
[511] The emphasis is mine
[512] Art.7 SSMFR
[513] SSMR Art.12(4); see also Rec.28
[514] *Landeskreditbank Baden-Württemberg v. ECB* Case T-122/15 Para.2

circumstances' clauses of Art.6(4) SSMR and Arts.70-71 SSMFR. However, both the EGC and the CJEU sided with the ECB.[515]

Whilst *L-Bank* is of significance for understanding the concept of 'particular circumstances', its *constitutional* significance goes well beyond this. This is because the EGC and the CJEU also considered (as part of L-Bank's appeal) the division of competences between NCAs and the ECB under the SSMR, as well as the application of the principle of subsidiarity.

In relation to the division of competences, the courts held that with respect to the prudential tasks found in the SSMR, the ECB had *exclusive* competence, notwithstanding that NCAs supervise less significant credit institutions. In a crucial passage of the judgment, the EGC held that NCAs were carrying out their tasks with respect to less significant entities as part of a 'decentralised implementation' of the ECB's exclusive competence, not their own national competence.[516] The ruling established "that direct prudential supervision by the national authorities under the SSM was envisaged by the Council […] as a mechanism of assistance to the ECB rather than the exercise of autonomous competence."[517]

What is more, the court provided an important clarification regarding the application of the principle of subsidiarity. L-Bank submitted that the ECB's decision breached the principles of proportionality and subsidiarity. The ECB and the Commission – importantly - argued that the principles of proportionality and subsidiarity have already been taken into account by the legislature when the SSMR was drafted and no further consideration in relation to these principles was required during the assessment of significance or *any other action* taken within the remit of the SSMR.[518] The EGC agreed with the ECB and the Commission. On appeal the CJEU also stated that:

"*the ECB is not required […] to determine case-by-case whether, despite the application of the criteria set out in the second subparagraph of Article 6(4) […], a significant institution should come under the direct supervision of the national authorities on the ground that they are better able to attain the objectives of that regulation*."[519]

This judgement, makes the demarcation between the NCA and ECB territories discretionary, with the discretion falling firmly into the hands of the ECB. More importantly,

[515] Case T-122/15 and Case C-450/17 P
[516] Ibid. para.72
[517] *Landeskreditbank Baden-Württemberg v. ECB* Case T-122/15, para.59
[518] Ibid. para.37
[519] Case T-122/15, para.59, see also Case C-450/17 P, para.75

it effectively indicates that the *type* of subsidiarity settlement applying to the SSM and, by extension, the EBU as a whole. It is materially different from the traditional constitutional subsidiarity settlement. While the traditional arrangement in the EU is that the decision-making process is to be elevated to the EU level if it is necessary, in the SSM it is the opposite – the decision-making is lowered to the local (state) level if *that* is necessary.[520] According to the CJEU, "[c]onsequently, direct prudential supervision of a significant entity by the national authorities is possible only when there are circumstances indicating that the classification of that entity as significant is inappropriate in order to achieve the objectives pursued by Regulation No 1024/2013."[521]

This ruling, while seemingly following the literal meaning of the provisions, was (in its effect) very favourable to the ECB, and quite unfavourable to the States and their NCAs. The ruling sends two fundamental messages: 1) that the subsidiarity settlement has been factored in during the legislative enactment and does not need to be revisited during the operation of the SSM, as long as the processes comply with the SSMR, and 2) that there is no such thing as exclusive NCA competences, based on significance. Consequently, the ruling largely disabled the protections against gradual power consolidation subsidiarity normally offers.

b) The context, aftermath, and significance of the case

The events preceding the succeeding the *L-Bank* case are as significant as the case itself. The early stages of the SSM development revealed how thorny the issues of supremacy and NCA autonomy can be. The Commission's initial proposal was to gradually place all credit institutions within the ECB's supervisory domain.[522] Undue centralisation and overreaching concerns were raised by many influential States, including Germany, the Netherlands and Finland, which fought fiercely to ensure that the micro-prudential supervision of smaller institutions, mainly those not engaging in major cross-border activity, continued to be supervised by the NCAs.[523] Industry pressures also played a role, particularly coming from smaller, less internationalised banks. Smaller banks are generally more likely to be saved by national and regional decision makers, and therefore often lobby for supervision

[520] Case T-122/15, para.81, see also paras.87, 88 for the applicant's argument see para 48.
[521] Case C-450/17 P, para.47
[522] Art.4 of the Commission Proposal for the SSMR, COM 212(511)
[523] Ch Gortsos, *The single supervisory mechanism: a major building-block towards a European Banking Union (the full europeanisation of the 'bank safety net')*, ECEFIL 2013, p.21

by the 'lower' level.[524] These pressures resulted in the settlement now embodied in Art.6(4) SSMR.

However, the interpretation of Arts.4 and 6 presented in *L-Bank* made much of this lobbying futile. The ECB was held to have broad powers to remove an entity from the NCAs' domain, essentially at its sole discretion.[525] This judgement was not a misnomer and followed a broader line of reasoning established in EU economic law. Moloney observes that generally "the Court, over time and albeit across a limited jurisprudence, has almost always favoured the EU interest in financial market construction over national interests in protecting distinctive market features."[526] She draws upon the examples of *Commission v. Germany*[527] *and Alpine Investments*[528] to support that conclusion. Similarly, in the cases of *Pringle*[529] *and Gauweiler* [530] in determining the distinction between economic and monetary policy, the CJEU also effectively expressed preference for wider powers at the EU level. As Tridimas observed, while allowing for institutional discretion, the interdependence between economic and monetary policy cemented by these decisions works mostly to the advantage of the ECB.[531] Historically, prior to the EBU, very few major banking measures were challenged, they were challenged unsuccessfully, and post EBU jurisprudence does not seem to indicate changes in that regard.[532] That is not to say that the legislation governing the EBU institutional components does not allow legal challenges. CJEU challenges are available by virtue of, *inter alia*, SSMR Arts.13(2), 24(11), Rec.60, SRMR Rec.120, Art.37(2) and especially Arts.86-87. However, the likelihood of success in such challenges is generally very low. However, the CJEU, whilst generally leaning towards the EU, has also ruled in favour of the Member States. In the *OPTA* case the CJEU rejected the binding nature of recommendations issued by the Commission.[533] While this case concerned the telecom sector, it has been suggested that it could also have an impact on the banking sector.[534] The

[524] S Deo, C Franz, C Gandrud, M Hallerberg, *Preventing German Banks Failures: Federalism and Decisions to Save Troubled Banks*, Politische Vierteljahresschrift, PVS, 56 2015, p.175
[525] *Landeskreditbank Baden-Württemberg v. ECB* Case T-122/15 Para.61
[526] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1657
[527] [1986] ECR 3755
[528] Case C-384/93, *Alpine Investments v. Minister van Financïen*
[529] Case C-370/12 *Pringle v Government of Ireland*,
[530] Case C-62/14 *Gauweiler and Others v Deutscher Bundestag*
[531] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.28
[532] E.g. Case C-233/94, *Germany v. Parliament and Council*
[533] Case C-28/15 *Koninklijke KPN NV and Others v Autoriteit Consument en Markt*
[534] H Micklitz, *The Internal Market and the Banking Union*, in Grundmann and Micklitz (Eds.) 2019, p.286

CJEU does not shy away from ruling on the main legal instruments and their applicability. What it avoids is interfering with is the internal 'administrative' processes within the instruments and institutional structures built on them, such as the SSM/SRM. That allows the ECB to expand its influence. Moreover, the role that the ECB takes in administrative enforcement is argued to marginalise the role and function of law – not only in the making of law but also in its application.[535] For that reason national law enforcement by the ECB, discussed in section C, is not always viewed favourably by the States.

Such situation was obviously not pleasing to the governments of multiple Member States, which effectively created another tension point between EU's neofunctionalist actions and States' intergovernmentalist reactions. The States – Germany, most prominently - pushed back on both – adjudicative and political levels. On the adjudicative side, in a subsequent ruling, the German constitutional court issued a judgement that seems to conflict with the ECG and CJEU's reasoning in *L-Bank*: that Arts.4(1) and 6 support a distribution of competences between the ECB and national authorities.[536] According to this judgement, the NCAs "exercise their powers on the basis of their primary competence, not on the basis of powers conferred by the ECB."[537] Schammo rightly observed that the German Constitutional Court's "findings are rooted in a different understanding of the relationship between Article 4(1) and Article 6, and a different appreciation of what the recitals of the SSM Regulation have to say about competence."[538] Moreover, unlike the European Courts in the *L-Bank* case, the German Constitutional Court also accepted subsidiarity as a consideration that *does* apply in such circumstances and *can* be invoked in the assessment of significance. It notably concluded that in this particular case:

"*a manifest violation of the principle of subsidiarity cannot be found, given that the SSM Regulation only conferred tasks and powers on the ECB which are indispensable for effective supervision, and that national authorities still retain extensive powers*."[539]

Therefore, the judgement technically did not conflict with the CJEU ruling in terms of outcome and did not cause much of a stir. It did, however, indicate that the national courts might not be willing to accept the exclusivity of the ECB's powers and the neofunctionalist

[535] Ibid. p.291
[536] BVerfG, Urteil des Zweiten Senats vom 30/07/2019 - 2 BvR 1685/14, para.193
[537] Press Release No. 52/2019 2 BvR 1685/14, 2 BvR 2631/14
[538] PJE Schammo, *Matching or clashing? Landeskreditbank Baden-Württemberg v ECB and the decision of the German Bundesverfassungsgericht on the Banking Union*, Durham Law School 2019, p.7
[539] Translated summary, Press Release No.52/2019

stance adopted by the CJEU, which stands in contrast with the positions of many participating and non-participating States. Grundmann predicted that the EBU might "become the playground for intense judicial assessment of the tension between diversity and unity", and important discrepancies between the EU and national courts might be a sign of such tension.[540]

The *L-Bank* decision sent a message that the CJEU is unlikely to come to the aid of a credit institution wishing to escape the ECB's supervision. Moreover, the protections introduced by Art.6 proved to be of limited value. Effectively, the only way to ensure that the ECB would not supervise a particular entity or group was to exclude them altogether through Art.1(2) SSMR, which, as explained, can be done by amending Art.2(5) of the CRD. Consequently, the governments scrambled to achieve some exclusions, which manifested in the amendments introduced by Directive 2019/878. Particularly the German government jumped on the opportunity to exclude some entities, as changes were being made to appease Bulgaria and Croatia, before the start of their participation. Perhaps the most interesting exclusion is the Landeskreditbank Baden-Württemberg – Förderbank (L-Bank), now one of the excluded German entities. This was a clear pushback, on the intergovernmental level, against the growing powers of the ECB and the CJEU support it seemingly enjoys. More broadly it could be viewed as a part of a counter-move against four phenomena, which, according to Micklitz, characterised the EBU and especially the SSM development: streamlining, depoliticisation, bureaucratisation, and centralisation.[541]

While it does not alter the validity of the L-Bank judgement, this change to Directive 2019/878 indicates that the power struggle between the national and the supranational is still ongoing in the EBU.[542]

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[540] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Bloomsbury 2019, p.115

[541] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.285

[542] Notably, this is not the only counter-move against centralisation; the Member States have also reportedly developed a tendency to merge institutions competent for different regulated markets. see Ibid. p.286 with reference to A Ottow, *Market and Competition Authorities, Good Agency Principles*, Oxford University Press 2015

F. Conclusions

This Chapter has overviewed the core pillars of the European Banking Union. It highlighted the fundamental problem of unequal participation, which can potentially deepen fragmentation. The crucial difference is that participating non-EMU States do not enjoy equal participation terms in the Governing Council of the ECB, which makes their participation in the SSM as a whole fundamentally unequal. That makes the subsidiarity settlement and the degree of centralisation objectively more concerning for them, than for their EMU counterparts. The differences in participation terms and EBU body memberships are vast, as illustrated by table 2.2.

Table 2.2 *Comparison of the position of EMU vs. non-EMU countries in the EBU*

Status	Euro area countries	Non-euro countries
Membership in the banking union	Obligatory	Voluntary
Participation in the Supervisory Board	Yes	Yes
Participation in the Governing Council	Yes	No
Participation in the Single Resolution Board	Yes	Yes
Access to the ECB liquidity facility	Yes	No
Access to Single Resolution Fund	Yes	Yes
Access to the Deposit Insurance Fund	Yes	Yes
Access to the ESM funds	Yes	No

Source and arrangement: Belke, Dobrzanska, Gros and Smaga, 2016[543]

The resulting concerns are aggravated by the involvement of the ECB in all other pillars of the EBU. As Moloney observed, the ECB deals with the entire bank lifecycle: authorisation, supervision, recovery and resolution planning, early intervention, and even the early stages of resolution.[544] Consequently, that allows for (arguably unnecessary) spill-overs of unequal and sub-optimal arrangements into other pillars.

In this chapter I explained the reasons why the SSM took the form of a mechanism rather than an institution. Its character as mechanism rather than a body created fluid power relationships, which thus allow for such spill-overs, in line with the path-dependency hypothesis. In line with this hypothesis, the EBU is argued to be capable of influencing the dynamism of integration beyond its scope, spilling over into rule-setting techniques,

[543] A Belke, A Dobrzanska, D Gros, P Smaga, *(When) Should a Non-Euro Country Join the Banking Union?*, Journal of Economic Asymmetries 2016, p.9

[544] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1644

adjudication in courts, and even affecting the interpretation of constitutional principles.[545] This phenomenon is predicted to continue, and to affect the future capital markets union.[546]

These processes are obviously concerning for the NoPS, which are naturally more averse to centralisation at the EU level. Consequently, they tend to scrutinise every detail of the participation offer in front of them, as well as the details of alternative arrangements, put in place to bridge the gap between the them and the Eurozone.

[545] S Grundmann, *The European Banking Union and Integration* 2019 in Stefan Grundmann and Hans-W Micklitz (eds.) The European Banking Union and Constitution Beacon for Advanced Integration or Death-Knell for Democracy? Bloomsbury 2019, pp.111-112
[546] Ibid.

Chapter 3

Existing Instruments for Mending the Supervisory Gaps Between Participating and Non-Participating States

Introduction

The institutional components of the EBU do not currently extend beyond the Eurozone and two newly-participating States, both of which will adopt the Single Currency in the near future. Although the Single Rulebook applies throughout the EU, the enforcement of its rules remains unharmonised among the Non-Participating States (NoPS). As I have discussed in Chapter 1, this is problematic, since pre-crisis developments and the financial crisis itself delivered a serious blow to the idea of national efficiency, in many ways putting pressure on the choices made in terms of the Financial Stability Trilemma. Avgouleas and Arner argued that the "premise of home-country control and the principle of minimum harmonization were bound to undermine at some point the stability of the EU banking system."[547] This problem remains largely unresolved in the NoPS. That in turn undermines the overall efforts to achieve pan-European harmonisation.

In order to resolve this situation, or at the very least mitigate the dangers presented by it, the Banking Union legislation foresaw several arrangements. The Close Cooperation Agreements (CCAs) allow the NoPS to opt-into full participation, albeit with a notable (and problematic) exception of decision-making mechanics. For those States which choose to stay out of the SSM/SRM framework, by *not* adopting the single currency and *not* signing the CCA, the framework of Memoranda of Understanding was created.[548] For countries outside of the EU, the combination of memoranda of understanding, agreements with regional coverage, and bi-lateral agreements is in place. Institutional and inter-institutional arrangements like the EBA and colleges of supervisors are also expected to play a role in this complex landscape.[549]

The purpose of this Chapter is to review these arrangements, highlighting key features and thorniest aspects. This Chapter concludes that the CCA is the only available 'hard'

[547] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.19
[548] Section B of this Chapter
[549] Section D of this Chapter

arrangement and thus, in order to ensure uniform application of supervisory standards and practices, as well as to achieve the goals of the EBU reform, it might be necessary to provide incentives for more NoPS to adopt it.

The Chapter is structured as follows. Section A discusses the current legal mechanics of cross-border supervision between the Eurozone and the NoPS. Section B analyses the close cooperation agreement, and highlights its legal and functional imperfections. Section C discusses the main legal alternative suggested by the SSMR - memoranda of understanding. Section D assesses the role colleges of supervisors could play in bridging the gap between the two groups of States. Section E briefly discusses the possibility of the EBA serving as the unifying institution. The final section concludes.

A. Current system of cross-SMM-border banking supervision

All of Europe's twenty largest banks do business across Eurozone borders. Be it on the basis of establishment of branches, acquisition of subsidiaries or mergers involving new members of the banking group - trillions cross the Eurozone borders every day. A non-Eurozone bank doing business in the Eurozone or a Eurozone bank doing business in a non-Eurozone State is a common occurrence. Large banking groups operating cross-border, as discussed in Chapter 1, are generally seen as a positive thing, which has historically allowed the States and their citizens to benefit from better services and cheaper products, thus boosting businesses and lifestyles, as well as deepening market integration. Avgouleas neatly summarised the need to balance the benefits of their smooth functioning with safeguards that need to be installed in order to prevent systemic disruptions:

"intra-group financing and transfers of assets from one group entity to another are at the heart of modern banking and create significant, even critical, efficiencies in the operation of banking groups. However [they] can also be used to weaken the financial position of one entity and strengthen another."[550]

The EBU has facilitated the consolidation of supervision of banking groups operating cross-border in the SSM/SRM area. However, fragmentation outside of this area has remained. In this section I will discuss the most problematic aspects of such fragmentation.

[550] E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.398

1. The new-old home-host

Due to non-participation of the NoPS, many of the changes introduced by the SSM and SRM have limited structural impact in relation to cross-Eurozone-border oversight of banking groups, and significant entities established outside of the Eurozone but within the Single Market. The allocation of powers and competences between participating States and the NoPS continues to be based on an (essentially) unaltered home-host model.

Simplistically, the home-host model is based on supervisory cooperation between the home (domicile) state and the host (branch/subsidiary) state. The home supervisor supervises the branches, subsidiaries and the headquarters established in its jurisdiction, whereas the host supervisor is only responsible for the branches and subsidiaries in that jurisdiction. In practice, it is common for large banks to have multiple host supervisors. This model received ferocious criticism following the GFC, as discussed in Chapter 1. The home-host system left room for national championship, inaction bias, regulatory arbitrage, and many other supervisory and resolution inefficiencies.

Moreover, even the home and host supervisors and regulators which generally perform well, might have incentives to act against each other's interest in crisis situations. Examples of that include the home supervisors delaying the information or downplaying the seriousness of the situation, or the host supervisors ring-fencing entities in its jurisdiction.[551] Either of the actions can make things worse for the other side: sudden ring-fencing can further increase stress on the group, deepening the crisis and forcing the other host supervisors to ring-fence the entities in their jurisdictions. Delays in information sharing can allow contagion effects to spread through the group and across domestic markets. In addition to systemic crises, this can spark regional crises, the impact of which I will discuss in Chapter 4(E). In more dramatic scenarios, one of the supervisors can trigger reorganisation, recovery, emergency takeover or a resolution of a distressed subsidiary, which can negatively affect the group's position, while the other level(s) of supervisors (e.g. Eurozone NCA, ECB) is still trying to nurse it back to health.[552]

As discussed in Chapter 1, despite these shortcomings, the home-host system stood as the primary system of international banking coordination, all the way until the GFC and the end of the Lamfalussy era. As part of the EBU, in the SSM area, these problems have been solved (or at least mitigated) by making the ECB the primary supervisor of cross-border

[551] K D'Hulster, *Cross-border banking supervision: Incentive conflicts in supervisory information sharing between home and host supervisors*, World Bank Policy Research Working Paper No.5871 2011, p.4
[552] LD Wall, MJ Nieto, D Mayes, *Creating an EU-Level Supervisor for Cross-Border Banking Groups: Issues Raised by the U.S. Experience with Dual Banking*, Austrian Economic Association, vol. 38(1) 2011 p.5

banks and banking groups, and effectively abolishing the home-host system. The changes to the rest of the EU have been less pronounced, and generally left the home-host system in place. This system also remains in place for cross-border banking stretching beyond the EU.

2. EBU changes to the remaining home-host system

The SSM framework put in place some arrangements designed to facilitate group supervision harmonisation between the SSM area and the NoPS. In relation to the supervision of cross-border institutions and groups active both inside and outside the Eurozone the ECB has to cooperate closely with the NCAs of the NoPS.[553] The arrangements for such cooperation include information exchange, and participation in colleges of supervisors. However, this participation is limited to the colleges established under the EBA or ECB guidance and does not include regional colleges, or other colleges operating outside of the EBU framework, discussed in Section D. This cooperation can be further strengthened through memoranda of understanding,[554] and coordination arrangements for obtainment of information, where the ECB's jurisdictional scope does not stretch far enough.[555]

In principle, such cooperation does not alter the character of the supervision mechanics, which is still essentially home-host, when either the host or the 'guest' (or both) does not participate in the SSM and SRM. Effectively, the ECB can only act as either the host of the home authority, when the Eurozone border is crossed. If the ECB acts as a host authority, it does not supervise the institution located in the home state and vice versa. When a bank operates cross-border between the NoPS and interconnected States (e.g. Danish bank in Sweden, Hungarian bank in Poland, etc.), the system is entirely home-host.

However, despite leaving the home-host system in place for the NoPS, the EBU has had an impact on how it functions. The biggest change is that, as Wymeersch expressed it, the ECB is the competent authority dealing with the NCAs of the NoPS "on the same basis, as was the case with authorities in the pre-SSM setting."[556] Schammo neatly summarised the mechanics: "*the ECB will, when it is competent according to the [SSMR], act in its relations with authorities of [NoPS] as either the competent authority of the home Member State or as competent authority of the host Member State.*[557] *For groups, it might also act as*

[553] SSMR Art.3, Rec.42
[554] See section C of this Chapter
[555] See e.g. SSMR Art.10, Rec.49
[556] EO Wymeersch, *The Single Supervisory Mechanism or 'SSM', Part One of the Banking Union*, National Bank of Belgium Working Paper No.255 2014, p.22
[557] For SSM to NoPS 'passporting out' of the SSM area, see Art.4(1)(b) SSMR, Art.17 SSMFR. With regard to NoPS to SSM 'passporting in', see Art.4(2) SSMR and Arts.13-17 SSMFR

consolidating supervisor".[558]

The ECB has essentially stepped into the shoes of the relevant NCAs and is empowered to participate in consolidated supervision of cross-border groups headed by parents based in NoPS, and to take on host State tasks with respect to the branches of banks originating from the NoPS, which are located within its domain.[559]

The presence of the ECB in this mix might in itself be an improvement. As Schammo observed, "the ECB might prove to be a more effective interlocutor in a home-host setting than some national authorities."[560] Moreover, the Single Rulebook is now in place, and it is possible that rule harmonisation will help ensure long term financial stability to a greater extent. Furthermore, in a Eurozone-to-NoPS scenario, the ECB has a lot of control over the credit institution's parents, even if the subsidiary is supervised by the host NCA. The effects of power consolidation in the hands of the ECB are felt particularly strongly in the situations where the ECB becomes the consolidating supervisor. For that to be the case, however, the part of the banking group in question needs to be significant enough to fall within the ECB's domain.

3. Significance assessment

In the scenario involving a NoPS-based bank or banking group with activities in the Eurozone (via branches and/or subsidiaries) the need for direct supervision by the ECB is determined by significance assessment, similar to the one applying within the SSM area. However, if a NoPS bank wants to directly provide services in the SSM area, under Art.16 SSMFR, the ECB will carry out the tasks of the NCA of the host (participating) State irrespective of the significance criterion. The significance criteria also apply to groups. If supervised entities are part of a supervised group, the significance is determined at the highest level of consolidation within participating States and in any of the following circumstances: [561]

(a) if the supervised group within the participating Member States fulfils the size criterion, the economic importance criterion, or the cross-border activities criterion;[562]

(b) if one of the supervised entities forming part of the supervised group fulfils

[558] PJE Schammo, *The European Central Bank's Duty of Care for the Unity and Integrity of the Internal Market*, 42 European Law Review 3 2017, p.13
[559] SSMR Arts.4(1)(g)-(i) and 4(2)
[560] Schammo, 2017, p.13
[561] Art.40 SSMFR
[562] Art.55 SSMFR stipulates the method of calculating the value of assets.

the direct public financial assistance criterion;

(c) if one of the supervised entities forming part of the supervised group is one of the three most significant credit institutions in a participating State.

A good example of type (c) situation can be found in the Nordic-Baltic market. Swedbank's Latvian subsidiary is one of the three largest banks in the country.[563] Thus, that part of the banking group falls under the direct supervision by the ECB. The SSM rules would still apply to its smaller presence in Finland, meaning that the ECB could supervise this part of the group directly, if the need arose, but currently does not, due to its (relatively) smaller size. The parent bank in Sweden avoids the ECB supervision. Importantly, under Art.53(2) SSMFR, for the purposes of determining significance on the basis of the size criterion, the supervised group of consolidated undertakings includes subsidiaries and branches in the NoPS and third countries, meaning that the assessment methodologies account for and encompass the full picture of a banking entity or group. Effectively, that also means that the consolidating supervisor needs to rely on the NoPS NCA for information. Particular branches can also be drawn to SSM supervision. Under CRD IV, Art.51(1) the branch can be "made" significant by the NCA of a host State sending a request to the consolidating supervisor, where Art.112(1) applies.[564] Art.39(2) SSMFR details the procedure for a group or an individual entity to start or cease being significant by the means of an ECB decision. This can open ways for banking groups to adapt their business models to have a choice of a supervisor by, for example, distributing smaller subsidiaries among more States. One might argue that this flexibility can also create opportunities for regulatory arbitrage. However, the ECB stands as the guardian of this provision, since it has to explicitly declare the institution no longer significant.

4. Branches, subsidiaries and consolidation

While the SSMR explicitly declares not to alter the framework regulating the change of legal form of subsidiaries or branches and its application, it does introduce unnecessary confusion in this respect.[565] A problematic outcome of the SSM group supervision arrangement, is that it artificially divides fully interlinked groups along SSM boundaries,

[563] The method for calculating this is provided in Art.56 SSMFR

[564] Note point (c) "in preparation for and during emergency situations, including adverse developments in institutions or in financial markets using, where possible, existing channels of communication for facilitating crisis management."

[565] SSMR Rec.44

which does not reflect the business models and distorts the significance assessment. Under Art.41(2) SSMFR branches opened in different participating States by an institution established in a NoPS are treated individually, as separate supervised entities. Moreover, branches established in a NoPS or third countries by an SSM/SRM country bank are considered separate supervised entities, even separated from subsidiaries of *the same* credit institution, when determining whether the significance criteria of Art.6(4) SSMR apply.[566] Darvas and Wolf discuss the example of Danske Bank.[567] They explained that although Denmark stayed outside the SSM, Danske's subsidiary in Finland is directly supervised by the ECB, because it is one of the three biggest banks in Finland. However, apart from two small subsidiaries in Luxembourg and Northern Ireland, in other Eurozone States Danske operates branches, and these branches would fall under ECB supervision only if Denmark joined the SSM.[568] Generally speaking, the difference between a branch and a subsidiary is that even the business itself sees the branch as a part of the same parent business. Going against that logic does not bring any benefits.[569]

This has deeper implications not just for classification, but also for the effectiveness of group-level (consolidated) prudential requirements.[570] Babis sees dangers in discrepancies in calculating consolidated requirements, making it difficult to compare between groups located in different States or between different layers within the same group, and creating opportunities for regulatory arbitrage.[571] Darvas and Wolff notably argued that the Single Rulebook, and the EBA's supervisory rulebook, alongside the Basel III accords and the Capital Requirements legislation and the EBA are all put in place to ensure supervisory convergence and consistency of outcomes. [572] However, while the Single Rulebook, ensures a considerable level of harmonisation, it also leaves a lot of discretion. Particularly, the PRR[573] derogations in Arts.7-8 and 9 leave a lot of flexibility. Consequently, in the absence of further harmonisation, a degree of differentiation between the NoPS and the participating States is likely, with further differentiation occurring in the EEA states and the UK.

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[566] SSMFR Art.41(3) and 42(2)
[567] Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013, p.5
[568] Ibid.
[569] This is notably an unforeseen result of constitutional limitations discussed in Chapter 2.
[570] V Babis, *Single rulebook for prudential regulation of banks: Mission accomplished?*, University of Cambridge Faculty of Law Research Paper No.37 2014, p.4
[571] Ibid.
[572] Darvas and Wolff, 2013, p.4
[573] Regulation (EU) 575/2013

These distortions need to be viewed in the broader context of how banks operate. Mayes observed that "where banks operate in more than one member state, these operations are separate", and separation leaves room for divergence of practices even within the same bank operating across the Eurozone and EU borders.[574] This phenomenon is likely to be more pronounced, where the somewhat artificial border at the SSM lines helps 'isolate' the branch or subsidiary. In the event of stress or failure such separation can delay decision-making or lead to misguided decisions, thus aggravating the crisis. This is particularly acute in insolvencies. As Avgouleas observed, "in cross-border insolvencies, transfers of assets from one member of the group to another are often restricted by member state laws, since the recovery of these assets is a very difficult process in insolvency due to the doctrine of separate legal entity."[575] The fact that the assets can be recovered eventually is a remedy of very limited potency, as the shock to the system and the taxpayer can be immediate. Avgouleas saw insolvency situations as a gap in the BRRD framework, since the resolution framework only covers "conditions under which assets may be transferred between entities of a cross-border banking group in stressed situations, but not when the institution has entered bank insolvency proceedings."[576] The ability of Eurozone parent groups to use the ESM funds for refinancing non-Euro subsidiaries has also been questioned.[577]

5. *Fees as a false incentive*

Fragmentation along the SSM/SRM lines also has the potential to distort competition for a very pragmatic reason - fees. The funding for the SSM's activities is collected in the form of fees levied on market participants. Such system was established with a view to ensure the ECB's independence from undue influences of NCAs and market participants, and separation between monetary policy and supervisory tasks.[578] Therefore, the institutions established entirely or predominantly in the SSM area pay all of their annual fees to the ECB. The calculation of the fees excludes subsidiaries established in the NoPS, but not branches.

However, the institutions originating from the NoPS, EEA/EFTA states and third countries only pay the ECB a chunk corresponding to the size of their branches. This is calculated at the highest level of consolidation in the participating States, based on the

[574] DG Mayes, *Banking union: the disadvantages of opportunism*, Journal of Economic Policy Reform, Volume 21 2018, p.140
[575] E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.400
[576] Ibid.
[577] Mayes, 2018, p.140
[578] SSMR Rec.77

importance and risk profile of the credit institution concerned, including its risk weighted assets.[579] The same, in principle, applies to subsidiaries, different consolidation rules notwithstanding.

While these arrangements are in line with the overall goals and aspirations of the EBU, in the presence of fragmentation alongside Eurozone borders, it also presents some dangers. As I will discuss in Chapter 4, all NoPS believe their supervision systems to be cheaper than that of the ECB/SSM. The only NoPS that approach the costs of the SSM are arguably Sweden and Denmark, but even their fees are lower. While this did no discourage Nordea from moving to Finland, other entities have not followed. The Visegrad states offer significantly cheaper supervision. Effectively, that means that a banking group has an interest to keep their operations in the NoPS, in the absence of other competitive disadvantages.

This inclination, while creating some unevenness in the playing field, will not be a fundamentally problematic issue, unless it starts feeding into path-dependency. If lower supervision costs are seen as an incentive for the choice of locale, the NoPS would also have an incentive to push these costs even lower, which would eventually start affecting supervision quality. Consequently, looser application of requirements or less supervisory attention would create incentives for riskier banking businesses to move to, remain or expand in the NoPS. In this respect, Appelbaum and Nakashima have discussed how the existence of incentives for a regulator to bring more institutions into its domain can lead to weaker prudential supervision.[580]

6. *One more supervisor*

While there are routes for NoPS-ECB coordination, in the presence of increasingly diverging paths the end result could be a multi-layered, overlapping and irreducibly complex supervisory system, the complexity of which would leave room for mistakes and regulatory arbitrage. As the CEO of UniCredit Federico Ghizzoni expressed it: "it would be a real tragedy if instead of one regulator we would have *one more* regulator."[581] Being interlinked with the ESRB, the ESAs, including the EBA, and the NCAs the SSM is already considered to be at risk of being tangled in the web of overlapping supervisory responsibilities and

[579] SSMR Art.30(3)
[580] B Appelbaum, E Nakashima, *Banking Regulator Played Advocate Over Enforcer: Agency Let Lenders Grow Out of Control, Then Fail*, The Washington Post 2008
[581] F Ghizzoni, *Rebuilding Banking in Europe*, *Davos 2014*. Verbatim and emphasis are mine.

duplicative requirements.[582] When the need to cooperate with NoPS' NCAs arises, overlapping, dual, or even triple supervision is common. The concept of multi-layered supervision has been subject to academic discussion for a long time, and the findings are not encouraging.

The first major effect is supervisory competition. On the one hand, it can discourage unnecessarily restrictive practices, thus improving business conditions, which under some circumstances could be a positive. However, the entire SSM project is generally meant to tighten supervision, not loosen it. Supervisory competition thus naturally works against the core premise of the reform. Multi-layered banking supervision has been accused of promoting competition in laxity.[583] Secondly, as discussed throughout this thesis, there is obviously plenty of room for conflict of interest between the NoPS' NCAs, the ECB, the Eurozone NCAs, the SRB, and the EBA. Such conflicts can relate to rule making, national discretions, sanctioning, resolutions, etc. Thirdly, in principle, all the concerns relating to home-host systems remain acute.

The problem of multi-level supervision and supervisory competition can be particularly acute not just for the NoPS, but also predominantly host participating States like the Baltic States, Slovakia, Croatia, Bulgaria, etc. As was the case in the Nordics-Baltic region during the GFC,[584] the banking groups based in larger home economies can indulge in excessive risk taking through their branches and subsidiaries, in smaller host economies, thus inflating bubbles and destabilising weaker host markets. However, if the parent entities themselves are sturdy, they can also help stabilise the host economies, which is one of the reasons why their presence is not, in itself, undesirable. Ensuring the stability of the parent entity and the group as a whole is, to a large extent, a responsibility of the supervisors. In the absence of single supervisory framework, and in the presence of multiple cross-border supervisory arrangements, with different geopolitical centres and somewhat different agendas, supervisory effectiveness becomes hard to gauge.

Spendzharova and Bayram's research reveals that SSM/SRM States and NoPS "share extensive links in banking supervision and crisis management," but also that the home State (NoPS) regulators can enjoy "significant decision-making power vis-à-vis the host

[582] Shearman & Sterling LLP, *Banking supervision within the Eurozone: The Single Supervisory Mechanism*, 2014, p.3
[583] AE Wilmarth, *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, George Washington University Law School 2004, p.258 and generally.
[584] See Chapter 4(E)

regulators" in the host (SSM/SRM) States.[585] As I will further explore in Chapter 4, small host States are therefore subjected to (sometimes conflicting) influences originating from the ECB and the larger home State NCAs. The reality is that smaller host states often have to try to please two masters, increasing supervisory complexity and the associated costs.

7. The widening gap

That is not to say that supervisors cannot cooperate without a legally binding arrangements and institutionalised cooperation mechanisms. Schoenmaker gives the example of multiple NCAs reaching a cooperative solution in the bailout of Dexia and the continuation of Western bank operations in Central and Eastern Europe.[586] The Nordic-Baltic arrangements discussed in detail in Chapter 4(D-E) also fall into this category. However, the effectiveness of such system is conditional on the existence of shared group or regional interest and the willingness of States, not just their NCAs, to cooperate. Moreover, such arrangements, are often blind to macro-prudential threats and, to a large extent, macroeconomic concerns.

In principle, the cross-border supervision mechanics between the NoPS and the SSM area are not too dissimilar from the relationship between EU Member States prior to the EBU. This appears to be an unfortunate complication resulting from differentiated integration and graded membership, rather than ideational consensus. As a consequence, as far as the NoPS are concerned, the institutional components of the EBU are largely ineffective in combating a number of pre-crises problems including national champions, regulatory arbitrage, uneven playing field, the NCAs siding with market participants, undue influence of largest credit institutions, etc. Moreover, due to their importance as banking centres (e.g. Sweden), size (e.g. Poland) and interconnectedness (e.g. Sweden, Denmark, Hungary), many NoPS have the capacity to spark new crises. As long as the home-host principle remains, the EBU remains fundamentally incomplete.

The geographical scope of the EBU is therefore an obstacle to its success. Addressing this issue, Jean Claude Juncker emphasised the need to expand EBU and EMU membership in his 2017 State of the Union speech.[587] This was echoed by Ursula Van der Leyen at the

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[585] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, pp.566-567

[586] D Schoenmaker, *Banking Supervision and Resolution: The European Dimension*, Law and Financial Markets Review Vol.6 2012, p.4

[587] JC Juncker, *State of the Union Speech*, 2017

beginning of her presidency.[588] Speyer concluded that "the objectives of maintaining financial stability in an interlinked financial market and of preserving the single market for financial services require that the geographic scope of the SSM to be the entire EU-2[8][589] and EU 2[8]-x membership will hurt the single market."[590] The Single Rulebook alone is widely considered insufficient for facilitating successful pan-European banking supervision harmonisation, or even create the impetus towards gradual centripetal processes. Avgouleas and Arner concluded that "[i]n order to avoid any divergence between the Euro Area and the rest of the EU, the single rulebook should be underpinned by uniform supervisory practices.[591] Schoenmaker asserted that "the ultimate goal should be to operate at the EU level since the Internal Market for Banking operates EU-wide."[592] As a sort of an extension of the path-dependency hypothesis, he warned that the opposite could result in centrifugal effects, as "an Alleingang of the euro-area in financial services would force a split in the EU's financial system."[593]

All of this boils down to one fundamental question: are the SSM and SRM necessary in order to ensure systemic stability? If the answer is in the affirmative, it would seem that by only covering a relatively small percentage of Europe's banking assets the SSM and SRM remain fundamentally incomplete. It is therefore meaningful to explore the avenues for SSM/SRM expansion, in terms of their direct remit and cooperative reach.

B. Close cooperation agreements

In order to address the threats posed by fragmentation, the EBU legislation foresees several types of agreements and structures, that can be used to increase the EBU's reach and effectiveness, or (failing that) mitigate the risks. The most effective solution is obviously getting the NoPS to join the SSM and SRM.

Joining takes the legal form of a Close Cooperation Agreement (CCA), effectively making a non-Eurozone state willing to enter into such agreement with the ECB a part of the SSM and SRM. This subsection seeks to introduce and discuss the legal structure of such

[588] U von del Leyen, *A Union that strives for more: My agenda for Europe, political guidelines for the next European Commission, 2019-2024*, 2018, p.9,
[589] B Speyer, *EU Banking Union: Do it right, not hastily!*, 2012, p.5
[590] Ibid. p.11
[591] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.42
[592] D Schoenmaker, *Banking Supervision and Resolution: The European Dimension*, Law and Financial Markets Review Vol.6 2012, p.12
[593] Ibid.

agreement, including the main legal and organisational reasons for the NoPS' reluctance to join. Before doing so, however, in subsection 1, I will discuss the centripetal factors pulling some States to join, which evidently had some sway in the south-eastern states of the EU – Bulgaria, Romania and Croatia. Subsection 2 covers the procedure of entering into the CCA and the legal implications of such decision. Subsection 3 analyses the legal status of the non-Eurozone participating states. In subsection 4 I move onto the thorny issue of conflict resolution, and the termination of the CCA as the (sub-optimal) ultimate solution to disagreements between the NCAs and the ECB. Subsection 5 focuses on the changes made to the CCA arrangements, in order to make them more appealing to the NoPS.

1) Centripetal factors for participation

a) Incentives to participate

In the preceding Chapters I have touched upon several problematic issues which make the CCA seem like an inherently unattractive concept. Such issues *inter alia* include representation in the Governing Council, decision-making mechanics, and the costs associated with supervision and the SRF.

On the conceptual and political level, however, there is a degree of consensus that participation in the EBU should remain open to non-Eurozone Member States and - most importantly – a degree of consensus among the NoPS that participation would be an option, if obstacles impinging on their national interests were removed. Such consensus is evidenced by the fact that even the countries which never intended to participate in the SSM or the SRM and refused to sign the SRF agreement - the UK and Sweden - fought to ensure the full inclusion of CCA states in the SSM. Moreover, even the most reluctant NoPS have clearly stated concrete reasons for their non-participation, and very few of such reasons are ideational or ideological. Basic constructivist consensus is therefore achievable. However, neofunctionalist and intergovernmentalist incentives and pressures would also need to align.

There are many compelling arguments why joining the SSM via the CCA might be beneficial for the NoPS. These arguments carry different weights in different NoPS, and thus should not be perceived as universally applicable, but all the arguments mentioned here have been recognised in the domestic EBU debate in more than one State. They range from broadly mirroring the general logic of participation in the SSM, to fear of being left behind or being left out of otherwise beneficial processes.

Firstly, opting-in would carry many of the same benefits as the 'normal' membership. The Vienna Initiative working group stated that opting in would give the NoPS *essentially*

the same benefits as for the Eurozone States with respect to mitigation of home-host problems, quality and consistency of supervision, crisis aversion or mitigation, and reversal of fragmentation.[594]

Secondly, the ECB supervision and SRB's resolution plans may enhance the opting-in State's reputation as a banking centre by reducing the risk of supervision being tainted by national bias.[595] Hüttle and Schoenmaker argued that joining could improve the credibility of national prudential arrangements.[596] It is also argued that banks headquartered in Member States outside EBU could be at a competitive disadvantage, if their domestic banking supervision was perceived as inferior to the SSM.[597] That could effectively result in higher funding and operating costs for both – the market participants and the States, as there might be a need for the domestic NCAs to outperform the SSM, not just be on par with it.[598]

Thirdly, it is argued that since some of the non-Eurozone States are important hosts to foreign banks headquartered in the Eurozone, they could gain from "improved management of interdependencies within EBU on the practical level."[599] They could expect to be "major beneficiaries of a supranational system" of supervision that is "more impartial and more conscious of cross-country spill-overs".[600] Hertig et al observe that the ECB has the ability to attract high-calibre supervisory staff and can recruit from a much broader pool of talent than what is available to most NCAs, thus potentially having the personnel with better understanding of international banking interdependencies.[601]

Fourthly, some Member States might see the CCA as a prelude to the Eurozone membership.[602] As I will discuss in detail in Chapters 4 and 5, the States seeking accession to the EMU are generally lenient towards the EBU, which is evident from Bulgaria and Croatia's participation.

Fifthly, for smaller, predominantly host States, the EBU can also provide a way to resist the influence of the home States and their institutions. It is well documented that high

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[594] Cited by K Pistor, *Governing Interdependent Financial Systems: Lessons from the Vienna Initiative*, Journal of Globalization and Development 2(2):4-4, 2012, p.4
[595] G Hertig, R Lee, JA McCahery, *Empowering the ECB to Supervise Banks: A Choice-Based Approach*, European Company and Financial Law Review, vol.7 issue 2, 2010, p.181
[596] P Hüttle, D Schoenmaker, *Should the 'outs' join the European Banking Union?*, Bruegel 2016, pp.6-7
[597] Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013, p.10
[598] Ibid.
[599] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.11
[600] Ibid.
[601] G Hertig, et al, 2010, pp.182-183
[602] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.7

foreign bank ownership has the tendency to result in the pressure to accept regulatory agenda set by the home states.[603] This can effectively expose them to Pistor's 'host's dilemma'.[604] The EBU can be argued to present a solution to it.

Sixthly, the NoPS with limited supervisory budgets and resolution capacities, could outsource the tasks (and banks) they have been struggling with to the ECB, thus avoiding potential reputation damage. That is particularly important for the states with questionable supervisory track record.[605] In the worst case scenario, even if the ECB supervision turned out to be inferior to domestic arrangements, or the magnitude of a crisis exceeded the contingency buffers, participation would still spread the blame for supervisory failure, reducing the direct reputational damage to the States.[606]

Furthermore, for States with disproportionately large banking sectors, the added financial backstop of the SRF could add extra safety.[607] The smaller States which are home to large multinational banks are aware of the potential struggle they would have to endure, if such banks failed. Schoenmaker provides a detailed discussion of such struggles and specifically points at the Nordic banking giants, arguably too big for their home states.[608]

It is thus unsurprising that Nordic credit institutions themselves often take somewhat unexpectedly EBU-friendly stance. Danske Bank, for example, has stated that the EBU "is an important step towards a more stable European banking sector and a more closely integrated market for capital and financial services."[609] Statements notably count for little in the banking world, but actual business decisions are certainly indicative. The biggest EBU-linked business decision so far came in 2017, when the Nordic banking giant, Nordea decided to move inside the EBU "to find a fiscal backstop large enough to see it through any future

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[603] I Iaydjiev, *The Political Economy of Cross-Border Banking Regulation in Emerging Europe, 2004–2010*, Cambridge University Press 2019, p.346; A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.567

[604] K Pistor, *Host's Dilemma: Rethinking EU banking regulation in light of the global crisis*, Columbia Law and Economics Working Paper No.378, 2010, p.5

[605] Ministry of Finance, Ministry of Foreign Affairs, Office of the Government of the Czech Republic, Czech National Bank, *Impact study of participation or non-participation of the Czech Republic in the Banking Union*, 2015, p.4; K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.3, D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.18, P Hüttle, D Schoenmaker, *Should the 'outs' join the European Banking Union?*, Bruegel 2016, p.2

[606] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.11

[607] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020

[608] D Schoenmaker, *Resolution of International Banks: Can Smaller Countries Cope?*, 2018, pp.6, 8

[609] Carlyle, T., *Lars Rhode 'firmly convinced' by merits of banking union*, CentralBanking.com, 2014

crisis."[610] While this was not the only formal reason, and reputation and prestige of the ECB were cited as the main factors, the hunt for stronger support footing was evident. The more lenient Finish tax system probably also played a role, but the EBU was certainly a major factor. Nordea's (then) CEO Casper von Koskull admitted that "[t]he main reason is that a bank with four domestic markets – Norway, Sweden, Finland and Denmark – with a balance sheet that I believe is two times Sweden's GDP, is a bank I think should be based within the European banking union."[611]

Nordea's move from Sweden to Finland also indicates that at least some large market participants, especially those already compliant with the Single Rulebook, are not shying away from ECB supervision. This impression is further strengthened by the directions of post-Brexit moves, with credit institutions and financial firms eyeing Paris, Dublin and Amsterdam as preferred destinations, often preferring them to non-EBU Stockholm, Oslo, Copenhagen or Zurich. This would be in line with Epstein and Rhodes's assertion that European banks are less beholden to their home States and markets than assumed, due to significant market consolidation across Europe, and thus less responsive to political influence.[612] If this assessment is correct, some NoPSs housing large international banks might have to adjust their positions, to accommodate the concerns of such institutions. On the other hand, it is important to note that Nordea's move did not affect Sweden's position.[613]

b) Pressures to participate

In some cases, the industry preference for participation can turn into outright pressure, especially in smaller markets dominated by Eurozone banks, which do not seek to derive any specific advantages from being shielded from the ECB's supervision. This possibility forms part of a mosaic of centripetal pressures. Such pressures are related to the above-mentioned incentives, but also distinct from them. The main difference is that the pressures are less about the individual interests of the Member States, and more about broader macroeconomic and geopolitical processes, which can at times override the national interests.

The second group of pressures is linked to globalisation and liberalisation of financial markets, which inherently conflicts with protectionism. Epstein and Rhodes contended that liberalisation of European economies is increasing the economic and political costs of

[610] D Schoenmaker, *Nordea's move to the Banking Union is no surprise*, Bruegel, 2017, p.1
[611] The Local, *Nordea owners vote to move headquarters to Finland*, 2018
[612] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.6
[613] Some of the reasons for that are discussed in Chapters 4 and 5 of this thesis.

protectionism.[614] As I will demonstrate in Chapter 5, protectionist and nationalist policies can still work as an alternative to joining the institutional components of the EBU, but this option is only available to a limited number of NoPS, and requires a very particular set of national banking sector structural characteristics. For such policies foreign bank penetration needs to be reduced and the banking sector needs to remain relatively small, compared to the State's GDP. While an option for some States, this would be an unreasonably costly path for others.

The third pressure is rooted in the growing size and power of the EBU institutional components. It is foreseeable that the EBU institutional structures could gradually annex the rest of the EU, due to their shear size and the political force they are effectively a manifestation of.[615] An acute concern for the NoPS is of course that this might happen on purely neofunctionalist basis, without due consideration as to whether the EBU presents the best possible supervision and resolution outcomes from individual States' perspectives. That would leave the remaining NoPS in a shrinking interest group, with diminishing influence in the EBA.[616]

The fourth pressure is inherently linked to the aforementioned ones. Epstein and Rhodes argued that reduced costs of international economic exchange raise the relative costs of the products and services that protectionist states produce, making those states less competitive.[617] Therefore, for the NoPS with large and highly internationalised banking sectors, especially those housing major international banking groups, protectionism would not be an option, as the globalisation and liberalisation of financial markets would suck them deeper into international arrangements.

The fifth pressure is linked to vulnerabilities. As discussed in Chapter 1, the GFC has revealed the dangers that troubled States and banks can present to each other. Therefore, Epstein and Rhodes claim that one of the major reasons why the Eurozone States became inclined to participate was the increased financial vulnerability of banks and States.[618] Such vulnerability, as I will demonstrate further in my analysis in Chapter 4, is partly what drives some of the NoPS to develop an interest in participation. Therefore, it is not unforeseeable that many NoPS might join following national, global or regional crises, particularly those with the potential to put the existing arrangements into question.

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[614] Epstein and Rhodes, 2014, p.3
[615] DJ Elliot, *Key issues on European banking Union; Trade-offs and some recommendations*, Global Economy and Development, Brookings, 2012, p.4
[616] See section E of this chapter
[617] Epstein and Rhodes, 2014, p.7
[618] Ibid. p.3

The fifth pressure is predominantly exerted by EU institutions on the neofunctionalist basis. Avgouleas and Arner observed that the EU institutions, especially the Commission, see the EBU and the development of the single market as inseparable and mutually reinforcing processes.[619] Therefore, avoidance of the EBU might become a politically and economically costly challenge, as the EU institutions have clear incentives to make the NoPS feel somewhat uncomfortable.

