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SHOULD NON-EURO AREA COUNTRIES JOIN THE SINGLE SUPERVISORY MECHANISM?

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Highlights

- Irrespective of the euro crisis, a European banking union makes sense, including for non-euro area countries, because of the extent of European Union financial integration. The Single Supervisory Mechanism (SSM) is the first element of the banking union.
- From the point of view of non-euro countries, the draft SSM regulation as amended by the EU Council includes strong safeguards relating to decision-making, accountability, attention to financial stability in small countries and the applicability of national macro-prudential measures. Non-euro countries will also have the right to leave the SSM and thereby exempt themselves from a supervisory decision.
- The SSM by itself cannot bring the full benefits of the banking union, but would foster financial integration, improve the supervision of cross-border banks, ensure greater consistency of supervisory practices, increase the quality of supervision, avoid competitive distortions and provide ample supervisory information.
- While the decision to join the SSM is made difficult by the uncertainty about other elements of the banking union, including the possible burden sharing, we conclude that non-euro EU members should stand ready to join the SSM and be prepared for the negotiations of the other elements of the banking union.

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1 INTRODUCTION

Following the euro-area summit of 29 June 2012, at which European Union leaders endorsed common supervisory oversight of banks, Europe is determined to move ahead with a banking union. The decision stemmed partly from the recognition of the discrepancy between the integrated European banking market and largely national banking policies. But perhaps even more importantly, the decision was a response to increasing market pressure on several interlinked euro-area banks and sovereigns, and increasing financial fragmentation, which entailed a risk of major negative impacts on the economy of the euro-area and beyond. It is worth repeating the first sentence of the 29 June 2012 euro-area summit statements: ***"We affirm that it is imperative to break the vicious circle between banks and sovereigns"***[1]. The vicious circle has been highlighted by different researchers (eg Gerlach, Schulz and Wolff, 2010; Véron, 2011; Darvas, 2011; Merler and Pisani-Ferry, 2012; Angeloni and Wolff, 2012). The European banking union initiative aims to address this vicious circle, to improve the quality of banking oversight and thereby to reduce the probability of bank failures and their cost to taxpayers.

The following elements are generally seen as central to completing the banking union: common banking supervision based on a single rulebook, a single resolution mechanism, agreement on fiscal burden sharing and some degree of common deposit insurance (Pisani-Ferry ***et al***, 2012). Better banking oversight would reduce the likelihood of bank failures and their cost to taxpayers while resolution equally aims to reduce costs for the taxpayer. Fiscal burden sharing is the logical complement in order to escape the vicious circle. Most of the discussion in the second half of 2012 focused on the supervisory mechanism, leading to Council agreement on the legislative proposal for the Single Supervisory Mechanism (SSM) on 12 December 2012 (see Council, 2012, hereafter 'draft regulation') and an accompanying agreement on modifying the regulation of the European Banking Authority (EBA). On the single resolution mechanism, including its fiscal backstop, the European Commission has announced its intention to publish first proposals before summer 2013 (see Véron and Wolff, 2013, for more details). The most contentious part of the discussion certainly relates to the fiscal burden-sharing arrangements (Pisani-Ferry and Wolff, 2012).

The final design of the future banking union is still unclear. While euro-area members will be included in all elements of the banking union, the Decem-

1. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

2. So far only the United Kingdom has expressed very clearly the intention to stay out of the European banking union.

3. COM (2012) 511. See http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm, and an assessment of the Commission's proposals in Véron (2012).

proposal for a regulation (COM (2012) 511) employs as a Treaty base Article 127(6) of the Treaty on the Functioning of the EU (TFEU). This article puts the European Central Bank at the centre of the mechanism. The ultimate decision-making body of the ECB is its Governing Council (Art. 129(1), TFEU), in which the non-euro area countries do not have a vote. The use of this Treaty base was seen by many non-euro area countries as essentially preventing them from participating in the mechanism[4]. In the subsequent negotiations, significant modifications were made, partly with the aim of addressing the concerns of non-euro area members. The significance of the changes is also highlighted by a change in the vocabulary. Article 2(1) of the Commission's September 2012 proposal put forward the following definition: ***"participating Member State' means a Member State whose currency is the euro"***, while the December 2012 draft regulation changed this definition to ***"participating Member State' means a Member State whose currency is the euro or a Member State whose currency is not the euro which has established a close cooperation in accordance with Article 6"***[5].

