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# Assessing the Challenges to the Single European Banking Supervision

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## Abstract

*The aim of this paper is to examine the challenges of the establishment of the Single European Banking Supervision. The financial crisis has powerfully demonstrated the need for a new approach to banking regulation and supervision. In fact, the Eurozone debt crisis has shown that there are weaknesses in the design of the EMU and a new architecture is needed. One of the strategic directions is to establish a regulatory and institutional framework at the European level with the aim of protecting and ensuring financial stability through the effective and consistent application of a single and uniform rulebook. The single supervisory mechanism is designed for those countries within the Eurozone, but is also open to other EU countries. Closer coordination would ensure that responses to EU-wide economic problems are coordinated and therefore much more effective. The Single European Banking Supervision will have a statutory objective to promote the safety and soundness of the EU banking system. It is one of the measures to overcome the debt crisis in the Eurozone and a decision with far-reaching implications. In this paper we will elaborate the positive and the negative consequences from the single supervisory mechanism. Critics of this idea of the Single European Banking Supervision point out the existence of a reputational risk and a conflict of interests. Also, according to critics of the current approach to making and dealing with the crisis marked as "too little, too late" creates the perception that decision is more a sign of weakness rather than of having a clear vision and plan for the future of the*

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*European (Monetary) Union and to exit from the current crisis. Vision for the future of the EMU in the long run, undoubtedly lies in a deeper financial, fiscal, economic and political integration of the Eurozone.*

*Keywords: European Union, banking sector, financial system, supervision, regulation*

## Introduction

The crisis has made it clear that a stronger institutional framework is desirable in order to achieve a single financial market and a stable financial system. An important element in reinforcing the financial institutional framework is the creation of the Banking Union. The Banking Union aim is to build an integrated financial framework to safeguard financial stability and minimize the cost of bank failures. It consists of two central elements: Single European Banking Supervision and a common deposit insurance and resolution framework. In this paper we will focus on the single supervision that it is the main pillar and the first step towards a full banking union.

The single supervision will be placed under the aegis of the European Central Bank. The ECB will supervise an estimated 150 banks representing around 80% of the banking sector in Europe, including all institutions with balance sheets holding over €30 billion as well as the three biggest banks in each country. But the vast majority of the Eurozone's approximately 6,000 small and medium-sized banks will remain under national supervision.

The ECB would be responsible for a list of prudential supervisory tasks, including: the licensing and conducting of on-site and off-site supervision activities and the subsequent requirement for corrective action by the banks, the oversight of prudential regulation compliance, the conducting of stress tests, the approving of mergers or acquisitions as well as the right to declare an "emergency" situation, and the supervision of the implementation of the banks restructuring programs. It would potentially allow eurozone banks to recapitalize using funds from the European Stability Mechanism. Supervisors can take a euro area-wide view of financial developments, identify early the build-up of systemic risks, and use appropriate macro-prudential tools and preventative measures to counteract them. One of the preconditions for successful supervision is respect and usage according to unique rulebooks applicable to all financial institutions in the single market. The single rulebook generally already exists by the agreement on the Capital Requirements Directive IV and Basel standards. This will contribute significantly for making the banking sector in Europe more stable and creating a level playing field.

The analysis of the creation of a Single European Banking Supervision opens many issues for discussion:

- What will be the impact on the ECB monetary policy responsibilities and its governance structure?
- Whether or not the inclusion of the supervisory function will create a significant concentration of power in one institution?
- What will be the influence on the role of national supervisors?
- What will be the influence on non-Eurozone countries?

The answer to these issues requires particular attention and deeper analysis. Their elaboration will consider the strong and weak sides of this complex and controversial decision for establishing a Single European Banking Supervision and will make appropriate conclusions.

## The Reasons for Establishing the Single European Banking Supervisor

The events of recent years have revealed a variety of weaknesses in the governance of the financial sector in the EU that were emphasized as a result of financial crisis. During the last period, the market integration has steadily increased in the Eurozone, witness the fragmentation of the banking system. The fragmentation within the single market arose from disparity in funding costs among businesses with similar levels of risks, sovereign debt loop fuelling fears among governments and market agents, and obstacles for the transmission mechanisms of monetary policy. Banks are increasingly withdrawing into domestic markets, as a consequence of the deeper crisis in the confidence of European financial markets. On the other side, the sovereign debt crisis emphasized and aggravated existing structural problems in the banking systems, which cannot adequately support the necessary structural adjustments in the real economy.

