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Accommodating diversity in the EU Banking Union:

The Single Supervisory Mechanism and the quest for supervisory consistency

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List of abbreviations

ABI	*Associazione Bancaria Italiana* (Italian Banking Association)
ABoR	Administrative Board of Review
AFME	Association for Financial Markets in Europe
A-IRB	(advanced) internal-ratings based approach
AQR	Asset Quality Review
AUT	Division Authorisations of the ECB Directorate General Micro-Prudential Supervision IV
BaFin	*Bundesanstalt für Finanzdienstleistungsaufsicht* (Federal Financial Supervisory Authority)
BCBS	Basel Committee on Banking Supervision
BCC	*Banche di Credito Cooperativo*
BdB	*Bundesverband deutscher Banken* (Association of German Banks)
BdI	*Banca d'Italia*
BIS	Bank for International Settlements
BMA	Business Model Analysis
BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
BVerfG	*Bundesverfassungsgericht*
BVR	*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken* (Association of German Cooperative Banks)
CA	Comprehensive Assessment
CEBS	Committee of European Banking Supervisors
CET 1	Common Equity Tier 1
CJEU	Court of Justice of the European Union
COI	Division Centralized On-site Inspections of the ECB Directorate General Micro-Prudential Supervision IV
CRD IV - V	Capital Requirements Directive IV - V
CRR – CRR II	Capital Requirements Regulation - II
DG COMP	Directorate General for Competition
DG-MSI	ECB Directorate General Micro-Prudential Supervision I
DG-MSII	ECB Directorate General Micro-Prudential Supervision II
DG-MSIII	ECB Directorate General Micro-Prudential Supervision III
DG-MSIV	ECB Directorate General Micro-Prudential Supervision IV
DGS	Deposit Guarantee Scheme
DI	Differentiated integration
DSGV	*Deutscher Sparkassen- und Giroverband* (German Savings Banks Association)
DGSSB	ECB Directorate General Secretariat to the Supervisory Board
EACB	European Association of Co-Operative Banks
EAPB	European Association of Public Banks
EBA	European Banking Authority
EBF	European Banking Federation
EBIC	European Banking Industry Committee
ECA	European Court of Auditors

ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
ECU	European Currency Unit
EDIS	European Deposit Insurance Scheme
EFC	Economic and Financial Committee
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
EMIR	European Market Infrastructure Regulation
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESAs	European Supervisory Authorities
ESBG	European Savings and Retail Banking Group
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
EU	European Union
Federcasse	*Federazione Italiana delle Banche di Credito Cooperativo e Casse Rurali*
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
G10	Group of 10
GBIC	German Banking Industry Committee
GDP	Gross Domestic Product
G-SIBs	Global systemically important banks
HLA	Higher loss absorbency requirement
ICAAP	Internal capital adequacy assessment process
ILAAP	Internal liquidity adequacy assessment process
IMF	International Monetary Fund
INM	Division Internal Models of the ECB Directorate General Micro-Prudential Supervision IV
IPS	Institutional Protection Scheme
ITS	Implementing Technical Standards
JSS	Joint Supervisory Standards
JST	Joint Supervisory Team
LSI	Less significant institution
MaRisk	*Mindestanforderungen an das Risikomanagement* (Minimum requirements for risk management)
MoU	Memorandum of Understanding
MSD	Division Methodology and Standards Development of the ECB Directorate General Micro-Prudential Supervision IV
NCA	National Competent Authority
NPEs	Non-performing exposures

NPLs	Non-performing loans
OECD	Organisation for Economic Cooperation and Development
OJ	Official Journal
OMC	Open Method of Coordination
ONDs	Options and National Discretions
P2G	Pillar 2 Guidance
P2R	Pillar 2 Requirement
PCS	Division Planning and Coordination of Supervisory Examination Programmes of the ECB Directorate General Micro-Prudential Supervision IV
RIA	Division Risk Analysis of the ECB Directorate General Micro-Prudential Supervision IV
RTS	Regulatory Technical Standards
SEA	Single European Act
SEP	Supervisory Examination Programme
SGP	Stability and Growth Pact
SHV	shareholder-value
SI	Significant institution
SM	Supervisory Manual
SMEs	Small and medium enterprises
SPO	Division Supervisory Policies of the ECB Directorate General Micro-Prudential Supervision IV
SQA	Division Supervisory Quality Assurance of the ECB Directorate General Micro-Prudential Supervision IV
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SSMFR	SSM Framework Regulation
SSMR	SSM Regulation
STV	stakeholder-value
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
VaR	Value at risk
VöB	*Bundesverband Öffentlicher Banken Deutschlands* (Association of German Public Banks)
VoC	Varieties of Capitalism

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Abstract

After decades of political and technical efforts to supranationalise prudential regulation at the EU level, a key step to bridge the gap between rule-making centralisation and its decentralised implementation has been the establishment of the Single Supervisory Mechanism (SSM). In spite of its major accomplishments, the SSM faces a key challenge: achieving supervisory consistency in essentially diversified euro area banking systems.

This dissertation identifies the building blocks of supervisory consistency and the sources of diversity inherent in banking supervision; it also distinguishes internal from external dimensions of consistency, which correspond to national and banking diversities, respectively. Drawing on the qualitative analysis of official documents, speeches, public hearings, and interviews with national and supranational supervisors, banks, banks associations, and EU institutions, the research examines the relationships shaping the balance between consistency in integrated markets and diversity, by focusing on the SSM's prudential and regulatory competences. It first traces and compares the evolution of supervisory governance through literature- and empirically-driven governance indicators and their conceptualisation. It then analyses the changing nature of the supervisory instruments beyond the hard-soft law dichotomy. The German and Italian cases are used to test the capacity of the supranational supervisor to accommodate diversity, and illustrate how different supervisory styles have emerged over time.

This study argues that centralisation, methodological standardisation, and the development of non-binding policy documents are important for the achievement of consistent results. However, the effectiveness of supranational law and its enforcement by the European Central Bank involve fundamental trade-offs: a more limited local autonomy, institutional overlap, communication and transparency concerns from banks, and legitimacy issues arising from supervisory instruments, can compromise the system. Nonetheless, thanks to its resources and privileged Banking Union-wide position, the SSM is well-placed to strengthen sensitivity to diversity in order to manage the current transformation of traditional banking paradigms.

CHAPTER 1

A journey through prudential regulation and supervision: From minimal regulatory coordination to supervisory consistency

Introductory remarks

> …In that Empire, the Art of Cartography attained such Perfection that the map of a single Province occupied the entirety of a City, and the map of the Empire, the entirety of a Province. In time, those Unconscionable Maps no longer satisfied, and the Cartographers Guilds struck a Map of the Empire whose size was that of the Empire, and which coincided point for point with it. The following Generations, who were not so fond of the Study of Cartography as their Forebears had been, saw that that vast Map was Useless, and not without some Pitilessness was it, that they delivered it up to the Inclemencies of Sun and Winters. In the Deserts of the West, still today, there are Tattered Ruins of that Map, inhabited by Animals and Beggars; in all the Land there is no other Relic of the Disciplines of Geography.
> —Suarez Miranda, *Viajes de varones prudentes*, Libro IV, Cap. XLV, Lerida, 1658

Del Rigor en la Ciencia ("On exactitude in Science", as per its English translation), is a short story that metaphorically captures one of the key topics addressed in this dissertation: the aim towards precision and accuracy in our times (Borges 1944). The realm of banking regulation and supervision is no exception. The level of detail, length, and complexity that banking regulation has acquired in the last 30 years—from a thirty-page 1988 Basel I Accord, to a still-in-the-making Basel III composed by a series of documents of around 460 pages—is undeniable. Since the EU framework is directly shaped by the content of these global standards, the same inflationary trend applies to Europe.[1] The refinement and proliferation of

[1] The first banking directive had a total of 8 pages; the last banking package adopted at the time of writing this work comprises 268 pages of Regulation (EU) 2019/876 and Directive (EU) 2019/878, amending the Capital Requirements Regulation and Capital Requirements Directive IV, consisting of 337 and 99 pages, respectively.

topics covered by the legal framework respond to an increasing sophistication of the banking sector and the need to address past flaws. Given the international dimension of the field, this regulatory expansion has been accompanied by greater attention towards the question of implementation, and—within the euro area framework—the need to align the evolution of the banking system with the interdependency created by the Economic and Monetary Union (EMU).

The aim of this introductory chapter is to provide a historical and evolutionary account of critical junctures in the banking regulatory and supervisory domains, in order to highlight the transition from regulatory harmonisation to supervisory consistency. The historical overview offered in this chapter is important not only to contextualise the central topic of the dissertation (i.e., the challenge of supervisory consistency in an inherently diversified banking sector), but also to elucidate the underpinning logic behind this policy shift, and understand the factors that have shaped the current supervisory regime. Before moving forward with the structure of the introductory chapter, a preliminary clarification is made. The dissertation distinguishes the domain of banking or prudential *regulation*, from *supervision*. Although the literature normally refers to 'regulators' to address regulatory and supervisory functions, this work distinguishes between them. Since the research focuses on the activities conducted by the Single Supervisory Mechanism (SSM), the supervisory arm of the Banking Union, it is useful to conceptually distinguish these two realms. However, it should be acknowledged that in practice there is no such clear cut difference, as supervisory authorities are conferred regulatory powers—within specific limits—,and regulatory authorities, in turn, are given quasi-supervisory powers (e.g. the case of the European Banking Authority (EBA)'s power to act in emergency situations or settle disagreements between competent authorities in cross

border situation, as per Articles 18 and 19 of the EBA Regulation, respectively).[2] In any event, it is useful to keep the distinction, especially in the EU framework, as regulatory and supervisory authorities are not necessarily completely aligned, as shown in the course of the work.

The chapter is organised as follows. The first section provides an overview of the increasing harmonising efforts in the prudential regulatory and supervisory fields at the global level. The second section focuses on the same institutional efforts, but takes into account the specificities of the EU and the single market logic. The distinction between the international and European levels, albeit useful from an analytical perspective, can be arbitrary at times, as these two levels have historically overlapped. In fact, the internationalisation of prudential regulation, nurtured by the acknowledgement that global financial markets could not be governed exclusively at the national level, goes hand in hand with the "Europeanisation" of this domain.[3] Hence, this chapter devotes separate sections to these two levels for expositive and analytical reasons, but reality is that global and EU levels are closely intertwined. The final subsection of the second part, focuses on how the previous institutional and legislative transformations have exerted influence upon the concept of *banking*.[4] The third section focuses on EU post-crisis economic governance. The first subsection analyses how post-crisis measures have impacted upon decision-making and implementation of supranational measures in the EU. The second subsection zooms in on the main transformations in the supervision and central banking arenas. Although the idea of a pan-eurozone supervisor existed well before the

[2] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.
[3] The question of Europeanisation is discussed in Chapters 2 and 3.
[4] This is complemented by the analysis provided in Chapter 3, when describing the German and Italian banking regulatory and supervisory frameworks.

crisis (see section 1.3.2 below), it was only after the financial turmoil that it materialised. The subsection also explores how the post-crisis governance arrangements have influenced the evolution of central banking tasks, in light of the pre-crisis "central bank independence" (CBI) paradigm. The fourth section concludes the chapter by describing the research questions and how they fit within the broader research aim; it also spells out methodological aspects of the thesis, and provides an overview of the dissertation structure.

The overall purpose of this introductory chapter is to provide the necessary background information for the reader to understand the context surrounding the research problem; the material and ideational factors that have shaped the current supervisory regime; and, in light of the previous aims, the importance of the research question from a comprehensive perspective and its broader implications—or, simply, the '*so what?*' question.

1.1 The international prudential framework: Regulatory and institutional transformations

> Central bankers, however, have not always been able to wait for an academic consensus to develop before they launched regulatory initiatives. While the body of banking regulation has generally been built on neoclassical economic theory, it also contains "soft laws" and practices that have evolved over time, ad hoc measures developed during crises, and policies that simply reflect political ideology. (Kapstein 1992, 274)

The quote belongs to a 1992 article published in an *International Organization* volume dedicated to "Knowledge, Power, and International Policy Coordination", in which the concept of epistemic communities was fleshed out and explored from the perspective of various international relations' fields. Kapstein's words summarise two key attributes that distinguish international financial regulation, especially prudential regulation and banking supervision,

from other international law domains. First, as shown in the course of this work, central bankers can wait neither academic nor regulatory consensus in order to launch their own initiatives. Second, the "soft law" nature of the practices and resulting ad hoc crisis measures characterise the regulatory ecosystem in banking supervision, where hard law sources coexist with supervisory tools whose binding force is to be defined on a case by case (or bank-by-bank) basis. This first section, thus, explores the early years of international cooperation in the banking supervision domain, and the initial regulatory harmonising efforts, in order to understand the main drivers and limitations. Some of the analysed periods of time coincide with the harmonisation developments in the European single market.

This section does not focus on the vast international regulatory efforts undertaken from Basel I to Basel III/IV: its purpose is to highlight the rationale for harmonisation and cooperation, and how it has evolved until our days, where consistency challenges faced by the SSM require more than rule harmonisation or cooperation. The fundamental aspect that this section examines, is how an early central bankers' 'club' was transformed into a full-fledged international regulatory forum thanks to the soft law instruments that have been gradually developed. Focusing on the substantive technical content of these tools is neither feasible nor helpful for an introductory chapter that is meant to provide a wider overview of the relevance of the research.

A common denominator to regulatory cooperation in international banking and financial regulation is the occurrence of crises. The fast market changes that have taken place during the 1970s, "led regulators to recognize 'the growing world-wide interdependence of banks' and the diminishing effectiveness of national controls" (Kapstein 1989, 328, citing a 1983 OECD report entitled *The internationalisation of banking: The policy issues*). The globalisation of

finance resulted in the expansion of firms' international activities on both sides of the balance sheet, assets and liabilities, in order to hedge themselves against changes in local economies. As the interbank network expanded across the globe, it became increasingly difficult to draw the line between domestic and international financial activities, which also meant that the power of domestic regulators and supervisors started to reveal limits and deficiencies (Kapstein 1989). The year 1974 witnessed two serious banking crises: "the failures of the Herstatt Bank in Germany and the Franklin National Bank in New York, [which]were crucial in bringing about a 'paradigmatic change' in the attitudes of national banking officials" (Kapstein 1989, 328). In fact, "the disproportionately large spillover effects from the closure of Herstatt, a relatively small, privately held German bank, focused official attention on the growing interdependence of the international banking system" (Herring and Litan 1994, 96).

The change of paradigm was crystallised in late 1974, when the Committee on Banking Regulations and Supervisory Practices—later named the *Basel Committee on Banking Supervision* (BCBS)—was created by the central bank governors of the Group of Ten (G10).[5] Central banking cooperation, however, was not a novel phenomenon. Central bankers share a sustained history of cooperation that has been reflected in the establishment of the Bank for International Settlements (BIS) back in 1930 (Kapstein 1992), which has provided the institutional setting to the BCBS. A series of informal activities, such as the regular exchange of information, the identification of best practices, and the development of personal bonds among national authorities, have been crucial to shape the characteristics of an epistemic community that was increasingly important "in ways that outsiders will never be able to measure" (Herring and Litan 1994, 132). Central bankers started to develop a set of common

[5] The Group of Ten is made up of eleven industrial countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

views on the risks that were being taken by international banks, and the acknowledgement that excessive speculative activities and irresponsible lending weakened the financial system as a whole. In spite of the increasing epistemic consensus, "national regulatory differences impeded the progress of policy convergence, and these differences could not be quickly smoothed by research, no matter how compelling" (Kapstein 1989, 336). This quote points to a crucial question that is still a key concern to supervisory authorities worldwide: the variety of regulatory and supervisory practices which has hindered the progress of the BCBS in its early years.

An illustrative example of this variety relates to the "different approaches to regulating the financial industry or the activities that it conducts" (Herring and Litan 1994, 142). This quote refers to the two major approaches in financial markets regulation: *institutional* and *functional* regulation. While in continental Europe "any institution that performs some of the functions of a banking firm is likely to be subject to bank regulation" (ibid), in the UK the way in which part of a financial services institution is regulated, depends on the business it does. In addition to these divergent regulatory approaches, effective supervision faced severe limitations from a practical perspective, not only because of the quality of the information supervisors received compared to the one that banks' managers possessed, but also due to time lags that authorities normally face when processing information (Herring and Litan 1994).

The growing epistemic consensus was not enough in order to overcome the substantial difficulties of negotiating an international agreement in such a sensitive and increasingly complex matter. In 1982, the failure of *Banco Ambrosiano*—the largest private bank at the time, which had been seized by Banca d'Italia—and the eruption of the debt crisis stemming from Latin American countries and other developing regions, emphasised the need to

strengthen international banking regulation and the vulnerabilities in the payment system, which were fundamental steps to restore public confidence (Kapstein 1992). Prompted by the series of critical events in the early 1980s, the BCBS issued its first report in September 1984, which provided central bankers with a framework to compare their local methodologies and statistics with those of their fellow national central bankers. However, in spite of this first important step towards an international accord, "and despite the accumulation of a large body of knowledge concerning the risks to the international financial system, work in the committee soon stalled" (Kapstein 1992, 276).

It was yet another crisis in the US—the need to infuse Federal Reserve (Fed) funds to Continental Illinois—that urged local supervisors and regulators to consider the adoption of substantive reforms. After a careful exploration of capital adequacy systems in other parts of the world, in January 1986 the Fed Board proposed supplementary capital measures that included the 'risk weighted' concept. (Kaptstein 1992). At this point, US central bankers were aware of the difficulties of achieving a G-10 agreement. However, a joint effort with the Bank of England was an appealing alternative, given that the Fed had based its proposal upon British standards. For the British authorities, a US-UK agreement "would provide a powerful counter to the capital adequacy standard which was being debated in the Brussels headquarters of the European Commission and which the Bank of England found objectionable" (Kapstein 1992, 281). This last citation is fundamental to understand the two harmonising efforts that were simultaneously under way. On the one hand, the bilateral agreement on capital adequacy standards, signed by the Federal Reserve Board and the Bank of England in 1987, was a crucial catalyser to the 1988 Basle Accord. On the other, the European Commission was working on its own capital adequacy standards, as part of the single market 1992 project. Therefore, it is

important to highlight how the international activities at the BCBS were closely intertwined with those at the European level, not only because they were both pursuing financial regulation harmonisation, but also the actors involved in these different fora were for the most part the same people. The frictions between the European and the G-10 efforts reflected the differences in leading authorities. While at the European level the harmonising attempts were Franco-German driven, the international endeavour was led by the US-UK coalition. In relation to the US-UK 1987 agreement, it is important to consider that

> The decision to pursue the idea of a single capital adequacy standard was *not so much the product of collective technical knowledge as it was the reflection of what the British and American central bankers considered to be the "art of the possible" given the international and domestic politics* in which the debt crisis was embedded. This does not mean that the decision to seek higher capital levels lacked intellectual merit, but there was little in the literature of regulatory theory to suggest that this was the "best" method for strengthening the international payments system. (Kapstein 1992, 267, emphasis added)

Acknowledging that a cornerstone provision of the international prudential regulation framework was not the result of technical and objective efforts on how to best preserve financial stability, evinces the political nature of banking regulation and supervision, which mirrors the intricacies of the local and international political arenas.[6] The final 1988 Accord (Basel I), was not a sheer replication of the US-UK agreement. In fact, important modifications were introduced to the 1988 text, that reflected the preferences of European and Japanese central bankers (Kapstein 1992). One of these was the "two-tier" definition of capital, according to which the first tier would consist of shareholders' equity, and the second would

[6] There were, however, technical reasons that justified the need to tackle asset capital ratios beyond the US-UK agreement, as explained by Herring (1993, 184): "higher ratios provide a large cushion to absorb losses and avoid insolvency; give shareholders and subordinated debt holders greater incentives to monitor and control risk; and give the supervisory authorities more time to detect any deterioration in a bank's condition".

comprise other elements left to the discretion of national authorities.[7] Albeit Basel I was a crucial first step in addressing common financial stability concerns at the international level, the BCBC "cannot sit on its laurels and expect rigorous and universal enforcement" (Kapstein 1989, 347). The challenges posed by a consistent application of common standards were a concern for the international community of supervisors since its very inception.

Another aspect that deserves to be explored is the evolution of the Basel Committee's role. As pointed out by Goodhart (2011, 542) in his historical investigation of the early years of the BCBS, citing private correspondence with Kern Alexander, "the growth in soft law has two dimensions: the rules or standards themselves and the *standard setters*" (emphasis added). The acknowledgement that the proliferation of soft law is given not only by the increasing number of regulatory tools produced under this label, but also by the legal status of the informal bodies enacting them, is a crucial aspect for understanding the current state of supervisory and regulatory affairs of the SSM. The legal scholars cited by Goodhart in this passage—Kern Alexander and Rosa Lastra—agree that although the BCBS does not have any legal personality, and it is meant to act as an informal forum or a 'club' of central bankers, "it has become a *de facto* international regulatory body" (ibid.). This rule-setter status is part of the Committee's evolution and internal dynamism. George Blunden, who was appointed as the first BCBS Chair from 1974-77, expressed that "the committee's objective *should not be to make far-fetched attempts to harmonise the twelve countries' individual systems of*

[7] Kapstein (1989, 341) further explains the reasons behind this "two-tier" definition, in which the German banking system played an important role: "After the accord was announced, British and American regulators launched a campaign designed to include regulators from France, West Germany, and Japan, since these countries were the most important recalcitrant. Each country had different reservations about international standards for adequacy of capital. West Germany, for example, debated the U.S./U.K. definition of bank capital. German banks held a substantial amount of corporate equities, but under the bilateral accord, this stake would not be treated as part of the capital account. The Germans and French also argued that it was impossible to come up with any objective measure of how much capital was enough, since this depended on a bank's activities and the quality of its management".

supervision, but should be to enable its members to learn from each other…" [emphasis added] (Goodhart 2011, 47, citing a 1977 paper from Blunden).[8] Therefore, in its early days, the Committee perceived itself as a learning forum, where national authorities shared their experiences and problems in order to find common grounds but, under no circumstances, aimed to harmonise national prudential law.

However, after Basel I was adopted in 1988, the official documents reflect a different attitude towards the benefits of harmonised principles. For instance, records of a meeting discussing limits on large exposures and risk concentrations, expressly stated that moving "towards a harmonized framework would also contribute to the process of diminishing the existing sources of competitive inequality among banks, at a time when competition is growing rapidly and the internationalization and mobility of banking activity facilitates 'regulatory arbitrage'" (Goodhart 2011, 411). This change of approach received scholars' criticisms, which emphasised that the Committee should continue to act as a forum for supervisory authorities to exchange their views, while questioning the usefulness of extending the Committee's rule-making prerogatives. As summarised by Herring and Litan (1994, 134/5),

> While it is easy to be enthusiastic about harmonizing the *right* rules, in a rapidly changing financial system there is a very real danger that the *wrong* rules will be harmonized, or that the rules that might be right for the moment will become wrong after they are implemented. The complexity of international negotiations means that international agreements are very difficult to fine-tune after they are made because all parties are likely to find it costly to reopen negotiations . . . [and hence the] efforts to develop internationally harmonized regulations may not be the best approach.

[8] Goodhart (2011, 542) also cites the words of the second Chair, Peter Cooke (1977-88), who similarly claimed that "the committee encourages some gradual convergence towards a common approach and common standards without attempting far reaching harmonization of member countries supervisory techniques".

The post-Basel I history has shown that the BCBS turned out to be more than an exchange forum, and its regulatory influence went beyond the G-10 core members, as other jurisdictions with globally active banks started to implement these provisions within their domestic frameworks. The subsequent reforms to the original 1988 Accord[9] expanded the set of tools at supervisors' disposal. First, the negotiations that started in June 1999 culminated in 2004 with the so called "Basel II", which introduced the so-called *three-pillar* approach (i.e., minimum capital, supervisory review process, and market discipline). One of the most important tools integrated in Basel II is in fact the second pillar, now called *Supervisory Review and Evaluation Process* (SREP), which has gone through important transformations from its early days until today.[10] Even before the global financial crisis, it became apparent that the approval of different risk measurement approaches in various jurisdictions was a challenge for supervisory authorities worldwide; this is why in 2006 the BCBS issued guidance on information sharing and cooperation, in order to reinforce supervisory mechanisms dealing with increasingly sophisticated risk measurement tools.

Before moving on with the overview of the post-crisis Basel framework, it is worth explaining the relevance of this soft law supervisory tool drafted by a Committee which, in principle, has no official legal status. In his *Banking on Basel* book, Tarullo (2008) comprehensively analyses the Basel II framework as, amongst other aspects, a *regulatory*

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[9] The most important among those reforms was the 1996 "Amendment to the Capital Accord to incorporate market risks" (or Market Risk Amendment), which was to be implemented from 1997 on. Its significance lies in the fact that it was the first attempt by the BCBS to address risks other than credit risk, and in line with that "banks were, for the first time, allowed to use internal models (value-at-risk models) as a basis for measuring their market risk capital requirements, subject to strict quantitative and qualitative standards". See the BCBS's historical highlights: https://www.bis.org/bcbs/history.htm

[10] Chapter 4 explores the SREP and its evolution in light of the transformations at the international, European, and national levels.

model[11] and an *international agreement*.[12] Regarding the former aspect, Tarullo assesses the efficiency and effectiveness of Basel II rules as a model for national prudential regulation by focusing on the advanced internal-rating (A-IRB) approach,[13] which was the most important regulatory innovation in relation to Basel I. In short, he questions the capacity of the new model to align capital requirements closer to the actual set of risks assumed by banks, given the (perhaps too) optimistic outlook "that rests on an expectation that bank regulators will successfully adapt their supervisory techniques to make workable a scheme that is at once complex, ambitious, and opaque" (Tarullo 2008, 190). Concerning the latter aspect, Tarullo (2008, 223) weighs the need for harmonising substantive capital regulation against more flexible forms of cooperation:

> In its own statements on implementation issues, the Basel Committee at times appears torn between flexibility and harmonization. For example, notwithstanding the enthusiasm of some committee officials for a common language, the committee has elsewhere noted that "*consistency* in implementation is best achieved not through developing top-down rules, but rather by tailoring implementation plans to the *unique circumstances of each banking organization and its supervisors*". (reference to the BCBS document omitted, emphasis added)

Tarullo's analysis based on the Committee's statements anticipates one of the key arguments developed in the dissertation, further elucidated in Section 1.4 below. The idea that harmonisation of rules across legal systems can eradicate opportunistic behaviour by equalizing the regulatory costs of transacting in different places, misses fundamental considerations regarding the application and practices stemming from these common rules (Riles 2013a). Balancing the need for supervisory consistency against institutional diversity is

[11] See Chapter 5 of his book.
[12] See Chapter 6 of his book.
[13] "The internal ratings approach to setting capital requirements looks to the bank's own estimate of the credit risk entailed by particular claims, rather than to a fixed risk category determined by the generic type of borrower" (Tarullo 2008, 150).

not an exclusive concern at the international level; it represents in fact the main challenge for the SSM given that, in spite of the construction of a common implementation mechanism, there are persistent differences stemming from local supervisory practices and diverse banking systems.

Moving forward to the last part of the international efforts in the prudential regulation realm, a major overhauling of the Basel framework was only possible after the events triggered by the 2007-2009 global financial crisis. The framework has been revamped in many aspects that will not be dealt with here,[14] in light of the objectives of this first section and the introductory chapter. Furthermore, amendments to the Basel III framework have been discussed and adopted over a prolonged period of time, and due to the prominence of some of the proposed reforms, the framework has been dubbed "Basel IV" among industry stakeholders, to emphasise the discontinuity with Basel III. This final part focuses on specific features that are useful to better understand the context of the overall research, i.e. supervisory consistency challenges under banks and national diversity. One of the main aspects concerns the definition of regulatory capital: the framework tightens its definition since "one of the key lessons from the financial crisis has been that a common understanding . . . will facilitate a true level playing field" (Meneau and Sabatini 2011, 95). The regulatory capital structure was improved from a *qualitative* perspective—for instance by defining in clearer terms the Common Equity Tier 1 (CET 1)—and also a *quantitative* one—by imposing higher regulatory capital requirements, amongst other reforms. The authors highlight that, in spite of the

[14] For a comprehensive review of Basel III regulatory changes, see the edited volume by Cannata and Quagliariello (2011). See Howarth and Quaglia (2016c) for a comparative political economy analysis of the configuration of national banking systems in the EU and its impact upon the preferences expressed by regulators during the Basel III negotiations. In line with these strands of research, see Goldbach (2015) for an analysis of the asymmetric influence and regulatory capture in global standard setting, and how these practices perpetrate incompleteness and regulatory loopholes in spite of the initial intentions.

improvements in the definition, the challenge of a consistent implementation of the standard remains. Back in the early Basel I days, criticisms towards definitional precision have been raised:

> A paradox inherent in attempts to provide a meaningful and uniform definition to bank capital adequacy is that, as more regulatory precision is given to the concept, more definitional problems arise. (Norton 1989, 1360/1)

This issue resonates with the short novel at the beginning of the chapter: *On exactitude in science*, and the need to strive for precision and scientific rigour in regulatory formulations. In dealing with this concern, Norton (1989, 1361) reminds us that capital adequacy, as an instrument, has been transformed into a "regulatory objective with a life on its own [, and] instead of the tool helping to understand the problem, the regulators have created an ever-increasing framework for trying to understand the tool". It is interesting to note that these observations have been formulated at a time the Accord was a relatively simple and vague instrument, compared to the lengthy and intricate tool that we have in these days.

The historical overview presented so far offers two main takeaways in light of the work that follows. First, supervisory consistency has been a key concern to prudential regulators since the early days of financial internationalisation. In order to make up for "past mistakes", regulators[15] at the international level have attempted to enhance the supervisory framework by developing more sophisticated tools. This sophistication responds not only to the need for a stronger supervisory architecture capable of preventing systemic risk from happening in a highly interconnected financial system, but also to the rapidly evolving banking and financial

[15] The word "regulator" here is used in a colloquial way, since the BCBS, as mentioned earlier, has no formal regulatory powers and therefore, the Committee members that issue these standards do not have a formal power to bind their respective national governments. In any event, from a practical perspective given the impact of these tools at both European and national levels, the issuance of soft law from this body is comparable to the hard law instruments issued by formal regulators.

markets. The SSM faces the same consistency challenges at the Banking Union level, but, contrary to what happens in the international arena, it is directly responsible for the consistent application of these common standards. Second, the role of soft law in prudential regulation and supervision has to be highlighted. Characterising a regulatory product as *soft law* relates not only to the instruments that are created, but also the nature of the body that issues them. As shown throughout this first section, the importance of prudential soft law tools has increased along these two dimensions. On the one hand, the sophistication and complexity of Basel III/IV has reinforced the more vague and non-binding tone of the original 1988 Accord. On the other, the characteristics of the standard-setter have also evolved in the last years: while Basel I has been adopted by a handful (eleven) of countries, the BCBS now comprises forty-five members from twenty-eight jurisdictions, and Basel III has been adopted by at least one hundred jurisdictions (Financial Stability Institute 2018),[16] thus demonstrating the importance of the (soft) regulatory activities carried out by the Committee even beyond its membership. The quote below summarises the intricacies hidden behind the image of the BCBS's products as mere soft law tools:

> Soft law-making has different stages: issuing rules is the first (and in this stage the language of the BCBS has become more assertive over time); the implementation stage refers to the 'observance' or 'adherence' to the rules (in hard law 'terminology' compliance and enforcement are key) and then, related to the observance, 'incentives' act as a substitute for formal enforcement mechanisms. Soft law rules themselves can be gradated according to their forceful (instead of binding) nature: from gentlemen's agreements to uniform rules or standards, in which various actions (substitute for sanctions) apply in the case of non-observance (substitute for non-compliance). Negative incentives—from institutionalized peer review to name and shame practices—can often have the

[16] The survey carried out by the Financial Stability Institute (2018, 29) belonging to the BIS, has examined the regulation and supervisory practices of a hundred jurisdictions, and found that "the current Basel III implementation status in non-BCBS countries is mixed. In regard to the Basel III . . . a majority of countries have implemented the new definition of capital"; although this shows that non-BCBS countries are for the most part focusing on core aspects of the Basel III framework, this is already indicative of the strength of these soft law tools.

same deterrent effect as formal sanctions. (Goodhart 2011, 544, citing Rosa Lastra's correspondence)

Before concluding, another relevant post-crisis regulatory development at the global level was the establishment of the G20 as a key forum for discussion and elaboration of policy responses to the crisis. At the Pittsburgh Summit in April 2009, the G20 Heads of State and Government established the Financial Stability Board (FSB), as the successor of the Financial Stability Forum (FSF).[17] The FSB "acquired a new policymaking and co-ordination mandate over, inter alia, the Basel Committee" (Lastra 2019, 12).[18]

The following section focuses on the European area in order to emphasise, on the one hand, the similarities and parallel trajectories followed at both the international and regional levels and, on the other, the specificities of the harmonisation process in Europe, which was embedded in two broader integration projects: the single market and the monetary union.

1.2 The European prudential framework and the deepening of financial integration

This section zooms in on the evolution of the European prudential framework, and explores the harmonising efforts in the early cooperation days, in which much of the activities overlapped with the discussions held at the BCBS, until the development of two fundamental integration projects at the regional level: the single market and the Economic and Monetary

[17] See the official FSB website for further details about the Board's origins: https://www.fsb.org/history-of-the-fsb/

[18] See Riles (2014) for a critical analysis of the FSB's new governance methods and potential shortcomings.

Union (EMU). In fact, harmonisation of prudential regulation and supervision has been a functional and normative aspect of these two projects.[19]

1.2.1 The early days: International and European institutional overlap

The Treaty of Rome, the seminal instrument establishing the European Economic Community (EEC), states that the Community, "by establishing a common market and progressively approximating the economic policies of Member States", has the task to promote "a harmonious development of economic activities". The word "harmonisation" is explicitly used when referring to tax provisions, commercial policy, and working conditions. In a nutshell, in the early Community days, "economic harmonization was to drive a much broader process of reconciliation and pacification" (James 2012, 40).

In the subsequent years, between the late 1960s and early 1970s when the "global monetary turbulence" occurred, Europe started to be seriously concerned about the rising inflation and discussed the possibility to have an alternative store of value to the dollar (James 2012). It was in this context that the first political initiatives focusing on the creation of a monetary union were set in motion: the Committee of Governors of the Central Banks of the member States of the European Economic Community (or shortly, "CoG"), served as a forum for discussing and deciding monetary cooperation issues; it is no accident that their meetings were held at the BIS in Basel. It has been acknowledged that "the development of monetary

[19] This section describes integration endeavours that, due to the characteristics of differentiated integration, do not coincide from jurisdictional and geographical perspectives. For instance, the section refers to the single market, EMU, and the Banking Union, although the title make a generic reference to the "European" framework for the sake of simplicity. At the time of concluding the dissertation, Banking Union countries (hence, SSM countries), coincide with EMU ones. However, Croatia has sent a request to enter into close cooperation with the SSM, according to the procedures set forth in Article 7 of the SSM Regulation, while Bulgaria hopes to enter the Exchange Rate Mechanism (ERM II) and Banking Union by April 2020.

cooperation should be based on harmonization of economic policies" (James 2012, 71, citing the statement of a German official taken from the Bulletin of the European Communities, 1970). In pursuing monetary unification, a further challenge was to coordinate a response to the dollar problem, which also meant resolving a broader problem related to global liquidity, as seen in the previous section. Thus, harmonising banking and capital movements control legislation was considered necessary . However, it was not until 1994, with the creation of the European Monetary Institute (EMI), the forerunner of the ECB, that "technical aspects of monetary harmonization were handled better", partly thanks to the EMI's superior institutional capacity (James 2012, 312).

In order to cope with the challenges arising from an increasingly complex international financial order, the early 70s were characterised by emerging forms of cooperation, what has been portrayed as "the proliferation of 'Groups'" (James 2012, 111), exemplified by the creation of the BCBS in December 1974. As mentioned above, the debate surrounding the preservation of international financial stability run parallel at the European and international levels, and the tension between international harmonisation and national regulations was particularly intense in the former. The quote below depicts the overlapping of membership in these simultaneous committees, which has contributed to consolidating central bankers' epistemic community:

> So, besides dominating the BCBS in terms of numbers, the Europeans had no less than three additional banking supervisory committees. But at the same time the number of senior bank supervisors at European supervisory authorities was limited. So it was commonplace for such senior officials to sit on, and attend, two, or even more, of these committees simultaneously. There was much overlapping of membership. In this respect there was widespread understanding, and sharing of knowledge of what other committees were doing. (Goodhart 2011, 436)

It should be recalled that the political negotiations surrounding the creation of the EMU dealt with not only economic and monetary policies. The extent to which the ECB should be engaged in banking supervision as part of its mandate was also a highly contested point at the time of drafting its statute: on the one hand, Governments were mostly in favour of keeping supervision as a national prerogative, while, on the other, central bankers supported the idea of having this task at least potentially for the prospective euro-area bank (James 2012). It was eventually the inclusion of the "enabling clause enshrined in article 105(6) EC Treaty that provided for a special fast-track procedure to decide the allocation of prudential tasks to the ECB" (Dragomir 2010, 286), that allowed for the creation of the SSM in 2013.[20]

1.2.2 Financial integration in action: The single market and the evolution of the prudential framework

Harmonisation of prudential regulation has been an integral aspect in the development of the single market; convergence of prudential supervisory practices was deemed essential after the global financial crisis, and the euro area fiscal and sovereign debt crises. Financial fragmentation along the national lines showed that the single currency was not enough in order to pursue a truly integrated market. The regulatory evolution of the prudential framework in the EU has followed not only the development and growth of the banking and financial industries, but, most importantly, the needs stemming from the wider economic integration project:

> Prudential rules have changed over time, from broadly specified policy guidelines, aiming to create a minimal degree of convergence between disparate national realities and striving for the creation of a single banking market, to a very detailed

[20] Article 105 (6) is now article 127 (6) of the Treaty on the Functioning of the European Union (TEFU).

> and extensive set of principles, rules and standards, albeit still incomplete, which addresses substantial issues relevant for an integrated market. (Dragomir 2010, 65)

December 1977 marked the beginning of the European harmonisation enterprise, with the adoption of the First Banking Directive,[21] which was meant to be an early stage instrument directed "to specify only certain minimum requirements to be imposed by all Member States" (recital no. 12). The Directive was a first step towards opening up national markets and foster competition among them; in spite of its minimum harmonisation approach, the Directive laid the foundations for the steps undertaken by subsequent regulatory instruments. Before the major strategic changes brought about by the Commission's 1985 White Paper on the completion of the internal market, harmonisation continued, and smaller additional regulatory steps were taken. For instance, in June 1983 the first directive on consolidated supervision was adopted:[22] "Despite its vague, barely harmonising content, the directive is important as it succeeded in introducing in all Member States the mandatory requirements that national authorities supervise on a consolidated basis" (Dragomir 2010, 72). This was an important step forward, which was accelerated by the crises episodes mentioned in the previous section, especially the case of Banco Ambrosiano and the Luxembourg subsidiaries that were not

[21] Directive 77/780/EEC, of 12 December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, O.J. No L 322/30-37. The directive was the result of a lengthy process that is not developed in the present section. For further historical references, see Dragomir (2010), chapter three.