Lastly, the effects of the EBU are not fully avoidable even for the NoPS. That in itself constitutes a synergic pressure. As I have illustrated, the SSM/SRM States and the NoPS still have to uphold the same Single Rulebook provisions. The ECB also plays a major role in cross-border group supervision. Consequently, as Wymeersch observed, the NoPS and third countries have to recognise the supervision system with the ECB at the helm, including aspects like the division between significant and less significant credit institutions.[620] As this recognition increasingly results in the need to adapt to, as well as mirror and mimic EBU structures, the institutional advantages of differentiation decrease, as the costs increase.

2. Problematic aspects of the joining procedure

a) Constitutional basis for the inclusion of the NoPS

For these incentives and pressures to have an effect, the EU obviously needed to provide a procedure for joining, which would be acceptable to the NoPS. This task turned out to be more legally complicated than expected. When the Council and Commission proposals for the SSMR were made public, they gave rise to a debate on the legality of opting-in through the CCA. More detailed discussion of the constitutional debate on participation of the NoPS can be found in Chapter 2 of this thesis. In essence, the question was whether Art.127(6) TFEU can be applied to non-Euro States.[621] Carmassi et al. neatly explain the situation, pointing to Council Regulation 1096/2010 "conferring specific tasks upon the ECB concerning the functioning of the European Systemic Risk Board", which used Art.127(6) as the legal basis for appointing the ECB President and Vice-President to the ESRB and charging the ECB with the specific tasks of setting up and funding the secretariat of the

[619] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.40
[620] E Wymeersch, *The Single Supervisory Mechanism or 'SSM', Part one of the Banking Union*, National Bank of Belgium Working Paper No.255, 2014, p.22
[621] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.22, and EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.8

ESRB - a body comprising all EU states.[622] By logical extension Art.127(6) should not be restricted to the Eurozone, as made explicit by the provisions of Art.139(2c) TFEU, which mentions other provisions of Art.127 that do not apply to Member States not using the euro, but not paragraph 6. Consequently, via Art.7(1) SSMR, the ECB is empowered to carry out the tasks in the areas referred to in Articles 4(1), 4(2) and 5, (the main functions conferred by the SSMR),[623] in relation to credit institutions established in non-Eurozone States, which have signed the Close Cooperation Agreements (CCAs) with the ECB. While this, highly technical, justification for the inclusion of the non-Eurozone States provided the constitutional basis for subsequent expansion of the institutional components of the EBU, it also brought a number of restrictions and complications to the process, discussed below. As sub-optimal as Art.127(6) may have been for the SSM and the EBU as a whole, in relation to the non-EMU States it arguably stands as the biggest obstacle.

b) The joining procedure

Art.7(2) of SSMR sets out the procedure for reaching the CCA. Further details, stipulating the timing and content of applications, assessment of applications, and admission of new members, were fully outlined by Decision ECB/2014/510.[624] It is essentially a three stage process. Firstly, the NoPS notifies the other States, the Commission, the ECB and EBA of its intention to enter into a close cooperation with regard to *all* credit institutions established in it. In this notification, the NoPS undertakes to ensure that its NCA will abide by guidelines or requests by the ECB, and provide the required information on all of its credit institutions. The NoPS then has to adopt relevant national legislation to ensure that its NCA will be obliged to adopt any measure in relation to credit institutions requested by the ECB, which arguably signifies surrendering part of national regulatory autonomy, in terms of the Financial Stability Trilemma.[625] Moreover, Under Art.4(3) of Decision ECB/2014/510, this national legislation passed to ensure ECB's supremacy needs to be to the ECB's satisfaction, including aspects relating to practical implementation.

[622] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, p.3
[623] For the discussion of which see Chapter 2
[624] ECB Decision of 31 January 2014: On the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (ECB/2014/5)
[625] SSMR Art.7(2)(c), see my discussion on the FST in Chapter 1(C)

c) Limited room for negotiation

Much to the dissatisfaction of the NoPS, the joining provisions do not leave much room for negotiation, which was available to the Eurozone States at the launch of the SSM, discussed in Chapter 2. While this can be justified on the basis of legal and procedural certainty, the NoPS are placed in an underprivileged position, compared to their Eurozone counterparts. Notably, the drafters of the SSMR were aware of these concerns and left *some* flexibility in terms of institutional scope. As mentioned in Chapter 2, the exclusions of particular types of institutions in Art.1(2) SSMR are not set in stone and can be adjusted by modifying Art.2(5) of Directive 2013/36/EU (CRD), which has been done on a few occasions.[626] As discussed, some entities based in the NoPS have been excluded, in order to get around political roadblocks in establishing the SSM, and in trying to sweeten the deal for the NoPS. Examples of that include the exclusion of Lithuanian credit unions shortly before its EMU accession in 2014 and the inclusion of Croatian credit unions, as well as the Croatian Bank for Reconstruction and Development, forming part of the effort to persuade Croatia to participate.[627] The remaining provisions of the SSMR do not, however, leave much room for additional negotiation of material aspects of participation.

d) Problematic nature of the agreement

The legal nature of the CCA is also somewhat unexpectedly thorny and politically problematic. Partly buried in the complexity of the language of the SSMR, lies the fact that the CCA is (formally) an ECB decision. This is evident from the first paragraph of Art.7(2) SSMR, as well as Art.5 of Decision ECB/2014/510, describing the agreement as a decision of the ECB "addressed to the requesting Member State and establishing a close cooperation." This decision is obviously preceded by an application from the NoPS, but the ultimate legal decision is made by the ECB, with all the symbolism such arrangement carries. While this can be explained by the constitutional and political considerations, it is nevertheless somewhat unfortunate. Firstly, the symbolism of the phrasing is widely understood by the Member States as that of subordination, especially since the State's request *can* be rejected by the ECB under Art.5(3). Secondly, a mere ECB decision is an unusual form for an agreement of such significance, which can be contrasted with the international treaty signed

[626] For full list of amendments to this Directive see https://ec.europa.eu/info/law/banking-prudential-requirements-directive-2013-36-eu/amending-and-supplementary-acts/amendments_en, Most notably, Directive (EU) 2019/878, Art.1

[627] Directive (EU) 2019/878, Art.1 amending CRD Art.2(5)(11)

for the SRF, bilateral agreements with Switzerland, or the free trade agreement encompassing financial services signed with the United Kingdom.

3. CCA country status in the SSM

The contentious aspects of the accession procedure are, however, just the tip of the iceberg. Historical development of the SSM in particular is marked by constant attempts of the NoPS to gain more say in decision-making, as well as to gain the status of actual members of the SSM and (consequently) the SRM.

a) Part of the SSM

The initial Commission's proposal for the SSM did not give non-Eurozone participating States full membership of the SSM and, in all likelihood, other EBU institutional components. This was notably changed in the Council's proposal.[628] The SSMR eventually explicitly declared that non-Eurozone participating States (the EU States that sign the CCA) are a part of the SSM and their NCAs are SSM authorities.[629] Such change is a result of the objections of a number of NoPS, ironically spearheaded by Sweden and the UK, following the publication of the Commission's proposal. Giving non-Eurozone States lesser status in the SSM was argued to be a violation of the fundamental principles of the EU. During the meeting of EU finance ministers in September 2012, Sweden's finance minister said that Sweden "could particularly not accept the supervision based on the ECB, where they cannot become members without joining the euro."[630] The (then) Swedish PM Fredrik Reinfeldt used his gift of foresight: "I don't think any of the [NoPS] will accept that."[631] As I will explain hereinafter, this concern has not been resolved to the satisfaction of most NoPS. Upon signing the CCA, the NoPS would not become – *de facto* and *de jure* - equal participants in terms of ultimate decision making and representation.

Nevertheless, giving formal membership in the SSM/SRM to the CCA States was perceived positively. Shortly after the publication of the Council's Proposal, Bulgaria and Romania expressed interest in participation, Croatia followed a few years later.

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[628] SSMR proposal (Council text, December 2012) Arts.2(1)-(2)), As Ferran and Babis, 2013, p.9 noted, "This interpretation of the Council's proposal and the final text is confirmed by the deletion of para 3 in art 6 (which becomes redundant if non-euro participating Member States are automatically represented in the Supervisory [Board])".
[629] SSMR Art.2(1), Art.2(2)
[630] Financial Times, *EU Ministers at Odds over Banking Union*, 15/09/2012
[631] Financial Times, *Eurozone Outs Fear Banking Union Plan*, 01/102012

The current definition of a participating State restricts membership to EU Member States and thus does not allow for membership of EEA, EFTA states, or the UK.

b) The Governing Council issue

Prior to the launch of the SSM, Elliot observed that "single supervisory regime for Europe would be good, but only if it has the right governance structure, so that all concerned can defend their view-points and their interests."[632] This leads us onto the most problematic legal issue in the entire EBU debate, on par with some of the most important economic concerns.

A crucial difference between the NoPS and the Eurozone States is the representation in the Governing Council. The SSMR Preamble explicitly states that "Member States whose currency is not the euro are not present in the Governing Council for as long as they have not adopted the euro in accordance with the TFEU" and cannot "fully benefit from other mechanisms" provided for the Eurozone States.[633] This monumental obstacle is rooted in the ECB's founding statute, limiting membership of the Governing Council to members of the Executive Board of the ECB and the governors of the national central banks of the Eurozone.[634]

The significance of this problem, however, is primarily related to decision-making hierarchy, particularly in relation to the most contentious decisions, which are, by their nature, exceptional. Darvas and Wolff therefore downplayed the problems stemming from lack of representation in the Governing Council. They claimed that this problem is counterbalanced by representation in the supervisory board, providing "*equal rights for euro-area and non-euro-area states.*"[635] Even the more critical commentators agreed that the "structure, and other safeguards in the SSM Regulation, appear to go as far as is legally possible to place euro and non-euro Member States on an equal footing […] and whilst the outcome is not ideal for non-euro participating Member States, it is expedient."[636]

Such reasoning has some merits. The Governing Council primarily sets the agenda and

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[632] DJ Elliot, *Key issues on European banking Union; Trade-offs and some recommendations*, Global Economy and Development, Brookings, 2012, p.4
[633] SSMR Rec.43
[634] Art.10, Protocol on the Statute of the European System of Central Banks and of the ECB annexed to the TEC. See also OJ C 191, 29.7.1992, p.78. For more on the structure of the governing council see Europa website.
[635] Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013, p.4
[636] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.16

standards, but it does not actively supervise credit institutions. The draft decisions of the supervisory board are deemed to be adopted unless the Governing Council objects. While indicating the hierarchy of decision-making power, such arrangement also means that most decisions are not tinkered with by the Governing Council. Its further involvement is mainly through appeals in cases of fundamental disagreement, which are not an everyday occurrence. The absolute majority of supervisory decisions are made by other bodies, like the Supervisory Board and the NCAs.

With that being said, as my research in Chapter 4 reveals, the Governing Council representation issue is a major factor in the eyes of most NoPS. While not actively involved in day-to-day supervision, the Governing Council is, nevertheless, an immensely powerful organ, which plays other significant roles in the European supervisory architecture.

The list of such roles starts with standard-setting and ends with being the ultimate arbitrator, meaning that the Governing Council impacts the entire supervision lifecycle. The Governing Council establishes the Code of Conduct for the ECB staff involved in supervision[637] as well as makes the ultimate decision in case of an NCA or credit institution disagreeing with the ECB. Importantly, such decisions are essentially administratively incontestable by private parties. For example, natural or legal persons can request a review of a decision of the ECB under SSMR relating to that person, but a request for a review against a decision of the Governing Council is not allowed.[638] As I will elaborate in Subsection 4 below, the only meaningful, non-judicial, recourse in case of a significant disagreement with the decision of the Governing Council, which could go beyond (possibly futile) objections within the SSM structures is termination of the CCA.[639]

Ferran observed, that through such arrangement, despite other forms of representation, the non-Eurozone States choosing to participate in the EBU are excluded from "the key formal decision-making forum."[640] Non-representation effectively creates what is considered second-class membership, in the view of most NoPS.[641] Some see it as being placed in the position of policy takers rather than policy makers – an issue which partly cooled down even

[637] Art.19(3) SSMR
[638] Art.24(5) SSMR
[639] Art.7(8) SSMR
[640] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.16
[641] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.565

the initial Romanian enthusiasm.[642] This problem should be seen in the light of other concerns, such as being outvoted in the SSM decision-making framework, including the Supervisory Board, by the EMU majority.[643]

Moreover, Sweden expressed the opinion - shared by other NoPS, academic commentators and discussed in more detail in Chapter 2 above - that the Supervisory Board of the SSM is ultimately subordinate to the ECB's Governing Council and that this sort of relationship ultimately makes participation unacceptable.[644] On top of that, while the presence of the NCAs on the supervisory board is a step forward, this change was reportedly diluted by the ECB's ability to influence the status and role given to the NCAs.[645]

The changes made moving from the SSMR Proposals onto the final text indicate considerable attempts to soften the problem within existing legal limits and structures. The SSMR obliges the Governing Council of the ECB to invite the representatives from non-EMU States whenever it is contemplated by the Governing Council to object to a draft decision prepared by the Supervisory Board or whenever the concerned NCA formally disagrees with a draft decision of the Supervisory Board.[646] However, as I have discussed in Chapter 1 of this thesis, after the GFC, banking regulators have become wary of any kind of advisory roles and view such mode of participation with scepticism.

4. Termination

The procedure for termination and, most importantly, the variety of events which could trigger such procedure, also deeply concern the NoPS. The problems are generally linked to involvement of the Governing Council and additional differentiation between the CCA States and the EMU States. Under Arts.7(7)-(8) SSMR, the ultimate recourse the CCA State has is the termination of the CCA. Moreover, the ECB can also trigger termination. The option to terminate the agreement by a CCA State was a major change from the initial proposals, which did not explicitly allow it, and was mostly introduced as an attempt to make the CCA more palatable to the NoPS. There are four principal ways in which termination can occur.

Firstly, the CCA signatory State can simply choose to terminate the CCA. Under Art.7(6) SSMR the State can request the ECB to terminate the close cooperation *at any time*

[642] OM Georgescu, *Romania in the Banking Union: Why the international supervision of cross-border banking is necessary*, CRPE, 2015, p.6
[643] Spendzharova and Bayram, 2016, p.566
[644] Ibid, p.573
[645] E Chiti, F Recine, *The Single Supervisory Mechanism in Action: Institutional Adjustment and the Reinforcement of the ECB Position*, European Public Law, Volume 24:1 2018, p.124
[646] Arts.6-7, Rec.72 SSMR

after three years of participation. The ECB is then obliged to immediately proceed to adopt a decision terminating the close cooperation and indicate the date from which it applies, within a maximum period of three months. This is in many ways unprecedented, as for the first time the in the history of European integration a country can simply quit (at least institutionally) one of the European 'unions'. This can be contrasted with the difficulties of leaving the EMU, Schengen or the Single Market. As Speyer observed, while this may make participation more palatable to the NoPS, "it sets a dangerous precedent – all the more so in an area, viz. financial supervision, where reliable and lasting structures are important for building confidence."[647] Legal certainty and security of expectations are the obvious victims, as yet another aspect of dynamic differentiated integration is given precedent. Notably, due to specific circumstances, the termination safeguards are not *meant* to be construed as a precedent for other areas of Union policy.[648] It can be recalled, however, that monetary policy differentiation was not meant to be construed as precedent for financial regulation either.

Secondly, termination is also an option for the States in case of a really strong disagreement with the ECB. Under Art.7(8), if a participating State disagrees with a draft decision of the Supervisory Board, it informs the Governing Council within five working days. The Governing Council, after five working day considerations, responds to the State. The State can request the ECB to terminate the close cooperation with immediate effect and *will not* be bound by the ensuing decision.[649] That is effectively the only 'guaranteed' way to avoid the implementation of the contested decision. The SSMR does not provide judicial review procedure for such decisions, but a mediation panel, discussed Subsection 6, is established in an attempt to heal potential rifts. Making termination the ultimate remedy arguably makes the arrangement more tolerable to the potential CCA States, but also increases the aforementioned risk of dynamic differentiated integration. Stipulating a direct route to judicial review in the SSM legislation could guarantee a greater degree of stability, but it also could – admittedly - prolong the procedures where timely decisions are imperative.

The third situation where the termination of a CCA can occur, detailed by Art.7(7) SSMR, arises from an objection of the Governing Council to a draft decision of the Supervisory Board. From the NoPSs' perspective – a situation where the ECB effectively disagrees with itself. The Supervisory Board and the State in question can formally disagree with the Governing Council's objection. Where the Governing Council confirms its

[647] B Speyer, *EU Banking Union: Right idea, poor execution*, Deutsche Bank, 2013, p.9
[648] Rec.43 SSMR
[649] On decision making and power balance see Chapter 5

objection, the participating State can notify the ECB that it will not be bound by the potential decision related to a possible amended draft decision by the Supervisory Board. The ECB then can consider the possible suspension or termination of the CCA, taking into account considerations like integrity of the SSM, consequences relating to the fiscal responsibilities of the State, whether or not it is satisfied that the NCA concerned has adopted measures which ensure that the playing field remains level between Member States, and that the national regime complies with EU law.

Fourthly, a non-Eurozone Member State can also be forced out of the institutional components of the EBU by the ECB. The most politically problematic (and conceptually peculiar) aspect is that the 'punishment' for non-compliance on the part of the CCA State or its NCA is also termination. Under Art.7(4) SSMR the ECB can "address instructions" to an NCA, specifying the relevant timeframe of no less than 48 hours, unless earlier action is deemed necessary,[650] to take actions relating to SSMR Arts.4-5 tasks. Failure to comply, can lead to a warning that the close cooperation will be suspended or terminated in the absence of a corrective act.

In addition to their individual shortcomings, all of these arrangements suffer from a couple of overriding flaws. Firstly, the Governing Council is involved in all three situations where the CCA is terminated due to disagreement. That effectively highlights all the representation issues, discussed in Subsection 3 above. Secondly, there is no termination procedure for Eurozone States, and thus no ultimate punishment of this type for non-compliance. This further deepens the division between the EMU and non-EMU States, fulfilling the prophecies of the path-dependency hypothesis, discussed in Chapter 1. Moreover, the existence of the (effectively) termination-as-punishment clauses, defeats the whole point of introducing this questionable system of flexible membership in the first place – namely to encourage the NoPS to participate. The temporary nature of the arrangement and the prospect of termination through factors partly beyond the States' control, coupled with the status of the Governing Council as the ultimate decision-maker, are an unappealing combination.

While the reputation damage done by not joining the CCA might exist, it is relatively small compared to the damage done by termination. Not to mention the costs of all the arrangements for participation, which could turn out to be in vain because of one disagreement, relating to (possibly) one individual institution, in a matter of weeks. Although

[650] If earlier adoption is indispensable to prevent "irreparable damage"

the SSMR leaves the re-joining opportunity, it is clear that virtually no Member State would do that. Especially since a State, which has terminated the close cooperation with the ECB is barred from entering into a new close cooperation for three years.[651] This applies regardless of who initiates the termination. While such limitation appears reasonable from the operational standpoint, as a short 'break' period would encourage States to quit and re-join in order to avoid individual decisions, thus aggravating network instability, it also effectively eliminates any practical possibility of the State in question re-joining.

5. Termination and the SRM

Moreover, further complications and costs come into consideration due to the symbiosis between the SSM and the SRM. As a form of a 'guillotine clause', withdrawal from the SSM also terminates the participation in the SRM and vice versa.[652] Such step would automatically terminate participation in the SRF. A 'refund' sum called recoupment would then be repaid to the NoPS in question.[653] The SRB and the withdrawing State would then need to ensure sufficient sum is retained for national resolution arrangements, taking into account a variety of factors including voluntary or non-voluntary termination of the CCA and national economic cycles.[654] At the time of writing there is no stipulation or guidance as to what would happen if the withdrawing state was a Eurozone country leaving the Eurozone or the EU altogether via Art. 50 TFEU. It could be assumed that a similar recoupment arrangement would apply, subject to broader withdrawal negotiations, similar to Brexit. However, the absence for such arrangement for EMU States once again indicates a distinction between the EMU and non-EMU States, as well as the fragility of the CCA as an instrument.

In case of the CCA State withdrawing, the national resolution fund would need to be reinstated and the relevant institutional structures recreated. This would come on top of the added costs of the sudden need to strengthen national resolution authorities, which might become weaker (or at least have to alter their mode of operation) during participation. Due to increased likelihood of withdrawal the NoPSs might need to retain the existing structures and keep smaller additional funds for the situations where the SRF funds are insufficient or recoupment delays occur. Under Art.4(3) SRMR, the decision on recoupment can take up to

[651] Per Art.7(9) SSMR, counting from the date of the publication of the ECB's decision in the Official Journal of the EU
[652] The participating non-Eurozone countries can withdraw from the SRM under Art.4 SRMR.
[653] Art.4(3) SRMR
[654] Ibid.

three months, with possible further delays. As the last paragraph of Art.4(3) seems to indicate, there is no precise deadline and the only stipulation as to the recoupment schedule is that it has to be a "limited period commensurate to the duration of the close cooperation."

Effectively, the States in close cooperation might have to hold more funds or spend more on resolution infrastructure per 1 euro of covered deposits than their Eurozone counterparts, if they wish to keep the termination option in Art.7(6) SSMR open. Such added costs could be tolerable, since for that cost the CCA State 'purchases' the option of termination, which is unavailable to EMU States. However, the ability of the ECB to terminate the CCA, puts the CCA States in a position of significant net disadvantage. This, in and of itself, is not an appealing prospect, especially for those NoPS which do not have plans to join the EMU at a later date.

These problems are further aggravated by the fact that non-EMU States do not participate in the ESM, so their financial firewall is weaker. As I have discussed in Chapter 2, the SRF might not always be sufficient to halt a systemic crisis, and ESM funding would really come in handy in such cases. The SRF was largely designed with additional backstop (ESM) in mind, and such thinking did not extend to the non-EMU States. As discussed in Chapter 2, the use of the SRF for problem situations that do not amount to a crisis is also restricted. Moreover, the funds available to individual States are also limited, and some NoPS, especially those which are hosts to larger international banking groups, like Hungary,[655] have expressed concerns about the limits of the maximum help they could receive.[656]

Most importantly, many NoPS are particularly unhappy with the possibility of using their funds to bail-out other countries' banks, especially those with limited exposure to their own. I will return to this in Chapters 4 and 5 of this thesis. Given the increased possibility of termination, some non-EMU States might end up in a situation where they bail out other States' banks, but have to leave the SRF before their banks can use it. In summary, the added organisational and monetary costs of the withdrawal from the SRF make the CCA even less attractive to the NoPS.

6. The safeguards protecting the interests of the CCA States (and their flaws)

[655] Discussed in detail in Chapter 5
[656] K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.9

It should be noted, that many of the scenarios described in the preceding subsections are the worst case scenarios. In all likelihood most disagreements will be solved without resorting to extremes. The extreme safeguards, in particular the termination of close cooperation, are expected to be used in justified and exceptional cases.[657] However, the less extreme arrangements also have their fair share of flaws. This subsection highlights the most important concessions made in order to appease the NoPS and indicates why they failed to alleviate the concerns of all five of the EMU-sceptic NoPS.

a) Representation in the Supervisory and Resolution Boards

Firstly, as mentioned, the CCA States were given full representation in the ECB Supervisory Board. While not a safeguard per se, it is a concession, giving the CCA States equal say on the majority of decisions. This was mirrored by the SRM arrangement, by which the CCA States will each delegate a member of the SRB under Art.43(1) SRMR.[658] While the SRB is an EU agency and its membership is (in principle) not restricted,[659] adding the CCA States to the ECB's Supervisory Board was an unprecedented move, which should not be understated. For the first time, non-Eurozone states were given equal say in a major ECB decision-making organ. This change had the promise of a major paradigm shift, as the ECB was primarily built for the Eurozone. Unfortunately, even in this structure, we can see the legacy of the 'EMU-first' orientation. For example, a somewhat unexpected constitutional problem arose in relation to the position of the Vice-Chair of the Supervisory Board. Art.139(2)(h) TFEU, excludes non-Eurozone States from participating in the appointment of the ECB's Executive Board. That could effectively reduce their influence in the Supervisory Board, as its Vice Chair is chosen *exclusively* from the members of the Executive Board. While this might not be a major issue, any instance where the legal arrangements privilege the EMU States over the CCA States confirms the perception of inequality. Notably, partly for this reason, the position of the Vice Chair of the Supervisory Board has been kept vacant for a number of years and remains vacant at the time of writing. This indicates some deference, shown to the current and potential CCA States.

The most important concern is, as mentioned, that the Governing Council is superior to the Supervisory Board. This is evident from a number of provisions.[660] Since the Governing

[657] SSMR Rec.43
[658] Following the same conditions as appointees of the Eurozone States under Art.56 SRMR
[659] Due to different constitutional basis, as discussed in Chapter 2.
[660] E.g. SSMR Art.7, Art.19(3), Art.24(7), etc.

Council retains the ability to override the Supervisory Board decisions, the caution of the NoPS is understandable.

b) Mediation Panel

As part of the attempts to alleviate such concerns, a number of balancing arrangements were introduced. One of such arrangements was the creation of the mediation panel. This panel resolves differences of views regarding an objection of the Governing Council to a draft decision by the Supervisory Board. The panel – importantly - ensures equal representation and includes one member per participating State (including CCA) chosen by each State from among the members of the Governing Council and the Supervisory Board.[661] It decides by simple majority voting. While the creation of such panel is a welcome step, which reduces the likelihood of termination of CCAs due to the Governing Council disagreeing with the Supervisory Board, the limitation of the Panel's capacity to Supervisory Board and Governing Council conflicts in unfortunate. An opportunity for the States concerned (or their NCAs) to address their own objections to this panel would be welcomed by the NoPS. The downside of such arrangement would obviously be the resulting sacrifices in decision-making efficiency. Part of the reason for not extending the use of the Panel for a broader spectrum of conflicts was also the existence of the review procedure, available via the Administrative Board of Review.

c) Administrative Board of Review

Unlike the Mediation Panel, the Administrative Board of Review (ABR) allows challenges from a range of interested parties, including natural and legal persons.[662] While this was generally perceived positively by the NoPS, the ABR is not an optimal organ to give voice to the non-Eurozone States or their banks either. Under Art.24(4) SSMR the members of the ABR are supposed to act independently of any national interest. In other words, even if a citizen of one of the current NoPS is appointed onto the ABR, they would be prohibited from advancing the interests of their home State or its credit institutions. Moreover, the ABR is not an easy place to bring up concerns with, since a natural or legal person seeking to challenge a decision would need to show direct and individual concern, unless they are the addressee of that decision.[663] The direct and individual concern doctrine has been borrowed from the EU procedures for the action of annulment, despite being heavily criticised in that

[661] Art.25(5) SSMR
[662] Art.24 SSMR
[663] Art.24(5) SSMR

field as an impractically high standard.[664] It is hard to find justifications for such choice, especially since the acts of the ECB within the SSM are - by their nature – non-legislative, and thus even in the field of annulment actions (post-Lisbon) would only require proof of direct concern.[665] Even for the NCAs the path to a successful challenge is not easy, as the decisions of the Governing Council cannot be challenged in front of the ABR.[666] The Governing Council is even explicitly granted greater appellate powers.[667]

d) *Safeguards tainted by the Governing Council issue.*

NoPS' concerns with the Governing Council representativeness were among the reasons why the supervisory and monetary capacities of this organ needed to be separated. Under Art.25(4) SSMR the Governing Council's meetings and agendas are different for each of the capacities. While this has some potential to alleviate concerns of at least those NoPS that will adopt the Euro in the future, such arrangement has notable shortcomings. It presents a twofold problem discussed in more detail in Chapter 2 above: on the one hand, such separation might not be optimal from the operational standpoint, on the other – it is difficult to ensure absolute separation with the same personnel sitting in a similar setting, often in the exact same room. As I will discuss in Chapter 4, despite this separation, the NoPS generally perceive the Governing Council as a single body, with a resultantly deeper interest in the affairs and wellbeing of the Eurozone States than those of the NoPS. Generally, all of the arrangements of the supervisory structure, including the ones designed with the CCA in mind, are in some way subjected to (arguably disproportionate) influence of the Governing Council. The Governing Council can (effectively) initiate termination of the CCA, impact the decisions of the Supervisory Board, and even influence the triggering of a bank resolution via the SRM.

[664] See A Albors-Llorens, *Standing of private parties to challenge community measures: Has the European court missed the boat*, The Cambridge Law Journal, Volume 62 Issue 1, 2003; A Kornezov, *Shaping the New Architecture of the EU System of Remedies: comment on Inuit*, European Law Review 39(2), 2014; R Schütze, *European Union Law*, Cambridge University Press, 2018, pp.355-374
[665] Art.263 TFEU
[666] SSMR Art.24(5)
[667] SSMR Art.24(8)

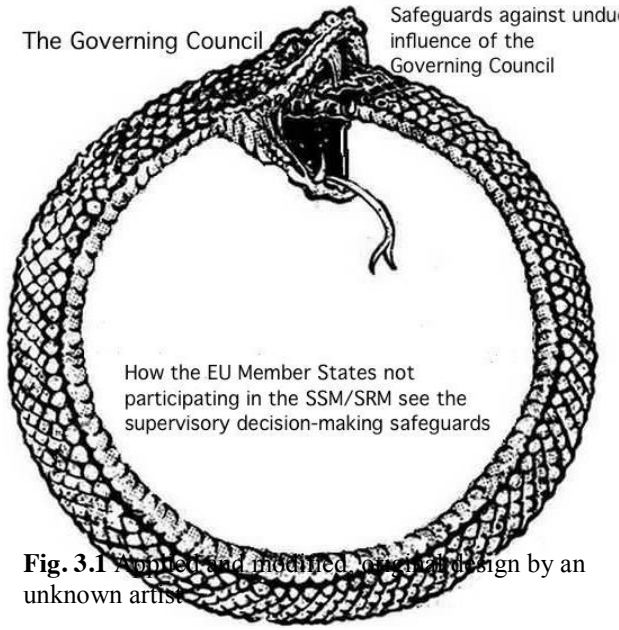

Fig. 3.1 Applied and modified [illegible] sign by an unknown artist

Moreover, it has a privileged standing in front of the Administrative Board of Review, while its decisions are immune from the scrutiny of this body. If needed, the Governing Council could also completely disregard the Mediation Panel.

Effectively, all of the safeguards introduced to protect the CCA States from disproportionate Governing Council influence are designed in a way that the Governing Council, or the EMU States represented on it, have disproportionate influence in the mechanisms facilitating such safeguards. That has locked the CCA arrangement safeguards in a sort of ouroboros situation. This comes in addition to the fact that the CCA States are a minority group in the SSM and SRM, so their (already limited) influence in the Supervisory Board would be limited even further, especially if we considered EMU and non-EMU States as separate interest groups. The NoPS are also aware that the number of CCA States will always remain very small, in all likelihood limited to 3-6 States, due to planned EMU accessions of Bulgaria and Croatia and (seemingly) permanent EBU derogation of Sweden. Unsurprisingly, none of the NoPS have been persuaded by the effectiveness of the safeguards, although some chose to bear the shortcomings while awaiting EMU accession.

C. Memoranda of understanding

Given the Treaty restrictions on CCA State participation in the Governing Council, infectiveness of the safeguards against the detrimental effects of such situation, and the fragility of CCA arrangement, it was foreseeable that at least some Member States would refuse to join the SSM and SRM. After the UK and Sweden refused to sign the SRF Treaty, it was clear that the largest EU banking centres outside Eurozone – London and Stockholm – would remain outside. The (now) largest non-Eurozone Member State – Poland – took a similar position. For this reason, the SSMR envisaged the use of memoranda of understanding as a tool to mend the gaps in supervision and build some bridges between the participating States and the NoPS. In this section I will discuss the origin and legal status of

the memoranda, circumstances under which the ECB is obliged adopt them, and assess the effectiveness of these soft-law instruments.

1. Purposes and types of the memoranda of understanding

Memoranda of understanding and similar arrangements, in essence, are not a new feature in the governance of European banking regulation. For example, in 2005 a Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations was entered into, as discussed in Chapter 1. The pre-crisis documents were, notably, very different from the ones used in furtherance of the goals of the SSM and SRM. Normally they were not public and lacked enforceability in some of the multitude of relevant jurisdictions.[668] The SSMR style memoranda are - at least - public and open, made available to the European Parliament, to the Council and to Member State NCAs.[669] While they still lack binding power, more political weight has been placed behind them.

Since the SSM's launch we have witnessed the memoranda appear in a variety of shapes, as their intended purposes mutated. More NoPS were originally expected to participate in the SSM by entering into the CCA with the ECB. However, as the CCA proved unpopular, the memoranda of understanding, originally envisaged as a temporary transition tools, now serve as primary documents stipulating the relationship between the ECB and the NCAs. The memoranda, *inter alia*, clarify the consultation relating to decisions of the ECB having effect on subsidiaries or branches established in the NoPS, whose parent undertaking is established in a participating State, and the cooperation in emergency situations, including early warning mechanisms.[670] They are flexible instruments, which can be reviewed on a regular basis.[671]

The SSMR memoranda have a broader geographical reach than the CCA and thus often apply to EEA/EFTA states, like Norway or Switzerland, as well as third countries.[672] They can also have regional coverage, especially in cases of integrated regional markets, like the memorandum of understanding between the ECB and the Nordic states.[673] These are

[668] As the EBC admitted, Press release 18/05/2005
[669] Art.3(1) SSMR
[670] Rec.14), Art.3(1) SSMR
[671] Ibid.
[672] A third country is defined in Art.2(27) SSMFR as a country which is neither an EU Member State nor an EEA State
[673] Memorandum of Understanding Between Finansinspektionen (Sweden), Finanstilsynet (Norway), Finanstilsynet (Denmark), Finanssivalvonta (Finland) and The ECB, on prudential supervision of significant branches in Sweden, Norway, Denmark and Finland, 2/12/2016

primarily used to make arrangements for dealing with the complex banking structures, strengthen working relationships, and can take a variety of mixed forms involving the NoPS, the ECB[674] *and* third countries' authorities.[675]

As Schuster *et al* observed, due to the global nature of banking activities, the supervision of EU credit institutions increasingly requires a network of cooperation with the supervisory authorities of third countries outside the EU.[676] Even though the ECB, as a new supervisory authority, was originally facing the challenge of not having such a network in place,[677] or rather not having one that would cover the 'edges' of its domain fully, this aspect seems to have been handled adequately, partly since the ECB inherited much of the pre-existing arrangements, as discussed in the next subsection. The international network of cooperation that the ECB has established is at the very least on par with those of most EU NCAs. The SSMR also expanded ECB's international relations powers, but only to a limited extent. Under Art.8 the ECB can develop contacts and enter into administrative arrangements with supervisory authorities, international organisations and the administrations of third countries, subject to appropriate coordination with EBA. Notably, in most cases the ECB is not obliged to do so, and neither are these third-country bodies.

Memoranda of understanding can also be seen as a clarification tool within the SSM area, where the ECB's SSMR mandate cannot reach. For example, as Moloney observed, the inherent network instability in the SSM can be aggravated by the limitation of the ECB's powers, where conduct supervision and prudential supervision intersect with respect to risk and stability supervision.[678] She sees Art.3(1) SSMR provisions on the ECB's cooperation with NCAs responsible for markets in financial instruments and related memoranda of understanding as a partial remedy for such issues.[679] In such cases the ECB enters into memoranda with NCAs responsible for markets in financial instruments, describing how they will cooperate in the performance of their supervisory tasks. Importantly, the EBU memoranda often co-exist in parallel with the inter-NCA cooperation and regional memoranda, which can involve NCAs from third countries.

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[674] See Rec.14 and Art.3(6) SSMR
[675] Art.8 SSMR
[676] G Schuster, K Lackhoff, M Benzing, DA Bauer, *The SSM Framework Regulation Part 2: Administrative procedure, legal remedies and transitional provisions*, Freshfields Bruckhaus Deringer, 2014, pp.8-9
[677] Ibid.
[678] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1647
[679] Ibid. and Rec.33 SSMR

2. Obligatory memoranda

The primary purpose of the memoranda in the SSM context is nevertheless the cooperation between the ECB and the NCAs. Such memoranda are expected to describe the terms of cooperation between the NCAs and the ECB in performance of their supervisory tasks under EU law. The SSMR presents two cases where the ECB is obliged to have memoranda-based arrangements in place.

The first instance is where the SSMR Art.3(6) requires the ECB to conclude a memorandum with the competent authority of *each* NoPS which is home to a 'global systemically important institution.' This is the only instance where the term 'systemically significant' is still used in the SSMR, although the word 'systemic' was emitted from the rest of the SSM Regulation moving from the proposals, despite the presence of this term in CRR and CRD IV, where 'significant' and 'systemic' institutions are defined for the purposes of EU law.[680]

This has implications for the memoranda. When determining which country to sign the memorandum with, the ECB consequently does not have to follow the Art.6(4) SSMR significance criteria. Rather, it is only obliged to aim at countries with significant institutions under Art.441 CRR[681], which are identified as globally significant in accordance with Art.131 of Directive 2013/36/EU. This identification methodology is different from the criteria used to designate an institution as significant under Art.6(4) SSMR. For example, criteria like "substitutability of the services or of the financial infra structure provided by the group" or "interconnectedness of the group with the financial system" are not present in SSMR, while simply being the largest institution in the country does not make an institution systemically significant under Directive 2013/36/EU.

The Directive 2013/36/EU checklist has been followed in all memoranda to date. It is somewhat peculiar that in this specific instance the SSMR does not use its own methodology. This differentiation, notably, helps avoid exclusions on technical or vestigial basis, creating a more straightforward system. This impression is strengthened by the fact that the ECB-NoPS memoranda diligently observe the principle of proportionality, with participants agreeing that the highest level of cooperation should apply to the largest branches.[682]

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[680] The reason why the term 'significant' was preferred over 'systemic', was that the Council and the Commission wanted to make sure that *all* Eurozone state would have some banks falling under the supervision of the ECB, thus minimising the likelihood of domestic or regional crises. It is questionable whether this logic needed to be dropped for memoranda requirements, however.

[681] Regulation No 575/2013

[682] See for example Memorandum of Understanding on prudential supervision of significant branches in Sweden, Norway, Denmark and Finland, 2/12/2016, III (12)

The second type of obligatory memoranda are the ones predating the SSM, that the ECB 'inherited'. Pre-existing memoranda of understanding and cooperation arrangements with other authorities entered into by an EBU NCA prior to 4 November 2014, that cover tasks transferred to the ECB by the SSMR, continue to apply.[683] The ECB participates in such existing arrangements in place or alongside the home NCA. The ECB, notably, does not automatically become a signatory to memoranda established *after* the launch of the SSM, and entered into by the NCAs on non-EBU/EBA basis.

3. Effectiveness of the memoranda

The main reason for discussing the memoranda in this context is the assessment of their capacity to mend the gaps between the SSM/SRM and the NoPS. There are multiple reasons why, for all their merits, the memoranda envisaged by the EBU legislation are unlikely to meaningfully contribute to the attainment of that goal.

Firstly, the EBU memoranda often do not do anything that was not previously done (or could be done), by the signatories themselves. It is worth contrasting the ECB-Nordics memorandum,[682] with a separate Nordic-Baltic memorandum, which is not directly based on EU legislative provisions.[684] Coming into force two weeks after its ECB-signed predecessor, the Nordic-Baltic memorandum has significantly broader geographical scope and reflects the banking market reality better. The differences between the two documents are significant. The ECB memorandum is mostly concerned with information exchange and transparency, whereas the Nordic-Baltic memorandum has provisions relating to supervision, resolution and recovery. The Nordic-Baltic memorandum discusses actual semi-institutional and inter-institutional structures employed for the purposes of attaining the memorandum's goals, and despite still being a soft-law instrument, resembles binding agreements. The ECB memorandum, by contrast, is very limited and abstract. Notably, the SSM memoranda, like the Nordic-ECB one, also recognise the interconnectedness in regional markets, effectively recognising that arrangements with individual states in this context might not have the intended effect. The Memorandum covers non-EU (EEA) Norway, two EU NoPS - Sweden and Denmark – as well as one EMU member - Finland. Such formal recognition of integrated banking markets existing across various European memberships is significant. However, it left out the Baltic States and Iceland, which needed to be rectified by the States immediately,

[683] Art.152 SSMFR
[684] Memorandum of Understanding on Cooperation regarding Banks with Cross-Border Establishments between the Central Banks of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden, 15/12/2016

in their own Nordic-Baltic memorandum not involving the ECB.

Secondly, the memoranda are not (and cannot be) legally binding and do not give rise to liability, as stipulated by the SSMR and their own texts.[685] This limits the effect of the SSM memoranda even further, especially when dealing with third countries. Such memoranda, as well as any other arrangements, also cannot create legal obligations in respect of the EU and its States.[686] Under SSMFR Art.2(27) a third country is any country which is neither an EU State nor an EEA State. The list of third countries notably includes Switzerland, Russia and the UK, which have significant impact on European finances. Although there are no restrictions for legally binding arrangements being created by the third countries in favour of the ECB, without reciprocity such arrangements remain unlikely.

It is reasonable to question whether documents which are not legally binding and cannot create obligations have any tangible value. Furthermore, (assuming that they do have some value) there is a strong possibility that much of that value would be lost in crisis situations. In the context of the fiscal backstop debate, Schoenmaker described non-binging memoranda of understanding as "paying lip service to international cooperation."[687] In the light of the ineffectiveness of pre-GFC soft-law measures, memoranda of understanding can at best be seen as a placeholder in the absence CCAs and bilateral agreements with third parties. At worst – a poorly designed smokescreen, put in place to create the illusion of formal arrangements. Even in the presence of political will at the time of signing the memoranda, they provide a 'decoy' solution to the Financial Stability Trilemma. Schoenmaker described this process as "starting […] from the wrong side. [since] it assumes that what is needed is to make sure that supervisors *can* cooperate (by harmonising rules and agreeing on protocols), but it does nothing to assure that they *will* cooperate."[688]

D. Colleges of supervisors

One of the ways to create channels for supervisors to cooperate is to create collegiate structures dedicated to a particular banking group or geographical region. That makes

[685] Memorandum of Understanding on prudential supervision of significant branches in Sweden, Norway, Denmark and Finland, 2/12/2016, III (13)
[686] Art.8 SSMR, with additional limitations reading: "Without prejudice to the respective competences of the Member States and institutions and bodies of the Union, other than the ECB, including EBA, in relation to the tasks conferred on the ECB by the SSMR."
[687] D Schoenmaker, *Banking Supervision and Resolution: The European Dimension*, Law and Financial Markets Review Vol.6 2012, p.2
[688] Ibid. p.6

colleges of supervisors one of the options for mending the gaps in European banking supervision, since they can - unlike the ECB, NCAs or even the EBA - transcend jurisdictional boundaries. In the presence of strong will and cooperative spirit among the participating authorities, the colleges can reduce the opportunities for a particular group to engage in regulatory arbitrage, encourage exchange of information, facilitate convergence of practices, and increase preparedness for emergency situations. Importantly, supervisory colleges exist in parallel (or as the case may be – symbiosis) with resolution colleges. Resolution colleges play an important role in bank resolution arrangements and exercise a set of binding powers. While supervisory colleges do not have such powers, they can help smooth functioning of resolution colleges by encouraging cooperation and information exchange, as well as strengthening ties between the NCAs and NRAs from different countries.

In this section I will discuss several types of supervisory colleges, and assess their effectiveness in mending the gap between the participating states and the NoPS. Detailed discussion of resolution colleges is beyond the scope of this thesis, and they will only be discussed here for contextual and comparative purposes. Subsection 1 introduces the functions and varied origins of the colleges. Subsection 2 discusses the changes introduced by the EBU to their structures. Subsection 3 explains why, despite notable merits and advantages, they cannot, serve as an adequate substitute for the CCA.

1. Shared characteristics and different origins of the colleges

Generally, colleges of supervisors are inter-institutional international structures, through which supervisory or resolution activities are coordinated in the absence of, or in supplement to, other arrangements.[689] Both supervisory and resolution colleges facilitate cooperation between authorities dealing with a particular banking group. Supervisory colleges can also operate across an integrated international banking market, on the basis of regional cooperation, like the Nordics and Baltics, or Visegrad 4. Most supervisory colleges share two at first sight conflicting characteristics: permanence and structural flexibility. Such flexibility allows them to transcend jurisdictional boundaries, and encompass non-EU NCAs. Colleges mostly facilitate exchange of information, planning and joint or coordinated

[689] Basel Committee on Banking Supervision, *Revised good practice principles for supervisory colleges*, 18/04/2014, p.1

performance of supervision. That can include all aspects of on-going supervision, including the preparation for and the handling of emergency situations.[690]

According to Basel Committee, the main objective of colleges is to help the NCAs in developing better understanding of the risk profile and vulnerabilities of credit institution groups.[691] The structure of the colleges based on these arrangements reflects the activities of the supervised entity. Some consist of two authorities, whereas others comprise a couple dozen authorities from multiple jurisdictions. The frequency and intensity of college activities, as well as interconnectedness between participating NCAs, can also differ significantly.[692]

Historically speaking, colleges of supervisors are not a creation of the EBU and many of well established colleges predate it. A good example of a supervisory college which, while (like most) created for a particular banking group, grew to play a role in deepening regional supervisory integration is the Nordic-Baltic college for Nordea, which was one of the factors leading to the Memorandum of Understanding on the management of a financial crisis with cross-border establishments signed by the NBR states in 2003. The regional integration deepened, and similar colleges were established for other major groups like SEB, Danske, and Swedbank. Well-integrated supervisory colleges also played a role in allowing the home (primarily Nordic) regulators to gain some decision-making power vis-à-vis host regulators in the Baltic states, thus facilitating supervisory convergence.[693] Notably, such influence was not always welcomed in the Baltic States, which saw EBU membership as a means to reducing it. I will return to the intricate network of supervision in this region in the next Chapter.

With that being said, although collegiate structures are not a new development, significantly more emphasis has been put on their role after the GFC. In the current era of European banking oversight colleges can be created in three main ways: by the EBA, by the ECB/SSM, and the NCAs themselves, but the EBU has had an impact on all three types of colleges.

2. Colleges created or altered by the EBU

Currently, regional and institution-specific colleges coexist across the continent. As

[690] Ibid.
[691] Ibid. p.4
[692] Ibid.
[693] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.567

Carmassi *et al* argued, the establishment of the SSM presented the opportunity to turn them into effective supranational supervisory structures.[694] The need to provide a pan-European blueprint for colleges arose since the level of collegiate coverage and intensity differed vastly between banking groups and regions. From the broader European viewpoint, effective collegiate cooperation was generally lacking. The consolidated basis of supervision with the colleges being involved was already envisaged in the Commission proposal for the SSM.[695] Notably, the EBU legislation does not see supervisory or resolution colleges as necessary for credit institutions concentrating their activities solely in the Eurozone (since that is the ECB and SRB's domain) and predominantly envisage them as structures meant to manage home and host relations and resolution planning between the Eurozone and the NoPS or between the NoPS, with possible addition of other European jurisdictions. Under Art.9(2) SSMFR, where there is no pre-existing supervisory college, and a significant bank has branches in the NoPS that are classed as significant,[696] the ECB establishes a college with the NCAs of the host States. Establishment of such colleges is an obligation of any EU NCA acting as the consolidating supervisor under Art.116(1) of Directive 2013/36/EU. In the cases where there is an existing college and the ECB acts as the consolidating supervisor, it chairs the college and sits on it as the main supervisor. The EBU NCAs whose responsibilities have been taken over by the ECB in such instances, participate in the college as observers.[697] This notably constitutes a degree of surrender of influence - or even a relegation for the NCAs - and many NoPS are not happy about it.

Art.10 SSMFR outlines the procedures for the ECB and NCAs as members of a college of supervisors to allocate responsibilities if the consolidating supervisor is *not* in a participating State (NoPS NCA). The ECB and NCAs then participate in the college of supervisors in accordance with the following rules:

(a) if the supervised entities in participating States are all significant supervised entities, the ECB participates as a member, while the NCAs participate as observers;

(b) if the supervised entities in participating States are all less significant, the NCAs participate in the college as members;

(c) if the supervised entities in participating States are both less significant and significant, the ECB *and* the NCAs participate in the college of supervisors as

[694] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, p.5
[695] Art.4(1)
[696] According to Art.51(1) Directive 2013/36/EU
[697] Art.9(1) SSMFR

members.

However, the NCAs of the participating States where the significant supervised entities are established can only participate in the college of supervisors as observers.

Art.7 of EBA's Regulatory and Implementing Technical Standards details the participation arrangements.[698] Typically, the authority assuming the role of consolidating supervisor wields important powers. When deciding which authorities should participate in a particular college meeting or activity in accordance with Art.116(7) of Directive 2013/36/EU, the consolidating supervisor has to take into account the topics to be discussed and the objective of the meeting or activity, in particular with regard to their relevance for each group entity, the significance of the group entity in the State where the group entity is authorised or established, and its importance for the group. It is important to note that such provisions give a lot of power to the consolidating supervisor (which is often the ECB). The consolidating supervisor also participates in the selection of delegates participating in the college.[699] The delegates have the power to commit their NCAs as members of the college to implement what the college decides. The consolidating supervisor can also invite the representatives of the supervised banking group itself to participate in a college meeting or activity, based on the relevant topics and objectives.[700]

3. Why the colleges cannot bridge the gap

Supervisory colleges clearly have their merits and uses. According to the Basel Committee, they facilitate ongoing relationships among supervisors, covering any cracks that might open in broader supervision systems.[701] To that end colleges can include supervisors in non-EU countries, which in that sense makes their reach a lot broader than that of most other supervisory structures, including the SSM itself.

