The Single Supervisory Mechanism within the Banking Union –

Novel Features and Implications for Austrian Supervisors and Supervised Entities

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Over the past decades, the internal market for banking services has flourished. The financial crisis and contagion from banks to sovereigns and across borders has underlined the need to match the size and level of cross-border activities of banks with the integration of banking supervision. To align supervisory and political responsibilities with the competence to provide a financial backstop, the heads of government of the euro area have proposed a three-pillar model for a banking union.

As a first step in implementing banking union, supervisory responsibility for banks in participating Member States will be conferred on the ECB. Within the framework of a single supervisory mechanism (SSM), the ECB will share duties with the national authorities. The ECB will be responsible for the overall functioning of the SSM. At the same time, national authorities retain certain responsibilities, including the supervision of less significant banks. The changes to the supervisory process require a suitable organizational setup and procedures that account for the roles and responsibilities of the ECB and national authorities within the SSM and vis-à-vis supervised institutions.

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During the crisis after 2007, several European governments had to intervene in their financial sectors to stabilize banks. The crisis demonstrated the rapid spread of distress across financial institutions and country borders, the risks of contagion for public finances, and market fragmentation. With the volume of banking sectors' total assets far exceeding that of national budgets, the need to create an independent integrated supervisory and regulatory framework moved up the priority list. Furthermore, financial stabilization mechanisms were created at the European level. Soon policymakers envisaged extending the scope of these mechanisms from providing financial support to euro area member countries to recapitalizing banks directly through the European Stability Mechanism (ESM) subject to appropriate conditionality once an effective single supervisory mechanism has been established.[2]

Evolution and Background of the Banking Union

To align supervisory and political responsibility with the competence to provide a financial backstop, the heads of state and government of the euro area put the objective of creating a three-pillar banking union on the political agenda on June 29, 2012. The proposed model is a precondition for banks' direct access to the ESM. Not only does it raise the responsibility for the prudential supervision of banks to the European level (single supervisory

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[2] *According to the main features agreed by the Eurogroup, which will be reflected in the operational framework of the instrument once it has been adopted, the ESM will be able to conduct direct recapitalizations of institutions only if certain eligibility criteria are met.*

mechanism, SSM), but it also aims at creating a single resolution mechanism (SRM) and provides for a coordinated European framework for deposit insurance, underpinned by a comprehensive single rulebook for financial services.

On April 18, 2013, the Council of the European Union and the European Parliament reached a compromise for the establishment of the SSM. The compromise involves two regulations: one confers specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (SSM regulation), the other modifies regulation 1093/2010 establishing the European Banking Authority (EBA regulation).[3]

The bank recovery and resolution directive (BRRD) is currently being negotiated, and the European Commission is expected to present a legislative proposal for a European single resolution mechanism in summer 2013. A further harmonization of the national deposit insurance frameworks is being debated and should – together with resolution tools and funds – contribute to resolving nonviable banks in a least-cost manner while fully safeguarding protected depositors.

All these proposals have to be viewed in the context of other initiatives, including the transposition of the Basel III proposals (the Capital Requirements Directive IV and Capital Requirements Regulation), a European Banking Authority (EBA) recommendation on asset quality, and possible revisions of EU State Aid rules as transitional arrangements to anchor market expectations about bank resolution by clearly establishing the pecking order for bail-ins.

Novel Features and Implications of the SSM

The reform of European banking supervision constitutes a milestone – but with limitations: The agreement on the SSM as a first step toward the creation of a banking union confers specific tasks in supervising euro area credit institutions on the ECB within the SSM framework. The SSM will be composed of the ECB and the national competent authorities (NCAs) of participating Member States. Hence, participation in the SSM will widen the scope of responsibilities of the OeNB and the FMA, e.g. in the context of duties of the new Supervisory Board (see below). Noneuro area Member States may opt to join the SSM by entering into close cooperation arrangements that oblige the respective NCAs to comply with the measures of the ECB and to provide the ECB with all relevant information.

Legal Foundations and Institutional Framework

The ECB will be responsible for the overall functioning of the SSM. It will oversee euro area banks, sharing responsibilities and closely cooperating with NCAs. The transfer of supervisory tasks to the ECB is based on Article 127 (6) TFEU. NCAs will remain responsible for tasks not explicitly conferred on the ECB.