[22] Directive 83/350/EEC. *Consolidated supervision* is one of the principles contained in the BCBS's "Core Principles for Effective Banking Supervision" (2012). According to principle 12: "An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide". This means that the consolidation principle is applicable not only to a banks' branches (which are not legally independent from their head), but also to a credit institution's' subsidiaries (legally independent from their parent institution).

wounded up by the Bank of Italy in 1982, a situation that emphasised the regulatory and supervisory loopholes at the international level.[23]

In 1985 a major step in the integration project was taken: the adoption of the Commission's White Paper on "Completing the Internal market".[24] The document contained an exhaustive study of the existing barriers hindering the creation of a genuine single market, and it also included a detailed list of almost 300 proposed measures accompanied by a detailed timetable (Eeckhout 1994), to be completed by the end of 1992. The ambitious programme was meant to complement the customs union and the common agricultural policy, running since the 1960s, by implementing the necessary measures to make the so-called four freedoms possible, i.e., free movement of persons, services, capital, and goods. The importance of this initiative can be assessed from both a conceptual and an operational perspective.[25] Concerning the former, the White Paper has coined the term "internal" or "single market",[26] which is to be understood as the merger of member States' markets into one larger market capable to "channel human, material and financial resources in an optimal way" (Dragomir 2010, 73). Regarding the latter, the document endorses economic integration techniques that go beyond legal harmonisation, as explained by Snyder (1993, 27):

> In the 1985 White Paper on 'Completing the Internal Market,' the Commission outlined its strategy for economic integration. A central aim was to ensure the effectiveness of Community law. Instead of relying mainly on the harmonisation of national laws by means of Community directives, the Commission envisaged the combined use of three techniques: essential harmonisation, mutual recognition

[23] In May 1983, the BCBS issued its Concordat containing the "Principles for the supervision of banks' foreign establishments" in response to these urging events.
[24] COM (85) 310 final, June 1985.
[25] These two perspectives are relevant in light of the topics analysed in the present chapter and the dissertation as a whole, but should not be understood as exhaustive; the document has wider implications in all single market areas.
[26] The terms are interchangeably used through the text, although it has to be acknowledged that the 1985 document refers to the concept "single market" five times, while "internal market" is used fifty-five times. Most legal documents, such as the TFEU or the Single European Act, use the latter instead of the former.

> and reference to standards. Each involved different institutions, different techniques and a rather different configuration of interests in the quasi-federal politics of the Community.

Snyder makes reference to a three-pronged strategy that combines harmonisation, mutual recognition, and standards, to be applied to all four freedoms. Concerning the prudential domain, the three principles that have been crystallised in the White Paper and eventually embodied in subsequent legislation, are minimum harmonisation, mutual recognition, and home-country control (Dragomir 2010).[27] These principles were developed in paragraphs 101-107 of the White Paper, which described the plan for the liberalisation of financial services, "a major step towards Community financial integration and the widening of the Internal Market" (Commission of the European Communities 1985, 27). In order to implement the ambitious agenda put forward by the Commission, the first Intergovernmental Conference adopted the Single European Act (SEA) on 28 February 1986, which entered into force on 1st July 1987 and amended the Treaties establishing the European Communities. The SEA has been a key legal instrument making the single market project possible, a regulatory landmark in the evolution of European integration. In fact, it introduced "qualified majority voting for common customs tariffs, free provision of services, free movement of capital and approximation of national legislation" (European Parliament 2019, 2). Apart from enabling the adoption of a 90 % of the measures envisaged in the 1985 White Paper by the December 1992 deadline, the

[27] The overlap between the principles enumerated by Snyder and Dragomir respectively, highlights the similarities and the interrelation between the regulatory patterns that underpin European integration, and those of banking regulation. However, as explained below, the post-crisis regulatory and institutional overhaul has dramatically changed the explanatory leverage of these principles, which no longer reflect the current regulatory paradigm.

SEA contained an important provision on economic and monetary policy cooperation, which was incorporated to the Treaties and allowed for a smoother transition towards the EMU.[28]

In fact, the developments in prudential regulation in order to strengthen the internal market run in parallel with the building up of the EMU project.[29] In fact, the European Monetary System (EMS) had been established in March 1979, some years before the launching of the Commission's White Paper. The EMS had three fundamental elements: the exchange rate mechanism (ERM), credit mechanisms, and the European Currency Unit (ECU). The aim of the EMS was to create a "zone of monetary stability in Europe", by reinforcing the monetary regime internally and externally (Maes 2016, 44); it was mostly a Franco-German initiative, in which the negotiating role of the Commission was limited. Despite its push towards a common European solution to a global financial problem, "the EMS was a profoundly truncated system . . . The ECU was in reality not at the centre of the system: such a role would have required an institution that had the capability of issuing or creating ECUs" (James 2016, 32). Therefore, the lack of a truly European institutional support was one of the main weaknesses of this initial monetary project.

In the mid-1980s, the internal market programme and the liberalisation of capital movements "was having consequences in the monetary field" (Maes 2016, 46), since this liberalisation was a fundamental German condition for more monetary cooperation. It was in this context that Jacques Delors, President of the Commission at that time, asked European

[28] Prior Treaty amendments and further considerations on the relevance of the SEA, can be found in the following fact sheet from the EP: http://www.europarl.europa.eu/factsheets/en/sheet/2/developments-up-to-the-single-european-act

[29] The previous section has briefly introduced some historical events in the evolution towards the EMU. This section does not provide a deep account of the events preceding the Maastricht Treaty, but only the most important features that help understand the concomitant evolution of the prudential framework. Chapter 3, for its part, examines the initial phase of the EMU and compares it with the Banking Union project, in order to explore diversity management in these two integration projects.

central bankers to draft a plan and a timetable for the currency union. The *Delors Committee* met between September 1988 and April 1989, when the "Report on economic and monetary union in the European Community" was presented (Delors 1989). In explaining the success of the project, James (2016, 33) observes that "Delors produced just the right mixture of vision and practical sense: the vision of a bold move to realize the idea of 'Union', and the pragmatic acknowledgement that only the central bankers could really remove the obstacles that lay in the way". The Report focused on two fundamental questions: first, the economic arrangements that were necessary in order to implement a successful monetary union, and second, the gradual steps that should be undertaken in order to reach it. The report envisaged a three-stage process: the first concerned the deepening of the existing cooperation arrangements; the second was the creation of the European System of Central Banks(ESCB), a key player in the transition between the national and a common monetary policy; and third, an irrevocable setting of the exchange rates (Maes 2016). The Commission fostered the integrationist dynamics by linking the single market process and the monetary union in its study "One Market, One Money" (Commission of the European Communities 1990). It was after two crucial intergovernmental conferences (IGCs) carried out in parallel, one on the political and the other on monetary union, that the Maastricht Treaty was adopted, and the transforming process of the EMU kicked off, a process that would entail deeper transformations beyond the single currency.

Coming back to the evolution of prudential rules, the application of the principles outlined in the 1985 White Paper (i.e., minimum harmonisation, mutual recognition, and home-country control) into the banking regulation domain, has been an important step in pursuing

financial and banking integration (Dragomir 2010). In 1989, the Second Banking Directive was adopted;[30] the thirteen-page long Directive was meant to

> Constitute the *essential instrument for the achievement of the internal market*, a course determined by the Single European Act and set out in timetable form in the Commission's White Paper, from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions. (Recital 5 of the Directive, emphasis added)

This Directive crystallised the triptych of principles that would ease the creation of a single banking market. As later discussed in Chapter 3, "member states' banking and financial systems are frequently the product of highly divergent economic, political, and legal developments which make substantial harmonisation unfeasible" (Clarotti 1993, 22). To overcome persistent and fundamental difficulties related to the harmonisation of prudential provisions, and to comply with the 1992 single-market deadline, the Second Banking Directive endorsed the principle of "mutual recognition" of prudential standards. This principle, in its turn, was part of the 1985 White Paper, where the Commission compared it with the mutual recognition requirement established by the European Court's decision *Cassis de Dijon*,[31] explicitly cited in paragraph 102 from the "financial services" section. The Commission draws

[30] Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC

[31] Judgment of the Court of 20 February 1979. *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*. Case 120/78. According to the summary provided by Clarotti (1993, 23) when discussing the adoption of this principle in the context of the Second Banking Directive, "the Court ruled that a product which has been lawfully produced and circulates freely in one member state should in principle be allowed to be commercialised throughout the Community, even though the country of destination has different technical standards".

similarities between the reasoning followed by the Court in relation to alcoholic beverages[32] and the free circulation of financial products, which should be facilitated at the European level.

The mutual recognition principle was complemented in the Second Banking Directive by the "home country control" principle, which meant that the activities carried out by banks and financial institutions through the European territory had to be supervised by the competent authority of the home member State. (Clarotti 1993).[33] The implementation of these principles had deep implications for the conduct of supervisory practices. First, it provided the necessary elements for the use of the so-called "European passport", with the single banking licence. Second, the interplay of principles created a 'geographical deregulation', since host member States were required to "abolish the authorization and endowment requirements for branches" by early 1993 (Clarotti 1993, 25). Third, this led to a 'product deregulation', due to the fact that banking activities were listed in line with the universal banking model, which comprised most of the commercial banking activities and securitization.[34] The Second Banking Directive laid the foundations for an integrated banking market; it was complemented by a "body of technical prudential rules" (Dragomir 2010, 78) that were adopted in separated legal texts, such as the own funds, solvency ratio, and large exposures directives, and a second directive on

[32] One of the relevant passages from the Court's verdict says that "Obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognized as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer" (paragraph 8 (ii)).
[33] This principle is the flip side of the consolidated supervision principle referred to above. According to Dragomir (2010, 77/8), "the most important contribution of the SBD [Second Banking Directive] lies in the explicit consecration of the home-country control principle as a cornerstone of the common banking market. The principle had already been announced in the FBD [First Banking Directive] and was also pushed forward by international fora: the Basel Committee had established in 1975 that the supervision of the solvency of foreign branches of domestic institutions should be the responsibility of the 'parent' authority and reaffirmed such a principle in the 1983 Concordat".
[34] Section 1.2.3 below deals with the evolution of the concept of banking, and deepens the analysis of universal banking and its reception in the European framework.

consolidated supervision, which introduced some amendments to the 1983 text, in light of the new regulatory and institutional environment. As pointed out by Herring (1993, 181), "the European Community has undertaken a bold initiative to harmonise banking regulation within the twelve member states. From an American perspective . . . the swift progress which the European Community has made is dazzling". The American scholar acknowledges, however, that part of the European success has been due to the fact that only a small number of regulations implied a strict harmonisation. In hindsight, the minimum harmonisation principle is the barking dog that never bites, compared to the current supranational control in the prudential framework. However, these early regulations actively contributed to the creation of a "set of common core prudential parameters aimed at establishing a common ground" (Dragomir 2010, 78).

In spite of the transformation described so far, "it became clear by the mid-1990s that the embryonic capital-market regime was not working" (Moloney 2003, 810). The degree of financial integration was considered disappointing due to the persistent fragmentation along national lines. In response to these challenges, late in 1998 a "Financial Services Policy Group (FSPG) was set up, and the work carried out by this group provided the groundwork for the Commission's "Financial Services Action Plan" (FSAP), launched in 1999 (Dragomir 2010). As its predecessor, the 1985 White Paper, the FSAP foresaw a series of ambitious measures (forty-two) to be adopted by 2004 , whose core objective was to "create a single deep and liquid financial market to serve as a motor for growth, job creation and improved competitiveness in the European economy" (European Commission 2005, 5/6). The FSAP legislative agenda needed to be supported by the necessary reforms at the decision-making level, just as the 1985 document had prompted the enactment of the SEA.

It was in this context that the Lamfalussy process "was launched in response to the call for an integrated approach to supervision and regulation based on an evolutionary method" (European Commission 2005, 10/11), whose aim was to foster cooperation among national regulators in order to consistently transpose directives into local legislation. The Lamfalussy Report was published in February 2001 and endorsed by the ECOFIN Council in March, in order to put "in place an efficient mechanism to begin *converging European financial supervisory practices*"[35] (European Commission 2007, 2, emphasis added). The Lamfalussy process set up a "four-level, comitology-based approach for financial services" (European Commission 2007, 2). First, the framework principles; second, the detailed implementing measures; third, cooperation and convergence committees; and fourth, enforcement and enhanced cooperation (CEBS 2005).[36] In February 2002, the European Parliament agreed to the implementation of the Lamfalussy process in the regulation of European securities markets; later that year, the ECOFIN Council consulted the Economic and Financial Committee (EFC), which recommended to apply the framework to all financial sectors based on what has been initially done with securities. In December 2002, the ECOFIN Council endorsed the EFC's report, containing a proposal for the creation of three sectoral committees—banking, insurance, and finance—which were set up as Level 3 committees by Commission Decision of 5 November 2003 (CEBS 2005). As a result of this process, in January 2004 the Committee of

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[35] Interestingly, the Commission's 2007 review of the Lamfalussy process referred to the 'convergence of practices', a more ambitious objective than rule harmonisation, as per the previous documents.

[36] As explained by the Commission (2005, 10): "At Level 1, framework legislation setting out the core principles is adopted by normal co-decision after a full consultation process. At Level 2, technical implementing measures are adopted by the Commission, on the advice of the relevant advisory committee, after a binding vote of the competent regulatory Committee representing the Member States and taking into account the European Parliament's view. At Level 3, the appropriate advisory committee, made up of representatives of national supervisory bodies, draw up common interpretation guidelines and common standards and compares regulatory practice in the various Member States to foster convergence of supervisory practices. Level 4 is where the Commission enforces the timely and correct transposition of EU legislation into national law".

European Banking Supervisors (CEBS) was created, which in the aftermath of the crisis was replaced by the EBA.

Although the FSAP had a specific deadline, it was not conceived as an aim in itself but, rather, as a springboard to the development of regulatory and enforcement mechanisms that would contribute to an ongoing process of financial integration. As pointed out by Dragomir (2010, 89, reference omitted), "the idea of a post-FSAP strategy emerged as a recurrent topic in the discourses of policy-makers, highlighting the necessity to go beyond the legislative phase and concentrate on *effective implementation* and *enforcement*" (emphasis added). The Commission crystallised this post-FSAP programme in its "White Paper on Financial Services Policy 2005-2010" (European Commission 2005). An important aspect that should be noted in the series of events described so far, is the Commission's shift of focus: while the 1985 White Paper "was largely conceived as a legislative exercise" (Dehousse, Joerges, Majone, Snyder, and Everson 1992, 7), the subsequent integration efforts were more concerned with the implementation and enforcement of the harmonised corpus of rules. For instance, the establishment of the CEBS as a Level 3 committee, in charge of "improving co-operation between supervisors and ensuring common and convergent implementation of level 1 and 2 legislation" (CEBS 2005, 6), emphasised the priority on *supervisory practices convergence* as a means to achieve a truly integrated financial sector. Although the Lamfalussy framework had been overall positively assessed by the Commission, mainly thanks to the flexibility of the regulatory process, it was not without its flaws. This was particularly evident in the case of Level 3 Committees, which in spite of their efforts to enhance supervisory convergence and cooperation,

> [Did] not seem to be fully equipped to delivered what has been expected from them. A stronger political impetus is needed. On the other hand, since supervisors

> first responsibility is a national one, they might not have either adequate powers or incentives to converge at the European level. (European Commission 2007, 7)

According to the Commission's Communication evaluating the framework, there was a mismatch between the importance of the decisions taken by Level 3 committees and their legal status, which directly impacted upon the effectiveness of their cooperation efforts. Perhaps one of the clearest examples of the limited effectiveness of the Level 3 committee in the banking sector, was the case of the first Capital Requirements Directive (CRD),[37] which was adopted through the co-decision legislative procedure:

> The first opportunity to make use of the Lamfalussy framework in the banking sector was missed. This might seem surprising in the light of the fact that the very demand for extending the Lamfalussy procedure to the banking sector was justified by the urgent need for adapting the capital adequacy rules. (Dragomir 2010, 128)

Since more than two thirds of the CRD belonged to annexes and technical aspects of the regulation, one reasonable solution would have been to leave those to the Level 2 comitology procedures, while adopting the core articles as Level 1 measures (Dragomir 2010). This directive transposed Basel II into EU legislation, albeit with some modifications; in fact, one of the main differences lied in the scope of the international agreement and the European directive, respectively. While the former applied to "internationally active banks", the latter was applicable to all credit institutions and investment firms in Europe. This initial one-size-fits-all approach of the European legislator sparked criticism, not only because of the large amount of banking institutions across the EU that are *not* internationally active, but also given

[37] Directive 2006/48/EC of The European Parliament and of The Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. O.J. L 177/1. 30.06.2006. The name 'Capital Requirements Directive' usually refers to both the Directive 2006/48/EC and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast). The chapter uses the general acronym 'CRD' to make reference to the former, while the latter corresponds to the 'recast CAD' (Capital Adequacy Directive) denomination, that is not referred to in the text.

that the US legislator has taken the size of banks more seriously.[38] One of the most important reforms in relation to the topics discussed in this work, concerns the CRD's reception of the supervisory review process (SRP) in articles 123 and 124, whose evolution is examined in Chapter 4.[39] The SRP has been one of the main innovative aspects developed by Basel II and subsequently the CRD, since this process acted as a qualitative complement to the quantitative capital requirements. Furthermore, in line with the effective implementation leitmotif, the CDR emphasises the need for more active supervisory authorities through *review* and *enforcement* (Dragomir 2010). According to the former, competent authorities have to ensure that the capital of the credit institution is consistent with its risk profile, while they also have to approve each of the institutions' internal risk processes and governance.[40] Regarding the latter, article 136 CRD established that supervisors have to intervene promptly in case of weaknesses and deficiencies.

In spite of the legislative efforts to reinforce the role of supervisory authorities, the global financial crisis struck and the European fiscal and sovereign debt crises made things more complicated. The CRD came fully into force on 1st January 2008; however, the first review measures under the name of "CRD II" were adopted in September 2009,[41] and in November

[38] See Masera (2013) for an analysis of the US Basel III transposition.
[39] The SRP corresponds to the so-called Pillar 2 in the Basel jargon. As critically pointed out by Dragomir (2010, 130), however, "the new provisions are scattered throughout the two amended directives and inserted within the old titles and chapters, thereby failing to reflect in the structure of the CRD the three pillars backing the Basel review". The three-pillar structure from Basel II, is indeed not recognisable in the CRD, which followed a legislative technique that aimed to consolidate the text in relation to previous Directives.
[40] An important tool to assess these internal elements is the ICAAP (Internal Capital Adequacy Assessment Process), also discussed in Chapter 4. The evaluative exercise that supervisors had to carry out as a result of CRD, entailed a much more complex and delicate role, since the qualitative elements brought about by the SRP and ICAAP had to be balanced against the quantitative criteria.
[41] Directive 2009/111/EC of The European Parliament and of The Council of 16 September 2009. L 302/97. 17.11.2009

2010 further amendments were introduced through the "CRD III".[42] In addition to the legislative changes, the crisis was a catalyst for a deeper review of the European supervisory arrangements in all financial sectors. The Commission entrusted a High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, with the task of advising "on the future of European financial regulation and supervision" (de Larosière 2009, 3). Among the different recommendations issued by the High-Level Group, a key point was the establishment of an integrated "European System of Financial Supervision" (ESFS), and the transformation of the Level 3 Committees into three distinctive European Authorities: a European Banking Authority, a European Insurance Authority, and a European Securities Authority, with a focus on micro-prudential oversight (de Larosière 2009, Recommendation 22). The ESFS is complemented by a macro-prudential supervision arm, led by the European Systemic Risk Board (ESRB). The three European Supervisory Authorities (ESAs) were established in January 2011, and it was in this moment that the CEBS was transformed into the European Banking Authority (EBA).

From a chronological standpoint, relevant follow-ups are the amendments introduced by CRD IV[43] and the enactment of a Capital Requirements Regulation (CRR) in 2013,[44] which transposed the Basel III framework into EU law—a framework that continued evolving after

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[42] Directive 2010/76/EU of The European Parliament and of The Council of 24 November 2010. O.J. L 329/3. 14.12.2010.

[43] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC Text with EEA relevance
OJ L 176, 27.6.2013, p. 338–436

[44] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance. OJ L 176, 27.6.2013, p. 1–337. The enactment, for the first time, of a regulation in order to complement the directive, is an indicative feature of the regulatory and policy efforts aimed to strengthen the prudential framework. The chapter will not examine the underlying logics behind the use of this regulatory tool; see Commain (2018) for a study on this choice by the Commission.

the 2011 version. The crisis revealed the need to revamp the international accord, due to some substantive flaws: first, it "was conceived fundamentally with reference to idiosyncratic risk", therefore leaving aside macroprudential and systemic risks; second, "liquidity management and excessive maturity transformation were not addressed" (Masera 2014, 382). The so-called "CRD IV package" is based upon three key elements: capital, liquidity, and corporate governance. Concerning the first feature, Basel III quantitatively and qualitatively reinforced the definition of capital, which must now be "fully loss-absorbing" (Masera 2014, 398). The package has also included a capital conservation, a countercyclical, and a systemic risk buffers, plus another one to deal with Global Systemically Important Banks (G-SIBs). The amendments have also strengthened the role of Pillar 2 (ICAAP and SREP), and Pillar 3 (public disclosure and transparent information on capital structure, risk management, among other aspects). Regarding the second element, the framework has introduced two novel liquidity requirements, the liquidity coverage ratio (LCR) and the net stable funding requirement (NSFR). Concerning the third element, corporate governance and remuneration policies, a series of measures were directed to ensure diversity in the board composition, and the separation between risk management and compliance from the operational function (Masera 2014).[45] In parallel, discussions surrounding the Banking Union and the SSM were taking place; these events are described in Section 1.3 below, within the broader discussion of post-crisis economic governance in the EU.

[45] An interesting point concerns the interaction between Basel III and its transposition at the EU level. At times, legal scholarship does not fully consider the relevance of EU financial interest groups, and the interplay between the international and the regional/EU arena. As Young (2014, 383) has acknowledged, there is a "disjuncture between global rules and local EU ones, in this case the transposition of Basel III into the EU Capital Requirements Regulation", as he claims that "EU financial industry groups were more successful 'at home' in the transposition of global rules into EU regulations than 'abroad'".

To sum up, this subsection has provided an evolutionary overview of the prudential and supervisory tools developed at the European level. Table 1.1 summarises the main regulatory and institutional endeavours, both at the European and international level. The following subsection complements the evolutionary aspects discussed so far, as it explores how the object of regulation—the activities developed by credit institutions—have affected these frameworks, and vice versa.

Initiative	Date	Countries affected	Regulatory aim/principle
Basel Committee on Banking Supervision (BCBS)[46]	1974	G-10	Enhance financial stability by improving quality of banking supervision; serve as a forum for regular cooperation.
First EU banking Directive	1977	European Community (EC) Countries	Facilitate the establishment of common banking market in branching.
Concordat on Consolidated supervision	1983	G-10	Comprehensive supervision by parent supervisory authority.
Directive 83/350 on Consolidated supervision	1983	EC Countries	Comprehensive supervision by parent supervisory authority.
White Paper Completing the internal market	1985	EC Countries	Removal of physical, technical, and fiscal barriers; embrace 'four freedoms'.
Basel I Accord	1988	G-10	Establish minimum levels of capital (8%) for internationally active banks.
Second banking Directive 89/646	1989	EC Countries	Banking passport; geographical deregulation; product deregulation; home country control.
Maastricht Treaty	1992	EU Countries	Foundations for the Euro/EMU.
FSAP	1999	EU Countries	Reinforce the construction of single financial market.
Lamfalussy Process	2001	EU Countries	Create efficient mechanisms to help converge financial supervisory practices and accelerate decision-making process.
Basel II	2004	27 member jurisdictions	Three pillar approach; advanced internal ratings–based (A-IRB) approach for setting capital requirements.
CEBS	2004	EU Countries	Lamfalussy Level 3 Committee; consistent implementation of rules and promotion of convergence of supervisory practices.
CRD	2006	EU Countries	Basel II implementation in Europe.
De Larosière Report	2009	EU Countries	New supervisory architecture at EU level.
Financial Stability Board (FSB)	2009	G20 – actually 25 member jurisdictions	Endorses recommendations to promote global financial stability.
Basel III/IV	2011/ 2017/…	28 jurisdictions, 45 institutions (adopted by 100 jurisdictions)	Enhanced capital, liquidity, and governance provisions; macroprudential buffers/measures.
New ESAs (EBA)	2011	EU Countries	Promotion of convergence through binding and non-binding regulation.
CRD IV - CRR	2013	EU Countries	Basel III implementation in Europe.
Banking Union – SSM	2013/ 2014	EMU countries (=BU) + close cooperation countries	Supranational banking supervision through ECB staff + NCAs.
CRD V and CRR II	2019	EU Countries	Implementation of Basel modifications.

Table 1.1: Global and EU financial regulatory initiatives and fora. Source: Own elaboration.

[46] Initially named the "Committee on Banking Regulations and Supervisory Practices". See https://www.bis.org/bcbs/history.htm

1.2.3 An evolving conception of banking and the underlying market-building logic

The first two subsections have analysed the evolution of the prudential institutional and regulatory frameworks, and the overlaps between the international and European levels. This last subsection focuses on how these transformations have impacted upon the concept of banking. The analysis considers the key junctures that have shaped the way in which banks have been understood in light of the legal, institutional, and economic transformations that have taken place not only at the European, but at the international level as well. Understanding the changing notion of banking activities is important to better grasp the changing role played by supervisors. The evolution presented here is complemented by the analysis carried out in Chapter 3, which considers the institutional diversity between the German and Italian banking sectors. As a premise, it should be acknowledged that the transformation of banking activities is the result of a complex set of factors, where the national, European, and international levels overlap and mingle together. Therefore, this subsection is not meant to offer causal explanations for the analysed phenomenon. Its aim is to account for the changing structure of the financial system during the period considered so far, and how the increasing overlap between the banking and financial systems has impacted upon EU integration aspirations, which have transformed the institutional and legal settings.

Before continuing, it is important to clarify that *banking* is not a univocal notion. In fact, it comprises a wide range of activities and organisational forms. Concerning the former, "unlike the textbook description of financial intermediation, whereby banks simply transform deposits to loans, the banks in reality are very much diversified" (Farnè and Vouldis 2017, 2). Regarding the latter, institutional diversity is inherent to the banking system: "alternative banks with social missions were founded alongside private commercial and merchant banks very

early in European history" (Mettenheim and Butzbach 2014, 11). As it is further explained in Chapter 3, alternative banks are banking organisations that do not follow the for-profit, shareholder-oriented model adopted by most retail banks worldwide. This subsection aims to explore the relationship between the process of single market construction and European integration, and the broader transformations in the banking and financial sectors. Let us remember that one of the cornerstone arguments of the Commission's 1985 White Paper stated that

> The liberalisation of financial services, linked to that of capital movements, will represent a major step towards Community financial integration and the widening of the Internal Market. (Commission of the European Communities 1985, 27)

The link between market liberalisation and the integration project is clear: these "are two sides of the same political project: the creation of an integrated European financial market, primarily to the benefit of a new European 'champions league' of financial services providers" (Mügge 2006, 992). The European market-building project has to be understood beyond traditional state-market dichotomies. Instead, the European financial market domain can be better understood through the *competition politics* lenses, meaning "politics being dominated by services providers worrying about their position in the marketplace compared to (potential) competitors" (Mügge 2006, 992). These fundamental "intra-industry dynamics" are not unintended consequences of broader liberalisation or globalisation forces, but, on the contrary, lie at the very core of the European financial integration project (Mügge 2006). These 'competition politics' account for a new policy focus too: the "disembedding of financial regulation from national economic policies has been an important condition for the transnationalization of policy-making" (Mügge 2006, 1017). These characteristic at the politics and policy-making levels, are fundamental to understand the regulatory and institutional

evolution described above, and also the subsequent developments in the prudential arena.[47] As explained further below, the 'competition politics' rationale in the banking domain was fully embraced by the Commission.

During the initial post-White Paper phase, financial integration was meant to be bolstered by two fundamental channels: first, the 1992 single market project and all related regulations mentioned in the previous sections; second, the establishment of the single currency, as the "one money, one market" Commission's report summarises. In this context, the European legislator opted for a broad definition of banking, which suggests the adoption of the *universal banking* model, in order to leave "space for accommodating different national particularities" (Dragomir 2010, 32). Universal banking refers to a "banking tradition found in continental Europe in which banks engage in a full range of securities activities, usually through the bank entity itself rather than through separately incorporated subsidiaries" (Dale 1992, 138). Universality is also associated with the close interconnection between banks and industry, which is "formalised by banks acquiring equity holdings in their client companies and seeking representation on those companies' boards of directors" (Dragomir 2010, 31). This last feature has been typical of the German universal banking model, in which "economic relations between banks and industry have been very close since the beginning of industrialization and engendered tightly organized forms relatively early" (Büschgen 1979, 1). In the path towards 1992, other member States, such as Italy, have undergone a significant transformation of their banking systems in order to develop a universal banking model, which can be summarised as follows:

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[47] For a cross-sectoral policy-making analysis of the balancing exercise between market integration and competition, on the one hand, and public services provision, on the other, see Héritier (2001).

> The Italian banking system of the early twenty-first century is essentially private, but from 1861 to 1993 a market share consisted of State-owned banks, special credit institutions and, from the 1930s, banks of national interest and public-law banks. In 1990, the [so-called] *Amato Law* transformed banks, public-law banks and many special credit institutions into companies limited by shares. The Italian banking system was also characterised by intermediaries belonging to different categories, until the enactment of the 1993 Consolidated Law on Banking cancelled all forms of specialisation, allowing universal banks to operate. (Siclari 2015b, 3)

As the Italian case shows, the liberalisation of financial services—instead of 'deregulation'—entailed important changes, such as the transformation of a substantial part of domestic banks into joint stock companies in 1990, and the abolishment of banking specialisation in order to comply with the second banking directive and the universal banking model in 1993. Although this period witnessed a "massive deregulation [leading] to an exceptional expansion of the banking systems", and a "large amount of domestic consolidation [which] has increased the level of concentration in several EU countries" (Dermine 2002, 13/48), this has not implied the disappearance of institutional and organisational diversity in the banking sector. In this sense, "liberalization in coordinated market economies has not produced convergence toward private banking, but instead different trajectories" (Mettenheim and Butzbach 2017, 30). Convergence expectations were commonly based upon contemporary banking theory in vogue since the 1980s, which reshaped the notion of banking activities. Under this conception, banks are characterised as private firms, capable of channelling market efficiencies in order to deliver cheaper investment and banking services to customers. Contrary to this belief, Mettenheim and Butzbach (2017, 32) provide a historical perspective according to which "alternative banks responded to demand for patient capital from groups left bankless by private commercial banks", hence emphasising the explanatory limits of contemporary banking theories. Examples of these alternative institutions are "savings banks and cooperative

banks with patient capital strategies and social purposes" (Mettenheim and Butzbach 2017, 45).[48] Table 1.2 below compares the conception of banks as 'financial firms' and as 'institutions for patient capital', along a set of theoretical and applied characteristics.[49] In order to explain the richness of the institutional evolution of the banking sector beyond efficient market perspectives, these authors suggests that

> Production frontiers of banking are being shaped not only by freer, more efficient markets, but also by hybrid reforms, complex path dependent trajectories, and institutional foundations of competitive advantage at alternative banks based on patient capital, stakeholder governance, long-term profit sustainability orientations, and relationship banking embedded in politics, society, and public policymaking. (Mettenheim and Butzbach 2017, 46)

	Financial Firms	*Institutions for Patient Capital*
Theory	Efficient markets	Long-term investment
Capital theory	Liquid capital	Patient capital
Governance	Shareholder	Stakeholder
Mission	Profit maximisation	Profit sustainability
Business model	Manufacture assets	Balance assets and liabilities
Strategy	Maximise leverage	Moderate leverage
Risk management	VaR [Value at risk] or risk model	Relationship banking and soft information
Theory	Financial intermediation	Uncertainty and institutional theory
Method of study	Econometrics	Historical-institutional
Expected change	Convergence	Persistent variety

Table 1.2: Banks as financial firms versus banks as institutions for patient capital. Source: Mettenheim and Butzbach (2017, 35).

Banking diversity, especially when it entails the existence of a strong public banking sector amidst universal private banks, can backfire: this was precisely the case of state guarantees to German public banks. The events that are further described below, illustrate the

[48] Chapter 3 provides a deeper discussion on banking diversity and alternative banking, as well as the theoretical underpinnings that account for the differences between banks as financial firms, and banks as institutions for patient capital.
[49] This table has been reproduced in Chapter 3 as Table 3.1, when referring to banking diversity and the so-called "alternative banking" sector.

strong links between financial market integration and competition concerns in the EU, which mirror the 'competition politics' underpinning the EU market-building process (Mügge 2006). The case concerned the structure of the German banking system, which consists of universal and special banks. Among the former, "there are three types of universal banks": commercial private banks, those under a public legal form (which in turn comprise *Landesbanken*, *Deka Bank*, and *Sparkassen*), and cooperative banks. Among the latter, special banks include private mortgage banks, other special credit institutions with a public legal form, and finally buildings & loans associations (Moser, Pesaresi, and Soukup 2002, 5).[50] The public banking sector, therefore, includes entities that belong both to the universal and special banking sectors. A key aspect of the case was that

> All credit institutions of public legal form (*öffentlich-rechtliche Anstalten*) have traditionally benefited from State guarantees: *Anstaltslast* and *Gewährträgerhaftung*, and, in some cases instead of Gewährträgerhaftung, a special refinancing guarantee of the State. (Moser, Pesaresi, and Soukup 2002, 5)

Despite having different legal basis, these two types of State guarantees, the *Anstaltslast* and the *Gewährträgerhaftung*, have caused rating agencies in the past to attribute 'triple-As' rating to these banks. It all started in 1992, when "North-Rhine-Westphalia (NRW) transcribed its public housing institute *Wfa*, with a value of four billion Deutsche Mark (DM), to WestLB, the then third biggest German bank and most ambitious rival of the major private banks" (Seikel 177, 2014). This triggered the reaction of the Association of German private banks (*Bundesverband deutscher Banken*, BdB), who turned to the Directorate General for Competition (DG COMP). The Commission saw the need "to remedy a *very significant economic distortion in the European banking market*" (Moser, Pesaresi, and Soukup 2002, 3,

[50] Chapter 3 also provides further details into the German banking system.

emphasis in the original). DG COMP consequently identified these guarantees as illegal state aid in 1995. Without these guarantees, "the Landesbanken could not sustain their rating and would lose their competitive advantage" (Seikel 2014, 177). After a lengthy "battle" over state guarantees,[51] which involved the intervention of the European Banking Federation (EBF), the *Länder* and their *Landesbanken*, the Federal Government, and the *Sparkassen*, DG COMP announced in May 2001 that the guarantees were illegal state aid, and that therefore they had to be abolished. Two months later, Germany agreed on the abolition of the guarantees, while DG COMP granted a transition period until 2005 before they expired.

The relevance of this competition case goes beyond the integration mechanisms deployed by DG COMP. The key issue is that the Commission's decision has shown that banks had no longer any particular status amongst other types of companies; hence, they were subject to competition rules as any other commercial institution, no matter their legal form. In fact, this lengthy conflict—which started in 1992 and was concluded in 2005 with the abolition of the guarantees—has reinforced the overall market- and competition-oriented logics originally conceived in 1985, and subsequently reinforced by the different regulatory (and 'deregulatory') measures adopted.[52] As shown in the following section, the global financial crisis and the subsequent fiscal and sovereign debt European crises, have reinforced competitive and consolidation pressures in the banking sector.

Moving now to the changes in the structure of the financial system, it has to be pointed out that "many banks are no longer funded predominantly by deposits", as bank lending is

[51] See Seikel (2014) for the details of the conflict.
[52] The end of these state aid privileges, has been pointed out as one of the key factors that led Landesbanken to seek more profitable opportunities elsewhere, which ended up in great losses as a consequence of the global financial crisis and its contagious effects, since they were largely exposed to the so-called "toxic assets".

"increasingly market determined" (Hardie et al. 2013, 720). In fact, the traditional dichotomy between *bank-based* and *market-based* finance has been blurring in the past decades, as banks increasingly engage in activities on both sides of their balance sheets, which have changed the pattern of credit provision to non-financial firms. The idea of a "market-based banking" (Hardie et al. 2013, 691) better represents the current state of affairs of modern banking activities. In order to characterise the hybridity of the current financial system, Hardie et al. (2013) identify four elements that characterise market-based banking. First, the fact that banks' assets are valued at market prices (known as 'marked to market'). Second, the rising level of securitisation and trading of loans. The former refers to the "procedure where an issuer designs a marketable financial instrument by merging or pooling various financial assets into one group",[53] while the latter implies that banks make loans not necessarily to be kept in their balance sheets, but, instead, to sell them to other market participants (Hardie et al. 2013). Third, the sale of banks' assets to the so-called 'shadow banking system'. Shadow banks "are financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees" (Pozsar et al. 2010, 2); hence, the concept refers to banking activities conducted outside of banks' regulated perimeter. The fourth and last characteristic refers to the increased level of market-based liabilities. Traditionally, the liability side of banks' balance sheet relied on customer deposits. Over time, "a funding gap has developed in many [European] countries, as the loans that banks make have exceeded their deposits" (Hardie et al. 2013 715); therefore, market borrowing has become a fundamental source to fill this funding gap.

[53] See Investopedia's definition: https://www.investopedia.com/terms/s/securitization.asp

The global financial crisis made the interconnectedness between banks and financial markets more evident, making clear that market-based finance remains a fundamental source of credit (Hardie et al. 2013). In spite of these structural changes, the European Commission (2015, 3) holds that "Europe's capital markets are still relatively underdeveloped and fragmented"; therefore, in order to "strengthen investment for the long term, we need stronger capital markets". These arguments have provided the underpinnings for the Capital Markets Union (CMU) project. Space limits prevent a detailed examination of the project, yet this subsection elucidates its most important characteristics and some of the criticisms that have been raised. In short, the CMU "aims to get money—investments and savings—flowing across the EU so that it can benefit consumers, investors and companies" (European Commission 2019, 1). The CMU requires a series of legislative measures, some of which have been adopted, while others are under negotiation.[54]

The CMU is an interesting case for the reasons that follow. On the one hand, the project is meant to "re-fashion Europe's financial system in the image of the US financial system", providing an example of 'governing through the financial markets' (Braun, Gabor, and Hübner 2018, 102).[55] On the other, the analysis of the "three pillars" of the CMU project, following the wording used in the Commission's factsheet, do not signal major institutional changes, other than the legislative measures that have been designed to support it. In fact, "making the most of the Single Market for consumers and investors through new European products"; "supporting businesses and entrepreneurs through clearer and simpler rules"; and building up "a more efficient supervision of EU capital markets", are aims that are in line with the current institutional setup—unlike for instance the Banking Union, which entailed a much deeper

[54] See page 4 of the European Commission (2019) factsheet cited in the text, for a list of the CMU legislative building blocks and the progress made so far (the document is updated as of March 2019).
[55] In the authors' view, 'governing through financial markets' means to "engineer and re-purpose financial instruments and markets as instruments of statecraft" to achieve economic policy goals at minimum fiscal costs (Braun, Gabor, and Hübner 2018, 104).

institutional and capacity-building exercise. However, the fact that no new pan-European authority has been established, does not mean that the project lacks financial integration ambitions. In fact, one of the most important components of the CMU project has been the revival of the European securitisation markets through the "Simple, transparent, and standardised securitisation" regulation (STS).[56] The puzzling aspect of the CMU is that it has been conceived as part of the 'solution' to the eurozone's persistent economic and financial problems, while at the same time some of the features that are being fostered—securitisation *in primis*—have been part of the 'problem' at the heart of the excessive risk taken that contributed to the global financial crisis (Braun, Gabor, and Hübner 2018).[57] The success of the CMU hinges on both a sound market supervision and a reliable design of financial products.

To conclude, this section has provided a historical and evolutionary perspective on the prudential regulatory and institutional framework, showing the overlap between the European and the international arenas. It has also focused on how these prior transformations and structural changes in the financial sector have impacted upon banking activities and the role assigned to banks within the broader economy. It has shown that the European market-construction process is an ongoing enterprise, which continues until today, not only via the CMU initiative, but also through the Banking Union, as the following section explains.