However, the depth of what colleges can achieve is inherently limited for three main reasons:

a) they lack interest and capacity to act in the interest of the EU or the banking system as a whole,

[698] EBA *final draft regulatory and implementing technical standards on colleges of supervisors*, EBA/RTS/2014/16
[699] Ibid.
[700] Ibid.
[701] Basel Committee on Banking Supervision, *Revised good practice principles for supervisory colleges*, 18/04/2014, p.4

b) they lack uniformity to facilitate deeper convergence,

c) they do not have sufficient legal capacity to effectively mend structural systemic gaps, such as the schism between the EMU States and the NoPS.

a) Lack of broader interest in convergence

Without direct linkages to macro-prudential structures, colleges typically lack direct interest in broader EU or European banking health. Such lack of pan-European interest is not surprising, given the nature of the colleges. As Schammo observed "unlike the ESAs, colleges are not subject to prescribed normative orientations such as to act in the EU interest."[702] Moreover, while colleges of non-EBU origin can have a broader spectrum of responsibilities, they have a narrow, group-specific, focus. In principle the colleges are designed to focus on a limited market participant group (or region), and instances where a college gives impetus to further cooperation, like in the mentioned Nordea's case, are rare. As a consequence, the information available to the college neither reveals the full picture necessary to understand and monitor systemic threats, nor does it provide additional direct incentives to do so.

To be sure, the involvement of the ECB can give the colleges greater awareness of systemic threats and, with the most influential supervisor having a (notably limited) degree of pan-European and single market interest, can tilt them towards greater convergence. The SSMR puts an obligation on the ECB to cooperate with the EBA, ESMA, EIOPA, ESRB, and other authorities, which form part of the ESFS, which collectively seek to ensure an adequate level of regulation and supervision in the EU as a whole.[703] Where necessary, the ECB can utilise the memoranda of understanding with NCAs or EU bodies to strengthen such relationships.

However, the ECB is just one of several participants in the college. The EBA can also play a role, as I will discuss in Section E, but its involvement also has limits. That does not alter the fundamental premise of collegiate cooperation. The colleges were created to mend individual gaps, not build entire bridges. While enhanced cooperation between supervisory authorities both at EU, EEA, and global level is seen as key to strengthening the supervision of cross-border banking groups, the colleges themselves are generally envisaged as

[702] PJE Schammo, *Home country control with consent: a new paradigm for ensuring trust and cooperation in the internal market?*, Cambridge Yearbook of European Legal Studies, Vol.15, 2013, p.480

[703] Art.3(1)

additional monitoring mechanisms.[704] Colleges, both resolution and supervisory, have a set of concrete functions, like reaching joint decisions on the risk-based capital adequacy of cross-border groups and their EEA subsidiaries, exchange of information,[705] and certainly have some level of interest in systemic stability. However, they do not owe a duty of care to *safeguard* the health of the financial system.

b) Lack of uniformity and shared interest

Most collegiate processes are based on written cooperation and coordination arrangements. Such arrangements differ college to college in respect to, for example, the list of invited observers and their rights. The blueprints provided by the EBA do not ensure that all colleges will behave or operate in the same way, not to mention that different standards apply to colleges established for different purposes. That does not seem to contribute to pan-European harmonisation to an extent that could offset existing fragmentation.

What is more, the NCAs participating in the colleges also differ among themselves. Particularly, they are subjected to the risks presented by divergence of practices between the EBU States and the NoPS. According to Baglioni, the divergence of supervisory practices is not only a problem for the SSM and the EBA, but also for the Colleges of Supervisors. [706]

As he expressed it, the colleges "*are composed of members from the [NCAs] of countries where an international financial institution is located, and they have to reach an agreement about the application of prudential rules to such an institution, possibly with the mediation of the EBA. Of course, it is difficult to reach an agreement when the cross-country differences in supervisory practices are significant*."[707]

While differences in supervisory practices and organisational structures are important in the times of relative stability, in the times of crisis they dwarf in comparison to another problem – national interests. In such situation the collegiate activities can even become counterproductive. In some cases, supervisory information sharing facilitated by a college and consequent early remedial action can further distress the banking group, for example if

[704] SSMR Rec.44, Art.4(1)(g), Art.32(b)
[705] See Art.116(1) of Directive 2013/36/EU and Europa website
[706] Baglioni, *supra*, p.23
[707] Ibid.

the host NCAs chooses to ring-fence the branches and subsidiaries in their domain.[708]

The SSM-based colleges tried to remedy that to some extent, but the resulting disproportionate amount of power given to the consolidating supervisor became a discouraging factor for the participation of some NoPS, the most powerful of which are not keen to surrender their college leadership positions to the ECB.

Combined these factors create network instability, which in itself is a further disincentive for potential CCA States. As the SSM and SRM do not see the need for colleges overseeing the groups operating solely within their frameworks, the future CCA and/or EMU States might lack incentives to participate in the collegiate activities with full vigour, while awaiting accession. The remaining NoPS, in turn, might also be further discouraged from participating in the SSM/SRM, as they would lose a lot of the influence that they currently wield in the colleges. For example, should Denmark and Sweden join the EBU institutional components, the entire NBR market would fall within the ECB's domain, and the influence that their NCAs now have in the NBR colleges would be lost.

c) Lack of legal power

In addition to lacking interest in pan-European regulatory harmonisation, the colleges also lack capacity to materially contribute to it. Carmassi et al. stated that prior to EBU, the colleges were "weak instruments in the hands of the parent company national supervisors" and provided "for limited exchange of information between the home-and host-country supervisors of the group."[709] While there were some notable exceptions to this tendency, even the well-organised NBR colleges did not prevent reckless lending and the resulting bubble in the run-up to the GFC, as I will discuss in Chapter 4.

It could be argued that post-EBU colleges are stronger, but they still do not have ability to fully mend the gaps left open due to NoPS' non-participation and systemic instability. Colleges have no legal personality and hence no legal capacity, like the ability to sue. "[N]or are they, for that matter, European bodies such as the ESAs," as Schammo rightly observed.[710] Consequently, they do not have any legal powers. A college derives its power directly from the participants, and therefore in that sense does not add any *additional* legal firepower to pan-European prudential supervision. This can also be contrasted with resolution

[708] K D'Hulster, *Cross-border banking supervision: Incentive conflicts in supervisory information sharing between home and host supervisors*, World Bank Policy Research Working Paper No.5871 2011, p.4
[709] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, p.5
[710] PJE Schammo, *Home country control with consent: a new paradigm for ensuring trust and cooperation in the internal market?*, Cambridge Yearbook of European Legal Studies, Vol.15, 2013, p.13

colleges, which can adopt binding decisions on a broad range of issues listed in the BRRD, including the valuation of solvency, removal of obstacles to an effective resolution, approval of resolution plans, and determination of loss-absorption capacity, etc.[711]

It could be suggested that supervisory colleges could simply be given binding legal powers, *a la* resolution colleges. Early stages of the EBU featured calls for colleges to have "full powers to control and inspect all branches and subsidiaries of cross-border banking groups, thus […] making full use of existing supervisory structures."[712] However, without going into the specifics of why some of these powers could not be entrusted to the colleges, it can still be safely argued that they would not solve the main problems discussed in this thesis – differentiated integration and instability presented by non-participation. Giving supervisory colleges formal legal powers would fully chain them to the groups they would oversee, reducing regional and pan-European convergence opportunities, thus aggravating the uniformity and lack of pan-European interest concerns.[713] Moreover, that would likely exclude non-EU jurisdictions. Even the cooperation with the NoPS would remain shaky and problematic, with limited improvements over the status quo.

While supervisory colleges have their place and uses, and can avoid many of the jurisdictional obstacles affecting the SSM, they cannot, in any form allowed by the existing legislation, serve as an adequate substitute (or even a placeholder) for the CCA.

E. The European Banking Authority

The European Banking Authority (EBA) has been discussed in a variety of contexts in this work already. In Chapter 2 I specifically addressed why it could not be placed at the centre of the SSM as the primary supervisor. A logical extension to that discussion is examining whether the EBA can help with building the bridges between the SSM and the NoPS. In this section, I will examine how the EBA helps bridging the gap between the participating and non-participating States, and also why it is not capable of doing that fully.

[711] F Lupo-Pasini, *The logic of financial nationalism: The challenges of cooperation and the role of international law*, Cambridge University Press, 2017, p.114
[712] Carmassi, Di Noia and Micossi, 2012, p.5
[713] See Art.88 BRRD

The section starts with a brief discussion of the most important differences between the EBA and the ECB, before assessing the EBA's bridging potential in Subsection 2. Subsection 3 discusses the voting mechanics and the efforts to give equal weight to the participating and non-participating States' positions. Subsection 4 explores the fundamental legal and structural obstacles which prevent the EBA from being able to mend the gap between the NoPS and the participating States.

1. EBA v ECB: different agendas and priorities

As Lastra expressed it, "[t]he existence of two 'banking authorities:' EBA and ECB is a reflection of the co-existence of the Single Market and the Banking Union."[714] They have different jurisdictional domains but some of their needs and goals intersect.[715] The crucial difference between the EBA and the ECB is that the EBA is angled towards the Single Market as a whole to a greater extent. This might not be immediately apparent, as the 'integrity of the single market' rhetoric is also displayed throughout the legislation relating to the ECB. In the spirit of the TEU non-discrimination principle, the ECB is cautioned against discriminating against any Member State or group of States as venues for the provision of banking services, and has to carry out its duties with duty of care for "the unity and integrity of the internal market."[716] That is similar to the EBA Regulation stating that EBA must act "independently, objectively and in a non-discriminatory manner, in the interests of the Union as a whole."[717]

Despite similar rhetoric there is a material difference in how these principles apply. The ECB is believed to only be expected to act in the interest of the Single Market in its conduct, rather than take proactive steps in furtherance of such market.[718] By contrast, the EBA is meant to *act* in the interests of the EU by actively striving to prevent regulatory arbitrage, promote equal conditions for competition, and provide a forum for all Member States.[719] The difference is evident from the tasks conferred upon the EBA, such as the duty to promote

[714] RM Lastra, *Banking union and Single Market: Conflict or Companionship?*, Fordham International Law Journal, Volume 36, Issue 5, 2013, p.1212
[715] Ibid.
[716] Art.1 SSMR
[717] Art.1(5) EBA Regulation.
[718] See PJE Schammo, *The European Central Bank's Duty of Care for the Unity and Integrity of the Internal Market*, 42 European Law Review 3 2017
[719] Art.1(5) of the EBA Regulation (as amended), Recs.1, 10, 22 EBA Amending Regulation, see also European Commission, *The Operating Framework for the European Regulatory Agencies*, COM(2002) 718

pan-EU convergence of practices, particularly between the ECB and the NoPS NCAs.[720]

Moloney attributes these differences between the EBA and the ECB to the ECB's wider mandate, resulting in turn from its legal basis in the primary sources of EU law and consequent breadth of its objectives and activities, which can be contrasted with those of the EBA under Art.1(1) of the 2010 EBA Regulation, reflecting EBA's status as an ESA.[721] The fundamental principles of EBA's behaviour, as Schammo observed, "reflect more deep-rooted expectations about the behaviour of agencies."[722]

2. *EBA's bridging potential*

In the light of all the fragmentation issues arising due to limited scope of the SSM, the EBA could seem like the optimal institution to serve a unifying role. It ensures equal representation for the NCAs of all Member States, and in that sense is materially different from the ECB. According to Avgouleas and Arner, the EBA thus acts as a "hub and support network of EU and member state national bodies, safeguarding the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors."[723] Being one of the EU ESAs, it has greater powers than the colleges, while also enjoying greater geographical reach than the ECB. There are some compelling reasons to believe that the EBA could help bridge the gap between the Eurozone and the NoPS.

Firstly, it is placed over the ECB, the colleges and the NoPS's NCAs as the main – unifying - standard setter. As Schammo observed, because of the EBU/SSM amendments, the ECB is still subject to the authority of EBA.[724] The EBA carries out its tasks, like its power to settle disagreements, with respect to the ECB "as in relation to the other competent authorities."[725] The ECB has to follow the Single Rulebook, as well as the EBA's guidelines, as discussed in Chapter 2.[726] So far the ECB has generally respected the EBA's authority, complying with the technical standards and other guidance. Where there is margin for interpretation, the ECB reportedly tends to take a temporary position; once the EBA has

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[720] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1665
[721] Ibid.p.1637
[722] PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, (Kluwer, 2016), p.22
[723] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.30
[724] Schammo, 2016, p.9
[725] Ibid. with reference to Rec.12, EBA Amending Regulation.
[726] Art.4(3) SSRM, Art.16, 2010 EBA Regulation, see also SSMR Recs.7, 12

clarified the issue, the ECB observes such clarification.[727]

Therefore, within the current institutional architecture, the EBU is best placed to ensure that the NoPS and the participating States remain on the same page rule-wise. Its standard setting powers have the ability to unite all supervisory systems, providing a harmonised baseline.

Secondly, the EBA does a lot of work in coordinating supervisory colleges, giving it some (limited) power to steer them towards broader European goals. The EBA is responsible for drafting the mentioned regulatory and implementing technical standards, which specify conditions for the establishment and functioning of colleges, establish procedures for interactions between the consolidating supervisor and other competent authorities, and stipulate the minimum frequency for college meetings for colleges established under Art.116 CRD, which normally meet annually.[728] The EBA does not just lay down the standards for the colleges – it actively promotes and monitors effective and consistent functioning of them.[729] In addition to setting the standards, this can be done through its own direct participation. Under Art.21(1) of Regulation (EU) 1093/2010, the EBA can participate in the activities of the colleges of supervisors, including on-site examinations, carried out jointly by several NCAs, which can include the ECB. Its leading role is emphasised in Art.21(2) and entails stress testing. It also plays a similar role in resolution colleges.

Thirdly, the EBA's geographical reach and interest are wider than those of the ECB. Despite the fact that the ECB has gained immense powers via the SSM, the EBA remains 'the guardian of the borderlands' meaning both: coverage of the NoPS and candidate states. For example, in 2015 the EBA updated its recommendation on the equivalence of confidentiality regimes to include the Bank of Albania, thus reinstating itself as the main authority for the 'outer rim'.[730]

Fourthly, the EBA is equipped with mediation powers, applying not only to the SSM but also the SRM under Art.95 SRMR. Such powers might go part of the way in compensating for the lack of effective dispute resolution mechanisms in the SSM and SRM, discussed above. Notably, in most respects, EBAs dispute resolution powers are limited to mediation and fall short of arbitration.

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[727] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.286

[728] EBA, *Final draft regulatory and implementing technical standards on colleges of supervisors*, EBA/RTS/2014/16, 19/12/2014, p.3

[729] Art.116(1) Directive 2013/36/EU

[730] EBA, EBA/Rec/2015/02 amending EBA/Rec/2015/01 on the equivalence of confidentiality regime.

Lastly, as mentioned, the ECB strives to ensure that all NCAs have equal say within its structures, which requires a further discussion, provided hereinafter.

3. Ensuring representation

As mentioned, the most important difference between the ECB and the EBA and is that the later ensures equal representation for all EU States in their individual capacities. Furthermore, the main decision-makers within EBA are NCAs, which are all voting members of EBA's Board of Supervisors.[731] It therefore unsurprising that States and their credit institutions sought to protect the EBA's role during the EBU construction.[732] Potential marginalisation was a major concern for hardliner NoPS, like the UK, Sweden or Poland, which also happened to be the most politically and economically powerful ones, among the group.[733] This stemmed from a broader concern that with the SSM, SRM and SRF targeted at the EMU States, the interests of the NoPS may get overlooked, thus threatening the authority of pan-EU bodies like the EBA and SBRB.[734] Such concerns were fully reasonable, as greater degree of supervisory convergence within the SSM called for different arrangements than those applying at EU level.[735] Former EBA Chairman Enria consequently warned that "repair of the Single Market will proceed with different speeds and will be driven by different priorities within and outside the SSM jurisdiction", that there is a "possibility that a rift opens up in the Single Market" between SSM and non-SSM Member States, and that an "attentive focus" to the Single Rulebook and common supervisory and resolution practices will be required to "contain the risk of a split two-tier system."[736] Such concerns are in line with the path-dependency hypothesis, discussed in Chapter 1.

Schammo sees such concerns as causal factors for the EBU-driven changes to the EBA Regulation, many of which were were voting-related.[737] A reasonable fear among the NoPS was that the members of the SSM could caucus (deliberately or naturally, due differentiated

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[731] EBA Regulation Art.40(1)
[732] F Demarigny, J Mcmahon, N Robert, *Review of the new European system of financial supervision. Part 1: The work of the European supervisory agencies*, European Parliament, 2013, pp.23–24.
[733] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1664
[734] A Millar, *EU Banking Union – Operational Issues and Design Considerations, Special Interest Paper*, 2012, p.12
[735] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.23
[736] Quoted by N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1664 citing *Financial Times*, 18/11/2013
[737] PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, (Kluwer 2016), p.3

arrangements and interests) and, in the case of conflict of interest between the Eurozone and the NoPS, the EBA would effectively end up doing the ECB's and participating States' bidding. Moloney described it as "the most significant pressure point."[738] According to her, a coalition of participating States' NCAs and the positioning of the ECB as the ultimate supervisor could, in conjunction, pose a threat to the EBA's effectiveness and even to the internal market interest.[739]

The EU sought to address such concerns by amending or adding a number of provisions in order to protect the interests of the NoPS.[740] The most significant (and telling one) was the modification of voting mechanics, which now includes procedures designed to protect NoPS NCAs from being marginalised, using the double majority voting system; which effectively means separate simple majorities within the participating States and the NoPS being needed for reaching the required qualified majority for all Board of Supervisors actions constituting or relating to rule-making.[741] Preamble of the EBA Amending Regulation states that the amendments to the decision-making arrangements in the Board of Supervisors were necessary in order to "ensure that the interests of all Member States are adequately taken into account and to allow for the proper functioning of EBA."[742]

It is also important to note that the ECB representative sits on the EBA's Board of Supervisors on non-voting basis and the SRB representative is a mere observer.[743] Therefore, while the participating States could still caucus on the political level, the ECB and the SRB are neither expected to speak on their behalf on the Board of supervisors, nor do they have a vote.

The double majority procedure also applies to the EBA's panels for particularly important decisions, where the interests of States are likely to conflict, such as breach of EU law or mediation processes with binding outcomes.[744] The Board of Supervisors must 'strive for consensus' when deciding on the composition of the panel under Art.44(1), which intervenes in the settlement of a disagreement. If such consensus cannot be reached, the Board of Supervisors have to take decisions by a majority of three quarters. The ECB cannot be included in the panels as they can only be composed of voting members of the Board of

[738] Moloney, 2014, p.1664
[739] Ibid.
[740] Schammo, 2016, p.14
[741] Art.44(1) EBA Regulation
[742] Ibid. Rec.14
[743] Art.40(1)(d) EBA Regulation, for the composition of the Board see: https://eba.europa.eu/about-us/organisation/board-of-supervisors/members
[744] Arts.41, 44 EBA Regulation

Supervisors.[745] While such procedures might appear cumbersome, Ferran and Babis reasoned that the complications are acceptable in the light of a bigger goal: preventing the States from caucusing.[746]

4. Why the EBA is unlikely to bridge the EBU gaps

a) National interests

Unfortunately, with all these changes and advantages, a few major issues still prevent the EBA from building a sturdy bridge between the NoPS and the EBU. As Baglioni observed, the EBA "is more a consultative body than an authority: its technical standards need to be incorporated into regulations issued by the EU Commission (which are directly applicable in member countries), and its guidelines are not legally binding."[747]

Moreover, the EBA is constantly wrestling with questions of representativeness and national interest. It is simultaneously being accused of being unable to act in unified and decisive fashion, due to manifestations of national interests, and being incapable of representing such interests.

As the main decision-makers in the EBA are the NCAs, it is an inter-institutional - not an inter-governmental - structure. Moreover, it is meant to be acting in the interest of the EU as a whole. The consensus principle is equally problematic, as although the requirement to strive for it is meant to be without prejudice "to the effectiveness of the Authority's decision-making procedures,"[748] for a "body […] whose decisions ought to be argument-or evidence-based, the merit of the consensus principle is nevertheless questionable – not least because it will make it more complicated to impose decisions in the face of differences between competent authorities."[749] The EBA thus seems like a sub-optimal forum for defending and promoting national, regional, or political interests.

That is not to say that the national interests are absent from the EBA. Quite the contrary, as Schammo's research reveals, the NCAs often neglect their obligations to act in the public interest while making EBA decisions, succumbing to the pressure of varied

[745] Rec.15 of 2013 EBA Amending Regulation, see also Art.41(1a) and (2), EBA Regulation.
[746] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.25
[747] Baglioni, *supra*, p.23
[748] Art.44(4a), EBA Regulation
[749] PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, (Kluwer 2016), p.19

organisational objectives and country-specific interests.[750] He points to the IMF's conclusion that "national interests may still influence decisions" in the EBA.[751] The European Parliament has also noted that "it has been difficult for national representatives to separate their role of head of [an NCA] and European decision-maker, challenging their ability […] to act independently and objectively in the sole interest of the Union as a whole."[752] Moloney points out that this can hinder the EBA's ability to develop distinct EU positions, particularly in more sensitive areas.[753] This problem is further aggravated by the fact that the EBU amendments to the EBA legislation lessened the influence of the only full-time independent EBA representative - EBA's Chairperson. [754]

The EBA thus finds itself in an unenviable position where it is the only forum where all Member States can defend their positions on equal footing, yet they are doing that through their NCAs, which, in turn, are not meant to be doing that in this capacity, and instead working towards the betterment of the single market as a whole. If the measures, seemingly designed to retain the pan-European supervisory integrity are misunderstood (or misused), fragmentation can be deepened by the very instruments, which were meant to stop it. On the other hand, the EBA moving into the Eurozone (to Paris) after Brexit, rather then NoPS Warsaw or Prague was in itself a symbolic shift, which in turn might distance the NoPSs from what was previously their main forum.

b) Voting arrangements and further disintegration

Paradoxically, even the changes to the voting arrangements introduced to safeguard the NoPS interests have been criticised as short sighted,[755] deepening the divide between the NoPS and the Eurozone[756] and not contributing to EU-interest-orientated decision-making.[757] As if to make things more complicated, these decision-making reforms were largely designed by the UK and finally agreed, despite the Commission raising concerns about potential

[750] Ibid. p.21 see also See PJE Schammo, *EU Prospectus Law – New Perspectives on Regulatory Competition in Securities Markets*, 2011, p.23-24
[751] see IMF, *European Union: Publication of Financial Sector Assessment Program Documentation* – Country Report 13/74 7
[752] see European Parliament, resolution with recommendations to the Commission on the European System of Financial Supervision A7-0133/2014
[753] N Moloney, *EU Securities and Financial Markets Regulation*, Oxford University Press, 2014, pp.916, 939–940
[754] PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, Kluwer 2016, p.19
[755] Ibid. p.3
[756] A Enria *The Single Market after the Banking Union*, EBA, 2013, p.3
[757] F Demarigny, J Mcmahon, N Robert, *Review of the new European system of financial supervision. Part 1: The work of the European supervisory agencies*, European Parliament, 2013, p.33

fragmentation risks and German opposition.[758] This is illustrated by, for example, by European Parliament noting that "the changes in the original voting system of EBA [...] were a concession to some Member States and made the decision making procedures in the Board of Supervisors more onerous and cumbersome."[759] It is worth remembering that the UK and other NoPS were also opposed to the EBA maximising its potential by fiscal means. The main conflict line was between two NoPS – the UK and the Czech Republic – (notably supported by Spain), rigidly opposed to any transfer of powers with fiscal consequences, against Eurozone France, Italy, Portugal, and the Netherlands.[760] Thus, somewhat paradoxically, the NoPS, by attempting to safeguard their interests within the EBA, arguably incidentally undermined its overall influence.

Moreover, the new voting mechanics for the EBA created an additional minor disincentive for the NoPS to participate in the SSM and SRM. As a NoPS, Croatia controlled 1/8 of the 'separate' NoPS majority. As a CCA State it holds 1/20 of the participating States' majority.[761] Bulgaria effectively traded 1/7 of a separate majority for 1/21. While this loss of influence was acceptable to these two States, which will shortly gain a say at the ECB's Governing Council as EMU States, purely from the perspective of the influence in the EBA, participation in the SSM/SRM is an objectively bad deal for States in *de jure* or *de facto* EMU derogation.

This has the potential to deepen the division between the two groups in the EBA. The existing voting patterns and mechanics could already be considered a manifestation of path-dependency, but the future events are likely to deepen the schisms. Since Bulgaria and Croatia signed the CCA in summer 2020, the entire 'NoPS majority', is commanded by the most Eurosceptic and anti-EBU States, such as the most determined NoPS Sweden and Czechia, Eurosceptic Poland and Hungary, and the only remaining State in permanent EMU derogation – Denmark. Not only do they have disproportionate influence in the EBA, but also, on some issues, their positions might be diametrically opposed to the SSM/SRM States. Moreover, if Romania signs the CCA, the three Visegrad States, long-time political allies, will have an effective veto on EBA decisions.

It does seem like the EU legislature itself has also given up on trying to bridge the gap between the two groups of States through the EBA. As Schammo observed,

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[758] at the final Dec. 2012 emergency ECOFIN meeting, according to A Barker, P Spiegel, and G Parker, *UK close to winning bank safeguard*, *Financial Times*, 13 Dec.2012

[759] European Parliament resolution on the ESFS Review A7-0133/2014, para.BF cited by Schammo, 2016

[760] AB Spendzharova, *Is more 'Brussels' the solution? New European Union Member States' preferences about the European financial architecture*, Journal of Common Market Studies, 2012, p.315

[761] Art.44(1), EBA Regulation 1022/2013

"*whilst in the past the EU legislature was concerned about putting in place modalities for ensuring that the ESAs could make decisions in the face of divisions between their members (e.g. simple majority voting, no consensus requirement), the more recent changes suggest that the EU legislature now considers that divisions in EBA are an inevitable outcome of closer integration among SSM members...*"[762]

c) Lack of firepower

One of the reasons for the lowered expectations for the EBA as a bridge between the NoPS and the participating States is that its powers are inherently limited. As discussed in Chapter 2, the *Meroni* doctrine limited the extent to which the ESAs could be empowered to take supervisory decisions in the first place. As Baglioni neatly summarises the EBA's role in the European Banking supervision system, which he described as a "two-tier system": [763]

"[T]he convergence of supervisory practices, [...] is mandated to the EBA [whose] technical standards need to be incorporated into regulations issued by the [Commission], and its guidelines are not legally binding. The application of the EBA regulations and guidelines is delegated to the [NCAs]. In the euro area countries, to the contrary, the delegation of supervision to [...] the ECB should allow a higher level of convergence in supervisory practices."[764]

Such arrangement indicates, that the ECB occupies a niche in the Eurozone, which is left empty in the NoPS. While, as discussed above, the EBA has convergence and co-ordination powers – including supervisory guidance, stress-testing, peer review, and participation in colleges of supervisors – it has only very limited direct, binding powers of intervention over NCAs and banks.[765] These powers mostly apply in unusual circumstances, like breach of EU law, binding mediation between NCAs, and emergency conditions, and essentially only allow the EBA to direct NCAs and banks with a specific purpose of ensuring compliance with EU law.[766]

Even in such instances the EBA arguably lacks power. The mediation powers, applying to the SSM and the SRM are a good example. Under Art.95 SRMR NRAs become subject to

[762] PJE Schammo, *Differentiated Integration and the Single Supervisory Mechanism: Which Way Forward for the European Banking Authority?*, in P Birkinshaw and A Biondi (eds), Britain Alone! The Implications and Consequences of United Kingdom Exit from the EU, (Kluwer 2016), p.20
[763] Baglioni, *supra*, p.23
[764] Ibid.
[765] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1621
[766] Ibid.

EBA's binding mediation powers. However, this does not apply where NRAs exercise discretion or make policy decisions. But with this limitation, Moloney argued, the binding mediation power risks becoming a 'dead letter' if it cannot be deployed where divergent and obstructive differences of opinion emerge between NCAs (and, crucially, between NCAs and the ECB).[767] She further contends that the "persistence of discretion as a touchstone for legitimate EBA action poses a challenge to EBA's effectiveness."[768]

There is also a notable problem of institutional asymmetry. Although the ECB is a non-voting member of the Board of Supervisors, the EBA is not a permanent observer at the ECB Supervisory Board.

While the EBA is expected to do its best to protect the integrity of the single market, it is evident that it was not envisaged as a body responsible for mending the gaps in supervisory effectiveness, opening due to non-participation of the NoPS, or in fact any gaps left (or created) by the EBU.

F. Concluding remarks

This Chapter discussed the main forms of cooperation between the EMU and non-EMU Member States in European banking supervision. The most straightforward and effective way to achieve supervisory and resolution harmonisation is the Close Cooperation Agreement. This agreement, in principle, could have several tangible benefits for the newly participating States. Unfortunately, the legal foundations of it could be considered sub-optimal. Many NoPS have very serious concerns about the (from their perspective) disproportionate influence of Governing Council, on which they are not represented, and the SSM decision-making in general. These concerns exist in parallel with a number of issues relating to the SRM, including funding. A variety of issues plague mediation, arbitration, conflict resolution and termination arrangements, which effectively make the CCA unattractive to essentially every NoPS, which is not willing to join the EMU afterwards.

A very significant problem for many NoPS is that the ultimate backstop for not being bound by an ECB decision is termination of the agreement. Therefore, NoPS naturally wonder whether a supervisory cooperation - which takes at least half a year to organise, a few months to terminate, but only a few weeks to deteriorate to an irreparable state - is

[767] N Moloney, *EU Securities and Financial Markets Regulation*, Oxford University Press, 2014, pp.916, 941
[768] Ibid.

worthwhile.[769] Especially given the costly and immediate termination of the SRM membership and the resulting need to recreate the national resolution fund, which is an inevitable consequence of leaving the SSM. While the option of a legal challenge using the court system also exists, the path to it is not straightforward, and its timeframe might not be optimal in the fast-paced banking industry.

As most NoPS, in all likelihood, will not join the SSM/SRM, some alternative arrangements discussed in this Chapter can, if used wisely, make some of the gaps between the two groups of States a little narrower. The level to which they can be stretched is, however, limited.

As a placeholder for the lack of CCAs, the legislation presents the memoranda of understanding. Such instruments, for all their merits, are just that – a placeholder. They are useful clarification tools in day-to-day supervision, but their value in crisis situations is likely to remain limited. They are not a new instrument, but rather a remnant of the failed Lamfalussy era approach.

Another potential solution is enhanced use of supervisory colleges. They have the notable advantage of stretching beyond the SSM area and even the EU, which adds value to the overall arrangement. However, the way supervisory colleges are now coordinated seems to suggest (once again) that European Banking is being harmonised on two overlapping levels, which leaves a questions of how *European* and how *single* the European Single Supervisory system really is. Colleges of supervisors existed before the GFC and the EBU and were helpful structures in day-to-day cross-border group supervision. However, they did not have any mitigating effect on the crisis deterioration processes or their aftermath. Useful as the colleges are for providing conditions for supervisors to cooperate, they do not in any way ensure that they will. Moreover, lack of legal personality or status, makes them mere extensions of the NCAs mandates within the home-host system.

The EBA is the only institutional structure with some powers which can compel the NCAs to act in a particular way, albeit within limited circumstances. It would appear that with the list of powers and geographical breadth of the mandate that the EBA has, it can serve a unifying role, but its effectiveness is being eroded by national interests, recent relocation due to Brexit, and the EBU itself. A serious concern is also that the distinction between the NoPS and the Eurozone states in the EBA Board of Supervisors and panels is deepening the divide between the two groups of States, as well as contributing to decision-

[769] See Art.7 SSMR

making complexity.

Within the existing legal infrastructure, the only instrument that can actually expand the SSM/SRMs remit is the CCA, and it is therefore worth examining why it remains so unpopular with the majority of the NoPS.

Chapter 4

Non-Participating States of the EU and their Regional Significance

Introduction

One of the main challenges the EBU is facing is its geographical scope limits. Such limits have further-reaching consequences for the differentiation mechanics, which arguably strengthen path-dependency. The EBU legislation provides a legal solution to these problems via the close cooperation agreements (CCAs).[770] However, only a minority of NoPS have signed them. Non-participation of the remaining NoPS creates a number of threats and complications, due their interconnectedness with the Eurozone, as well as non-EU States and credit institutions.

In addition to the legal characteristics of the CCA itself, there are two additional broad groups of factors affecting the (non)participation decision: 1) the political, historical and economic circumstances of each NoPS, and 2) the structural characteristics of their banking sectors. This chapter focuses on the former, whereas Chapter 5 will examine the later. These chapters discuss every non-Eurozone Member State, seeking to find a set of common reasons for (lack of) participation. I specifically aim to develop and (to an extent) prove a hypothesis explaining why some countries are keen on signing the CCA, while others are strongly against it, despite sharing similar concerns relating to the Governing Council, financial arrangements, and EBU legislation.

This chapter is structured as follows. Section A summarises the main shared concerns among the NoPS. Sections B, C and D discuss all NoPS, divided into three broad groups by geographical proximity and banking market integration. Section E analyses the Nordic-Baltic Region in greater depth. It is an area of Europe comprising Eurozone, EU and EEA States, which together form a fully integrated banking market. The findings on this region can inform a broader debate on the EBU, as it has become a microcosm of the most important processes in European banking (dis)integration. The final section concludes.

A. Shared concerns of the non-participating States

As I have discussed in Chapter 1, the pre-EBU system of banking supervision and

[770] Art.7 SSMR

resolution had fundamental flaws. Furthermore, every EU State suffered from the crises, which would therefore make it seem natural to take part in a reform that solves at least some of the GFC problems. That, as Mérő and Piroska observed, raises a number of "intriguing political and economic questions" the most important of which is "why do some […] member states dissent from an arrangement that promises safer and more stable banking to all?"[771] As will become evident in sections B, C and D, even the most reluctant NoPS are not (in principle) opposed to the EBU, but rather concerned about certain legal arrangements, political costs, and economic implications. While the NoPS are not a homogenous group, with the differences between such states often outweighing similarities, there is still a worrying lengthy list of shared concerns relating to the institutional components of the EBU. Namely:

- Single-Currency-centric rhetoric and agenda
- Congruence between the EMU and the EBU
- Exclusion of non-EMU States from the Governing Council of the ECB
- The ability of the Governing council to overrule the Supervisory Board
- The ability of the Governing Council to influence the status of the State representatives on the Supervisory Board
- Lack of scope for negotiations in signing the Close Cooperation Agreement (CCA)
- Inflexibility in accommodating national baking sector characteristics
- The ECB's ability to terminate the CCA
- The impact of CCA termination on the contributions to the SRF
- The influence of the ECB on the Single Rulebook
- The ECB's ability to trigger the resolution procedures
- Lack of exclusive competences for the NCAs and NRAs
- Liability sharing in the SRM
- Having to contribute to bailing out other States' banks
- Distribution, allocation, and deployment of the SRF
- Costs associated with (generally more expensive) supervision and resolution planning
- Not being persuaded that the ECB can deliver better outcomes than the NCAs

[771] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.1

- Consolidation of power at the European level
- Ongoing administrative centralisation within the institutional pillars of the EBU
- Loss of sovereign autonomy
- Ideological prevalence of neofunctionalism over intergovernmentalism in the EBU
- The stance of the European Courts, seemingly leaning towards the ECB
- Political influence of the largest Eurozone States

This long list of concerns is almost certainly non-exhaustive. It is also only a part of the equation, which includes further country-specific concerns. Nevertheless, it allows for drawing a (somewhat simplistic) narrative, forming the baseline for the NoPS participation considerations.

Having the luxury to engage in a prolonged consideration and give due weight to each concern is in itself a fundamental difference, compared to their Eurozone neighbours. Unlike the Eurozone States, the NoPS were not put on a strict path of monetary integration. That allowed for more flexibility during and after the GFC. As Howarth and Quaglia observed, the NoPS do not face the fourth element of the so-called 'inconsistent quartet'[772] - the EMU. Consequently, they could "cope better with the instability created by cross-border banking - and thus the financial trilemma - because they retain[…] their lender of last resort powers […] through both monetary and fiscal policy."[773] This hypothesis is strengthened by the tendency of the countries considering the EMU membership to gravitate towards the EBU. As explained in Chapter 5, such tendency requires further nuanced analysis, since the EMU-leaning States share the same concerns as their more Euro-sceptic counterparts and – furthermore - move towards the SSM and SRM at different speeds. Some countries willing to join the Eurozone take the full package at once, when EBU membership becomes compulsory due to joining the EMU (Lithuania); others do it incrementally (Croatia, Bulgaria) or even remain hesitant about the EBU despite the long term goal to adopt the Euro (Romania).

In principle, the NoPS' concerns reflect the concerns of the Eurozone States during

[772] 1) financial stability, 2) financial integration, 3) national financial policies and 4) the single currency. Discussed in more detail in Chapter 1(C)
[773] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.6

(and after) the EBU negotiations. However, the NoPS are more vocal; their concerns are more pronounced, more illustrative, and more indicative. As Howarth and Quaglia expressed it, "(Non)membership of euro outsiders is a clearer indicator of preferences than very reluctant membership by euro area member states."[774] The group of the initial 2014 NoPS split along the same lines as their Eurozone counterparts during the EBU negotiations. Describing these negotiations Merino wrote: "*[…] two camps represented well identified interests: on the one hand, those which advocated for Member States […] sharing collectively bank risks, for the sake of […] stability of the euro and the avoidance of excessive austerity; [versus] those which could not accept that their taxpayers assume the risks of the banking sector of third countries nor accept solutions that would incentivise moral hazard in the financial sector*."[775]

The same split gradually occurred among the NoPS. What factors push some NoPS to participate, while most others decline? Why do schisms appear even between tightly politically and economically linked neighbours, otherwise forming fully integrated banking markets? In order to answer these questions, it is important to consider every NoPS as an individual state, shattering the notion of the NoPS as a homogenous body, putting the individual narratives together and trying to weave a coherent thread of tendencies. I will therefore discuss all NoPS in the context of their regional settings.

B. Romania and the new EBU states of the South-East

Before delving into the discussion of the States that have chosen to opt out of the EBU, it is important to address the only States that opted in. Romania was the first State to express an interest in participation. However, it has not started participating yet. Instead, Bulgaria and Croatia became the first CCA countries in 2020. This section briefly overviews the main reasons why these States were more lenient towards the EBU than other NoPS. Subsection 1 discusses the relationship between Eurozone membership and participation of the South-Easter States. Subsection 2 assesses the impact of banking sector instability. Subsection 3 summarises the reasons for Romania's (possibly temporary) non-participation. Subsection 4 summarises the region's positions. Deeper analysis of structural characteristics will be provided in the next Chapter.

[774] Ibid. p.3
[775] A Merino, *European Banking Union, FIDE Congress Proceedings*, 2016, p.106

1. Eurozone waiting chamber

Howarth and Quaglia observed that in the Southeast, SSM participation was presented as the first step to full EMU membership, although near-term participation remained unlikely for some of the States.[776] For Croatia, and – to a lesser extent – Bulgaria, EMU membership is a near term prospect, for Romania that is not the case. The June 2020 EU convergence report indicated that Bulgaria and Romania did not meet the inflation target, while Croatia managed to achieve that.[777] Bulgaria and Croatia, unlike Romania, posted budget surplus in 2019. Near-term EMU participation not being on offer might have in turn cooled down Romania's initial enthusiasm for the EBU.

Bulgaria and Croatia's participation strengthens Howarth and Quaglia's hypothesis that Eurozone membership (or planned membership) correlates with support for the EBU.[778] It would also be in line with path-dependency hypothesis, suggesting the congruence between the EMU and the EBU.[779] This correlation (or causal relationship) splits into two distinct, yet related, paradigms. Some States might be willing to enter into a CCA for its own merits and overlook the shortcomings, like decision making and liquidity provision, since for them they are temporary. Other States might consider the SSM and SRM sub-optimal regardless of their status, but choose to turn the blind eye to their shortcomings, since the benefits of the EMU outweigh the negatives of the EBU. The later was arguably the case with Latvia and Lithuania, which joined the EMU and EBU simultaneously, whereas Bulgaria and - to a lesser extent – Croatia partly joined the EBU for its own merits.

The recent impetus towards further integration during the EU's post-Brexit period is also at play here. In the post-Brexit State of the Union speech the president of the European Commission Jean Claude Juncker urged further integration including financial and structural assistance for Member States seeking to join the euro.[780] It is therefore possible that EBU membership could serve as an exhibition of solidarity, in turn winning these States some favours from the EU, which could be needed for future EMU membership, should meeting the Maastricht criteria prove problematic.

The waiting chamber hypothesis seems to best fit Croatia, which has applied to join the EBU in 2020 and the EMU in 2024. However, Croatia is still entering the EBU much earlier

[776] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.7
[777] ECB, *Convergence Report*, June 2020
[778] Howarth and Quaglia, 2015, p.7
[779] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.487
[780] JC Juncker, *State of the Union Speech*, European Commission, 2017

than it would otherwise have to as an EMU candidate. This is peculiar, since it previously intended to join 'when the EBU is completed.'[781] In 2016 the Croatian National Bank Governor Boris Vujcic stated: [782]

"*the best option for Croatia is to wait until all three pillars are completed: joint monitoring […] (SSM), a joint bank bailout fund, and a joint deposit guarantee (a deposit insurance scheme). When that is completed, only then would it be in Croatia's national interest to enter the Banking Union.*"

Why has Croatia changed its mind? As discussed in Chapters 1-2 of this thesis, the deposit guarantee scheme project is currently limited to national harmonisation, and the fiscal backstop for the SRF is not completed. The EBU does not seem to be completed, in the way Croatia expected it to be, before joining. Moreover, as Huertas, Schelling, and Goretzky emphasised, Croatia needed to undergo a number of significant and costly adjustments in its banking governance.[783] It would seem counterintuitive to undergo such adjustment sooner than necessary. It might thus mean that the progress made so far, combined with EMU membership intentions, can encourage a State to overlook certain shortcomings. It is notable that the SRF mutualisation is approaching completion, which is favourable to a small, predominantly host, banking markets like Croatia or Bulgaria.

2. *Banking sector instability as a catalyst*

Banking sector instability and shaky supervision could also be a catalyst. Hüttle and Schoenmaker argued that, Bulgaria decided to join following a failure in supervision, which resulted in the collapse of its fourth biggest lender.[784] This collapse was plagued by allegations of fraudulent bankruptcy and seriously damaged Bulgaria's international banking reputation. Howarth and Quaglia also argued that in Bulgaria CCA was a part of the effort to stave off a major banking crisis spiralling from this collapse.[785] The decision to participate could thus mean that the Bulgarian government sought to spread the supervisory blame resulting from future failures, which Ferran argued to be an incentive for participation.[786] It is well known that such considerations were present when Lithuania joined the EMU in 2015.

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[781] EBL News, *Cenbank governor: Croatia should join Banking Union when completed*, 18 May 2016
[782] Ibid.
[783] M Huertas, H Schelling, K Goretzky, *Croatia's accession to the European Banking Union – the outlook ahead*, Dentons, 2019, p.1
[784] P Hüttle, D Schoenmaker, *Should the 'outs' join the European Banking Union?*, Bruegel 2016, p.2
[785] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.18
[786] See also E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.11

The otherwise serious concerns with EBU's financing and decision-making were largely already brushed aside by the bigger goal of joining the Eurozone, but the shadow of scandalous failures of Snoras and Ukio Bankas also made the decision easier. Notably, since solid fiscal policy allowed Lithuania to join the EMU and the EBU on the same date, the Governing Council issue did not arise. That is something the South-eastern States have not been able to achieve.

Banking sector internationalisation also played a role. According to Howarth and Quaglia, with their banking systems dominated by foreign (largely Eurozone) banks the South-Eastern States had an incentive to join EBU because they were are not in a position to fully safeguard financial stability domestically.[787] These subsidiaries are of systemic importance for the host country […] but not for the for the home countries (Austria, France, Italy)."[788] Georgescu highlighted that as one of the reasons why Romania should join the EBU.[789]

3. Romania – the one remaining NoPS in the region

That leaves us with a glaring question: why is it that Romania, being the first country to express interest in participation, has not followed Bulgaria and Croatia in doing so? Not only does it share many characteristics with Bulgaria and Croatia, doubts have also been raised about the ability of domestic Romanian mechanisms, resources and instruments to cope on their own with the contagion effects of crises.[790] There is one major difference. Romania has been delaying its accession to the EMU every few years, most recently expressing the intention to do so in 2027-2028.[791] That allows Romania to weight near term participation in the EBU very carefully. The Member State remains concerned with burden sharing in the SRM and the SSM decision-making procedures. As Georgescu observed, the 'policy makers v. policy takers' problem of the Governing Council is a major issue.[792] She further noted that the EBU's one size fits all approach does not necessarily account for the specific

[787] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.7, 18
[788] Ibid.
[789] OM Georgescu, *Romania in the Banking Union: Why the international supervision of cross-border banking is necessary*, CRPE, 2015, p.7
[790] M Isarescu, *Relations between euro and non-euro countries within the Banking Union*, Speech before UniCredit 15th International Advisory Board, 10/07/2014, p.5
[791] N Banila, *Romania aims to adopt euro in 2027-2028, enter Schengen this year – PM*, SeeNews, 19/02/2021
[792] Georgescu, 2015, p.6

circumstances of the Romanian banking system, providing the example of FX lending, which is a major source of vulnerability for Romanian banks.[793]

4. Incomplete answer

Generally, the South-Eastern States' concerns broadly mirrored those of the rest of the NoPS or less keen Eurozone states. For each of them the calculus was different, however. Bulgaria took the opportunity to spread the blame for future supervisory failures, and potentially decrease the likelihood of such failures by making supervision more impartial. Croatia seemingly decided to take a leap towards the EMU. For Romania, which struggled to make such leap, the scales are not fully tilted towards participation yet. Looking at the bigger picture, it is therefore questionable whether Bulgaria and Croatia would participate without the incentive and prospect of the EMU membership.

Such general considerations fail to fully explain the differences in the decisions of these States. The legal and political concerns were the same, yet the decisions differed. A more complete answer can be provided by examining the banking sector structural characteristics, which I will discuss in Chapter 5. Such characteristics explain why Bulgaria and Croatia decided not to wait for full EMU membership before joining the EBU, like Lithuania did, and partly why Romania remains unconvinced.

C. The Visegrad States

The second region in this discussion, including three NoPS, is known as the Visegrad 4. These four States share close ties and much of their history, which has led to a political, economic and military alliance originating from the meeting of the leaders of Czechoslovakia, Hungary, and Poland held in the town of Visegrád in 1991. Since joining the EU in 2004 the countries have generally demonstrated solidarity on a large number of issues, but the EMU and EBU were among the exceptions. Slovakia adopted the Single Currency back in 2009, before the EBU legislative proposals. The remaining three NoPS, have opted out. This section highlights the most important concerns the Visegrad NoPS have expressed. Subsection 1 discusses dissatisfaction with always changing (yet never complete) character of the EBU. Subsection 2 addresses why the Visegrad NoPS see the position of the CCA States in the EBU as lesser, compared to the Eurozone States. Subsection 3 discusses why EMU

[793] Ibid.

membership is currently not a factor that could pull the Visegrad NoPS in. Subsection 4 summarises the positions.

1. Seemingly permanent incompleteness

The Visegrad NoPS are particularly concerned about the incremental character of the EBU's development. The Czech Republic criticised the EBU for being delivered in an incremental fashion and warned that should the process get stuck at any point, the EU could end up with a "half-baked" solution, "worse than the status quo."[794] Poland was adamant that supervision and resolution could only be moved to the EU level if responsibilities are moved there too.[795] The Czech National Bank (CNB), similarly wanted to see the transfer of powers, financial responsibilities, and burden-sharing undertaken simultaneously.[796] In addition to also sharing concerns in relation to the EBU's incompleteness and insufficiency, Hungary was particularly unhappy with gradual accumulation of funds for the SRF. The local experts estimated that the actual pay-out Hungary could receive is not significantly greater than the domestic NRF.[797] Furthermore, they saw the decision-making of the SSM as cumbersome, and crisis management decision making procedures as "complicated and time-consuming."[798] Poland has expressed dissatisfaction with the geographical limits of the SRM. It advocated full harmonisation of the national solutions on resolution issue, including the specific conditions of the each financial market, on the EU-wide level.[799] The Visegrad NoPS are also concerned with the absence of the EDIS, and insufficient weight being given to national authorities in resolution decisions.

Generally, the Visegrad NoPS fear that the seemingly permanent character of the EBU as a constantly changing creature, can result in either ineffectiveness through incompletion, or dynamic gradual consolidation of power, which would be hard for participating non-Eurozone (CCA) States to resist.