At the time of writing, Council negotiations with the European Parliament are taking place, and a plenary vote is expected in April 2013, which would lead to the enactment of the draft regulation a few months later.

In this Policy Contribution we assess the December 2012 draft regulation (Council, 2012) from the perspective of EU states outside the euro area, and we evaluate arguments against, and in favour of, joining the SSM. The next section analyses the legal text, while section 3 discusses the arguments for and against. The last section concludes.

2 THE DRs.

4. The alternative treaty base, Article 352, was not pursued and the Council had to find a compromise solution based on Article 127(6) which refers to the ECB. Article 127(6) says the following: ***"The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."***

5. Similarly, the title of Article 6 dealing with non-euro countries was changed from ***'close cooperation with the competent authorities of non participating Member States"*** in the September 2012 proposal of the Commission to ***'close cooperation with the competent authorities of participating Member States whose currency is not the euro"*** in the December 2012 draft regulation.

6. When the national supervisor is not the central bank, then a representative of the central bank can also participate in the supervisory board. But for voting they will have only one vote (Article 19(1)).

state participating in the SSM[6]. Decisions of the

share in total assets under direct ECB supervision in each non-euro country if it was to join the SSM (see details in the appendix). Our results (Figure 1, left column for each country) indicate that for most non-euro area countries, participation would lead to a large share of their assets being covered, but relatively low numbers of banks (de Sousa and Wolff (2012) document a similar result for euro-area countries). For countries outside the SSM, only branches of large banks that are headquartered in a participating member state will fall under ECB supervision, while subsidiaries remain under the supervision of national supervisors.

In central and eastern Europe, where the banking systems are dominated by subsidiaries and branches of euro-area parent banks (right column of Figure 1), coverage by the SSM would mainly relate to these subsidiaries and criteria concerning the three biggest banks (see Appendix for details of criteria). In contrast, in the United Kingdom, Denmark and Sweden, the role of subsidiaries of foreign banks is minor.

Another interesting aspect in terms of coverage is the case of subsidiaries in participating member states of those banking groups that are headquartered in a non-euro area member state. For

BOX 1: COVERAGE OF TWO BANKING GROUPS HEADQUARTERED IN NON-EURO AREA COUNTRIES: DANSKE GROUP AND OTP GROUP

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of the SSM in order to enshrine the full participation of non-euro area countries[11]

tered in euro-area member states (Figure 1), if non-euro countries would join the SSM, this problem would have a lesser relevance thereafter, because the ECB will be the supervisor of both the parents and the subsidiaries in participating member states.

Still, as discussed , national supervisory authorities in the SSM could apply various macroprudential measures that may also serve ringfencing, and the ECB will not be able to block such measures.

But arguably, addressing cross-border supervisory coordination issues would be easier if both the parent and the subsidiary belong to the SSM. This suggests that those non-euro area member states in which subsidiaries of parent banks from SSM participant countries have a significant role, ie CEE EU members, should enter the SSM.

Similarly, since Swedish banks have significant activities in the Baltic countries and Estonia is a member of the euro area and Latvia may join the euro area in 2014, these two countries will likely be included in the SSM. We cannot rule out that Lithuania will also join the SSM[13]. Therefore, the suspected improvement in the supervision of cross-border banking groups by the SSM would benefit Sweden as well.

Beyond these earlier concerns, a number of additional factors have to be considered.