Schoenmaker (2012) has called this the trilemma of financial supervision-fragmentation: similar to the famous Mundell trilemma, there is an inherent incompatibility between integration, financial stability and independent national supervision. Academic research and policy experience over the last decade has shown the gap between institutional integration and financial integration, especially for multinational banks. Subsidiaries of foreign banks effectively come under dual supervision, both home and host supervision. The home-host cooperation, based on two main principles, decentralization and weak cooperation endeavors to resolve the problem, but is most difficult in the event of the failure of a multinational bank, due to a direct conflict of interest over the distribution of the fiscal costs of bank resolution. This gap can threaten financial stability.

An important dimension on the response to the crisis is institutional integration: an attempt to build stronger supranational institutions and legal frameworks in the Eurozone. The goal is to place the responsibility for enforcing the new rules at a European level. The bank risks and supervision liability would be located in a single body under the aegis of the European Central Bank. The single supervisor would pay attention mainly to eurozone-wide stability threats, rather than to the soundness of the financial systems of each member country. It will be responsible for the recapitalization of the troubled euro area banks by using the European Stability Mechanism funds.

In the aftermath of the crisis, many suggestions arise for establishing a single EU supervisor for the largest financial institutions with cross-border operations throughout Europe. Pisany-Ferry and Sapir (2010) point out that the European supervisory infrastructure is plagued with substantial problems, as bank supervision remains under the sanction of national authority. In particular, there was poor sharing of information among policy-makers and limited transparency leading to the potential erosion of confidence. The main argument for institutional consolidation at the EU level, as per Kern (2011) is that Europe's growing internal financial market is much more integrated and cannot be supervised efficiently because of different institutional capacities and supervisory practices. According to Kozanoglu (2011) the establishment of European financial stability is completely dependent on the efficiency of the supervision mechanism and on the maintenance of monetary stability. Hence, the national supervisors and the ECB need a clear and precise knowledge on the situation of the Euro zone's banking and financial services, and certainly on the situation of its main actors.

According to Whelan (2012), the global financial crisis has swung matters decisively back in favor of the central banks playing a key role in supervising banks because during a crisis, the central bank's lender of last resort role is crucially important. Therefore, he believes that an official role for the ECB in supervising banks will help provide a far more efficient set of procedures for diagnosing problems with banks and then diagnosing the correct mix of solvency and liquidity measures required to resolve these problems.

The advantages of the Single European Banking Supervision`, according to Eijffinger (2012), are that: the ECB has an interest in a stable financial system for the transmission of monetary policy; it is responsible for the oversight of payment systems, which can also be combined with banking supervision because of informational synergies; its financial sector expertise; and, it is an independent body that is not subject to political interference.

The justification of creating a Banking Union has three interconnected objectives: (a) Maintaining financial stability on the basis of effective supervision and crisis management (b) Preserving the single market for financial services, and (c) Avoiding competitive distortions in the single market. Even the results from a numerical simulation exercise and empirical analysis in the Beck and al (2011) model show that a supra-national supervisor can improve on the efficiency of the intervention decision, but only if equipped with the necessary mechanisms and information.

The Boomgaarden (EU Committee, 2012) noted that many banks would welcome central supervision as creating a level playing field and reversing the renationalization of banking that had taken place since the crisis took hold. Roubini (EU Committee, 2012) considered that the "too little, too late" approach in decision making and dealing with the crisis, created the perception that decisions are more a sign of weakness, rather than having a clear vision and plan for the future of European monetary union and the outcome of the current crisis. In fact the nature and speed of decision making is more the result of the more democratic environment in the EU, than of any lack of vision or ignorance.

## Single European Banking Supervision Opened Issues

The EU integrated financial framework is widely recognized by critics. Although there are recognized benefits to such a centralized institutional structure, an extensive literature has emerged questioning the utility and effectiveness of the single supervisory model for Europe.

1. *Risks from Assigning Supervision to the Central Bank*

There is a lively discussion about the appropriateness of a central bank taking on a supervisory function in addition to its core monetary policy function. Persson and Alexander (2012, Q198) noted that the ECB might be tempted to use monetary policy inappropriately, by lowing interest rates or loosening liquidity conditions, for banking system stabilization. Wieser (EU Committee, 2012) proposed as “tall, thick and impenetrable” as possible firewalls between the two functions. Constancio (2012) concludes that the idea of involving the ECB in banking supervision activities highlights the existence of reputational risk and a conflict of interest. Central banks that are also banking supervisors run a reputational risk: if they fail in their role as banking supervisor, this will tarnish their credibility for monetary policy, too (Veron 2012). On the other hand, the conflict between supervision and monetary policy in the direction that the central bank has much more weight when taking care of the banking sector and could jeopardize price stability, for example by providing liquidity or lower interest rates for banks.