2. 'Subservient' position

Karoly Szasz, head of Hungary's financial regulator, echoed the concerns about unequal participation terms shared by many other NoPS and described the CCA States' role

[794] Central Banking Newsdesk, citing Czech National Bank, CentralBanking.com, 16 Dec 2014
[795] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.5
[796] Ibid.
[797] K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.9
[798] Ibid.p.7
[799] Profant and Toporowski, 2014, p.5

in the SSM as "subservient."[800] Similarly, CNB's Hampl is quoted saying that "participation in the banking union for the EU member states outside the Eurozone could mean transferring supervisory powers in return for a not entirely equal position within the ECB", and no access to a fiscal backstop.[801] The Polish Parliament also emphasised that participation in the EBU cannot be asymmetric, giving advantage to the Eurozone States in terms of decision-making within the SSM.[802] During the EBU negotiations Poland strenuously argued for maintaining a balance between the SSM and non-SSM banking systems, and stated that the SSMR gives the ECB/SSM "excessive powers over the non-SSM authorities."[803] Poland's push for more equal representation was among the reasons for the changes made moving from the Proposals to the final SSMR text, giving the non-Eurozone participating States more of a say in the Supervisory Board and access to some liquidity support.[804] This, however, did not prove enough to satisfy Poland. That is because Poland's concerns with the EBU stretch beyond the SSM arrangements themselves. The head of the main Polish NCA has pointed out that the SSM should be analysed jointly with the CRD IV and CRR packages, which (allegedly) negatively affect the powers of national supervisory authorities.[805] It is broadly recognised that the SRM gives home countries even less control over recapitalisation decisions, which aggravates Poland's concerns.[806]

The SSM/SRM and CRR/CRD concerns come in as part of the bigger picture, where recovery and resolution is still effectively funded by the States, but decisions on triggering these procedures are taken at the EU level, partly by the ECB. Also, the need to contribute to the SRF would mean redirecting resources from domestic financial markets, thus potentially slowing down their development, especially in weaker economies, thus privileging the more established pre-2004 EU capitals, Visegrad is keen to compete with. Moreover, "[i]n extreme cases, when […] a major European bank is in distress [SRF] contributions [would] have to go towards the bailing out of another country's bank."[807]

These concerns are generally shared by all three Visegrad NoPS. In an interview conducted for this research, Mojmir Hampl, vice-governor of the CNB, summarised the

[800] Z Simon, *Hungary to Probably Opt-Out of EU Banking Union, Szasz Says*, Bloomberg, 29/09/2012
[801] T Bowker, *Czech central bank opposed to joining banking union*, Central Banking, 29/04/2013
[802] Stanowiska Rządu, (Polish Parliamentary Session) 12/09/2012, cited in T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.5
[803] Profant and Toporowski, 2014, p.5
[804] Ibid.
[805] Ibid.
[806] D Howarth, L Quaglia, *Steep road to European Banking Union: Constructing the Single Resolution Mechanism*, JCMS Journal of Common Market Studies 52(S1), 2014, p.136
[807] K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.9

situation as follows:

"*Once in the euro zone, the country has got a i) single monetary policy, ii) single lender of last resort, iii) single supervision of credit institutions and a iv) single resolution mechanism. But for a country outside the EMU, entering the SSM is like sitting at the table with just two legs – the country will still be responsible for monetary policy and for its lender of last resort, while having almost no say in supervising their key banks and very little say in resolution. Clearly not an equilibrium.*"[808]

3. Eurozone entry as the game-changer

The Czech position epitomises broader Visegrad NoPS' consensus that the EBU is worth the sacrifices, only if the State in question is a Eurozone State or is planning to become one.[809] As Hampl further explained:

"*The key issue was keeping the balance between powers and responsibilities of public authorities of a non-EMU country within the SSM. And our strong opinion was and still is, that this balance could not be reasonably maintained once we join the SSM without simultaneously joining the euro zone itself.*"[810]

The examples of Lithuania or Croatia indicate that if the State is determined to adopt the Single Currency, the EBU is not an obstacle *sensu stricto*. However, unlike their Baltic and South-Eastern counterparts, the Visegrad NoPS would not necessarily agree to accept the EBU with all of its imperfections just to join the EMU. They would seemingly remain concerned about power consolidation and the (perceived) neofunctionalist agenda of the ECB, discussed in Chapters 1 and 2, even if the seat at the Governing Council was on offer. Poland has been the most vocal on this issue. Due to increasing de-internationalisation of its banking sector, Poland naturally wishes to increase the powers of its home NCA, whereas the SSM, in Poland's view, is essentially doing the opposite - shifting the power balance to host authorities and the ECB.[811]

Czechia is also unhappy about the arrangements in the ESM. That is mostly linked to the cost, which for this fairly small country could spiral out of control. Such costs would

[808] Research interview, 5/5/2018
[809] Ministry of Finance, Ministry of Foreign Affairs, Office of the Government of the Czech Republic, Czech National Bank, *Impact study of participation or non-participation of the Czech Republic in the Banking Union*, 2015, p.3, see also for Hungarian position Kisgergely and Szombati, 2014
[810] M Hampl, Research interview conducted for this thesis, 5/5/2018
[811] Stanowisko Rządu, (Parliamentary Session) 25/09/2012, cited in T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014

come in addition to the contributions to the SRF and paying for the ECB's supervision.[812] Notably, the Czech objections delayed the ratification of the amendment of Art.136 TFEU authorising the establishment of the ESM by four months in 2013.[813] The CNB and the ministry of finance also mentioned the costs as a disincentive for joining the ERM II.[814] Poland and Hungary share these concerns, but they are not as pronounced. Poland, due to its size, is a much bigger economy with a notably proportionately smaller banking sector. Hungary is home to the international OTP banking group and needs to weight the costs against potential risks such banking group could pose to the domestic economy.[815]

4. Current positions

Despite almost identical concerns, different situations and banking sector structural characteristics have resulted in slightly different approaches to EBU participation. The Czech Republic is unlikely to participate. Its government decided in 2015 not to join the SSM and then reaffirmed its decision again on 2016. Poland has not ruled participation out entirely, but being disappointed with non-implementation of its demands, and having adjusted its banking sector and supervision system to operate as a NoPS,[816] it is likely to join Czechia as one of the more determined 'outs'. Hungary, unlike Poland or Czechia, perhaps surprisingly, considers joining the SSM/SRM an option, albeit not a short-term one. This represents a shift from the original position in reaction to the Proposals, which was negative.[817] Commenting on EBU Prime Minister Viktor Orbán said that Hungary was in favour of the overall arrangement, bar specific concerns.[818] A paper published by the Hungarian Central Bank (*Magyar Nemzeti Bank* or 'MNB') highlighted the perks of the Banking Union membership associated with "a wider analyst base and ultimately, the 'ammunition' of the €55 billion available for crisis management."[819] Is it possible that Hungary (or even Poland) could choose a different path from their neighbours, like Slovakia did, and, if so, what could prompt them to do so? The answers to these questions are not readily apparent from legal and

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[812] Ministry of Finance, Ministry of Foreign Affairs, Office of the Government of the Czech Republic, Czech National Bank, *Impact study of participation or non-participation of the Czech Republic in the Banking Union*, 2015, pp.6-9
[813] European Council Decision amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro 01/05/2013
[814] Ibid.
[815] See case study in Chapter 5
[816] See Chapter 5(C)
[817] Z Simon, *Hungary to Probably Opt-Out of EU Banking Union, Szasz Says*, Bloomberg, 29/09/2012
[818] G Lovas, *EU closer to banking union; Hungary on the fence*, Budapest Business Journal, 01/2014
[819] K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.5

political considerations, and thus require analysis of banking sector characteristics, which I will provide in the next Chapter.

D. Nordics and Baltics

The Nordic-Baltic Region (NBR) is connected through cultural, historical, political, military and social ties, to an even greater extent than Visegrad. Its banking sector can reasonably be called a single banking market, which is evident from market share distributions and supervisory cooperation levels. According to Ferran, the NBR is characterised by a high degree of financial market integration and long-standing cross-border collaboration in financial supervision.[820] Spendzharova and Bayram described it as "one the most densely integrated and effective cross-border banking regions in the EU."[821]

Somewhat paradoxically, the NBR is also extremely diverse in terms of European organisational memberships. The three Baltic States and Finland are part of the Eurozone, Sweden and Denmark are non-Eurozone EU members, and Norway and Iceland are only affiliated through EEA arrangements. To make matters more complex, Denmark and Sweden differ in terms of their potential Eurozone membership obligations. Whilst Sweden has a choice in the matter and could (in theory) join the EMU, Denmark is in permanent derogation.

[820] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.14
[821] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.566

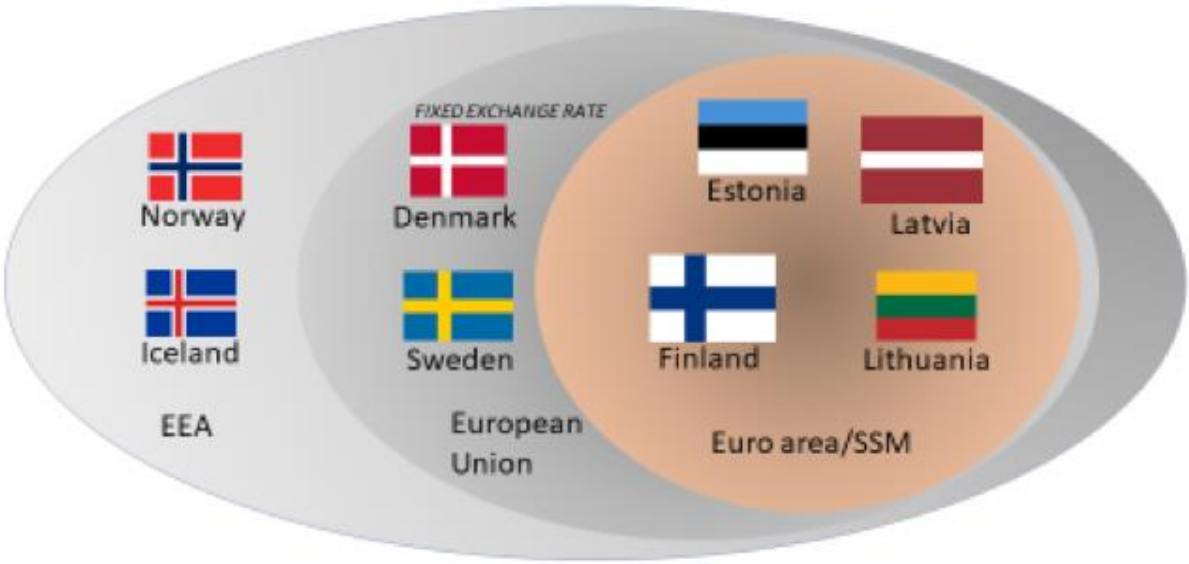

Fig.4.1 *Nordic-Baltic EU integration levels. Source: Farelius et al*[822]

This contrasts sharply with other areas of deep integration, with either more uniform approach to European integration or a smaller number of sovereign states. Due to its unique position the NBR can serve as a fertile testing soil for many problems plaguing the EBU. It is home to the EU's largest banking centre outside of Eurozone – Stockholm, as well as the first country to join the EMU and the EBU after the launch of the SSM – Lithuania. The institutional architectures range from some of the world's oldest (Norway, Sweden) to fairly new (Baltics). The NBR exhibits significant economic discrepancies, as well as radically different positions in relation to the EBU and EMU. In many ways it could be described as a microcosm of Europe.

How did these States, exhibiting a number of differences among them, become a *de facto* single banking market? How do the realities of such market affect the EBU positions? This section seeks to introduce the Nordic-Baltic market and the positions of its NoPS, before using it as an example of the complexity introduced by the existence of fully integrated markets that stretch across the SSM/SRM borders in the next section.

[822] D Farelius, S Ingves, M Jonsson, *Financial integration in the Nordic-Baltic region vis-à-vis the EU: A Swedish perspective*, SUERF Policy Note 189, 2020

1. Ahead of the game: supervisory integration beating the EU curve

In principle, the NBR's market integration is attributable to high banking sector concentration, with the six largest banks (Danske, DNB, Handelsbanken, Nordea, SEB, and Swedbank) holding over 80% of the total bank assets.[823] All of these banks also have significant presence in several NBR States, which effectively created the phenomenon known as the 'extended home market' (EHM).[824] In order to match market integration, the NBR countries developed corresponding supervisory cooperation networks.[825] Importantly, the NBR authorities embarked on some regulatory and legislative reforms aimed at strengthening banking supervision and crisis response, even before the GFC, which, although proven insufficient, serves as a testimony to shared interest in regional stability.[826]

The efforts obviously intensified following the GFC, setting good precedent for the EBU. A prominent example is the Crisis Management Group for Nordea, which ended up serving as the resolution college, required under the BRRD. In 2011, the NBR countries established the Nordic-Baltic Macroprudential Forum (notably, without any binding powers), which shares some features with the ESRB. The three largest non-Eurozone NBR states, Norway, Denmark and Sweden, also have an agreement for utilisation of central bank deposits as collateral for intraday lending, called the Scandinavian Cash Pool, which could serve as a (partial) substitute for the ESM. Most importantly, the NBR memorandum on financial stability, crisis management, and crisis resolution, discussed in Chapter 3,[827] also led to the creation of a permanent regional body, the Nordic–Baltic Cross-Border Stability Group, which deals with financial stability issues including *ex ante* burden-sharing agreements.[828] In some sense the NBR has its own light-touch SRB, SSM, and even an ESM substitutes.

This cooperation and market realities led to cohesion of practices. Given existing political ties and institutional cooperation, it is not surprising that the Baltic States sought to emulate many of the practices of the Scandinavian authorities. The banks themselves

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[823] IMF, *Nordic Regional Report*, IMF Country Report No 13/274, September 2013, p.7, see Chapter 5 of this thesis for further discussion.
[824] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.566
[825] Ibid. p.565
[826] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.11
[827] Memorandum of Understanding on Cooperation regarding Banks with Cross-Border Establishments between the Central Banks of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden, 15 December 2016
[828] European Bank for Reconstruction and Development, *Transition Report 2012: Integration across Borders*, p.55

indirectly brought the supervisory culture of their home States to the hosts States through increasing market integration. For the Nordic banking giants, the newly-capitalist Baltics was a new rising market for expansion, whereas for the Baltic States that meant an opportunity to stabilise their banking markets, following several domestic bank failures in the 1990's. These failures also prompted the Baltic authorities, especially in Lithuania and Latvia, to look for solutions in the practices of other countries. Adopting the practices of the home countries of the majority of their market participants was a reasonable choice, justified by the Nordic regulators' track record. They had a long tradition of being the "forerunners at the end of the 1980s and early 1990s" in terms of regulatory oversight and transparency regimes, in many ways – the standard setters.[829] Even the establishment of the FSA in the United Kingdom was partly inspired by Scandinavian practices.[830] Going back even further, the tradition of successful central banking is illustrated by the fact that Sweden's Riksbank is the oldest central bank in the world, and the Norwegian Kredittilsynet is one of the oldest integrated supervisors. As Wymeersch observed, the Nordic countries were at the forefront of many trends in financial regulation and supervision.[831] That positioned the Nordic states as the standard setters, creating a sense of pride and confidence, strengthened by very successful financial management and good record of financial supervision in the last two decades. Sweden and Denmark are therefore particularly unhappy with the fact that "the ECB might become dominant in setting technical rules," which challenges their dominance, especially when positions on the optimal course of action diverge.[832]

2. Interest in European cross-border supervision and the EOFS proposal

Due to their regional interconnectedness and cooperation, the NBR states became increasingly aware of the dangers of a fully integrated banking markets, safeguarded by semi-integrated supervision, and consequently foresaw some threats arising on the European level. Particularly the NBR NoPS (Denmark and Sweden) have been argued to be too small to deal with the failure of their massive banking sectors, which also presents an incentive to take part in supranational arrangements.[833]

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[829] D Masciandaro, M Quintyn, M Taylor, *Inside and outside of the central banks: Independence and accountability in financial supervision - trends and determinants*, Paolo Baffi Centre Research Paper No.2008-15, 2008, p.17
[830] Ibid.
[831] E Wymeersch, *The Structure of Financial Supervision in Europe: About Single, Twin Peaks and Multiple Financial Supervisors*, 2006, p.46-47
[832] A Hennessy, *Redesigning Financial Supervision in the European Union (2009–2013)*, 2014, p.163
[833] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, Journal of European Public Policy, 21:2, 2020, p.10

It is therefore unsurprising that the EU NBR countries advocated stronger supervisory coordination and deeper prudential cooperation for the entire continent, even before the crisis. In 2006, Riksbank governor, Stefan Ingves, proposed the idea to establish the European Organisation for Financial Supervision (EOFS). [834] This plan, while imperfect, was significantly more suitable for the political, legal, and economic situation than the Lamfalussy version. EOFS would have supervised forty biggest cross-border credit groups in the EU. It emphasised cross border-interdependence, impact of NCA decisions on other interconnected and exposed states, problematic and artificial distinction between branches and subsidiaries, and overlapping jurisdictions in crisis management.[835] The report argued that the EOFS was the only way "to manage conflicting national interests."[836] The striking similarities between the EOFS and De Larosier reforms (and even the SSM) are unlikely to be incidental; it is mostly for the constitutional limits discussed in Chapters 1 and 2 and the EU's reluctance to give so much power to private sector actors that the EOFS was not created, but its merits were recognised.

3. Nordic preference for national regulatory autonomy

The feeling of suspicion was mutual, as the Nordic countries, in their own right, were suspicious about giving far-reaching supervisory powers to EU institutions, which is one of the reasons why Denmark and Sweden opted out of the SSM. Generally speaking, the biggest difference between the NBR structures and the EBU is the level of importance assigned to national regulatory autonomy. Especially the non-Eurozone NBR states are adamant about retaining national autonomy, even in crisis management situations.[837] This insistence is particularly pronounced in banking rescue and restructuring. That results in a very cautious approach to the SRM, and the ECB's role in early intervention. Such caution extends beyond institutional architecture, to legislative frameworks, including the Single Rulebook.[838] There are multiple reasons for this approach.

Firstly, the national supervisory and resolution models of Denmark and Sweden (as

[834] S Ingves, *Regulatory Challenges of Cross-Border Banking – Possible Ways Forward*, Reserve Bank of Australia, 2007, p.193-194
[835] Ibid. p.291-292
[836] Ibid.p.193
[837] AB Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.566 see also AB Spendzharova, *Banking Union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-States: Regulatory preferences in banking supervision*, Review of International Political Economy, 21:4, 2014
[838] Ibid. p.572

well as non-EU Norway) require speed and flexibility. Such models were largely designed in Sweden after a banking crisis in mid 1990's, following detailed research and careful considerations, and subsequently adopted elsewhere. The maximum harmonisation approach of the EBU is perceived by the NBR NoPS as *limiting* the speed and flexibility of decision-making.[839] During the GFC, as well as other crises, clarity and speed in decision-making were crucial, and the Nordic NoPS do not think this has been achieved by the EBU.[840]

Secondly, as I will further elaborate in Chapter 5, due to their structural characteristics, Danish and (especially) Swedish regulators have little to gain in terms of extra information sharing facilitated through the SSM. That is a consequence of limited exposure to non-NBR banking markets, which allowed Nordic (home) countries to basically develop a cross-border extended 'domestic' supervisory network, utilising their influence on the host NCAs, and thus mirroring the extended home market itself on the supervisory level.

Thirdly, much like the Visegrad States, Denmark and Sweden are not keen on taking part in rescue, recapitalisation, or deposit guarantee schemes, to save the banks of countries their banks have no significant exposures to. According to Spendzharova and Bayram "The Swedish authorities were apprehensive about a systematic transfer of resources from Sweden to other countries, which would be a liability in the eyes of Swedish taxpayers."[841] This does not just apply to the contributions, but also the perceived lack of influence on how the money is spent. The Nordic NoPS were among the harshest critics of the EBU subsidiarity settlement, which I discussed in Chapter 2(E). The Swedish parliament's Finance Committee has claimed that the EBU fundamentally contradicted the principles of subsidiarity and proportionality and even went as far as a 'yellow card' procedure attempt, arguing that the EU institutions would gain disproportionate influence over the potential allocation of States' taxpayer revenue for bank recapitalisation in other States.[842] The SRM and other burden-sharing arrangements are sensitive issues for Denmark and Sweden, as home countries to large banks with international presence.[843] Generally, the SRM is said to give home countries less control over recapitalisation decisions, compared to the status quo before EBU.[844] It is, of course, equally problematic for Finland, but its EMU membership did not leave much room

[839] Ibid.
[840] D Howarth, L Quaglia, *Steep Road to European Banking Union: Constructing the Single Resolution Mechanism*, JCMS Journal of Common Market Studies 52(S1), 2014 p.133
[841] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.572
[842] Ibid. p.573
[843] Ibid, p.568
[844] Howarth and Quaglia, 2014, p.136

for separate EBU considerations.

4. Differences between the Nordic-Baltic state positions

a) Differences between Denmark and Sweden

The two Nordic NoPS – Denmark and Sweden – notably differ in terms of how strong their unwillingness to participate is. Sweden is considered the least likely participant, since it could not opt-into the SSM and SRM, without signing the SRF agreement, which it has refused to do. Following the UK's departure, it remains the only Member State in such position. By contrast, Denmark is generally in favour of the EBU as a solution for Europe, and would consider participation, if some stumbling blocks were removed. Hougaard Jensen and Schoenmaker argued that joining the EBU would be in the Danish interest due to its banking sector characteristics.[845] As I will illustrate in Chapter 5, some of these characteristics would make Denmark a more likely participant than Sweden.

However, Denmark is concerned about the operational compatibility of several features of its financial system with the EBU, especially the mortgage sector. The National Bank of Denmark governor Lars Rohde has insisted that, despite general inclination towards participation, he could not imagine Denmark joining the union "at [the] expense of the mortgage credit [sector]."[846] The disagreement is mostly about Denmark wanting to keep a tacit exemption that allows its banks to count mortgage-backed bonds - a market worth about 3 trillion Danish Krone - as highly liquid assets.[847] Denmark wanted to obtain further security in the form of an explicit statement in the CCA, in addition to the ECB's general obligation to take different business models into account.[848] Obtaining such assurance has been difficult, not least since, as I have discussed in Chapter 3 of this thesis, there is essentially no guaranteed negotiation process available to the NoPS.

b) The Baltic States – the informal EBU 'opt-ins'

Denmark and Sweden nevertheless stand in stark contrast to their Baltic counterparts. While Estonia joined the EMU at the start of 2011, before the publication of the EBU proposals, for Latvia and Lithuania the SSM was a very real factor. This was particularly the case with Lithuania, which joined the EMU and EBU two months *after* the launch of the

[845] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020
[846] T Carlyle, Lars Rhode 'firmly convinced' by merits of banking union, Central Banking.com, 10 Oct 2014
[847] Reuters, *Denmark to decide on EU's banking union membership after Brexit*, July 4, 2017
[848] Ibid. See SSMR, Rec.17, Art.1

SSM.[849]

The three Baltic States epitomise the concept of a host country, with Estonian and Lithuanian banking systems being around 90% foreign-owned. This might appear similar to most South Eastern and Visegrad States, but there is one major difference: while the Visegrad States (and - to a lesser extent - the South-Eastern States) are hosts to mostly Eurozone banks, the Baltic States mostly host *non*-Eurozone Nordic banks. While this market penetration process was predominantly based on establishment of subsidiaries, these entities remained heavily dependent on parent bank funding.[850] Moreover, since the GFC, the Nordic banks have turned a number of such subsidiaries into branches, thus increasing their dependency. This also puts the Baltic States in stark contrast with neighbouring Finland, which is the only predominantly 'home' Eurozone state in the region. This position was solidified by the recent Nordea's move to Finland, discussed in Chapter 3.

Lithuania was the first country to join an already functioning SSM. Latvia was the last country to join the EMU before its launch. There are several reasons that made this decision more palatable to them than it would be for Denmark and Sweden. Latvia was able to take part in the EBU drafting processes as an EMU State. Lithuania, despite being a NoPS for a couple of months, joined the EBU via the EMU, not the CCA. It was also able to negotiate the exception for its credit unions, as they are listed in Art.2(5) of Directive 2013/36/EU and thus excluded from the scope of the tasks conferred on the ECB by Art.1(2) SSMR. The same applies for investment firms, as long as they fall within the scope of Directive 2004/39/EC, which was very important for the dynamic and tech-driven domestic financial sector, comprising mainly of small firms. Moreover, while the Swedish and Danish decision-makers were concerned that participating States outside the Eurozone would not fully participate in EBU decision-making, this was not the case for EMU Baltic States.[851] This is generally in line with the path-dependency hypothesis.[852] As I have discussed in relation to Bulgaria, Croatia and the Visegrad States, Member States that are already determined to join the EMU see the EBU as a possible downside, but not one that could fundamentally alter their decision.

Lastly, the crisis experience and several bank failures showed not just the vulnerabilities of the domestic Baltic supervisory systems, thus mirroring the Bulgarian

[849] See V Vasiliauskas, *Speech on Lithuania's Participation in the ECB Governing Council*, Bank of Lithuania, 2014
[850] IMF, *Nordic Regional Report*, IMF Country Report No 13/274, September 2013
[851] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.565
[852] See Chapter 1(C)

predisposition and the resulting need to spread supervisory blame,[853] but also dangerous dependence on their Scandinavian partners.[854] This, in turn, made the Baltic states more willing to participate in alternative stability arrangements. I will explore this further in section E, below.

E. The financial crisis in the Nordic-Baltic Region: an example of the dangers of a fully integrated market with decentralised supervision

The contrasting positions of the NBR States are firmly rooted in their experiences of the GFC, as well as several domestic crises in these countries preceding it. In this section I will explore the reasons why different NBR states made different decisions in relation to the EBU, specifically concentrating on the interplay between the Baltic States and Sweden during the GFC, and the roles each of them played in shaping each other's position. This discussion will further illustrate the dangers that the NoPS can pose to some Eurozone States, when they operate in the same integrated regional markets.

1. Sweden: An example of Nordic preparedness

As the GFC was shaking and shaping the global financial landscape, different NBR States (predictably, given the diversity in their ranks) saw the entire spectrum of possible crisis experiences. Crisis-stricken Latvia and Lithuania stood in stark contrast with resilient Sweden. This contrast is particularly interesting due to their interconnectedness, as the Swedish banks were the biggest players in the Baltic markets. When the GFC struck, the Swedish banking system demonstrated that it had learned the lessons of a domestic crisis in mid 1990's. Good budgeting and consequently accumulated surpluses, allowed Sweden to mitigate the shock. The Swedish subsidiaries in the Baltics obviously suffered, but their losses were absorbed by the parent institutions (albeit not without difficulty), avoiding major spill-overs to the domestic market, and were essentially the only significant losses of the Swedish banking giants, which at the time still included Nordea.[855] On top of that, the Swedish banking groups contributed to stabilising the NBR banking market by providing

[853] Suggested as a possible incentive to join the SSM in E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.11

[854] For more on the crisis in the Baltics see K Bukovskis (ed.), *Politics of Economic Sustainability: Baltic and Visegrad Responses to the European Economic Crisis*, Latvian institute of international affairs, 2014

[855] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.569

their Baltic subsidiaries with sizeable capital injections.[856] Such injections effectively contributed to stabilisation of inter-bank lending, and thus helped unclog the monetary transmission channels. Obviously, as a small economy housing a massive banking sector, Sweden needed to be careful with investor confidence, and thus walked a fine line trying to, on the one hand, do what it can to stabilise the NBR banking market, and on the other - contain the crisis in the private sector. This task was made easier by the limited geographical distribution of Swedish banks, with most of their activities being contained in their NBR extended home market (EHM). The banks were also in a good state and exhibited good level of capitalisation.[857]

A number of special measures were also taken during the GFC to protect the domestic banking markets.[858] Some of these measures were confidence retention tools rather than instruments of actual effect. For example, in order to ensure the supply of credit to non-financial companies, a credit facility where counterparts could use commercial paper with a maturity of up to one year as collateral was established in late 2008.[859] It was notably closed in September 2009 due to lack of demand, but similar measures would have helped many other EU countries during the GFC.

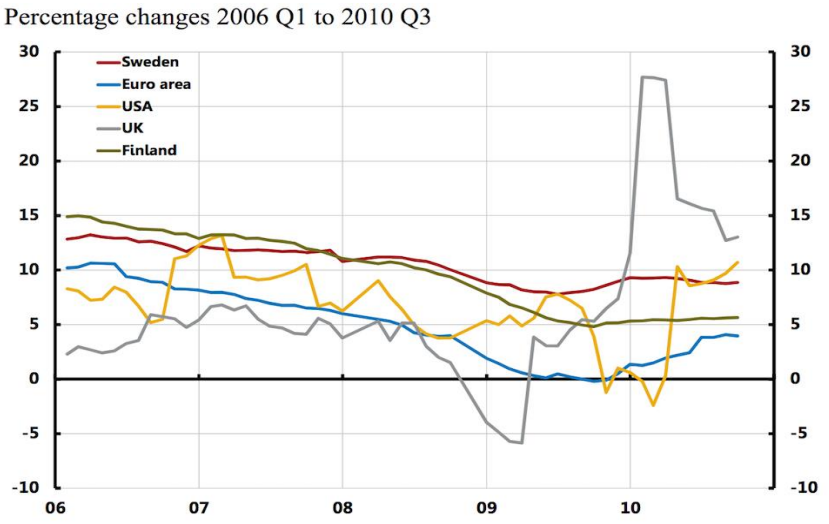

Fig.4.2 Bank lending to households; Chart from Goodhart and Rochet 2011[860]

[856] Ibid. p.566
[857] C Goodhart, J Rochet, *Evaluation of the Riksbank's Monetary Policy and Work with Financial Stability 2005–2010*, Sveriges Riksdag, 2011, pp.12, 39
[858] Ibid. p.13
[859] Ibid.
[860] Ibid.

As a result of such preparations and swift decisions during the crisis, Sweden's credit market did not experience 'boom and bust dynamics' seen in many other places, including the Baltic states.[861] This is evident from Fig.4.2, provided by Goodhart and Rochet. Such reforms were expensive, at times unpopular, and difficult politically. Therefore, as Spendzharova and Bayram observed, having built a fairly resilient domestic system, Swedish decision-makers were not keen to join a supranational resolution mechanism, possibly entailing a transfer of resources to other States, without corresponding say in decision making.[862] It can be recalled that the economic precautions of the 90's and early 2000's were sold to the electorate as a means for self-sustainability and regulatory independence, thus making joining any supranational structure an inherent electoral risk.

2. The Baltic bubble

The Baltic States, especially Lithuania and Latvia, found themselves at the opposite end of the spectrum in terms of crisis preparedness. The dominance of Nordic banks with seemingly limitless liquidity provision, recent EU membership, EMU preparations, entrance to ERMII, as well as booming property and construction industries lulled the Eastern side of the NBR. Good macroeconomic situation promoted undue satisfaction globally, thus leading to underestimation of the rising imbalances and associated risks, and the Baltic States were not immune to that.[863] Confidence was further boosted by the fact that, much like their Nordic partners, they had successful crisis management experience under their belt, having bounced back from the 1998–99 Russian crisis.[864] These factors inflated private sector confidence, thus incentivising risky behaviour of the markets.[865] The most important factor was, however, continuity of growth. In early 1990s the Baltic States adopted the Washington consensus policies: currency boards with fixed pegs, fiscal discipline, liberalisation of prices and trade, as well as a wildfire of privatisations.[866] The economic environment created as a result of these neoliberal policies put the Baltic countries on an impressive growth track.[867] Two socio-cultural factors reinforced the impression of stability: reputation for fiscal and

[861] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.573
[862] Ibid.
[863] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.4
[864] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.4
[865] Ibid.
[866] R Kattel, R Raudla, *The Baltic Republics and the Crisis of 2008–2011*, Europe-Asia Studies, 65:3, 2013, p.428
[867] Ibid.

macroeconomic responsibility and a socio-cultural narrative of catching up with 'the west', as a rectification of historical injustice inflicted by a half-century communist occupation.

However, the warning signs were – by every objective measure - obvious. Aarma and Dubauskas mention "uncontrolled and unsustainable practice of commercial banks' credit expansion [in the] Baltic States in years 2003-2008." Loans to businesses and residential portfolio grew from 11 billion litas[868] in 2003 to 66 billion in 2008.[869] Deposits, in turn, grew faster than real GDP.[870] The credit expansion fuelled what seemed like (and in some ways was) economic growth. Between 2004 and 2007, the Baltic countries led the EU with their unprecedented growth rates, with dream-like annual averages of 10.3% in Latvia, 8.5% in Estonia and 8.2% in Lithuania.[871] Even if these indicators were not clear signs of overheating, there were plenty more obvious ones, such as double-digit inflation, a housing boom, appreciating real exchange rates, accelerating wage growth exceeding productivity growth, fast accumulation of net foreign liabilities, and growing current account deficits.[872] Herzberg provides a detailed discussion on the magnitude of the enormous private sector debt levels.[873] During the last boom year, 2007, the current account deficits exceeded 20% of GDP in Latvia and 15% in Estonia and Lithuania; credit to non-financial corporations and households exceeded 75% of GDP in Lithuania and 100% in Latvia and Estonia.[874] The European Commission warned that the growth rates of mortgage loans were especially high in the Baltics – with growth rates "among the highest recorded in emerging economies in recent times."[875]

3. The role of the Nordic banks in inflating the Baltic bubble

Aarma and Dubauskas's analysis of developments in international banking expansion revealed that skyrocketing credit growth was only partially financed by local savings, and largely fuelled by cross border international credit institutions' resources.[876] What encouraged the banks to lend so cheap and so much? In addition to broad global trends discussed in Chapter 1 of this thesis, Nordic foreign parent banks saw this as an opportunity

[868] Pre-Euro Lithuanian currency (1:3.45 to Euro)
[869] Aarma and Dubauskas, 2012, p.4
[870] Ibid.
[871] Kattel and Raudla, 2013, p.428
[872] Ibid.
[873] V Herzberg, *Assessing the Risk of Private Sector Debt Overhang in the Baltic Countries*, 2010
[874] European Commission, *Cross Country Study: Economic Policy Challenges in the Baltics*, 2010, p.48, Kattel and Raudla, 2013, p.428
[875] European Commission, *Cross Country Study: Economic Policy Challenges in the Baltics*, 2010, p.46
[876] Aarma and Dubauskas, 2012, p.6

to expand their market share in rapidly growing Baltic markets.[877] This was a part of the broader tendency for Western European Banks "facing low margins in overbanked Western European countries, and looking for a source of profits […embracing] a "second home market" strategy focused on Eastern Europe," which resulted in a surge of capital.[878] Domestically-owned banks thus had to follow, in order to remain competitive, and did not face any 'natural' difficulties attracting funding through non-resident private deposits and wholesale credit market, due to broader economic boom.[879] Such conditions encouraged excessive risk taking by domestic banks, while simultaneously contributing to further growth (or bubble), thus making the markets even more attractive for foreign entrants keen to compete, and to that end, offer even cheaper credit. Credit growth and capital inflows (as a share of GDP) to the Baltics exceeded those to most other NBR and Visegrad States, which is argued to reflect the role of parent-bank funding, as their loan-to-deposit ratios rose sharply.[880]

Cheap credit drove up domestic demand and was channelled into real estate, construction, financial services and private consumption – the sectors that caused or aggravated the GFC globally.[881] As Purfield and Rosenberg rightly observed, these sectors are not tradable as commodities and at the times of economic stagnation tend to turn illiquid.[882] The obvious question is why the market did not regulate itself. No matter how cheap the credit, surely the demand for it should run dry at some point? The short answer is that it did. In 2007. What kept inflating the Baltic bubble all the way to the point of meltdown was a combination of high permanent income expectations and very low real borrowing rates.[883] It is argued that increased absorption of EU grants may have had an impact and cyclically loose fiscal policy, thus exacerbating the effects of other factors.[884] Consequently, "all Baltic economies were rapidly losing competitiveness in addition to becoming massively indebted."[885]

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[877] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.4
[878] I Iaydjiev, *The Political Economy of Cross-Border Banking Regulation in Emerging Europe, 2004–2010*, Cambridge University Press 2019, p.360, see also RA Epstein, *When Do Foreign Banks 'cut and run'? Evidence from West European Bailouts and East European Markets*, Review of International Political Economy 21:4 2014
[879] Purfield and Rosenberg, 2010, p.4
[880] Ibid.
[881] R Kattel, R Raudla, *The Baltic Republics and the Crisis of 2008–2011*, Europe-Asia Studies, 65:3, 2013, p.428
[882] Purfield and Rosenberg, 2010, p.7
[883] Ibid.p.4
[884] Ibid.p.7
[885] Kattel and Raudla, 2013, p.429

Example 1: SEB Group

SEB, headquartered in Sweden, had penetrated different national markets in different ways: in Norway, Denmark and Finland it focused on providing corporate services, in Germany it concentrated on the mid-corporate segment and investment, in Sweden, Estonia, Latvia and Lithuania it provided all universal banking services. It also had presence in Luxembourg, in the form of SEB International.

Source: SEB 2015[886]

On 31 December 2014, the year considered to be the final year of the crisis in the NBR, the Group's total assets amounted to €284.7bn. About 20% of its income was generated by activities within the Eurozone, which jumped to 25% following Lithuania's EMU accession.[887]

The example of SEB illustrates that foreign activities of Nordic banks are not restricted to the Baltics. While, the exposure of, for example, the German economy to this credit institution is not significant, multiple troubled foreign institutions could still leave a dent. Nevertheless, the Baltics still serve as the most obvious example.

SEB loan portfolio in the Baltics increased significantly every year 2004-2008, end even managed to increase by 1% in 2008.[888] These loan volumes of SEB and its main rival – Swedbank, discussed below, increased more than fourfold from 2004-2008.[889] A huge part of the total loan portfolio increase during the economic growth was financed from the outsourced capital inflows.[890] These tendencies were fairly universal throughout the Baltics and most evidently manifested in Lithuania, where SEB was the pre-crises leader in credit volume. Its overall loan portfolio volume increased fourfold 2004-2008.[891]

[886] SEB Bank, The Nordic Bank With Global Presence, SEB annual Report 2014, August 2015 p.9
[887] SEB Bank, *The Nordic Bank With Global Presence*, 2015, p.9
[888] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.5
[889] Ibid.
[890] Ibid.
[891] Ibid.

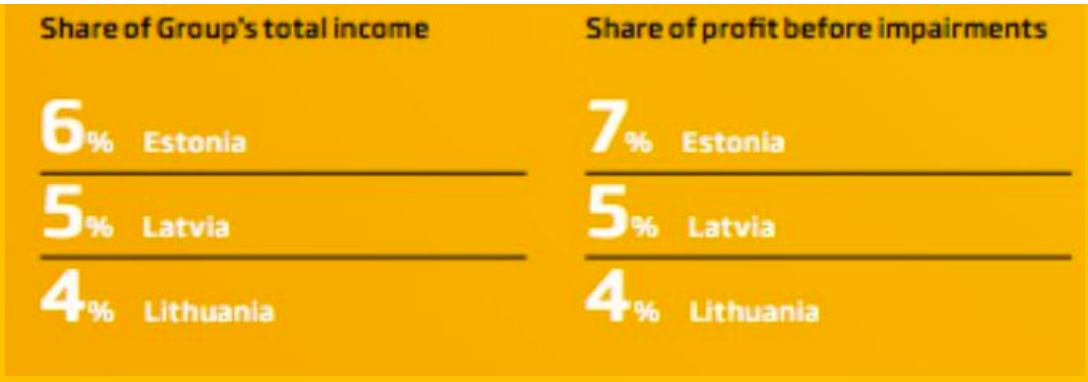
From this example we can see that a credit institution operating across the 'EBU border' can be both: vulnerable to the market turbulences in the Eurozone, and have a significant impact on individual Eurozone States.

Summarising the analysed credit sector indicators of the Baltics, Aarma and Dubauskas conclude that the lowest credit deposit ratio was in Estonia followed by Lithuania and Latvia during their study period of 2004-2010.[892] This correlates with the gravity of GFC in all three States, with Estonia surviving it easier, followed by Lithuania, and Latvia experiencing the full wrath of the crisis. Their analysis of network and credit expansion activities in the Baltic States revealed that in all three countries Swedbank played the leading role.[893] With that being said, Danske and Nordea banks had the lowest deposits to loan ratios 2004-2010, which is an indicator of systematic use of additional funding from their parent banks.[894] For instance, an accumulated loan portfolio for the five biggest Baltic banks was €17.4 billion while the aggregated deposits of the same banks were just €8.2 billion.[895]

Example 2: Swedbank

With 8 million private customers and 0.6 million corporate customers, Swedbank occupied a leading position in its extended home market of Sweden, Estonia, Latvia and Lithuania during the GFC, with meaningful presence in Norway, Finland and Denmark.[896] It also had operations in the USA, China, Luxembourg, and South Africa. It was Europe's fifth largest card payment acquirer and tenth largest issuer.[897] As is evident from the table below, the overall share of Baltic operations was not very big compared to, for example, Swedish operations.

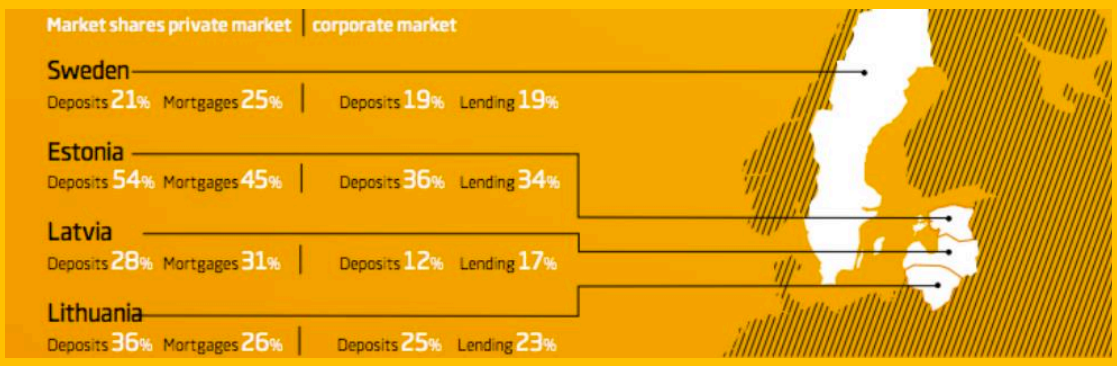
[892] Ibid. p.6
[893] Ibid.
[894] Ibid. pp.5-6
[895] Ibid.
[896] Swedbank *Annual Report*, 2014
[897] Ibid. p.32



Source: Swedbank[898]

Nevertheless, Swedbank's presence was very significant for the Baltic States, where it was the largest bank by the number of customers.[899] At the launch of the SSM is was designated as one of significant institutions in all three States within the meaning of Art.6 SSMR.

Given such established market position, it is not surprising that Swedbank played a significant role in the build up of the Baltic bubble. In Estonia its volume of loans almost tripled from 2004 to the end of 2008, which was still modest compared to *quadruple* increase in Latvia.[900]



Source: Swedbank 2014

These practices continued virtually unchallenged. Somewhat surprisingly, the confidence in the Swedbank brand itself in the Baltics was higher than in Sweden even *after* the GFC, despite additional reputation damage that came from a major profit accounting scandal.[901] Such good reputation is partly attributable to good performance in stress-testing.[902]

The way stress tests were conducted, however, exemplifies one of the core problems

[898] Ibid. p.1
[899] Ibid. p.27
[900] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.5-6
[901] Swedbank *Annual Report*, 2014, p.9
[902] Ibid.p.13

revealed in this thesis – the irreducible complexity of supervising cross-border entities located in the NoPS. The annual stress tests of major Swedish banks are conducted by the Riksbank and the Swedish Financial Supervisory Authority. On the European level, stress tests are done by the EBA and the ECB. Therefore, Swedbank as a whole participates in national annual stress test and the EBA's pan-European stress test, while the Baltic subsidiaries participate in the ECB's review of asset quality, and the accompanying stress test.[903] Such system divides a bank up along the legal lines, which are entirely divorced from business reality, thus putting supervisory effectiveness into question.

4. The GFC in the Baltics

The Baltic 'franchise' of the GFC started in the housing market, mostly in Lithuania and Latvia, where global real estate markets' stagnation resulted in failures of construction companies, most of which were wildly over-leveraged. This over-leveraging, along with indulgence in subprime mortgages, was, as discussed, largely banking sector driven. As Aarma and Dubauskas observed, "[R]ealizing the real estate prices had underwent a sharp rise, high-value commercial banks created extra money supply, which in certain cases was virtually out of control of the central banks."[904] Purfield and Rosenberg also attributed the subsequent decline to shrinking exports and the fall in domestic demand, as well as the deterioration of the private sector demand, resulting from credit squeeze and plunging consumer confidence, further aggravated by reduced public sector spending.[905] This reduction in public spending, although hailed by some as one of the more successful examples of austerity, reduced private spending even further.

The hit was more painful for the Baltic States because it was delayed and more concentrated. In early 2008 the Baltic markets were still holding up, despite the tsunami of banking collapses in Western Europe and across the Atlantic. The local press called it 'stagnation' rather than crisis; recession was still believed to be avoidable. The credit system seemed relatively safe since the Baltic banks and the majority of their Scandinavian parent institutions did not have significant exposures to the likes of Lehman Brothers, Northern Rock, RBS or Icesave. Generally, they also steered clear of risky Southern European real estate markets.

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[903] Ibid.p.37
[904] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.1
[905] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.8

While the early signs of the GFC were ignored, the failures of seemingly not interconnected banks still resulted in contagion effects, which eventually reached the Baltics. The domestic bubbles started bursting in March 2008, when the credit supply started running dry, as the market participants started tightening credit conditions due to domestic processes generally "reflecting the freeze-up of global financial flows and concerns about the health of parent banks."[906] Unsurprisingly, the 'stagnation' was followed by private borrower defaults; as construction companies started defaulting on their business loans, buyers also started defaulting on their mortgages. The later largely included construction and financial sector workers, logistics companies, etc., the services of which were no longer needed. An unfortunate exacerbation was the collapses of three domestic Lithuanian and Latvian banks, now defunct Snoras, Ukio Bankas, and Parex. Their collapses were mostly attributable to reckless management (Parex), and violations of banking rules (Ukio and Snoras). These failures had a number of effects that pushed Lithuania and Latvia even further towards participation. They put into question the reputation of national supervisors, exposed the flaws in national resolution regimes, and strengthened the market positions of the Nordic banks, as large Lithuanian and Latvian banks with cross-border presence got wiped out. National resolution decisions in particular were highly questionable. During the Parex liquidation, Latvian government took an 85% stake and imposed withdrawal restrictions.[907] That amplified the contagion effects and made the collapses of the two Lithuanian banks even more threatening, as other Latvian and Lithuanian banks struggled to attract liquidity due to dramatic fall in trust. Lithuanian authorities were involved in multiple scandals during the liquidation of Snoras, which further aggravated the problems.

These events had instant real economy effects. GDP fell by 14.3% in Estonia, 14.8% in Lithuania and 17.7% in Latvia.[908] However, somewhat surprisingly, the decline in industrial production in 2009 was the biggest in Estonia (25.9%), followed by 15.8% in Latvia and 14.6% in Lithuania.[909]

5. *Baltic NCA performance during the GFC*

It is not surprising that the Baltic NCAs were somewhat scapegoated for these failures and the SSM and SRM thus became somewhat desirable to their States, rather than just

[906] Ibid. p.7-8
[907] Ibid.
[908] R Kattel, R Raudla, *The Baltic Republics and the Crisis of 2008–2011*, Europe-Asia Studies, 65:3, 2013, p.430
[909] Ibid.

tolerable.[910] Aarma and Dubauskas criticised NCAs in the region for their passive approach and not acting as "is suggested by many monetary expansion theories."[911] Cooperation between the NCAs, despite the existence of the aforementioned NBR coordination infrastructure, was also insufficient. However, blaming them for the Baltic crisis exclusively would be unfair.

Firstly, likelihood and magnitude of a potential financial crisis were underestimated globally. Secondly, as Kattel and Raudla observed, high growth rates effectively made the political elites oblivious to the warning signals.[912] Furthermore, the governments contributed to the overheating through "cyclically loose fiscal policies (including the spending of boom-generated windfall revenues […]) – although more so in Latvia and Lithuania than in Estonia."[913] The political positions seeped into the regulatory domain. The national central banks were partly forced into the position of observation, due to political pressure to facilitate growth, even when it seemed 'bubbly'. That led to inadequate powers being given to the NCAs. The NCAs' powers in these liberal economies were limited, as the policy was to avoid affecting credit institutions complying with existing requirements.[914] The NCAs thus lacked firepower to address macro-prudential factors through micro-prudential actions, as their early intervention powers were restricted to manifest breaches of domestic banking regulations, not overall banking health.[915] Furthermore, in the rare instances where the overall banking sector health was considered as a reason for interference, like in the case of Lithuanian Snoras, the actions of the NCAs were met with public and political resistance. The Baltic States' central banks also lacked monetary policy instruments due to currency boards arrangements.[916] Even when the Baltic governments adopted some steps to deflate the bubble, by increasing reserve requirements and tightening the formula for calculating capital adequacy, these measures came too late and ended up popping the bubble rather than deflating it.[917]

The Baltic bubble was least pronounced in Lithuania, which Purfield and Rosenberg

[910] See V Vasiliauskas, *Speech on Lithuania's Participation in the ECB Governing Council*, 2014
[911] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.6
[912] R Kattel, R Raudla, *The Baltic Republics and the Crisis of 2008–2011*, Europe-Asia Studies, 65:3, 2013, p.429
[913] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.4
[914] Ibid.
[915] Ibid.
[916] Ibid.
[917] S Deroose at al, *The Tale of the Baltics: Experiences, Challenges Ahead and Main Lessons*, ECFIN Economic Briefs 10, 2010, p.5

attribute to the absorptive capacity of its larger economy and larger productivity gains.[918] Moreover, as is evident from the examples of Snoras and Ukio Bankas's liquidations, Lithuanian NCAs also were less afraid of taking action, having learned from their Nordic counterparts and a series of bank collapses in mid 1990's. However, the decisive steps of Lithuanian authorities could also be seen as aggravations of an already bad situation, as bank liquidations and nationalisations during a financial crisis can further destabilise the market.

6. The role of parent banks and home State central banks in untangling the crisis

With a lot of the blame falling on the Baltic States themselves, it becomes apparent that undue demonisation of the Nordic (especially Swedish) banks would be unjustified. Despite their role in creating the bubble, the Nordic banks and the central banks of their home States played an important role in crisis resolution. The Nordic banking groups reportedly delivered on their commitments to stabilise the broader Baltic market by providing their subsidiaries with capital injections.[919] Even before the GFC, there were some notable, albeit partly self-preservation-driven, attempts on the part of the Nordic banks to stabilise the economic development in the Baltics and make it more sustainable. Swedbank and SEB, recognised the vulnerabilities associated with rapidly expanding Baltic exposures and sought to engineer a controlled deceleration of credit growth from 40–60% per annum in 2005–07 to a more sustainable 20-25% level. [920] These efforts obviously came too late, but the behaviour of the Nordic banks could still be described as - at worst - somewhat reckless, rather than outright cynical.