1.3 The EU's post-crisis 'new economic governance'

[56] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation. OJ L 347, 28.12.2017, p. 35–80

[57] See also Bavoso (2018), for a detailed critical analysis of the CMU project along the same line of reasoning.

While the previous two sections have examined historical aspects related to prudential regulation and supervision at the European and international levels, this section focuses on institutional and legal transformations from a contemporary perspective. The first subsection explores the main characteristics of the post-crisis economic governance, and how it has impacted upon EU integration and the market-building logic. The second subsection zooms in on banking governance, and emphasises the evolving role of central banks, and the development of a supranational supervisor under the aegis of the ECB.

1.3.1 The dual character of supranationalism revisited: Deepening integration in times of crisis

EU integration scholars have widely explored the concomitant cris*e*s that have impacted upon the integration project in recent years (Majone 2014; Fabbrini 2015; Jones, Kelemen, and Meunier 2016; Börzel 2016; Chalmers, Jachtenfuchs, and Joerges, eds. 2016; Schimmelfennig 2018; Genschel and Jachtenfuchs 2018; just to mention a few). While the refugees, migration or Schengen crisis has created an impasse in the integration process, "the eurozone has both widened and deepened in the crisis" (Schimmelfennig 2018, 979). The common negative externalities associated with the possibility of a collapse of the Euro, among other factors, prompted members States to take bold steps not only to preserve, but also to strengthen the euro area. The Banking Union and the creation of the SSM are just examples of the measures adopted that help better understand how post-crisis integration has unfolded, as the following subsection explains. While Chapter 2 examines EU integration theories and provides a critical perspective on the limits and modes of integration, the aim of this introductory subsection is

to focus on the so-called 'new' post-crisis economic governance, and how it has impacted upon decision-making in the EU and, hence, on the integration project.[58]

To understand the mechanisms behind the deepening of integration, it is important to consider how the crisis affected modes of decision-making. Let us remember that before the crisis, since the adoption of the Maastricht Treaty, the EU's decision-making process was governed by two families: the inter-governmental (IG) and the community (CM) methods (Dawson 2015a). The literature analysing the EU's post-crisis 'new economic governance' is useful to identify novel decision-making patterns. However, in order to understand the meaning of 'new economic governance', it is important to make a step back to better understand the 'new governance' (NG) approach. Contrary to the 'integration through law' paradigm, according to which the Union's capacity to bring member States under a common legal order was conceived as a fundamental integration mechanism (Dawson 2015a), NG is a way of achieving integration by *coordination*. This novel approach was crystallised in the early 2000s, as part of the Lisbon Strategy.[59] The fulfilment of the socio-economic objectives foreseen in the Lisbon strategy, needed the support of a specific procedure, "a novel, non-binding instrument, the Open Method of Coordination (OMC)"[60] (Dawson 2018, 106). This method was officially portrayed as "a form of intergovernmental policy-making that does not result in binding EU legislative measures and it does not require EU countries to introduce or

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[58] There is an implicit assumption contained in this sentence, which is spelled out in greater detail in Chapter 2. According to the analytical framework provided in the following chapter, the new legal and institutional architectures adopted as a response to the crisis, have created new patters of interaction and coordination among different stakeholders, for the purpose of adopting and implementing joint decisions, characteristics that belong to the governance definition proposed by Diedrichs et al. (2011). In turn, these different modes of governance have added new dynamics to the integration process.

[59] For a concise explanation of the Lisbon Strategy and its core socio-economic pillars, see https://portal.cor.europa.eu/europe2020/Profiles/Pages/TheLisbonStrategyinshort.aspx.

[60] For a comprehensive and critical account of the OMC and its relationship with EU Law, see Dawson 2011.

amend their laws".[61] The OMC has changed EU policy-making from both procedural and substantial perspectives. Concerning the former, new intergovernmental decision-making features were introduced. Regarding the latter, "because of its power to structurally converge national laws and policies *in sensitive areas of Member State competence*, the . . . OMC is probably the *most important source of competence creep through soft law* (Garben 2019, 210, citing de la Porte, 2002, emphasis added). The fact that the OMC's "rationale is precisely to overcome the limits on EU legislative competence" (Garben 2019, 217), makes it a "stealthy" or covered approach to integration, as further discussed in Chapter 2. This form of governance provided the necessary tools to surmount harmonisation and regulatory competition challenges (Trubek and Mosher, 2003). These considerations apply mostly to the social policy field; the case of financial integration was less of a stealthy process, albeit with some exceptions as the following chapters elucidate.

The core of NG is the notion of *governance*, a concept that suggests "a de-centring of the State as the primary means of exercising public authority" (Dawson 2018, 108).[62] Its *newness* insinuates, first, a deviation from traditional forms of regulation. Contrary to the Community method, through which directives, regulations, and decisions were enacted, NG does not embrace a 'command and control' approach to regulation. Second, the dividing line between law creation and its application, characteristic of the Community method, becomes fuzzy under this new paradigm.[63] These characteristics are examined by the *experimentalist governance* literature (Sabel and Zeitlin 2008, 2010; Zeitlin 2015), which is further elucidated

[61] For the complete definition and further characteristics of the methods, see https://eur-lex.europa.eu/summary/glossary/open_method_coordination.html.
[62] As anticipated, Chapter 2 provides further characterisations of the notion of governance.
[63] The blurred lines between rulemaking and application are also characteristic of the supervision-regulation dyad in the SSM, which is further developed in the chapters that follow, especially chapter 5.

in the next chapter. The experimentalist perspective stresses two features that are crucial in order to characterise the post-crisis new economic governance: (i) *revisability*, related to the blurred distinction between rule formation and application, and a cyclical revision of 'decisions' based upon practical experience; and (ii) *differentiation*, related to the experimentalist rejection of the 'one-size-fits-all' approach, as a way to accommodate diversity in the EU (Dawson 2018).

The unfolding of the crisis, coupled with the limited results achieved by the Lisbon strategy, have seriously called into question the effectiveness of NG instruments. The inherent *softness* of the tools produced through the OMC were likely to be manipulated by member States when its complying costs became too high. By 2008, it was clear that the mechanisms of fiscal policy coordination that would strengthen economic convergence across the EU, and limit both member States' deficits and public debt, were not delivering the expected results (Dawson 2018). However, there are certain nuances in the 'post-crisis' decision-making process that render its characterisation as a 'command and control' regulation problematic, as the SSM case proves. First, the shortcomings of the Community and the inter-governmental methods have led to a mixed approach, in order to face the challenges arising from the crisis: "while *decision-making* has a strongly inter-governmental character, a second feature of post-crisis governance is that the *implementation* of decisions post-crisis is highly supra-nationalized" (Dawson 2015a, 981). The question of supranational implementation seems to add a new feature to the "dual character" described by Weiler (1981), which distinguished between *normative* and *decisional* supranationalism. The supranationalisation of implementation is at the core of the SSM project and the delegation of prudential supervision to the ECB, as explained below.

A second key element of the post-crisis 'new' economic governance approach concerns the characteristics of the regulatory instruments adopted by the authorities—which is particularly relevant to the regulatory activities carried out by the SSM, as explained more in depth in Chapter 5. This second element refers to a subtler distinction between *rules* and *legislation*. While the post-crisis institutional overhauling has introduced new legal arrangements, for example the procedures belonging to macro-economic governance surveillance in the EMU, or Banking Union-related provisions, these broad legislative frameworks contain a series of rules that empower administrative authorities to take decisions in their areas of respective competence. For instance, the Commission's excessive deficit (EDP) and macroeconomic imbalance (MIP) procedures have led to the adoption of "detailed and intrusive" recommendations, with a high level of policy prescription. (Dawson 2015a, 980).[64] The ECB has adopted a series of instruments in order to adapt prudential governance to the supranational level, which also contain detailed and prescriptive elements, as explained in Chapters 4 and 5. The implementation of decisions as 'highly-supranationalised', has been a centripetal force, since "there is more centralisation of powers, more norm creation at the EU level, extension of EU presence beyond rulemaking to the field of *monitoring and enforcement*, and a recognition of a crisis management role for the EU. (Micklitz and Tridimas 2015, 14, emphasis added).

Although this quote refers to the EU in general terms, banking supervision represented a textbook case of delegation and power centralisation at the supranational level. It is true that the SSM is a joint mechanism composed by ECB officials and national authorities, in which cooperation and information exchange play a fundamental role. Still, the evolution of the

[64] For a practical explanation of the post-crisis economic governance regime adopted in the macro-economic surveillance area, see Kilpatrick 2016.

SSM's governance, as analysed in Chapters 4 and 5, suggests the pervasiveness of centralising features. As shown in the following subsection, the monetary policy ECB has also undergone important changes, in line with the post-crisis dynamics and the fact that the very foundations of the 'central bank independence' paradigm started to shake.

The post-crisis scenario, however, has entailed deeper political transformations of the economic governance, other than the legal and institutional changes described so far. The legal, political science, and integration literatures have boomed over the last years in order to explain these deeper transformations of the integration project. This subsection focuses on two key aspects that help understand the changes at the central bank level and, more specifically, the evolution of the supervisory framework: first, the politicisation of economic governance and second, the redistributive aspects triggered by these transformations. Regarding the first aspect, economic integration was meant to be "an autonomous and apolitical process", guided by a "constitutional commitment to price stability" (Joerges 2015, 11). The EMU was therefore structured as a "stability community", or *Stabilitätsgemeinschaft*, in the words of the *Bundesverfassungsgericht* (BVerfG)'s Maastricht ruling. In fact,

> The idea of the single market was presented in the White Paper as an *ideologically neutral program* around which the entire European polity could coalesce in order to achieve the goals of European integration . . . This neutralization of ideology has fostered the belief that an agenda could be set for the Community, and the Community could be led towards an *ever-closer union* among its peoples, *without having to face the normal political cleavages* present in the Member States. (Weiler 1991, 2476, emphasis added)

The success of the single market programme depended upon a large-scale harmonisation exercise in multiple domains, such as consumer and environmental protection, health, transport, financial services, among others. This highlighted not only the pressure towards uniformity, but also expressed an ideological choice for "market efficiency and European-wide

neutrality of competition above other competing values" (Weiler 1991, 2478). The 'integration through law' paradigm would then provide the necessary regulatory tools to make this wide-ranging harmonisation possible: "law is used as a regulatory instrument to create an internal market where politics is ineffective" (Afilalo, Patterson, and Purnhagen 2014, 286). Even acknowledging that

> A "*single European* market" is a concept which still has the power to stir . . . it is also a "single European *market*." It is not simply a technocratic program to remove the remaining obstacles to the free movement of all factors of production. It is at the same time a highly politicized choice of ethos, ideology, and political culture: the culture of "the market". (Weiler 1991, 2477, emphasis in the original)

This passage shows that even in the early days of the single market, it was apparent that functionalist and technocratic ideas would not provide a comprehensive basis for legitimising the European project. The 'market culture' entailed ideological and political choices, whose impact would become increasingly evident as "the European market building agenda intruded into spaces that the members states had exempted from market governance" (Joerges 2016, 305). These conflicts and tensions become particularly acute with the unfolding of the fiscal and sovereign debt crises, which affected the EU as a whole. It became clear that it was no longer possible to rely upon 'one-size-fits-all' assumptions, as they were unable to deal with the challenges of diversity and legitimacy. It can be argued against the 'one-size-fits-all' idea that, by its very nature, the EU is a "system of differentiated integration" (Leuffen et al. 2012, 1), given that the integration project has always been accompanied, and even made possible, by differentiation. In fact, aware of the shortcomings stemming from the 'one-size-fits-all' philosophy behind the integration-through-law tradition, the European Court of Justice (ECJ) resorted well before the crisis to the "development of procedural frames" (Joerges 2016, 305), within which conflicts between the supranational and national levels could be accommodated.

It was then “the normative quality of the decision-making process, rather than [legal] uniformity, which could ensure the legitimacy of the European rule” (Joerges 2016, 307). The court reasoning provided the basis for the pre-crisis “turn to governance” explained above, which emphasised the role of ‘coordination’ as a key integration tool. The advent of the crisis amplified two characteristics of the governance turn: “rise of executive power and the strengthening of technocratic rules” (Joerges 2016, 308). These two features are of particular importance when it comes to the analysis of the post-crisis central banking features, as the following subsection shows. The deployment of specific crisis management tools should be understood in the broader emergency context. However, other crisis responses triggered institutional changes that have gone beyond the ‘emergency’ situation: the creation of the Banking Union, the amendment of Article 136 of the Treaty on the Functioning of the European Union (TFEU), which enabled the creation of the European Stability Mechanism (ESM), and the adoption of the ‘Treaty on Stability, Coordination and Governance in the Economic and Monetary Union’ (TSCG), commonly referred to as the ‘Fiscal Compact’, among others.

One of the paradoxical aspects of the crisis-led integration dynamics is that, while the multiple crises have increased the politicisation of the Union— citizens have become more aware of how the EU impacts their lives and, hence, it became “easier to blame for a failure in deliverance of public goods” (de Wilde 2016, 169)—this has not prevented the deepening and hardening of EU competences in several areas. Before moving on, the final part of this subsection focuses on the flipside of EU economic governance politicisation: its redistributive dimension. The combination of a higher level of political contestation and a greater supranational involvement has provoked a deeper transformation of the EU: the transition from

a *regulatory* to a *redistributive* state. The regulatory state's functions revolve around "the control of market failures, including negative externalities, co-ordination failures, and the undersupply of public good" (Caporaso et al. 2015, 890). Supranational institutions currently play a much deeper and complex role: they actively engage in implementation-related aspects, and monitor the performance of domestic institutions in the economic, fiscal, and financial domain.

> The tragedy of the new European redistributive State is that it has no public law of struggle. Instead, the mechanisms deployed are those of the regulatory State. Domestic arenas are treated as spaces to be regulated and supranational arenas as processes engaged in regulating. (Chalmers 2012, 669)

Chalmers' claim is that there is the need for a "new EU law of struggle", given that the current structures are incapable of channelling the conflicts arising from these new types of interaction between supranational institutions and the national counterparts. Under this "law of struggle" paradigm, conflicts are understood as mechanisms that facilitate harmonious mutual dependence, which requires parties to mutually recognise the importance of each other's claims and interests. In this context,

> An EU law of struggle would be concerned that conflicts take place only in those political arenas which form part of the wider EU legal settlement, that these arenas have sufficient authority that parties engage with them and that all parties with a stake in the process are granted sufficient voice. (Chalmers 2012, 669)

The aim of the EU law of struggle is to align the levels of the ongoing political contestation over economic, fiscal, and financial policies, with the level of interference by the supranational institutions. Transferring the "machinery and thinking of the regulatory State to questions of redistribution" (Chalmers 2012, 685) can trigger important legitimacy questions concerning the supranational apparatus, if not properly handled. One of the most important EU

institutions that embarked upon a massive redistributive role during and in the aftermath of the crises, has been the ECB:

> To the extent that some redistribution from the strong to the weak is required for keeping over-indebted states solvent and monetary union together, it must be accomplished through covert channels, also because of certain voter resistance in the European North. Serving as an invisible conduit for money transfusions is another function today performed by the ECB. (Streeck 2015, 18)

This final quote, related to the active role that the ECB has been playing since the crisis, leads us to the second subsection, which zooms in on the post-crisis effects on central banking activities.

1.3.2 The Banking Union, the Single Supervisory Mechanism, and the changing role of central banks

> The establishment of the European Banking Union represents the most important achievement of the European Union in the last decade, one which goes well beyond the boundaries of the banking area and the Eurozone. (Chiti and Santoro 2019, v)

As mentioned earlier, one of the major post-crisis institutional and legal transformations at the EU level has been the creation of the Banking Union. This subsection addresses two interrelated issues that help better contextualise the research questions and their relevance: first, the main drivers behind the establishment of the Banking Union in the context of the post-crisis economic governance, and the creation of the SSM and the supranationalisation of banking supervision within this broader framework. Second, this last subsection examines the impact of the global financial turmoil upon central banking activities, more precisely the case of the ECB and its post-crisis governance approach.

The Banking Union comprises a complex set of rules and institutional arrangements that, on the one hand, entail a considerable degree of centralisation and transfer of competences from national to supranational authorities; on the other, the Banking Union creates specific patterns of interaction amongst these two levels. In fact, the supervisory and the resolution arms of the Banking Union contain similar provisions that govern the cooperation and exchange duties that are fundamental to the smooth functioning of both the Single Supervisory and the Single Resolution Mechanisms (SRM). The SSM and the SRM are two of the originally conceived three "pillars" upon which the Banking Union is based. The third pillar,[65] the construction of a European deposit insurance scheme (EDIS), is still a debated and contested point at the time of writing. The discussion on whether it should be adopted or not has revolved around the risk-reduction vs risk-sharing (false) dichotomy. While this subsection does not deal with the details of this fallacious opposition,[66] suffice it to say that in the context of a monetary union, these two mechanisms have a complementary nature, and the lack of proper public risk-sharing mechanisms can hardly lead to the much sough-after private sector risk-sharing channels (Draghi 2019).

The causes and mechanisms underpinning the construction of the Banking Union—particularly the transfer of competences to the supranational level that enabled the creation of the SSM—have been widely studied by international political economists.[67] These scholars have explored the drivers behind domestic regulators' preferences during the legislative

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[65] Howarth and Quaglia (2016a) have referred to a fourth pillar, consisting of a common backstop for temporary financial support, while the current official websites of both ECB banking supervision and the Commission, speak of two pillars only. See https://www.bankingsupervision.europa.eu/about/bankingunion/html/index.en.html for the ECB, and https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/what-banking-union_en (as of December 2019).

[66] See Fracasso (2018) for a deeper discussion on the point.

[67] Legal scholars have also extensively analysed the creation of the SSM during its early days (Ferran and Babis 2013, Wymeersch 2014, Tröger 2014). However, the legal literature does not delve into member States' preferences.

negotiations through different theoretical lenses. For instance, Howarth and Quaglia (2016a,b,c) have focused on the intergovernmental nature of the negotiations, and how material interests (mostly related to national economic and banking systems) have shaped the outcome. Other studies have instead followed an ideational or constructivist approach, where 'policy paradigms' (Hall 1993) are attributed explanatory power (Lombardi and Moschella 2016); other scholars have focused on the neo-functionalist logic behind the Banking Union project, stressing the empowerment of supranational institutions at the expenses of national control over banks (Epstein and Rhodes 2016a).[68] Further explanations have focused on the role of policy entrepreneurs, and how they "create and not just use opportunities . . . by taking actions that redefine the nature of the policy problem" (De Rynck 2016, 121). This research, albeit fundamental to understand the genesis of this major integration project, needs to be complemented by an analysis of how these institutional efforts have worked in practice, and the types of governance arrangements that have emerged as a result.

The idea of a supranational supervisory authority, however, was not completely novel. Padoa-Schioppa referred to the existence of a *euro area supervisor* back in 1999, referring to the different cooperation arrangements between European authorities. With the creation of the EMU and the development of the first transnational payment system (now TARGET2), scholars have discussed the importance of a pan-euro area supervisor in light of the increasing interconnectedness between national banking systems, and the increasing risks of financial contagion (Goodhart and Schoenmaker 1995,[69] Lanoo 2002, Schüler 2003, Hertig et al. 2010). As mentioned above when describing the evolution of the prudential framework, pre-Banking

[68] Chapter 2 provides an overview of the three grand theories of European integration.
[69] In the case of Goodhart and Schoenmaker, they have mostly argued for combining the monetary and supervisory functions in central banking activities generally speaking, even before the debate about the ECB had taken place.

Union supervisory cooperation relied on two key principles: national competence, based on the "home country control" approach and mutual recognition; and bilateral and multilateral cooperation between competent authorities. To implement the former, Memorandums of Understanding (MoUs) were concluded between home-host countries supervisors, whereas the latter was carried out by the Banking Supervision Committee (BSC), a forum for cooperation and discussion at the ESCB level (ECB 2000; Schüler 2003).[70] These soft forms of cooperation, however, proved insufficient to cope with the complexity arising from the growing interconnectedness among credit institutions:

> Market developments underscore the urgency of enhancing cross-border convergence and cooperation in the supervision of EU banks in order to ensure an effective monitoring of and response to cross-border financial risks and to provide a streamlined supervisory interface and a level playing field for market participants. Adequate progress in supervisory convergence and cooperation requires improvements at each step of the regulatory and supervisory process . . . While substantial work has already been carried out or is currently under way in each of these fields, further efforts will be required. (ECB 2007, 13)

The ECB's review of the Lamfalussy framework coincides with the Commission's (2007) assessment, which claimed that Level 3 Committees (CEBS in the field of banking supervision) "needed a stronger political impetus", and that national supervisors did not have enough incentives to converge at the European level. Amidst the crisis, the de Larosière report (2009) highlighted a series of flaws that affected the EU regulatory and supervisory framework, such as the lack of strong mechanisms to challenge the decisions of a national supervisor, and the lack of information exchange. The report, however, did not consider the

[70] According to Article 282 TFEU, the ESCB comprises the ECB and the national central banks, whereas the Eurosystem consists of the ECB and the national central banks of those member States whose currency is the euro.

possibility of a centralised pan-European supervisor; instead, it recommended setting up the abovementioned ESFS as “a decentralised network” (de Larosière 2009, 48). During the decision-making process setting up the EBA, as recommended by the report, some member States opposed an extensive power delegation; a compromise solution was found according to which the EBA was allowed to overrule national competent authorities in specific circumstances (De Rynck 2016).

The June 2012 euro area summit was a critical point in the construction of supranational supervision. The two-page euro area summit statement was clear about the urgency and the need to “break the vicious circle between banks and sovereigns”, and the imminent submission of a single supervisory mechanism proposal by the Commission. The statement also made it clear that the adoption of this mechanism, involving the ECB, was a precondition for the direct recapitalisation of banks by the ESM.[71] During the drafting of the proposal, the Commission worked very closely with the ECB, a fact that impacted upon the content and the powers that were transferred in the final version of the draft (De Rynck 2016). Although the aim of this subsection is not to examine the mechanisms that accounted for this major policy shift in 2012,[72] it is important to acknowledge two interrelated factors that have contributed to this unprecedented and fast supranationalisation of banking supervision. First, the strategic motivation and the proactivity of policy entrepreneurs has been crucial: the “Commission and the ECB have exploited the costs of the European debt and currency crisis to maintain the Euro’s credibility, with the further consequence of consolidating their power” (Epstein and Rhodes 2016a, 419; in line with De Rynck’s 2016 explanation). Second, the sequence of

[71] See the corresponding document: https://www.consilium.europa.eu/media/21400/20120629-euro-area-summit-statement-en.pdf
[72] This is elucidated by the above cited international political economy scholars. See also Epstein and Rhodes (2016a,b) for a detailed analysis of the structural shifts in the EU banking system.

(crisis) events and the timing have provided the impetus for change. During the initial period of the debt crisis—from early 2010 until late 2011—"attention of policy-makers went mostly to national fiscal discipline in order to regain bond market confidence . . . [which] prevented the opening of the policy window on banking union in 2011" (De Rynck 2016, 127/128). The fact that Spain had refused to accept eurozone loans before, made the deteriorating state of its banks increasingly evident: the question of the Spanish banks acted as a "'focusing event' that redefined the nature of the euro crisis" (De Rynck 2016, 128, citing Kingdon 2002). Although national fiscal discipline has never disappeared from policymakers' attention, the worsening condition of credit institutions and the sovereign-bank nexus, prompted the use of new monetary policy tools (long-term refinancing operations, LTROs) in order to reduce market pressure on those member States in distress. Hence, "unconventional central bank actions and an expansion of ECB tools to tackle the sovereign debt crisis ultimately spilled over into a formal expansion of its competences" (De Rynck 2016, 130). This point is fundamental to understand the final part of this subsection, concerning the changing role of central banks and their activities during and after the crisis.

Before moving on, however, we should note that the ECB was a key actor not only during the drafting phase, but, even more, during the setup of the SSM. In fact, from the conferral of "specific tasks" concerning prudential supervisory policies (in the wording of Article 127 (6)) to the adoption of Regulation No 1024/2013 (SSM Regulation),[73] the ECB has embarked upon a massive capacity-building exercise. Formally speaking, and due to the TFEU's "constitutional constraints" (Gren 2018), the SSM is not a European institution; it is instead a

[73] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. OJ L 287, 29.10.2013, p. 63–89

mechanism made up by the permanent collaboration and cooperation between supranational and national authorities. The ECB is responsible for the direct oversight of the so-called *significant institutions* (SIs), while it also oversees in an indirect fashion the so-called less significant institutions (LSI), which remain in principle under the supervision of their respective *national competent authorities* (NCAs).[74] During the policy-making debates prior to the adoption of the SSM Regulation, the question of the thresholds and boundaries between the institutions that would be under direct ECB supervision and those supervised by the NCAs was a crucial concern, which reflected for the most part national banking structures and the degree of internationalisation of the respective banking systems (Howarth and Quaglia 2016a,c). Every year, the ECB assesses which banks fall under the SI criteria; hence, the status of a bank can change over time, or it can also change due to legislative amendments: this was the case of the so-called "banking package" and the adoption of CRD V and CRR II in 2019, which exempted specific types of banks (mostly public or promotional institutions) from the ECB's oversight.

The SSM can be considered an example of "integration by capacity building" (Genschel and Jachtenfuchs 2016, 171), as it created and developed its own resources in addition to—and in concomitance with—those of member States. Some of the features that characterise this major capacity-building exercise are, first, the establishment of Joint Supervisory Teams (JSTs), which constitute key supervisory units made up of both ECB and NCAs officials, in charge of day-to-day supervision. Second, the well-developed internal structure, which consists of four Directorate General Micro-prudential supervision (DG MS I, DG MS II, DG

[74] Whether an institution is considered an SI or LSI, depends upon a series of criteria defined in Article 6 (4) of the SSM Regulation.

MS III; and DG MS IV), and the Secretariat to the Supervisory Board.[75] DG MS I and II perform ongoing supervision of significant institutions; DG MS III is responsible for the LSIs oversight conducted by NCAs, and makes sure that national authorities apply high-quality methodologies (ECB 2018a), which derive from those supervisory methodologies developed for SIs; DG MS IV performs the so-called horizontal and specialised tasks in relation to all credit institutions, and it also provides expertise to the other DGs when needed. Chapters 4 and 5 analyse in greater detail the operational aspects of the SSM performed by these units.[76]

One final aspect that mirrors the capacity-building integration efforts, in spite of the existent constitutional constraints, is the decision-making process in the SSM. Article 127 (6) TFEU does not foresee the possibility of adjusting the ECB's decision-making framework as a consequence of the additional prudential function; hence, the ECB's Governing Council necessarily remains the main decision-making body also for supervisory decisions (Gren 2018). In light of this situation, the so-called *non-objection procedure* was adopted, according to which "complete draft decisions are approved by the Supervisory Board and subsequently submitted to the Governing Council for final adoption. The complete draft decisions are deemed adopted if the Governing Council does not object within a maximum period of ten working days" (ECB 2018a, 16). However, the amount of decisions adopted by the Supervisory Board, made centralisation of the decision-making process to some extent inefficient. This is why the SSM developed a delegation framework,[77] by which the Governing Council transferred "a number of its supervisory decision-making powers to ECB lower

[75] Prior to 2018, the functions of the Secretariat were part of DG MS IV, which was then splitted given the vast set of tasks performed by this DG.
[76] The SSM Supervisory Manual (ECB 2018a) provides a detailed description of its functioning.
[77] Decision (EU) 2017/933 of the European Central Bank of 16 November 2016 on a general framework for delegating decision-making powers for legal instruments related to supervisory tasks (ECB/2016/40) (OJ L 141, 1.6.2017).

administrative levels other than the Executive Board"; this solution was "inspired by the second paragraph of Article 12.1 of the ESCB/ECB Statute, which allows the Governing Council to delegate to the Executive Board some of its monetary policy powers" (Gren 2018, 34). This example shows how, in spite of the Treaty constraints, a series of regulatory solutions have been adopted in order to allow for the smooth functioning of the supranational supervisor, thus, proactively contributing to the capacity-building efforts at the supranational level.[78]

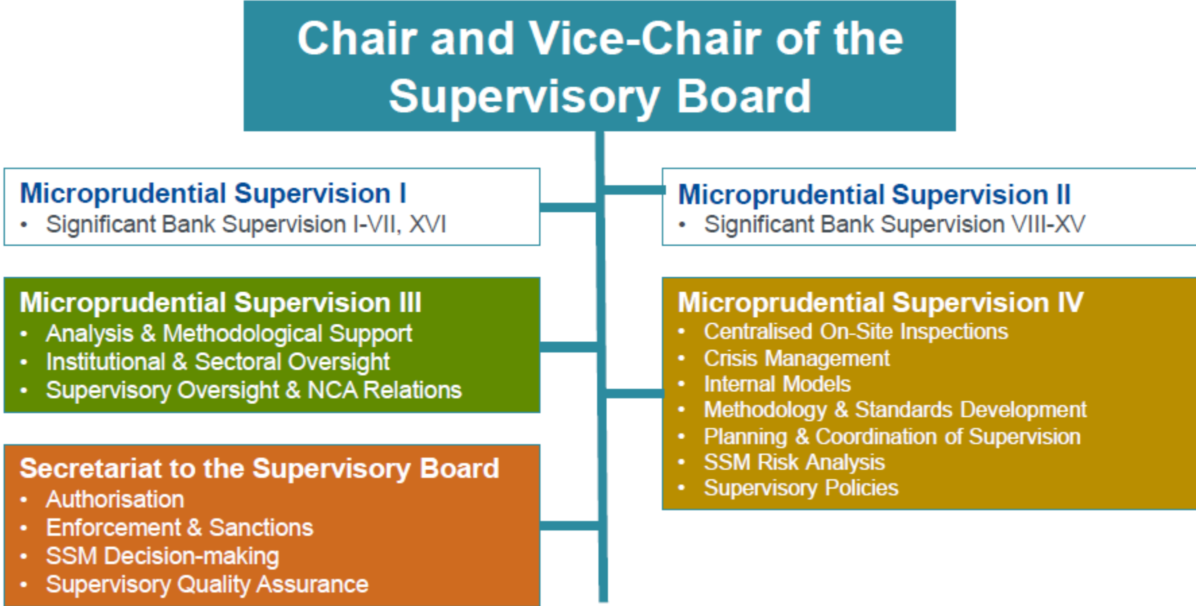

Figure 1. 1: Operating structure of the SSM. Source: Schulte (2019, slide 10).

After having provided an overview of the rationale behind the construction of the Banking Union and, in particular, its supranational supervisor, the final part of this subsection focuses on central banks and their transformative role during and after the crisis. It is important,

[78] Given the SSM's strong capacity building enterprise, there are a few clarifications worth making. Although the SSM is *not* formally speaking an EU institution—due to the treaty constrains explained above—some passages of the research refer to it as such, or associate it with institutional characteristics (e.g. Chapter 2). Furthermore, whenever the text addresses the binding and non-legally binding legal acts, instruments, and documents adopted by the SSM's Supervisory Board as part of the *non-objection procedure*, reference will be made to the "SSM" only. Otherwise, it would be necessary to allude to "ECB/SSM", but it could be tedious throughout the text; if, on the contrary, the "ECB" acronym is used on its own, it would be confusing as it is not clear whether the text talks about the monetary policy or the supervisory side.

however, to clarify the scope of the analysis, given that literature on post-crisis central banking is considerably vast and multidisciplinary. One of the topics that is not covered by this subsection relates to central banks' unorthodox or unconventional monetary policies in order to stimulate the economy and inject liquidity into the system.[79] The focus is instead placed on the move from a central bank independence (CBI) paradigm, to more multi-faceted institutions that actively participate not only in the political, but in the broader social arena as well. One of the most recent analysis of central banks and central bankers is in fact entitled *Unelected power. The quest for legitimacy in central banking and the regulatory state* (Tucker 2018). In order to better understand the context within which the SSM operates, it is important to consider how the crisis—in its multiple forms—has reshaped central banking, and the potential legitimacy questions arising from these changes.

Central bank independence has been considered as "one of the most prominent examples of the delegation of policy-making to non-majoritarian institutions" (McNamara 2002, 49), in which the delegation is justified by the ability of central bankers to solve inflation problems allegedly caused by political involvement in the making of monetary policy. Therefore, in order to break with the 'political business cycle', in which the economy is dependent upon the electoral ebbs and flows, "delegation to non-representative institutions is seen as the key way to enhance commitment" (McNamara 2002, 52). However, the functional logic of delegation can be challenged under, at least, two grounds. First, the technical decisions made by central bankers are not neutral: they involve fundamental trade-offs which, in their turn, imply the existence of preferred values. Second, the principal-agent theory explaining the government-

[79] Elsewhere I have explored central banks' interventions from a comparative perspective, by analysing the US and euro area responses and its effects (see Biondi and del Barrio (2019)). For a critical analysis of the unconventional measures adopted by the ECB, see Högenauer and Howarth (2016).

central bank relationship, leaves out of its analytical framework the society as a whole, which is widely affected by decisions taken in the monetary policy domain. The fact that "delegation does not occur in a political vacuum" (McNamara 2002, 55), seems evident these days.

When reviewing the political economy of monetary policy in the post-crisis epoch, Tucker (2018, 528) highlights that, if anything, it proved the possibility "to provide monetary support to economies in distress without unleashing the inflation genie". He then turns to the distinction between *distributional effects* and *choices*; while the former is an unavoidable consequence of monetary policy, the latter "should remain in the hands of elected politicians, as only then are prospective losers represented at the decision-making table" (Tucker 2018, 14). To make this distinction clearer, central bankers should have been more explicit in stressing the costs of their policy, so as to raise awareness among the broader public that political authorities could have mitigated some of the distributional effects. While central banks do not constitute a fourth branch, Tucker (2018, 289) considers that

> An independent monetary authority is a *means* to underpinning the separation of powers once the step to adopt fiat money has been taken. The regime is derivative of the higher-level constitutional structure and the values behind it.

As further explained in Chapter 3, central bank independence was one of the essential characteristics of the German Bundesbank, which was instrumental to the fulfilment of its price stability mandate and which, in 1992, was transferred to the European Central Bank. As reminded by Joerges (2016, 315), the German Constitutional Court's Maastricht ruling "found that it was precisely the substitution of politics and policies by legal rules and the independence of the ECB which ensured the compatibility of the EMU with the [German] Basic Law". The independence of the ECB has been enshrined in Article 130 of the TFEU, however, "the constitutional argument for central bank independence applies only to monetary policy . . . It

does *not apply to the other responsibilities* a central bank may have, notably *regulatory policy and prudential supervision*" (Tucker 2018, 396, emphasis added). In line with this reasoning, the issues raised by "postcrisis central banking, which combines monetary policy with bank supervision and, in some cases, other functions" (Tucker 2018, 397), are of particular relevance to the ECB case. In fact, the post-crisis ECB has seen a significant expansion of its role within the euro area governance along, at least, two dimensions.

First, it played a fundamental role in the euro zone fiscal and sovereign debt crises, which made the political nature of these interventions evident. Examples of this are the involvement of the ECB in the Troika, together with the Commission and the International Monetary Fund (IMF),[80] while at the same time acting as Greece's monetary policy authority; or the fact that the ECB stopped accepting Greek government bonds as collateral in its (non-declared) lender of last resort role, which pushed Greek banks to borrow from their respective central bank through the Emergency Liquidity Assistance (ELA) (Braun 2017). In relation to the ELA, the ECB used some controversial 'secret letters' to communicate with those member States that needed this assistance. For instance, in the case of the letters to the Irish Finance Minister in 2011,[81] it has been claimed that

> Simply asserting that these secret letters are not 'law' does not suffice to allay rule of law concerns . . . Should these letters be considered not to contain binding obligations, they evidence that national labour laws and other highly significant decisions about the use of ECB powers are being shaped in secret institutional structures with significant normative power outside the law". (Kilpatrick 2018, 90)

[80] It should be recalled that the ECB's institutional presence in the Troika was required by the ESM Treaty, and the need to comply with specific procedures in order to grant stability support. For further details about the ECB's involvement, see European Parliament (2015).

[81] The Irish case was not the only one. As explained in the Transparency International report on the ECB (Braun 2017, 4), "the success of President Draghi's Outright Monetary Transactions announcement was preceded by secret letters from the ECB to the Prime Ministers of Spain and Italy, which made support from a similar bond-buying programme conditional on specific reforms to be achieved within a timeline dictated by the ECB".

Kilpatrick takes the distinction between law and 'managerial direction' developed by Fuller in *The morality of law* (1964), according to which the latter constitutes a mode of governance that works for everyday contexts, but that does not entail any commitment towards generality and congruence between official action and the content of the rule. The question about the not-just-technical but also political choices made by the ECB in these cases, has to be understood in a context in which political inaction at the national level was frequent. The second dimension that accounts for the expansion of the ECB's role within eurozone economic governance, is the delegation of prudential tasks. Chapters 4 and 5, in particular, analyse how the exercise of its supervisory and regulatory tasks have shaped the characteristics of the SSM and its supervisory style which, contrary to the monetary policy realm where it was possible to identify a clear blueprint, is made up of a mix of different supervisory practices. This peculiarity of the SSM's supervisory style makes sense if we consider the distinctive nature of its tasks: to ensure the consistent application of the single rulebook across a diversified banking sector, in which local supervisory practices have been developed over time.

Before concluding this subsection, it is important to recapitulate the most fundamental implications of the crisis on central banking, as they help understand the subsequent section. In a nutshell,

> The 2008 financial crisis and its aftermath have left central bankers with *more discretion* and *more ability to make policy*. They have changed how they use their policy instruments both to stabilize the financial system and to restore their influence over the wider economy. All this has implications for distributive outcomes. Second, the crisis led elected politicians to see the *interaction of monetary policy and financial supervision* in a different light. Central banks now have a much stronger hand in *regulating private financial institutions*, bringing these banks into more frequent conflict with private interests and their political patrons (Jones and Matthijs 2019, 129/130, emphasis added).

The resulting politicisation and the ever more active policy role played by central banks, emphasises the need to rethink the relationship between them and political institutions (Jones and Matthijs 2019). As part of its supervisory tasks, the ECB has also been conferred regulatory powers which, as shown in the empirical chapters, have been used to actively shape the supervisory space and the interaction between the SSM and the supervised banks. Therefore, although it is not the regulator as such, the SSM does exercise influence upon the behaviour of credit institutions, by issuing non-binding instruments that contain detailed supervisory expectations. Therefore, and in spite of the organisational separation between monetary and supervisory activities within the ECB, the institutional challenge of balancing these two responsibilities remains: the interplay between monetary policy and a supranational supervision can generate "winners and losers" (Jones and Matthijs 2019, 136). An example drawn from fiscal policy governance illustrates this point, given that prudential supervision and regulation are essentially risk regulation domains:

> Risk regulation touches the question of sovereignty insofar as it frames euro-area states as forming a *community of risk*. The grounding for Union power over public finances set out in the 'Six Pack' and Fiscal Compact is based on a recognition of risks that euro-area economies and public finance pose to each other and a mutual commitment to manage these risks." (Chalmers 2016, 278)

The fiscal and sovereign debt crises in the EU have enhanced the idea of the EU as a *community of risks*. This section has analysed some of the most important changes brought about by these critical events, both from an economic governance and a more specific central banking perspective. After having outlined one of the main policy challenges faced by the SSM, the next and final section explores the fundamental research questions and aims.