The SSM regulation will also empower the ECB to adopt guidelines, recommendations and decisions. Furthermore, within six months of the entry into force of the SSM regulation, the ECB must publish an ECB

[3] *These regulations are expected to be submitted to the European Parliament and the Council for a formal vote by July 2013 at the earliest; potentially, the voting will take place in September.*

framework regulation, which is to specify the framework to organize the practical modalities, procedures and division of responsibilities between the ECB and NCAs. In conducting its supervisory tasks, the ECB will apply all relevant EU laws and, where this law is composed of directives, the national legislation transposing those directives. The ECB will be able to require NCAs to make use of certain early intervention powers if national law provides for such powers for the NCA. Above and beyond the competence of NCAs, the ECB may apply certain macroprudential measures, including higher requirements for capital buffers.

The planning and execution of the tasks conferred upon the ECB will be undertaken by a Supervisory Board composed of a Chair, a Vice Chair (the ECB is to submit proposals for the appointments to these two positions to the European Parliament; once the proposals have been approved, the Council will make the appointments), four representatives of the ECB and one representative of each NCA. If the NCA is not a central bank – as is the case in Austria – a central bank representative may participate in addition. The participation in this board is a quantum leap for the OeNB and the FMA in being involved in making decisions about the largest euro area banks. Draft decisions proposed by the Supervisory Board will be deemed adopted unless the ECB Governing Council objects. The Supervisory Board will be supported by a Secretariat and a Steering Committee. An Administrative Board of Review will be established to carry out internal reviews of decisions taken by the ECB in the exercise of its supervisory powers.

The ECB and the NCAs must act independently within the SSM, and the ECB must carry out its supervisory tasks without prejudice to, and separately from, its monetary policy tasks. The ECB is accountable to the European Parliament and to the Council, and as such, it must present in public an annual report to the European institutions and the national parliaments of the participating Member States, which have inquiry rights.

The European Banking Authority (EBA), which was founded in 2010, will be predominantly responsible for rule setting and for the convergence of supervisory practices in the EU, thereby promoting a level playing field.

Division of Responsibilities among the SSM and the European System of Financial Supervision

The allocation of supervisory tasks and the function of the competent authority at the European level calls for new ways of cooperation between the (formerly) national competent authorities and the ECB, as well as between the ECB and the EBA. The far-reaching deferral of supervisory powers to the ECB with NCAs assisting will also affect the way in which the OeNB and the FMA perform their respective tasks now and in the future.

ECB and NCAs

The ECB will be competent to carry out its prudential tasks in relation to all credit institutions established in participating Member States. However, these tasks will be performed within a framework of cooperation between the ECB and NCAs: While the ECB will be the competent authority for about 130 significant banking groups, for which it will enlist the assistance of the NCAs in preparing and implementing supervisory tasks and decisions, the NCAs will be responsible for adopting supervisory decisions on less significant credit

institutions.[4] Based on a preliminary assessment, eight banking groups are considered significant in Austria. The NCAs must follow the instructions given by the ECB, and the ECB will oversee the functioning of the system and may at any time make use of its own investigatory powers.

To carry out its tasks, the ECB will, in general, have all the powers that competent authorities have under the relevant EU law, including wide-ranging supervisory and investigatory powers to ensure compliance with prudential requirements and to perform stress tests in coordination with the EBA; it will also have powers related to early intervention and bank recovery planning.

Special procedures for cooperation are in place to authorize credit institutions and to withdraw authorizations as well as to assess acquisitions and disposals of qualifying holdings. Certain areas, such as branch supervision of non-EU institutions, anti-money laundering, payment services and consumer protection remain national competencies.

The SSM requires an organizational setup that accounts for all relevant activities, links and reporting lines between the ECB and NCAs and their respective roles and responsibilities within the SSM. Joint supervisory teams consisting of ECB and NCA staff could be set up to perform the day-to-day supervision of significant banks. Supervisory processes and procedures for, inter alia, authorizations, supervisory examination programmes, ongoing supervision and decision making for significant banks will need to be defined.