The commitment to regional banking stability was also evident in the actions of the central banks. During the GFC Latvia found itself in arguably the most uncomfortable situation in the entire NBR, rivalled only by Iceland, in terms of the impact of the credit market crisis on the real economy. It was the first Baltic State to get the 'all-inclusive' crisis experience including a run on the currency in 2008 and rapidly diminishing euro holdings, which effectively forced it into the EMU. The Latvian government had to ask for

[918] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.7
[919] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.566
[920] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.7

international support from the IMF, the EU and other NBR States.[921] While Latvia was the only NBR country to require a stand-by agreement with the IMF, Lithuania also considered this option.[922] As part of the rescue effort, the Swedish Riksbank agreed a currency swap agreement with the Latvian Central Bank (which at the time was not part of the EMU), worth €500 million.[923] It further provided bridging loans and liquidity to the Latvian financial system, while Latvia awaited the assistance from the IMF and EU, thus making Latvia's otherwise terrible negotiating position a little better.[924] In December 2008, Latvia signed an agreement with the IMF, the EU, and other NBR countries.

As I have discussed above and will empirically illustrate in Chapter 5, the NoPS are notoriously averse to recapitalising the banks in other States, and generally not keen on helping their central banks. However, for Riksbank the situation in the Baltics was effectively a 'domestic' concern. By assisting the Baltics, Riksbank was also saving the reputation and the books of the parent banks. In 2009 60% of Swedbank's and staggering 75% of SEB's total losses stemmed from their operations in the Baltics.[925] If the subsidiaries in the Baltics were individual banks, they probably would have failed. Arguably, due to the size of the Swedish economy (relative to any individual Baltic State) and stability of the parent banks, Riksbank could have allowed the subsidiaries to fail or allow the losses to be absorbed by the Swedish parent banks, without assisting troubled host States. However, as Spendzharova and Bayram rightly observed, "as a small [by global standards] and highly internationalised open economy, Sweden strives to maintain investor confidence."[926] Letting the subsidiaries fail would have undermined this confidence and the absorption option could have spooked investors and inter-bank lenders, at a time when private liquidity was scarce.

7. *Host state autonomy costs*

This rescue effort was not unconditional and came with major autonomy sacrifices for the host States. Riksbank demanded that Latvia signs a binding agreement with the IMF in order for the currency swap agreement to come into play and even sought to dictate some of the conditions of Latvia's crisis management processes. This conditionality might have been

[921] R Kattel, R Raudla, *The Baltic Republics and the Crisis of 2008–2011*, Europe-Asia Studies, 65:3, 2013, p.441
[922] Ibid. with reference to A Aslund, *Lessons from the Baltic Crisis*, 2007-10, 2011 and M Engström, *Latvia's Crisis: the Swedish Factor*, 2009
[923] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.570
[924] Ibid.
[925] S Ingves, *Crisis in the Baltic - the Riksbank's Measures, Assessments and Lessons Learned*, BIS 2010
[926] Spendzharova and Bayram, 2016, p.569

one of the reasons why Latvia and, by extension, Lithuania (which would have faced similar conditions, had it opted for the same path as Latvia) started questioning the power that Riksbank and the largest Swedish and (to a lesser extent) Danish and Norwegian credit institutions had over the Baltic host markets. The Riksbank also offered an agreement to the Central Bank of Estonia for short-term currency support.[927] In 2009 Sweden offered to assume responsibility for 80 per cent of the losses of Swedish-based banks operating in Estonia, while Estonia would bear the remaining 20 per cent.[928] However, Estonia rejected it due to autonomy risks, also considering such agreement a threat to the peg to the Euro, which it needed to maintain in preparation for EMU membership.[929] Notably, as measured by the level of reported non-performing loans, Estonia's banking system found itself in a considerably stronger position than Lithuania or Latvia, so the need for assistance was not desperate.[930]

This was a pivotal point in what Pistor has described as the 'host's dilemma', where, through financial integration, the host State ends up having to accept the regulatory agenda dictated by the home State.[931] In the NBR the home (Nordic) regulators reportedly hold significant decision-making power vis-à-vis host regulators in the Baltic states.[932] As I have discussed in Chapter 3, this has become even more entrenched in the NBR than it would be in some other regions, due to extensive supervisory cooperation and strong supervisory colleges. As Pistor argued the host State control over subsidiaries is effectively further "undermined by the ease with which transnational financial groups can side-step regulatory controls imposed on one vehicle (banks) by channelling capital through other vehicles […] or by engaging in direct-lending activities to customers."[933]

Consequently, the Lithuanian and Latvian authorities were presented with an uncomfortable fact: much of their regulatory autonomy had already been relinquished. In terms of the financial stability trilemma, joining the EBU did not mean major additional sacrifices, but it presented an alternative backstop. Unwilling to be at the mercy of their Nordic partners, determined to join the EMU and keen to spread the blame for future

[927] S Ingves, *Crisis in the Baltic - the Riksbank's Measures, Assessments and Lessons Learned*, BIS 2010
[928] Spendzharova and Bayram, 2016, p.570
[929] Ibid.
[930] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.10
[931] K Pistor, *Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis*, Columbia Law and Economics Working Paper No.378, 2010, p.5
[932] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.567
[933] Pistor, 2010, p.9

supervisory failures, they were willing to overlook the remaining shortcomings of the EBU.

8. Why the Nordic willingness to help the Baltics does not translate to the rest of the EU?

The same events led to the exact opposite conclusion for Denmark and Sweden. Since the Baltic markets are a part of their extended home market, over which they have a lot of control, effectively, no additional exposures are created by entering into inter-NBR agreements, recapitalising branches and subsidiaries in other NBR States, or even structures for providing liquidity support to central banks in the region. The Nordic (and particularly Swedish) contributions in the Baltics were largely self-interest-driven and linked to pre-existing exposures. Even the assistance on the State level, was part of the effort to avoid devaluation in any given state, which could affect other currency pegs in the region. Moreover, further loan losses of Nordic banks could have had additional contagion effects by hurting confidence in the parent banks.[934] Generally, the Baltic rescue was a limited, conditional rescue, within what the major NBR banking groups perceive as their extended home market.[935]

That is not to say that the NBR NoPS are happy with being *obliged* to contribute, even within the NBR. The bail-in mechanism introduced in the BRRD is therefore particularly problematic. Analysing the effects of the BRRD bail-in tool on the Swedish banking system, Eliasson *et al*. raise concerns about potential contagion effects. In their view, indirect contagion effects, such as a sharp decline in market confidence, could be particularly severe, due to an interconnected banking market and institutions' reliance on market funding.[936]

By contrast to their dominance in the NBR, the Nordic banks do not have significant exposures to the banking markets of Southern Europe and France. It could thus be argued that the EBU would *create* that exposure for them. The Baltic market is of very limited size. Lithuania and Latvia combined have roughly the same population as Denmark. Moreover, the Baltic capitals, while holding some significance in the regional markets and political settings, are not major financial centres. In other words, these markets cannot significantly harm the Nordic interests, no matter how sour they went. The Baltic rescue was something that the Nordic banking groups could afford, without creating dangerous liabilities, but they have no

[934] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.11
[935] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.566
[936] E Eliasson, E Jansson, T Jansson, *The bail-in tool from a Swedish perspective*, Sveriges Riksbank economic review, 2014, p.43

interest in going further. The general Nordic aversion to participation in rescues and recapitalisations in other markets remains.

Furthermore, the Nordic countries are not keen on changing their systems, which reflect philosophical considerations and uneasy political compromises. Even the BRRD, in that sense, was problematic, as its order of claims in bank liquidation was very different from the national regimes.[937] Such concerns would be even more pronounced if the institutional framework of the EBU, including the SSM and SRM, were adopted. The SRM entails a considerable loss of regulatory discretion in crisis management, as it is thought to give home States less control over recapitalisation decisions.[938] This comes in stark contrast to the status quo. Even after the implementation of the BRRD, the Danish and Swedish NRAs retain considerable discretion. They can set minimum requirements governing how much capital and eligible debt instruments banks must hold on their balance sheets.[939] Furthermore, the ultimate resolution trigger decision is still in the hands of the NRAs.[940] The SRM is therefore a particularly 'sensitive issue […] due to [Nordic Countries'] structural position as a home country to large internationalised banks."[941]

9. Norway and Iceland: non-EU states in an integrated European market

The discussion of the NBR would not be complete without addressing Norway and Iceland. Neither of the countries are members of the EU. However, they are members of the EEA. The legal basis for the relationship between the EU and EEA states is Art.217 TFEU, under which all rights and obligations are reciprocal. The cooperation with the EEA states is detailed by association agreements, which are more intricate instruments than free trade or bilateral agreements (such as the ones with Canada or Switzerland respectively), and effectively facilitate access to the single market, conditional on compliance with EU law.[942] Their banking oversight arrangements differ from the EBU system in numerous respects, including institutional infrastructure and resolution planning.[943] Despite these differences, having accepted the four freedoms and complying with the relevant legislation, including the

[937] Ibid. p.31
[938] Spendzharova and Bayram, 2016, p.568
[939] E Eliasson, E Jansson, T Jansson, *The bail-in tool from a Swedish perspective*, Sveriges Riksbank economic review, 2014, p.43
[940] Ibid. p.36
[941] Spendzharova and Bayram, 2016, p.568
[942] Art.3(2) TEU, Art.26(2) TFEU See European Parliament, The European Economic Area (EEA), *Switzerland and the North, Fact Sheets on the European Union*
[943] E Wymeersch, *The Structure of Financial Supervision in Europe: About Single, Twin Peaks and Multiple Financial Supervisors*, 2006, pp.46-47

EBU legislation, in relation to branches and subsidiaries in the EU, these states form an integral part of the single banking market in the NBR and (to a lesser extent) broader EU.

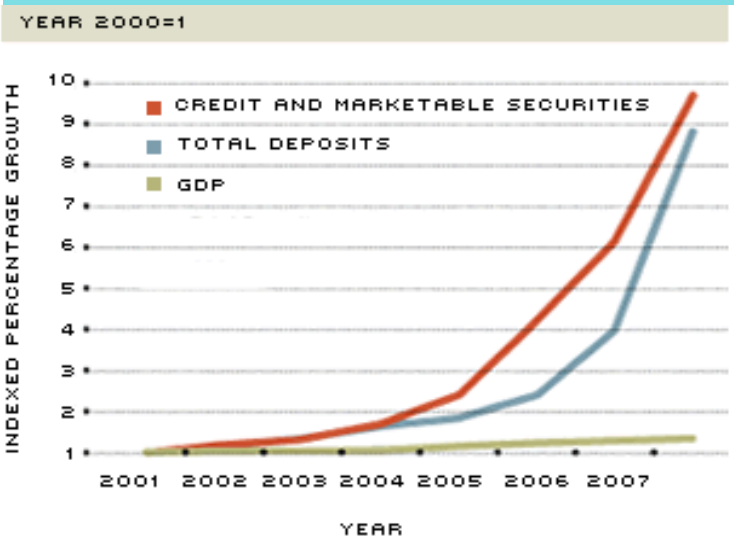
Their integration in the NBR structures, includes membership in the Nordic Passport Union and the Nordic Council, which is linked to the Baltic Assembly. Icelandic and Norwegian authorities participate in NBR supervision and resolution systems, which include the NBR Memorandum of Understanding, supervisory colleges and the Nordic–Baltic Cross-Border Stability Group. The Danish and Swedish banking groups generally consider Norway and Iceland part of the extended home market and vice versa.

However, as far as the SSM and SRM are concerned, these states are barred from participating. This is inherently problematic. As Mayes observed, "the discrepancy for non-euro area members would disappear if they join the euro area, but this would not apply to the non-EU EEA members such as Norway."[944] A significant part of my discussion in this Chapter concentrated on Denmark and Sweden – countries eligible for CCA. Such choice results from the dominance of their banks, especially the Swedish ones, in the EMU Baltics. However, the Norwegian banks also hold significant market share. Most prominently, Luminor AB (merger of Baltic businesses of Finish/Swedish Nordea and Norwegian DNB), is a top five bank by market share and number of customers in the Baltic States and supervised by the ECB as significant in Estonia. The DNB group contributed to the Baltic credit crises alongside its Swedish competitors, following broadly the same patterns of business practices.

An even more illustrative story of how much havoc an EEA state can wreak on EU economies (as well as its own) is one of Iceland. Iceland exemplified a situation where, as Mayes put it, a lacuna opens "where a small national central bank cannot provide adequate support for a large cross-border institution."[945]

[944] DG Mayes, *Banking union: the disadvantages of opportunism*, Journal of Economic Policy Reform, Volume 21 2018, p.133
[945] Ibid. p.140

Cautionary Tale: Iceland



During the GFC Europe faced many situations where a bank was too large relative to its home country to either rescue the bank or the pay out all insured deposits, and Iceland was a prime example of such state.[946]

As Sibert[947] noted: "*When the Icelandic bank Icesave went down, the court ruled that the Icelandic government was not legally obligated to repay UK and Dutch depositors in a timely fashion.*" [948] [...t]*he court accepted Iceland's argument that the EU directive was never meant to deal with the collapse of an entire banking system."*[949]

The likelihood of bank failures can obviously be reduced by effective cross-border supervision, but this aspect was also sorely lacking. According to Avgouleas, the failures of Icelandic banks also exposed the gaps in cross-border supervision of banking groups in the EU and the EEA and, in particular, the failure of home country control.[950] "Foreign bank branches, which proved to be […] a menace to host country's systemic stability, were, nevertheless, supervised by their home regulator. […] identified loopholes in supervision were left unattended while the level of harmonization of national prudential regulation regimes was getting increasingly dense. […] uncoordinated bank rescues […] highlighted the lack of cross-border structures for crisis management and bank resolution."[951]

Have these problems been solved? Mayes argues that the implementation of the BRRD has altered the system of deposit insurance and to a large extent removed the problem revealed by the Icelandic crisis - that deposit insurance funds in small countries with large cross-border banks might be inadequate to meet the claims in the event of failure.[952] He

[946] DG Mayes, *Early intervention and prompt corrective action in Europe*, Bank of Finland Research Discussion Papers, No.17, 2009 p.8
[947] A Sibert, *Deposit insurance after Iceland and Cyprus*, VOXEU/CEPR, 2/04/2013
[948] EFTA Court 2013
[949] Ibid.
[950] E Avgouleas, *Governance of global financial markets: The law, the economics, the politics*, Cambridge University Press, 2012, p.264
[951] Ibid.
[952] DG Mayes, *Banking union: the disadvantages of opportunism*, Journal of Economic Policy Reform, Volume 21 2018, p.138

explains that making depositors preferred creditors and the deposit insurers "super-preferred" creditors, reduces the chance of their incurring major losses in the failure of a large bank.[953] However, his research also reveals that the deposit insurers might have to contribute to resolution when "creditors of the same priority are bailed in and hence they become liable, along with uninsured depositors, for the (proportionate) amount that depositors would have had to contribute to the resolution had they not been insured."[954]

Moreover, the entire edifice largely stands on the assumption that other creditors will be sufficiently large to absorb the loss. Unfortunately, there is no guarantee that this would be the case and, if it is not, with less liquidity available, the contagion effects might be amplified. In the SSM/SRM area the remainder would be handled by the SRF. However, the NoPS have no access to the SRF or the ESM. The same problem applies to the EEA states.

In such situation it would seem that a very robust cross-border supervision system is needed, not just between the EBU and the NoPS, but also the EEA states. It is therefore unfortunate that cooperation between the ECB and EEA NCA/NRAs is limited to soft law measures.

It would seemingly be in the EU's interest to offer the EEA states a cooperation arrangement beyond the current framework of predominantly soft law measures, discussed in Chapter 3. Such cooperation would need to take a different form from what is currently on offer for the NoPS, since, not only would EEA state involvement in the EBU bodies be unconstitutional, they also have somewhat similar structural characteristics to Sweden, and thus would lack incentives to participate.[955]

F. Conclusions

In this Chapter I have discussed all NoPS divided into three geopolitical regions, exhibiting varying levels of banking sector integration. As far as the SSM is concerned, the biggest stumbling block is still fair participation terms. This issue has been emphasised by all of the NoPS and is 'empirically' confirmed by the fact that the only NoPS willing to join the SSM and SRM are the ones also planning to join the EMU. However, as Ferran expressed it, although "fair participation terms are necessary, they are not a sufficient precondition to

[953] Ibid.
[954] See also Directive 2014/59/EU Art.109
[955] See Chapter 5 for the discussion of such characteristics.

the exercise of the option to participate."[956] Independence, autonomy and burden sharing concerns (especially in resolution) are also acute. Furthermore, banking sector structural characteristics also play a major role, as I will discuss in the next Chapter.

It is evident that the relationship between the EBU, the NoPS, and broader Europe is symbiotic. While non-participation of NoPS can be dangerous to them as individual states, lack of coherent-pan European framework is a threat to the EBU as a whole, and broader European financial stability in general. Where integrated markets cross the SSM/SRM borders, the level of market integration still exceeds the level of regulatory integration, as the home-host system remains in place. That can undermine the intended effects of the EBU in some participating States. As the example of the Baltic States illustrates, since the parents of most of their banks are outside the SSM's remit, the ability of the ECB or the Baltic NCAs to ensure effective prudential supervision of the region's banks is conditional upon voluntary cooperation of the Nordic NoPS and EEA states.

[956] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.1

Chapter 5

Domestic market structural characteristics and their relationship with (non)participation

Introduction

As is evident from the discussions in Chapters 3 and 4, all non-Eurozone Member States share the same legal concerns about the EBU and the conditions of Close Cooperation. Nevertheless, some countries have made a decision to join the SSM and the SRM. It is therefore evident that non-legal differentiating factors affect the participation decisions. Domestic structural, political and economic incentives can encourage some of these States to overlook the legal shortcomings, limitations, and possible sacrifices.

The aim of this Chapter is to provide a domestic-banking-sector-characteristics-based political economy analysis. Through this analysis, I find compelling evidence that several structural factors strongly correlate with the NoPS positions. Such factors include, *inter alia*, the percentage of non-performing loans, banking sector profitability, exposure to problematic Eurozone banking markets, and the level (as well as type) of banking sector internationalisation. It is also evident that politico-economic agendas like banking sector nationalism, banking sector socialism, and banking sector regionalism have an impact. Such factors also dictate the strategies that the NoPS adopt seeking to mitigate the possible dangers of non-participation.

The Chapter is structured as follows: section A reviews the relevant literature, consulted to compile the analytical framework of the analysis and to devise the hypotheses to be tested. In section B I test the hypotheses against structural data, in order to determine which correlations can be established. In section C I briefly discuss the political and economic policies that the most reluctant NoPS adopt in order to find alternatives to the EBU, when dealing with structural threats. The final section concludes.

A. Literature and methodology review

The purpose of this section is to find a set of inter-disciplinary methods, in order to ascertain the reasoning patterns which led to rejections and acceptances of the Close

Cooperation Agreement, discussed in Chapter 3. The need for such research arises as previous legal, economic and political research efforts have been unable to fully answer why, despite very similar legal, administrative and structural concerns, some non-Eurozone States are quite keen to sign the CCA, while the majority remain leery.

The task of finding a single, domestic-characteristics-based, set of methods for the analysis of positions taken by different States is not an easy one. Correlations discovered can often have no underlying causal relationships and countries formally stating seemingly identical positions can have little in common structurally. There is an existing body of literature exhibiting varyingly successful attempts to develop such methodology, including those in the EBU and EMU context.[957] The specific gap in existing knowledge that this Chapter seeks to fill is the lack of detailed and comprehensive study of all non-participating States. Simplistically, previous researches in this field lacked in at least one of the following three respects: a) lacked structure in terms of quantifiability and ascertainability of the findings b) had limited geographical scope (e.g. focused on a particular region) c) concentrated on a small number of selected structural indicators, ignoring or neglecting other factors. My goal is thus to comprise, develop and apply a single analytical and methodological framework, uncovering correlations which would hold true for all (or most) non-Eurozone Member States of the EU. For that purpose, I consulted literature in the fields of political economy, economics, and law, since my choice of statistical information used for this research requires academic and empirical justifications in all of these fields.

1. Howarth and Quaglia

Howarth and Quaglia were among the first to use a comprehensive set of structural data in the SSM and EBU academic analysis, and I adopt some of the core principles of their

[957] JA Frieden, *Real Sources of European Currency Policy: Sectoral Interests and European Monetary Integration*, Cambridge University Press, 2003; K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016; RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014; D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015; D Howarth, L Quaglia, *The Political Economy of European Banking Union*, Oxford University Press 2016, S Donnelly, *Power Politics and the Undersupply of Financial Stability in Europe*, Review of International Political Economy 21:4 2014, S McPhilemy, *Integrating rules, disintegrating markets: the end of national discretion in European banking?*, Journal of European Public Policy, 21:10, 2014; A Spendzharova, *Banking Union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-States: Regulatory preferences in banking supervision*, Review of International Political Economy, 21:4, 2014; A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016; P Hüttle, D Schoenmaker, *Should the 'outs' join the European Banking Union?*, Bruegel 2016

methodology.[958] Their work sought to explain national positions on the establishment, membership and scope of the SSM, mainly focusing on the preferences of national policy-makers, predominantly finance ministries.[959] They looked at the degree of banking system concentration (i.e. market share of the largest credit institutions), the degree of internationalisation, degree of foreign bank penetration, funding of different banking systems, and selected exposures, ultimately concluding that national banking sector characteristics strongly influence States' positions regarding the EBU. I adopted the use of these variables to form part of my research.

As a basis for their conceptual framework, Howarth and Quaglia adopt a modified version of Schoenmaker's financial stability trilemma, to argue that the Eurozone States faced the 'financial inconsistent quartet'. I have detailed these concepts in Chapter 1(C) of this thesis. Generally, the Inconsistent Quartet theory suggests that the Eurozone States struggled to manage financial stability, financial integration, national financial policies and the single currency simultaneously.[960] Howarth and Quaglia use this concept to explain national preferences of States towards the SSM, relying upon its nuanced application to individual countries and taking into consideration the distinct configuration of national banking systems. Crucially, as the authors argue, "the inconsistent quartet […] suggests that, *ceteris paribus*, a […] state less exposed to cross-border banking would be more reluctant to lose control over regulation and supervision because this member state is less subject of financial instability coming from abroad."[961] Howarth and Quaglia find that willingness to participate in the institutional pillars of the EBU tends to correlate with concentration and internationalisation of the national banking sector.[962] The magnitude of these effects also depends on the levels of exposure to the most problematic Eurozone markets, known as 'Euro peripheries'. They use a limited data sample from selected countries to indicate that countries opting-out of the EBU or opposing it tend to have lower exposure to Euro periphery debt. In my research I updated and expanded this data sample to encompass all NoPS and a broader set of exposures. It is discussed in section C(4) of this Chapter.

Howarth and Quaglia's argument can be summarised in their two working hypotheses: Firstly, that actual or intended "Euro area membership is neither a necessary nor sufficient condition for support for the SSM/Banking Union [although it] encourages support especially

[958] Howarth and Quaglia, 2015
[959] Ibid. p.2
[960] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.3
[961] Ibid. p.7
[962] Ibid. p.10

by having eliminated lender of last resort and by having distorted patterns of internationalisation."[963] Secondly, the "[h]igher the internationalisation to other euro area member states and/or higher the foreign penetration from the euro area, greater the support for creating/joining the SSM and widening the scope of direct ECB supervision." [964]

2. *Epstein and Rhodes*

Epstein and Rhodes also primarily examined the reasons why Eurozone countries decided to move towards the EBU.[965] Nevertheless, some of their methods, hypotheses and findings apply to my research on the NoPS. Firstly, the authors point out that global liberalisation of European economies made banking sector protectionism costlier, as well as financially and politically conflictual.[966] They argue that one of the major reasons why the Eurozone States became inclined to give up banking sector protectionism was the increased financial vulnerability of both banks and States.[967] Such vulnerability, as I have discussed in Chapter 4 and will further demonstrate in my analysis hereinafter, is a major factor in the participation decisions. By extension, banking sector strength is a disincentive for participation. As my research illustrates, the NoPS that joined the EBU or declared intentions to do so, have the lowest GDP per capita, highest levels of non-performing loans and low banking sector profitability. By contrast, the three most reluctant NoPS have some of the best performing banking sectors and economies, among the non-EMU States.

Secondly, Epstein and Rhodes discussed the impact of the EMU membership, which in the presence of fragmented banking systems and limited adjustment tools, increased the vulnerability of the EMU States,[968] reduced the effectiveness of monetary policy,[969] and created pre-conditions for contagion, since troubles in one Eurozone State could easily affect other States' borrowing costs.[970] As Howarth and Quaglia rightly observed, in the absence of the 'inconsistent quartet', namely by not being part of the EMU, the NoPS were shielded from this issue,[971] and as my research demonstrates, they remain worried about exposing themselves to this instability through joint EBU schemes.

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[963] Ibid. p.7
[964] Ibid. p.10
[965] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, 2014
[966] Ibid.
[967] Ibid.p.3
[968] Ibid.
[969] Ibid.
[970] Ibid.
[971] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.18

Epstein and Rhodes's third hypothesis rests upon the financial crisis experience. They claim that international banks became increasingly wary of the conflicts they faced with home and host regulators and demanded a common framework of supervision in Europe.[972] The biggest banks have internationalised their operations and now (allegedly) prefer centralised European regulation and supervision.[973] Nordea's move to Finland is argued to confirm this. This observation prompted me to explore a structural factor, which is often overlooked in the literature on his topic - the presence, size and impact of international credit institutions headquartered in the State in question, known as 'outward internationalisation'. The absence of large international institutions would reduce the 'stake' that the State in question has in the banking sector health in other countries, as long as possible deteriorations do not amount to outright failures with contagion effects.

3. Spendzharova

Spendzharova argued that the structure of the domestic financial sector is an important determinant of "the extent to which governments are prepared to endorse EU-level solutions."[974] She also agreed with Epstein and Rhodes, as well Howarth and Quaglia, that the levels of foreign ownership and domestic bank internationalisation are crucial determinants of the extent to which governments are prepared to accept EU-level solutions and provided in depth analysis of these factors.[975]

Most importantly, Spendzharova used a numerical (1-5) index to quantify willingness to participate in the EBU, with 5 meaning full and enthusiastic participation and 1 representing absolute scepticism (e.g. the UK's position). This is preferable to Howarth and Quaglia's method (1-3), as it leaves more room for nuance. I adopted this methodology for my research. An indexed version of this willingness scale is also optimal for comparisons with percentile expressions of structural indicators.

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[972] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.3
[973] Ibid.
[974] AB Spendzharova, *Banking Union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-States: Regulatory preferences in banking supervision*, Review of International Political Economy, 21:4, 2014, p.950
[975] Ibid. p.949

4. *Schoenmaker et al.*

I consulted several papers written by Dirk Schoenmaker with other co-authors. The first one of these publications is a Bruegel study by Hüttle and Schoenmaker.[976] The paper, written with a view to advise the non-Euro States on EBU membership, and strongly advocating it, builds upon a similar study of the same think tank by Darvas and Wolff.[977] Schoenmaker also participated in a more recent study focusing on Denmark and Sweden in particular (with Hougaard Jensen), which retained and refined the methodologies used in the above-mentioned papers.[978]

Hüttle and Schoenmaker specifically indicated that outward internationalisation (i.e. where the country 'exports' banking services and in what volumes) is an important factor, which was unduly neglected in the publications discussed above.[979] As I will elaborate further in this Chapter, outward internationalisation can help explain some of the phenomena left unexplained by inward internationalisation analysis. The studies also pay attention to the impact of differentiation between regional and other international exposure, which I have addressed in Chapter 4 and will return to later in this Chapter. Hüttle and Schoenmaker specifically point out the substantiality of banking claims of Danish and Swedish banks in the Nordic-Baltic Region, as opposed to other countries. This is further explored in Schoenmaker's paper written with Hougaard Jensen. This paper, *inter alia*, looked at the distribution of assets of the largest banks assets and the country's ability to withstand the need to recapitalise all of its banks.[980] I adopted the lines of reasoning from these publications and took this idea further, analysing the exposure levels of all NoPS, considering total exposures to the Euro periphery[981] and extended home markets, where such markets exist.

5. *Mérő and Piroska*

Mérő and Piroska criticised Spendzharova's research on the grounds that selecting only two structural data categories is insufficient to illustrate how banking sector conditions influence governments' policy formation. According to them, financial depth, banking sector concentration, profitability of banks (RoE), levels of non-performing loans, loans-to-deposit

[976] P Hüttle, D Schoenmaker, *Should the 'outs' join the European Banking Union?*, Bruegel 2016
[977] Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013
[978] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020
[979] P Hüttle, D Schoenmaker, *Should the 'outs' join the European Banking Union?*, Bruegel 2016, p.9
[980] Hougaard Jensen and Schoenmaker, 2020
[981] The most problematic Eurozone banking markets during the GFC and its aftermath: Portugal, Italy, Greece and Spain.

ratios, and other factors also need to be taken into account.[982] Crucially, they debunked the popular oversimplification that by simply being a predominantly host country the State becomes inclined to participate, as the examples of Bulgaria, Croatia and Lithuania would indicate. According to Mérő and Piroska, countries sharing one or two structural characteristics can have differing positions vis-à-vis the EBU and a more holistic assessment is necessary.[983] Their findings are generally in line with Howarth & Quaglia's and Epstein & Rhodes's hypotheses that history of difficulties during the GFC increase the likelihood of participation.

However, while they provide a robust technical analysis based on a good set of data, they only apply it to Eastern European NoPS. Moreover, Mérő and Piroska's methodology does not leave enough room for nuance in participation willingness assessment. Much like Howarth and Quaglia, Mérő and Piroska simplify participation willingness level to essentially three levels: opting-in, opting-out and wait-and-see.[984] The 'wait-and-see' position, when allocated a numerical bracket of the same size as the ones for determined participation and non-participation, is bound to create false equivalences and distort the findings. It fails to answer two fundamental questions: "wait for how long?" and "see what?". In effect, Poland and Czechia's 'wait-and-see' actually meant 'no' and Croatia's 'wait-and-see' meant 'yes'. These limitations did not allow Mérő and Piroska's work to reveal the full picture, and arguably distorted the conclusions.

Unlike all of the above-mentioned researchers, Mérő and Piroska argued that the participation choices *cannot* be explained by the structural characteristics.[985] Instead they sought to demonstrate "how banking nationalism dominates policy making in CEE, and that this policy choice explains their distance from the BU."[986] I partly disagree with this conclusion. I argue that structural characteristics need to be considered *alongside* government policies and political predispositions. With a sufficient sample sizes including all NoPS and multiple structural indicators, clear patterns become evident.

6. *Schimmelfenning*

Similarly to Mérő and Piroska, Schimmelfenning also did not accept the argument that participation willingness is impacted by structural characteristics to a material extent, and

[982] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.4
[983] Ibid. p.1
[984] Ibid.
[985] Ibid. p.9
[986] Ibid. p.3

relied on a different line of reasoning. As discussed in Chapter 1, he argued that the "membership in the banking union is congruent with euro area membership."[987] He did not *deny* the existence of predispositions resulting from structural characteristics. His main contention is that the effects of prior differentiated integration stemming from the EBU *override* the impact of structural characteristics and other domestic factors.[988]

Schimmelfenning further explains that despite the availability of the CCA, EBU membership follows the division between EMU States and the NoPS, which is in line with the path-dependency hypothesis, detailed in Chapter 1.[989] Simplistically, the hypothesis holds that the EU has become fundamentally differentially integrated after the EMU and thus the divisions on the EBU are merely a consequence of a series of previous schisms. He bases this conclusion on the SSM and SRM legislation, as well as the Treaties, pointing to the fact that EBU membership is mandatory for EMU States, but non-mandatory for NoPS, and even when the latter opt in, the Union creates fundamentally different rights and obligations for both groups of States.[990]

Moreover, according to Schimmelfenning, while the original differentiation between the EMU States and the rest of the EU has put both groups on different paths of integration, different financial crisis experiences and the resulting reforms have forced their respective curves to diverge even further, drawing distinctly different trajectories.[991] It is argued that the EBU "was designed to meet the deficits" of the Eurozone and thus "its institutional setup reinforced the original reasons why Non-Eurozone states decided to abstain from the euro area."[992] As a result, the banking union "not only reaffirms the original differentiation" but also "widens the institutional gap between the euro area and the rest of the EU."[993]

While written as an antithesis to the hypotheses based on structural characteristics, Schimmelfenning's work itself rests on the presence of a national characteristic: the willingness to join the EMU. It is arguably the most important structural characteristic, but I nevertheless argue that it needs to be considered in conjunction with other characteristics, as Howarth and Quaglia's findings on the EMU States originally suggested.

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[987] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.487
[988] Ibid.
[989] Ibid. p.492
[990] Ibid.
[991] Ibid. p.484
[992] Ibid.
[993] Ibid.

7. *Summary of hypotheses*

These publications, in conjunction, paint a broad-stroked picture of a country that would be willing to participate in the SSM and SRM. Table 5.1 summarises the structural factors highlighted by these publications and the resulting rationales for joining the EBU stemming from them. These are simplified and will be elaborated on hereinafter.

Table 5.1: *The ultimate participating state*

Structural Characteristic	**Rationale for joining the EBU**
Highly internationalised domestic banking sector	Additional financial backing for crisis situations via the SRF. Ability to resist the influence of parent banks.
High foreign bank penetration	Improved supervision of the parent institutions and prevention of loss-shifting to/from non-participating states.
Highly concentrated banking sector	Systemic importance of large banks active in the state to the domestic economy.
High percentage of non-performing loans	Financial backing in case of resolution/recapitalisation.
Loss-making or stagnated banking sector during the GFC	The need to move away from a failed approach, public pressure.
History of banking failures or bad NCA performance	Blame-sharing and financial backing in case of resolution, public pressure, need to reform the NCAs.
Presence of large domestic international banks	Need to spread the blame in case of failure and ensure the availability of resources for recapitalisations and resolutions, improved supervision of branches and subsidiaries abroad.
Exposure to Euro peripheries	Dangers posed by interconnectedness with states dealing with problematic banking sectors or high non-performing loan levels.
Short-medium term intention to join the EMU	Unavoidability of eventual membership, full participation rights in the SSM and SRM decision-making. Use of the ESM.
Political impetus towards EU market integration	Macroeconomic interest in pan-European financial stability. Avoidance of contagion effects.

Most of these factors can be expressed numerically and compared. However, in order assess how they correlate with participation intentions, a participation willingness index needs to be devised.

5	**4**	**3**	**2**	**1**
Applied	Formally expressed interest	Expressed multiple different positions or regularly reviews the position	Expressed reluctance, subject to review	Formally decided to opt out

Table 5.2: *Numerical Participation Values*

As mentioned, for that purpose I adopted Spendzharova's 1-5 scale.[994] In my adjusted classification, the Czech Republic (1), Hungary (3) and Denmark (3) retained Spendzharova's original scores. Bulgaria and Croatia, which have joined the EBU, are assigned the maximum value of 5. Romania has previously expressed its intention to participate but has not moved to do so, which results in the ranking of 4. Sweden has formally decided not to participate, and alongside the UK, refused to sign the SRF agreement, thus barring itself from participation in the SRM. It is therefore assigned the value of 1. Poland has decided not to participate 'for the time being', and was assigned the value of 2, moving down by one mark from Spendzharova's original classification. Such classification is obviously somewhat simplified, as it does not reflect some nuances like the permanent EMU derogation of Denmark, barring it from participating in the Governing Council. Sweden is, legally speaking, more 'non-participating' than Czechia. The later is still technically able to sign the CCA at any point, whereas Sweden would need to sign the SRF intergovernmental agreement first. With that being said, such simplistic assessment is the established method in the literature on the subject and it is sufficient for the purposes of this thesis. I will now turn to comparing this indicator against the hypotheses summarised in Table 5.1.

B. Structural Analysis

Looking at any summary of the NoPS concerns, including the one provided in Chapter 4 of this thesis, the immediate impression is that many of them are strikingly similar, especially if the different weights that States assign to particular concerns are ignored. However, the positions and plans of non-Eurozone States differ. This section aims to look at the structural characteristics of the NoPS banking systems, in an attempt to find correlations between such characteristics and willingness to participate. It then proceeds to analyse these correlations, seeking to find possible causal relationships. I use comparative political economy analysis of national banking systems, testing the hypotheses discussed in section B. This section finds that certain banking sector structural characteristics can present significant incentives and disincentives for participation of individual States.

[994] AB Spendzharova, *Banking Union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-States: Regulatory preferences in banking supervision*, Review of International Political Economy, 21:4, 2014, p.959

1. The internationalisation and concentration hypotheses

As discussed in section A, Spendzharova, Epstein and Rhodes, as well as Howarth and Quaglia, used internationalisation and (to a lesser extent) concentration as indicators in determining the ultimate willingness of an EU State to participate in the EBU. In principle the hypothesis is that the higher the levels of these two indicators, the more likely the state is to participate. Mérő and Piroska notably questioned the validity of this hypothesis.[995]

a) Measuring internationalisation

The term 'banking internationalisation' has been understood in a variety of ways and even the very existence of such measurement has been questioned.[996] For the purposes of this thesis I focus on internationalisation of the banking system of a given non-EMU State. However, even this, narrow, aspect is not understood in a uniform way. Distinction has been made between inward and outward internationalisation,[997] as well as between foreign bank ownership and internationalisation of the activities of domestic banks.[998] The term inward internationalisation is used when foreign institutions settle and operate in a country or region.[999] Outward internationalisation is defined as the establishment of the banking institutions of a given country in other countries.[1000] Inward nationalisation is often used interchangeably with the terms 'foreign bank penetration' and 'foreign bank ownership'. Variance of terms aside, it is the measurement used (or criticised) by all researches cited in the literature review in section A, as well as the majority of publications in the field. Aarma and Dubauskas proposed several criteria, which can be used to calculate internationalisation: the volume of banking claims in foreign countries, the share of banking claims in foreign countries as a percentage of total banking claims, structure of an institutions' balance sheet, the quantity of foreign banking institutions, the share of foreign banks' assets as a percentage of total banking market assets, etc.[1001]

This list of criteria is as diverse as are the limitations to their informative value. In line

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[995] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.1
[996] R Aliber, *International banking: a survey*, 1984 p.666
[997] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.1
[998] A Spendzharova, *Banking Union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-States: Regulatory preferences in banking supervision*, Review of International Political Economy, 21:4, 2014, p. 960
[999] Aarma and Dubauskas, 2012, p.1
[1000] Ibid. See also S Pintjens, *The Internationalization of the Belgian Banking Sector: A Comparison with the Netherlands*, University of Antwerp – RUCA, 1994
[1001] Ibid.

with the majority of publications on the subject, for the purposes of this research, I chose the percentage of foreign banks' assets among the total banking market assets, and used Hougaard Jensen and Schoenmaker's data.[1002]

b) Inward internationalisation

As mentioned, Spendzharova, Epstein and Rhodes, as well as Howarth and Quaglia, consider inward internationalisation to be linked to participation decisions. The general correlative tendency with participation willingness is obvious in relation the two CCA States (Bulgaria and Croatia), Romania, which has declared an intention to join, as illustrated in Fig.5.1 below. Hungary and Poland and Sweden's positions are also in line with this hypothesis. It should also be noted that over 90% of 'foreign' assets in Sweden are held by formerly-Swedish Nordea.

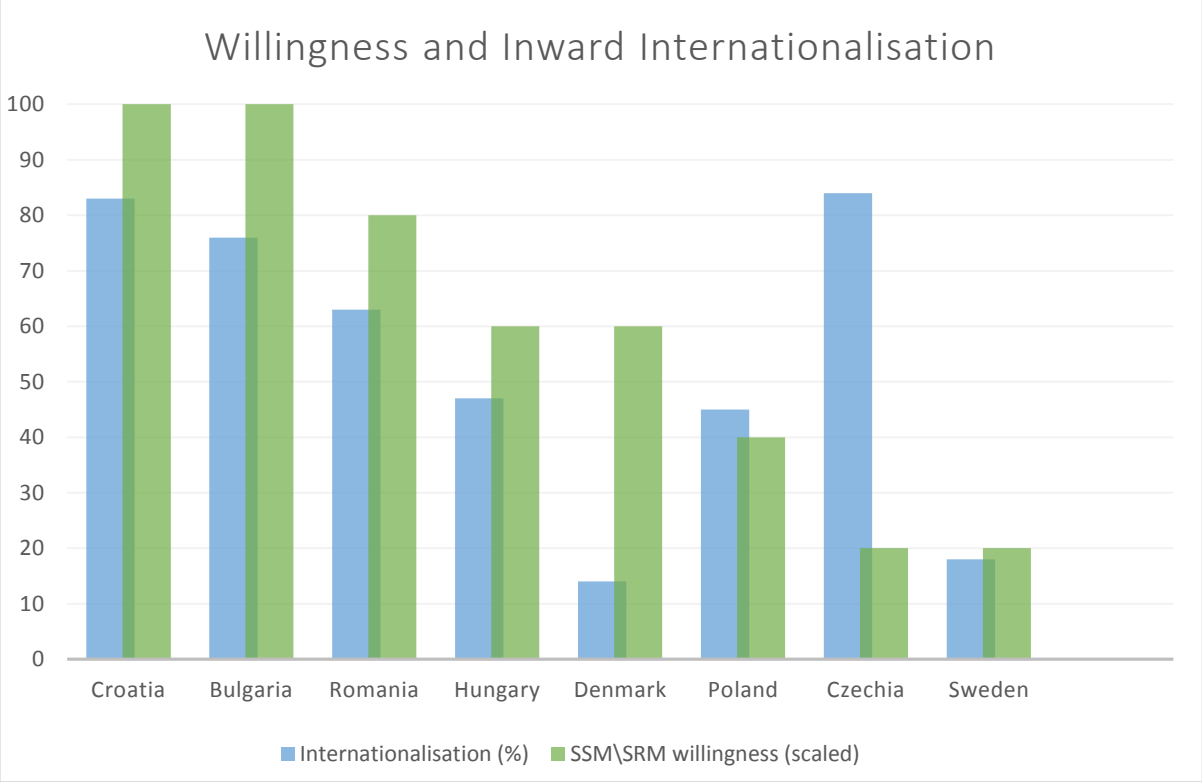

Fig. 5.1: *Willingness and internationalisation. Data: Hougaard Jensen and Schoenmaker (2020)*

Denmark has very low inward internationalisation. However, since it has not formally made the decision, this does not (yet) indicate a discrepancy, and thus does not constitute an

[1002] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020, p.4, they use data from J de Haan, D Schoenmaker, P Wierts, *Financial Markets and Institutions: A European Perspective*, 2020

outlier *sensu stricto*. The Czechia could be reasonably argued to be an outlier. In fact, it appears to be the *ultimate* outlier in this analysis, with the highest inward internationalisation among the NoPS, and exceptional unwillingness to participate.

c) The Czech Republic: the ultimate outlier or a new rule?

Czechia's stance has puzzled many researchers trying to develop a structural-characteristics-based explanation for the NoPS' positions. Howarth and Quaglia concluded that the "main exception remains the Czech Republic, where foreign ownership by EU banks was high, but the country expressed no intention of joining the SSM."[1003] They observed that looking at the level of inward internationalisation, Czechia would seem to have more incentives to join the SSM than Poland and Hungary. In this respect it is more similar to the opt-ins: EMU Latvia and Lithuania, EBU Bulgaria and Croatia, and (potentially) EBU Romania. Profant and Toporowski point out that in Czechia there are only two state-owned banks, serving specific purposes, and only one universal bank, FIO Bank, is fully owned by the domestic capital.[1004]

Moreover, as I will explore further in subsection d), the Czech market is also quite concentrated with TOP4 banks holding the majority of banking assets, with parents mostly headquartered in the Eurozone, and most subsidiaries wholly owned.[1005] Darvas and Wolff thus provided a detailed account of the incentives for Czechia to join the EBU, presented by such market characteristics.[1006]

There are several potential explanations for the Czech phenomenon. Firstly, as discussed in Chapter 4, Czechia is not ideologically opposed to the EBU, nor is it a particularly Eurosceptic country. Its concerns are largely about *how* the EBU was built, not the premise of the Union itself. The Czechs are not oblivious to the incentives, just painfully aware of the disincentives.[1007]

Secondly, it is possible that a country can reach such levels of inward internationalisation that it actually *stops* being an incentive to participate. Darvas observed

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[1003] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.20
[1004] Ibid.
[1005] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.3
[1006] See Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013
[1007] See Ministry of Finance, Ministry of Foreign Affairs, Office of the Government of the Czech Republic, Czech National Bank, *Impact study of participation or non-participation of the Czech Republic in the Banking Union*, 2015

that as "over 90% [around 79% from Eurozone] of Czech banks are owned by west European banking groups, if they need to be recapitalised [that] will anyway be done by the parent group."[1008] As discussed in the previous Chapter, the phenomenon where being a host banking market actually works to the advantage of the host state during a systemic shock occurred during the GFC in the Baltics. Kattel and Roudla observed that the Baltic states gained additional wiggle room provided by the high internationalisation.[1009] As a result of the Nordic banks refinancing their own subsidiaries, the less troubled Estonia and Lithuania could also keep more fiscal space for their domestic bail-outs and other crisis management processes.[1010] Consequently, especially if the parent institutions are headquartered in the Eurozone, the negatives of not having access to the SRF and the ESM are mitigated. This is likely to be the case for Czechia.

Thirdly, it could be argued that in some ways high internationalisation creates pre-conditions for improved national supervision, or at least eliminates some of the obstacles. Internationalised ownership structures can also mean that there is little scope for the national champion and home bias issues, especially if disruptive effects stemming from other countries' participation are avoided. Moreover, due to their character as international banking conglomerates, most of the parents of the banking groups operating in Czechia are already supervised by the ECB, which means that the Czechs are also indirectly benefiting from the SSM, without incurring the associated monetary costs and autonomy sacrifices. Just like most NoPS, this State does not fundamentally distrust the ECB or SSM NCAs on the operational level, and recognises the quality of their parent bank supervision.

Fourthly, a state where all major market participants are foreign-owned, has (in some sense) already lost a lot of control over its banking sector. It might therefore be unwilling to weaken the only leverage instrument it still has left – the NCAs. Spendzharova argues that being a host jurisdiction to foreign financial institutions constrains states' ability to steer credit flows and tackle perceived threats to national financial stability.[1011] As discussed in Chapter 3, that can be dangerous, as during systemic crises, home NCAs have strong incentives to pursue policies that minimise losses for domestic stakeholders and shift burdens

[1008] T Bowker, *Czech central bank opposed to joining banking union*, Central Banking, 29/04/2013, see also commentary of Darvas and Wolff, *Should non-euro area countries join the single supervisory mechanism?*, 2013
[1009] R Kattel, R Raudla, *The Baltic Republics and the Crisis of 2008–2011*, Europe-Asia Studies, 65:3, 2013, p.442
[1010] Ibid.
[1011] AB Spendzharova, *Banking Union under construction: The impact of foreign ownership and domestic bank internationalization on European Union member-States: Regulatory preferences in banking supervision*, Review of International Political Economy, 21:4, 2014, p.951

onto foreign ones.[1012] This, in turn, raises decision-makers' sensitivity regarding any transfers of regulatory authority away from the NCAs.[1013] Obviously, such situation is traditionally argued to be an incentive to participate in the SSM, as the host State, like Czechia, would then gain *some* control over the parent entities, but that is only the case if the State believes that it is gaining that control. As discussed in Chapter 4, just like many other NoPS, Czechia is not convinced that this would be the case.

Obviously, taking high internationalisation as a *disincentive* would be very risky for a State which has its own international banking powerhouses, sporting significant cross-border presence, but this is not the case with Czechia. In this country, inward internationalisation is so high that it simply does not leave enough domestic market share for outward internationalisation via sprawling domestically-owned banks.

d) Outward internationalisation

Due to the limitations of the informative value that the characteristic of inward internationalisation presents, outward internationalisation can be an important factor, which might explain the positions of some States. According to Aarma and Dubauskas, outward internationalisation is best understood as "the importance of the domestic banks in foreign and international financial markets."[1014] That can mean a lot of things, including the number of foreign outlets, banks acting as intermediaries for international payments or attracting liabilities in foreign currencies, provision of international financial services, expanding electronic banking activities abroad, etc. In Aarma and Dubauskas's paper internationalisation of banks (as a process) is described as "enlargement of banks' movements into foreign markets by setting up controlled units in foreign countries."[1015] I adopt this understanding of outward internationalisation, using the value of the assets held by such 'controlled units' for comparative purposes. While other measurements also have their merits, value of assets is typically used for internationalisation measurement in most of the literature cited in this Chapter.

Simplistically speaking, high outward internationalisation can create the risk of 'the Icelandic problem', discussed in Chapter 4, when the country's banking sector becomes disproportionately big relative to its GDP, as it expands abroad. Under severe market stress

[1012] Ibid.
[1013] Ibid. p.973
[1014] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.2
[1015] Ibid, see also; J Uiboupin, *Performance of domestic and foreign banks in transition countries*, Banks and Bank Systems 1(3):41-59, 2003, pp.155-161

such banking system can face a systemic collapse, as the state cannot afford to recapitalise the banks. Schoenmaker and Hougaard Jensen see this factor as a major incentive for Denmark and Sweden to join the EBU.[1016] The BRRD bail-in tool might not be a sufficient bulwark in case of a systemic shock. Arguably, this is the biggest danger of non-participation, especially for a State with otherwise solid day-to-day supervision and regulation structures.

However, such dire scenario would not materialise without the presence of at least one highly internationalised domestic behemoth, the likes of which Czechia does not have. The Czech position can thus be partly explained by low outward internationalisation, which is (depending on chronology) either a natural consequence of high inward internationalisation or the reason *for* high inward internationalisation (or both). This logic could also be used to explain the positions of the other two Visegrad NoPS. Poland, also a fairly reluctant NoPS, has a few medium-sized internationalised entities. However, Poland is also a large country of 38 million people. Therefore, its largest bank, PKO BP, and its 296.912 billion zloty (£61 bln.) asset portfolio seems manageable, relative to Poland's (approximately £457 bln.) national GDP. Moreover, for Poland the threats posed by inward internationalisation are not severe, as the overall internationalisation is below 50%, with the largest foreign entrants already supervised by the ECB. Outward internationalisation also does not seem threatening, as the combined assets of all Poland's banks' international assets barely reach a quarter of its GBP. The story is very different for ten million people Hungary, home of the international OTP group.

e) Hungary and the OTP group – the impact of outward internationalisation

Hungary not ruling our EBU membership entirely comes across as a bit of a surprise. In principle, lower inward internationalisation, compared to the majority of its Eastern European counterparts, and one of the most Eurosceptic governments would naturally suggest a stance similar to that of the Czech Republic or at least as cautious as Poland's. However, Hungary was one of the first NoPS to implement the Single Rulebook and mirror the SSM arrangements.