1.4 Research questions, methodological aspects, and outline of the thesis

The previous sections have provided the evolutionary, regulatory, and institutional background required to understand the research questions and the research rationale offered in this final part of the introduction. As discussed earlier, the fiscal and sovereign debt crises in Europe created a window of opportunity for further integration, but in particular ways. One of the key features that characterises the post-crisis economic governance, relates to the supranationalisation of the *implementation* of decisions. This feature introduces an additional layer to the traditional characterisation of supranationalism, which goes beyond *normative* aspects—meaning the relationship and hierarchy between national and supranational regulatory measures—and *decisional* ones—relating to the decision-making process and its institutional framework (Weiler 1981). The move from a regulatory to an implementation-focused polity is an aspect that deserves deeper scrutiny. The Single Supervisory Mechanism provides an interesting case to delve into these post-crisis transformations, in particular the interaction between regulation and capacity-building as two complementary and intertwined instruments of integration (Genschel and Jachtenfuchs 2014; 2016).

1.4.1 Research purposes, methods, and data sources

In order to account for the interplay between regulation and capacity-building as integrations tools in the context of the SSM, this work focuses on the notion of *supervisory consistency*. Supervisory consistency represents a critical challenge faced by the SSM as the supranational supervisor. As Chapter 2 explains, other concepts such as harmonisation or convergence do

not fully apprehend the phenomenon under analysis. The former because it refers only to the legal dimension, i.e. harmonisation of the regulation; and the latter because it makes reference to the achievement of an end result, be it policy goals, tools, outcomes or policy styles. The achievement of supervisory consistency is different from these two aims, as it unfolds in the process of implementation. Therefore, the attainment of supervisory consistency comprises what happens before, during, and after the implementation phase. In the context of the SSM, what renders consistency particularly challenging is, first, the variety of (pre-existing) supervisory practices and national rules in each of the SSM countries, and, second, the variety of the banking sector, which comprises credit institutions of different sizes, risk profiles, complexity, and institutional organisation, among other characteristics.

Therefore, the purpose of this study is to explore the regulatory and supervisory tools used by the SSM in order to achieve supervisory consistency, and identify the (changing) patterns of governance deployed by the SSM in order to balance consistency against the inherent banking and national sources of diversity. The schematic representation in Figure 1.2, links the two fundamental research purposes, i.e. explore and describe, with their corresponding and more specific research aims, i.e. the action verbs of the second column. Each of these research purposes and detailed aims, are connected to the resulting research questions. Although the 'exploratory' and 'descriptive' research purposes can be subsumed under the *what* research question (Blaikie 2010), this does not mean that the research aim is limited to the production of narratives. On the contrary, the aims comprise the identification of themes, patterns, and plausible relationships between the phenomena studied.[82]

[82] The other two categories of research questions, according to Blaikie (2010) are *why* questions (whose aim is to explain), and *how* questions (whose aim is to predict).

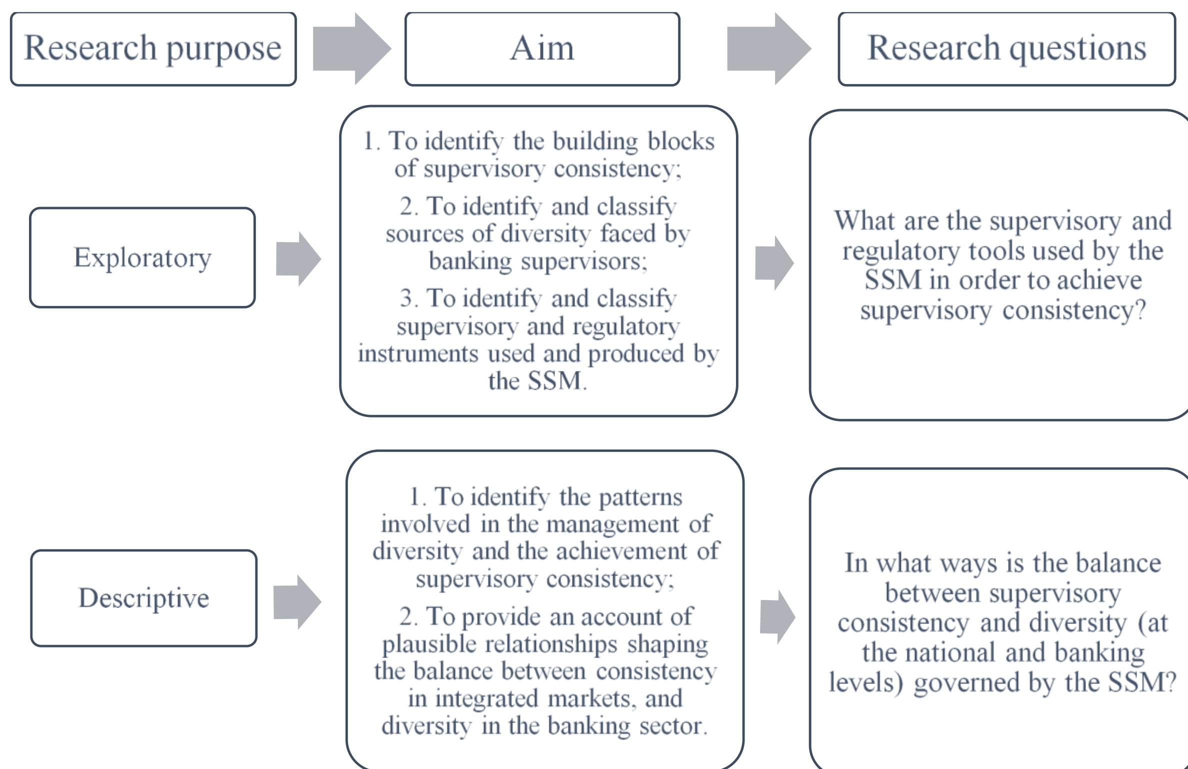

Figure 1. 2: Schematic representation of the links between research purposes, aims, and research questions. Source: Own elaboration.

These purposes and aims have to be matched by relevant data collection and data analysis processes. In order to answer the proposed questions, the research employs a qualitative data analysis (QDA) approach, which

> Involves searching and discovering *patterns of themes* in the data, describing how these patterns were identified, challenged and supported, and illustrating their relationships using narratives or visualisations in the support of the study findings such as conceptual propositions, causal explanations, theoretical predictions or middle-range theories. (Paré 2019, slide 10).

These themes and patterns are fundamental elements of QDA: the former refers to the existence of "statements of meaning" running through most of the data (Paré 2019, slide 11,

citing Ely 1991), while the latter can be characterised as regularities in the data (Paré 2019, slide 12, citing Guba 1978), which are expressed in different ways, either similarities, differences frequencies, sequences, etc. (Hatch 2002). An important characteristic of QDA is its cyclical approach, in the sense that the analysis of qualitative data is hardly linear. Qualitative data is in fact "reduced" mostly through *coding* and *memoing*. These activities are fundamental to the subsequent "transformation" of the data, which makes the uncovering of relationships and hidden patterns possible. The cycle continues with ensuring trustworthiness and conclusions phases (which can lead to further refinements of the initial analysis) (Paré 2019). The analytical process carried out in this research has been facilitated by a qualitative data analysis software, MAXQDA, especially during the first two phases, i.e. the reduction and transformation of data.

The study relies on the following five data sources. First, official documents, which include a wide set of tools: relevant legal acts and instruments, legal opinions, reports from EU and national authorities, including those regularly published and special ones, and relevant court cases. Second, speeches from the former chair of the SSM's Supervisory Board, comprising the period 2014 to 2018. Third, position papers from a wide range of stakeholders, submitted in the course of public consultations carried out by the CEBS, EBA, and ECB banking supervision in the exercise of its regulatory powers. These position papers are complemented by the documents produced by the authorities in response to these consultations, and the video recordings of the public hearings carried out within these processes, which are publicly available on YouTube. Fourth, personal notes taken during conferences and lectures, which I had the possibility to attend while conducting research periods abroad in Frankfurt and Berlin.

Fifth, this work draws on forty-two semi-structured interviews, conducted with bankers from Italian and German credit institutions; banking associations representing the interests of commercial banks, and specific types of banks at the EU level,[83] and national associations representing German and Italian interests, respectively;[84] ECB/SSM officials; NCAs officials; officials of other EU institutions (such as the EBA, the European Commission and the European Court of Auditors, ECA); and, finally, a smaller number or experts from think tanks and universities. These interviews have been conducted in person, via telephone, and via Skype (depending on the interviewees' location), and only three out of the forty-two have been fully recorded and transcribed. All the interviews have been documented through notes, which have been taken while the conversation took place, and subsequently transcribed in Word documents. The purpose of these interviews was to gain insights into the challenges faced by different stakeholders during the supervisory process. In fact, some aspects that emerged during these open conversations would have been hardly available through other sources. Incorporating the variety of perspectives from the different experiences of the actors, however, has not been a straightforward task. The main challenge concerned the fact that most of the interviews were documented through notes, and therefore their content was not as accurate as that of recorded and transcribed ones. Interviews are one amongst other data sources, and therefore they have to be understood and analysed in the broader context of the additional documentary (written and audio) sources. For further details on the interviews conducted during 2018-2019, see the Annex. Given the vast amount of qualitative data that has been

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[83] The European Banking Federation (EBF), European Association of Co-operative Banks (EACB), European Savings and Retail Banking Group (ESBG), and European Association of Public Banks (EAPB).

[84] For Germany: German Savings Banks Association (DSGV), Association of German Banks (BdB), and Association of German Public Banks (VöB); for Italy: Italian Banking Association (ABI), and the Cooperative and Savings banks Association (Federcasse, *Associazione nazionale delle Banche di Credito Cooperativo e Casse Rurali*).

gathered throughout the data collection process, the use of a specialised software has been of great help.

The focus placed on the German and Italian cases is further discussed and developed in Chapter 3; however, it is worth clarifying some specific aspects in the context of this introduction. Since the research aims to analyse the phenomenon of supervisory consistency against wide contextual diversity, it is important to empirically make sense of these differences. The choice of countries is not intrinsically fundamental, as the purpose is not to compare between them; rather, the research addresses SSM-wide governance questions, and therefore the Italian and German cases are ways to explore and test the capacity of the supranational supervisor to accommodate diversity. The decision to restrict the fieldwork to these countries is also based on practical reasons (mostly time and logistics), and research considerations (i.e., QDA approach and its in depth, case-oriented nature). The choice for Germany and Italy accounts for the data selection process in the following ways. First, interviews were conducted with relevant industry stakeholders and officials belonging to these countries and the EU level;[85] second, the empirical analysis of public consultations and the respective position papers has also focused on German, Italian, and EU-level actors (again, pragmatic considerations such as time and resources restrictions help explain the range of sources analysed).

From a methodological perspective, the research falls within the category of *analyticism* (Jackson 2011, chapter 5):

> Analyticists require a way to order the experiences arising from their concrete practical involvements in the activity of research; this gives rise to the procedures of ideal-typification and the production of *case-specific analytical narratives*,

[85] An exception was the interviewee from BNP Paribas.

> which serve to ground or warrant particular empirical claims by relating them to their pragmatic explanatory utility. (Jackson 2011, 157, emphasis added)

The question about 'case-specific analytical narratives' is one of the main characteristics of this methodological approach, which organises "the empirical material of specific cases into a coherent story that differentiates between analytically general and case-specific factors responsible for bringing about an outcome"(Jackson 2011, 154). The premises of this philosophical stance are in line with the concept of *analytic eclecticism*, which can be defined as "an intellectual stance that supports efforts to complement, engage, and selectively utilize theoretical constructs . . . to build complex arguments that bear on substantive problems of interest to both scholars and practitioners" (Sil and Katzenstein 2010, 411).

Before moving to the final part of the introduction, it is worth acknowledging that

> Ontological commitments are "foundational"—not in the sense that they provide unshakable grounds that universally guarantee the validity of claims that are founded on them, but "foundational" in the sense that they provide the conditions of intelligibility for those claims. In that way, ontological commitments are world-disclosing, since they make a particular kind of tangible world available to a researcher (Jackson 2011, 41, citing Habermas 1990, 321).

1.4.2 Outline of the dissertation

In order to address the research questions explained in the previous subsection, the thesis is organised as follows. **Chapter 1** sets the scene and provides the main elements in the evolution of the regulatory and institutional frameworks in the prudential realm, which help understand the broader context of the research, and the relevance of the questions posed. The field of post-crisis economic governance in the EU has specific characteristics that makes it different from other EU policies. For instance, the presence of decision-making process which are mostly non-legislative, their redistributive effects, and the characteristics of the non-binding

instruments that are adopted. This first chapter also explains the *fil rouge* of the thesis: the identification of the diversity management tools used by the SSM in order to strike a balance between the need to strengthen supervisory consistency, and the inherent diversity of the banking sector and national institutions. **Chapter 2** explores the tensions arising from the integration process, and develops an operational definition of *supervisory consistency* and introduces the indicators that are used in the empirical part of the thesis in order to make sense of governance change. **Chapter 3** analyses the sources of diversity that impact upon the work carried out by the SSM. It first explores the question of banking diversity, and zooms in on the German and Italian banking sectors. Then, the chapter moves on to consider 'national diversities' and how the combination of different factors at the local level has shaped specific supervisory practices in the case of German and Italian authorities.

After developing the notions of supervisory consistency and diversity, the next two chapters empirically explore the relationships between them. Chapters 4 and 5, therefore, analyse the ways in which the balance between supervisory consistency and the inherent diversities is managed within the SSM framework. **Chapter 4** aims to open the "black box" of banking supervision, in light of the supervisory consistency objective of the SSM. To do so, it focuses on the most comprehensive supervisory tool, the Supervisory Review and Evaluation Process (SREP), and its evolution starting from the pre-SSM era. The chapter highlights the main elements that account for governance changes, and identifies the patterns deployed by the SSM in order to strengthen supervisory consistency under heterogeneous circumstances. **Chapter 5** continues exploring the consistency challenges but from a particular angle: the regulatory powers exercised by the ECB, since they constitute a fundamental tool in the search for supervisory consistency. The chapter also critically analyses the variety of tools adopted

by the SSM, in order to go beyond the hard v. soft law dichotomy, and critically analyses the impact upon the legitimacy of these instruments in light of the consistency challenge. **Chapter 6** concludes by connecting the previous chapters and their main findings, and discusses the major theoretical and practical implications of the study. The dissertation is not limited to the analysis of supervisory powers, but, rather, it focuses on the practices and activities deployed by these actors. This pragmatic-oriented perspective seeks to move the EU economic governance literature forward, by addressing the challenges arising from supranational implementation in the context of diverse member States.

CHAPTER 2

Unravelling the dynamics of supervisory consistency and EU governance change

Introduction

Chapter 1 provided the historical evolution and foundations behind the aspiration to a more harmonised framework for banking and prudential regulation, in light of the existing trends at the global and EU levels. The discussion has shown that, as a consequence of the global financial crisis and, predominantly, the EU fiscal and financial crises, supranational authorities have seen an expansion of their fields of action. The SSM has been no exception to this trend, and its policy aims go beyond those of the authorities in charge of contributing to the creation of a level playing field (i.e., the EBA and the European Commission at the EU level). In fact, one of the main objectives of this joint mechanism is that of achieving *supervisory consistency*. Therefore, this chapter focuses on the specific notion of supervisory consistency, and develops an analytical framework where this concept is operationalized in order support empirical research.

Supervisory consistency is an important goal in the context of the SSM, in light of the inherent diversity of the banking sector. Hence, this dissertation examines the existing tensions between the achievement of supervisory consistency within the SSM framework and the need to accommodate (and eventually learn from) the existing diversity. In order to systematically explore these tensions, this chapter develops a comprehensive framework that draws on the governance and European integration literatures, with a view to complementing and enriching the legal perspective. Thus, the starting point of this chapter is the research questions posed at

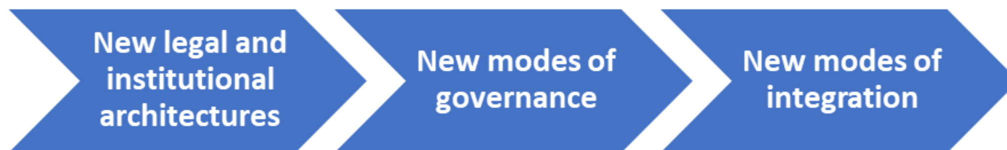
the end of the introduction, which explore the ways in which supervisory consistency is balanced against diversity. The chapter critically analyses the strands of literature that have helped formulate the analytical framework that underpins this study. In order to do so, the analysis adopts an interdisciplinary perspective, which offers a more comprehensive outlook on the multiple tensions and paradoxes surrounding the concept of supervisory consistency.

The previous chapter has examined the innovations introduced by the SSM. Its legal and institutional architecture represented a novelty and a rupture with prior supervisory arrangements.[86] This transformation, in turn, has created new "patterns of interaction and coordination of social and political actors for the purpose of adopting and implementing collectively binding decisions", which corresponds to the definition of 'governance' proposed by Diedrichs, Reiners, and Wessels (2011, 19/20). The second part of this definition that focuses on the adoption and implementation of collectively binding decisions might sound counter-intuitive in line of the main aims of the SSM, it being the euroarea supervisor and not a regulatory authority. However, this chapter argues that the definition is suitable given that the SSM has not confined itself to supervisory activities *stricto sensu*.

These emerging modes of governance, which are closely connected to the legal and institutional architecture at the EU level, add "new dynamics and dimensions to the integration process" (Diedrichs et al. 2011, 21). And this is so because of the close interrelation among these concepts: new legal and institutional architectures reconfigure the patterns of interaction and coordination amongst actors. Therefore, "new modes do not simply emerge as a result of policy goals to be achieved but are to be seen as a peculiar expression of the interrelation

[86] From a legal standpoint, the most innovative element represented the application of national law by an EU institution, since some of the supervisory powers in the hands of the SSM are provided for in national and not supranational law.

between policy objectives, institutional concerns, and windows of opportunity exploited by political entrepreneurs" (Diedrichs et al. 2011, 25). These different elements lead to a redistribution of resources amongst actors which might trigger more informal or formal ways of cooperation, depending on the existing Treaty provisions and decision-making processes adopted. This, in turn, results in different instances of integration, characterised by a more explicitly and open way of integration or, on the contrary, by a covert or 'stealthy' process. Section 2 below reviews the relevant governance and integration literatures that provide important elements to better understand the framework of this study.



In order to establish the foundations of this review, the next section examines the main tensions and paradoxical features in the field of prudential regulation and how they might increasingly decouple the supervisory exercise from national realities.

2.1. Multiple tensions and the 'integration paradox'

The topics addressed throughout the present study embed a series of paradoxical features or tensions, which range from European integration to more specific ones concerning financial regulation. To start with, socio-legal studies have highlighted the differences between two levels of norms or, in a broader sense, two different layers of institutions. On the one hand, social interactions are shaped by formal institutions or *constituted* explicit norms and, on the other, by informal institutions or *instituted* norms (Ladeur 2014, 387). In a similar vein, these two distinctive levels have been put forward by North (1991), when distinguishing between

formal and informal constraints, and also by sociologists of law when describing how local normative orders that operate in the shadow of the law, become indeed law for those it actually regulates (Carruthers and Halliday 2007).[87]

The importance of this formal-informal distinction is revealed by the "diversity management" paradox, which underpins the relationship between EU and Members States Laws. As explained by Ladeur (2014, 383):

> Conflicts between European law and Member State law will always exist and will, even paradoxically, increase in the process of a deepening of European Union law. This is due to the fact that, in this process, the impact of social norms, procedural versions of societal self-organisation and complex "regimes" that are composed of different forms of legal and non-legal norms, patterns of decision-making, preferences for conflictual or consensual versions of social governance, versions of coupling between social systems, traditions, levels of trust, etc., become increasingly relevant.

What this means is that the deeper the supranational legal interference with national orders, the greater the need to consider other social, non-legal norms that, despite their informality, actively shape the law in action through patterns of behaviour and practices that go beyond the letter of the law.[88] The interaction between legal and social spheres may seem obvious in certain legal realms; however, this relationship can be overlooked in regulatory arenas characterised by a high degree of homogenisation, in which the need for centralisation

[87] When describing their analytical framework for the recursivity of law, Carruthers and Halliday (2007, 1146) explain that the recursivity cycle has two poles: *law on the books* (which would be analogous to the notion of formal rules) and the *law in practice* (which accounts for behaviours and practices that shape the way rules are applied regardless of the specific letter of the law, therefore closer to the informal rules/institutions conception). The four mechanisms identified by the authors that link theory and practice within the recursivity framework are explained below in this section.

[88] Ladeur (2014, 387) further explains that formal rules do not let us know how they will be applied in practice: "Patterns of rule application have an emergent character, in that they are generated by a practice that cannot be formulated in advance; they are the outcome of an acentric search process that is distributed over a heterarchical network of experimental moves of social actors . . ." What this suggests is that, inasmuch as rules are centrally defined and harmonised in advance, their application follows the opposite pattern. The novelty of the SSM is that it aims at surmounting this "acentric" implementation process, by developing centralised methodologies and centralised assessments.

and rule harmonisation are key objectives. Therefore, these paradoxical linkages between EU law and member States' law calls for a cautious approach when analysing the integration phenomenon and the ways in which a uniform set of rules is applied in different contexts. In fact, the supranationalisation of banking supervision via the SSM—i.e., not the mere harmonisation of rules but also their application—mirrors these tensions between formal rules (either hard or soft law) and non-legal domains of social governance.

An additional paradoxical feature entails the financial regulation realm, to which banking supervision belongs. This has been summarized by Black (2012, 5), when describing that there are "conflicting policy dynamics, with *centripetal* pressures to move regulation to the international level being countered by *centrifugal* pressures for unilateralism either by individual countries or the EU" (emphasis added). Albeit this refers to regulation and not supervision as such, these two activities are closely interwoven, therefore the same considerations apply to both. The tension depicted by Black between centripetal pressures pushing regulation towards specific central nodes, and the counteractive centrifugal forces that push back to national governments is widely acknowledged in the realm of European integration, and they are not confined to the financial and banking domain. However, these forces are particularly relevant in the case of banking supervision: on the one hand, the global financial crisis and the subsequent European fiscal and financial crises exposed the need to go beyond the harmonisation of rules and move onto a more centralised banking supervision—in light of the difficulties that leaving this in the hands of national authorities entailed. On the other, the presence of centrifugal forces is still present, due to the specificities of some banking sectors and the need to maintain their status. In the SSM domain, this tension is epitomised by the relationship between supranational and national authorities—which in turn deserves a case

by case analysis, given the different dynamics that might be triggered by the relationship between the ECB and specific national authorities; therefore, no general claims can be made.

From a micro-level perspective, there is an additional tension that emerges from the internal dialectics that take place within the SSM structure. The Directorates General in charge of supervising banks (DG MS I and II), have a specific bank-oriented perspective, which is complemented by all the analytical work and horizontal view that DG IV brings to the fore. In spite of their complementary nature and the positive aspects that emerge from the combination of a bespoke view and a more transversal one, the unfolding of everyday tasks creates some internal frictions.[89] This tension, however, is only natural and mirrors the difficulties in balancing a micro- with a macroprudential view of risks and supervision.

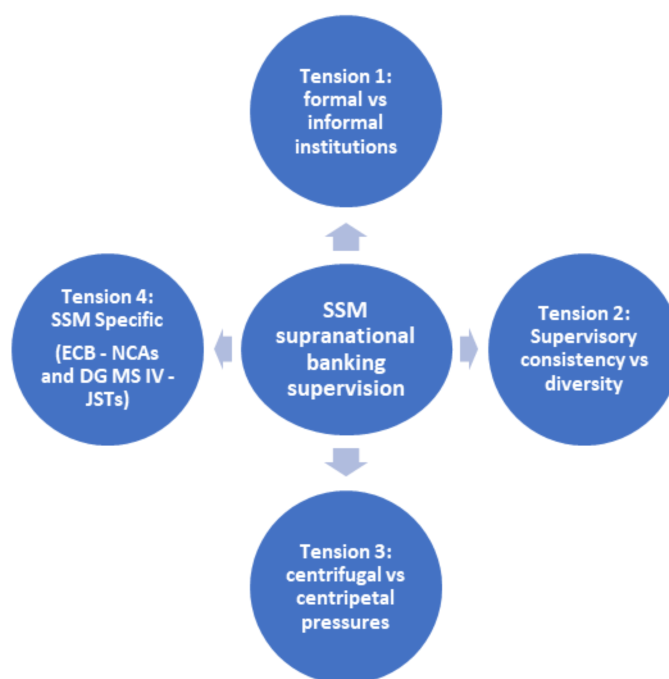


Figure 2.1: Tensions arising from the implementation of the SSM framework. Source: Own elaboration.

[89] For instance, DG MS IV has no direct contact with the banks. Ergo, all data and information requests that this DG needs in order to perform their different analysis is channelled through the respective JSTs (DG MS I and II), which in some cases do not know the exact motivation of the request. These aspects will be further examined in the empirical chapters.

The implementation of a single regime under diverse circumstances raises the following paradoxical features. From a macro socio-legal standpoint, the expansion of EU law and the deepening of integration is prone to increase the frictions between European and member States' law, given the set of formal and informal norms that need to be balanced, in an attempt to adapt a single set of rules to varied contexts. From a micro-level perspective, the diversity management paradox is related to the need to achieve supervisory consistency in the treatment of a wide variety of credit institutions embedded in diverse national contexts. In order to cope with the needs of individual institutions and make bespoke assessments, supervisors rely on a specific tool that is the object of analysis of Chapter 4: The Supervisory Review and Evaluation Process (SREP). The SREP is a supervisory device by which a comprehensive risk assessment is conducted for each bank. The deployment of the SREP creates an ample set of intra-institutional dynamics (and also inter-institutional, if we consider the relationship between the SSM and the supervised entities, or between the SSM and other relevant EU institutions) that provide a better understanding of how supervisors deal with consistency challenges.

An alternative approach to deal with the gap between uniform norm-making and its differential implementation is provided the socio-legal "recursivity of law" framework. The authors identify four ways in which this recursivity is manifested (Carruthers and Halliday 2007, 1149-1153), which in turn can help understand the mechanisms at play at the SSM level. First, the *indeterminacy of law*: law is inherently "ambiguous and subject to interpretive confusion or manoeuvre" (Carruthers and Halliday 2007, 1149). The porosity of the law has been and is of particular relevance in the realm of financial regulation, where 'creative' interpretations have been a matter of concern for supervisors and regulators. A second mechanism is given by existing *contradictions*: according to the authors, the cycles between

law-making and implementation are normally driven by contradictions that are afterwards reflected in the final regulatory product. In the case of EU law this is particularly relevant, given that compromises reached at the political or decision-making level tend to mirror partial solutions that, when taken to the implementation level, can trigger inconsistencies and therefore call for additional clarifications. Another type of contradiction is of a "structural" nature, when for instance implementation is distributed among different executive agencies.

A third mechanisms is what the authors call *diagnostic struggles*: the law-making and law-implementation cycle involves the identification of a problem, and its construction in such a way that enables specific instances of reforms. The word *struggles* here denotes a crucial feature of these diagnosis: they are more often than not contested within the law-making process. As acknowledged by Carruthers and Halliday (2007, 1151) "the contest among actors in diagnosis" is an important filter for information, perceptions, and treatment of the problem. This mechanism is fully reflected in the SSM case, given that its unique position as supranational supervisor allows it to have both a specific and a pan-euroarea view that makes it particularly suitable for the diagnosis of certain problems that might escape the purview of regulators that do not conduct supervision on the ground. Furthermore, although most of the issues that concern prudential supervision are of a rules-based and technical nature, the choice in the end is not solely scientific, given that there are other policy and distributional elements that contribute to the build-up of supervisors' judgement.

The last mechanism identified concerns the tensions arising between law-makers and the actors that need to deal with the practical side, called *actor mismatch*. This is also reflected in the way the SSM operates. However, contrary to the situation described by the authors, according to which actors who are in charge of implementing the law are sometimes not part

of the law-making process, the SSM has frequently resorted to its regulatory powers in order to steer the decision-making process to better reflect their supervisory needs. Therefore, albeit there is to some extent an actor mismatch at the higher regulatory levels, the SSM has made use of these competences in order to minimise these effects, as later explained.

To conclude, Table 2.1 provides a sketchy description of different literature strands and the ways in which each of them has acknowledged the coexistence of formal and informal orders, in order to better understand how the *law in the books* is translated into *law in practice*. If the purpose is to analyse not only the law in theory but also in action, it is fundamental to consider both formal rules and institutions, and their informal dimensions. This is an important premise for the dissertation, as the work does not solely rely on formal sources of law, but also on informal or implicit dynamics that are crucial to understand the application and unfolding of rules. An additional aim of the table and the formal-informal interdependencies is that of embracing a comprehensive concept of institutions. As anticipated in Chapter 1, the SSM will be frequently referred to as an institution. Albeit from a strictly legal perspective the SSM is *not* an EU institution—it can be described as an integrated system of national supervisors and ECB—it nevertheless performs a series of fundamental actions in the realm of banking supervision and it can be materially differentiated from the 'traditional' ECB.[90] Hence, given the specific characteristics and the substantive functions performed by the SSM in the context of the present work, it will be identified as an institution.

[90] For instance, the supervisory and monetary policy premises are located in two different buildings.

Literature	Realms distinguished (law & application)
Legal (Ladeur 2014)	Constituted explicit norms and instituted norms ("implicit" character of decision making)
Socio-legal (Carruthers and Halliday 2007, 1190)	"Local normative order that operates in the shadow of the law"[91] + recursivity framework
EU studies/Europeanisations (Börzel 2001)[92]	Formal and informal institutions
Institutional Economics (North 1991)	Informal and informal (institutional) constraints

Table 2.1: Different disciplines addressing the law and its application literature. Source: Own elaboration.

2.2. Integration and governance

The introduction has hinted at some of the fundamental links between new legal and institutional architectures, the emerging modes of governance, and the development of different integration patterns. This section provides an in-depth and critical assessment of the integration and governance literature. The aim is to uncover potential drawbacks and some of the limits of the integration project, in light of the diversity analysis provided for in the next section. The examination of the following literature strands also helps better understand the subsequent empirical chapters.

Integration

2.2.1 Grand theories

[91] After portraying this "conventional" law and society analysis, the authors explain that in their view this is not enough to fully account for the existing recursive cycles between the national and international arenas.
[92] Discussed in Section 2.2.4 below.

There are three theories that aim to explain the process of European integration:[93] neofunctionalism, intergovernmentalism, and postfunctionalism. These theories could be better described as 'schools', as each of them "identifies key political actors, suggests paths of inquiry, and situates European integration within a broader literature" (Hooghe and Marks 2019, 1114).[94] In spite of the different perspectives and methodological insights, these theories are complementary, since they provide different angles from which EU integration can be examined.

First, *neofunctionalism* "conceptualise[s] the state as an arena in which societal actors operate to realize their interest" (Hooghe and Marks 2019, 114). Hence, contrary to classical realists' assumptions about the interests of States, neofunctionalists consider that international relations are made up of the interaction of societal actors. While functionalists have argued that the only way in which State sovereignty could be bypassed was by means of transferring State functions to specialised agencies, neofunctionalists stress the "potential for deeper and broader governance at the regional level" (Hooghe and Marks 2019, 1114). Therefore, their main concern revolves around the way in which regional integration in some specific policy domain could trigger integration in others. Albeit this theory expects integration to follow a bumpy trend, there is the guiding assumption that "policy spillover and supranational activism will produce an upward trend" (Hooghe and Marks 2019, 1115). From a causal point of view,

[93] For the purposes of the present section, the focus is placed on EU integration as such, without distinguishing EMU from non-EMU countries. Subsequent sections dealing with the case of the SSM specifically focus on integration from a euroarea perspective. It is important to note, however, that the distinction between the integration project at the EU and EMU levels respectively, has become more blurred in the aftermath of the eurozone crisis, given that the need to save the Euro ended up supporting the whole EU project as such. For a deeper analysis on this point, see Jones (2019).
[94] This section follows a recent review of the three grand integration theories elaborated by Hooghe and Marks (2019), in which the authors assess each of them in light of the current integration challenges (such as the Eurozone and the migration crises, Brexit, and the illiberal turn). This section, however, does not intend to comprehensively deal with integration theories, given that this vast topic is not directly relevant to the work that is developed in this dissertation.

this theory relies on path-dependency and the importance of sequencing and timing in the unfolding of the integration process.

Second, *intergovernmentalism* sees European integration from the perspective of individual member States that are constantly looking for mutually advantageous bargains. In this sense, integration is the outcome of cooperative and competitive relationships amongst national governments. A more recent version of this theory, *liberal intergovernmentalism*, "combines a liberal theory of domestic preference formation with an institutionalist account of intergovernmental bargaining" (Hooghe and Marks 2019, 1116), in which the State is instrumentally conceived and driven by economic interests. The decision process has three main steps: first, the configuration of national preferences, second, the intergovernmental bargaining, and third, the creation of European institutions that seal such agreements. Liberal intergovernmentalism envisages institutional outcomes as a functional solution to cooperation problems, and it expects that the level of integration will vary in relation to the nature of the cooperation problem that needs to be solved.

The third and final theory is *postfunctionalism*. While the previous two theories view integration as a process that enhances efficiency and economic gains, postfunctionalism "emphasizes the disruptive potential of a clash between functional pressures and exclusive identity" (Hooghe and Marks 2019, 1116). Postfunctionalism does not simply differ from the previous two theories due to its later development in time; it proposes a different theorisation and way of unravelling the integration process, which is divided in three steps. First, "there is a mismatch between the institutional status quo and the functional pressures for multilevel governance that arise form interdependence" (ibid.). The second step analyses the arena in which decision making takes place, which depends, amongst other things, on the capacity of

specific contending actors to politicise an issue that would be by default negotiated in a traditional élite setting. The third step examines "how European integration shapes the structure of political conflict" (Hooghe and Marks 2019, 1117), by drawing on the political psychology literature, which clearly departs from the rationalist-economic logic that lies at the basis of neofunctionalism and intergovernmentalism. Postfunctionalism "conceives European integration as a conflictual process arising from incompatible belief systems"(Hooghe and Marks 2019, 1117). What emerges from these different approaches is that, while the first two theories envisage a cooperative process that, in case of divergent preferences, can lead to a deadlock (i.e., a failure to change the status quo), the inherent conflict in the integration process heralded by postfunctionalism might lead to cultural divides that do not exclude the possibility of disintegration too.

Each of these theoretical approaches focuses on different questions and aims to understand different underlying mechanisms. Hence, their explanations can be considered complementary. In any event, the purpose of this review is to expose the main theoretical scaffolding behind integration puzzles. Given the specific research aims and questions posed by this study, integration theories are not directly addressed in the proposed analytical framework, in light of the different possible levels of analysis under which the phenomenon can be studied. Therefore, it is important to distinguishing between the *polity* from the *policy* level: the former refers to changes at the institutional level that redefine membership, decision-making rules, and allocation of competences, while the latter encompasses change that occurs by establishing new areas or modifying others (Héritier 1999, 9). What is important to note here is that these two levels have been for the most part considered as unfolding in parallel:

albeit the polity and the policy level are for the most part interwoven, their speed and frequency of development can differ.

Hence, apart from the more visible and explicit changes that occur at the polity level, there is "a subtle, steady and indeed rather stealthy process of redefining decision-making power and policies" (Héritier 1999, 11), which is normally crystalized at the policy level.[95] This two-level analysis of the polity in flux and the more dynamic policy developments is key to understand and analyse the evolution of the SSM. For the most part, early works on the SSM have dealt with the changes brought about at a higher polity level: new distribution of competences, the relationship between the existing national supervisors and the ECB, and so on. The present work, instead, focuses on "persistent, small-scale attempts made by all institutional actors involved to push forward the frontiers of their policy-making powers by consistently linking institutional with substantive policy interest" (Héritier 1999, 12) that happen at a more every-day policy level. In light of this analytical distinction, it is possible to understand why broader integration theories might not be particularly suitable to the present analysis. The following section, on the contrary, provides some critical insights to the limits and potential drawbacks of the integration process, bearing in mind the multiple paradoxes that have been addressed in the previous section.

2.2.2. An ever closer Union? The limits of the integration project

[95] Héritier (1999, 12) further explains that "the EU, as a polity in flux, in which a slow but substantial stream of institutional decisions runs parallel to a rapid flow of policy developments, allows for specific linkages between the two which speed up developments and institutional reforms."

The historical overview provided in Chapter 1 has outlined the rationale and motivation behind an increasingly homogeneous banking regulation framework. The single market and level-playing field logic trigger some fundamental questions that are at the heart of this work: to what extent can integration efforts be extended without overstepping specific national interests? How can increasingly centralised policy domains be responsive to the institutional variety in the banking sector? How do supranational regimes account for national diversity? It would be over-ambitious and unrealistic to provide complete answers to these questions. However, the following sections aim to provide some hints.

The critical literature on the limits of European integration is vast and interdisciplinary, given that the problem is assessed from legal, political, economic, and sociological perspectives. The present overview is however limited to the socio-legal aspects. In this sense, it is possible to identify three broad junctures in the integration project (Joerges 2016). First, there has been an "Integration through law" phase as pointed out in Chapter 1. Second, scholars' attention has focused on the regulation and governance turn, as means to overcome specific stalemates, and accelerate the integration in specific areas, one of those being the single market and the EMU project. Third, scholarly efforts have been concentrated in explaining the rise of an "emergency Europe".

One fundamental point that lies underneath the integration project is given by the tension between the "national" and the "supranational" elements. An early attempt to characterise and provide a more accurate definition of the concept of "supranationalism" was made by Weiler, who analytically distinguished two different "facets of supranationalism" (Weiler 1981, 271). The first one is the *normative* supranationalism, which refers to the relationships and hierarchies between Community (now, Union) policies and legal measures, and competing

policies and legal measures form member States. The second facet is what he calls *decisional* supranationalism, which concerns institutional frameworks and decision-making process. In this seminal paper, he traces the evolution and the dynamics of these two facets, and acknowledges the rise of "conflicting trends": normative supranationalism went through a process of *approfondissement*, whereas the decisional supranationalism has suffered the reverse process of a *diminution* (Weiler 1981, 273). This distinction and the different evolutionary patterns followed by the normative and the decisional dimensions provide an important analytical tool to better understand the meaning of "supranationalism" and thus elucidate in a clearer way the relationship between the Union and member States. I argue that EU post-crisis governance has seen the emergence of an additional facet of supranationalism, that could be characterised as *implemental*, in light of the increasing role of the EU in not only deciding, but also implementing and/or monitoring the execution of legal and quasi-legal provisions.[96]

An additional and subtler distinction made by Weiler (1981, 290/1) concerns what he calls a "first" and "second generation" of Community policies. He explains that it was much easier for the Commission to implement the first order policies, which are explicitly set in the Treaties. The need to move on to the implementation of a secondary line of policies, "imposed a much more delicate and politically sensitive task" on the Commission's side. Although this might seem unrelated to the SSM, the same pattern of first and second generation policies can be also applied to the case at hand. In fact, the SSM regulation has conferred limited regulatory powers onto the ECB/SSM, "only to the extent necessary to organise or specify the

[96] One of the cases that has received extensive academic attention is the role of the European Commission in the European Semester (see Dawson 2015; Zeitlin and Vanhercke 2014, 2018; D'Erman, Haas, Schulz, and Verdun 2019).

arrangements for the carrying out of the tasks conferred" by the SSM Regulation.[97] The same legal text confers the power to adopt guidelines, recommendations, and decisions. In this sense, the more explicit "first" order policies have been less controversial (e.g. the enactment of the SSM Framework regulation, which had an organisational scope),[98] while the publication of subsequent instruments of a more specific nature turned out to be a "more delicate and politically sensitive task", in line with Weiler's characterisation (e.g. the NPL case analysed in Chapter 5). What these examples suggest is the increasing the level of supranationalism (in its two or even three dimensions), and that the more it departs from explicit duties stated in the Treaties, the more politically sensitive the tasks might get, and more prone to contestation by member States, therefore crystallising the "integration paradox" referred to above.