Quinjon (2013) states that the argument for combining monetary policy and supervisory responsibility within the central bank stems from the natural role that it has in ensuring financial stability. Whilst, Veron (2012) finds a number of arguments against entrusting financial supervision to central banks, one of which is conflicts of interest that can arise between the mandates and objectives of monetary policy and those of financial supervision, because the ECB would be deeply involved in three important and related areas: monetary policy, banking supervision and macro-prudential supervision. This would not only constitute an enormous concentration of powers, but would only be tantamount to the ECB controlling the impact of its own actions.

The German Council of Economic Experts (2012) argued against assigning supervisory functions to the central bank, having in mind that the ECB has no direct fiscal institution as its counterpart so that monetary policy in the Euro area differs from monetary policy in a single country. Central bank independence requires operation outside the usual democratic controls, and by contrast, a supervisory authority must be accountable to democratically legitimated bodies. The European Commission's proposal attempts to solve this conundrum by making the ECB accountable to the European Parliament and the EU Council – albeit only as regards its supervision of banks.

The solution to the problem of a monetary authority's need for independence and a Supervisory authority's need for accountability (Sibert, 2012) is to separate the monetary authority from the rest of the central bank. So, it is important to create a clear organizational separation and hierarchical mandates between the two functions within the ECB and respect the following principles:

- the need for full personnel separation between the supervisory and monetary policy tasks,
- the need to grant the proposed Supervisory Board wide decision-making autonomy,
- the need to minimize the Governing Council role in relation to supervision as far as is possible under the Treaty framework and
- the need to make clear the ultimate responsibility in a crisis of the body within the ECB.

Such a system would ensure that the supervision of banks in all EU Member States is equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds. To this end, the European level would be given supervisory authority and pre-emptive intervention powers applicable to all banks.

2. *Which Banks Would Be Supervised by a European Supervisor and What Would Be the Influence on the Role of National Supervisors?*

Although the ECB will ultimately be responsible in the conduct of its supervisory function, the ECB would be assisted by national supervisory authorities and the system would be highly decentralized. National supervisors that have the knowledge of local and regional markets and a long-established expertise in supervision would be required to follow the ECB's instructions.

The argument for applying a common supervisory mechanism to only larger banks appears to be based on the idea that the problem being solved by the common supervisor is the systemic risk to financial stability posed by these banks. Whelan (2010) does not agree with this argument because large banks are not the only threat to financial stability-the collections of small banks with similar characteristics can often act in the same way so that the sector as a whole can occasionally present a threat.

According to Da la Dehesa (2012) keeping present national supervisors for most banks whilst leaving the ECB only supervising the "too big to fail" euro area banks does not make sense because of the following: (a) in the previous banking crises, most banks which went bankrupt were not *"too big to fail"* (b) Basel II has been applied with broad different levels of rigor by different euro area supervisors, (c) 75% of the ECB monetary transmission mechanism of the monetary policy is done through banks, so that the supervision of banks becomes a key factor for monetary policy as well. He found some obstacles with those Euro area Member States where the supervisor is not the central bank and will need time not only to move their supervisors to their central banks, but also for their central banks to start using them effectively.

On the word of Schoenmaker and Oosterloo (2005) a European System of Financial Supervisors could combine the advantages of a European framework for financial supervision and crisis management with the expertise of local supervisory bodies. Pisiani-Ferry and Sapir (2010) suggested that a reasonable compromise would be for the ECB to have the necessary authority to cover all banks whilst delegating supervision where appropriate. But, for Whyte (2012) it is not clear how this compromise would work in practice as there would continue to be "policies of forbearance driven by local political considerations".

National supervisors would retain some of the supervisory share not transferred to the ECB such as: consumer protection, and money laundering protection. This would be reasonable given the assumption of direct conducting of the national supervisors by the ECB, but with its ability for the immediate assumption of responsibility for the supervision of smaller banks as required. The ECB must have an opportunity to eliminate any national supervisory bias where it occurs. The proposed supervisory arrangement may produce positive results if the ECB and the national supervisors act as a single system with close cooperation, by setting out a clear demonstration of the separate authority with a strictly defined relationship. Thus, the whole supervision gains credibility and increases investor confidence.