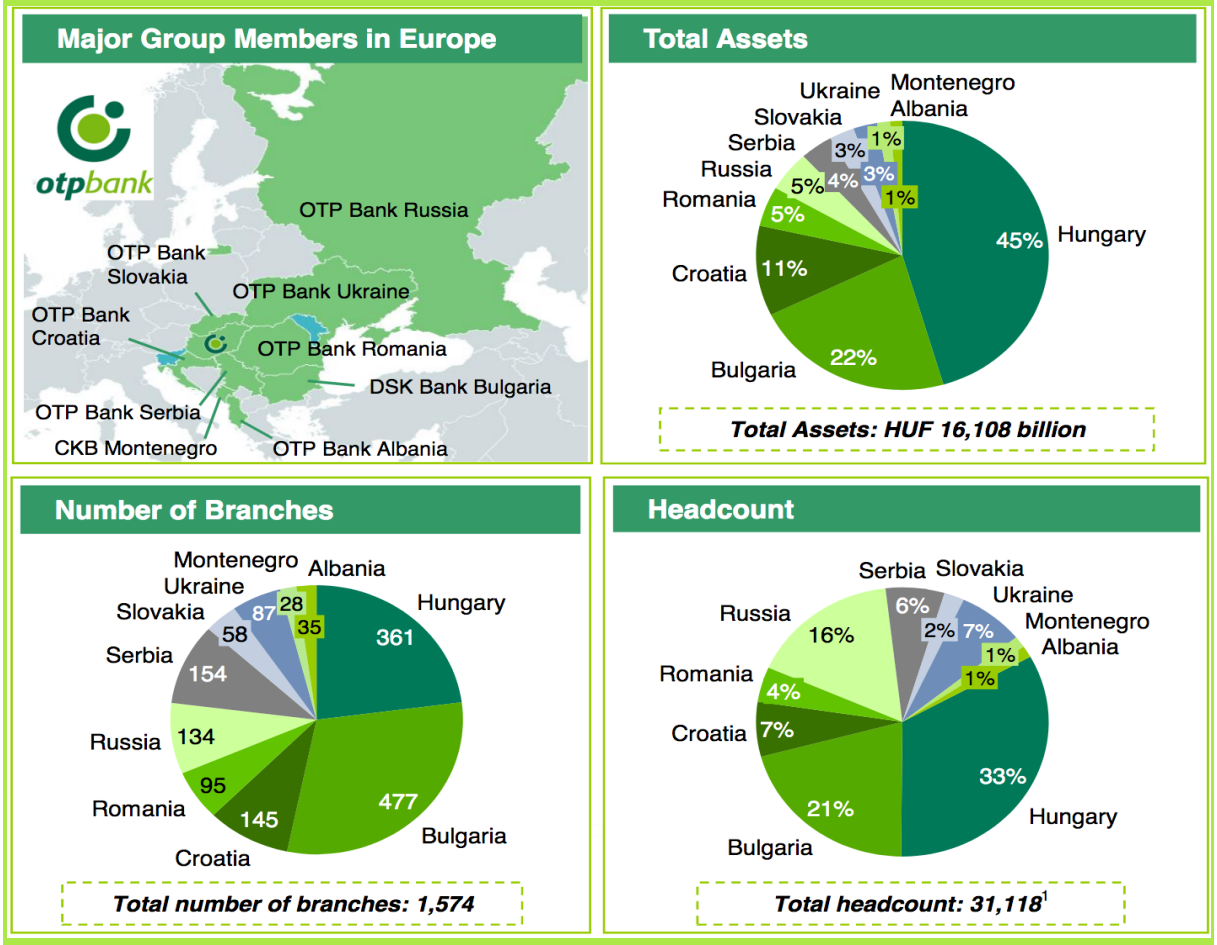
In the literature Hungary is often placed within the same bracket as Poland and the Czech Republic, in terms of both: structural characteristics and position. Mérő and Piroska went as far as to contend that "Hungary's position is still the same" as that of its Visegrad

[1016] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020, pp.9-10

counterparts and that "this fact in itself disproves Spredzarova's argument which presupposes similar policy formation under similar structural constraints."[1017] This assessment is not correct. Mérő and Piroska are correct in arguing that the discrepancy between the Czech Republic and Hungary cannot be explained by inward internationalisation. However, other factors, including outward internationalisation, can contribute to such explanation. The main reason for Hungary's unexpectedly favourable (given its overall level of euroscepticism) attitude towards the SSM and SRM, and especially the Single Rulebook is its financial behemoth – the OTP group.

Case Example: OTP Group

The Budapest Headquartered OTP group is the most internationalised Eastern European bank in the European Union. The bank offers commercial banking services in Hungary, Bulgaria, Russia, Ukraine, Croatia, Romania, Slovakia, Serbia, and Montenegro.



Source: OTP, 2019[1018]

[1017] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.4

[1018] OTP Group, *Investor presentation based on 1Q 2019 results*, 2019, p.4

Unsurprisingly, it is Hungary's largest bank. Moreover, it is also the largest bank in Bulgaria measured by the 'banking hat trick' - assets, loans and deposits. Its asset portfolios in the smaller host economies are generally quite large. By assets OTP is also leading in Montenegro and occupies the 4th position (close to 3rd) in Croatia.[1019] Mérő and Piroska highlighted OTP as a major difference between Hungary and other CEE countries in their research.[1020] Its (approx. £38 bln.) asset portfolio is also quite large relative to Hungary's (approx. £145 bln.) GDP. Especially since over 50% of these assets are located abroad. Darvas and Wolff saw the international presence and domestic market share of OTP as a major incentive for Hungary to join the EBU.[1021]

OTP aside, the rest of Hungarian banking market is quite diversified. The key players, in addition to OTP, are "large and medium-sized foreign banks with a strong corporate and retail market presence and an ownership structure largely subject to the Banking Union, mixed-activity small banks and […] cooperative bank[s]." [1022] Hungary thus also exhibits a healthy degree of inward internationalisation.

Unlike Czechia, Hungary therefore faces simultaneous pressures as a host and a home country in international banking, and is also consequently facing both types of associated risks. By contrast, the Czech Republic only faces inward internationalisation. It can be concluded, that internationalisation can play a part in the decisions of some NoPS, but the assessment of this indicator needs to take into account both inward and outward internationalisation. Moreover, internationalisation as a factor carries different weight in different states, depending on what other states they do cross-border banking business with, the size of the banking sector relative to the overall economy, and the size of the international banks relative to the GDP.

f) Concentration

The measurement of concentration is quite straightforward: it usually reflects the market share of 3-5 largest institutions in the country, either by assets, customers or claims. The most common measurement is the value of banking assets, used by the majority of researches I have

[1019] Ibid.
[1020] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.4
[1021] Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013, p.5
[1022] K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.8

reviewed. This characteristic formed part of the hypotheses of Howarth and Quaglia, Spendzharova, and Epstein and Rhodes. There seems to be a consensus that high concentration correlates with willingness.[1023] Establishing causal relationship, however, has been more problematic. The causal relationship can be inferred by looking at the (atypically direct) legal relevance of this characteristic for the participation decision. Since, pursuant to Art.6(4) SSMR, the three biggest institutions in every participating State are to be supervised by the ECB directly, the more concentrated the market is, the bigger proportion of it will automatically fall within the ECB's domain. That effectively means that the stakes for a highly concentrated States are higher, as the ECB would directly supervise a bigger chunk of their markets. This is particularly the case for smaller States, which are home to large or medium-sized banking groups.

This can be illustrated by the example of Sweden. Howarth and Quaglia emphasised that high concentration effectively means that by signing the CCA Sweden would effectively put its entire banking sector under the ECB's supervision.[1024] As a State in (practically) permanent EMU derogation, Sweden does not have an incentive to participate stemming from the prospect of eventual Eurozone membership. As discussed in Chapter 4, it has very low inward internationalisation and its outward internationalisation has mostly taken place within the extended home market, which arguably reduces the likelihood of external shocks. Moreover, the Swedish banking sector is largely domestically-owned, with some presence of banks from other NBR countries. The percentage of bank assets held by other EU-owned subsidiaries or branches is the lowest in the EU.[1025] Howarth and Quaglia thus argued that the limited EU bank presence in the Swedish market weighed more heavily than the significant Euro area presence of Swedish banks in Finland and the Baltic States.[1026] They also point to limited exposure to the Euro periphery, which I will address later in this section. This can be contrasted with Hungary's OTP, with significant exposures to, as well as presence in, southern European States, many of which have high levels of non-performing loans.

The example of Sweden thus illustrates that the 'high concentration = participation' hypothesis is an oversimplification. Moreover, Howarth and Quaglia's assertion that concentration correlates *grosso modo* with participation willingness does not apply to the NoPS, as Fig.5.2 below illustrates. In fact, all NoPS have high average concentration of

[1023] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.10
[1024] Ibid. p.18
[1025] Ibid.
[1026] Ibid.

almost 67% and they all are - as the name suggests - not participating.

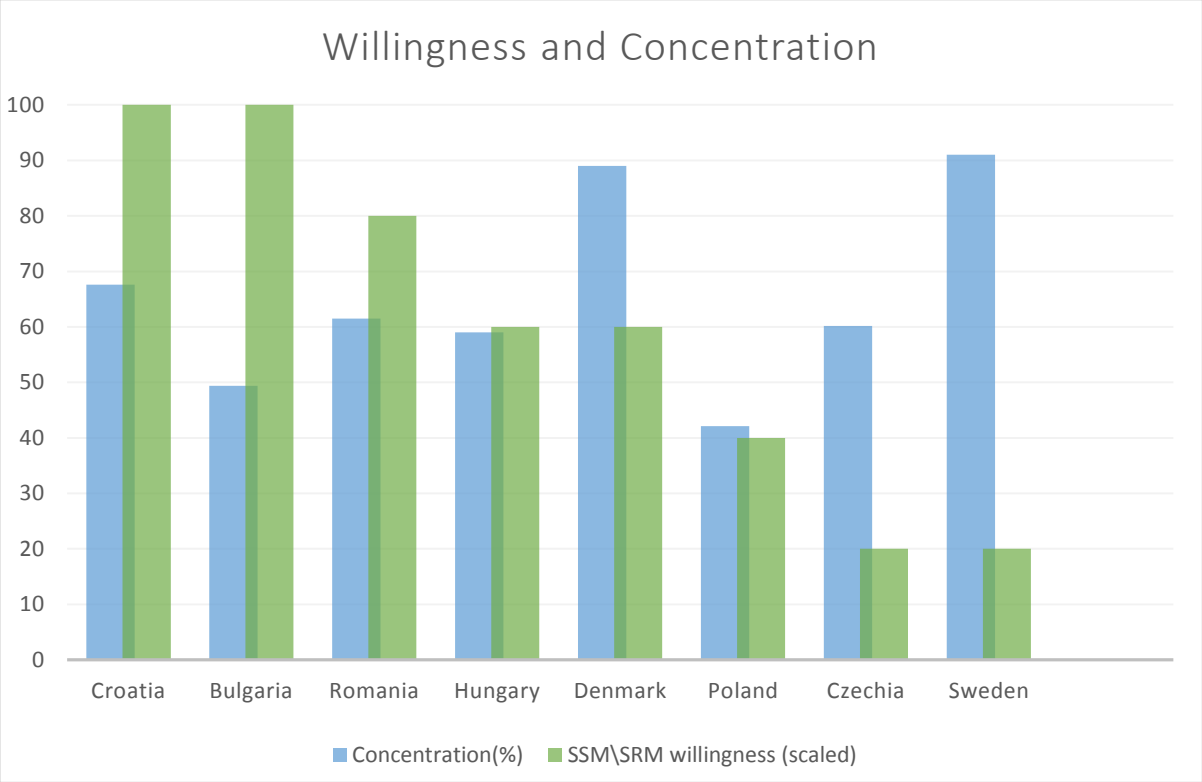


Fig.5.2. *Data: Worldbank 2018*

Just like the internationalisation hypothesis, the concentration hypothesis needs to be applied in a more nuanced way. Purely on the basis of the NoPS banking statistics, it would seem that concentration is not in itself a variable in the EBU equation, but rather a coefficient; an amplifier of other related factors. High concentration of *foreign-owned* banks seems to be an incentive to participate, as the case was with Latvia, Lithuania and is going to be with Croatia, Bulgaria, and Romania. However, for countries with high concentration of *domestically owned* banks operating mainly in their home market or extended home market - like Denmark and Sweden - concentration can become a disincentive, due to potential loss of control over otherwise domestic credit institutions, forming essentially the entirety of the domestic market. As an inevitable consequence, of this loss of control, the Swedish and Danish authorities would also see their influence on the Baltic regulators weaken.

Similarly, it could be speculated that a particularly problematic banking market would see high concentration as a potential *liability* and would *seek* the ECB's supervision. In such states high concentration would amplify the contagion effects in crisis situations. This effect could potentially be further amplified by a high total banking assets to GDP ratio. In any

event, it can safely be concluded that concentration is directly linked to the significance assessment of Art.6(4) SSMR and plays a role in the NoPS considerations.

2. The financial stability and regulatory performance hypothesis

One of the most established hypotheses in this discussion is that the less willing NoPS had sturdier economies and/or better performing NCAs during the GFC. This hypothesis is upheld in all of the sources discussed in section A (even the ones arguing against reliance on structural indicators), and is arguably one of the most important factors in the EBU considerations. Among the EU policy makers there is a "generally accepted notion [that] the entry into the Banking Union tends to be more beneficial for Member States, where the domestic banking sector is less stable."[1027] Profant and Toporowski argued that Non-Eurozone Visegrad countries drew conclusions from the fact that their regulatory and supervisory authorities were successful during the GFC, discouraging unnecessary risks and encouraging capital reserves.[1028] Mérő and Piroska argued that Bulgaria and Romania are keen to join the EBU because of the fragility of their banking systems "coupled with a low level of state capacity to maintain financial stability."[1029] In this subsection I will therefore assess the validity of these conclusions in the light of banking sector profitability levels in the aftermath of the GFC, and supervisory performance, as evaluated by policy makers and highly-regarded researchers. I find that the resilience of the banking sector and the track record of domestic NCAs can materially alter the NoPS positions.

a) Good performance of the NCAs

In the most reluctant NoPS, domestic supervisory and regulatory achievements have led to the belief that even outside of the EBU "the probability of the emergence of crisis situations can be reduced by a sound macro prudential policy" and the "appropriate use of supervisory tools, including early intervention."[1030] This stands in contrast with the ideological premise of the EBU. By providing for a larger level playing field the EBU, further aimed "at reversing the trend for financial institutions to contribute to the

[1027] Ministry of Finance, Ministry of Foreign Affairs, Office of the Government of the Czech Republic, Czech National Bank, *Impact study of participation or non-participation of the Czech Republic in the Banking Union*, 2015, p.4
[1028] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.5
[1029] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.3
[1030] K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.7

disintegration of the EU financial market by making the conditions for cross-border activity more effectively equivalent."[1031] This was meant to lessen regulatory arbitrage opportunities and weaken the influence of the "national champion" factor, by ensuring consistency in supervisory practices.[1032]

The crucial difference exhibited by the most reluctant NoPS is that the market confidence in them was retained to a greater extent, and therefore the need to cleave themselves from the past did not arise. Moreover, Czechia and (to a lesser extent) Poland do not have clear national champions, and thus the need to limit their influence did not arise either. Generally, the three most reluctant states - Poland, the Czech Republic and Sweden - see their financial authorities as models of best practices for resisting external shocks.[1033]

For example, Jiří Rusnok, the Governor of the CNB, highlighted the institution's technical achievements like successful implementation of inflation targeting, valuable technical know-how, and position as "one of the top players in this area."[1034] I have discussed the remarkable preparedness demonstrated by the Nordic states at some length in Chapter 4.

Crucially, good performance of the NCAs was often attributed to far-reaching national regulatory autonomy. This was often assisted by the ability of domestic banking sectors to perform their functions on autonomous basis. I have discussed the Swedish preference for autonomy and how it shaped its decision. Similarly, the Polish Financial Supervision Authority (UKNF) has stated that the banking sector performed well during the GFC because of the high autonomy of the sector, making it resilient to external shocks.[1035] They also emphasised a high level of prudence and actions of state institutions towards the stability of the sector, such as increasing liquidity, recommendation against dividend payments, and recapitalisations.[1036] Hungarian researchers also concluded that the "potential added value in the reinforcement of financial stability [through the EBU] in Hungary is limited."[1037]

Nordic and Visegrad sturdiness stands in stark contrast to many Eurozone States. From the NoPS' perspective most Eurozone States "provided relaxed rules to the banks, which

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[1031] EO Wymeersch, *The European Banking Union, a First Analysis*, Financial Law Institute Working Paper Series 2012, p.4
[1032] Ibid.
[1033] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.5
[1034] Interview of the CNB Governor Jiří Rusnok, CNB Press Release, 25/08/2016
[1035] Komisja Nadzoru Finansowego, cited by Profant, and Toporowski, 2014
[1036] Ibid.
K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.7

effectively resulted in the need for a common supervisory framework."[1038] This effectively created the underlying motivations for the EBU, not all of which are shared by the NoPS.

b) Good banking sector performance

The trust put in national regulators and the resulting preference for their autonomy is linked to the overall economic performance during the GFC. All three of the most reluctant countries recovered remarkably well. As quickly as 2015-2016 Poland and the Czech Republic saw the CEE region's fastest growth, ahead of the Eurozone Baltic States and Slovakia.[1039] Sweden and Denmark also returned to steady growth very quickly, while Hungary (notably) took a bit longer.

Poland's net banking profit in 2012 (the year the GFC effects weakened and EBU Proposals came out) was €2.5 billion, the Core Tier 1 ratio amounted to 12.6% and there were no banks with capital adequacy ratio below 8% - the Basel minimum value for a stable bank. Profant and Toporowski attributed this to strong and conservative domestic supervision, which discouraged banks from loosening their credit policies.[1040]

The Czech and Swedish banking sectors were even stronger, which was reflected in the public and political sentiment. According to Andrej Babiš, the GFC-time Czech minister of finance, and current prime minister, the banks were "very liquid and in very good shape."[1041] CNB's Singer has indicated that the Czech financial sector in the EU is extremely specific in that it is liquid and well capitalised, and although it is primarily functioning on a host basis, it is a net creditor towards the financial sector of the Eurozone.[1042]

The Czech banks were indeed highly capitalised with capital of high quality and respectable shock absorption capacity, with CET1 ratio of 17.2% and T1+T2 ratio of 17.8%.[1043] As CNB national stress tests repeatedly also indicate resilience to shocks.[1044] The capitalisation of the sector as a whole would remain above the regulatory minimum of 8%, even in a scenario involving a "sizeable decline in economic activity in the Czech Republic and abroad."[1045] The net profit of the Czech banks in 2013 (just before the decision to decline

[1038] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.5
[1039] SEB Bank, *Nordic Outlook Economic Research*, August 2015, p.31
[1040] T Profant, P Toporowski, 2014, p.2
[1041] Ibid.
[1042] T Zavadilova, *Bankovní unie se piblížilam, Česku ještě nehrozí*, e.15.cz, 2013, Translation is mine.
[1043] Data from: M Hampl, *Banking Union: The Czech Perspective*, 2015
[1044] See *Czech Banking Sector Stress Tests*, November 2014 and November 2020, Financial Stability Department, on testing methodology, largely mirroring the ECB.
[1045] Ibid.

participation was made) was €2.23 billion and the Core Tier 1 ratio reached as high as 16.77%.[1046] With one of the highest GDPs per capita in the Vienna Initiative countries Czechia is simply not keen on fixing what (at least from the national perspective) does not seem to be broken.

In line with the hypothesis, Sweden's banking sector was even sturdier than those of its Visegrad counterparts. Tier 1 capital ratios of all of its banks ranged between 11 and 15 percent.[1047] Sweden generally upheld banking sector requirements exceeding those of Basel III and the Single Rulebook in most respects. Generally, the banks in all three of the most reluctant NoPS outperformed the EU average and the vast majority of Eurozone States in terms of bank profitability during the post-GFC recovery period. This is illustrated by Fig.5.4 below.

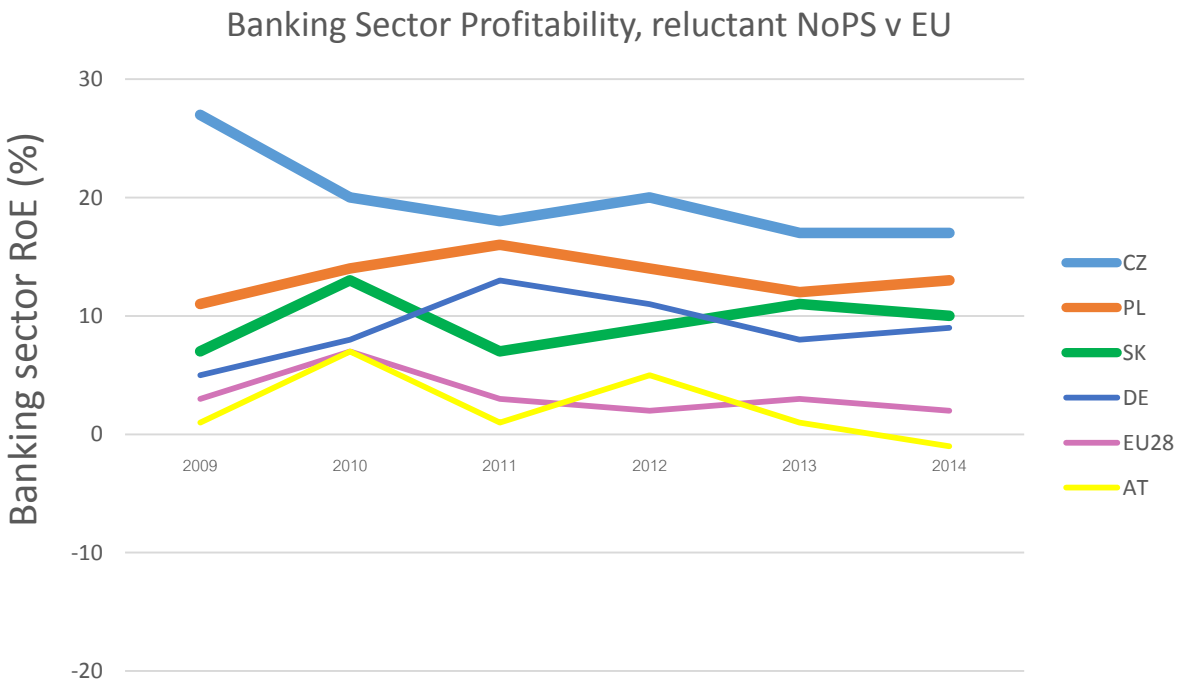

Fig.5.4, *Data: Trading Economics*

In this respect Croatia, Bulgaria and Romania stood in stark contrast. Taking the year 2010 as an example (the first year after the crisis) Bulgaria and Croatia roughly matched the EU average, and Romanian banks were among the very worst performers. Meanwhile, the most reluctant NoPS - Czechia, Poland and Sweden - towered over the EU average.

[1046] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.2
[1047] IMF, *Sweden Article IV Consultation*, IMF Country Report No. 12/154, June 2012, p.10

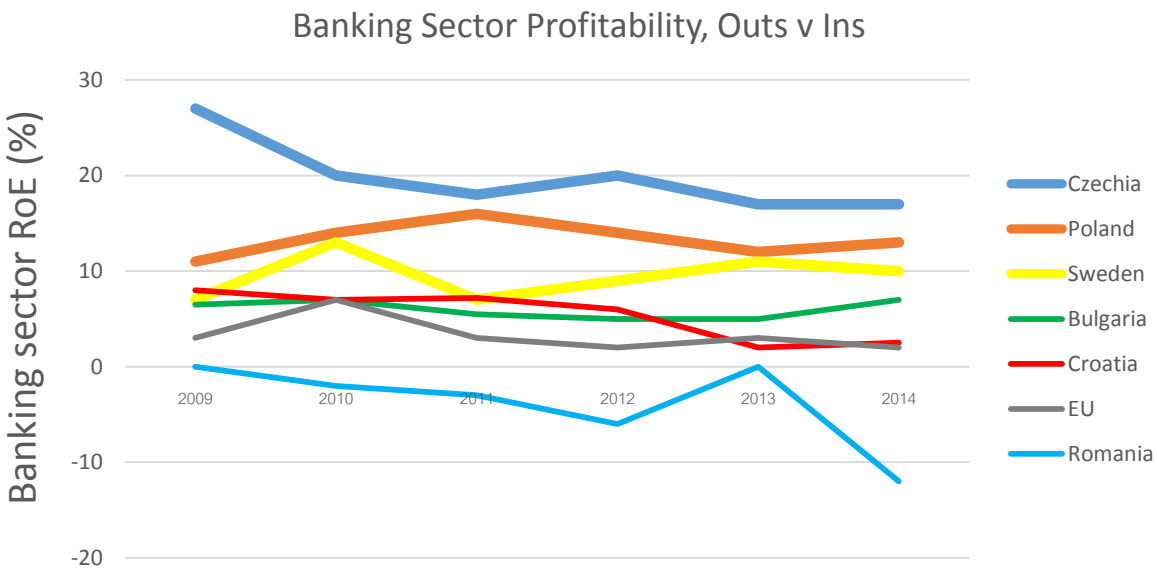

Fig.5.4, *Data: Trading Economics*

The performance of Croatian and Bulgarian banks in this period was far from catastrophic, but it was not good either. Moreover, Croatia's downward trend extended and plunged into loss-making territory in 2015-2016. Bulgaria also remained in generally downward trend until almost 2018, and, as discussed in Chapter 4, endured a major supervisory scandal.

It can therefore be concluded that the banking sector Return on Equity of banks in the three most reluctant NoPS was significantly higher in the post-crisis period than the RoE in the NoPS which decided to, or expressed the intention to, participate. A similar tendency could be observed in terms of the public perception of NCA performance.

c) Relying on past performance: dangers and indications

Generally, the most reluctant NoPS survived the GFC easier than their Eurozone counterparts or the keenest NoPS and lacked incentives for sovereignty-affecting changes. To paraphrase Wolfgang Schäuble, former FM of Germany, reforms are rarely agreed at the times of prosperity.[1048] It is not easy to persuade countries to tinker with what they consider to be an adequately performing system. In the absence of a systemic shock, there is a notable and well documented tendency, discussed in Chapter 1A-B, to uphold the existing structures. As Moloney aptly summarised:

[1048] A though expressed at Davos 2014 Debate: *Rebuilding Banking in Europe*, Moderated by LM Karlsson

"*National governance frameworks tend to reinforce [the existing] patterns of economic co-ordination, and Member States – deriving a comparative advantage from their institutional infrastructures and related economy types – can be expected to protect these institutions. While particularly acute with respect to financial market regulation, these interests have shaped domestic banking regulation and its development and supervision at EU level."*[1049]

Reluctance to reform and overreliance on the GFC experience has notably attracted criticism. Mérő and Piroska described the GFC-based considerations as "backward-looking" and implicitly containing "the unjustified assumption that the future probability of banking crises and the related resolution costs will be also lower in [the reluctant NoPS] than in the Eurozone countries."[1050] While the Nordic and Visegrad States have a solid track record of economic sustainability and resilience in crisis situations, that does not make any state or region *immune* to global financial fluctuations. While track record matters, banking profitability and past resilience are not necessarily the optimal predictors of future resilience. Even Denmark and Sweden might be taking what has been described as a "large and undiversified risk", since they "cannot provide a credible fiscal backstop to their large banks" in "the case of an asymmetric shock to the economy (e.g. a national housing market shock)."[1051]

As discussed, partly for that reason, Sweden has already endured Nordea's exodus. The Czech and Polish banks might also be more vulnerable than they seem at first glance. Profant and Toporowski observed that foreign-owned Polish and Czech banks are often subsidiaries of the foreign banks and also generally stand among the most profitable assets of the parent groups.[1052] This could be attributed to many factors, such as high fees, high interest rates, lower staff costs or exemplary asset management, but could also indicate excessive risk taking, wherever it is left unaddressed by the Basel guidelines or the Single Rulebook. As Nikolopoulos and Tsalas observed, "a vast amount of literature claims that enhanced competition may lead to increased credit risk undertaken by credit institutions. That is,

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[1049] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1618

[1050] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.2; for further criticism see Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel 2013

[1051] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020, p.7

[1052] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.3

especially if their quest for market share instigates an undue relaxation of lending standards."[1053] This phenomenon, as discussed in Chapter 4, occurred in the Baltics in the run-up to the GFC and typically correlates with bubbling prices of a particular type of assets, such as a group of stocks or housing. This is particularly concerning in relation to the Czech Republic, whose high banking profitability correlated with skyrocketing real estate prices.

Long term, industry might also pressure the central banks into undue laxity, even if it is not doing so now. As Aarma and Dubauskas observed, where central banks are weaker, the

"*dominant commercial banks take over the central bank's role in regulating the money supply and demand. In the absence of a serious interest in the country's macroeconomic stability, the international banks maximize their profits and increase supply of money by widely giving cross-border credit from the funds of the primary banks*."[1054]

Over-reliance on past regulatory performance can also be questioned, as such assessment is vulnerable to confirmation bias.[1055] It is natural to speculate that a State which is already unwilling to join the SSM/SRM would claim that their national supervision and resolution authorities are superior and have performed well. The opposite is also true – a State willing to participate would be keener on admitting supervisory failures.

d) Impact on the decisions of undecided States

However, despite the dangers stemming from overreliance on past experience, such considerations undoubtedly impact the participation decision. It is therefore worth addressing the two 'wait-and-see' states – Denmark and Hungary.

[1053] KI Nikolopoulos, AI Tsalas, *Non-performing loans: A review of the literature and the international experience*, in Monokroussos, Platon and Gortsos, Christos (eds.) Non-performing Loans and Resolving Private Sector Insolvency, Springer International Publishing, 2017, pp.47-48

[1054] A Aarma, G Dubauskas, *Foreign Commercial Banks in the Baltic States: Aspects of the Financial Crisis Internationalization*, European Journal of Business and Economics 2012, p.1

[1055] In the legal and economic context confirmation bias often manifests as a tendency to interpret past data as a predictor for future events.

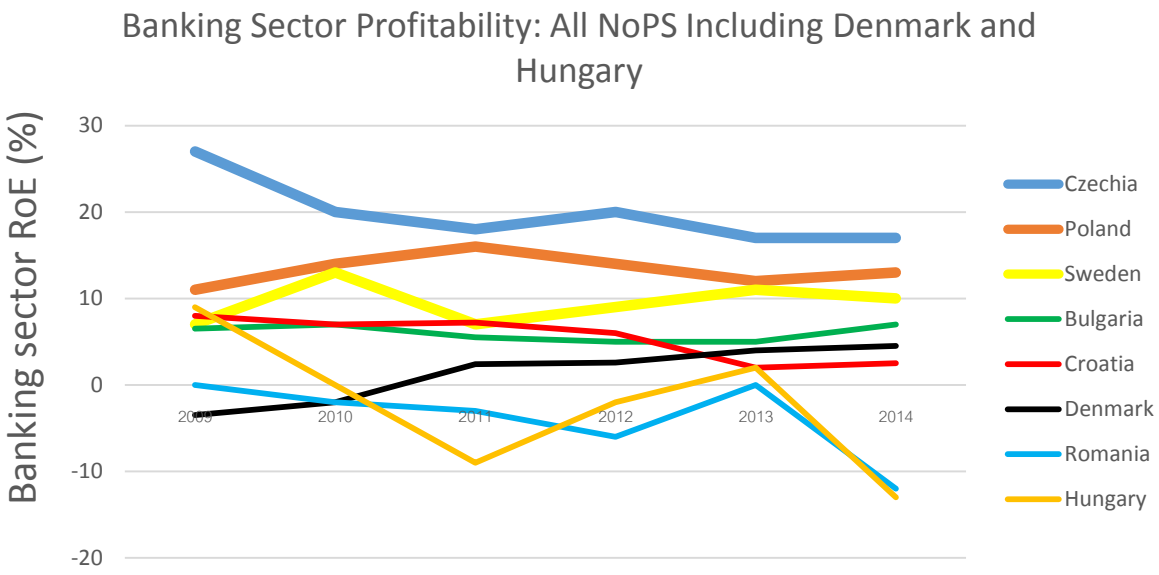


Fig.5.5, *Data: Trading Economics*

The chart (above), including all NoPS, reveals that in the post-crisis period Hungary and Denmark had banking sector RoEs closer to those of the opt-ins than those of the determined outs. Hungary broadly followed the pattern of Romania, while Denmark was comparable to Croatia, albeit demonstrating an increasing, rather than decreasing trend, which eventually reached double-digit profitability in 2017-2018. As discussed, Denmark (the only State in permanent EMU derogation and Hungary (one of the most Eurosceptic EU States), went against their (seemingly natural) predispositions and did not rule the EBU out completely. While both states' NCAs performed reasonably well during the GFC, banking sector profitability might still be a part of the equation.

3. *The non-performing loan hypothesis*

As mentioned, banking sector profitability, is not the only (or best) indicator of the banking sector health. It only forms part of the puzzle. Another significant structural characteristic is the level of non-performing loans as a percentage of all loans. This subsection therefore analyses the potential impact of this structural characteristic on participation decisions. The tested hypothesis is: the higher the percentage of NPLs - the more likely the NoPS is to participate.

a) Significance of the NPLs

Healthy banking sectors require successful performance of maturity transformations – well-performing loans. As J.C. Juncker summarised in one of his last State of the Union Speeches, non-performing loans (NPLs):

Fig. 5.6 *NPLs after the GFC, Source: stratfor.com*

> *"not only impede banks' competitiveness, but they also limit their ability to lend to the economy. While the responsibility for tackling NPLs falls primarily to the affected banks or Member States, there is nonetheless a European dimension."* [1056]

According to Nikolopoulos and Tsalas, "empirical studies indicate that problem loans are usually responsible for bank collapses as well as increased vulnerability of the banking and broader financial sectors."[1057] One of such studies, conducted by Barseghyan, indicates that NPLs can cause a decline in economic activity by locking in and crowding out funds that could otherwise be used for performing investments.[1058] As discussed in Chapter 1, NPLs were among the most important underlying reasons for the GFC. It is thus reasonable to assume that a country with a high percentage of problematic loans would want to benefit from the reputational advantages of the ECB supervision and EU-level liquidity support mechanisms.

b) NPLs and willingness to participate in the SSM and SRM

Mérő and Piroska recognised that there is a positive correlation between non-performing loans and participation willingness in Eastern Europe.[1059] My findings indicate that this correlation broadly extends to all eight NoPS. Moreover, it further extends to the two former

[1056] JC Juncker, *State of the Union Speech, European Commission*, 2017
[1057] KI Nikolopoulos, AI Tsalas, *Non-performing loans: A review of the literature and the international experience*, in Monokroussos, Platon and Gortsos, Christos (eds.) Non-performing Loans and Resolving Private Sector Insolvency, Springer International Publishing, 2017, p.48
[1058] L Barseghyan, *Non-performing loans, prospective bailouts, and Japan's slowdown*, *2010*, pp.873-890
[1059] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, p.9

NoPS: Lithuania as the newest member of the EMU, and the UK as the ultimate 'non-participator'.

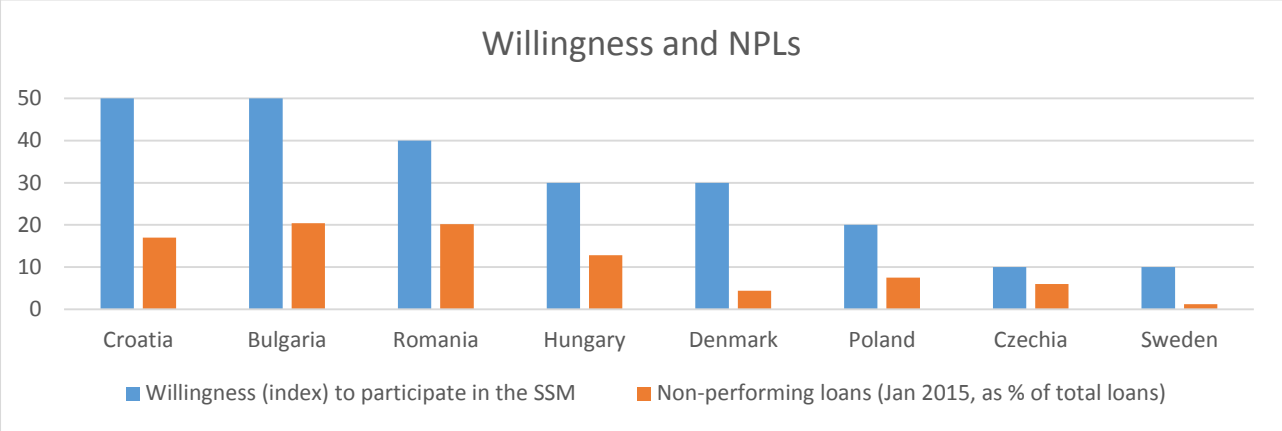


Fig.5.7 *Willingness and NPLs, Data: BIS, Worldbank*

The methodology for assessing the NPL level in a given state is more uniform and straightforward than for internationalisation. According to Nikolopoulos and Tsalas, the most common indicator used for this purpose is the ratio of NPLs to total bank loans.[1060] This ratio is said to be "related to the quality of bank assets and reflects the risk that the underlying cash flows from loans and securities held by financial institutions may not be repaid in full."[1061] I compared this to scaled and adjusted willingness index, to illustrate the correlation between NPL percentage and willingness to participate in the SSM/SRM.

Looking specifically at the current and former NoPSs with the highest GFC-time NPL percentages, Lithuania has joined the EMU, Bulgaria and Croatia joined the EBU, and Romania has expressed the intention to do the same. Alongside other factors, this hypothesis could form part of the explanation why the (otherwise Eurosceptic) Hungarian government has not ruled out the EBU, and why high inward internationalisation of the Czech Republic does not push it to participate.

Unsurprisingly, as illustrated by Fig.5.7, at the launch of the SSM, the three most willing states (Bulgaria, Romania and Croatia) had the highest non-performing loan percentages. Sweden and the UK had the lowest percentages, followed by Denmark and Czechia. Generally, only the NoPS with NPL percentages in the double digits in 2014 have expressed intentions to participate.

[1060] KI Nikolopoulos, AI Tsalas, *Non-performing loans: A review of the literature and the international experience*, in Monokroussos, Platon and Gortsos, Christos (eds.) Non-performing Loans and Resolving Private Sector Insolvency, Springer International Publishing, 2017, p.48
[1061] Ibid. with reference to Saunders et al., *Financial institutions management: a risk management approach, 2008*

The United Kingdom, was also technically a NoPS until 2020, when it left the European Union's legal framework. In 2015 such step still seemed like a somewhat distant prospect, but the UK nevertheless made a decision not to participate in the EBU. At that time the UK had the lowest NPL percentage among the NoPS. At the other extreme, on the 1st of January 2015 Lithuania became the 19th Eurozone State. While this is not 'opting-in' or close cooperation *per se*, it was nevertheless a decision to, *inter alia*, join the SSM.[1062] Howarth and Quaglia rightly observed that Lithuania, dominated by subsidiaries of Swedish banks, would seem to have less interest in joining the EBU.[1063] The NPLs might have played a role. Lithuania got this measurement under control just in time for its EMU accession, but in 2010 its NPL percentage reached eye-watering 20.4%; highest in the Nordic-Baltic region.

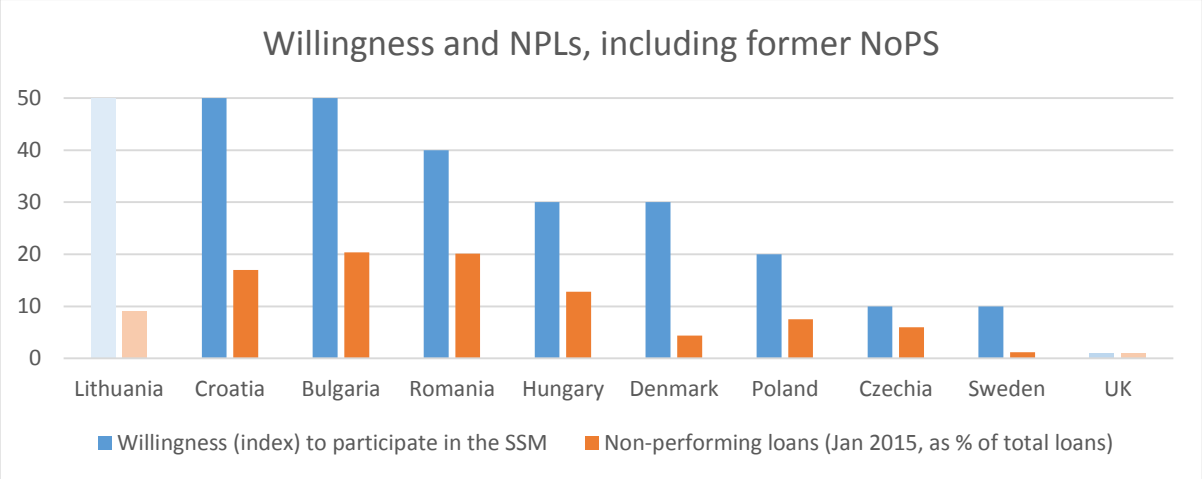


Fig.5.8. *Willingness and NPLs, Data: BIS, Worldbank*

c) The most reluctant and the keenest

At the start of the EBU the distinction between the most reluctant States and the keenest candidates was more than obvious, and broadly reflected the same tendencies as the participation decisions, banking sector profitability indicators and internationalisation.

[1062] V Vasiliauskas, *Speech on Lithuania's Participation in the ECB Governing Council*, 2014
[1063] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.19

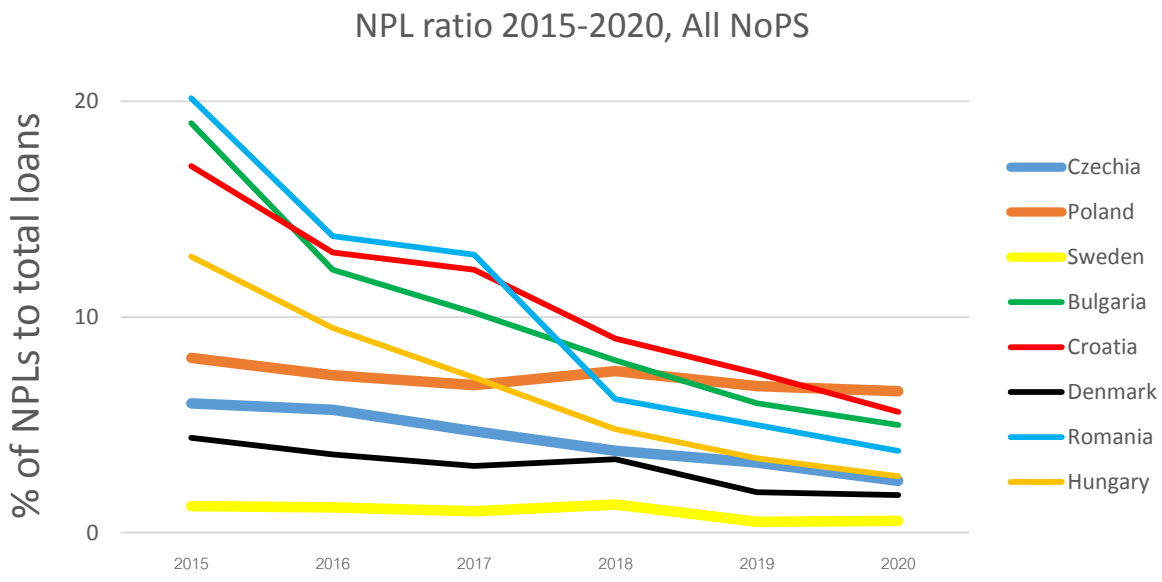


Fig.5.9 *Changes in NPL %, Data: CEIC*

Throughout the post crisis period and during the half-decade of the functioning the SSM, Sweden stood out among the NoPS with an exceptionally low amount of NPLs. Stable Swedish loan market is also credited with helping the stabilisation of the Baltic markets during and after the GFC.[1064] The Czech Republic had the third lowest NPL level and reduced it steadily over the past five years. Good performance of loans is particularly important to the Czech domestic economy, as it has a 2:1 loans-to-other instruments ratio, which is quite high.[1065] As discussed in the previous subsection, the Czech banking profitability is also very high, but the maintenance of such profitability is symbiotically dependant on the health of loans.

Generally, most NoPS have lowered their NPL level from their peak significantly, but the keenest States are still among the most problematic, NPL-wise. As recently as in 2017 Croatia, Bulgaria and Romania occupied the unfortunate top 3 positions among the NoPS, with double-digit NPL percentages (Fig.5.9). In 2018-2019 Croatia ended up wearing the crown of thorns, which might partly explain its decision to join the EBU sooner, not waiting for accession to the EMU. Similar reasoning could be applied to Bulgaria. Romania, notably, managed to lower its catastrophic NPL percentage to a very respectable 5% level, which also coincided with the State decelerating its EBU accession process. Nevertheless, the previously-high NPL numbers might have been one of the reasons why it was also the first

[1064] C Purfield, CB Rosenberg, *Adjustment under a currency peg: Estonia, Latvia and Lithuania during the global financial crisis 2008-2009*, IMF 2010, p.11
[1065] Data from: M Hampl, *Banking Union: The Perspective of One Non-SSM Member State*, CNB, 2015

NoPS to express the intention to participate.

d) Denmark, Poland, Hungary and their NPLs

Denmark, Poland and Hungary, have not expressed a formal intention to participate, but did not completely rule that out either. They require further analysis in this context. Looking at the NPL level at the launch of the SSM, Hungary seemed like a bit of a head-scratcher. Just like with bank sector profitability and outward internationalisation, purely from the perspective of structural characteristics, Hungary seemed like the potential fourth opt-in. Yet, while otherwise supportive of the EBU, it did not join. Its wait-and-see position meant close monitoring of various indicators. The changes in its NPL curve observed during this 'waiting and seeing' might have provided a bit of a lulling disincentive. Hungary managed to largely solve its NPL issue and in early 2020 nearly tied the Czech Republic. Successful NPL management has potential to further inspire trust in the national bodies and, in the long run, even boost profitability, thus weakening other incentives to join.

The most sceptical State among the undecided – Poland – is an unusual specimen in respect to NPLs. At the launch of the SSM, it had the fourth-lowest NPL percentage, just above Czechia. Moreover, even in the midst of the GFC Poland managed to keep its NPL percentage under the glass lid of 8% and – impressively – achieve its record low of 4.4% in 2008! This can be attributed to its previous NPL management and overall bank resolution experience. The State managed to overcome a mountain (22.6%) of NPLs in 2003. The peculiar thing about Poland is that, while it retained relatively low levels of NPLs throughout the GFC, it did not manage to lower it afterwards. Somewhat surprisingly, for the better part of 2020 Poland even had the highest NPL percentage among the NoPS. While the current level of around 7% is still manageable and acceptable, a significant increase could revive the EBU talks in Warsaw.

If the non-performing loan hypothesis is correct, Denmark would seem like a particularly unlikely opt-in. Its record high NPL level, reached in 2012, was 6%, which many other States could envy. However, Denmark has repeatedly claimed that the EBU is still on the table. While the State had shelved the plans for a few years, the discussion was unexpectedly revived in 2017-2018. Interestingly, that coincided with a spike in NPLs in 2018 from 2.5% to more than 4%.

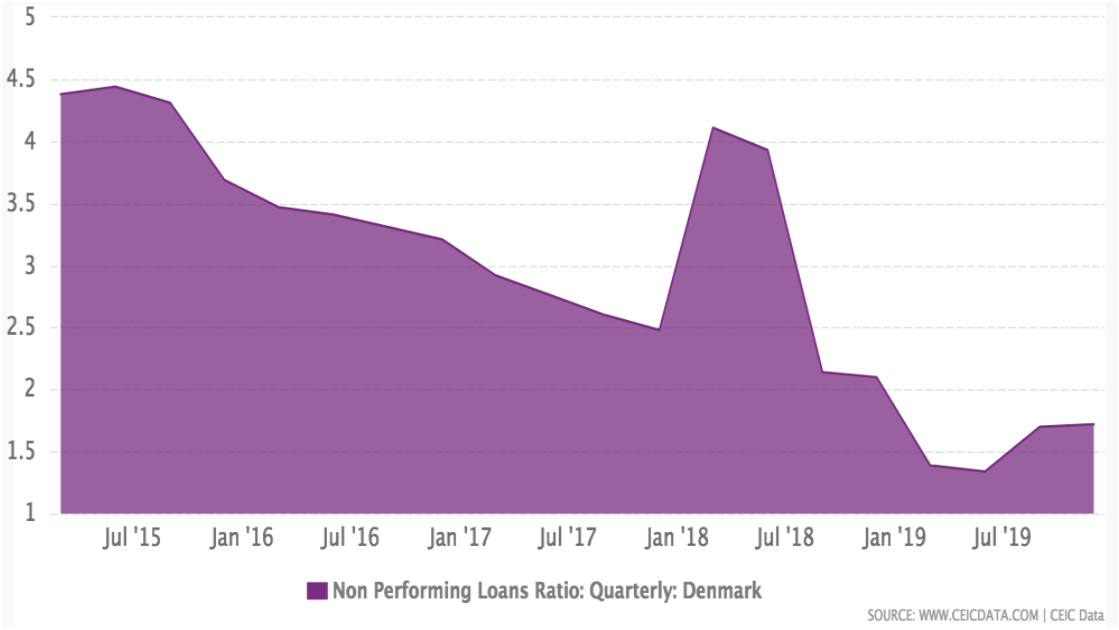


Fig.5.10 *Changes in NPL%: Denmark. Source of Data and visual: CEIC*

The spike turned out to be temporary and the level has dropped since, and so has the Danish enthusiasm. Temporary 2% NPL spikes are unlikely be enough for the Danish decision makers to ignore the lingering issue of the classification of mortgage-backed bonds, discussed in the previous Chapter, and the disincentives presented by permanent EMU derogation.

e) Assessing the impact of non-performing loans on participation

NPLs seem to have some pull in participation considerations, but that pulling force is proportionate to the overall NPL level. None of the NoPS currently have NPL problems of existential proportions, and this factor, on its own, is unlikely to determine participation. It seems to be an important factor nonetheless. As a general rule, the NoPS with high NPL percentages during and after the crisis tend to opt in. The same conclusion can be made looking at a 5 year rolling average, taking any 5 year interval from 2007 until now. Moreover, Romania and Croatia declared their intentions to participate while being the NoPS with the highest NPL percentage. Bulgaria had the second highest NPL percentage at the time of formal expression of interest. By contrast, the five NoPS with the lowest rolling 5-year averages have not expressed the intention to participate yet. Generally, the countries with a stable NPL percentage tend to reject (or be sceptical about) participation, as the case is with Sweden, Czechia, and Poland. Hungary's NPL fluctuations seem to be in line with its in-between wait-and-see position. High post-crisis NPL level would explain not ruling out

participation, yet clear downward trend would explain why it has not moved to express formal interest. Notably, Hungary's NPL management did not result in an increase in the banking sector RoE, as discussed in the previous subsection. That might indicate lingering legacy costs of underwritten NPLs. Denmark would seem to constitute an outlier, but its NPL level needs to be considered in context. For the past decade Denmark has had more trouble with NPLs than its Nordic counterparts – Sweden, Norway, and Finland. Given the country's dependency on the mortgage sector, its flirtation with the EBU membership does not seem entirely out of character, especially in the light of its fairly low banking sector RoE.