One way of analysing the evolution and nature of the integration project is by tracing the underlying rationality criteria and functions assigned to the law (which in the end mirror the changes in governance modes). Following the sequencing proposed by Joerges (2007, 2016), it is possible to distinguish the following three phases.[99] First, an "integration-through-law" phase, which focuses on the legal nature of the Union.[100] The question goes beyond the analysis of the Community/Union's nature; this characterisation responds to the need to better understand the relationship between the normative quality of the supranational law and its effectiveness. The action performed by the European Court of Justice (ECJ) in this realm has been of the utmost importance, especially in relation to the principle of supremacy of EC/EU

[97] Article 4 (3) 2 para. SSM Regulation.
[98] Although it has to be mentioned that some specific actors, such as the European Association of Public Banks (EAPB) have questioned during the respective public consultation whether the ECB could issue such a regulation, which indeed provided for a detailed set of rules.
[99] As a matter of clarification, the sequences explained here do not mean that each phase is over by the time the following begins. Although the sequence is accurate and fulfils its purpose of analytical device, there are of course overlaps and coexistence among different phases.
[100] Back then referred to as the 'Community system'.

law. However, this conceptualisation has equated integration with uniformity (Joerges 2012), which relies on a one-size-fits-all approach philosophy in an ever more diverse Union.[101]

Perhaps one of the most important exponents of the integration through law approach is Weiler, whose dual characterisation of supranationalism has been described earlier. This conceptualisation of supranationalism has been portrayed as the "traditional or orthodox version" (Joerges 2007, 14), which relies on a more "vertical" approach to EU law (Joerges 2005). The alternative view is that of *deliberative supranationalism* (Joerges and Neyer 1997; Joerges 2002, 2005), developed as a response to the integration-through-law approach. Deliberative supranationalism grounds the validity of EU law "on the normative (deliberative) quality of the political process that created it" (Joerges 2005, 14). The underlying idea is that, given the existence of a multilevel system, the legitimacy of this transnational governance arrangement has to "be measured by the deliberative quality of the decision process" (Joerges 2002, 139). This concern about governance legitimacy has been complemented by the *conflicts-law constitutionalism* approach (Joerges 2007, 2012; Everson and Joerges 2012). Under this conception, EU law has the potential to perform key functions in light of the observed democratic deficits at the national level: "European law has the vocation to compensate for the democracy failures of the nation states" (Joerges 2012, 2), and it can also organise cooperative problem-solving instances in order to overcome the nation States incapability to autonomously cope with societal concerns.[102] Joerges' complementary

[101] For a detailed review of the "effectiveness" of EU law as an integrative tool, together with other non-legal tools deployed at the supranational level, see Snyder (1993).
[102] The same consideration has been pointed out by Schelkle (2017, 35), when explaining the problem of rational cooperation in the context of "monetary solidarity", and the "perennial" democratic deficit charge against the EU: "While not a false accusation, it misses an important point: the democratic deficit is the flip side of the attempt to mend deficits of national democracy. It does so by committing elected governments to policies that can be rationally justified as in the common interest and hence are not easily changed by shifting national majorities or domestic special interests."

characterisation of supranationalism is a response to an increasingly complex polity that needs to justify the deployment of its activities and cope with a wide range of member States diversity. On a smaller scale, this is also a key concern for the SSM: maintaining its level of legitimacy in complex and varied contexts.

Going back to the evolution of the integration path, a second phase is characterised by a shift towards a market-oriented culture, starting with the Delors Commission internal market project, as outlined in Chapter 1. This period has also witnessed the turn to regulation and governance, which could be interpreted "as an attempt to respond to the practices developed in the shadow of the internal market policy, compensate for their pragmatic and legitimatory weaknesses" (Joerges 2007, 18). During this phase, substantive integration milestones have occurred: after the Commission's White Paper on "Completing the Internal Market", the Single European Act was enacted in 1986 (with a turn to majority voting), followed by the establishment of EMU and Maastricht Treaty in 1992, the Stability and Growth Pact (SGP) in 1997, and the Commission's White Paper on 'European Governance'" in 2001.[103] By fully embracing the governance parlance, the Commission has taken account of the experiences gathered so far in the internal market programme, and the need for a proactive cooperation in increasingly complex socio-economic domains (Joerges 2002), which has entailed a reconfiguration of activities and actors.

A third (and partly ongoing) phase in the evolution of the integration project, is that of "emergency Europe" (Joerges 2016). Although the most acute part of the crisis is probably over, we are still operating within the legal and institutional frameworks created at this juncture. In relation to this third phase, some authors have critically pointed out the asymmetric

[103] COM (2001) 428 final, 25 July 2001.

nature of the integration process, which started back in 1992 with the EMU process and escalated with the fiscal and financial crises. Perhaps one of the most revealing expressions was the demise of the EU *political culture of total optimism*, coined by Majone (2015, 1): "the collapse of the EU's political culture of total optimism—a general attitude of the euro-élites that found its clearest expression in the Maastricht Treaty with its commitment to proceed with monetary union by a fixed date, notwithstanding the failure to reach agreement on some key aspects of monetary policy".

Other transformations occurred at the decision-making and relational levels: concerning the former, decision-making should be made more accountable and contestable, especially in the case of "executive accountability" (Joerges 2016, 23)—the ECB being one of the institutions that is part of this criticism; in relation to the latter, relationality or "how EU law and government relate to domestic institutions, processes, and symbols [has been] dominated by too much hierarchy … and mistrust " (Joerges 2016, 24). These observations have not only exacerbated the widely debated democratic deficit in the EU, but have also prompted additional claims regarding the need to produce deeper institutional transformations, due to the increasing transfer of powers to the supranational level and the persistent diversity within the Union.[104] This point is of particular relevance in light of the analysis of the existing diversities in the banking sector, and how different local preferences are dealt with in a framework characterised by an increasing harmonisation.

[104] The point is clearly stated by Joerges (2016, 17/18): "the further transfer of essential powers to the Union would, in order to remain democratic, have to be embedded in democratic processes and go hand in hand with profound institutional transformations… For this reason, the persistent diversity of Europe is not only a factual obstacle, but gives rise to normative objections against federal or quasi-federal visions. The varieties of European capitalism and social models are the result of historical processes, often bitter contestation, the formation of preferences and their evaluation, which cannot be undone."

Other authors have noted pre-crisis settings that have contributed to the "hollowing out" of national authorities (Della Sala 1997). For instance, Chalmers (2016, 270) has emphasised the way in which the SGP has "overlooked national systems of public finances, and claimed a pre-eminent substituting legal authority for this regime". Such redefinition of public finances has also instrumentalised them.[105] Furthermore, the sort of instruments that are utilised by the Commission, in this case, do not comply with formal legal structures but are rather "malleable notions" (Chalmers 2016, 275), whose legal consequences that could be triggered by a formal breach are not clear, also because they are constantly revisited. These two characteristics, i.e., the non-legal malleable notions and the revisability, are important in light of specific features of the SSM instruments that will be pointed out in the subsequent chapters. Other literature strands have focused, instead, on the specific means used by the supranational authorities to achieve a "conflict-minimising integration" (Genschel and Jachtenfuchs 2016) in spite of being massively criticised. This point is analysed in the subsequent section, which focuses on the modes and instruments of integration, and touches upon the related question on "competence creep" (Weatherill 2004, Garben 2019).

Before concluding this section, it is worth investigating the relationship between the limits of this (seemingly) deepening integration, and the legitimacy concerns that might arise all along this process, including the supranationalisation of banking supervision in the hands of the SSM. Perhaps one hint to better understand underlying legitimacy concerns is the idea of "inverted regionalism" coined by Weiler (1995), which could be understood as follows: "even if the Union were to replicate in its system of governance the very same institutional set-

[105] He further explains how "a non-majoritarian institution monitors the risks posed by national activities to these goods on the grounds that it has credibility, expertise, and is not affected by the pressures posed by electoral processes" (Chalmers 2016, 273). Even though he is referring to the European Commission, similar considerations apply to the case of the SSM.

up found in its constituent States, there would be a diminution in the specific gravity, in the political weight, in the level of control of each individual within the re-drawn political boundaries (Weiler 1995, 232). Although this notion could seem too abstract to be applied to case at hand, some implications can be inferred. Irrespective of its benefits, supranationalisation of supervision and the much needed 'horizontal view' bear the risk of overlooking concrete situations and particular needs, thus creating the risks of increasingly disconnect specific needs of the banking sector from the real economy and concrete societal demands. This could be seen as a natural trade-off between, on the one hand, a better horizontal view of common risks and problems affecting similar groups of banks and, on the other, the need to deep dive into the specificities surrounding a particular credit institution. This claim is examined in more detail and supported by empirical materials in the corresponding chapters.

2.2.3. Modes and instruments of integration

The previous subsection has focused on the criticism to the ever closer union. This one, instead, draws its attention to the modes and instruments of integration that have been identified in the literature, which provide a useful analytical lens through which the tools that have been deployed in the domain of prudential supervision can be examined. This, in turn, helps better understand the emergence and evolution of different modes of governance, i.e., patterns of interaction amongst social actors, which is then reflected in specific manifestations of integration.[106]

[106] The governance indicators are introduced in Section 2.5.2 below.

Integration by	**Instruments**	
Modes	**Regulation**	**Capacity Building**
Stealthy/Covert	Taxation, internal security, defence, procurement	EIB, Europol, Eurojust, Frontex
Publicity	Lisbon Agenda Europe 2020, fiscal surveillance under EMU	EMU/ECB, EFSF, ESM

Table 2.2: Patterns of EU integration of core state powers. Source: Genschel and Jachtenfuchs (2014, 10).

According to the typology proposed in an edited volume by Genschel and Jachtenfuchs (2014), it is possible to analytically distinguish between *modes* and *instruments* of integration (Table 2.2). Modes can take two different form: on the one hand, *publicity* occurs whenever there is a politically open instance of integration, supported by specific treaty provisions. On the other, there is a *stealthy* or *covert* approach to integration (Majone 2005, Meunier 2017), when a process "takes place outside the formal European political decision-making arena" and touches upon areas of core State powers (Héritier 2014, 230). Concerning the second analytical category defined by Genschel and Jachtenfuchs, it is possible to identify instruments of integration.[107] In this sense, they distinguish between regulation and capacity-building.

In a later contribution, the same authors empirically explore the unfolding of these two instruments: "the EU can either regulate how Member States use their national capacities for policy making (integration by *regulation*), or it can create such resources for itself and use them in addition to those of the Member State (integration by *capacity building*)." (Genschel and Jachtenfuchs 2016, 171). However, their understanding of the EU as a regulatory polity goes beyond the original conception by Majone (1996), according to which the EU integrates

[107] When developing this typology, the authors stress the importance of separating empirical from analytical considerations, given that in reality there might not necessarily be such a clear-cut distinction between instruments and modes of integration (Genschel and Jachtenfuchs 2014).

the internal market through harmonisation. Under this paradigm, the EU "subjects policies which are remotely or not at all related to the internal market to European regulation, including core state powers such as security, budgets, and public administration" (Genschel and Jachtenfuchs 2016, 171). The 'integration by regulation' strategy leaves the vertical division of competences intact; however, the creation of European capacity dramatically changes this vertical division of power between the EU and the member States, by creating more resources for the former. This differentiation points out to fundamental aspects related to redistributive effects, as the creation of common capacities exacerbates the costs and benefits, contrary to a less intrusive integration by regulation.

When analysing how the EU has been surmounting different integration challenges, the authors pinpoint two main strategies: one is the "relaxation of the unanimity requirement" (Genschel and Jachtenfuchs 2016, 169),[108] and the other is the use of "conflict-minimising strategies", in line with Héritier's 1999 analysis. Some of the techniques to accommodate underlying intergovernmental conflicts include delegation to non-majoritarian actors, incomplete contracts, and integration by regulation (Genschel and Jachtenfuchs 2016, 170/1).[109] According to the authors, banking supervision has been part of this conflict minimizing strategy, and one of the key features of the system is the strong delegation to independent institutions, such as the ECB. They stressed the fact that the banking union project entailed a substantive build-up of financial and administrative capacity, characterised by an unsettled division of powers between member States and the ECB, a good example of

[108] Which, according to the authors, has nevertheless created a decision-making architecture biased towards maintaining the status quo (Genschel and Jachtenfuchs 2016).
[109] An example of integration by regulation and incomplete contracts is the case of budgetary surveillance, characterised by an impressive scope and intrusiveness, and the fact that these rules strengthen the role of the European Commission, by transforming it "into the central supervisory and enforcement agency for member states' macroeconomic performance". (Genschel and Jachtenfuchs 2016, 176).

incomplete contracts which are a typical outcome of a joint decision-making situation.

Another term that has been coined in order to analyse—essentially stealthy or covert—modes of integration is that of *competence creep* (Weatherhill 2004, Garben 2017, 2019). It "refers to the adoption of EU legislation in areas where no specific legislative competence has been conferred on the EU" (Garben 2019, 206). This phenomenon can be materialised in different ways, some of which are relevant for the SSM analysis. In fact, those means identified as soft law and economic governance seem to fit some of the mechanisms deployed by the SSM in order to achieve greater consistency. What these two competence creep manifestations have in common is that they involve non-binding measures from an EU Law perspective but, in spite of this informal characteristic, they "carry important normative power and constrain national action in various ways, doing so largely without the free involvement of the legislator and particularly the European and national parliament" (Garben 2019, 2017). These means represent another instance of covert integration, or stealthy mode, which accentuates the legitimacy deficit at the EU level. In the case of the instruments issued by the SSM, specific considerations will be made in light of the highly-technical nature of the regulatory and quasi-regulatory tools which, in spite of their non-binding nature, are capable of triggering concrete consequences in the oversight of financial institutions, reducing NCAs room for manoeuvre in interpreting and applying those tools when it corresponds.

One final point to be mentioned in the context of this subsection relates to the *deepening* of integration (Héritier 2014). In a study characterising the increasing task expansion at the EU level, Börzel (2005, 220) analyses the integration process along two dimensions:

> The *level* (breadth) of integration refers to the locus where the competence for policy decisions resides. It is operationalized by the number of issues in a given policy sector for which the EU has the power to legislate . . . The *scope* (depth) of integration is not understood as the initial expansion of EU tasks into new issue

> areas . . . Rather, scope is operationalized by the procedures according to which policy decisions are taken focusing on the involvement of supranational bodies and Council voting rules.

According to the operationalisation proposed by Börzel (2005), the *level* of authority (i.e., "breadth") is given by the number of issues which fall under EU competence, while the *scope* of authority (i.e., "depth") by the involvement of supranational bodies and Council voting rules. Héritier (2014), in its turn, characterises the deepening of integration as the transfer of competences to the supranational level, and the stringency of policy prescriptions as a result of it. By combining Börzel's and Héritier's approaches, it is possible to connect both the level (breadth) of integration with the "transfer of policy making competences to a higher/supranational level", and the scope ("depth") with the "strictness and intricacy of policy prescriptions issued by the supranational level" (Héritier 2014, 230).

As further explained in the empirical chapters, banking supervision has seen a transformation at both the level and scope of integration. Regarding the former, there has been not only a transfer of policy-making and regulatory competences, but also the conferral of direct operational and adjudicative powers. As far as the latter is concerned, the strictness and intricacy of the provisions will be explored in Chapters 4 and 5, especially through the analysis of supervisory tools' characteristics.

2.2.4. Europeanisation and its differential impact across countries

Within the broad spectrum of EU studies, there is one field that deals with the empirical question of the impact of European integration upon member States institutions and policies: Europeanisation. The issues that this field aims to better understand and conceptualise relate

to what the EU causes at domestic levels, and how can those effects be isolated from concomitant processes (Exadaktylos and Radaelli 2015). Although the framework proposed by this vast strand of the EU studies literature might not seem directly applicable to the case under analysis—which to some extent looks at the opposite phenomenon—some of its premises are worth mentioning, as they can shed light on the diversity management examination.

To start with, scholars have identified *necessary* and *sufficient* conditions for Europeanisation to occur: regarding the former, there should be a policy and institutional misfit; concerning the latter, there are facilitating factors that follow either a rationalist or sociological institutionalist approach (Börzel and Risse 2003). Leaving aside the scope conditions, an interesting point highlighted by these studies is that they predict a "differential Europe" (Héritier et al. 2001). In fact, there is enough "empirical evidence that the outcome of the domestic effects of Europeanisation is much more diverse" than rational institutionalist or sociological institutional approaches account for (Börzel and Risse 2003, 24/38). This means that predictions that lean towards convergence might not be supported by the real Europeanisation processes and their effect on member States, since domestic institutional change ends up being categorised at best as 'mixed', given that some countries move towards convergence patterns, whereas others manage to keep their specific arrangements.

The Europeanisation framework provides an empirical refutation to simplistic accounts that "expect strong structural convergence". In fact, the economic meaning and conceptualisation of convergence depicts an overly optimistic picture, and theories that focus on economic convergence expect "increasing similarities in institutional arrangements in areas exposed to global market forces" (Börzel and Risse 2003, 25/38). From a legal perspective, a

similar prediction is the underlying assumption of the ‘integration-through-law perspective’, and the logics behind the use of maximum harmonising tools, i.e., Regulations.

It has to be acknowledged that measuring convergence or divergence is a difficult task, as the answer depends on two aspects that needs to be clarified when empirically assessing Europeanisation effects (Héritier et al., 2001). First, it is important to be clear about the *level* at which one looks for convergence: while at a macro level there might be some convergence, the same might not be the case at a deeper micro-level. A good example concerns the set of adaptations that took place at the national level in the run-up to the EMU project: what seems to be convergent at one level might not be at a lower level of analysis. Second, it is important to define the *object* of the convergence analysis: it can either be the outcomes (which would be similar to the analysis of compliance), or policy processes and instruments. Hence, Europeanisation studies provide important and complementary empirical insights in order to improve our understanding and refine the analytical tools to deal with implementation and integration studies.

Governance

2.2.5 Modes of governance

The word *governance* has become such a popular term in different fields of research that it is useful to devote some time to explain the meaning assigned to it in the present work, and its value as an analytical tool. The concept of governance is understood in the context of this research as those “patterns of interaction and coordination of social and political actors for the purpose of adopting and implementing collectively binding decisions” (Diedrichs et al. 2011,

20). This broad definition captures the whole decision-making and law in action cycle, given that it comprises preparation, adoption, implementation, and control of decisions. Since the definition comprises both the *adoption* and *implementation* of *binding* decisions, there are two arguments that could be potentially raised against this definition. First, it could be argued that the SSM is not a rule-maker, and therefore the only relevant concept is that of implementation. Second, it can be claimed that the SSM, even in the cases in which it regulates, issues not only binding, but also a variety of non-binding instruments as well. These assertions are partially true. In relation to the first one, the SSM has widely exercised its regulatory powers conferred by the SSM regulation in Art. 4 (3) 2nd para., sometimes under legally doubtful circumstances as shown in Chapter 5. Regarding the second objection, characterising these tools as non-binding may be right only if a formalistic perspective on the matter is adopted. A closer look at these instruments, the way in which they are formed, and the consequence that are triggered in case of non-compliance, reveals a much more nuanced picture than the dichotomy between hard binding and soft non-binding rules.[110]

As explained above, the "governance turn" represented one of the phases in the integration journey; from an academic and analytical perspective, it has been accompanied by developments in other fields, such as policy analysis and international relations. In systematising this knowledge, the governance turn examines first a "process dimension that explores the patterns, instruments and conditions of policy formulation and implementation and the diversity of actor constellations. Second, it reflects the different aspects of 'system transformation' (at both EU and national levels)" (Kohler-Koch and Rittberger 2016, 33).

[110] A more detailed explanation is provided in Chapter 4, in relation to the nature of the instruments, and chapter 5, which offers a wider typology of supervisory instruments.

Perhaps one of the most common ways of conceptualising this term is by assigning it a space of co-production between governmental and private and social actors, broadly speaking. Figure 2.2 schematises different dimensions that account for the concept of governance. Although these dimensions provide a comprehensive overview of the complexities embedded in the term governance, it is hard to operationalise and empirically examine all of them, at least in the context of this research.

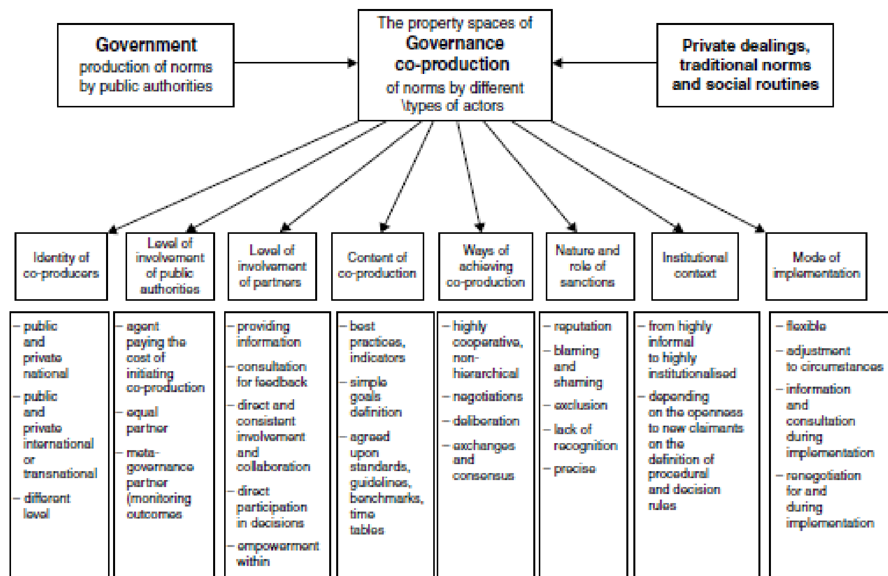


Figure 2.2: Eight dimensions of variation in forms of governance. Source: Bartolini (2011, 13).

The review provided in this section cannot fully do justice to the wide literature concerning different modes of governance, the multiple theoretical lenses through which it is possible to analyse the topic, and the series of subfields within this umbrella term.[111] However, in order to sharpen the theoretical approach and make a stronger link with the proposed framework of analysis, I will limit the review to the most characteristics modes of governance

[111] For a comprehensive analysis and a detailed review of these elements, see the edited volume by Levi-Faur (2012), which also focuses on economic, risk, democratic, European, and global governance. In the context of the present chapter, the fields of European and risk governance are analysed in more detail.

theoretically and empirically found, in order to examine the extent to which they can be applied to the SSM case. The three modes of governance that are examined in the rest of the section are: hierarchical governance (and the so-called "shadow of hierarchy"), network governance, and experimentalist governance.

Hierarchical governance is characterised by a top-down, traditional command and control exercise of power, which has served as the "backbone of the modern welfare states that developed in most Western countries in the aftermath of World War II" (Torfing 2012, 1/16). When tracing the origins and different dimensions attached to the concept, Levi-Faur (2012) claims that an influential distinction that helped mature this characterisation has been Williamson's (1975) distinction between markets and hierarchies. As a response to this dichotomic market vs. hierarchies conception of governance, the notion of *networks* emerged, as a means of recognising the ever increasing importance of informal spheres of authority (Levi-Faur 2012). Governance networks can be defined as a "horizontal articulation of interdependent, but operationally autonomous, actors from the public and/or private sector who interact with one another through ongoing negotiations" (Torfing 2012, 3/16). The "horizontal" link in this form of governance contrasts with the more "vertical" type of relationship present in hierarchical modes.[112]

An alternative way of conceptualising emergent modes of governance is the joint work by Sabel and Zeitlin (2008, 2010, 2012), that develops the idea of *experimentalist governance*. This is an effort to make sense of some of the most profound transformation in contemporary

[112] In any event, the hierarchical element can be expressed in other subtler modes. In fact, the idea of "shadow of hierarchy" (Héritier and Lehmkuhl 2008, 2011), reflects the critical importance of the State in the development of alternative modes of governance. For example, in connection with the public-private decision-making modes, the authors claim that the "industry is only likely to engage in collective action if confronted with a credible legislative threat or the 'shadow of hierarchy'. In other words, governments have to exert some pressure before industry takes the necessary self-regulatory steps" (Héritier and Lehmkuhl 2011, 55).

governance. The authors propose two scope conditions for the development of experimentalism: this first is *strategic uncertainty*, which is "the situation where the parties face urgent problems, but know that their preferred problem-solving strategies fail and therefore are willing to engage in a joint, deliberative . . . investigation of possible solutions" (Sabel and Zeitlin 2012, 11/16); the second is a *polyarchic* distribution of power, meaning that there is no single actor capable of imposing its own views without carefully considering the view of others (Sabel and Zeitlin 2008). A full-blown experimentalist architecture consists of four key elements that are linked in an "iterative multi-level cycle" (Rangoni 2019, 65), which are depicted in Figure 2.3 below. These elements—local discretion, comparative implementation and monitoring, and non-governmental stakeholders consultation—are further discussed in the final section of this chapter, given that they can be used as indicators to empirically assess the extent to which the range of practices developed by the SSM are in line with an experimentalist architectural design.

In a study of the evolution of EU governance following the financial and eurozone crises from an experimentalist standpoint, Zeitlin (2016) provides an early analysis of the SSM's modes of governance, in order to examine "not only the institutional design of the revised governance arrangements but also their practical operation" (Zeitlin 2016, 1077). This initial assessment of the practices deployed by the SSM claimed that, despite having a more centralised institutional designed compared to the ESAs framework,

> Experimentalist practices of 'learning from difference' in joint teams of European and national supervisors, contextual adaptation of common rules and processes to banks' individual risk profiles, and recursive revision of supervisory methods on the basis of comparative benchmarking and review appear to be flourishing, at least for now, under a hierarchical veneer. (Zeitlin 2016 1090)

This conclusion is based on the assessment of the SSM as a simplified experimentalist architecture, and the acknowledgement of the specific characteristics of supervisory activities, which prevents the SSM from imposing 'one-size-fits-all' approaches but, instead, urges it to embrace banking diversity and the exercise of case-bounded supervisory judgement.

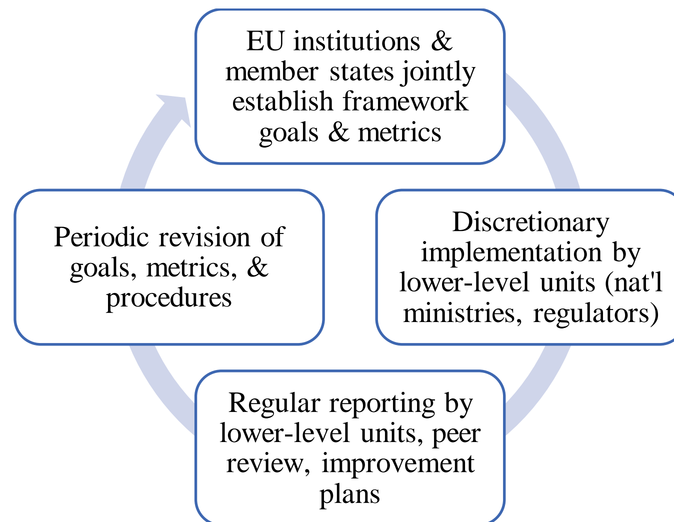


Figure 2.3: EU experimentalist governance as an iterative, multi-level architecture. Source: Zeitlin (2019).

Before moving on to the following section, it is important to clarify that, in spite of the analytical distinctions developed above, these modes of governance are not always mutually exclusive, and therefore it is possible to empirically find some sort of "governance mix", in which pure forms do not exist. Therefore, whether these modes supplant or supplement each other, depends on the research object and the level of analysis. The last section devoted to the examination of governance focuses on one of its manifestations that lies at the heart of the supervisory activities carried out by the SSM: risk regulation.

2.2.6 Risk governance

Before concluding this subsection, it is useful to introduce some notions in relation to *risk governance*. Risk governance embraces a vast set of policy domains ranging from health, climate, environmental, agriculture, and finance, among others. Risk regulation can be understood as the activity that aims to minimise and manage risks resulting from the development, production, and use of technological innovations, which in turn interferes with market and social processes to control or minimise adverse consequences that affect publicly protected interests (Weimer 2019, citing Hood et al. 2001).

In the banking and financial regulation domain, the question concerning risks drivers is fundamental from both technical and political perspectives. More importantly, perhaps, is the *extent to which* these risks are to be tolerated—which, again, is not only a technical issue but fundamentally a political one, given that it entails key distributional concerns.[113] In fact, risk regulation involves a "fictional certainty":

> Risk regulation does not aspire to eliminate risk but to substitute acceptable for unacceptable risk. To accomplish this, risk regulation carves up the amorphous totality of risks we are exposed to into discrete, manageable segments, and it engages with these segments to the exclusion of others. (Heyvaert 2011, 820/1)

Although these considerations have been made in the context of climate change, it is possible to transfer them to the banking supervision context. In fact, banking supervision is essentially a risk-governance activity. The ECB's Supervisory Manual (SM) explicitly embraces a risk-based approach to banking supervision: this means that activities are geared towards a consistent treatment of risks, both across jurisdictions and credit institutions.

[113] The extensive work of Sheila Jasanoff (2012, 2013, among others) has been particularly influential in the realm of risk regulation, and how the technical or scientific aspects of it are deeply rooted in political institutions and preferences.

If risk regulation and its subsequent application operate within a 'fictional certainty', this is because policy-makers need to find a way to deal with *uncertainty*.[114] As explained in Section 2.5 above, uncertainty, together with a polyarchic distribution of power, is one of the scope conditions under which the development of an experimentalist governance approach would be expected (Sabel and Zeitlin 2008, 2010). Banking supervision presupposes and entails exposition to uncertain scenarios; hence, the way in which the SSM deals with the risks stemming from the banking activity can provide some insights into its governance modes. This is in fact the aim of Chapter 4, which examines the evolution of one of the most important supervisory tools, the SREP, with a view to evaluate the extent to which the governance approach has changed compared to the pre-supranationalisation of supervision. The SREP comprises two specific assessments that are analysed in detail—Internal Capital and Liquidity Adequacy Assessment Process (ICAAP and ILAAP, respectively—which, in spite of the highly-technical nature, gives a glimpse of the SSM's approach to uncertainty and what it expects from the credit institutions that are the sources of such risks. The ICAAP and ILAAP instruments are also important because they illustrate the blurred lines in the SSM governance between regulation and supervision, as later explained in the empirical chapters. Hence, even if this work does not rely on a risk-regulation framework as its main analytical tool, it acknowledges that this strand of literature dealing with different policy domains, provides insightful keys for interpretation.

An author that has deeply studied the management of risk in the banking and financial sector is Julia Black. In a 2010 paper co-authored with Baldwin, the authors provide a rich

[114] "Uncertainty, in this view, is not a lack of knowledge which can be remedied, but is instead the inescapable consequence of the process of the self-creation of society beyond tradition, which has to be accepted as a precondition of societal operations." (Ladeur 2015, 56).

account of what constitutes a *really responsive risk-based regulation* system. In their analysis, the authors identify five core elements that represent the main challenges faced by regulators. Although Black and Baldwin refer to regulators, these considerations are applicable to the SSM, which despite being the supervisory authority it nevertheless redefines the rules of the game while applying them, which makes the regulation-supervision distinction somewhat blurred.

A first factor is the "responsiveness to the behaviour, attitudes, and culture of the firm" (Black and Baldwin 2010, 7). In fact, one of the challenges of incorporating behavioural and cultural matters into risk-based assessments is related to the key difference between risk-based assessment and compliance-based assessment: the former is forward-looking, while the latter aims to evaluate in an *ex-post facto* fashion what has been done.[115] The "prospective subjectivity" inherent to risk-based regulation is an essential aspect, but "discretionary decision-making" needs to take into account a desirable level of *consistency* across evaluators (Black and Baldwin 2010, 7/8, emphasis added). This last consideration is of particular significance in the case of the SSM, where the consistency challenges arises not only at the abstract and legal levels, but at the implementation one too. And this is, indeed, the greatest challenge for the SSM: how to ensure a consistent implementation.

Within the structure of the SSM, the technical and methodological support to deal with the consistency challenge is given by the work carried out by DG MS IV. However, the "horizontal view" developed at this DG, involved other difficulties that arise from the use of "risk-analyses to guide all regulatory operations" (Black and Baldwin 2010, 8). Although these

[115] An example of a potential clash between these assessment tools will be given when examining the SREP and, especially, the ICAAP public consultation procedure in Chapter 4, in which one of the critical points raised by some stakeholders relates to the conceptual confusion between risk *appetite* and risk *managemen*t by the SSM.

horizontal tools, such as risk scoring or peer reviews, can help identify high-risk actors, they might be less useful in the identification of the *mode of intervention* that is best suited to assure compliance. In fact, "the *kind* of intervention required, may at best be loosely linked to the level of risk that the firm presents" (Black and Baldwin 2010, 9). This is a fundamental aspect in the context of supranational banking supervision given that, even in the presence of similarly-scored or profiled institutions, the SSM might need to apply different tools depending on the cases, so the rationale behind peer-grouping credit institutions might—in some instances—not be enough to determine the level of supervisory intrusiveness needed. In fact, one of the mechanisms through which the SSM puts the principle of proportionality into practice, is by calibrating the *intensity* and *frequency* of the supervisory interventions which, in the end, depend on the level of risk posed by the specific institution.

The second element of Black and Baldwin's *really responsive risk-based regulation* framework is the "responsiveness to the institutional environment" (Black and Baldwin 2010, 12). This element resonates with the SSM in light of the different "institutional environments" in which it has been inserted and with whom it needs to interact in the conduct of everyday supervision. I am referring to the NCAs and the cooperation levels between national and supranational actors. A third element is the responsiveness to the interaction between regulatory tools and strategies—"logics of control instruments" (Black and Baldwin 2010, 15). These considerations are related to the competing logic explained above, which might hinder the effective application of the rules: "the mismatching logics of risks and compliance can thus produce significant lacunae in the regulatory regime at the point of implementation and enforcement." (Black and Baldwin 2010, 17). The last two elements, "responsiveness to regime performance" and "responsiveness to change"—in each of the elements—(Black and

Baldwin 2010, 17/22), can be mentioned together, since they both refer to the capacity to react from past experiences and learn from those, in a forward-looking manner; they deal with the capacity of the regulator to act in a reflective manner. These last elements from the *really responsive* framework point out some of the components detailed in Figure 2.3: revision is informed and driven by actual application experiences.

These elements that constitute a *really responsive risk-based regulation* highlight the challenges faced by the SSM not only when applying the existing regulation, but also when actively defining its field of action, which sometimes requires the redefinition or clarification of specific situations not foreseen by the regulator.

To conclude, this section has provided additional elements from the risk regulation and risk governance literatures that help frame and qualify the activities conducted by the SSM. The following section focuses on the diversity management faced by the SSM, which is analysed in greater detail in Chapter 3.

2.3 Managing diversity

2.3.1 Differentiated integration and the experimentalist alternative

The question of diversity management is transversal to any field of EU law and governance, and is perhaps one of the key puzzles that EU scholars have been dealing with given the rising number of member States and the concomitant need to accommodate a larger number of preferences and local contexts. Indeed, the diversity question is intricately connected to the integration project and its limits. The "limits" in this context refer to the existent limitations to

uniform regulation in a heterogeneous policy and the critique towards "one-size-fits-all" approaches (Zeitlin 2019).

The underlying premise according to which a deeper integration of the internal market requires uniform regulation, has neither been promoted by the 1985 Commission's White Paper on "Completing the Internal Market", nor by the integration through law approach. The intellectual seeds of this conception can be traced back to two fundamental assumptions in the comparative law domain (Teubner 1998). The first one is the 'convergence thesis', which implies that in the context of Europeanisation and globalisation, industrial nations are expected to converge towards similar socio-economic structures. The second is the 'functional equivalence': although national legal frameworks are based upon different doctrinal traditions, "they face the same structural problems which they have to resolve" (Teubner 1998, 13). Contrary to these assumptions, even in highly-technical fields, legal transplants insulated from their broader societal context will not end up working as expected. Teubner (1998, 19) refers to the existence of different legal *épistémes*, or different styles of legal reasoning. Likewise, Jasanoff (2012, 2013) has developed a similar idea with her conceptualisation of *public reason*, meaning the ways in which "policy-relevant knowledge is generated, how it is evaluated for policy purposes, how scientific disputes are resolved, and how lay publics are engaged in decision-making" (Jasanoff 2013, 134). These "public epistemic practices" are a constitutive dimension of the political cultures.

Therefore, the problem of convergence and the main debates surrounding it go beyond the EU integration and governance contexts. The question of convergence is part of a broader debate that can be treated more as one of epistemological differences than simply theoretical approaches. For instance, Legrand (1996) argues against simplistic assumptions in relation to

the convergence of European legal systems. In his view, “comparative legal studies leads the lawyer astray by suggesting that to have knowledge of the law is to have knowledge of the rules (and that to have knowledge of the rules is to have knowledge of the law!)” (Legrand 1996, 60). He claims that a myopic focus on rules only does not properly account for underlying differences in the legal cultures, which is a much deeper phenomenon. “The comparatist must, therefore, focus on the cognitive structure of a given legal culture and, more specifically, on the epistemological foundations of that cognitive structure”: this is what he characterises as “the legal *mentalité* (the collective mental programme)” (Legrand 1996, 60). The affinity between the concept of legal *mentalité* and legal *épistémes* is manifest, and is also in line with Jasanoff’s *public reason*, which focuses not so much on legal but on political cultures and how these are shaped. These considerations provide a solid theoretical ground for the analysis and discussion developed in Chapter 3, in which the question of “diversities” is explored.

Since differences among member States persist, instead of imposing homogeneous regimes, the institutional response has been to provide an alternative mechanism in order to prevent deadlocks in the integration process; this is what *differentiated integration* is meant to achieve. Differentiated integration “is part of the DNA of the European Union” (Antoniolli 2019, 84), and part of the complex institutional architecture of our days is precisely the outcome of the ups and downs of the integration process. For instance, the pillar architecture established by the Maastricht Treaty entailed the creation of a comprehensive institutional framework that “granted different powers to EU institutions and member States depending on the competence and pillar involved” (Antoniolli 2019, 85). This asymmetric institutional design mirrors some of the fundamental ambiguities of the integration project, which

comprises a patchwork of economic purposes with limited political and social integration aims that only came later in time.

The attempts to conceptualise differentiated integration have not been simpler than the phenomenon itself: "multi-speed (leaders/laggards), multi-tier (core/periphery), multi-menu (variable geometry, Europe à la carte)" (Zeitlin 2019, 3) are some of the dimensions that have been examined in order to account for a comprehensive typology. Models have evolved from traditional tripartite classifications into time, space, and matter (Stubb 1996, cited by Antoniolli 2019), to more sophisticated constructions, such as the six-dimensional proposed by Holzinger and Schimmelfennig (2012, cited by Antoniolli 2019, 95): "permanent versus temporary differentiation; territorial versus functional differentiation; differentiation across States versus multi-level differentiation; differentiation within versus outside the EU Treaties; EU level decision-making versus regime level decision-making; reserved to member States versus extended to non-EU countries". This multi-dimensional characterisation of differentiated integration can be also examined in tandem with other modes and instruments of integration, in line with the typology presented in Section 2.2.3 above, and also taking into account the element that characterised the 'competence creep' approach—which in relation to the SSM case comprises the use of soft law instruments and economic governance.[116] This is in fact connected to the ultimate aim of an empirical examination of differentiated integration: to assess, on a case by case basis, whether its effects are centripetal or centrifugal, i.e., whether they strengthen or hamper integration (Antoniolli 2019).