Furthermore, the processes and procedures for performing financial analyses of less significant institutions and the risk profile classification principles of the ECB for supervised banks will be defined. The ECB needs to be notified ex ante of material NCA decisions about less significant banks.

The assumption of supervisory responsibilities by the ECB will be accompanied by comprehensive assessments, including balance sheet assessments of the relevant institutions.

Experts from NCAs will also be involved in on-site examinations of significant banks, while the ECB – in coordination with the EBA – needs to ensure a harmonized approach to the conduct of supervision, thereby promoting the level playing field in supervisory practices and avoiding a home bias.

As the supervision of less significant banks will continue to be driven by the NCAs, these banks do not have to expect fundamental changes to the relationship with their national supervisor. NCAs will continue to be responsible for managing on-site inspection processes and related decision-making. The ECB may assume supervisory responsibilities from the NCA if this is deemed necessary to ensure high supervisory standards.

European Banking Authority

The EBA was mandated with producing a single supervisory handbook for the entire EU. This set of rules addressed to supervisors will complement the single rulebook, which consists of regulations and directives, guidelines,

[4] *Article 6 para. 4 of the SSM regulation defines a "significant institution" (credit institution, financial holding company, mixed financial holding company or branch) by the significance of its cross-border activities and by its size: An institution is significant if the value of its assets exceeds EUR 30 billion, or if the value of its assets exceeds EUR 5 billion and at the same time the ratio of its total assets to the GDP of the relevant Member State exceeds 20%, or if the ECB, following a notification by the NCA, considers such an institution significant for the domestic economy. Institutions accessing funds of the European Financial Stability Facility or its successor, the ESM, and the three largest instutions of each country will also be subject to the ECB's supervision.*

standards and opinions, with new practical instruments and convergence tools to promote common supervisory approaches and practices.

As a competent authority, the ECB will be a nonvoting member of the EBA's Board of Supervisors and will be subject to the provisions of the EBA regulation. The ECB's manual of supervisory practices will complement EBA rules.

Implications for Supervisory Cooperation

The authorities of countries participating in the banking union will coordinate their work on significant banking groups within the joint supervisory teams. Therefore, the new focus of supervisory colleges will be coordinating the ECB and NCAs of nonparticipating Member States. While the ECB will play the role of home and/or host supervisor (with the NCAs of all participating Member States as observers) in the context of significant institutions, the NCAs will be home and/or host-supervisors for less significant institutions, with the ECB having the option of participating in the colleges.

The ECB is to assume the tasks conferred on it 12 months after entry into force of the SSM regulation. However, it can decide to carry out its supervisory tasks (other than adopting supervisory decisions) immediately from the date of entry into force of the SSM regulation: As it will be in charge of operational supervisory tasks and responsibilities, the ECB may require NCAs, banking institutions and persons belonging to such institutions to provide information to carry out a comprehensive assessment, including a balance sheet assessment. Such assessment must be performed at least for the significant banks. The interaction between the ECB, NCAs and the banking industry may thus commence at an early stage.

To cover its expenditure, the ECB will levy a risk-based supervisory fee on credit institutions. The higher coordination within the SSM should lead to increased supervisory efficiency for banks with cross-border activities and should produce benefits for market participants and society through financial stability and a level playing field.

By way of representation in the new supervisory board, the OeNB and the FMA will be involved in the decision making on the largest euro area banking groups. These new tasks resulting from the far-reaching deferral of supervisory powers to the ECB with NCAs assisting will significantly alter both the supervisory scope and the procedures of these institutions over time.

Conclusions and Outlook

The launch of the banking union will extend the regional reach of European supervisory institutions. The single supervisory mechanism, which is scheduled to start operating fully in summer 2014, is a first step in rolling out best supervisory practices to participating Member States and in reconciling responsibilities and accountability. However, to reap the full benefit of a banking union, it will be necessary to establish a single resolution mechanism, to converge material laws for bank recovery and resolution, and to further harmonize credible deposit insurance frameworks. Impartial supervision across Member States and harmonized practices coupled with an effective backstop as a last resort would raise confidence and enhance financial stability by decoupling financial institutions from sovereigns' finances and would prevent market fragmentation along national borders. Ideally, such arrangement would cover the entire single market.