In summary, NPL level generally indicates banking sector health, while declining trend tends to correlate with efficient financial regulation. Alongside other indicators, the NPL level forms part of the puzzle revealing the full picture of the countries' banking sectors. Notably, this measurement needs to be considered in context, taking into account other factors, like loans-to-other-instruments ratios, size of the overall loan portfolios, inter-linkages between lending and the real economy in a given state and banking sector RoE. Nevertheless, statistically, the NPL levels generally correlate with the NoPS positions to a great extent.

4. Exposure to Euro peripheries

As I have discussed in Chapter 4, NoPS with strong banking sectors and a solid banking supervision record generally seek to avoid indirect participation in bank recapitalisations in the more problematic banking sectors via the SRF, especially those to which they are not otherwise exposed to. Therefore, the States with low or decreasing NPL percentages might be reluctant to create artificial exposures to those with high NPL levels, or finance their bank recapitalisations, especially since these recapitalisation decisions are made via the SRM. Slaný summarised the sentiment in a blunt way: "The Czech banking sector is one of the most stable ones, so our participation in the banking union would mean little more than just guaranteeing foreign debts and risk sharing with the […] countries such as Spain, Portugal, Greece and others."[1066] The same sentiment, albeit not expressed so bluntly, echoes through all NoPS. This sentiment is not new or NoPS-specific. Schoenmaker even found evidence that some national supervisors in the Eurozone encouraged their banks to reduce their exposures to troubled sovereigns as well as to banks in these countries during the

[1066] Cited by T Zavadilova, *Bankovní unie se piblížilam, Česku ještě nehrozí*, e.15.cz, 2013, Translation is mine

GFC.[1067] Five European states - Greece, Italy, Ireland, Spain and Portugal - were at the epicentre of the GFC. Howarth and Quaglia even argued that the EBU was sought by these Euro periphery countries and France (due to its particular exposure to periphery sovereign debt) as a way to deal with the banking and sovereign debt crises.[1068]

For the purposes of this research I decided to explore whether the levels of exposure to this particular group of EMU States, would correlate with the willingness to participate in the EBU. Howarth and Quaglia conducted a somewhat similar research, looking into the exposure to the sovereign debt of the same five States for their analysis of the Eurozone States' preferences. Although based on the same hypothesis, my approach is slightly different. One of the lessons from the GFC is that it is hard to predict which banking activities will turn sour. Therefore, for my analysis, I considered the total exposures to the periphery States by claims on immediate counterparty basis.[1069]

Firstly, I compared the percentage of exposures to the EU peripheries as a percentage of all cross-border exposures to the participation willingness index.

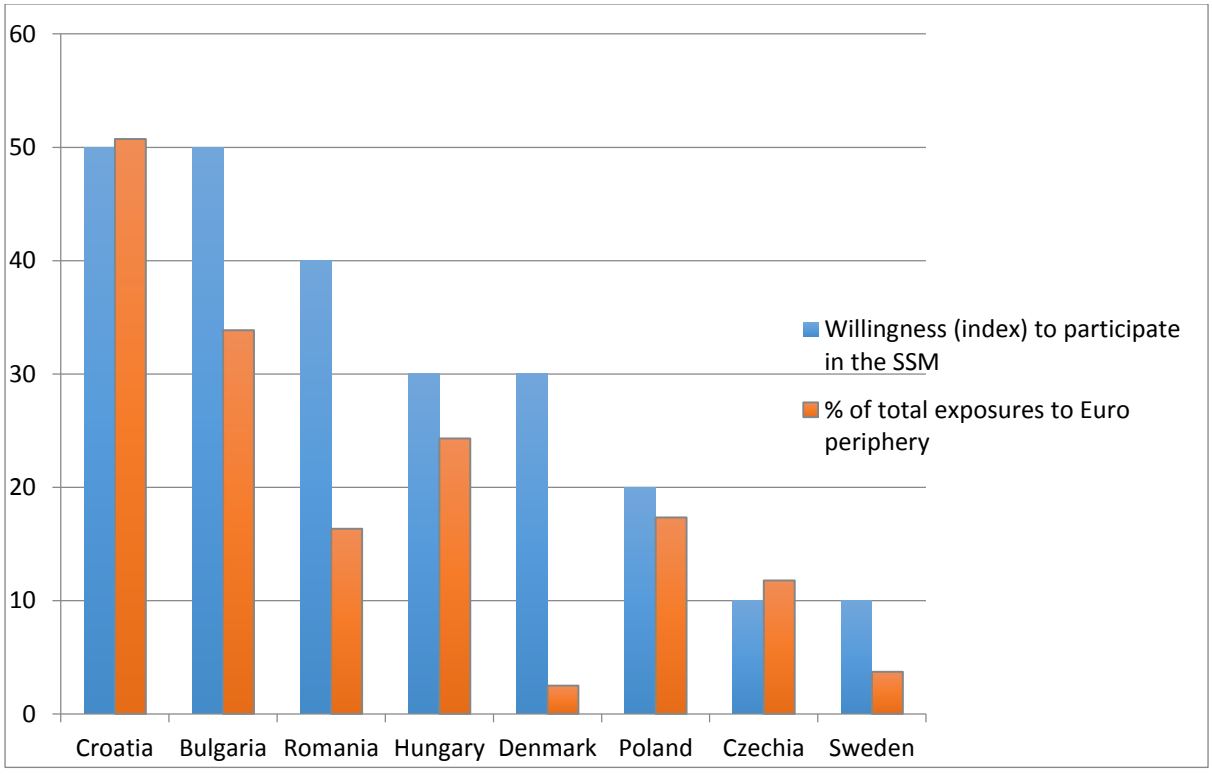


Fig.5.11 *Periphery exposures as a percentage of all exposures. Data: BIS*

[1067] D Schoenmaker, *Banking Supervision and Resolution: The European Dimension*, Law and Financial Markets Review Vol.6 2012, p.5

[1068] D Howarth, L Quaglia, *The Political Economy of European Banking Union*, Oxford University Press 2016, p.23

[1069] Data for this analysis has been primarily collected from the World Bank and bis.org statistics, supplemented by national bank data and SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020

The illustration based on this method generally confirms the hypothesis - the more the Member State is exposed to the peripheries, the more likely it is to want to join the EBU.

The correlation follows the same pattern as with NPLs and banking sector profitability: the countries with low direct exposure to peripheries do not want to create that 'indirect exposure' through participation in the SSM and SRM. The two non-EMU States with the highest exposure are also the ones that joined the EBU – Croatia and Bulgaria. Unsurprisingly, the two NoPS with the lowest exposure to the peripheries – Czechia and Sweden – are also the ones that have formally rejected participation. Poland's periphery exposure levels also seem to be in line with its reluctant-yet-not-fully-ruled-out position. Moreover, recent changes in banking ownership have significantly reduced Poland's reliance on Italy. I will return to this in the next subsection.

Of course, the percentage of such exposures merely illustrates how important such exposures are to the national banking system, but not necessarily to the State as a whole. Therefore, I also calculated the percentage of national GDP that the periphery exposures amount to.

$$ExEP = \frac{Ex_{Po} + Ex_{It} + Ex_{Ir} + Ex_{Gr} + Ex_{Sp}}{\text{Gross domestic product}} \times 100$$

ExEP = Exposure to Euro Peripheries, ExPo = Exposure to Portugal, ExIt = Exposure to Italy, ExGr = Exposure to Greece, ExSp = Exposure to Spain.

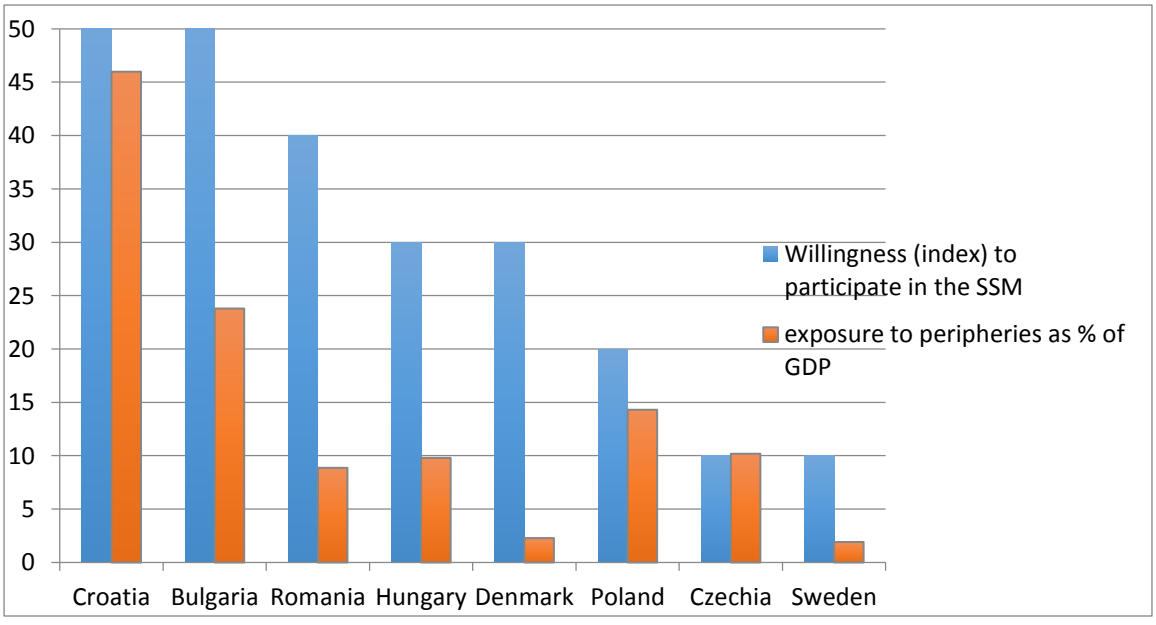


Fig.5.11 *Periphery exposures as a percentage of national GDP, Data: BIS, Worldbank*

Again, Bulgaria and Croatia had the highest levels, whereas Sweden had the lowest. Just like with all other structural characteristics, the positions of the remaining NoPS whose decisions are not 'sealed', requires more detailed assessment. Romania, the first state to express interest in participation, is not particularly exposed to the peripheries. That is partly attributable to a significant market share held by Société Générale (France), Erste and Raiffeisen (both Austria) groups. The only major 'peripheral' entrant is Italian UniCredit. Somewhat counter-intuitively, a romance-language-speaking Southern European Romania only has 18% exposure to the peripheries, which amounts to less than 9% of its GDP. This is a notable drop from the Q3 2014 level (data available at the launch of the SSM), which stood at 14.85% of GDP. This drop notably coincided (or correlated) with Romania putting EBU participation on the back burner.

Denmark does not have an incentive to participate arising from this structural characteristic. Its geographical position, low overall internationalisation and a comfortable position in the Nordic-Baltic EHM has historically shielded the Danish Kingdom from Euro periphery exposures. Looking at the total exposures Denmark would seem like a particularly unlikely participant and in this respect seems to be aligned with Sweden. Notably, Howarth and Quaglia's research reveals an important difference between these two Nordic States: Denmark is significantly more exposed to Euro periphery debt (both, sovereign and corporate) than Sweden.[1070] This factor might partly explain the differences in the positions of the two Nordic NoPS.

Periphery exposure is yet another structural characteristic which would seem to suggest that Hungary should participate. Especially considering that Hungary also has significant exposures to NPL-heavy and soon-to-be EMU Croatia and Bulgaria.

The hypothesis of unwillingness to bail out peripheral States is of course partly conditional on the opposite being true: bail-out 'enthusiasm' for proximate, already integrated and interconnected markets. As I have illustrated in Chapter 4, that is very much the case with the Nordic States. Reluctance to bail-out or recapitalise 'peripheral' banks should not be confused with unwillingness to deliver during subsidiary rescues, or even indirectly contributing to the rescues of non-affiliated banks, which pose systemic threat to the NoPS in question. Sweden, for example, did not shy away from recapitalising Lithuanian subsidiaries, and offered assistance to the Baltic States on the inter-state level. Similarly, the UK contributed to Icelandic rescues. The general conclusion would be that most NoPS only

[1070] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, pp.30-31

want to participate in bank rescues of the countries that they are already exposed to. In the absence of other incentives, they are unwilling to create *de facto* 'artificial exposures' through joint European schemes.

5. National origin and business type of foreign credit institutions

Another important nuance, binding together the concentration, internationalisation and periphery exposure hypotheses is the national origin of foreign entrants. Generally, the three countries willing to join the SSM exhibit a considerable degree of foreign bank penetration from the Eurozone. Among the largest players in Bulgaria we find UniCredit Bulbank (Italy), Raiffeisenbank (Austria), Greek Piraeus Bank, and German Allianz. The only exception is DSK Bank which is part of the OTP group. Romania is host to many of the same institutions, but it notably hosts *two* major Greek banks - Alpha and Piraeus. In Croatia a significant market share is held by Privredna Banka, which is a subsidiary of Intesa Sanpaolo (Italy) and Zagrebacka Banka, owned by UniCredit.

The market penetration of the Greek and Italian banks is an important structural factor. As discussed above, the home States of these banks are among the Euro peripheries, banking systems of which are still considered weaker, albeit sometimes unduly. That effectively creates a pre-existing exposure to the peripheries and thus arguably encourages participation. By contrast, the only significant 'peripheral' market participant in the Czech Republic is Unicredit, which generally has a good reputation and is widely considered too-big-to-fail. Moreover, it is directly supervised by the ECB. Due to low inward internationalisation, Denmark and Sweden do not have significant market participants headquartered in the Eurozone, besides Nordea.

C. Politics, path-dependency, nationalism and banking socialism: how the NoPS learned to live without the EBU

My analysis in this thesis primarily focused on legal, economic and structural factors. Nevertheless, the decision to participate in the SSM and the SRM is a political step, requiring governmental impetus and legislative amendments to national legislation. While legal, economic and structural factors can explain the choices made by the most reluctant and the keenest NoPS, the 'undecided' or 'wait-and-see' States exhibit a mixed batch of characteristics and can certainly be tilted one way or another, depending on non-structural factors. Denmark, with its permanent EMU derogation, low inward internationalisation, few

non-performing loans and low exposure to Euro peripheries seems like a particularly unlikely participant, but not only has it not ruled out participation, but also seems to be revisiting the decision in the light of political developments. By contrast, the structural characteristics of Hungary would seem to dictate keener interest in participation, but its politics distances it from such step.

Once a NoPS has reached a decision, political factors and market philosophies also shape domestic market and its relationship with the EBU. In this section I will briefly discuss three national banking sector philosophies, which could provide additional context for the policies of some NoPS, as well as explain how they have adapted to live surrounded by the EBU, but not being part of it. The emergence of these alternative policies are a further manifestation – or a logical extension - of Schimmelfenning's path-dependency hypothesis.[1071]As Avgouleas and Arner observed, the geopolitical reality might be that the EMU and non-EMU members "are pulling much further apart than ever before."[1072] If that is the case, in the near future some NoPS will cross the point of no return, becoming so entrenched in their alternative strategies that reeling them back to the SSM and SRM will no longer be feasible, regardless of the concessions made to that end.

1. Banking nationalism

Mérő and Piroska argued that banking sector nationalism shaped the reluctance of the Visegrad NoPS. [1073] Lupo-Pasini overviews a broader spectrum of manifestations of financial nationalism, particularly in cross-border resolution and in crisis situations.[1074] In the regulatory and supervisory domains, banking nationalism essentially means that the state focuses on protecting its domestic economy and banking sector in the event of an international crisis, rather than trying to avert or mitigate the crises altogether through international arrangements. It is generally linked to a lack of trust in international arrangements or emphasis on structural and economic inefficiencies of such arrangements. This thinking could explain why Hungary has not joined the EBU yet, as well as add a politico-philosophical reinforcement to Czechia's structural predisposition against participation.

[1071] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.492
[1072] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.40
[1073] K Mérő, D Piroska, *Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic*, Policy and Society 35:3, 2016, pp.24-25
[1074] F Lupo-Pasini, *The logic of financial nationalism: The challenges of cooperation and the role of international law*, Cambridge University Press, 2017, pp.I-Ii

By contrast, for governments which are less keen on banking nationalism, either by political conviction or as dictated by structural characteristics, ever-closer-union aspirations provide additional intellectual backing when joining the EBU and getting that decision through national parliaments, as discussed in Chapters 1 and 4. Mérő and Piroska pointed out the impact of general Europhilic climate in Bulgaria and Romania, which is also notably different from all other NoPS, except - of course - Croatia.[1075]

In banking nationalism, broader euroscepticism coexists with legitimate concerns regarding the political significance of the EBU, discussed in Chapter 1. Czechia sees the EBU as 'yet another' way to deepen European integration. This position dominates the discourse among local experts. Slaný has said that EBU "represents further regulatory integration without the genuine political mandate of citizens from the countries of the Union."[1076] This is in line with Epstein and Rhodes's neofunctionalist argument that European institutions took advantage of the GFC to "push through reforms that fundamentally contradict the perceived interests of many member states."[1077]

In some sense, banking sector (or supervision) nationalism represents a choice in terms of the Financial Stability Trilemma. Namely, the choice of regulatory independence and financial stability over deeper integration. However, the sustainability of such strategy in Hungary and the Czech Republic is questionable, due to high internationalisation of the domestic banking sectors. Particularly, it might not deliver on the financial stability promise, since it might be too late to limit regulatory integration, when the banking sector is already integrated. Unless, the State embarks on the titanic effort of altering the market itself, as the case is with Poland, discussed below.

2. *Banking socialism*

Poland's approach is deeper-reaching and represents a slightly different version of financial nationalism, which has also been described as 'banking sector socialism'.[1078] It refers to the phenomenon where the state tries to gain and retain a significant (or even controlling) share in large banks operating in the country, even when they are not in distress. This is rather unconventional, as in the past few decades state-orchestrated takeovers have been largely reserved for failing or imprudent entities. A prominent Polish example came in

[1075] Mérő and Piroska, 2016, p.3
[1076] Cited by T Zavadilova, *Bankovní unie se piblížilam, Česku ještě nehrozí*, e.15.cz, 2013, Translation is mine
[1077] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.6
[1078] M Miszerak, D Rohac, *Poland's rush to banking sector socialism*, Financial Times, 30/06/2017

late 2015, when a state-owned insurance giant, PZU, acquired a substantial stake in highly successful Alior Bank. Even more indicatively, in 2016 PZU and the Polish Development Fund jointly spent €2.5bn, purchasing the controlling stake in Bank Pekao, Poland's second-largest bank from UniCredit (Italy).[1079] As a result, four major banks, representing over 50% of Polish banking assets are under state control.

This step significantly reduced Poland's periphery exposure. If Howarth and Quaglia's hypothesis is correct, this would mean that Poland found an alternative solution to the periphery exposure problem, which does not involve the EBU. The 'banking sector socialism' policy can be traced to concerns raised during the GFC over the ability of international owners to provide liquidity to their Polish and other central European subsidiaries, during the periods of widespread distress or a systemic shock.[1080] Therefore, by reducing the dependency on foreign bank groups, especially those headquartered in the peripheries and other NPL-heavy states, the Polish government and NCAs might be expecting to minimise the effects to the Polish economy in the event of future crises. Not having achieved the changes it desired in the EBU negotiations, Poland took a different approach to the financial stability trilemma. Instead of sacrificing national control this State expanded it, seeking financial stability but arguably at the expense of market integration. Poland's banking socialism is the perfect example of trying to solve the dilemma, by trying to 'insert' a Polish element (ideally - state-owned) into the ownership structures of the banks operating in this the country. That way the networks of international cooperation are (partly) bypassed, by increasing direct visibility and control over the institution itself.

Notably, Poland was able to do this due to certain unique pre-conditions. Firstly, its own NPL levels were relatively low and, as discussed, were kept flat during the GFC. Secondly, although Unicredit's investment in Pekao was the biggest stake held by a foreign bank in any Polish bank,[1081] 2.5 billion Euros is not that much, as far as the absolute largest foreign stakes go. Such semi-nationalisation was something Poland could afford, and many other States could not. Lastly, the Polish banking sector is quite small relative to the overall size of the economy, compared to most other NoPS, especially Denmark and Sweden.

[1079] M Goclowski, *Poland expects more foreign owners to sell banks in 2017*, Reuters, 21/12/2016
[1080] M Miszerak, D Rohac, *Poland's rush to banking sector socialism*, Financial Times, 30/06/20
[1081] Ibid.

3. *Banking sector 'regionalism'*

The size of the banking sector is the main reason why Hougaard Jensen and Schoenmaker suggested that Sweden and Denmark should join the EBU, particularly seeking financial resources for resolution cases through the SRF.[1082] They further contended that Denmark and Sweden "have the same cross-border characteristics as the euro area countries, which suggests that the rationale for joining the banking union would be similar for Denmark and Sweden and for the Euro area countries."[1083] This conclusion, while correct in some respects, does not take into account the full spectrum of considerations. As my analysis has shown, Denmark and Sweden differ from other states in terms of a number of structural characteristics. Moreover, as discussed in Chapter 4, the creation of the Nordic-Baltic Extended Home Market also allowed the States in the region to create an alternative solution to the EBU through regional harmonisation and integration, which does not require the sacrifices of banking sector socialism and mitigates the risks of banking sector nationalism. In line with the thinking behind the host's dilemma, it is argued that the Nordic NoPS have gained "significant decision-making power vis-à-vis the host regulators in the Baltic states" and developed strong regional supervision networks.[1084] This has effectively reduced the risks the Nordic Banks face abroad. In principle, as long as such ties are maintained and as long as 'extended-domestic' supervision performs well, the alternative solution to the EBU, which could be described as banking sector regionalism, serves its purpose.

The choice of the banking regionalist framework is notably more sustainable for Nordic NoPS than pure nationalism and more lucrative than socialism. As Epstein and Rhodes observed: "reduced costs of international economic exchange raise the relative costs of the products and services that protectionist states produce, making those states less competitive."[1085] As long as regionalist States and their banks do not have further expansion ambitions (which has largely been the case since the GFC), they do not face any inherent risks. As a result, Sweden, and, to a lesser extent, Denmark lack the incentives to participate.

[1082] SE Hougaard Jensen, D Schoenmaker, *Should Denmark and Sweden Join the Banking Union?*, Journal of Financial Regulation, 2020, p.9
[1083] Ibid. p.2
[1084] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.567
[1085] RA Epstein, M Rhodes, *International in life, national in death? Banking nationalism on the road to banking union*, KFG 2014, p.7

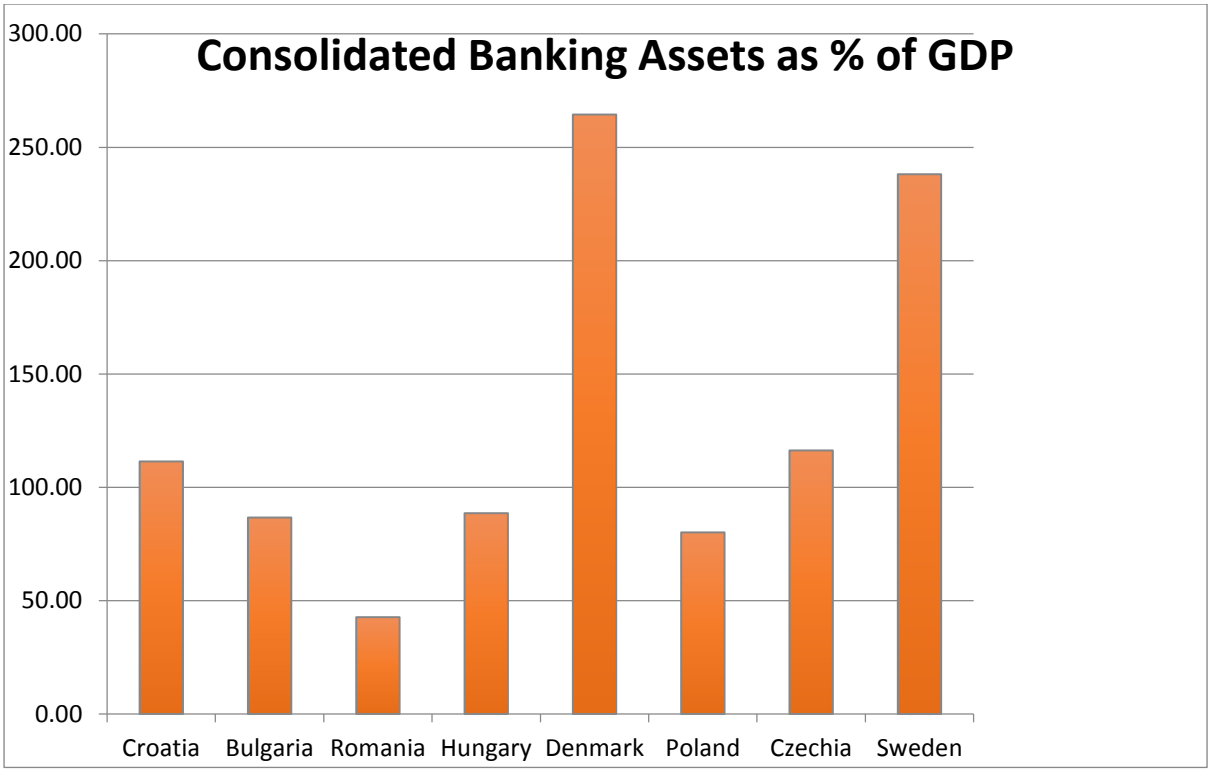


Fig.5.12 *Consolidated banking assets as a percentage of national GDP. Data: thebanks.eu*

However, no solution is perfect. Banking regionalism rests on the fundamental premise that the regional or national supervision and regulation is superior. Learning that this is not the case would be very costly. Hougaard Jensen and Schoenmaker are correct in their contention that the NBR structures might not be able to provide a sufficient financial backing in crisis situations. The Scandinavian Cash Pool and other regional structures would go part of the way, but might not suffice. As is evident from Fig.5.12, Denmark and Sweden's banking exceed the size of their economies to a significantly greater extent than any other NoPS.

The Nordic-Baltic solution is also *sui generis*, and would be very hard to replicate, so this philosophy might be of little use to other NoPS. The same could be said for banking socialism. While the size of the NBR extended home market and the national structural characteristics of Poland create the capacity to absorb the impact of the negative implications, the three NoPS with intentions to participate (and, arguably, Hungary) do not have such privilege, and need to take that into account.

Nevertheless, at least half of the current NoPS have alternatives at their disposal. The longer they remain 'non-participating', the stronger those alternative solutions get. This is one of the unintended centrifugal effects of the EBU. Banking sector socialism, regionalism

and (to a lesser extent) nationalism, can also take lighter forms, where, as Profant and Toporowski predicted, the NoPS would seek to reduce the financial dependence between parent banks abroad and their branches and subsidiaries, while simultaneously strengthening national supervisory regimes.[1086] Such solutions could be available to Czechia and Hungary. If these tendencies continue to manifest, the EU's largest financial centre outside of Eurozone – Stockholm, as well as the largest non-Euro state – Poland – will remain outside. That can deepen the fractures in the single market.

D. Conclusions

The aim of this chapter was to complete the discussion on the factors influencing the Member States' decisions regarding the institutional pillars of the European Banking Union, by analysing domestic banking sector structural characteristics. For this purpose, this chapter began by examining existing literature on the subject, based in political economy as its primary scientific discipline. I discovered several shortcomings of the exiting methodologies, including limited sample sizes, failure to account for variation of indicators over multi-year timeframes, and lack of nuance in the application of several hypotheses. Having filled the gaps in the existing methodology and knowledge on the subject, I compared participation willingness to a number of structural indicators, the legal relevance of which became evident through legal analysis in Chapters 2-4.

Following the assessment of the hypotheses linked to banking sector structural characteristics, it is clear that many of such characteristics correlate *grosso modo* with willingness to participate in the EBU. By way of conclusion, it is worth briefly summarising the main findings. Based purely on structural data, it would seem that the keenest NoPS would have high banking concentration, high banking internationalisation, low banking sector profitability, high foreign bank ownership, high exposure to peripheries and high percentage of NPLs. A predisposition resulting from these considerations would be amplified by banking sector concentration and the level of past financial crisis management success. A state with a predisposition against participation on the basis of low internationalisation, low NPLs and low exposure to Euro peripheries, would become even more unlikely to participate, if its banking sector is highly concentrated. A possible explanation would be that such State is less vulnerable to cross-border banking problems, and retains a higher level of control of

[1086] T Profant, P Toporowski, *Potential for cooperation: Polish and Czech standpoints on the Banking Union*, PISM, 2014, p.1, see also K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.8

its banking sector. This logic broadly applies to the two CCA States and one State intending to sign it in the future: Croatia, Bulgaria and Romania, as well as the three States least likely to participate: Czechia, Poland and Sweden.

It can also be argued that a set of factors could potentially override the State's structural predisposition. Eurosceptic or Europhilic political climate, broader macroeconomic strategy, and the level of interest in adopting the Single Currency in particular, can shape the decision. It should be noted that both NoPS that have joined the EBU intend to join the EMU in the near future. Romania has similar, albeit longer-term, intentions.

It is therefore worth discussing whether structural characteristics could shape the decisions of the two 'undecided' NoPS – Denmark and Hungary. Both States have been very cautious about European integration in the past, and thus even *considering* the SSM and SRM is somewhat surprising. Schimmelfennig and Winzen pointed out that Hungary and Denmark, alongside Estonia and Malta have opted for a long-term exemption from the free movement of capital.[1087] Special domestic reports, highlighting some positives and negatives of participation, have been published in both states, but they have not produced conclusive answers.[1088]

It seems that Denmark has political and organisational reasons to join, but lacks incentives, due to low periphery exposure, low NPL level, and low inward internationalisation. Howarth and Quaglia also observed that Denmark has very low outward internationalisation within the Eurozone, especially if Finland and the Baltic States are not counted as Euro exposures, since they form part of the NBR Extended Home Market.[1089] Moreover, there are two, country specific, stumbling blocks, which might prevent Denmark's participation. Firstly, as a State in permanent EMU derogation, Denmark is unlikely to adopt the single currency and thus would not be represented in the Governing Council, as discussed in Chapter 3. This is something that Croatia could overlook for a few years, but probably not something that Denmark could ignore for decades. Secondly, the disagreements about the status of the Danish mortgage sector have not been solved.

With that being said, some structural characteristics are also pulling Denmark into the EBU. Firstly, Denmark has an absolutely massive banking sector relative to its GDP. Relative to the State's overall economy, the banking sector is third largest in the EU and the

[1087] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.120
[1088] See *Rapport om Mulig Dansk Deltagelse I det Styrkede banksamarbejde*, Erfaringer siden 2019, and K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014
[1089] D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.18

largest among the NoPS.[1090] Furthermore, Denmark's banking sector profitability is among the lowest and that provides an extra incentive to shake things up. If my interpretation of the concentration hypothesis is correct, high concentration would amplify this pulling force, as the internationalised entities form a very large percentage of the domestic market. With that being said, high concentration also raises the stakes for Denmark, as it would, in one sweep, give up supervision of its entire banking sector to the ECB. In the light of permanent EMU derogation, the weight of this decision is probably greater than for other NoPS.

Hungary's structural characteristics also seem to indicate a mix of incentives and disincentives. High outward and inward internationalisation, historically high levels of NPLs and above-average level of periphery exposure would indicate predisposition towards participation. Banking sector profitability has also been disappointing, which might dissuade the national decision makers from banking nationalism. However, decreasing NPL percentage in the recent years has negated the immediate threat stemming from this characteristic. Moreover, while periphery exposure amounts to a large proportion of all Hungary's banking exposures, Hungary's banking sector is smaller than its GDP (Fig.5.12). Consequently, periphery exposures only amount to around 10% of Hungarian GDP, which leaves room for some risk-taking.

Hungary might need to recalculate its position now that Croatia and Bulgaria have joined the EBU. If Romania follows their example, a very significant percentage of Hungary's largest banking group's (OTP) business will be carried out in Southern European EBU States with problematic NPL histories. That might prompt Hungary to look for financial backing in case of a crisis. Another factor to watch is whether Hungary will manage to keep its own NPLs down while improving profitability. Ultimately, it is highly likely that, given a fairly balanced mix of structural incentives and disincentives, the position will be determined by political considerations and the likelihood of concessions that the EU would be willing to make.

[1090] See Fig.5.12 above

Chapter 6
Conclusions, Solutions and Recommendations

Introduction

As is evident from the discussion in Chapters 4 and 5, persuading the most reluctant NoPS to participate in the EBU institutional pillars is an irreducibly complex task. In fact, many of them might never be persuaded. This is a problem of significant consequence for the EBU as a whole, the unity and integrity of the Single Market, and – arguably – financial stability. As Avgouleas and Arner observed, the EU institutions, especially the Commission, see the EBU and the Single Market as mutually reinforcing processes.[1091] It can therefore be argued that non-participation of a significant number of Member States distorts both processes. The resulting fractures can be seen as a part of a dynamic disintegration process. As Schimmelfenning argued, the EBU thus becomes the highlight of the path-dependency hypothesis and a major rift in the EU, not only "reaffirming the original differentiation" but also widening "the institutional gap between the euro area and the rest of the EU."[1092]

Should this divergence continue (assuming the path-dependency hypothesis is correct) that gap will grow bigger, as the NoPS adjust their legal arrangements and business environments to safeguard their banking systems from systemic threats by alternative means, while also deriving some advantages from the unevenness of the playing field. Such processes, should they become irreversible, will create market pressures to uphold the systems, fostering differentiation. Jorg Asmussen, ECB Executive Board member, claimed that the EBU "would ensure that all banks in the EU […] benefit from a level playing field, as bank funding costs would not be determined by the soundness of their sovereigns, but rather the soundness of their balance sheets and business models."[1093] The problem with this thinking is that some sovereigns *do not* have this incentive, and thus also have no *inherent* need for playing field levelling. Especially, if they do not think that the market discrepancies pose a threat to the stability of their domestic banking systems, or – alternatively – if they find alternative ways to counter such threats.

[1091] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.40
[1092] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.484
[1093] J Asmussen, *CEEs and the crisis: current challenges and benefits*, ECB, 29/04/2013

In the light of the risk of deeper fractures and spill-over effects into other areas of EU law, it is imperative to enhance pan-European supervisory coordination and rule harmonisation. Equally, existing frameworks of international supervisory cooperation need to be improved, enhanced and utilised, in order to ensure effective banking supervision, capable of crisis prevention or mitigation. While some of the measures taken to that end might not, by themselves, close the gap between the NoPS and the participating States, they can decelerate further divergence.

This concluding Chapter is written with the purpose to contribute to the debate on the possible solutions to the problems stemming from non-participation of the NoPS. Section A briefly summarises the reasons for NoPS unwillingness to participate and highlights the connections between legal provisions and structural indicators, shaping the States' positions. Section B summarises the problems stemming from the divergence between the NoPS and the participating States. In section C I discuss the possible solutions, suggesting legal changes to existing instruments, and proposing new arrangements, which could solve or mitigate some of the problems identified in this thesis. The final section concludes.

A. Summary of reasons for non-participation

Shortly after the launch of the SSM, Ferran predicted that "each non-euro Member State will make its own wide-ranging […] calculations on whether there are net welfare gains from EBU."[1094] The irreducible variety of legal, political and economic factors discussed throughout this thesis make such calculations irreducibly complex. Nevertheless, there are evident overriding patterns that generally prompt States to opt in, opt out or remain on the fence. This section explains how these factors feed into each other or, alternatively, create conflicting pressures. Subsection 1 highlights the impact of the relatively safe banking environment, that has disincentivised change. Subsection 2 discusses the aspects of the NoPS' situation that are not a direct result of the main EBU legislation itself, but nevertheless discourage participation. Subsection 3 briefly revisits inequality of participation terms. Subsection 4 highlights certain privileges that the NoPS currently enjoy, and would need to part with upon signing the CCA. Subsection 5 discusses the lack of accountability of the ECB. Subsection 6 revisits structural characteristics and practical considerations in participation decisions.

[1094] E Ferran, *European Banking Union and the EU Single Financial Market: More Differentiated Integration, or Disintegration?*, University of Cambridge Faculty of Law Research Paper No.29 2014, p.1

1. Economic climate and banking stability

It took six years for the first States to join the institutional components of the EBU, bar Lithuania's adoption of the Euro. The majority of non-Eurozone States still do not participate. However, only two of them have completely ruled participation out, with Czechia taking one and a half years and two major reconsiderations to settle in this position. Denmark's position changes with virtually every significant political event. Practically speaking, the fence does not rank high, in terms of comfort, within the hierarchy of seats. The financial markets normally hate uncertainty and unnecessary ambivalence. It is therefore peculiar that many NoPS do not shy away from leaving the EBU question unresolved. That can be attributed to three factors. Firstly, the EBU is evolving and the NoPS often want to see how a certain stage of that evolution unfolds. Secondly, the NoPS with EMU plans tend to delay the decision, pushing it closer to the adoption of the Single Currency, in order to avoid the Governing Council representation issue. Lastly, in the absence of obvious negatives of non-participation, due to relatively stable banking climate in the past seven years, the NoPS did not experience systemic shocks that could bolt them into participation. The early stages of the EBU were marked by apocalyptic rhetoric with the participation decision being described as "decisive for financial stability."[1095] The proponents of the EBU warned of "devastating effects" on domestic banks, as depositors would shift their accounts to banks headquartered in EBU States.[1096] Since most NoPS did not experience major 'devastating effects', they also lacked the impetus to make the leap into the EBU, which is otherwise politically difficult, due to major autonomy costs, discussed in Chapters 1(C) and 2(E). Steen Bocian, Danske Bank's chief economist, has observed that there is "no real cost" in delaying the EBU decision.[1097] This is all the more the case since, the NoPS have avoided the Howard and Quaglia's Inconsistent Quartet,[1098] due to retaining their national currencies, and consequently retaining more flexibility.

The situation started changing with Nordea's move from Sweden to EMU Finland, discussed in Chapter 3(B), which has been described as a precursor for future market tendencies.[1099] Bulgaria moved to join the EBU shortly after, following a domestic

[1095] J Asmussen, *CEEs and the crisis: current challenges and benefits*, ECB, 29/04/2013
[1096] See Z Darvas, GB Wolff, *Should non-Euro area countries join the Single Supervisory Mechanism?*, Bruegel Policy Contribution, Issue 2013/06 and D Howarth and L Quaglia, *The Political Economy of the new Single Supervisory Mechanism: Squaring the 'Inconsistent Quartet*, EUSA 2015, p.18
[1097] T Carlyle, *Lars Rhode 'firmly convinced' by merits of banking union*, centralbanking.com, 10/10/2014
[1098] Chapters 1(E) and 5(A)
[1099] D Schoenmaker, *Nordea's move to the Banking Union is no surprise*, Bruegel 2017, p.1

supervisory failure.[1100] Croatia decided to join the EMU, and joining the EBU made perfect sense in the light of its banking sector's structural characteristics. These events indicate that the EBU is capable of attracting at least some States and some banks, when their circumstances and needs align with what the SSM/SRM have to offer.

Moreover, the relative stability of European banking in the past decade is a result of unprecedented central bank activity. With seemingly endless streams of liquidity flowing into the system, the banking system did not really face a major test, even during the Covid-19 pandemic. A major liquidity freeze could, however, also encourage participation of one or two NoPS.

2. *Material differences in the positions the NoPS find themselves in*

The non-Eurozone Member States find themselves in a fundamentally different institutional and infrastructural reality. Ferran highlighted concerns on how the SSM and SRM would work long term in non-Eurozone States with their own interest rates and no access to Eurosystem liquidity provision.[1101] In principle, the Eurozone States have access to liquidity through ordinary ECB monetary policy, the ELA,[1102] and the ESM.[1103] The NoPS (and even the CCA States) do not generally have access to any of these sources. The banking groups headquartered in the NoPS could still have such access through their subsidiaries established in the Eurozone, but that is only of practical relevance for Sweden, Hungary and Denmark – hosts of big international banking groups. While this situation is not in itself unfair or discriminatory (since the NoPS have access to their own central banks' liquidity provision), it is still a concern for the NoPS, because the SRM and the SRF were largely designed with Eurozone States in mind, and thus calibrated primarily for a potential crisis in the EMU, with ELA and ESM being a part of that equation. On its own, the SRF has been argued to be insufficient to fully absorb the shock of a systemic crisis, especially in the absence of a fiscal backstop.[1104] As discussed in Chapter 1(A-B), the historical developments

[1100] See Chapter 4(B) and Chapter 5(B)
[1101] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.1 see Centre for European Policy Studies (CEPS) (2014). 'ECB Banking Supervision and beyond', *Report of a CEPS Task Force*, December 2014. p.27
[1102] Emergency liquidity assistance
[1103] European stability mechanism
[1104] JN Gordon, WG Ringe, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, Oxford Legal Studies Research Paper No.18/2014, 2014, p.2; K Kisgergely, A Szombati, *Banking union through Hungarian eyes – the MNB's assessment of a possible close cooperation*, MNB Occasional Papers No.115, 2014, p.20; T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.26, House of Lords, EU Committee,

and the crisis experience have resulted in congruence between the EBU and the EMU. As discussed in Chapter 2(C-D), that has shaped the SSM and the SRM. The EBU was built to save the Eurozone, and the NoPS are right to worry about being excluded from this philosophical conviction. In the eyes of the NoPS, the bulwark of the SRF might not be sufficient for holding back the wave of a systemic banking crisis of GFC proportions, yet not accessible enough for dealing with smaller flare-ups, especially those occurring in the NoPS.[1105]

3. Unequal participation terms

As discussed in detail in Chapters 2 and 3, the CCA States are excluded from the Governing Council of the ECB, with numerous far-reaching consequences. The safeguards provided to compensate for such discrepancy are in many ways a poisoned chalice, since the ultimate remedy in case of a fundamental disagreement between the ECB and an NCA is termination of the CCA. Such termination can also be initiated by the ECB, which puts the CCA states in a very insecure position. Furthermore, termination of the CCA means simultaneous 'guillotine' withdrawal from both: the SSM and the SRM. In turn termination of the SRM means withdrawal from the SRF, with high corresponding costs and massive reputational damage. The Administrative Board (ABR) of Review and the Mediation Panel, which could soften these concerns, have not achieved that, partly because of their composition, and partly due to direct and individual concern basis for challenges in front of the ABR. That is an unnecessarily high standard, which excludes many public bodies. While, as I have explained in Chapter 2(C), some of these problems could be argued to be constitutionally unavoidable, they have been aggravated by the fact that the ECB's influence has spilled-over into the other pillars of the EBU and continues to grow within the SSM.[1106] That has resulted in a certain degree of push back from the Member States, on the political and adjudicative levels.[1107] Such fluid and uncertain power dynamic in the EBU is in itself undesirable for the NoPS. Not having a say in the highest ranking organ of the ECB, the NoPS need to be able to gauge the exact power settlement on offer, and it does not help if it keeps changing.

Genuine Economic and Monetary Union and the implications for the UK, 2014, pp.27–28, implicitly acknowledged by Ursula von der Leyen, *A Union that strives for more: My agenda for Europe, political guidelines for the next European Commission*, 2019-2024, p.9

[1105] As discussed in Chapters 2 and 4, see also House of Lords, EU Committee, *Genuine Economic and Monetary Union and the implications for the UK*, 2014, pp.27–28.

[1106] See Chapter 2E

[1107] Ibid.

4. Existing benefits that the NoPS would need to part with

The NoPS also derive several unique advantages from their current status, that they would need to relinquish upon signing the CCA. Despite rule harmonisation on the EU level, the NoPS retain a lot of operational autonomy and flexibility, particularly in relation to intra-group liquidity flows, institutional arrangements, and resolution processes, which they seem to be keen to preserve.[1108] For example, the institutional design flexibility allows the NoPS to set the independence, accountability, and transparency balance at the desired level. Some countries have given supervisors more independence, while others put greater emphasis on political accountability and are therefore leerier of vesting power in unelected bodies, like the ECB.[1109] Supervisors can also become scapegoats in the aftermath of a crisis, or more independence can be given to them in advance, because the government does not want to be blamed, if a crisis erupts.[1110] The EBU effectively takes such (perhaps manipulative) freedoms away from national governments, and puts the independence-accountability–transparency settlement in more restrictive confines, often different from national preferences.

It is important to note that during the design process of the EBU, an intellectual consensus among the Member States on the best supervisory structure was never achieved.[1111] Individually, the States have reached different conclusions on things like the particular institutions that act as supervisors, degree of centralisation, and division of authority between supervisory discretion and legal procedures.[1112] The settlement we have in the EBU was dictated by the majority of Eurozone States, but it is not necessarily optimal for all NoPS. This schism became even more evident in the aftermath of the GFC. As discussed in Chapter 1 the patterns of post-GFC regulatory reforms were shaped by a natural reaction to move away from the approach that had failed, effectively leading to one conclusion - impose stricter regulation. Naturally, some aspects of such approach were met with scepticism in many NoPS, especially those which demonstrated considerable banking sector resilience during the GFC. That is particularly the case for the most reluctant NoPS. As discussed

[1108] IMF, Central and Eastern Europe: New Member States Policy Forum, 2014, Country Report No.15/98, April 2015 p.38
[1109] D Masciandaro, M Quintyn, M Taylor, *Inside and outside of the central banks: Independence and accountability in financial supervision - trends and determinants*, Paolo Baffi Centre Research Paper No.2008-15, 2008, p.17
[1110] Ibid.
[1111] DJ Elliot, *Key issues on European banking Union; Trade-offs and some recommendations*, Global Economy and Development, Brookings, 2012
p.22
[1112] Ibid.

Chapter 4, many NoPS also take pride in their supervisory standards, and give due credit to the lessons of the past which allowed them to build sturdy banking oversight systems. The participating States obviously retain the discretion to express their banking oversight philosophy through national law,[1113] but since the ECB can also take part in national law application, the NoPS have reasonable concerns about this application process being in line with legislative intent.

Importantly, the NoPS, in their unique status, have also carved out certain concessions in the European banking oversight architecture. That includes the double majority voting in the EBA's Board of Supervisors, discussed Chapter 3E, which was recognised as a good deal even by the UK.[1114] By signing the CCA, a non-EMU State effectively exchanges a vote in a smaller pool of NoPS for a vote in a larger pool of participating States. Since Bulgaria and Croatia joined the SSM/SRM, and the UK left the EU, the Nordic and Visegrad NoPS now wield a lot of power in the EBA. Furthermore, some NoPS also hold significant powers through the colleges of supervisors and regional structures. Joining the SSM would often mean giving up the role of the consolidating supervisor to the ECB, and thus also much of their regional influence.

5. Lack of accountability of the ECB

Increasing ECB's influence in the SSM, spill-overs into other pillars of the EBU, and exclusion from the Governing Council makes the NoPS particularly concerned about the (lack of) constraints imposed on the ECB. As Ferran and Babis explained,

"*weak constraints are unacceptable in the supervisory context because a financial supervisor has the power to affect in profound ways the interests of individual financial institutions, of financial consumers, and even of nation states; the accountability framework must be commensurate with the nature and extent of those powers*." [1115]

Clear and effective review procedures are considered imperative for an effective accountability regime, which, by reducing the scope for discretionary interventions, can even enhance performance.[1116] Basel Principle 2 declares that in order to ensure effective

[1113] See Chapter 2(C)
[1114] A Barker, P Spiegel, *EU sets out framework for Banking Union*, Financial Times, 2013, see Art. 44(1), EBA Regulation
[1115] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.17
[1116] M Quintyn, EHG Hüpkes, M Taylor, *The Accountability of Financial Sector Supervisors Principles and Practice*, 2005, p.8

supervision, bank supervisors must be accountable for the discharge of their duties and use of their resources.[1117] Even the Commission stressed the need to strengthen the accountability of the ECB as a banking supervisor.[1118]

The ECB itself, however, expressed the need to highlight its independence during the SSM legislation drafting process.[1119] Howarth and Loedel once compared the ECB to Hobbes's Leviathan: "a supreme ruler that is nonetheless greatly restrained in its actions."[1120] The problem is that the NoPS do not want it to be a supreme ruler and sometimes feel that it is not sufficiently restrained in its actions, as is evident from the discussion in Chapter 1E. Meanwhile, the ECB does not seem to want to be restrained in its actions. That is a significant underlying tension in the EBU's development.