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[116] The need for a better and updated understanding of the diversity management in the EU is epitomised by ongoing academic enterprises, such as the "Integrating Diversity in the European Union (InDivEU)", a Horizon 2020 interdisciplinary funded research project that aims to analyse different scenarios of differentiated integration, its foundations, and explore alternatives to it. One of the alternative theories is precisely experimentalist governance. More details are available in the official website: http://indiveu.eui.eu/ (last accessed 6 January 2020).

An alternative way to address diversity in the EU is provided by the experimentalist governance, which has already been examined in Section 2.2.5. Although it was introduced in the context of 'modes of governance', the experimentalist approach can also provide a way of surmounting some of the challenges raised by diversity. In fact, the starting point that its proponents have taken (Sabel and Zeitlin 2008, 2010), is that in many core policy areas, EU governance is not characterised by a hierarchical top-down approach; on the contrary, rule-making and revision follow an experimentalist pattern based upon comparative implementation experiences from local context. As shown in Figure 2.3, in its most developed form, experimentalist governance comprises four fundamental elements that are cyclically organised: common frameworks of action established by EU institutions and member States; scope for local discretion in the implementation; regular reporting, peer reviews and other comparative assessments; and systematic revision of goals, metrics and procedures (Zeitlin 2019, slide 8). Section 2.5.2 takes these core elements in order to develop heuristic governance indicators which are subsequently used in the empirical analysis.

Albeit not universally present in EU regulation, experimentalist approaches have been extensively applied in different policy realms, such as competition, energy, telecoms, environmental protection, and financial regulation, among others (Zeitlin 2015, 2016).[117] In order to assess the suitability of the experimentalist framework in the diversity management context, it is important to consider its potential advantages in relation to its alternatives. First, experimentalist governance provides a more flexible framework to adjusts common goals to specific contexts, instead of imposing one-size-fits-all solutions. Second, the learning-by-doing approach entails a more dynamic mechanism that enables updates and improvements of

[117] Zeitlin's 2015 edited volume analyses different policy areas in which experimentalist traces can be found.

the framework, based on the problems identified during the implementation phase. As already mentioned in the governance section, it is important to note that this architectural framework is rarely found in its "pure form", meaning that in practice experimentalist governance coexists with other hierarchical forms, and that in some policy fields it is not possible to identify all of the elements that account for a fully-fledged experimentalism.

The question is now the extent to which the analysis of alternatives to diversity management is applicable to the SSM case, and the ways in which it can help better understand the consistency-diversity paradox. Although some early assessment on the SSM have highlighted experimentalist's traits at least in its simplified forms (Zeitlin 2016), its institutional and practice evolution calls for a more nuanced characterisation, as explained in Chapters 4 and 5. In order to set the foundations for the diversity framework developed in Chapter 3, the next section clarifies some fundamental conceptual aspects.

2.3.2 Unravelling diversity in the context of banking supervision

What is it about diversity that matters here?

When addressing the puzzle of diversity, this work distinguishes between two dimensions. The first one can be considered "positive": this is the inherent diversity of the banking sector, that includes the different types of institutions that operate either nationally or on a cross-border basis. This type of institutional diversity is positive for two reasons. First, because both legislators and supervisors fully embraces this type of diversity amongst credit institutions, and acknowledges the importance of recognising and protecting financial diversity in order to

enhance the resilience of the system as a whole.[118] Second, institutional diversity is not only positive, but is also connatural to the activities carried out by banking supervisors. And this is so because banking supervision, in spite of being a densely regulated domain, is in the end confined to bespoke assessments that have to consider the situation of individual credit institutions.

The second dimension, instead, does not necessarily have a positive connotation: this concerns the question of national diversity. In fact, one of the key drivers of the supranationalisation of banking supervision and the delegation of competences to the ECB has been precisely the alleged forbearance from national supervisors, given the strong links between banks and sovereigns. Furthermore, the numerous regulatory options and national discretions (ONDs) allowed by EU law that had once served to protect local specificities, have been identified as a source of fragmentation of the single market and a threat to the creation of a level playing field. In spite of this pessimistic picture when it comes to national diversities or specificities, the present study looks beyond these claims in order to identify and examine the intervening factors at the country level that would require a more nuanced diversity management.

Furthermore, diversity challenges are often related to the issue of *proportionality*. Indeed, proportionality stands as a bulwark against a wide range of considerations: on the one hand, it is evoked in stakeholders' claims whenever any proposed measure is thought to threaten the institutions and business sector they represent. On the other, it is evoked by

[118] Recital no. 17 of the SSM Regulation specifically recognises the importance of institutional diversity in the supervisory context: "When carrying out the tasks conferred on it, and without prejudice to the objective to ensure the safety and soundness of credit institutions, the ECB should have full regard to the diversity of credit institutions and their size and business models, as well as the systemic benefits of diversity in the banking industry of the Union."

supervisors in order to account for the fact that 'specific circumstances have been considered' when applying the relevant regulation. Despite the similarities, diversity management differs from the principle of proportionality. For example, the Supervisory Manual rightly refers to proportionality in relation to the treatment of both SIs and LSIs, given that the conduct of tailor-made assessments is at the heart of banking supervision. In this sense, "proportionality is integral to the manner in which the SREP is carried out: the *frequency, scope and depth of the SREP reflect the level of supervisory engagement that is deemed necessary for an institution . . . depending on its risk profile*"[119] (ECB 2018a, 80, emphasis added). The speeches delivered by the former SSM Chair also refer to proportionality as a means to apply the same set of "tough" rules on different institutions.[120]

A related additional element in assessing diversity is the question of LSIs supervision, which is explained in more detail in Chapter 5. LSI oversight is a supervisory and coordination challenge for both national and supranational authorities given that their supervisory treatment needs to be consistent; hence, it is necessary to apply similar methodological tools and comparable levels of 'supervisory engagement' (as the smaller size of an institution does not imply less stringent rules or a more relaxed supervision). This concern is illustrated by the following passage from the supervisory manual:

> The ECB is entrusted with an oversight responsibility to ensure that the supervisory activities carried out by NCAs are in line with high supervisory standards, also with a view to *fostering consistency of supervisory outcomes within the SSM*. The general responsibility for the oversight of the system therefore covers the oversight of supervisory practices and standards applied by NCAs . . . as well as the oversight of LSIs. (ECB 2018a 106, emphasis added)

[119] This is due to the risk-based approach that informs all supervisory activities, as developed in the risk regulation section above.

[120] This was examined through specific lexical functions provided by MAXQDA, that allow for a quick content analysis of key words. The frequency of a concept, however, is not an indication of its centrality. Hence, quantitative content analysis provides only a partial analytical view.

What emerges from this quote is that the achievement of consistency does not make distinctions between the SIs directly supervised by the ECB and the LSIs directly supervised by NCAs; on the contrary, the implementation of high supervisory standards in both groups is a key concern of the ECB. However, in the case of LSI supervision, the achievement of consistency needs to be balanced against the decisional autonomy and supervision carried out by the NCAs.

In practice, the coordination of the activities carried out by the NCAs and the development of joint supervisory standards for LSIs is done by DG MS III in close collaboration with the national supervisors, and this is usually done via stock-taking exercises or thematic reviews. It is worth highlighting that when dealing with LSI standard development, the Manual states that "it is necessary to take into account the characteristics of the banking sector, and if appropriate the legal framework, in the different countries" (ECB 2018a, 107). The document explicitly mentions that joint supervisory standards have to balance the interest, on the one hand, of fostering consistency but, on the other, "they need to consider specificities of LSIs" (EBC 2018a, 108). This allusion to LSIs' specificities acknowledges that there are differences that concern not only the type of credit institutions but also additional country-related elements, therefore recognising the two types of diversities discussed so far.

This section focuses on the two main sources of diversity that the operation of the SSM deals with: on the one hand, the diversity stemming from the variety of credit institutions, which can be assesses on the basis of size, riskiness, business models, among other criteria; on the other, diversity related to national legal and institutional aspects. Chapter 3 goes deeper in the analysis of these diversities, not only by fleshing out each of these dimensions, but also by suggesting the existence of additional culturally-related factors.

The following section aims to tease out key words that bear some resemblance to the notion of consistency, but that are worth clarifying before moving into the last section, in which the analytical framework for supervisory consistency is explained.

2.4 Making sense of the outcomes

2.4.1 Harmonisation, policy convergence, isomorphism, and norm and policy diffusion

Different terminology, different institutional aims?

Chapter 1 provided an overview of the evolution of regulatory harmonisation at both the European and international levels. The precedent sections have also explained how prior convergence or functional equivalence theories have been of little predictive value, and how the dichotomy between divergence and convergence does not do justice to the underlying complexities of Europeanisation and globalisation processes. Hence, a difficulty that emerges when trying to understand these processes, characterised by the imposition of identical rules in different context, and the degree to which outcomes are more or less homogeneous, is given by the proliferation of concepts and definitions that refer to similar but not identical phenomena.

In light of this conceptual challenge, this section unravels other notions that are normally associated with the outcomes of the integration process: convergence, diffusion, and isomorphism, in order to distinguish them from the issue of consistency and provide a clearer framework.

A first question that needs to be addressed in order to gain conceptual clarity is why is this chapter—and the whole dissertation—focused on the achievement of *supervisory consistency* and not, instead, on the *convergence of supervisory practices*? Does this terminological difference have any concrete consequences? The provisional and short answer is *yes*, there are differences between consistency and convergence, and the reason why the focus is placed on the former and not on the latter is because the attainment of supervisory consistency is the specific aim of the SSM, which can be distinguished from other policy aims and therefore from other (partially overlapping) institutions. The rest of the section is devoted to the characterisation of convergence and the related notions of harmonisation, institutional isomorphism, and diffusion, and their conceptualisation in the academic and policy domains.

A strand of literature that has theoretically and empirically dealt with convergence and its effects, is that of *policy convergence*. Comparative policy studies have conceptualised the different channels through which policy convergence occurs. Given its affinity and interchangeable use in the policy-making arena, an early parallelism between convergence and harmonisation is drawn. Despite its colloquial usage, comparative policy literature tends to conceive (international) harmonisation as one of the mechanisms through which convergence occurs (see Table 2.3).

An early review of the literature identifies five meanings of policy convergence: it can either refer to policy goals, policy content, policy instruments or institutional tools, policy outcomes or results, or policy styles (Bennett 1991). When conceptualising the processes that lead to policy convergence, this review identifies four causal channels. *Emulation* is characterised by a conscious and purposeful use of evidence generated by a foreign programme and the drawing of lessons from those experiences. In relation to *élite networking and policy*

communities, convergence is the result of identifiable élites that share similar backgrounds, ways of conceptualising policy problems, and have a common approach to their solutions.[121] Bennett (1991, 225) explains that although the consensus is shaped at the supranational level, the "locus of influence remains at the national governmental level". *Penetration* can be identified by the acquiescence of States to actions that have been taken by external actors in a different setting, further characterised by the dynamic role played by multinational stakeholders, such as corporations, in identifying common interests and acting to harmonise national policies.

The last mechanism of convergence is *harmonisation*, which is characterised by the presence of a solid group of transnational actors having a coherent motivation, and official action taken by intergovernmental organisations. This "authoritative action" (Bennett 1991, 225) at the supranational level and the acknowledgement of the interdependence among actors is what distinguishes harmonisation from the élite networking mechanism, which in his view had an essentially national connotation. Another difference is given by the fact that harmonisation presupposes the existence of a *formal* international regime, whereas the élite network factor entails more informal cooperation.[122]

In a later review of the policy convergence literature, Knill (2005) draws a distinction between *causal mechanisms* that trigger convergent changes, and *facilitating factors* that have

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[121] Very similar to the characteristics put forth by Haas' (1992) seminal paper on "Epistemic Communities and International Policy Coordination", published a year after this review article.

[122] This distinction, however, is not conclusive in the specific case of international prudential standards, i.e. the Basel Committee on Banking Supervision (BCBS). The differences between informal networks, on the one hand, and authoritative action and interdependence, on the other, become blurred. The BCBS is organised in working groups that deal with specific and highly technical topics but, in spite of this initial informality that shapes discussion and content, the influence of the decisions that are endorsed by the Committee, that are later on transposed into EU and national legislation, presupposes an acknowledgement of the reciprocal interdependence among the different Member States, and the importance of the soft law standards that are agreed upon.

an influence on the effectiveness of these mechanisms. One of the five mechanisms he identifies is "harmonisation of national policies through international or supranational law" (Knill 2005, 770). The four remaining mechanisms are independent problem-solving, imposition, regulatory competition, and transnational communication (Holzinger and Knill 2005, see Table 2.3).

Mechanism	*Stimulus*	*Response*
Imposition	Political demand or pressure	Submission
International harmonization	Legal obligation through international law	Compliance
Regulatory competition	Competitive pressure	Mutual adjustment
Transnational communication		
Lesson-drawing	Problem pressure	Transfer of model found elsewhere
Transnational problem-solving	Parallel problem pressure	Adoption of commonly developed model
Emulation	Desire for conformity	Copying of widely used model
International policy promotion	Legitimacy pressure	Adoption of recommended model
Independent problem-solving	Parallel problem pressure	Independent similar response

Table 2.3: Mechanisms of policy convergence according to the classification elaborated by Holzinger and Knill (2005, 780).

This review further compares the notion of convergence with *institutional isomorphism*. In fact, "when organizations in a field are similar [. . .] socialization acts as an isomorphic form", since these organizations "respond to an environment that consists of other organizations responding to their environment" (DiMaggio and Powell 1983, 153/149). Isomorphism predicts that the characteristics of an organization will be modified in order to strengthen its compatibility with the characteristics of the environment as a whole. In the course of this adaptive process, organizations do no compete just for resources or tangible

goods; instead, they also do it to reinforce their political power and institutional legitimacy. DiMaggio and Powell (1983) identify three mechanisms through which institutional isomorphic change takes place: coercive, mimetic, and normative. These mechanisms comprise those identified in greater detail in Table 2.3 above. *Coercive isomorphism* denotes a situation in which institutions change as part of formal or informal pressures (e.g., imposition or international harmonisation); *mimetic* processes are shaped by the power of uncertainty in specific policy domains, therefore, there is a tendency to imitate what has been done provided the limited experience; finally, *normative pressures* are tightly connected with professionalisation, common academic backgrounds, and the subsequent creation of networks that can have a cross-institutional impact, mechanisms that resembles that of epistemic communities.

Leaving aside academic considerations, policy-makers have also dealt with the conceptualisation of convergence, and more precisely, the convergence of supervisory practices. In this sense, the EBA defines convergence as "a process for achieving comparable supervisory practices in Member States which are based on compliance with the EU rules and which leads to *consistent supervisory outcomes*" (EBA 2017b, 7, emphasis added). This definition accounts for three key components of convergence: compliance, comparability, and consistency. There are in fact differences between the analysis of convergence from an academic perspective, which focuses mostly on the underlying mechanisms, and from a policy-oriented one, which focuses on the elements of convergence.[123] It is important to note that one

[123] Academic studies on policy convergence have been increasingly trying to distinguish the conditions (i.e., *when* or *under which* circumstances policy convergence takes place), from the causal mechanism underlying the convergence process (*how* it happens) (Löblová 2018). From a policy perspective, this does not seem to be the case, since for instance the analysis on convergence by the EBA does not focus on causal links but, instead, on the set of elements that account for a convergent policy domain.

of these building blocks is precisely the notion of *consistency*. Section 2.5.1 below deals in detail with this concept and its specific characteristics.

Figure 2 4: Elements of Supervisory Convergence. Source: EBA 2017b, 7.

One last theoretical related concept that helps elucidate how convergence unfolds is *policy diffusion*.[124] A recent article that addresses specific methodological concerns in the measurement of policy diffusion mechanisms, draws a distinction between convergence and diffusion. The former "represents policies of different units becoming more similar over time" (Maggetti and Gilardi 2016, 89), whereas the latter is essentially characterised by an inherent interdependence between these units.[125] Interdependence, in turn, adopts different forms or "mechanisms": learning, emulation, and competition. The case of coercion, i.e. the adoption of a policy as a consequence of the pressure stemming from powerful States or international institutions, is not considered within these mechanisms as, in their view, diffusion implies that there is no central actor governing how specific policies disseminate.

[124] When it comes to the notion of *diffusion*, legal scholars have mostly addressed the *norm* diffusion phenomenon. This strand of the legal literature advocates for complementary approaches to the analysis of law, for instance, by incorporating the inputs, methodological approaches, and conceptual frameworks from the sociologic and social sciences broadly speaking, in order to make sense of legal phenomena. As for the concept of *policy transfer*, the present work follows the approach adopted by Maggetti and Gilardi (2016), according to which, given the significant overlap between transfer and diffusion, they avoid useless distinctions and thus "regard the former as a special case of the latter" (Maggetti and Gilardi 2016, 90).
[125] The authors acknowledge that interdependence might be present in convergence, but they stress that in this case units might act out of independent pressures.

A more comprehensive framework that assesses convergence within the political economy literature is provided by Quaglia (2008), when examining the reform of financial regulation and supervision in the UK, Germany, and Italy. In explaining these policy trajectories, she identified three different approaches: the first one stresses the importance of domestic interests and institutions in explaining divergent supervisory reforms (referring to Lütz 2004); the second focuses on ideational diffusion, which traces how ideas spread and reshape existing policy paradigms; and the third one is policy transfer, according to which transfers operate via the influence of international institutions or from country to country. Albeit recognising that these different explanations do not exclude each other, their separate explanatory leverage is not enough. Hence, the author proposes an *integrative analytical framework* that combines three level of analysis: "International and EU, national, and micro-institutional" (Quaglia 2008, 444). An interesting aspect that arises from this integrative analytical framework, is that the two independent variables accounted for at the national level resemble the two types of diversities which are further developed in Chapter 3. Quaglia (2008, 445) distinguishes between the "configuration of national financial systems" in terms of size, openness, and segmentation, and the "configuration of national political institutions", defined and measured in terms of State structure and veto players, which are comparable to the distinction drawn between the diversity of credit institutions and the diversity of national legal and institutional orders.

2.4.2 Consistency and its specificities

The focus on the notion of supervisory consistency has been empirically driven.[126] In fact, the idea of *consistency* competes against other concepts that are widely used in academic literature and policy-analysis to explain the degree of convergence or divergence in specific domains. As seen above, consistency is understood by the EBA as one of the building blocks that leads to convergence of supervisory practices, and is related to supervisory outcomes. However, in the SSM's understanding, consistency refers to both supervisory *outcomes* and the *application* of *high supervisory standards*.[127] Therefore, in light of the range of activities carried out by the SSM, consistency embraces practically all three elements that, in the EBA's view, account for convergence of practices.

Furthermore, the notion of consistency takes the problem of banking supervision to a different level, which goes beyond strictly legal issues. As explained by the first EBA report on the Convergence of Supervisory practices (EBA 2015, 3), "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". Hence, the achievement of supervisory consistency needs more that harmonised rules, which, as exposed by the EBA report, do not guarantee the achievement of uniform application.

As anticipated, the focus on supervisory consistency instead of alternative notions, such as (rule) harmonisation or convergence (of practices), is rooted on the specificity of the

[126] By "empirically driven" I mean that earlier research phases focused on the harmonisation and convergence phenomena. However, after a careful analysis of the documentation and the interviews with key stakeholders, it has been possible to identify the specificity of supervisory consistency in the context of the SSM, and differentiate it from similar notions.

[127] For instance, Article 6.5(b) of the SSM Regulation states that "when necessary to ensure consistent application of high supervisory standards", the ECB can supervise LSI institutions that are not under its direct oversight in normal circumstances. Article 6.5(a) refers to the possibility of the ECB to issue instructions directed to the NCAs, "for the purposes of ensuring the consistency of supervisory outcomes within the SSM". Similar passages are found in the SSM Framework Regulation and the Supervisory Manual.

activities deployed by the SSM. In fact, this also helps demarcate policy and institutional domains, and contributes to the distinction between regulation and supervision (at least from an analytical perspective). In fact, *regulation* is harmonised, which is primarily a task developed by the EBA; while *supervision* aims at being consistent, which is an SSM task, and includes both directly supervised SIs and indirectly supervised LSIs. As the following section explains, conceptualising supervisory consistency requires the analysis of meta-legal elements that entail empirical challenges, and requires a closer look at micro-processes that are outside of the traditional rule-making arena.

2.5 Supervisory consistency and governance change: Analytical tools for their assessment

2.5.1 Operationalising supervisory consistency

As anticipated, a closer examination of the activities carried out by the SSM reveals that a key concern of the supranational supervisor, and one of the fundamental aspects that distinguish it from the activities of the EBA, is the achievement of supervisory consistency. Thus, this section identifies the key characteristics that conform the concept of supervisory consistency. These building blocks have been singled out through the following sources: first, interviews conducted with key stakeholders steadily pointing out the consistency element in the course of the SSM action. Second, the most relevant documents issued by the SSM, the speeches from the chair, and the two fundamental pieces of legislation establishing the SSM's activities refer to 'consistency of supervisory outcomes', and 'consistent application of high supervisory standards', therefore

qualifying and providing a more specific content to this notion.[128] Apart from the SSM's own tools and the insights from interviewees, the EBA Reports on Supervisory Convergence also helped define these elements. These reports, in fact, point out the areas of prudential regulation and, chiefly, supervision, that have achieved a certain degree of convergence and those that need further improvements. When identifying the core areas that need to be addressed in order to improve the overall convergence, the 2016 Report (EBA 2016a) mentions *methodologies, practices, and outcomes*. These three areas are the core of the activities carried out by the SSM.

In fact, a detailed analysis of the SSM practices and operational activities (for the most part crystallised in the Supervisory Manual, whose shortened public version has been released in March 2018), suggests that methodologies, practices, and outcomes are the three key encompassing elements that characterise the SSM's efforts in achieving supervisory consistency. This categorisation also helps identify the actors involved and the level in which these three activities are performed. This point is further analysed when discussing the nature of horizontal activities and the horizontal view from DG MS IV, and how they differ from the tailor-made activities carried out at the JST level.

This analytical framework is a stylised version of much more dense and complex processes, and provides a conceptual starting point in order to identify specific patters of governance evolution in the pre- and post-SSM eras. The main tension addressed by the framework schematised in Figure 2.5, is the one between the centralised definition of

[128] Additional tools, such as the word frequency analysis from MAXQDA, revealed that for some key SSM official documents, the word consistency was generally close to the concepts of *application* (accompanied by "high supervisory standards"), or *outcomes*, which goes in the direction of the consistency building blocks presented in this subsection.

methodologies and assessment of outcomes, and the decentralised application of rules (being it by JSTs in the case of SIs, or NCAs for the LSI case).[129]

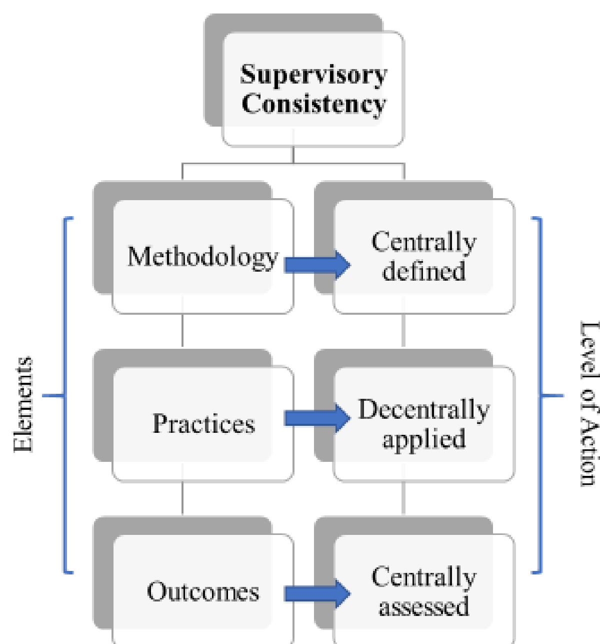

Figure 2.5: Supervisory consistency: elements and levels of action. Source: Own elaboration

Although the meaning and implication of each element will become clearer in the course of the empirical analysis, some preliminary definitions are provided. The centrally defined *methodology* represents a cornerstone element of the supranational oversight, given that it tackles one of the greatest challenges from the pre-SSM situation. In fact, as already pointed out, harmonisation of prudential rules did not prove enough in light of the variation of practices at the national level. Hence, the way to overcome these divergent practices and minimise the room for contrasting interpretations has been the development of common methodological tools. This represents an SSM innovation given that it is one of the aspects that differs from

[129] Interviews conducted with EBA and European Commission officials have shown the existence of some sort of splitting between, on the one hand, supervisory tasks in the field, and the elaboration and interpretation of that data which is done centrally in Frankfurt (in which the tasks of DG MS IV are relevant).

the activities carried out by the EBA. The EBA, albeit being in charge of contributing to the harmonisation of the Single Rulebook, does not exactly prescribe uniform methodologies. It has done so only in relation to the stress test,[130] but for instance, the generality of the Guidelines establishing common procedures or minimum standards to be complied with, do not define homogeneous methodologies to be followed by the different national supervisors. The EBA has indeed claimed that "in order to reach consistency in the SREP outcomes, it is key that risk assessment is conducted according to common definitions of risks and *comparable methodologies*" (EBA 2016a, 22, emphasis added). The SSM, moved by different incentives, does prescribe common methodologies to be complied with, not only in the case of the SIs under the direct oversight of the ECB, but increasingly more in the case of LSIs as well. The second element that accounts for supervisory consistency relates to the (supervisory) *practices* carried out by both ECB staff and NCAs, according to the structural organisation and competence allocation within the SSM. A useful approximation to understand the meaning of practices is provided by Adler and Pouliot (2011, 6), in a volume dedicated to "international practices". In this sense,

> Practices are competent performances. More precisely, practices are socially meaningful patterns of action which, in being performed more or less competently, simultaneously embody, act out, and possibly reify background knowledge and discourse in and on the material world.

In spite of its abstraction, the definition is aligned with what can be expected from the banking supervision domain, as practices can also be identified as "patterned actions . . . embedded in particular organised contexts" (Adler and Pouliot 2011, 6), which possess a structured dimension that stems from repetition, and the presence of groups of individuals who

[130] Which constitutes a specific case in which the EBA was called upon to work together with the SSM

interpret their performance along similar standards. Hence, practices comprise both an individual (agential) and a structural dimension, supported by the communities of practice and diffusion of background knowledge. Finally, the third element of consistency, (supervisory) *outcomes*, refers to the development of "similar supervisory responses to institutions with similar exposures and risk profiles" (EBA 2016a, 7). The assessment of how consistent and comparable supervisory outcomes throughout the EU are, is carried out by the EBA in its convergence of practices reports; however, the SSM has developed a strong internal structure in order to evaluate this feature within their scope of action.

One of the challenges in the elaboration of an operational definition of consistency is that it entails a dynamic process, where a variety of institutions and a series of parallel processes and activities are involved.[131] Perhaps one of the most cumbersome part involves the distinction between supervision and regulation, which seems clear in theory but is not really in practice. Given that the outcomes and supervisory findings feed into new regulatory policies (which is not necessarily reflected in conventional rule-making processes, in line with the iterative cycle proposed by the experimentalist approach), it is hard to draw the line between these two policy domains. Hence, by identifying these three core elements, the framework is expected to highlight the differences between the decentrally applied practices and groundwork that is done while conducting banking supervision, and the centralised approach to decision-making within the SSM framework. This, in turn, might suggest the presence of hidden integration patterns, in light of the literature analysed above.

[131] In line with the 'actor mismatch' mechanism identified in the recursivity of law framework, another distinctive feature of supervisory consistency is that its achievement requires a quicker and more dynamic policy response, as opposed to rule harmonisation, whose attainment is characterised by longer public consultations procedures. This specific 'timing' issue is further developed in Chapter 5, when assessing the differences between the consultation and regulatory procedures conducted by the EBA and the SSM, respectively.

Each of the consistency elements, i.e., methodologies, practices, and outcomes, are further explored in Chapter 4. The following section examines the dimensions that account for specific changes and evolution in the governance framework.

2.5.2 Operationalising governance change

Before focusing on the operationalisation of governance evolution, it is useful to recall the sequence stated at the beginning of this chapter: new institutional and legal architectures generate new patterns of interaction and coordination for the adoption and implementation of collectively binding decisions, meaning new modes of governance. Diedrichs, Reiners, and Wessels (2011, 20) propose three dimensions through which it is possible to operationalise the evolution and change in the modes of governance discussed above, which in turn suggest the emergence of different patterns of integration. The three dimensions are represented in Figure 2.6, and they address these core governance elements: the public-private sphere of authority, the patterns of decision-making, and the nature of the instruments adopted.

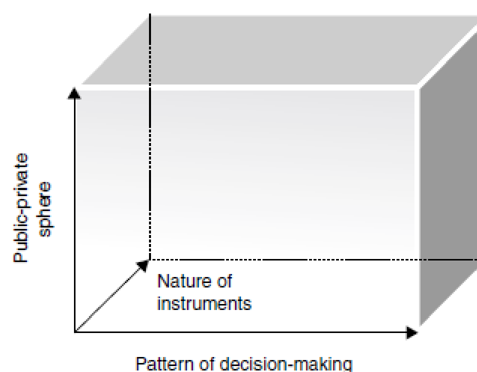

Figure 2.6: The governance cube: describing a three-dimensional space. Source: Diedrichs et al. 2011, 20.

In order to examine the dimensions of governance change identified above, this work operationalises them through heuristic indicators which aim to shed light on the SSM's institutional and policy-making evolution, in an attempt to understand whether a more experimentalist or centralised governance architectures are being shaped. The proposed operationalisation has been based on the characterisations provided by the scholarship reviewed along this chapter, chiefly Diedrichs et al. (2011) and the experimentalist literature (Sabel and Zeitlin 2008, 2010). The third dimension—nature of the instruments in the space between hard and soft law—has been fleshed out from a "framework that distinguishes hard law from soft law along a continuum in three dimensions of governance: obligation, delegation, and precision" (Schelkle 2007, 705). This framework is in turn based on the work developed by Abbott et al. (2000), where they propose these dimensions to characterise *degrees of legalisation*, which are broadly interpreted as shifts from soft to hard law in international agreements. The aim is to avoid confining the indicator to the hard and soft law dichotomy, since it is not accurate enough to portray and describe the supervisory domain. The characterisation of each indicator, however, is elaborated in Chapter 4, where these indicators are used to empirically assess the evolution of important supervisory tools. Table 2.4 below summarises the three-dimensional framework and the respective indicators.

Governance dimension	*Indicators*
Sphere of authority between private-public	• Level of stakeholders' involvement in the consultation process. • Level of consideration of industry's view expressed in the public consultations. • Level of communication between authorities and the industry along supervisory activities.
Decision-making and institutional forms	• Level of national involvement and local interest representation along decision-making processes • Level of local discretion granted to NCAs in the supervisory process. • Level of coordination between regulators (EBA) and supervisor when conducting regulatory activities
Nature of the instruments (space of hard and soft law)	• Obligation: use of non-binding language, certainty about legal consequences triggered by SREP process. • Precision: clear expectations on intended objectives and means; transparency on P2R and SREP holistic view. • Delegation: operational and adjudicative.

Table 2.4: Governance change dimensions and their operationalisation. Own elaboration.

2.5.3 Case selection rationale and structure of the empirical chapters

The selection of the cases analysed in Chapters 4 and 5 is motivated by the following considerations. First, these cases represent real challenges to the achievement of supervisory consistency, while they also address high policy priority issues within the SSM. Second, as explained below, they reveal the existence of the diversities mentioned in the previous sections and the ways in which they have been managed by the supervisor.[132]

[132] It is important to point out that the selection of the topics has been informed by additional motivations, particularly the availability of time and expertise. In fact, there are other technical topics addressed by the SSM that also deal with the consistency problem, such as the Targeted Review of Internal Models (TRIM). Another topic that is widely relevant in connection with supervisory methodology and consistency are stress tests.

Chapter 4 explores the governance evolution of the Supervisory Review and Evaluation Process (SREP) and banks' Internal Capital Adequacy Assessment Process (ICAAP).The SREP is a comprehensive and complex supervisory tool, which holistically assesses banks business models, governance and risks, capital, and liquidity status. Chapter 4 does not examine each of the four SREP elements; instead, the analysis is based on the evolution of the tool since its early days, until the present time and the SSM's use of it. Furthermore, the chapter focuses on the evolution of the ICAAP, which has been running in parallel to that of the SREP. The ICAAP is a process to ensure that the management body properly identifies, measures, and monitors banks' risks, that banks hold adequate internal capital in relation to its risk profile, and that sound risk management systems are used and put in place (CEBS 2006). There is in fact a dynamic interaction between the internal evaluative tool developed by banks (ICAAP), and the supervisory instrument to assess it (SREP), which is materialised through the "supervisory dialogue" with a view to exchanging opinions and mutually challenging banks and supervisors' respective positions. Both ICAAP and SREP have been in the eye of the EBA and SSM work, as they are deemed fundamental tools to strengthen supervisory consistency.[133] In addition, both the SREP, and more specifically its ICAAP element, were already covered by the EBA's regulatory products, but were nevertheless reconsidered and deepened in the course of the supervisory cycles conducted by the SSM.

Furthermore, the SREP is a tool that exemplifies both the need for consistency and bespoke assessments carried out by supervisors. As the Supervisory Manual reads,

[133] The EBA Reports on supervisory convergence (EBA 2015 – 2019) have consistently pointed out the different practices and uses of the SREP tool by national authorities; divergences that, according to the reports, have been diminishing for SSM countries since the establishment of ECB banking supervision.

"proportionality is integral to the manner in which the SREP is carried out: the frequency, scope and depth of the SREP reflect the level of supervisory engagement that is deemed necessary for an institution . . . depending on its risk profile." (ECB 2018a, 80). In addition, interviewees with key stakeholders (in this case Italian and German banks) have revealed that the implementation of the SREP, as it is now, has been one of the most important changes in the conduct of supervision.

Chapter 5 deals with the Non-performing loans (NPLs) case, or saga, as we characterised it. There are two fundamental reasons that account for its incorporation in the thesis structure. First, it has been an early policy priority for the SSM, as it was directly related to the crisis legacy and the need to clean banks' balance sheets. Second, the NPL case addresses important structural differences in national legislative and institutional frameworks, since the underlying causes of the phenomenon are much deeper than the economic woes left by the global financial crisis, and the fiscal and sovereign debt crises. Chapter 5, in turn, tackles another case that deals with the SI-LSI consistency challenge: the presence of Institutional Protection Schemes (IPSs). Albeit a less controversial case than the preceding one, the regulation of IPSs stresses once again the need to achieve supervisory consistency, this time between directly and indirectly supervised institutions.

There is one final distinction to be made between the cases included in Chapters 4 and 5, respectively. The harmonisation of SREP and ICAAP aimed at developing a more comparable approach amongst banks, whereas the NPL and IPS cases focused on dealing with national differences. However, the application of the SREP has also an important national component, in light of the practices of the national authorities in the pre-SSM era (and post

too, given that NCAs are also responsible for the SREP of LSIs),[134] which is analysed in detail in Chapter 4 and 3 as well. The main aim of the SREP and ICAAP tool is that of assessing and providing bespoke assessments to credit institutions, while the NPL efforts developed by the SSM (and later on, the Commission and the EBA) are geared towards a holistic strategy which aims to clear-up legacy assets in a more comprehensive manner at the Banking Union level. As a final remark, both the NPL and the SREP/ICAAP cases are instances of "overlapping" instruments: these were issues that had been almost simultaneously dealt with by the SSM and the EBA, which highlights once again the need for clearer institutional boundaries in order to avoid unnecessary regulatory overlaps and the institutional and legal uncertainly associated to it.

Conclusions

This chapter has shown the paradoxes embedded in the integration project: the more comprehensive the supranational legal tools, the more they are prone to interact with social norms simultaneously developed in local context. The interplay between these normative and meta-normative levels, creates patterns of interaction that can lead to different modes of norm application, in spite of the existence of a common corpus of rules. This chapter has also explained the links between the establishment of new legal and institutional architectures, and how they create new modes of governance which, in turn, beget new modes of integration. By linking these elements, the chapter has provided the basis for understanding the changes in banking supervision governance, which are examined in greater detail in Chapters 4 and 5.

[134] Although it has to be underlined that even in the LSI case, the SREP process has being gradually harmonised, since the implementation of an LSI SREP methodology in 2018.

Furthermore, the chapter has explained the specificities linked to the *consistency* notion, and how it differs from other conceptual tools offered by the literature. The aim of the analysis has been to operationalise the concept of supervisory consistency in order to allow for a better understanding of its elements and how they interact with the second fundamental notion that is examined in the next chapter, the question of *diversity*.

CHAPTER 3

Managing diversity: Deep-diving into banking and national-related heterogeneities

Introduction

The present chapter provides, at different levels of analysis, an overview of the elements that account for "diversity" in the realm of banking supervision. The chapter goes beyond the description of the differences between the German and Italian context: it aims to identify structural elements that—if not properly considered at the supervisory level—might compromise the banking ecosystem. In fact, this domain has been characterised by, on the one hand, increasing interconnectedness and integration of the markets, and, on the other, uneven effects of financial integration upon member States:

> Despite more than 60 years of financial integration in the EU and significant strides forward in the single financial market in recent years, national banking systems remained very distinct, complicating the negotiations on the SSM and *ensuring the persistence of national variation in supervisory practice*. (Howarth and Quaglia 2016b, 456, emphasis added).

Thus, the chapter aims to uncover these diversities in order to account for the emergence and variation in supervisory styles. The chapter is structured as follows: the first section explores and maps the different elements that account for diversity, while explaining why the analysis developed is not meant to be a traditional comparative study. The second section focuses on banking-related diversity. It explores the concept and the elements that define "banking diversity", and it illustrates this diversity in the German and Italian banking sectors, highlighting similarities and differences. The third section focuses on national-related features

that account for diversity. The aim is to examine legal and economic local features to better understand the development of specific institutional frameworks, that in turn provide a clearer rationale for the emergence of distinct supervisory styles. The fourth section assesses the features that account for diversity against the emergence of integrated financial markets. It examines the structural changes that had to be accomplished in the run-up of the EMU, as this provides a good precedent to illustrate how diversity has been managed against the need for achieving greater convergence. It also provides a primer on the differential impact of Europeanisation. The final part concludes by highlighting the ways in which the supranational supervisor can reap the benefits of diversity and the coexistence of different supervisory styles, sketching a high-level definition of supervisory cultures based on the insights provided by the previous sessions.

3.1 Mapping diversities

3.1.1 Why this is not a traditional comparative analysis

The purpose of the present chapter is to map a range of elements that account for national institutions and banks' characteristics in the German and Italian systems. The purpose is not to develop a comparative analysis that draws on their differences and similarities. As a matter of fact, it would be overly ambitious to develop a comparison of all these elements within a single chapter. The aim is to map and explain the way supervisory practices have unfolded, by identifying a set of legal, political, bank-related, and institutional factors.