3.5 Effect on cross-border financial integration with non-participating countries

Some observers argue that large banking groups headquartered in euro-area countries may re-consider the geographical scope of their business and may reduce their cross-border banking activities with non-SSM countries. In particular, they may reduce the activities of their subsidiaries and branches established in countries that do not participate in the SSM. This may in particular be a concern if one sees the decision to join the SSM as a clear decision to also join the forthcoming Single Resolution Mechanism. If that was to happen, it may generate economic costs for these countries and it may prove to be difficult to re-establish the currently strong cross-border financial integration, once a country has joined the SSM later.

A number of arguments need to be considered carefully in this regard. First, delaying a decision on joining the SSM increases uncertainty for the banks concerned. Banks do not know whether

3.6 Competitive disadvantage of banks not owned by a parent bank headquartered in an SSM country

When a country remains outside the SSM, then domestically owned banks and those banks that do not have a parent bank in an SSM participating member state may face a competitive disadvantage. If supervision by the ECB is regarded as an important safeguard in the assessment of the soundness of banks, then staying out may imply higher financing costs: the cost of wholesale funding may be relatively higher and the depositors may also require a higher interest rate. While it is difficult to assess the risk and the magnitude of such competitive disadvantages, they call for membership of the SSM.

3.7 Implicit obligation to join other elements of the banking union after SSM membership

Clearly, there is uncertainty about the next steps of banking union, and belonging to the SSM may imply an obligation to join other elements of the banking union when they are adopted. More specifically, Point 11 of the 14 December 2012 European Council conclusions foresees that the Single Resolution Mechanism will apply to

notches and a corresponding increase in bank borrowing costs, a development acknowledged by Danish central bank Governor Lars Rohde in his speech at the parliamentary hearing for which this Policy Contribution was originally prepared (Bloomberg, 2013a; see also slide 5 of Danske Bank, 2012). While the SRM will also likely have important elements of bail-in and other possibilities to impose losses on bank creditors, this would apply to all members of the SRM and thereby prevent competitive distortions[16].

In CEE countries, where the banking system is dominated by foreign banks, fostering financial integration, getting supervisory information on parent banks and improving the supervision of cross-border banking groups could also be of major relevance. Also, a number of CEE countries went through unsustainable credit booms before the crisis, mostly accompanied by foreign currency lending, which has had major repercussions. Addressing national credit booms through national supervisory action only is difficult since banks can exploit supervisory arbitrage. A single supervisory mechanism is more suitable to address such credit booms. The SSM will also be able to address more easily previous possibilities of regulatory arbitrage in which banks could turn subsidiaries into branches and vice versa to benefit from different regulatory requirements.

Making a decision on joining the SSM is made more difficult by the uncertainty concerning the design of other elements of the banking union. At the same time, little is known at the moment about the eventual burden sharing element of the banking union. Stakeholders in some of the countries fear that their taxpayers will have to bail-out foreign banks, while some others fear that an eventual lack of a proper burden-sharing agreement would not break the vicious circle between banks and sovereigns, and therefore the full benefits of the banking union cannot be attained.

We agree that the full benefits of the banking union can be achieved only with a coherent system that also involves some burden sharing together with very stringent resolution tools. However, improved supervision and consistent resolution among participating member states should reduce the probability of the need for cross-border burden sharing. And even if such a proper agreement on burden sharing is not on the horizon at the moment, the SSM in itself would bring a number of benefits for all EU countries outside the euro area and the main contours of the SRM will also be revealed in the coming months. We therefore conclude that non-euro area countries should stand ready to join the SSM and should be prepared for constructive negotiations on the SRM.

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APPENDIX: SSM COVERAGE OF NON-EURO AREA EU MEMBER STATES

We use the extensive but not comprehensive ***The Banker*** database to estimate the percent of total banking assets covered by the Single Supervisory Mechanism (SSM) in non-euro area member states, should they decide to join. This database includes 1,032 bank holding companies and subsidiaries out of the 7,533 monetary and financial