Such tension resulted in a rather ambiguous accountability regime in the SSM.[1121] Some of the Art.20 SSMR accountability obligations are imposed on the Supervisory Board, which can be overruled by the Governing council. As non-Eurozone States are excluded from it, this does not sit easily with the principle of subsidiarity. According to the European Council, ideally, "accountability takes place at the level at which decisions are taken and implemented."[1122] Furthermore, the accountability rules and operational restrictions on national supervisors under national law continue to exist in parallel with the SSM rules.[1123] There is no harmonised accountability framework for the NCAs within the SSM, which adds to the uncertainty. The NoPS thus have a dual concern of being responsible for decisions they have no power over, made by the Governing Council, and not being able to hold this organ to account.

6. *Structural Characteristics and practical considerations*

There are many pragmatic considerations that also pull some NoPS away from participation. Firstly, Hungary, Czechia, Poland and Sweden have all claimed to be able to provide the same level of stability and supervisory standards of their banking sector as the

[1117] Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, 2012, principle 2
[1118] Communication of the Commission of 28 November 2012 on a Blueprint for a deep and genuine economic and monetary union
[1119] ECB, Opinion on the SSM proposal, 27 Oct. 2012 (COM (2012) 96), para 1.6
[1120] D Howarth, P Loedel, *The European Central Bank: The New European Leviathan?*, Palgrave Macmillan, 2003, p.177
[1121] See E Wymeersch, *The Single Supervisory Mechanism or 'SSM', Part one of the Banking Union*, National Bank of Belgium Working Paper No.255, 2014, p.23
[1122] Pt 15 of the European *Council conclusions* of 18 October 2012
[1123] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.16

ECB, but cheaper.[1124] The EBU schemes and instruments are generally considered more expensive than the national equivalents.

Secondly, the reputation argument does not have much pull in the most reluctant NoPS, since they themselves performed well during the GFC, whereas the reputation of the ECB was rather shaky, and thus there is no real financial cost to non-participation. Ehrmann et al. documented a fall in trust in the ECB, reflecting macroeconomic deterioration, broader decline in trust in EU bodies, and the severity of the Eurozone's banking problems, to which the ECB was associated in the public opinion.[1125] By contrast, some of the NoPS' NCAs and central banks avoided being associated with the crisis.

Thirdly, banking sector concentration can shape the participation decisions, as the SSMR significance criteria designate the three largest entities in each State for direct ECB supervision. The more concentrated the market, the bigger chunk of it the ECB will supervise. Notably, that can be both an incentive and disincentive, depending on the origin and financial health of these three entities.

Fourthly, the level of non-performing loans on the books of the country's banks tends to correlate with participation willingness, as the State might seek additional security in the SRF, as well as to spread the blame in case of a supervisory failure, if the situation gets dangerous. As the levels of NPLs declined across the EU, some of the incentives to participate were lost.

Fifthly, the NoPS are concerned about using their taxpayers' money to bail out other States, especially those they have little exposure to. When a CCA State has minimal exposure to a troubled Eurozone State, it lacks say in the decision-making regarding the supervision of the entities in that EMU State. That is because they do not participate in the relevant colleges of supervisors, in addition to potentially having lesser decision-making powers as part of the SSM due to their non-participation in the Governing Council. That effectively diminishes their level of control over how the money is spent, even if equal participation in the SRM is ensured. Lack exposure also means reduced interest in the wellbeing of the institutions active in more distant Eurozone States, as contagion effects from their collapse would not be immediate. The CCA transfer of power and money is therefore argued to constitute an

[1124] See IMF, Central and Eastern Europe: New Member States Policy Forum, 2014, IMF Country Report No. 15/98, p.38. Also see discussion on Sweden and the Nordic-Baltic market in Chapter 5D-E.
[1125] M Ehrmann , M Soudan, L Stracca, *Explaining European Union citizens' Trust in the European Central Bank in normal and crisis times*, ECB, 2013, pp.782, 806-807

electoral liability.[1126]

Lastly, additional disincentives can also be presented by certain levels and types of internationalisation.[1127] Importantly, those NoPS which are determined to stay out of the SSM/SRM can seek to alter the levels of their internationalisation, as a safeguard against some of the dangers of non-participation, which requires political decisions and entails sunk costs, making such decisions hard to reverse.

B. Limited scope

As illustrated in Chapter 4, the European banking markets are interconnected across the Eurozone - and even EU - borders. I have covered the effects and influence of the NoPS and non-EU states. Such states have substantial credit sector impact across the EU, significantly influence banking in individual Eurozone States, and can have destabilising impact. Therefore, pan-European arrangements need to stretch beyond the EU. As the new reality of Brexit dictates – they might even need to stretch beyond the EEA. This section summarises the most important problems resulting from limited geographical scope.

1. What the limitations look like in practical terms

While, given the magnitude of the reform and the associated struggle, the EBU can be seen as an enormous harmonisation effort, its geographical scope leaves a lot to be desired. All the more so, since the ECB and SRB's domains do not even cover half of European banking assets. Moloney observed that nine of the world's 29 Global Systemically Important Banks, as identified by the FSB are supervised by the ECB and subject to the SSM and SRM.[1128] A third would be a lot for most other continents, besides North America, but Europe's banking industry is huge and most of it remains outside of the ECB's remit. At the time of writing, the most important European financial centres by the Global Financial Centres Index are 1. *London* 2. Frankfurt 3. *Zurich* 4. Luxembourg 5. Munich 6. *Geneva* 7. Vienna and 8. *Stockholm*.[1129] The SSM does not cover credit institutions located in four out of eight most important hubs, which means that the playing field remains very bumpy. Moreover, the three largest non-Eurozone financial centres are located outside of the EU, and

[1126] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.573
[1127] See Chapter 5(B)(1)
[1128] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, pp.1657-58
[1129] Longfinance financial centres index

thus even the application of the Single Rulebook can be problematic in some cases. Even assuming that the situation in relation to SSM membership will improve with Romanian and possibly Danish and Hungarian memberships, half of Western European[1130] bank assets would be located in the NoPS, EEA/EFTA states, and the UK. That does not even take into consideration interconnectedness with Eastern Europe,[1131] the Middle East, Turkey, the United States, etc.

Moreover, 18 of Europe's 50 largest banks are headquartered outside of the SSM area, in the NoPS, the UK, Norway, Switzerland, and Russia. All of them have significant exposures to the Eurozone States. Furthermore, 27 of the 32 Eurozone banks on this list have branches or subsidiaries in the NoPS, the UK or the EEA/EFTA states. Essentially almost all of these banks have presence, interests, or significant exposures crossing the Eurozone borders on everyday basis. The banking market can be argued to be fully integrated throughout Western Europe, and at least semi-integrated throughout the entire continent.

Therefore, a reform covering 40-50% of that market only goes a similar percentage of the way. Avgouleas and Arner highlighted the "axiom that, although financial markets may be established anywhere […] in the absence of restrictions on cross-border flows, their stability may only be guaranteed through appropriate institutions and not by reliance on market forces' rationality and co-ordination." [1132] They assert that the arrangements designed "to safeguard the stability of the cross-border market cannot be delayed until formal integration efforts reach a peak, whether in the form of establishment of a single currency area, or otherwise."[1133]

At this point, cross-Eurozone-border flows are largely governed by harmonised rules, but such rules are not underpinned to adequate institutional arrangements, which lag behind market realities. Therefore, by virtue of the EBU, the threat to European financial stability stemming from the banking market is mitigated, but not eliminated.

2. Consequences of limited scope

Geographical scope limitations have left plenty of room for further differentiated integration in the EU. The dangers stemming from differentiated integration, and the harm they can do to the overall outcomes of the EBU, cannot be overstated. Schimmelfenning

[1130] For these purposes Western Europe is taken to mean the EU, the UK, Switzerland, Iceland and Norway.
[1131] Meaning the Commonwealth of Independent States and Ukraine
[1132] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.47
[1133] Ibid.

warned that:

"*if endogenous interdependencies and supranational institutionalisation among insiders grow faster and more strongly than externalities and informal institutions between insiders and outsiders, then differentiated integration produces centrifugal effects and causes the gap between insiders and outsiders to widen*."[1134]

As I discussed in Chapter 1, the GFC further merged the narratives of the EBU and the EMU, and thus strengthened path-dependency. That has been a catalyst for further disintegration. According to Schimmelfennig and Winzen "Euro crisis not only produced more integration in the Eurozone, but also more differentiation from the non-Eurozone countries. The Eurozone not only strengthened existing institutions (such as the Stability and Growth Pact), but also created new institutions, in which non-Eurozone countries do not participate."[1135] In addition to Brexit and the EBU, Schimmelfennig and Winzen point out other tendencies of disintegration, such as Cyprus joining Ireland as a long-term non-Schengen Member State, and Estonia, Hungary, Malta and Denmark seeking long-term exemptions from the free movement of capital agreements.[1136]

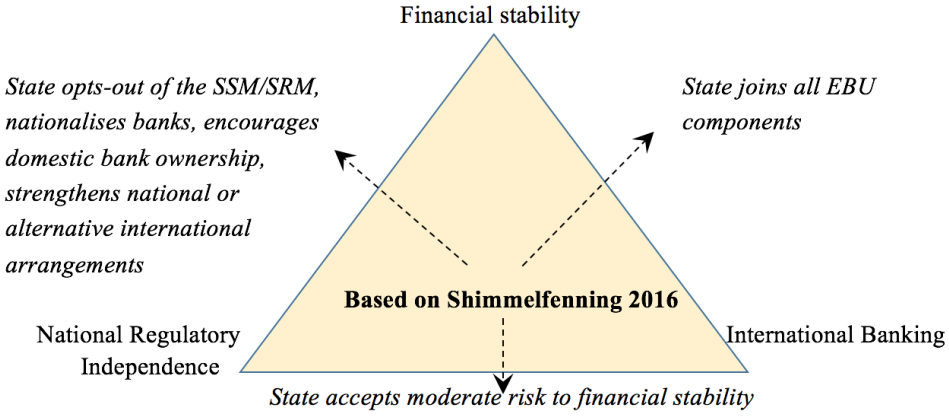
The centrifugal effects of differentiated integration are likely to further distance most NoPS from the EBU, which also makes the participation offer seem increasingly worse. For example, under the SSMR the ECB needs to take into account the principles of equality and non-discrimination, as well as the interests of the EU as a whole.[1137] However, according to Tridimas, as a "consequence of asymmetric integration […] the normative content of non-discrimination becomes more difficult to pin down."[1138] Some features of the EBU clearly favour the EMU States over the non-EMU States. Other features allow for a dynamic power fluctuation, the opportunities presented by which can be seized by EU institutions. The meaning of normative content can be lost in the crack between the two situations.

As mentioned, in the light of such imperfections, once determined to decline participation, the NoPS often invest in proofing its system against systemic shocks through banking sector nationalism or regionalism. I have discussed this phenomenon from the theoretical[1139] and

[1134] F Schimmelfenning, *A Differentiated leap forward: Spill-over, Path-dependency and graded membership in European banking regulation*, West European Politics 39:3, 2016, p.487
[1135] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.127
[1136] Ibid. p.120
[1137] Rec.30 SSMR
[1138] T Tridimas, *The Constitutional Dimension of Banking Union*, in S. Grundmann & H. Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.45
[1139] Chapter 1(C)

empirical[1140] perspectives. This dynamic was illustrated by Fig.1.7, which I would like to draw the attention to one more time.

Fig.1.7. Path dependency and the financial trilemma



The EBU is certainly a factor, in the pursuance of pan-European banking stability, but if it deepens differentiation rather than limits it, the EBU reforms can become counterproductive, especially if permanent dividing lines are drawn. "EU2[8] needs a strong EU1[9]. But measures to strengthen EU1[9] could undermine the integrity of EU2[8]. This is a core conundrum,"[1141] as Ferran and Babis concluded. The lack of harmonisation in banking oversight is an important issue. The EBU without the UK, Switzerland, Norway, Poland, Denmark, Czechia, Hungary and Sweden does not look like a pan-European reform. In the light of increasing banking sector nationalism and socialism in Visegrad, regionalism in the Nordics and Baltics, and Brexit, the SSM and SRM are themselves at risk of becoming regional structures.

That can undermine the effectiveness of the Single Rulebook and the EBU as a whole. The ECB has admitted that "despite the existence of common rules, divergent supervisory practices and outcomes pose a potential risk to the effective oversight of cross-border groups and the development of a level playing field in financial services."[1142] This is a very old problem that will not be solved, as long as unreformed home-host system remains. The Lamfalussy report, back in the day, warned about the banking oversight system's reliance on

[1140] Chapter 5(C)
[1141] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.22
[1142] ECB, *The fiscal impact of financial sector support during the crisis*, ECB Economic Bulletin, Issue 6/2015, p.3

national competence and political will.[1143] This is still the case in relation to the NoPS.

Importantly, the financial services markets are not fragmented along the same lines as the EBU mechanisms, which introduces further complications. Regional banking markets exist across the borders of European organisational memberships. Furthermore, the fragmentation in the EBU is deepened by exclusions of particular entities on political and constitutional basis, as well as arguably unnecessary flexibility left by the capital requirements legislation.[1144]

This fragmentation raises fundamental questions about the EBU's ability to safeguard financial stability, which is a very different aspiration from restoring it after a crisis. Tridimas stated that as "the fundamental objectives of BU are to safeguard financial stability within the EU and promote the internal market […] the underlying rationale of the of the SSM is to contribute to the soundness of credit institutions and safeguard financial stability by laying down a centralized supervisory system." [1145] How far does that goal stretch? How much of a guardian does the ECB, SRB and EBA, have to be? The answers to these questions depend on what we mean by "financial stability." From the perspective of economics, mere stability is not enough – what is required is stable *growth*. The main public function of the financial system is to finance the real economy. Therefore, maintaining and deepening the EU's internal market for banking services is considered "essential in order to foster economic growth in the Union and adequate funding of the real economy."[1146] That effectively presents three fundamental goals for future EBU development: 1. Contributing to banking sector stability throughout the Single Market, not just the EBU 2. Preventing further differentiation, and 3. Mitigating the effects of fragmentation.

C. Mending the divide: solutions and recommendations

Simply declaring that the EBU is 'too small' to ensure pan-European stability is hardly original. Contending that it might be insufficient to achieve the bare minimum of adequately protecting the Eurozone might be more contentious, but would still constitute a valid argument. Stating the problem is important, yet insufficient. The goal of research is - ultimately - to provide answers and solutions. In this section I will therefore explore potential

[1143] A Lamfalussy et al, *Regulation of European Securities Markets*, Final Report 15/2/2001
[1144] See V Babis, *Single rulebook for prudential regulation of banks: Mission accomplished?*, University of Cambridge Faculty of Law Research Paper No.37 2014, pp.9-15 and Chapter 2B of this thesis.
[1145] Tridimas, Takis, *European Banking Union, FIDE Congress Proceedings*, 2016, p.60
[1146] SSMR Rec.3

solutions to the SSM/SRM's geographical scope problem, assessing their merits and shortcomings. Before doing so, in Subsection 1, I will assess the likelihood of the NoPS considering the (potentially revised and improved) participation offer.

1. Can the NoPS still be persuaded?

Despite their reluctance to participate, the NoPS are not ideologically averse to the idea of the EBU. Even the most reluctant States like the UK, Sweden and the Czech Republic welcomed the reform as a whole. None of the current NoPS rejected the SSM/SRM from the start and gradually arrived at their conclusions, as they assessed the final form the Mechanisms took, and the processes that shaped them. Many of the NoPS, including Sweden and Poland, fought to achieve better conditions for the non-Euro States signing the CCA, indicating that participation was very much a possibility. The rhetoric coming from the NoPS did not indicate hostility. The Hungarian Prime Minister Viktor Orbán said that Hungary was in favour of the overall arrangement, as far as the essence of it is concerned.[1147] At the launch of the SSM, the National Bank of Denmark governor Lars Rhode was "firmly convinced" that Denmark "should opt-out of the EBU," but also recognised its merits.[1148] Mugur Isarescu, the Governor of Romania's central bank, said that participation could act as a mechanism for removing incentives for deleveraging on the part of banks with foreign capital, reduce opportunities for regulatory arbitrage, and allow the country to resist crisis contagion effects better, while also contributing to market competitiveness.[1149] It can be recalled that Romania still intends to join the SSM and SRM *eventually*, even if alongside the EMU. Even the former Czech National Bank Governor, Miroslav Singer has said that the CNB generally "supports the idea of a banking union in Europe."[1150]

This indicates that some, if not most, NoPS would consider full EBU membership, if participation conditions were to their satisfaction or in their interest. Creating such conditions will not be easy. Despite the favourable view of the EBU as an idea, as far as the actual mechanisms go, the reaction to the EBU proposals indicated "fundamental opposition rather than mere technical concerns" among the NoPS, and many of such concerns remain.[1151] As I have discussed in Chapters 2-3, the Governing Council Representation issue is a major stumbling block, resulting in a number of sub-optimal features of the SSM and EBU as a

[1147] G Lovas, *EU closer to banking union; Hungary on the fence*, Budapest Business Journal, 01/2014
[1148] Carlyle, T., *Lars Rhode 'firmly convinced' by merits of banking union*, cenralbanking.com, 10/10/2014
[1149] M Isarescu, *Relations between euro and non-euro countries within the Banking Union*, BIS, 2014, p.4
[1150] T Zavadilova, *Bankovní unie se piblížilam, Česku ještě nehrozí*, e.15.cz, 2013 Translation is mine.
[1151] B Speyer, *EU Banking Union: Right idea, poor execution*, Deutsche Bank, 2013, pp.1, 17

whole. This is confirmed by the fact that only the States that expect to avoid it through eventual EMU membership have signed the CCA. Persuading countries with no intention to join the EMU will obviously prove more problematic. It is, however, imperative for triggering a centripetal reaction. In order to create a pull towards the EBU for more States, the EU will first need to find ways to persuade at least one State which does not have plans to join the EMU. That is a critical challenge.

The effort to facilitate that is most certainly worthwhile, as changes in membership would affect not just the NoPS joining, but also the interconnected Eurozone markets. For example, in the Baltic States fundamental rebalancing between the Eurozone on non-Eurozone banks would occur, if Denmark or Sweden joined the EBU. If two of the NBR giants (SEB, Swedbank, DnB and Danske) were placed within the EBU, the market share of non-SSM banks in Lithuania, Latvia and Estonia could drop below 50%. Predominantly host States could also tip the scales. If the Czech Republic joined, that would reduce the percentage of Eurozone groups' assets located outside of the ECB's reach. Such developments would also affect consolidation mechanics.

The path to such scenario is not easy. Even Romania's participation is not guaranteed and might require additional incentives. As discussed in Chapters 4 and 5, improving banking sector health and diminishing short-term prospects of the EMU membership have slowed down its integration. Denmark and Hungary would probably expect some concessions in membership negotiations, which is something the EU has (so far) been unwilling to compromise on. Czechia, Poland and Sweden would expect a systemic reform. The most reluctant NoPS are unlikely to move in the absence of a major domestic deterioration, or significant improvements to membership conditions. Generally speaking, by addressing the concerns of the NoPS and having due regard for the underlying structural factors influencing their decisions, the EU might be able to encourage participation of some - but probably not all - NoPS.

2. Treaty Change

The possibility (and need) for change is recognised in the EBU legislation itself. The SSMR[1152] refers to the Communication of the Commission[1153] discussing the possibility of amending Art.127(6) TFEU to allow a direct and irrevocable opt-in procedure beyond the

[1152] Rec.85
[1153] Communication of the Commission of 28 November 2012, *Blueprint for a deep and genuine economic and monetary union*

CCA, granting the non-EMU States participating in the SSM "full equal rights in the ECB's decision-making," and constitutionalising the separation of decision-making for monetary policy and supervision.[1154] Back in the Lamfalussy era, it was generally thought that a Treaty change would be necessary for "the creation of a single EU regulatory authority for financial services."[1155] While a workaround has been found by limiting the ECB's domain to banking and the SSM/SRM scope to the Eurozone and CCA States, such limitations are an unfortunate necessity, rather than an optimal arrangement. The possibility of a Treaty change might need to be revisited.

Given the level of centralisation, the magnitude of the reform and the amount of liquidity in question, Arts.114 and 127 TFEU seem to be inherently problematic as sources of constitutional legitimacy. The former due to its limitations in relation to institution building, the later due to its jurisdictional limits and imprecision. That is especially the case since the EBU powers of the ECB do not sit easily with the established reading of the principle of subsidiarity, as discussed in Chapter 2E. Of course, the biggest issue is that Treaty limitations bar the NoPS from representation in the ECB's Governing Council.[1156] This problem is further aggravated by the inter-linkages with the SRM, and the ECB's influence on the provisions of the Single Rulebook.

A Treaty change is of course possible, and the procedure for that is well known. Treaty change proposals can be submitted by the Government of any Member State, the European Parliament, or the Commission.[1157] These proposals may, *inter alia*, serve to increase the competences conferred on the Union, such as the competencies of the ECB. However, Treaty changes require political consensus, which is unlikely. The inclusion of the CCA State representatives in the Governing Council would dilute the power of Eurozone insiders, and give CCA States undue say. In theory, the Governing Council could include the CCA representatives, when sitting in its supervisory capacity, and not include them when sitting in the monetary capacity, making use of the existing separation. However, as discussed in Chapter 2, such separation itself has been criticised as sub-optimal.

Moreover, Eurozone States might insist on weighted voting, which already exists for some Governing Council decisions. Under Art.10.3 of the ECB Statute, Governing Council decisions relating to the ECB's capital are made through weighted voting, according to the national central banks' shares in the subscribed capital of the ECB. If voting was weighted on

[1154] Ibid.
[1155] A Lamfalussy et al, *Regulation of European Securities Markets*, Final Report 15/2/2001
[1156] See Art.10 ECB Statute
[1157] Art.48(2) TEU

the basis of the contributions to the SRF or a similar measure, most CCA States would be at a disadvantage, due to the size of their banking sectors.

Furthermore, the Treaty change would still not make the position of the non-Euro opt-ins 100% equivalent (or ideal for them), as they would not be able to take part in the ECB's liquidity provision. The communication of the Commission stressed the irrevocability of the new (proposed) cooperation agreement, which would remove the threat of being 'kicked out', but that would also remove one of the safeguards the CCA States now have at their disposal. It is unclear whether there as a NoPS' consensus on the matter. While persuading some NoPS, such changes could dissuade some others.

Most importantly, this Treaty change would, in all likelihood, need to come as part of the package of measures further reforming European financial supervision, with all the associated costs. In the current political and economic situation, where the financial system is flooded with cash and liquid assets, the appetite for such reform will remain minimal for the foreseeable future.

3. Giving legal capacity to the supervisory colleges

Another proposal, discussed at length by Carmassi at al., was turning the supervisory colleges into effective supranational supervisory structures, acting under the ECB's instructions, with "full powers to control and inspect all branches and subsidiaries of cross-border banking groups, thus getting rid of the current artificial task allocation between home and host country control while at the same time making full use of existing supervisory structures."[1158] According to this proposition, the colleges would deliver supervisory reports, including proposals for remedial action, to the ECB Supervisory Board, which would deliberate on the report's recommendations, and entrust the colleges with the implementation of the ultimate decision.[1159]

Such reform could in fact contribute to the effectiveness of cross-border supervision between the Eurozone, CCA States, and the NoPS. As I have discussed in Chapter 3, the main problem with the current EBU-style colleges of supervisors is that they do not have legal capacity, nor do they actually have any of the above-mentioned powers. A further problem is that supervisory colleges created on non-EBU basis, even if created under the EBA's guidance, are unevenly distributed around Europe and display huge disparities in

[1158] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, p.5
[1159] Ibid.

cooperation intensity and effectiveness. Some level of improvement can be achieved, but questions remain as to the extent of that improvement.

To achieve its full potential, a colleges-based system would need to be able to stretch beyond the EU, at least as far as the UK, EFTA, and EEA states. The problem is that the ECB could not take part in such colleges, if they had legal capacity or power in their own right. That is because the ECB as a supervisor cannot impose obligations on itself in respect to third countries. A college-based system would thus need to either continue to ignore the integrated regional banking market realities, or operate on the basis of an international Treaty that the EU as a whole would accede to. Both solutions are impractical. Moreover, as some degree of differentiation between colleges would remain, that would go against the goal of European harmonisation and the EU's neofunctionalist agenda of centralisation. The result could be further regionalisation of supervision. That could create duplication of tasks and possibly generate conflicts, where the interests of large regional colleges and the ECB would collide. A college-based solution could make cross-border supervision even more complicated and – possibly - costlier.

That is not to say that the existing college system cannot be improved and utilised better. That should involve more recognition for regional colleges, created on the initiative of the participating supervisors, and reducing the disproportionate influence of the largest members of the college (particularly the consolidating supervisors), redistributing the powers more evenly.

4. Stipulating the scope and procedure for negotiations

The most effective and straightforward way to further integration and harmonisation of EU banking oversight is, of course, encouraging more NoPS to participate in adjusted existing arrangements. Assuming some NoPS are willing to live with the Governing Council issue and its consequences, it might well be that the best way to go about it is to expand the scope of negotiations preceding the CCA. The NoPS would potentially want to use Art.1(2) SSMR excluding institutions referred to in Art.2(5) CRD. I have criticised such exclusions as a threat to level playing field and regulatory harmonisation in Chapter 2. Nevertheless, such exclusions, if created through a clear and transparent process, could be successfully used in order to remove particular stumbling blocks in negotiations. This would not be unprecedented, as changes to this provision have been made by Directive 2019/878, *inter alia* facilitating the exclusions requested by Croatia and Bulgaria. The obvious danger is further politicisation of this provision, the evidence of which I have provided in Chapter 2E.

If the EU showed willingness to accommodate broader negotiations, Denmark and (possibly) Hungary would consider participation, as some of their structural characteristics have produced natural incentives, as discussed in Chapter 5. However, it is questionable whether the EU would be willing to make such concession, not in small part due to level playing field and operational stability concerns. Furthermore, additional exclusions would be unlikely to change the positions of predominantly host NoPS.

5. *Liability of the ECB and legality of actions*

Moloney mentioned Member State concerns "with respect to the legal protection of banks, in particular in relation to the appropriate judicial forum for bank remedies where NCA action has been dictated by the ECB."[1160] The ECB itself is almost impossible to sue, and there are certainly good reasons for that. According to the Basel Principles, the legal framework for banking supervision has to include legal protection for the supervisor.[1161] The laws need to "provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith."[1162] Academics also see outright ECB liability with scepticism, partly due to the limits of the courts' knowledge in this highly technical area.[1163] The ECB thus fought tooth and nail to limit its liability to 'qualified unlawfulness', such as intentional misconduct or gross negligence.[1164] This is generally the established practice in many national jurisdictions, in line with the CJEUs jurisprudence.[1165] The ECB justified such protections on the basis of an "obligation to protect the plurality of interests" in the banking system, and needing to operate, particularly in the times of crises, "under tight time constraints."[1166]

The problem is that the SSM liability restrictions, in principle, do not stand in the way of the liability of the NCAs in national law.[1167] Furthermore, the liability standards differ between Member States, with some allowing liability only for wilful misconduct or gross

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[1160] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1647
[1161] Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, 2012, principle 2
[1162] Ibid. essential criteria, p.22
[1163] See JA Ponce, *Normative analysis of banking supervision: Independence, legal protection and accountability*, Paolo Baffi Centre Research Paper No.2009-48, 2009, p.4
[1164] Opinion of the ECB of 27/11/2012 on a proposal for a the SSMR and the EBA Regulation amendment, CON/2012/96, point 1.7
[1165] Ibid.
[1166] Ibid.
[1167] E Wymeersch, *The Single Supervisory Mechanism or 'SSM', Part one of the Banking Union*, National Bank of Belgium Working Paper No.255, 2014, p.59

negligence, while others apply the common rules on liability for mere negligence.[1168] For example, under Art.2 of the Statute of the Bank of Lithuania, the institution is a legal person.[1169] It does not have exclusive legal protection and can be sued. This stands in stark contrast with the German Bundesbank. A hypothetical NCA1 could be doing the exact same thing - following the 'orders' of the ECB - as NCA2. However, NCA2 is legally protected if the measure backfires, whereas the NCA1 might not be, especially if the ECB's direction is limited to guidance, rather than outright instructions. This situation is even more complicated for non-EMU States, which are not part of the Eurosystem. A clearer NCA liability framework needs to be established as part of the SSM legislation, to alleviate the NoPS concerns.

6. Creation of an appeal and review panel

Given the ambiguity and impracticality of the liability provisions, the creation of a more effective and timely review and appeal system is imperative. I have highlighted the ineffectiveness of the current dispute resolution system in Chapter 3, including the limitations of the SSM Mediation Panel and Administrative Board of Review. As things stand, the NoPS are unwilling to accept the Governing Council as the absolute and unquestionable authority on all decisions, with the termination of the CCA being the only pushback option. A possible solution could be creating an independent appeal panel, including personnel delegated by all NCAs involved in the supervision of (and resolution planning for) the credit institution in question, as well as the ECB. Such panel could also serve as a first instance of review for ECB's rule-making.

Alternatively, the SSMR could be amended, giving an opportunity for the States concerned (or their NCAs) to address their own objections to the Mediation Panel. The downside of such arrangement would obviously be the resulting sacrifices in decision-making efficiency, but that could be mitigated by a simplified procedure for such objections and the Panel being able to issue interim decisions.

[1168] Ibid. p.58, with reference to D Nolan, *The liability of financial supervisory authorities*, Journal of European Tort Law, Vol. 4, 2, 2013, pp.190–222

[1169] Bank of Lithuania Statute, 1 December 1994 No I-678, last amended on 30 June 2016 – No XII-2562

7. *EU-level supervisory standards legislation*

While it is important to note that, quality-wise, standards of supervision do not differ much between the Eurozone and the NoPS,[1170] as Avgouleas and Arner observed, "*[d]ifferent supervisory handbooks and supervisory approaches between the Member States participating in the [SSM] and the other Member States pose a risk of fragmentation of the single market, as banks could exploit the differences to pursue regulatory arbitrage*."[1171]

It is clear that the EU supervisory system lacks a common supervisory practices statute, which would draw a baseline for all EU supervisors. The EBA standards still lack the firepower to achieve cohesion of practices. Moreover, gaps are still evident in somewhat unexpected places. For example, the entire body of legislation (TFEU, CRR, CRDIV, SSMR, SSMFR, SRMR, PRR, etc.) does not include a precise definition of prudential supervision. While the details should continue to be specified by the EBA, a brief and precise EU Regulation stipulating the most important commonly agreed definitions and practice requirements is both desirable and feasible. Moreover, in the long run, it could phase out the ECB's supervisory handbook, which is deemed to create discrepancies between the SSM/SRM and the NoPS.

8. *Stricter separation between pillars*

The SRM is fundamentally legally joined to the SSM in terms of its geographical and jurisdictional scope and is therefore limited to Eurozone States, and those in close cooperation, in accordance with Art.7 SSMR.[1172] There are, of course, credible justifications for such interconnectedness. Supervision without the Single Rulebook would lead to fragmentation and competition distortions.[1173] Supervision without the SRM would not break the vicious circle, and neither would resolution without burden-sharing.[1174] It is believed that subjecting the NoPS to the SRM without the SSM would create wrong incentives. The NoPS NCAs could be disproportionately and unduly lenient towards banks in their jurisdictions "as they would not have to bear the full financial risk of their failures."[1175] This could arguably lead to exacerbation of the 'national champions' problem, discussed in Chapter 1, rather than

[1170] P Smaga, *Assessing Involvement of Central Banks in Financial Stability (May 23, 2013). Center for Financial Stability Policy Paper*, Center for Financial Stability Policy, 2013, p.42
[1171] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.42
[1172] SRMR Rec.16 and Art.2
[1173] B Speyer, *EU Banking Union: Right idea, poor execution*, Deutsche Bank, 2013, p.4
[1174] Ibid.
[1175] SRMR Rec.17

reduce it. Baglioni also pointed out BRRD Art.32(4)(d) conditions as a means to "to deter early bailouts by national governments" seeking to avoid the resolution procedure.[1176]

A fundamental problem for the EBU highlighted in Chapters 2-3 is that the interconnectedness between the SSM and SRM has brought all the problems stemming from the inequality of representation in the Governing Council into the domains of other pillars of the EBU. While participation in the two Mechanisms should not be separated, for the aforementioned reasons, a stricter division between functions needs to be established. The SRB needs to be strengthened. The ECB now has meaningful say in triggering resolutions and can facilitate early interventions. As long as the Governing Council stands as its most powerful organ, such spill-over will remain unacceptable to many NoPS. At the very least, the SRB needs to have the ability to meaningfully object to the ECB's decision to intervene early, through a quick and timely procedure. If a dispute arises, it could be handled by the above-mentioned appeal and review panel. Furthermore, the Single Rulebook and the supervisory technical standards should remain the sole responsibility of the EBA, and the ECB should be more restricted in its attempts to influence their content.

9. A convention that the Governing Council interferes less

Another solution would be to reduce the impact that the Governing Council has on the practical level. Currently, the Supervisory Board can only propose decisions which must ultimately be adopted by the Governing Council. As Moloney observed, the default scenario is silent assent of the Governing Council, but it can nevertheless object in a time-limited manner, in which case a Mediation Panel intervention can be requested by the NCAs.[1177] This convention could be strengthened, ensuring that the Governing Council would only interfere under exceptional circumstances. That solution would not go very far, however. The Governing Council bares the ultimate responsibility for the actions of the ECB, which creates conflicting pressures with respect to accountability. The Governing Council cannot be a figurehead or a passive organ in any system involving the ECB.

10. Unwillingness to bail out non-interconnected States

As my research in Chapter 5 has indicated, important concerns relate to having to bail out banks in otherwise not interconnected States, and creation of direct pathways of liquidity

[1176] Baglioni, *supra*, p.88
[1177] N Moloney, *European Banking Union: assessing its risks and resilience*, Common Market Law Review, Vol.51, Issue 6, 2014, p.1652

into the economies where such need is the most likely to arise through the SRF. Such economies tend to have credit institutions with a high percentage of non-performing loans. The reluctance to partake in the SRM in turn incentivises banking sector nationalism and regionalism, which are - from the perspective of the Single Market - undesirable. There is no single solution to this problem, but a set of measures could alter the balance of incentives and disincentives.

Alexander recalls that in 2013, Germany and France proposed an alternative single resolution mechanism, established on the basis of existing EU treaties, based around a single resolution board consisting entirely of national resolution authorities who would have had powers to act expeditiously.[1178] With the supranational element weakened and the influence of the NRAs increased, some NoPS might be more comfortable with taking part. While it is too late to change the SRM structure into this model (and there are important reasons why it was not adopted), strengthening the positions of the NRAs individually, (or collectively as part of the SRB) would go a long way. A reduction of the ECB's impact on resolution decisions should be a part of this set of measures.

The second leg of the solution would involve changes to existing legislation, seeking to provide incentives for States and banks to create exposures across the EU, including other Member States' sovereign debt. That would eventually result in greater market cohesion, as well as deepen the collective interest in the stability of the banking markets in other States and regions.

One of the possible examples of such changes could include alterations to capital requirements legislation. In Chapter 2 I discussed a number of provisions in the CRR/CRD package allowing a number of questionable exemptions from the large exposures limit, which includes intra-group exposures, assets constituting claims on governments, central banks or public sector entities.[1179] A further exemption is for government bonds and asset items constituting claims on regional governments or local authorities. This makes a big difference, as otherwise credit institutions are prohibited from creating exposures exceeding 25% of their capital to a single counterparty or a group of counterparties.[1180] As discussed in Chapter 1, the vicious cycle of the GFC was largely linked to disproportionate bank exposures to central governments of their own home States. If an exposure limit was imposed on claims on the

[1178] K Alexander, *European Banking Union: A Legal and Institutional Analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism*, European Law Review Vol.40 2015, p.175, see Présidence de la République, *France and Germany—Together for a stronger Europe of Stability and Growth*, 2013, pp.4–5
[1179] CRR Art.400(1)(a) and (2)
[1180] Art 395 CRR

national governments of the States where the banks have established presence, they would be forced to look into government-backed claims in other Member States. As the market would become more integrated, the NoPS would also develop a greater interest in the broader EU banking sector health, which would make the contributions to the SRF, as well as the costs of the SSM, more palatable. This stick should obviously come with a carrot. Although fiscal union is not (currently) on the cards, an agreement on tax incentives could still be reached, encouraging exposures to claims on governments and public bodies in other Member States, including sovereign debt.

Such exposures would contribute to blurring the distinction between the NoPS and the Eurozone States, as well as the 'peripheries' and the more 'resilient' banking markets. The Euro States are already indirectly exposed to other Euro States through shared currency - an element of the 'inconsistent quartet' that the NoPS lack. Any measure that would deepen the interconnectedness between the NoPS and the SSM/SRM States (while presenting notable short-term dangers) would also produce participation incentives.

11. Return to integration through law

Micklitz argued that the EBU is a culmination of a process whereby "integration through law was gradually replaced by "integration through governance." [1181] One of the ways to restore the NoPS trust in the EBU agenda would be to return to integration through law. This could also help modify the Single Rulebook in a way that would make the attainment of the goals of the SSM and SRM easier. Generally, that would mean removing some of the flexibility enjoyed by the ECB, the NCAs and the States. However, since all three would need to make sacrifices, that (in theory) should not create further power imbalances.

Carmassi et al. proposed what they called an "American-style" system, with capital weakness indicators to signal the need for corrective action, based on a set of thresholds corresponding to remedial actions of increasing intensity, coupled with a mandatory supervisory action when the thresholds are crossed. They point out that the adoption of such system was discussed by the Basel Committee but never agreed upon.[1182] This idea is

[1181] H Micklitz, *The Internal Market and the Banking Union*, in S Grundmann and H Micklitz (Eds.) *The European Banking Union and Constitution: Beacon for Advanced Integration or Death-Knell for Democracy?* Hart Publishing 2019, p.289

[1182] J Carmassi, C Di Noia, S Micossi, *Banking Union: A Federal Model for the European Union with Prompt Corrective Action*, CEPS Policy Brief No.282, 2012, p.7

generally half-implemented in the EBU, as the thresholds give supervisors the power to act, but the legislation falls short of creating an outright obligation.

Babis proposed further harmonisation of the rules themselves, taking place on two levels: Level 1 comprising of fully harmonised prudential requirements, technical rules and methodologies (e.g. calculation of capital, definition of capital instruments, approaches to group consolidation, statistical models, reporting requirements and methods), and level 2, comprising rules where some margin is left for national adjustments: e.g. waivers, adjustments to macroprudential and systemic requirements, or even adjustments to minimum prudential requirements as a result of supervisory review.[1183] The objective would be not to eliminate all divergence, but rather to harmonise supervisory practices.[1184]

Another improvement, this time linked to the SSM itself, would be to recognise classifications as credit institutions in national law. While this might disturb the surface of the playing field, it could also give the States more say in what they see as concerning and in need of the ECB's attention. On a related note, more attention should also be paid to the track record of the institution in question, as the case is in many national jurisdictions, especially since one such factor – ESM support – is taken into account. While this suggestion might appear to go against the premise of legal certainty - it does not. Recognising the entities' history and national classifications, while an imperfect solution, is preferable to having two overlapping regimes.

Most importantly, the definitions of micro and macro prudential supervision and regulation need to be clearly stipulated in primary legislation. While such stipulation has its downsides, as discussed in Chapter 2, it would nevertheless mitigate legal uncertainty and reduce jurisdictional competition.

12. Demarcating the limits to ECB's discretion

In order to return to integration through law, ECB's discretion in relation to its expanding powers should be curbed. The situation regarding the ECB's ability to draw any institution into its domain is unsatisfactory. In principle, the SSM - and consequently the SRM - is based on a system of separation by significance, which, as the *L-Bank* decision discussed in Chapter 2(C) shows, can be quite easily overridden by the ECB's discretion. The only counter argument the NCAs have is that there are particular circumstances because of

[1183] V Babis, *Single rulebook for prudential regulation of banks: Mission accomplished?*, University of Cambridge Faculty of Law Research Paper No.37 2014, p.8
[1184] Ibid.

which the "supervision of a significant entity by the national authorities would enable the objectives pursued by [SSMR] to be better achieved" by the NCA.[1185] This is an unrealistically high standard, which only works if the ECB agrees with the NCA on the issue, as the NCA would find it very difficult prove that in court. However, the home State can then use political influence to exclude a specific entity using Art.1(2) SSMR by amending the CRD, which has been done in relation to L-Bank itself. As things stand, the leading judicial authority on the demarcation of jurisdictions between the NCAs and the ECB prescribes the outcome which is *de facto* not the outcome of the dispute which gave rise to that litigation. That is a mind boggling maze which, albeit not uncommon in the complex and intricate EBU legal framework, leads to unjustifiable legal uncertainty. As a consequence, the most important exemptions happen on the basis of lobbying and political pressure, likely favouring large Eurozone States' banks.

Mills has observed that subsidiarity as an EU legal doctrine is subject to periodical constitutional renegotiation,[1186] where the settlement is achieved "through a legal rule or political negotiation," allocating a competence exclusively to the States or to the supranational level, and justifying such allocation.[1187] Dynamic elements in such settlement make the basis of such justification difficult to pin down. While, through complex manoeuvring and legal jargon, it is possible to uphold such arrangement on the legal level, on the political level the NoPS retaining temporal flexibility or unwilling to adopt the Euro are right to be sceptical. A solution, which will eventually be necessary, is for the EU to stipulate clear demarcation between the domains of the NCAs and the ECB, which should take the form of an unambiguous statement in the amendment to the SSMR and SSMFR. Such legislative statement should take place, even if the ECB's domain is absolute. In fact, in such case it is even more imperative.

13. Bilateral agreements

The EU has a long history of establishing cooperation with other parties through the so-called bilateral agreements. That is yet another legal avenue that enhanced cooperation could take, but their uses are limited. Bilateral agreements are not something that the EU could enter into with its own Member States. They could, however, be used to formalise and strengthen the cooperation with EEA States, Switzerland and the UK.

[1185] *Landeskreditbank Baden-Württemberg v. ECB*, Case C-450/17 P, para.55
[1186] A Mills, *Federalism in the European Union and the United States: Subsidiarity, Private Law and the Conflict of Laws*, University of Pennsylvania Journal of International Law, Vol.32, No.2, 2011, p.384
[1187] Ibid.p.382

It is worth exploring such agreements as an alternative to the memoranda of understanding, currently in place for cooperation with the NoPS and third countries. Unlike the memoranda, bilateral agreements are legally binding and have the status of an international treaty. They would, notably, impose reciprocal obligations on the ECB, EU and possibly the Member States, so they would need to be entered into by the EU as a whole. While, as mentioned, they cannot be used for the NoPS, bilateral agreements could be an option for cooperation with the EEA States. The current EEA Agreement does not establish binding provisions in all sectors of the internal market or in other policies under the EU Treaties. In particular, its binding provisions do not concern the EMU and some aspects of the financial services policy.[1188] Bilateral agreements could, in theory, go beyond that.

Notably, these agreements would need to take a different form from the ones currently in use, such as the ones facilitating the cooperation and trade with Switzerland. The Swiss agreements are bound by the so-called guillotine clause: terminating any of the agreements terminates them all. Such clause would obviously be unacceptable in the banking oversight context, and the supervisory cooperation or resolution planning agreements would need to stand as separate international treaties. It is questionable whether the political will needed for such arrangement can be harnessed.

14. Riding the waves of natural processes

Some of the problems stemming from non-participation can be solved through more nuanced use of ongoing processes in the market, rather than legislative reforms. In some sense they are not measures in their own right, but rather utilisation of the effects of existing measures.

Schimmelfennig and Winzen's analysis suggested that differentiated integration becomes self-reinforcing if a shock hitting a differentially integrated area affects the insiders more than the outsiders, forcing "the insiders to press ahead with integration."[1189] They further reasoned that "if insiders and outsiders were equally affected, we would not see a widening gap; if outsiders were more affected than insiders, we might even observe convergence."[1190] Notably, if the insiders could efficiently deal with the shock without having to integrate further, insiders and outsiders would not diverge.[1191] From that it can be reasoned even further, that any improvement in European banking supervision and resolution

[1188] European Parliament, *The European Economic Area (EEA), Switzerland and the North*, Fact Sheet
[1189] F Schimmelfennig, T Winzen, *Ever Looser Union?*, Oxford University Press 2020, p.135
[1190] Ibid.
[1191] Ibid.

planning, even within the Eurozone, increases the likelihood of convergence, if it ensures financial stability, and thus prevents a shock. Therefore, any measure that strengthens financial stability is in itself a countermeasure to disintegration. As the findings presented in Chapter 5 illustrate, the level of non-performing loans is an important variable in the participation decision. Hypothetically, at the moments where the Eurozone State (particularly peripheral) NPLs are low and the NoPS' NPLs are relatively high, strong centripetal forces would be created. Notably, that needs to be achieved through sustainable banking practices, not artificial processes created by the ECB's activity.

The consequent membership of a couple influential NoPS could create a further centripetal effect, as being one of – hypothetically – three remaining NoPS might not be comfortable. While that would give those remaining NoPS a massive say in the EBA, such privileges could turn out to be temporary.

Furthermore, even if centripetal tendencies do not manifest in signing of the CCA, if present, they can lead to a certain degree of convergence through less tangible influences. For example, Spendzharova and Bayram have found evidence that despite Sweden's decision to opt-out, the implementation of the EBU structures in the Baltic States "significantly affects the decision-making scope of Swedish and other home supervisors."[1192] There is a further notable tendency of legislative convergence. For example, Hungary rushed to mirror the SRM resolution system as soon as it started becoming clear what it was going to look like.[1193] Even Norway promptly adopted the EBU capital requirements legislation. The Norwegian Ministry of Finance subsequently issued a regulation on the identification of systemically important financial institutions in Norway, largely mirroring the SSM methodology.[1194] DNB ASA, Nordea Bank Norge ASA, and Kommunalbanken AS were designated as 'systemically important'.

Public and private stakeholders also had some influence on the recent convergence (and divergence) processes after the launch of the EBU. Nordea's calculated move into the Eurozone indicates that the EBU is attractive to at least some market participants. Such moves can also change the financial stability outlook for particular participating States. As a consequence of Nordea's move, neither NoPS nor EEA banks pose a threat to the Finish banking sector, since Nordea's move from Sweden to Finland effectively 'moved' ¼ of the Finish market share entirely into the EBU. Consequently, 70% of the Finish market is

[1192] A Spendzharova, I Bayram, *Banking union through the back door? How European banking union affects Sweden and the Baltic States*, West European Politics, 39:3 2016, p.566
[1193] G Lovas, *EU closer to banking union; Hungary on the fence*, Budapest Business Journal, January 2014
[1194] Norwegian Government, Ministry of Finance, *Press release No.21/2014*, 2014/05/12

controlled by three largest ECB-supervised domestic entities. It should be noted, however, that Nordea's move to Finland, significant as it was, has not triggered a wave of EBU-bound exodus or altered Sweden's position towards the EBU. While the Eurozone might be slightly more attractive to some institutions, the non-EBU States also have their advantages, and so does the avoidance of the ECB's scrutiny, as the L-Bank saga would suggest.

D. Conclusions

This thesis sought to explain why most non-Eurozone Member States of the EU have so far chosen not to participate in the European Banking Union. The explanation comprises political, economic and legal domains, all firmly intertwined with each other. As this research has indicated, there is no single answer. However, through legal and politico-economic structural analysis, I have developed a methodology allowing for an informed assessment.

Before concluding on the findings based on this assessment, it is important to stress that the completion and expansion of the European banking Union is of paramount importance to the EU long term, if European banking market is to ever become fully self-sustainable and shock-absorbent. As Ferran and Babis expressed it "there are hard-nosed pragmatic considerations as well as genuine high-minded principles that lie behind the emphasis that has been placed on avoiding fragmentation of the internal market following the establishment of the SSM."[1195] According to Avgouleas and Arner, the EBU is inseparable from the completion of substantive regulatory reforms of the Single Market and the Single Rulebook.[1196]

If that is the case, the processes leading to disintegration (and amplified by path-dependency) need to be recognised, halted, or – at the very least - decelerated. The NoPS have many reasonable concerns, as well as their own unique sets of banking sector structural characteristics, all of which need to be accounted for. All of the analyses provided in this thesis lead to one overriding problem: congruence between the EMU and the EBU, which is unfavourable to non-EMU States, and has the potential to further distance them from participation. That is ultimately the conclusion of the historical analysis in Chapter 1, legal analysis of the pillars of the EBU in Chapter 2, analysis of the voluntary participation mechanics in Chapter 3, discussion of all individual NoPS in Chapter 4, and structural

[1195] E Ferran, VSG Babis, *The European Single Supervisory Mechanism*, University of Cambridge Faculty of Law Research Paper No.10, 2013, p.22
[1196] E Avgouleas, DW Arner, *The Eurozone debt crisis and the European Banking Union: A cautionary tale of failure and reform*, The University of Edinburgh 2013, p.40

analysis of statistical data in Chapter 5. Even the (hesitant) memberships of Bulgaria and Croatia are not an outlier in this equation, as they only moved to sign the Close Cooperation Agreement when the EMU membership became a mid-term option.

However, while the congruence between the EBU and the EMU is evident, it does not in itself determine the behaviour of individual NoPS. My research in Chapter 3 reveals that participation terms offered to non-Eurozone States put them at inherent disadvantage, but the effects of such disadvantage can be mitigated by altering legal measures. Moreover, my findings in Chapter 5 reveal that banking sector structural characteristics can ultimately determine how the Member State approaches participation, and how much the legal imperfections affect them. Subtle and informed legal changes can thus create a mosaic of incentives, which can encourage participation, especially if the economic cycle of the country in question presents suitable conditions for close cooperation.

Decisive and informed action at this junction is very important. If the EBU continues as a manifestation of path-dependency, it will condition further differentiation, consequently producing spill-over effects, impacting future EU developments. The current levels of differentiation would undoubtedly threaten the future capital markets union, which will be particularly exposed to the EBU. The relationship between these unions will be an interesting strand for further research, for which the findings in this thesis could serve as a starting point.

This Chapter therefore sought to provide solutions for legal reforms that could bridge the gap between the NoPS and the EMU States. A suitable combination of such measures could trigger natural processes leading to centripetal dynamic of gradual integration, and mitigate the centrifugal dynamic of further differentiation.

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