The analysis presented in this chapter, does not amount to a traditional comparative analysis. Instead, the proposed analysis aims to capture the main elements that account for

"diversity" in the context of SSM activities. As anticipated in Chapter 2, there are two sources of diversity relevant for the supervisory activities. One is the diversity of the banking sector, consisting of different business and organisational models. This type of diversity is deemed to be "positive", in the sense that it is beneficial to the resilience of the financial system, and it has been recognised as a desirable characteristic worth promoting. The other dimension of diversity comprises a set of elements that accounts for national variation, such as regulatory frameworks, cultural, and structural economic conditions. As mentioned in Chapter 2, a concept capable of encompassing of a wide set of national characteristics is that of *public reason* (Jasanoff 2012): the notion of public reason comprises different features that, taken as a whole, help identify member States' characteristics which, in turn, provide some hints to understand how different institutional, regulatory, and supervisory styles have been shaped over time. Albeit roughly, this can also provide a way to understand what could be characterised as different "supervisory cultures". This elusive and fuzzy expression, in fact, has become an important element of the characterisation of the SSM and its promotion of a "common supervisory culture".[135] In any event, before the setting up of the SSM, the common supervisory culture was explicitly mentioned in Art. 29 of the EBA Regulation. In spite of this discoursive presence in speeches and even legal texts, the concept has not been seriously analysed from an empirical perspective. A notable exception is Carretta, Farina, Fiordelisi, Schwizer, and Stentella (2015), where the authors empirically assess the existence of *supervisory cultures* in the euro area in light of the establishment of the Banking Union and

[135] The SSM Regulation mentions the "common supervisory culture" only once in recital no. 79, when referring to staff exchange and the benefits of having a smooth cooperation between national and supranational authorities in the context of the JSTs. However, the expression has been widely used in other discoursive tools, such as speeches.

the amalgamation of supervisory cultures as a result of the SSM, through text data processing of the national authorities' official documents.[136]

What this chapter aims to highlight is the interconnectedness between banking and national characteristics, pointing out the difficulties in decoupling banking-related questions from their specific contexts. Within the SSM framework, this decoupling or separation of banks from their context can arise from two interrelated sources. First, the SSM's emphasis on quantitative and standardise approaches to supervision, compared to a more qualitative approach followed by national supervisors. Second, the achievement of supervisory consistency has fostered the need to strengthen common methodologies and a centralised assessment of the practices and supervisory outcomes. This organisational arrangement has pros and cons: on the one hand, it bolsters consistency, thanks to the development of common methodological starting points. On the other, strengthening common centralised methodologies can overlook the consideration of additional soft elements, or those stemming from qualitative approaches.

This chapter is not meant to be a nostalgic attempt to re-establish national orders in the banking supervision domain. This would be neither possible in the short to mid-term nor efficient: the wide institutional and regulatory efforts in order to set up a common supervisory structure imply that it would be difficult to go back to the previous status, from both an internal-organisational and an external industry-related perspectives. Regarding the former, NCAs' structures have been changed because of the SSM, and both national and supranational authorities have also undertaken major human resources reorganisations; concerning the latter,

[136] The authors acknowledge that "measuring supervisory culture is the most difficult issue in such a study: culture is a broad concept that refers to implicit and explicit contracts governing behaviour within an organization" (Carretta et al. 2015, 181).

banks have also modified their internal structures accordingly, in order to streamline their relationship with the SSM.

This chapter aims to emphasise those areas in which supervisory activities need to better consider contextual diversity, and better scale the weight of harmonised rules. This is not to suggest that the supranational supervisor is not aware of these challenges. However, some of the characteristics of the SSM, such as the split between decentralised fieldwork in supervision and the development of centralised uniform methodologies, call for a cautious approach when it comes to the development of “horizontal” views.

Both regulators and supervisors are sensitive to the question of preserving a diverse banking landscape, and that institutional diversity is relevant for the preservation of a financially healthy system. However, when it comes to the role of national idiosyncrasies in shaping different banking characteristics, the assessment is not necessarily positive. Part of the pessimistic outlook on the relationship between banks and local governments is linked to the scepticism towards complacency of national supervisors, which was materialised in the post-crisis scenario. The SSM however, incorporates by its own nature the knowledge, experience, and the cultural heritage of the local supervisors. Therefore, these common efforts and the collaborative framework that makes the SSM possible, considers and embraces, through ECB-NCAs interactions, local knowledge and preestablished supervisory practices.

The vast regulatory enterprise at the supranational level to harmonise the prudential framework needs to be brought down to earth by supervisory authorities. In the case of the SSM, the implementation challenge is twofold, as the authorities not only have to apply the supranational law in a consistent manner, but also local rules in relation to SSM’s supervisory

powers that are provided for under national legislations.[137] Since a considerable portion of these rules is not "hard law", this has prompted a fundamental question of the meaning and scope of "national legislation" in the context of Art. 4(3), 1st para, which refers to the application of local rules by SSM authorities. In fact, when NCAs or local authorities exercise their regulatory powers in the supervisory domain, they adopt a wide range of instruments, whose legal value might not be uniform across SSM countries. Furthermore, as discussed in greater detail in Chapters 4 and 5, the SSM expands its supervisory toolbox by creating soft law instruments that, albeit not-binding from a formal stance, can steer the behaviour of supervised entities and entail the imposition of supervisory measures.

The question of diversity management is transversal to all EU domains, and has therefore prompted a rich and vast literature that deals with EU integration and modes of differentiated integration (DI). By its very nature, the EU has been characterised as a 'system of differentiated integration' (Leuffen et al. 2012, 1), given that EU integration has been accompanied (and even made possible) by differentiation. More recently, differentiated integration studies have been moving towards differentiated *implementation*, in an attempt to go beyond the study of the variation in the nature and degree of integration in different EU policy areas (classic DI analysis), by focusing instead on locally developed practices that are at the heart of the multi-level system.

Chapter 2 has provided an introduction to DI and one of its alternatives, the experimentalist governance approach, which considers local implementation as one of its fundamental building-blocks. This chapter builds upon those strands of the integration

[137] The legal singularity of this situation has been pointed out by, mostly, legal scholars. See Magliari (2015), D'Ambrosio (2016), and Annunziata (2018).

literature and provides some background to better understand the dynamics of differentiated or local implementation experience. The chapter does not go as far as empirically assessing the differences in norm implementation in light of the local practices. Although this question deserves to be further explored, the scope of the chapter and its overarching aim (i.e., to link local and banking-related characteristics to the existence of certain institutions and their practices), cannot provide fully-fledged answers to differentiated implementation queries.

One final question relates to the extent to which these features that account for diversity can be deemed "legitimate". In fact, this question is at the heart of the integration project and, most importantly, the modes of integration; hence, its considerations are important from both normative and empirical perspectives. Chapter 2 has pointed out the criticisms to the integration through law approach, which tended to disregard the fact that "legal rules and institutions do not operate in splendid insulation, but constitute interdependencies." (Joerges 2018, 232). This question speaks directly to the legitimacy of the EU and its sphere of action, which is tested anytime EU policies have to accommodate highly political salient issues in member States, whenever national preferences hinder the agreement on common EU policies, but at the same time a national response only is not enough (Scharpf 2003). The banking realm can be considered of highly political and economic salience within the national sphere, in light of the importance of the banking industry at the member State level, but at the same time there are large players that act on a cross-border basis and therefore add an international dimension to the story. Some segments of the banking sector have tried to preserve their specific status and, either directly or indirectly, have stressed the question of their legitimate diversity in light of the historical, legal, and institutional features that characterise their special role within

financial intermediation, which can hardly be appreciated without knowing the circumstances.[138]

The chapter moves now to different conceptualisations of diversity and how it has been featured by socio-legal and political economy literatures.

3.1.2 Diversity paradoxes in socio-legal and political economy literatures

Before delving into the two main sources of diversity—banks and national configurations—this section focuses on how diversity paradoxes have been conceptualised in different strands of the literature. Chapter 2 has highlighted the existence of multiple tensions surrounding EU integration. One of the most important in relation to this chapter concerns the fact that "more intense integration requires a paradoxical 'diversity management'" (Ladeur 2014, 386). This is so because in the process of deepening EU law, the conflicts with social local norms will continue to increase, as these norms are non-codified cultural products emerging from common understandings. [139]

In this sense, the optimistic assumption that EU law is exactly the same in all countries, and that "equal law leads to equal conditions of life" disregards "the possibility that equal law imposed under unequal conditions of life can even deepen differences" (Ladeur 2018, 240). Although this conundrum is present in a wide range of EU law areas, the question of applying equal rules under different contexts is of the utmost importance in relation to the implementation of the SSM framework for the following reasons. First, as stated above, the

[138] These conclusions are supported by statements from interviews with relevant stakeholders and the analysis of position papers submitted during public consultations, as further detailed in Chapter 4.
[139] "Implementation of norms needs, first of all, a common idea of its social and technical pre-conditions, and, secondly, a common idea of its implementation, one that is - at least in part - generated in "real time" ex post" (Ladeur 2018, 239).

regulatory framework applied by the supranational supervisor is a complex web of EU law (Regulations, Directives, and Commission's delegated regulations) and member States' law transposing the relevant Directives, which can be done through a myriad of instruments. Furthermore, the ECB has been entrusted with regulatory powers, according to which it adopts both biding and non-binding tools,[140] and it must also comply with regulatory products adopted by the EBA, which can be binding and non-binding as well. Second, the SSM is responsible for the effective and consistent implementation of the highest supervisory standards, while "tailoring the intensity of supervision to the systemic importance and risk profile of the supervised banks" (ECB 2018a, 6). Therefore, banking supervision entails additional application challenges: first, in spite of the rule-harmonisation efforts in this field, some regulatory tools still differ from country to country, hence, it is not possible to refer to "equal law";[141] second, these instruments are applied not only in different local contexts, but also to a wide range of credit institutions that have different risk profiles, and thus require different levels of supervisory scrutiny.

The challenges of supervisory consistency stem from the integration paradox referred to above: the higher the level of integration through supranational authorities in charge of implementing the supervisory framework, the more they need to consider the underlying social and cultural norms that make implementation possible. This is not to disregard the importance of applying "higher supervisory standards" in order to ensure a common supervisory level. What this means is that the increasing levels of harmonisation and rule uniformity need to be

[140] See Chapter 5 for a detailed taxonomy of the ECB banking supervision instruments and a critical analysis of this classification.
[141] This is why the ECB has focused on the harmonisation of Options and National Discretions (ONDs).

accompanied by a realistic assessment of the circumstances in which rules are to be made effective.

The diversity paradox also manifests itself in the design of monetary policy institutions. From a political-economy perspective, the fact that the EMU has brought together a number of unequal and diverse member States, has led to the paradox that "the more diverse the membership of a risk pool, the higher the potential economic benefits from risk sharing but also the greater the political obstacles to exploiting these benefits" (Schelkle 2017, 61). In order to attenuate the tensions arising from these paradoxical features, Schelkle claims that some degree of *monetary solidarity* is necessary to make the system work, and that this solidarity ends up being more by default than by design, as it has been the case in the EMU response to the crisis. From this political economy stance, the diversity paradox is related to the risk-sharing and risk-reduction dichotomy, which has dominated the debate around post-crisis euro area economic reforms: the completion of the Banking Union and the creation of a common European deposit insurance has been one of its most controversial points. Although "the problem is framed as a contrast between risk sharing and risk reduction [. . .] the more political expressions of these concepts are solidarity and moral hazard" (Jones 2019, 37). The core of the EMU politics debate now is about striking the right balance "between *national responsibility* and *European solidarity*" (Jones 2019 4, emphasis added). What his analysis suggests is that the solidarity v. responsibility dichotomy has seen the emergence of a fundamental "ethical" dimension (Jones 2019, 37) in the EMU that is common to both economic and political analyses.

When explaining the puzzle of rational cooperation within a monetary union, Schelkle (2017, 36) claims that the potential gains that could arise from diversity (along the national

lines), are hampered by "the sheer lack of familiarity with the ways other political economies work [which] can create a residual mistrust that only obvious economic success, the endorsement by markets, can suppress". The author also highlights that what might be originally related to national *diversity*, is considered in the monetary union context an *asymmetry*. Although both concepts relate to the heterogeneity of members, they trigger different policy responses, given that diversity is not per se something negative that should be suppressed, while asymmetry conveys the idea of a situation that needs to be levelled to guarantee a more balanced outcome:

> The characteristics of another member's political economy that are different tend to be perceived as responsible for any calamity that befalls them. Support is then made conditional on these characteristics being transformed: all have to converge on some "best practice"[142] (Juncker et al. 2015: 4; van Rompuy et al. 2012: 9) (Schelkle 2017, 310/11).

According to Schelkle's understanding of the diversity paradox, the more diversified the "club", the better, given that the insurance system is built upon this intrinsic diversity. However, it has been argued that this interpretation mixes up two different dimensions of diversity.[143] From an insurance perspective, diversity can be interpreted as the *non-correlation of risk*, which is actually what is needed in order to make an insurance system work.[144] The other aspect of diversity concerns *heterogeneity of risks profiles*, and this feature could be

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[142] This final remark on convergence towards best practices is relevant to the question of supervisory consistency, given that a vast amount of the horizontal analyses carried out by DG MS IV aim to develop a core set of best practices, based upon implementation experience.

[143] Insights provided by Frank Vandenbroucke when hosting a webinar on European Social Union on 11 September 2019. For further details about the webinar see https://ysd.ineteconomics.org/project/5d6f76a0342858679cd3a74a/event/5d6f7a7c342858679cd3a880

[144] Correlation is "the extent to which multiple risk profiles move in relation to each other. Correlated risk profiles move in concert when affected by the same set of stimuli. For example, there is substantial correlation between the Dow Jones Industrial Average (DJIA) and the Standard & Poor's (S&P) 500 Index because both are affected by the same factors. In contrast, *uncorrelated risk profiles* (e.g., a book of ocean marine business and a book of products liability coverage) react to entirely different stimuli. The combination of uncorrelated risk profiles results in lower combined volatility." Source: https://www.irmi.com/term/insurance-definitions/correlation emphasis added.

problematic: why would somebody be willing to organise a pool of risk under such diversified conditions? An explanation for this can be found in the concepts of *asymmetry of information* and *adverse selection*. In order to build up a proper insurance framework, it is important to focus on one specific dimension of diversity: the non-correlation of risks. While this type of diversity is beneficial to the functioning of the insurance system, diversity of risk profiles of the member can affect the pool of resources. Hence, there should be sufficient convergence in the risk profile of the parties, while keeping risk correlation heterogeneous (Vandenbroucke 2019).[145] In this way, insurance systems can create positive externalities, by producing what Vandenbroucke (2017) calls a "vaccination effect", which guarantees stabilisation capacity among members States. This section will not go further into the details of risk-sharing and the creation of insurance systems. The main takeaway from this debate is that the concept of *diversity* entails a complex set of features that need to be spelled out in order to make sense of how to better manage it.

Albeit the socio-legal and the political-economy perspectives highlight different aspects of the paradoxical features of diversity, they nonetheless share an important message: the deepening of integration, either through regulation or capacity-building, requires a careful institutional design in order to manage members' heterogeneity. The two sections that follow focus on banking and national diversity respectively, in order to map and identify the sources of diversity that the SSM deals with in carrying out its supervisory activities.

[145] This point is closely related to the debate around the creation of the third pillar of the banking union, the EDIS. One of the main arguments against moving forward with the common deposit insurance scheme, is precisely that there is the need to achieve a comparable level of risk reduction amongst banks belonging to the Banking Union. At the time of writing, it is likely that the EDIS proposal as such will be abandoned and probably replaced, given the lack of political consensus achieved so far.

3.2 Banking-related diversity features

> European banking is a heterogeneous industry with respect to issues such as ownership structures, governance arrangements, capital structure and business objectives (Ayadi et al. 2010, 7).

The previous section has shown that diversity is a concept whose contours need to be specified in order to make it policy-relevant. This section focuses on the question of banking diversity and teases out the multi-dimensional elements that amount to it; the second part illustrates this variety in the German and Italian cases.

3.2.1 Defining banking diversity and its core elements

Recital 17 of the SSM Regulation contains a clause on banking diversity within the SSM:

> When carrying out the tasks conferred on it, and without prejudice to the objective to ensure the safety and soundness of credit institutions, the ECB should have full regard to the diversity of credit institutions and their size and business models, as well as the systemic benefits of diversity in the banking industry of the Union.

Diversity of credit institutions is an aspect that has to be preserved in order to ensure a healthy financial system: "the lack of diversity in banking (by which we mean the lack of heterogeneous organizational forms and business models in national banking systems) has been acknowledged as a critical regulatory issue by policymakers at national and EU level alike" (Butzbach 2016, 240, references omitted). The bracketed proviso suggests two features that help characterise the notion of diversity, i.e. the heterogeneity of organisational forms and business models. Although the relevance of preserving a diverse banking system is widely recognised, the question of what exactly accounts for banking diversity remains elusive. In fact, the literature review provided by Butzbach (2016) asserts that there is no widely shared

definition of it. Banking diversity is in fact "multi-dimensional: banks differ in terms of ownership, governance and size, and these differences have to do with distinctive business models and, therefore, behaviour" (Butzbach 2016, 244).

Before delving into each of these elements, it is important to recall some of the factors that have triggered specific transformations in the banking sector. Chapter 1 has provided a historical evolution of the logic underpinning the EU's single market, and how the conception of banking changed accordingly. Prior to the financial crisis, competitive pressures have pushed banks towards consolidation and structural changes, and although this trend operated at the European level, national banking systems evolved at their own pace. Table 3.1 below contains the main elements that differentiate *financial firms* from *institutions for patient capital*; in other words, it portrays the differences between modern banking and what is known as *alternative banking*, a distinction that helps better understand the meaning and effects of banking diversity. As explained by Butzbach and von Mettenheim (2014, 2) in an edited volume focusing on the performance of alternative banks before and after the financial crisis,

> 'Alternative banks' [are] all those banking organizations that are not run to maximize profit, are not required to satisfy shareholders, and have, as a result, developed over time a business model that is at the antipodes of the model embraced by most for-profit, shareholder-oriented retail banks in past decades around the world. We call these banks 'alternative' because they do, indeed, represent an existing and sustainable alternative to the 'mainstream' way of banking—a way that stands at the heart of policymakers' attention, of current regulatory efforts and of scholarly analyses.

An interesting feature from this comparative exercise is that it not only examines empirical differences, such as business models, strategy, risk management, and governance, but also theoretical and philosophical foundations for these two conceptions of banking, being the first two items (theory and capital theory) important to understand the role played by

smaller institutions in Germany and Italy, as illustrated in the next subsection. In fact, the long-term, patient capital or "boring banking" (Shackmann-Fallis, Gischer, and Weiss 2017), is crucial to some of the productive sectors of these countries, who do not normally have access to financial markets' funding channels.

Mettenheim and Butzbach (2017) present four theoretical approaches to describe and understand 'patient capital' in the case of alternative banks. First, *social banking*: both savings and cooperative banks were founded to reach those societal groups that were not served by commercial banks; development banks, in turn, were meant to devote their resources to national or regional public policies. According to this theoretical approach, "these banks were not designed to maximise profits" (Mettenheim and Butzbach 2017, 33). Second, *political capture theory*: despite their initial social-oriented missions, once savings banks and cooperative banks started to accumulate capital, they became an appealing target to political forces, and had been particularly used by totalitarian regimes. Third, *banking theory*: some basic premises of banking theory explain how patient capital helped alternative banks to manage their balance sheets better than their private counterparts. Fourth, institutional foundations of *competitive advantages* (VoC approach):[146] "greater trust among clients, consumers, and depositors" enable these banks to manage liability risk, and given their presence in political and policymaking networks these banks keep certain competitive advantages "in relational, retail, and wholesale banking" (Mettenheim and Butzbach 2017, 34).

[146] Inspired by the Varieties of Capitalism (VoC) approach, further developed in this chapter when exploring economic cultures.

Table 3.1[147] summarises theoretical and empirical differences between these two conceptions of banking.

	Financial Firms	*Institutions for Patient Capital*
Theory	Efficient markets	Long-term investment
Capital theory	Liquid capital	Patient capital
Governance	Shareholder	Stakeholder
Mission	Profit maximisation	Profit sustainability
Business model	Manufacture assets	Balance assets and liabilities
Strategy	Maximise leverage	Moderate leverage
Risk management	VaR [Value at risk] or risk model	Relationship banking and soft information
Theory	Financial intermediation	Uncertainty and institutional theory
Method of study	Econometrics	Historical-institutional
Expected change	Convergence	Persistent variety

Table 3.1: Banks as financial firms versus banks as institutions for patient capital. Source: Mettenheim and Butzbach (2017, 35).

Moving on to the analysis of the elements that account for banking diversity multi-dimensionality, this first part focuses on ownership, size, and governance. A comprehensive study entitled "Banking Business Model Monitor Europe" (Ayadi et al. 2016) has extensively analysed "the diversity of bank sizes and ownership structures in European countries . . . [in order] to identify the response function of each model in a crisis situation".[148] The study distinguishes among the five largest ownership structures and their main objectives according to the following criteria (Ayadi et al. 2016):

1. *Commercial banks*: the main characteristic is that they are privately owned by their shareholders, no matter what specific form they take.

[147] This table has been also included in the introductory chapter when describing the evolution of the concept of banking as Table 1.2.

[148] In order to identify the variety of business models, the study has focused on the interaction between these elements: "ownership structures, internationalisation, migration, financial and economic performance, risk behaviour, as well as response to legislation and supervision at a system level" (Ayadi et al. 2016, 10).

2. *Cooperative banks*: the most important distinguishing characteristic is that they "belong to their members that have equal voting power (one member one vote) and are entitled to the nominal value of the shares" (Ayadi et al. 2016, 26).
3. *Nationalised banks*: they have been the result of the public interventions that occurred during the financial crisis, in which "support came in the form of recapitalisations, asset relief measures, loans and guarantees" (Ayadi et al. 2016, 26). Governments received fees and also shares in return for these measures; in those cases where the government got more than the 50% of the shares, the bank is considered nationalised.
4. *Public banks*: public entities at different levels "have banks to support them in fulfilling their objectives"; these banks "raise funds and provide financing for the activities of the public bodies" (Ayadi et al. 2016, 26).
5. *Savings banks*: in spite of the variety of characteristics, their common feature is that "they originally focused on providing access to financial services for the less wealthy amongst the population" (Ayadi et al. 2016, 26). As in the case of cooperative banks, savings banks are also supported by a central institution.

From these different ownership structures, there is a further high-level distinction that can be made between shareholder-value (SHV) and stakeholder-value (STV) banks. The former can be conceptualised "as those whose primary (and almost exclusive) business focus is maximising shareholder interests, while . . . [the latter] have a broader focus on the interests of a wider group of stakeholders" (Ayadi et al. 2010 7, 2015). In the case of cooperative banks, stakeholders include customer-members, while for savings and public banks, these can be as broad as the local economy and the general public. In drawing the distinction between shareholder- and stakeholder-value banks, more differences can be seen in systematic differences in their respective balance sheets: "one key prediction of why these two types of bank might be different are their *attitudes towards risk-taking*. In shareholder banks, the typical high leverage of banks gives managers high incentives towards risk-taking. In stakeholder banks, the advantages of risk-taking are much more muted." (Kalmi 2017, 43, emphasis added). These two dimensions along which SHV and STV banks diverge, "banks' bottom line business objectives" (Ayadi et al. 2010, 7) and their risk aversion, point to a crucial difference

between them. While SHV banks exist to maximise shareholder value and thus the rate of return to equity (RoE), STV banks pursue profitability amongst other objectives, therefore it is neither an exclusive nor a primary aim (Ayadi 2010). The importance of the SHV-STV distinction resides in the fact that profitability (or its lack), has been a matter of concern for the SSM, especially in the last years. For instance, it is quite telling that in all the risk assessment exercises conducted by ECB banking supervision since 2017, the question of banks' profitability is a high priority issue.[149]

In a different report assessing the dimensions of governance and ownership structures of significant euro area banks (SIs), Véron (2017) fuses these two indicators and identifies six patterns of governance arrangements. First, *'dispersed' governance* refers to "groups whose parent entities are publicly listed and in which no individual shareholder holds sufficient influence to unilaterally alter the bank's direction and strategy" (Véron 2017, 3). Second, *minority influence* are those groups in which no single shareholder has majority control, but "one or more minority shareholders have significant leverage over the bank's direction and strategy" (Véron 2017, 3). This category includes publicly listed and unlisted groups, and the influential minority can be from the private, public, or non-for-profit sector. Third, private control are those groups in which a single private-sector shareholder owns more than fifty percent of the shares, thus having a dominant control over the direction and strategy of the bank. The fourth, fifth, and sixth categories, *cooperative governance*, *public sector governance*, and *nationalised governance*, are in line with the characteristics outlined above.

[149] The following link contains all four risk assessment mapping exercises (2017, 2018, 2019, and 2020), in which the profitability of the banking sector is always highlighted as a supervisory concern. For instance, the Risk Assessment for 2020 claims that "business model sustainability remains an area of focus as significant institutions (SIs) in the euro area continue to struggle with low profitability. The outlook of prolonged low interest rates and intense competition weigh further on banks' ability to generate income." See https://www.bankingsupervision.europa.eu/banking/priorities/risk_assessment/html/index.en.html

Hence, as acknowledged by Ayadi et al. (2016) and Véron (2017), ownership and governance are two overlapping dimensions that result in a variety of arrangements.

In turn, these institutional arrangements impact upon the heterogeneity of banks' size, which is another aspect that accounts for diversity. In fact, the size criterion is one of the key indicators to identify those credit institutions categorised as 'global systemically important banks' (G-SIBs). As a consequence of Basel III, G-SIBs have higher loss absorbency (HLA) requirements, which is directly related to higher capital levels that these banks should hold. A 2017 Deutsche Bank report analyses key indicators that contribute to measuring banks' size, that for the most part correspond to commercial, privately-owned institutions: market capitalisation, total assets, total revenues, equity capital, risk-weighted assets, and additional elements such as number of customers, employees, branches, and total lending volume.[150]

The key feature of banking diversity that condenses all of the previous elements is the *business model*, which also provides an approximation of an institution's complexity and risk profile. Interestingly, the Liikanen report (2012) conflates the concept of diversity of banks' business models in the EU, with banking diversity itself. The report describes six dimensions along which bank business models can be characterised, which includes characteristics belonging to the conceptualisation of banking diversity: "(i) size; (ii) activities, as evident from a bank's customer base, asset structure and income model; (ii) capital and funding structure; (iii) ownership and governance; (iv) corporate and legal structure; and (v) geographic scope, including how cross-border operations are legally and operationally structured" (Liikanen 2012, 32). The report assessed all these dimensions in detail, and the high-level group made

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[150] The Deutsche Bank (2017) report describes in detail the pros and cons of each of the abovementioned criteria. See https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD0000000000443314/Large_or_small%3F_How_to_measure_bank_size.pdf

substantive recommendations that directly concern the structure of the European banking system. One of the key recommendations was the "mandatory separation of proprietary trading activities and other significant trading activities" (Liikanen 2012, 101), from traditional deposit-taking and lending activities.

The question of business models should not be confused with banks' *internal models*. Although supervisory authorities assess both elements, they relate to two different dimensions. Internal models are used by banks to estimate the minimum amount of capital they must hold according to the law (own funds requirements), "provided they have prior authorisation from the competent authority".[151] The use of internal models was regulated for the first time by Basel II in 2004, with the so-called internal ratings-based (IRB) approach, which aimed to optimise capital allocation. However, after the financial crisis it became evident that "individual calculations of many banks were not crisis-proof, as their assumptions were way too optimistic", and had in fact fostered a dangerous herd behaviour (Dombret 2017, 2/5). The ECB has thus dedicated a substantial amount of resources to investigate these internal models; the latest document on the topic is a 230-page revised version of the *ECB Guide to internal models*, finalised in October 2019.

The business model, on the contrary, is a multidimensional concept that comprises both key banking activities and the respective funding strategies (Ayadi et al. 2016). The 'Banking Business Models Monitor Europe' report has analysed a large dataset of banks of different sizes and ownership structures, and has identified five types of business models through clustering analysis statistical techniques. The first three models "represent the retail-oriented

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[151] For further details about the SSM's approach to internal models investigation, see https://www.bankingsupervision.europa.eu/banking/tasks/internal_models/html/index.en.html

banks, which are relatively more active in lending to customers" (Ayadi et al. 2016, 20). Model 1 is called *focus retail*, referring to those banks that are mostly active in the traditional deposit-loan intermediation. Model 2 is identified as *diversified retail (type 1),* given that it shows a greater diversification of activities and funding, and it has a higher dependence on customer deposits compared to Model 1. Model 3, referred to as *diversified retail (type 2)*, relies for the most part on debt liabilities for its funding. Model 4 is called *wholesale*, "and includes banks that are active in the intermediation between banks, with a heavy reliance on interbank lending and funding" (Ayadi et al. 2016, 21). Model 5 is referred to as *investment banks*, which groups banks that have considerable trading activities, and fund their respective activities through less stable and less traditional sources, like debt liabilities.[152]

As anticipated, business models are also supervisors' business. The 2014 EBA SREP Guidelines introduced the concept of business model analysis (BMA), as one of the four key elements that are analysed within the ongoing supervisory practices. During the public consultation carried out before the launching of these Guidelines, some banks associations and credit institutions have reacted negatively to the introduction of the BMA as part of the SREP. The following excerpt from the position paper of the German Banking Industry Committee (GBIC 2014, 2/17) during the SREP 2014 public consultation illustrates this position:

> Including an analysis of business models and of the sustainability of business strategies in the SREP guidelines introduces an important new element to banking supervision . . . We would strongly oppose any inference that supervisors should have a say in banks' business policies. Supervisors should not see themselves as "better bankers" than the banks themselves.

[152] For its part, the ECB has also examined the business model issue through clustering techniques. Farnè and Vouldis (2017, 22/3/4) have identified four business models: wholesale funded banks, securities holding banks, traditional commercial banks, and complex commercial banks.

These claims are closely related to deeper transformations of the supervisory practices that are pointed out in Chapters 4 and 5, broadly related to supervisors' intrusiveness and the margin of leeway left to credit institutions. In fact, BMA was not part of the 2004 original SREP design; it acquired greater relevance in the post-financial crisis regulatory and supervisory scenarios, in order to assess both banks' *viability*, i.e. the ability to generate profits over a twelve-month period, and their *sustainability*, i.e. the ability to generate returns over a three-year period (SREP Guidelines). The question of profitability and business models has been a supervisory concern since the early days of the SSM; the main results from a comprehensive assessment on the topic were published in the *SSM thematic review on profitability and business models*, issued in September 2018.

Taking banking diversity seriously is fundamental to any supervisory authority; however, within the SSM context this question acquires particular relevance, if the consistent functioning of the system is to be maintained. In order to balance an accurate and tailor-made assessment of individual banks against a consistent application of the supervisory standards, it was necessary to adapt and broaden the tools from both micro- and macro- perspectives. In relation to the micro-tools, the EBA has played an important role when developing the 2014 SREP Guidelines, as it has contributed to widening authorities' functions and made them more incisive when assessing items such as banking models and internal governance of individual banks. On the macro side, the same Guidelines have emphasised the role of peer analysis and benchmarking exercises in order to enhance system-wide comparability.

3.2.2 Zooming in on the German and Italian banking sectors

The previous subsection has described the set of factors that accounts for banking diversity, and different possible classifications based on governance, ownership structure, and business models. In addition to these pan-European differences, there is a second element to be added to the complexity formula: the diversity between countries. This subsection provides the link between the considerations put forth in the previous section and the following one, where national diversity is examined. As it is beyond the scope of this chapter to conduct an in-depth analysis of all the elements that account for banking diversity in the German and Italian sectors, this subsection limits its focus to the following aspects. First, it provides a general overview of both countries' composition and size of their banking sectors, highlighting the progressive reduction in the number of credit institutions. Second, it discusses the impact that ECB banking supervision can have on local supervisors' practices in the LSI sector. As a matter of fact,

> In the European economies, such as Germany and Italy where commercial banking is highly concentrated, there is diversity owing to differences in legal structure or organization (Miklaszewska and Wachtel 2017, xx).

The previous quote is an example of banking diversity within the German and Italian sectors: large commercial institutions coexist with smaller alternative banks. However, this cohabitation has not been smooth, since "rather than being facilitated, traditional banks ended up being unduly burdened by the new rules . . . [and] the more prudent approach to intermediation of the cooperative and savings banks was not rewarded" (Ferri 2017, 2). Structural transformations of the banking sector date back way before the financial crisis and have had a differential impact upon member States. In order to adapt to the Europeanisation of banking regulation from late 1970s on, national authorities have adopted a series of regulations that aimed at liberalising the sector and enhance cross-border competition, with the ultimate objective of having a truly pan-European banking sector.

Rather than adopting a neutral stance towards the ownership structure of credit institutions, the Italian regulator "intervened to force the transformation of cooperative and savings banks into joint stock banks . . . in the early 1990s, when all the savings banks were forced by law to transform into joint stock banks, and then again in 2015, when the ten largest *Banche Popolari* (cooperative banks of the *Volksbank* type) were obliged to demutualize" (Ferri 2017, 18). This trend has continued until today with the reform of the cooperative banks (*Banche di Credito Cooperativo*, BCC), which are required to join a cooperative banking group incorporated as a joint stock company in order to continue operating. As an alternative to the cooperative group organisation, some stakeholders have resorted to the possibility of forming an Institutional Protection Scheme (IPS).[153] The reform has triggered a series of controversies regarding the proposed joint stock company structure and its impact on the activities carried out by the BCC, but it was implemented in the end.

While "the three-pillar structure [commercial, savings, and cooperative banks] of the banking systems of several European countries has . . . given way to simpler structures in which shareholder-owned banks clearly dominate", Germany is an exception (Schmidt, Bülbül and Schüwer 2014, 101). The alternative banking sector has also undergone problematical situations, which have been exacerbated by the financial crisis. In fact, "there have been problems associated with the central organizations of the savings banks sector (*Landesbanken*), whereas the local savings banks have managed to go through the crisis more or less unharmed"

[153] In a speech by the of head of Banca d'Italia's Supervision Department, Carmelo Barbagallo, he has supported the implementation of the reform, opposing to the alternative of the IPS in light of previous failed attempts to implement it: "Quanto alla soluzione alternativa dell'Institutional Protection Scheme (IPS) - da taluni ventilata come la più adatta a risolvere i problemi delle BCC - vorrei anzitutto ricordare che la categoria del credito cooperativo ha cominciato a discuterne già dal lontano 2005, per poi accantonarla, per mancanza di consenso all'interno del sistema delle BCC, dopo che la Banca d'Italia aveva approvato lo statuto del costituendo Fondo di garanzia nel 2011 e autorizzato l'avvio di una fase sperimentale di operatività nel 2013" (Barbagallo 2018b, 9).

(Kalmi 2017, 39). The weaknesses of Landesbanken started to be evident well before the financial crisis, when State guarantees were abolished by the Commission in 2002, as explained in Chapter 1. The elimination of this beneficial support meant that refinancing was not as easy as before; hence, in order to maintain their profitability, the Landesbanken "took greater risks and invested heavily in securitisation (Lui 2017, 166). The first 2003 IMF FSAP had already pointed out the increasing level of derivatives exposure, reflecting a search for higher yielding products by the Landesbanken (IMF 2003).

There are some broader sectorial trends that are applicable to the German and Italian system. One is the reduction in the number of banks which, as Figure 3.1 below shows, has been steadily declining until today. This is due to the consolidating pressures stemming from the low profitability of the sector and the question of *overbanking* in the EU, compared to the US case. A recent ECB study conceptualises the main dimensions that account for "overcapacity" or "overbanking", terms that are interchangeably used throughout the paper:

> Overcapacities in banking are defined as a state in which the economy is over-financed, the banking sector is over-banked or the customer is over-serviced (or any combination thereof). In fact, a review of the literature suggests that the concept of overcapacities in banking needs to rest on three pillars, comprising (i) the size of the banking system, (ii) the underlying competitive pressures in the sector, as well as (iii) the prevalent market infrastructure/efficiency. (Gardó and Klaus 2019, 4)

One of the consolidation channels are mergers and acquisitions (M&A), an activity that has been on a downward trend. Furthermore, most of the deals that take place are domestic and among smaller institutions (Enria 2019b).

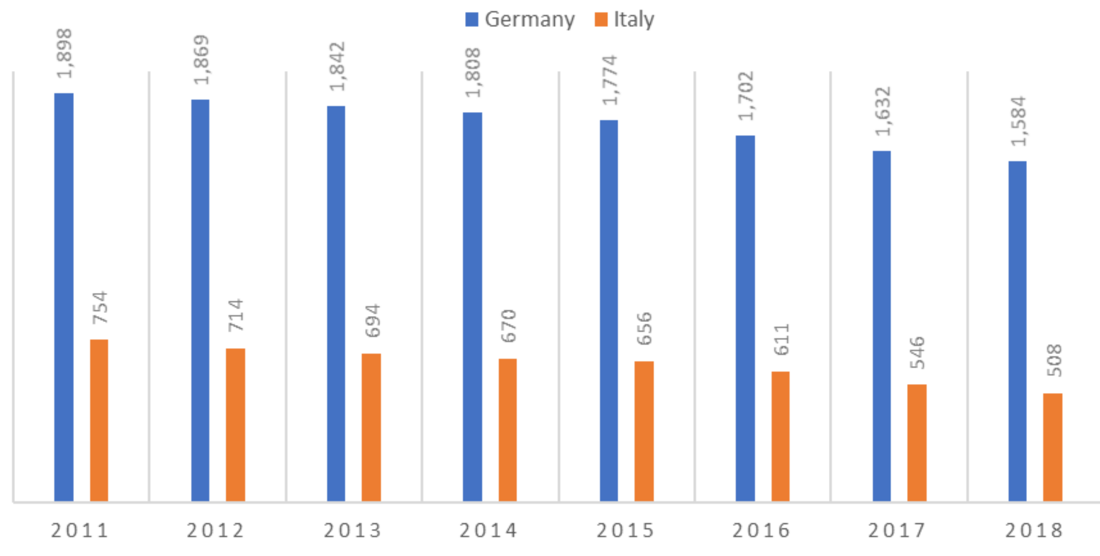

Figure 3.1: Number of banks in Germany and Italy and its declining trend from 2011-2018. Own elaboration. Source: European Banking Federation's (EBF) Facts & Figures from 2012- 2019.

Another commonality between these two countries concerns the relationship between local credit institution and small and medium enterprises (SMEs). One of the most important differences between large commercial banks and smaller local institutions resides in the assessment of the creditworthiness of the borrower, which is reflected in the distinction between *hard* and *soft* information. As far as their nature is concerned, the former is mostly quantitative and is 'backward looking', comparable and transmissible; the latter, on the contrary, is qualitative and linked to the context in which it was produced. Soft information is associated with decentralized organisations, who provide the credit officer with more power and authority (Cosci, Guida, Meliciani, and Sabato 2014). The authors of the study that has assessed the impact of Basel III on Italian SMEs financing, claim that hard information is "cheaper" to communicate because it is ultimately less information; thus, replacing soft with hard information results in a loss of information. Cosci et al. (2014, 161) explain that Basel III has reinforced this deficit: "the new standards seem to have limited the production of soft

information and, therefore, small firms' credit availability." They claim that those who finance small innovative firms are mostly small banks, whose business model was not to blame for the financial crisis.

"Small local banks' screening technologies based on soft information are more able to reduce asymmetric information than those adopted by larger banks, based on standardised rating models using hard information." (Cosci, Guida, Meliciani, and Sabato 2014, 141). Consequently, small, informationally opaque firms prefer to borrow from small banks to avoid credit rationing that would not be beneficial to them. These results are in line with another study carried out by the Italian BCC Federation (*Federazione Italiana delle Banche di Credito Cooperativo, Casse Rurali ed Artigiane,* 'Federcasse'), which highlights that the quality of the credit granted to smaller enterprises was better than the credit given to larger enterprises (Federcasse n.d.). This, again, can be explained by local knowledge, and relational banking, "meaning the existence of a long-term business relationship" (Shackmann-Fallis, Gischer, and Weiss 2017, 5). In Germany, indeed, "many large and medium-sized firms that belong to the so-called 'Mittelstand' have a main relationship bank, which is now more often a savings bank or a cooperative bank than a large private bank." (Schmidt, Bülbül and Schüwer 2014, 109). According to Schackmann-Fallis et al. (2017, 28), this "boring banking" business model is under threat because of the

> Growing dominance of banking regulation based on a plethora of indicators. This approach prevents the inclusion of soft factors which are crucial to SME lending. On top of this, a *strongly quantitative approach in regulation and supervision creates a false sense of security*, which is blind towards new risk factors that might emerge (emphasis added).