*3. What Would Be the Influence on Non-Eurozone Countries?*

The very important issue is how to integrate the non-Eurozone countries into the arrangement. The expectation is that the banks in countries outside the euro will be involved in the SSM, which will facilitate wider market access for banks and investors across Europe. Also, it will contribute to a more effective implementation of the supervisory practices and coordination of the failures between national supervisors. Constâncio (2013) stated that the SSM should provide an option for the competent national authorities in the non-euro area states to participate in the SSM through establishing a close cooperation with the ECB. By establishing a close cooperation, they need to adhere to the decisions taken by the ECB, if not the cooperation may be suspended or terminated.

The EBRD (2012) declared that the proposed unified bank supervision has raised concerns in several European countries, both inside and outside the eurozone and especially in emerging Europe. Some countries outside the Eurozone worry that giving banks in the euro area the possibility of direct recapitalization from ESM resources will tilt the competitive balance against banks headquartered outside. There is also a concern that national resolution authorities may not face the right incentives if fiscal losses are mutualised at the Eurozone level. Furthermore, unifying supervision in the Eurozone does little to address home-host coordination failures that affect countries outside the single supervisory mechanism or coordination failures in respect of banking resolution (which can be particularly severe).

The key issue is the banking resolution. The Single Supervisor model planned the banking resolution to remain at the national level, although within a common EU bankingframework. Beside the coordination problems in the banking resolution, the lack of congruence between the supervision, resolution and ultimate responsibility could create a problem of moral hazard. Maintaining resolution authority at the national level while raising ultimate fiscal responsibility to the supranational level could produce a moral hazard and may be one of the reasons why the banking union proposal has not met with universal support in Europe.

*4. And on the Republic of Macedonia?*

The situations in the EU and the euro area are of interest for the Republic of Macedonia because of its strategic goal to become an EU member, its economic relations with some EU countries, and because of the economic situation in Greece as the closest neighboring country. According to the monetary strategy of the Macedonian National Bank and considering the importance of the stability of the euro for the stability of the denar, a regular and watchful monitoring of the current Euro zone situation is becoming necessarily more significant for the Macedonian economy.

The Macedonian National Bank ought to continuously monitor and make compliance with the ongoing changes in the EU supervisory legislation, caused by the redesigning of the EMU. In this respect, the Bank Union promoted the concept of supervision set within central banks, which already exists in the case with the National Bank of the Republic of Macedonia. Hence, all subsequent regulatory, procedural and organizational-technical activities for setting up banking supervision within the ECB might be used to improve the supervisory function of the National Bank of the Republic of Macedonia.

## Conclusion

Over the last decade it has been shown that the gap between institutional and financial integration in the Eurozone results in a number of difficulties which can threaten financial stability. The purpose for establishing the Single Banking European Supervisor is to protect and ensure financial stability through the effective and consistent application of uniform prudential rules and practices (single rulebook), greater transparency in the application of the rules, as well as a significant reduction in the possibility of an impact on the regulator (regulatory capture). Additional arguments in favor of the idea of a supra-national regulator result in the expectation that it would overcome the problem of fragility of current economic and monetary union in times of crisis and would prevent the process of fragmentation of financial markets that is currently happening in the euro zone and would reduce the unjustified funding-cost differences.

The ultimate goal is to centralize the responsibility for enforcing new rules at the European level, thus locating the liability for bank risks and supervision in a single body under the aegis of the European Central Bank. This new regulation gives the European Central Bank additional authority to directly supervise the European banking sector. In the theoretical discussions about the prospective operation of the Single European Banking Supervision there are still many issues that question whether this measure can be a real solution to dealing with a possible new financial crisis.

The introduction of a single supervisor is already a major step forward, but there are still a lot of the steps to be taken on the path towards the completion of the Banking Union. In any case, it will take an enormous effort to end the segmentation of European financial markets. Yet, the creation of a single, credible and effective supervisor will make direct recapitalization of struggling banks by the European Stability Mechanism more politically acceptable.

The ECB Vice-President, Constancio, (2013) quoted Victor Hugo: “you can resist an invading army, you cannot resist an idea whose time is come” to emphasize the Single European Banking Supervision is exactly such an idea, but it depends how it will be turned into reality. The vision for the future of the European Monetary Union makes us expect that the long term sustainability of the monetary union is possible only with its gradual, deeper and systemic transformation to full banking, budgetary and economic union, followed by political integration.

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