This final remark on the perils stemming from a quantitative approach to supervision cannot be ignored in relation to LSI oversight.[154] In fact, it points directly to the relationship between the supranational authority and the NCAs in the performance of their supervisory activities. Although the SSM Regulation contains a series of detailed provisions that aim to organise the activities between these two layers, there remain open questions in relation to the role of ECB banking supervision within the LSI sector. This stems from the umbrella clause in Article 6 (1), last sentence of the SSM Regulation, which reads: "the ECB shall be responsible for the effective and consistent functioning of the SSM". Thus, LSI supervision within the SSM is relevant to both diversity and consistency. In fact, supervisory consistency is the rationale behind the possibility to assume the oversight of LSIs, "when necessary to ensure consistent application of high supervisory standards".[155] In fact, as explained in the 2015 BaFin annual report,

> European supervision *also has consequences for the LSIs going beyond these common procedures*. It is true that the ECB supervises these banks only on an indirect basis. But because the SSM standardises the various national supervisory practices for these institutions as well, it automatically ensures that supervision in all the SSM countries conforms to common standards. (BaFin 2016, 92, emphasis added)

As shown in Chapter 5, an emerging pattern of LSI supervision relates to the fact that the SSM's influence on NCAs does not necessarily come from supervisory practices themselves, but, rather, from the regulatory powers exercised by the ECB.[156] Although the

[154] As the next section shows, the impact of the quantitative approach has been stronger in Germany due to a more qualitative-oriented tradition.
[155] Article 6 (5) (b) first sentence, of the SSM Regulation.
[156] To illustrate the point, when explaining the SREP exercise for LSIs, Banca d'Italia explains that this is based on SSM's Guidances and material developed for SIs: "Anche lo SREP delle banche meno significative si è basato sulle indicazioni fornite dalla BCE per tutto il Meccanismo, tenendo conto del contesto specifico in cui operano i singoli enti" (Banca d'Italia 2015, 95).

instruments issued by ECB banking supervision are—in most of the cases—not directly applicable to the LSI sector, NCAs have played a limited role in adapting these tools to their LSIs.

After having analysed the wide array of factors that account for banking diversity, and the supervisory challenges attached to it, the following section focuses on national diversities. As expressed by BaFin (2016, 87) in its annual report, the supranational supervisor "must reconcile the SSM's objective of treating all institutions equally with an acceptance of specific national differences".

3.3 Unravelling national diversity and related supervisory practices

> *Innanzitutto, si deve riconoscere che le differenze nelle pratiche hanno origine in diverse tradizioni e approcci nazionali.* (Enria 2008, 63).[157]

These words have been written by the current SSM's Chair of the Supervisory Board while working at the CEBS. The circumstances have considerably changed in the domain of banking supervision since then. Although the idea of a pan-European supervisor had been spelled out well-before the crisis,[158] the calls for a centralised supranational supervisor were no more than wishful ambitions, given the close ties between national supervisors and their respective supervisees, which suggests the prominent political role played by banks within national economies.[159]

[157] "First of all, it must be acknowledged that the differences in (supervisory) practices stem form differences in traditions and approaches at the national level" (own translation).
[158] See Chapter 1.
[159] One of the main objectives of the Banking Union and chiefly the organisation of a common supervisor, has been precisely to break these ties between the national supervisor and the banking sector, which has led in some cases to a lenient treatment from the former towards the latter. An open question is whether the SSM might prompt the same ties but at the supranational level in relation to the biggest cross-border players, who are the direct beneficiaries of a unified supervisor and the existence of common rules at the EU level.

Prior to the establishment of the SSM, there were mechanisms in place to ensure that information was shared among supervisory authorities, in light of the cross-border nature of banking activities. The execution of banking supervision was indeed a national task; however, there was what Tommaso Padoa-Schioppa (1999, 301) called a *euro area supervisor*, consisting of "the cooperative system of banking supervisors". In fact, the author explains that "the *euro area supervisor* can be regarded as a rather peculiar entity composed of national agencies working in three modes: stand-alone, bilateral and multilateral" (Padoa-Schioppa 1999, 301). The stand-alone was the predominant mode back then, as it entailed the supervisory activities carried out at the national and even local level. The bilateral mode essentially involved cooperation between two supervisory agencies, and it was made effective through the adoption of Memorandum of Understanding between 'home' and 'host' authorities. The multilateral mode consisted of different supervisors working collectively "as a single consolidated supervisor . . . when the problems involved are area-wide" (Padoa-Schioppa 1999, 302). Although Padoa-Schioppa was ahead of his time when referring to the existence of a *euro area supervisor*, this cooperative system shown some inefficiencies and difficulties in implementing a common supervision. The financial and eurozone crises had been a concrete proof that cooperation and information exchange was not enough, and the differences between national supervisors become apparent.

The "differences in national approaches and traditions" referred to by Enria in 2008, comprise an interconnected set of factors that, in addition to the inherent diversity of the banking sector examined in the previous section, add a layer of complexity in the purse of supervisory consistency within the SSM. The aim of this section is to spell out the elements that configure "national diversity" which, in turn, have shaped the practices and approaches of

the local supervisors. Although there are numerous factors at the legal, social, political, economic, and institutional levels that account for diversity of supervisory practices, this section is restricted to some of them only, due to both technical and space constraints.

In order to identify the factors frame local practices, the first subsection fleshes out the notion of *legal cultures*, and Jasanoff's idea of *public reason*. These two concepts encompass characteristics related to the legal, administrative, policy-making, and public debate cultures at the local level. The aim is to sketch broad differences in patterns that help better understand the characteristic of the national supervisor, in order to shed light on the influence of national diversity within the SSM. This explains why, as anticipated, this study is not a traditional comparative legal analysis.

The second subsection draws upon the insights from an edited volume that compares the German and Italian responses to the EU crisis, through a thorough analysis of dimensions that aim to go beyond the Varieties of Capitalism (VoC) literature (Hien and Joerges 2018b). The edited volume comprehensively deals with the question of *economic cultures* through the contributions of economists, political and social scientists, sociologists, and legal scholars. The third and final subsection assembles the content of the previous two in order to identify patterns in the institutional practices in banking supervision. These institutional practices emerge from the broader socio-legal and economic context in which they are embedded. Hence, this section borrows some of the key insights from the economic cultures' literature, complemented by institutional considerations emerging from the concept of public reason, in order to provide a deeper understanding of different institutional arrangements and practices carried out by local institutions in the German and Italian contexts.

3.3.1 National idiosyncrasies, legal cultures, and public reason

While diversity in the banking sector is considered a positive and desirable aspect in order to maintain financial stability, the question of national diversity has a different connotation. In fact, as outlined in Chapter 1 in relation to the evolution of the single market logic and the enhancement of competition, national specificities appear as a threat and obstacle to a smooth integration process. The harmonisation process that started with a timid directive aiming at coordinating legal provisions back in 1977, culminated with the establishment of a supranational system in charge of enforcing banking supervision. The creation of the SSM has represented a legal, operational, and institutional shift for national supervisors, who had nevertheless already been subjected to cooperation duties in order to manage supervision of cross-border institutions. The SSM is thus integrated by human resources, background knowledge, and worldviews of not just ECB officials, but national authorities as well. Understanding the specific characteristics of member States is crucial to comprehend a substantive part of the SSM's functioning. Therefore, this subsection relies on two mutually related conceptual tools that help better understand the role of national features and their interplay with the supranational order. One is the concept of *legal cultures*, and the other is the idea of *public reason*.

The notion of *legal culture* shows blurred contours and ambiguities: "from the starting point that law and culture and uneasy bedfellows it has become clear that the legal norms are as much shaped by culture as culture is shaped by legal norms. (Helleringer and Purnhagen 2014b, 13). In fact, the edited volume from which this quote has been extracted is entitled *Towards a European Legal Culture*, and its contributors have elaborated different

conceptualisations of legal cultures, which demonstrates the richness of the concept but also its multifaceted connotations.

One of the proposed definitions describes legal cultures as “the sum of non-enforceable prerequisites that a legal society within an autonomous legal system has developed to make, find, interpret, and confirm law” (Afilalo, Patterson, and Purnhagen 2014, 278).[160] A different understanding claims that the notion of “legal culture can be understood as a sociological concept that remains merely empirical and explanatory . . . as an interpretative instrument that enriches the technical nature of rules, or rather as a desirable state so that the notion retains a normative element” (Semmelmann 2014, 306). These references to legal culture do not qualify its jurisdictional scope, i.e., whether they refer to sub-national, national, or supranational legal frameworks. However, some authors have found similarities between the use of legal culture in order to construct the idea of nation-State, and the same use of a European legal culture in order to govern the European market. In fact, since “the achievement of such an internal market could not draw on national politics, law and especially a new, supranational legal culture was assigned a regulatory function that shall work towards this end” (Afilalo, Patterson, and Purnhagen 2014, 285).[161] This market-making instrumental conception of law and the European legal culture represents “constitutional law without politics” (Semmelmann 2014, 311, citing Shapiro 1980, 538).[162]

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[160] The authors conceptualise EU legal culture as “those factors that influence ‘hard’ EU law but can never be subject to direct legal control”, and consider that this European legal culture “resembles what R.[Rodolfo] Sacco has called the ‘legal formants’” (Afilalo, Patterson, and Purnhagen 2014, 278).

[161] Chapter 2 has described the same phenomenon from a historical integration perspective by referring to the “integration through law” phase.

[162] See also Chapter 2 in relation to the criticisms raised to the integration through law approach and the alternatives exposed such as conflict-law-constitutionalism (Everson and Joerges 2012, Joerges 2012).

In line with this reasoning, it has been claimed that "nation states aim to build a homogeneous and coherent legal order . . . [while] the European Union as a Market State is based on a different logic: the market-building logic" (Micklitz 2014, 85). This is mirrored by the existence of 'fragmented markets', and the fact that in a multi-level construct such as the EU, the un-systematics of both supranational law and a European legal culture are part of the same phenomenon (Micklitz 2014), which evidences the different underlying logic between national and supranational conceptions. Micklitz uses *patterns of justice* as an analytical blueprint in order to assess how national legal cultures clash with emerging European legal cultures, given that this concept is understood as one element of legal culture. He compares the UK, France, and Germany's respective social and evolutionary constructs of the notion of *social justice* against the European *access justice*, which constitutes a different genuine model of justice crafted by the "'European legal order' and the 'European constitutional charter'" (Micklitz 2014, 97). In his view, the European model of justice *access justice*, refers to the fact that the EU grants "access to justice to those who are excluded from the market or those who face difficulties in making use of the market freedoms . . . [and it] is not to be equated with social justice" (Micklitz 2011, 2). In fact, access justice is different from the national protective concept, as it is does not aim to guarantee a redistributive social protection. Hence, he claims that "the EU is not coalescing with the Member States' models of justice" (2014, 97), and the reason for this is that access justice "is not flowing from a central power as a political project, but is bound to the European integration process, which is *market driven and bound to a market integration logic*" (Micklitz 2014, 98, emphasis added).

These different logics beget patterns of interaction between national law and EU law, "depending on the degree to which law is replaced, supplemented, completed, overlapped, or

merely amended" by EU law (Micklitz 2014, 99). The "un-systematics of European legal culture" as a distinctive feature from the supranational legal order, stem from these four patterns of interaction between legal orders: *conflict and resistance* (when member States do not want to give way to EU private law); *intrusion and substitution* (the idea of EU law as a self-sufficient order, where law-making and law enforcement aim to build and enhance the workability of markets, as opposed to national logics); *hybridisation* (a composite legal order where both national and EU law play a role within a broader framework); and *convergence* ("a process of mutual approximation of the two different legal orders(" (Micklitz 2014, 107).

The differences between the rationale underpinning national and European legal cultures are relevant to the banking supervision case. In fact, the question of achieving a "common supervisory culture" appears in Recital 79 of the SSM Regulation, and in Article 29 of the EBA Regulation. Since "legal norms are as much shaped by culture as culture is shaped by legal norms", the possibility of constructing a common supervisory culture within the SSM depends on both norms and non-legal elements that influence how these rules are applied. Hence, in the same way as Micklitz has used "patterns of justice" as an analytical device to test the un-systematics of EU legal culture, a similar exercise can be done in relation to the SSM.[163]

An initial comparison between the legal texts that contain the main banking supervision provisions in the German and Italian frameworks, and the SSM regulation, reveals some differences in line with the market integration logic. To start with, concepts such as "single currency", "integration" of banking markets, and "internal market" are integral elements of the

[163] The analysis that follows is not intended to be exhaustive, it is offered to illustrate the differences between the national and supranational logics, but it does not provide a detailed empirical analysis. It is based upon primary legal sources and secondary sources that account for differences among supervisors and their practices.

SSM Regulation. Article 1, setting the subject matter and scope of the regulation, states that prudential supervision shall be exercised

> With a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State, *with full regard and duty of care for the unity and integrity of the internal market* based on equal treatment of credit institutions with a view to preventing regulatory arbitrage. (emphasis added)

This means that the objective of financial stability and integrity of the banking sector needs to take into account internal market considerations and the achievement of a level playing field (echoed by the prevention of regulatory arbitrage). On the contrary, the respective German and Italian texts make reference to broader financial stability and systemic considerations affecting the overall economy, but do not refer explicitly to internal market or integration concerns, even less questions on equal treatment of credit institutions.[164] In fact, the creation of a level playing field is more a pan-European claim than one promoted by national authorities, who are much more conscious of and concerned about the situation of local institutions that have a different scope and institutional characteristics—in line with the features described in Section 3.2 above.

[164] The basic provisions of the text state as follows. The "Testo Unico Bancario (TUB) Decreto legislativo 1° settembre 1993, n. 385, Testo unico delle leggi in materia bancaria e creditizia", states in its article 5 (1): "*Le autorità creditizie esercitano i poteri di vigilanza a esse attribuiti dal presente decreto legislativo, avendo riguardo alla sana e prudente gestione dei soggetti vigilati, alla stabilità complessiva, all'efficienza e alla competitività del sistema finanziario nonché all'osservanza delle disposizioni in materia creditizia*." In turn Article 6 (2) and (4) from the German Banking Act (Gesetz über das Kreditwesen) state that: "(2) BaFin shall counteract undesirable developments in the lending and financial services sector which may endanger the safety of the assets entrusted to institutions, impair the proper conduct of banking business or provision of financial services or entail major disadvantages for the economy as a whole. (4) In exercising its functions, BaFin shall duly consider the potential impact of its decisions on the stability of the financial system in the EEA states concerned". What these texts make clear is that the systemic dimension has to be duly considered and pondered by the supervisors in light of the interconnectedness between banks and the risks this entails, but this does not mean that strengthening the internal market and banking integration is amongst the key aims pursued by the national authorities.

This comparison shows that national and supranational supervisors follow different logics when performing their tasks, and that there could be a degree of inherent "un-systematics" in the pursuing of a European common supervisory culture, due to the different possible interactions between national and EU legal orders (and the practices that emerge from these regulations). This analysis is illustrative and does not intend to be exhaustive, as there are other elements that should be empirically tested in order to scrutinise the presence of the patterns described by Micklitz concerning the relationship between national and supranational law. Given that the SSM Regulation gives preeminence to the supranational authorities when it comes to SIs supervision, it could be claimed that "intrusion and substitution" is the category that best summarises the interaction between the national and supranational domains.[165] However, the SSM Regulation specifically acknowledges the need to apply national legislation transposing Directives, and national legislation exercising options and discretions granted to member States; therefore, this can give rise to other patterns of interaction, such as "conflict and resistance", "hybridisation", or "convergence", depending on the specific content of these national provision and the local practices in relation to them. This, again, highlights the mutual interdependence and connection between legal and meta-legal elements in the unfolding of supervisory practices.

After having outlined the notion of legal cultures, the second part of the section focuses on a concept that condenses further characteristics local particularities: *public reason*. Public reason is an "answer to the problem of trust in an age of uncertainty . . . [and] what ruling

[165] And LSI supervision in some cases as well, in light of the provision set forth in Article 6.5(b) of the SSM Regulation, according to which the ECB can exercise its supervisory powers upon LSIs in cases where it is "necessary to ensure consistent application of high supervisory standards". This relates to the question about the nature and sources of the ECB supervisory powers discussed above, and the conflicting visions expressed by the General Court in the *L-Bank* case and the *BVerfG* (German Constitutional Court) afterwards, and the latter's efforts in order to reconcile different views. See section 3.4 for further discussions on this question.

institutions do in practice when they claim to be reasoning in the public interest" (Jasanoff 2012, 5). This particular type of reasoning includes "institutional practices, discourses, techniques and instruments through which modern governments claim legitimacy in an era of limitless risks" (Jasanoff 2012, 5). The importance of this concept, and its link with national idiosyncrasies and legal cultures, rests upon the reference to *non-legal elements* that account for the "reasoning" of specific institutions. These considerations seem rather abstract; they are nevertheless related to the study of diversity within supervisory practices, and complement the insights on legal cultures explained above. Jasanoff's (2012, 15) work examines the intersection of law and science "as sites of shared knowledge production and norms-making" and conceives this law not as a mere written text, but, instead, "as a set of practices . . . a continuous historical narrative of what societies are about" (Jasanoff 2012, 6).[166] The narrative feature might be more difficult to detect in highly-technical domains such as prudential regulation. However, as Chapters 4 and 5 show through the analysis of public consultations and the respective position papers submitted by relevant stakeholders, the field is loaded with "diagnostic struggles" (Carruthers and Halliday 2007, 1150), which entail defining a problem, constructing it, and relating it with concrete legal amendments in order to reframe the issue at stake.

It is precisely in this regulatory battlefield that policy-relevant knowledge is translated into regulation, and in Jasanoff's view, countries systematically differ in their approaches to public reason, "that is, how policy-relevant knowledge is generated . . . evaluated for policy

[166] Practices and culture are indeed closely related. According to constructivist literature focusing on international practices, "culture is not only in people's mind, discourse, and interactions; it is also in the very performance of practices" (Adler 2013, 126). These practices, in turn, are not only useful to systematize the world, but also are the basic elements that help building it: in fact, they "acquire concrete and workable theoretical and empirical meaning in the concept of 'community of practice'", and it is in these collectives that "practices develop, diffuse, and become institutionalized" (Adler 2013, 126).

purposes, how scientific disputes are resolved, and how lay publics are engaged in decision-making" (Jasanoff 2013, 134). This means that banking supervision and the regulatory apparatus governing its practices, are a product of public reason features. Jasanoff (2012, 20) also claims that "making sense of public reason as a social and cultural achievement dissolves the boundaries between micro and macro . . . [and] culturally distinctive styles of reasoning are reinforced in the micro-practices of powerful institutions".

This chapter provides a broad-brush of such practices and differences. Chapters 4 and 5, instead, analyse in greater detail these institutional "micro-practices" in relation to both supervisory and regulatory competences.[167]

What is of particular interest in this field is that these elements shaping public reason operate at the local level, but are influenced by global forces that mould the way banking and financial institutions work. The next section zooms on in the question of *economic cultures*, which mirrors this intricate relationship between local, European, and global forces in the making of institutions and their practices; Section 3.3.3 identifies how these socio-economic and socio-legal patterns impact on the way supervisory practices have unfolded in Germany and Italy.

3.3.2 Beyond Varieties of Capitalism: Economic cultures

The varieties of capitalism (VoC) literature, which has been first exposed in Hall and Soskice's seminal 2001 book, has taught us that national economies have developed a series of

[167] When explaining the relationship between law and science/knowledge, Jasanoff (2012, 16) insists on the importance of digging into the "complexities of adjudicatory practice and discourse" in order to dissect expertise, and how this should be done in crucial moments in which expert rationality is being reconceptualised. These adjudicatory and discursive practices are also examined in the respective empirical chapters.

institutional complementarities that give them economic leverage, which is condensed in the concept of *comparative institutional advantage*. The idea behind it is that "the institutional structure of a particular political economy provides firms with advantages for engaging in specific types of activities there" (Hall and Soskice 2001b, 37). This literature has indeed taken diversity seriously, in an attempt to call into question monolithic economic and political approaches that are normally associated with the phenomenon of globalisation.[168] When explaining national varieties of capitalisms, the authors consider a broad set of elements that goes beyond "formal institutions" (e.g. what they call "deliberative institutions"). In fact, they believe that formal institutions are not enough for coordinating strategic interaction, and therefore "emphasise the importance of informal rules and understandings . . . [which] are an element of the 'common knowledge' that leads participants to coordinate". (Hall and Soskice 2001b, 13).

These insights suggest some affinity between the authors' analysis and the role played by the banking sector within national economic systems. VoC studies have identified five spheres in which firms need to resolve coordination issues: industrial relations, vocational training and education, corporate governance, inter-firm relations, and employees (Hall and Soskice 2001b, 7). Among these spheres, the *corporate governance* one focuses on the firm and its access to finance, which is closely related to the ties between banks and firms or the broader industrial sector. It is precisely this financing relationship that evinces the political side of banks, due to the importance that industrial policies have at the political level. As referred in Section 3.2.2 above, the presence of LSIs in the German and Italian banking sectors

[168] This is in line with Teubner's (1998) criticism of the so-called "convergence thesis" of industrialised nations, and the explanation provided in Chapter 2. In fact, Teubner's 1998 paper was republished in the 2001 VoC book.

can be also explained in terms of the financial needs that these smaller credit institutions fulfil.[169]

While acknowledging the importance of the VoC literature and its invaluable contribution to the understanding of national political economies, diversity of supervisory practices can be better grasped through an *economic cultures* approach, which is also better aligned with the legal cultures and public reason concepts introduced in the previous section. As mentioned above, the industrial policy of a country is closely related to the ways in which these firms finance their activities, and hence determines to some extent the structure of the banking sector—and the existence of more or less sources of alternative financing available, such as capital markets, which are not considered for the purposes of this work. The broader panorama offered by the economic cultures approach goes beyond institutional configurations by including a "historical perspective that sheds light on the political evolution of these economies and how it is embedded in national cultures, traditions, and economic ideas" (Hien and Joerges 2018b, 9). Since the aim of this section is to trace and identify patterns of supervisory practices in the German and Italian frameworks, the scope is more limited than the broader conceptualisation of economic cultures proposed by Hien and Joerges in their volume.

A way to unravel the notion of economic cultures in the context of banking supervision is by focusing on central banks. Although it is true that there are different institutional arrangements in the supervision realm, and not all central banks are the competent supervisory authorities—the German and Italian comparison is indeed a good example of these institutional

[169] Although Germany and Italy, together with Austria, are among the countries with the largest number of LSIs, the Italian banking system has recently undergone structural changes according to which the Cooperative Banks (*Banche di Credito Cooperativo, BCC*), are required to join a cooperative banking group incorporated as a joint stock company, in order to continue operating, as earlier explained.

differences—monetary policy institutions are in one way or another related to the development of supervisory practices. In fact, the *Banca d'Italia* (BdI) and the Bundesbank are two influential institutions in their respective countries, regardless of the powers they have been conferred in banking oversight. From a historical standpoint, BdI was established in 1893, and in 1926 it became the sole institution having the right to issue currency. With the 1936 Banking Act, BdI was granted supervisory powers, and its public nature was explicitly acknowledged.[170] The Deutsche Bundesbank, on the contrary, was set up in 1957, although it was not a completely new institution: "its roots stretch back to . . . the Bank deutscher Länder, set up by the Allies during the post-war occupation" (Marsh 1992, 18). A comprehensive supervision was established after the 1931 banking crisis; before that, only specific groups of credit institutions were under oversight. In fact, the 1934 Banking Act of the German Reich established a more encompassing supervision.[171] After World War II, supervision was decentralised in the Western occupation zones, and was centralised again with the Federal Supervisory Office for Banking, following the enactment of the 1962 Banking Act (Detzer et al. 2017).

As evinced by this brief account, both the Fascist and Nazi regimes deemed banking regulation and, most importantly, the link between monetary policy and the banking sector, as a policy priority. For instance, the 1936 Italian Banking Act acknowledged that banks

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[170] Further historical details can be found in BdI's official website: https://www.bancaditalia.it/chi-siamo/storia/index.html

[171] "The Act marked the beginning of a general, codified system of banking supervision, the basic principles of which have in some respects survived to this very day. These include, for example, the involvement of the central bank in banking supervision (section 7 of the Act), the obligation to obtain an official licence in order to be able to conduct banking business, principles governing the amount of liquidity that banks must hold as well as reporting requirements for all banks." For further historical details, see the BaFin official website: https://www.bafin.de/EN/DieBaFin/AufgabenGeschichte/Bankenaufsicht/bankenaufsicht_node_en.html

performed public interest activities.[172] Credit allocation was considered a key policy instrument within the fascist centralised economic organisation.[173] Furthermore, the 1936 Act contained a lengthy set of supervisory tools, although the objectives that the authorities were meant to pursue were not clearly spelled out in the act (Donato and Grasso 2014). Furthermore, the Italian 1948 Constitution introduces the principle of savings protection (*principio della tutela del risparmio*), through which access to credit is granted constitutional status.[174] Apart from encouraging and safeguarding savings in all forms, the provision establishes that the Republic "regulates, co-ordinates and oversees the operation of credit".[175]

In Germany, the Nazi regime was also characterised by centralising efforts of banking supervision. In response to the 1931 banking crisis, "a banking supervisory authority with jurisdiction over all the German banks was established for the first time on September 19, 1931 by the Emergency Decree of the Reich President" (Deutsche Bundesbank 2000, 32), and the 1934 Banking Act confirmed this allocation of functions. In 1939, another Banking Act transferred prudential tasks to the Reich Banking Supervisory Office, which directly reported to the Ministry of Economics; however, in 1944, an amendment to the Banking Act "granted complete sovereignty over banking supervision to the Reich Ministry of Economics"

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[172] Article 1 states that: "*la raccolta del risparmio fra il pubblico sotto ogni forma e l'esercizio del credito sono funzioni di interesse pubblico*..." ("savings collection from the public and the provision of credit constitute public interest functions", own translation).

[173] As explained by Donato and Grasso (2014, 4/5), "«il regime [fascista] stava avviandosi verso un modello di organizzazione dell'economia fortemente accentrato», nell'ambito del quale le autorità governative ambivano a disporre della leva del credito come strumento di politica economica; al contempo, si intendeva evitare che, nel futuro, potessero verificarsi nuove crisi di sistema, la cui causa scatenante venne ravvisata nelle specificità del modello della banca mista (o universale)" (citing Costi, *L'ordinamento bancario*. 2012, p. 57.). This quote refers to the fact that the fascist regime supported and developed a centralised economic model, in which targeted credit provision was an important political economy tool.

[174] Article 47 of the Italian Constitution: "La Repubblica incoraggia e tutela il risparmio in tutte le sue forme; disciplina, coordina e controlla l'esercizio del credito. Favorisce l'accesso del risparmio popolare alla proprietà dell'abitazione, alla proprietà diretta coltivatrice e al diretto e indiretto investimento azionario nei grandi complessi produttivi del Paese."

[175] As per the official English translation of the constitutional text.

(Deutsche Bundesbank 2000, 32). With the end of World War II, banking supervision was decentralised by the Western military governments, and responsibilities were conferred to the Länder. After more than ten years of debate, the 1961 Banking Act was adopted. This legislation centralised once again banking supervision in the hands of the Federal Banking Supervisory Office (BAKred), in order "to ensure the uniformity of administrative practices throughout [the] Federal territory" (Deutsche Bundesbank 2000, 32).

The historical overview provided in the Bundesbank report, mentions an additional aspect that helps characterise the German supervisory system. The monthly report states that in order to keep pace "with the notion of a free-market economy, the guiding idea behind the Banking Act had been . . . to hold *government prudential regulation down to the necessary minimum*" (Deutsche Bundesbank 2000, 33, emphasis added). This somewhat "light touch" approach can be understood in light of BAKred's weak institutional position. In fact, the Banking Act gave the Bundesbank an important role within the supervisory process, which has remained until these days.[176] Furthermore, "it was always left to market participants to ensure compliance to the rules through their respective associations"; this "practice of delegating" allowed BAKred to operate with a limited number of financial and human resources, and "led to a relatively high distance between the BAKred and the regulated institutions" (Detzer et al. 2017, 93). Another interesting fact pointed out by the Bundesbank's historical report, relates to the lengthy parliamentary fight before the adoption of the 1961 Banking Act: "at the centre of this

[176] Section 7 of the currently in force Banking Act stipulates the conditions under which the close cooperation between BaFin and Bundesbank takes place, which evinces the importance of the Central Bank's role in the supervisory domain: "BaFin and the Deutsche Bundesbank will cooperate as stipulated in this Act. Without prejudice to further legal provisions, this cooperation encompasses the ongoing supervision of institutions by the Deutsche Bundesbank. Ongoing supervision notably entails evaluating the documentation submitted by institutions, audit reports pursuant to section 26 and annual financial statements as well as performing and evaluating on-site inspections with a view to assessing institutions' capital adequacy and risk management procedures, as well as appraising inspection findings. As a rule, the Deutsche Bundesbank's ongoing supervision is performed by its Regional Offices (*Hauptverwaltungen*)."

struggle stood the transfer of banking supervisory competence, which had previously been the preserve of the individual Länder, to a 'superior Federal authority'" (Deutsche Bundesbank 2000, 33); this legislative battle was subsequently taken to the German Constitutional Court (BVerfG). Interestingly, some year afterwards, similar petitions had been submitted before the BVerfG in relation to the transfer of competences operated in the SSM.[177]

One of the key differences between Germany and Italy, relates to the series of institutions that were created in the case of the German supervisory authority, while in Italy, notwithstanding the many legislative reforms, banking supervision has always been performed by the same institution. This is linked to the powers that these institutions have been conferred since their establishment. While BdI concentrates what we now know as monetary and supervisory powers, the Bundesbank was circumscribed to safeguarding currency stability. The Bundesbank's seemingly restrictive mandate should not lead us to believe that the institution has circumscribed powers, for at least two reasons. First, as further explained below, maintaining currency stability went well beyond mere economic and exchange rate performance, as within the German socio-political folklore, price stability represents more than just economic stability: "stable money brings stable government, and stable government brings a stable society" (Marsh 1992, 257). The exclusive focus on safeguarding the currency allowed for strong central bank independence, which provided a shield from political control. Second, as explained above, apart from its monetary policy tasks, the Bundesbank plays an important role in the supervisory domain. In fact, it shares banking oversight responsibilities with BaFin: Sections 6 (1) of the Banking Act establishes that BaFin is the administrative authority

[177] Judgment of 30 July 2019, 2 BvR 1685/14, 2 BvR 2631/14; see Section 3.4.1 below for further details about the BVerfG's decision.

responsible for banking supervision, while Section 7 (1) governs the cooperation between BaFin and the Bundesbank in the institutions' ongoing supervision.[178] Hence, its high public standing in relation to the price stability mandate, and the continuous cooperation with BaFin in the provision of technical expertise in the supervisory field, highlight the importance of the Bundesbank within the German institutional framework, in spite of its seemingly limited powers.

	ITALY	**GERMANY**
Responsibilities of Banking Regulators (Micro/Macroprudential)	Banca d'Italia has both micro and macroprudential responsibilities	Shared responsibilities: Deutsche Bundesbank: macro BaFin: micro (subordination of the Central Bank)
Fragmentation of Monetary and Supervisory Policies	Concentrated institutional arrangement: Banca d'Italia is both the supervisory and monetary authority	Close cooperation with Bundesbank, but BaFin makes final decisions on supervisory measures

Table 3.2: German and Italian monetary and supervisory institutional arrangements. Source: Own elaboration.

As anticipated, the evolution of the legal and institutional settings is the result of the interplay of national, European, and global forces. In addition to local crises and the impact of global finance, the need to adjust to the single market and single currency provisions at the EU level has triggered successive legal amendments, under which the notion of banking supervision has been modified.[179] The Italian framework has undergone an important

[178] This legal provision "stipulates that, among other things, the Deutsche Bundesbank shall, as part of the ongoing supervision process, analyse the reports and returns that institutions have to submit on a regular basis and assess whether their capital and their risk management procedures are adequate." BaFin's official website: https://www.bafin.de/EN/DieBaFin/AufgabenGeschichte/Bankenaufsicht/bankenaufsicht_node_en.html

[179] Scatamacchia (2012, 594) illustrates the ways in which international and local factors have conflated in shaping the evolution of supervisory governance: "Di qui l'ipotesi che la configurazione assunta in Italia dal sistema di vigilanza, benché imprescindibile dal quadro internazionale, sia stata – anche – il frutto di una complicata dialettica tra governo, banca di emissione, istituti di credito e delle problematiche relazioni tra sovranità e autogoverno, dottrina e politica, legittimità e disciplina."

transformation from a structural supervision (*vigilanza strutturale*), to a prudential regulatory oversight (*vigilanza regolamentare*). The so-called structural approach had been crystallised in the 1936 Banking Act, which conferred a more dirigiste role to the supervisory authority in the planning of the banking sector's structure (Donato and Grasso 2014). Banking supervision, thus, has undergone a paradigmatic shift: it went from determining and organising the optimal market, to adopting a prudential approach, whose focus was placed on market dynamics and banks' capacity to comply with sound and prudent risk management practices, assessed against objective and specific criteria.[180] With the adoption of the first banking coordination directive in 1977, and the second one in 1989 establishing the single banking licence across the EC, supervisors were required to issue the respective authorisation on the basis of harmonised objective criteria to be fulfilled by the credit institutions (Brescia Morra 2016). The banking activity has therefore lost its special status and was considered as any other commercial activity subject to competition considerations.[181]

In Germany, the evolution of banking supervision and regulation has also been moulded by global finance, and the increasing efforts at the European level in order to harmonise the field. For a considerable time, the Bundesbank "resisted liberalisation and the introduction of many financial innovations due to concerns about the effectiveness of monetary policy, minimum reserve requirements, and a spread of short-termism" (Detzer et al. 2017, 102). As anticipated, this short-term view was detrimental to the traditional long-term financial

[180] When explaining the evolution of supervisory approaches, Donato and Grasso (2014, 6) refer to the influence of the EU Directives and the changes imposed by them in opening the banking market to international actors: "la legislazione comunitaria ha imposto di «sganciare» le valutazioni dell'autorità di vigilanza da considerazioni in merito all'assetto di mercato ritenuto ottimale, già alla base di numerosi procedimenti autorizzativi . . . attraverso l'apertura del mercato bancario domestico a nuovi players internazionali".
[181] For further historical aspects concerning the evolution of the supervisory arrangements, see Brescia Morra (2016), chapter 7. Specific historical aspects of the early years of banking supervision can be also found in Scatamacchia 2012.

relationship between the industry and the most important German banks.[182] However, the ties between banks and non-financial firms started to loosen once the big private banks decided to go global and turn to a more profitable investment banking business, which came along the proposal of making Germany an international financial centre, crystallised in the 2003 *Finanzplatz Deutschland* ('Germany as a financial centre') initiative (Detzer et al. 2017). The need to adjust to the new pro-finance context, and the awareness of the regulatory arbitrage operations carried out abroad in order to overcome local restrictions, made the Bundesbank both unwilling and incapable of slowing down financial innovation. Furthermore, the reform of the supervisory structure was hotly debated by the end of the 1990s and early 2000s, given the weaknesses of the framework, which was characterised by understaffed and poorly equipped agencies, and the lack of cooperation between them. After long disputes between the Bundesbank, the agencies, and the ministries concerned, the Federal Financial Supervisory Authority, BaFin, was established in May 2002 (Detzer et al. 2017), and made responsible for the supervision of the banking, insurance, and securities industries, respectively. The next section provides further details about the relationship between Bundesbank and BaFin, and banks' perceptions regarding the allocation of tasks between them.

The last part of this subsection focuses on a feature that well depicts the notion of economic cultures, and which has been important in the way central banking aims—monetary and supervisory policy activities—are conceptualised: the notion of *stability* in its different forms. In the aftermath of the global financial crisis, the question regarding central banks' "financial stability mandate", in addition to the price stability one, came to the forefront. This

[182] As explained by Detzer et al. (2017, 98), "traditionally the big German banks had tight relations with the big German industrial firms. The banks provided the firms with long-term loans, held large amounts of their shares, and were represented at their supervisory boards."

final part of the subsection, hence, aims to provide a broad-brush overview of how the concept of stability relates to the Banca d'Italia and the Bundesbank, in light of the different supervisory arrangements and competences.[183]

As anticipated, the seemingly restrictive mandate of safeguarding the currency has indeed a deeper meaning within the German institutional framework. The rich and detailed historical account of the Bundesbank provided by Marsh (1992) portrays the wider implications of monetary stability. Prior to 1945, the State was responsible for monetary stabilisation; "afterwards, the Germans learnt that stable money would stabilise the state" (Marsh 1992, 30).[184] Hence, stable money became "an anchor" for the new democratic regime: "for Ludwig Erhard . . . architect of the economic 'miracle' of the 1950s and 1960s, monetary stability deserved a place as one of the 'basic human rights'" (Marsh 1992, 30, citing Erhard's 1957 book *Wohlstand für alle*).[185] Given that the conception of currency stability is deeply rooted in Germany's history and cultural baggage, it is fair to question how the Bundesbank's model has been "transplanted" to a wider euro area context, given the divergent underpinning rationales and the different degree of governments' control in other European central banks. In fact, "as a result of differences in their legal statutes and traditions", not all central banks have the same determination to pursue *Stabilitätspolitik* ('stability policy') (Marsh 1992, 15). Therefore, legal

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[183] It should be clarified that the analysis refers to the competences originally assigned to these central banks, regardless of the transfer of competences to the ECB that took place firstly, in the monetary policy domain and, secondly, in the banking supervision one.
[184] "The roots of the Germanic attention to stability, indeed, go deeper, to the concept of order as the foundation of state power" (Marsh 1992, 29). In a different passage of the book, Marsh (1992, 31), illustrates how "monetary and political history have marched in tandem", given that the key monetary reforms over the XX century—"the creation of the Reichsmark after the 1923 hyperinflation, the birth of the D-Mark in 1948, and the 1990 demise of the East Mark which accompanied the Bundesbank's expansion into East Germany"—represented major junctures at the national socio-political level as well.
[185] Erhard, economic minister from 1949 to 1963, and his adviser Alfred Müller-Armack had been some of the most prominent ordoliberal leading figures. For a detailed discussion about ordoliberalism and its (potential lack of) relationship with the EU financial crisis, see Hien and Joerges (2018a).

and economic culture differences cast doubts on whether this approach to central banking could be effectively transferred to the euro area level.

In fact, when key bargaining sessions before the adoption of the Maastricht Treaty took place, the Bundesbank feared that the primacy of *Stabilitätspolitik* would be disregarded (Marsh 1992). However, "the Community's heads of government accepted the Bundesbank-inspired regulations for the independence of the EC central bank . . . [and therefore] countries like France and Italy, long used to their central banks being dependent on the government, could agree to such far-reaching innovation" (Marsh 1992, 247).[186] The Maastricht process, therefore, symbolises a first attempt to bring together different central banking cultures. In fact, albeit the Bundesbank managed to export its "anti-inflation rectitude" (Marsh 1992, 259) and its *Stabilitätspolitik* consensus throughout Europe, the ECB's decision-making process is based upon the joint decision of all of the euro area's Governors.

Stability and European integration had a particular connotation in Germany, beyond the question of currency stability. Although the Basic Law for the Federal Republic of Germany (*Grundgesetz*) does not have a similar provision on credit and savings' protection as the Italian does, Article 88 of the *Grundgesetz* refers to the establishment of the Bundesbank ("The Federal Bank", in the English official translation), and the delegation of powers and responsibilities to the European Central Bank.[187] This article has been amended in order to

[186] The present section does not further explore the motivations behind the acceptance of a completely different model of central bank on the part of the Italian authorities. However, as discussed in Section 3.4 below, there is partly an instrumental use of the integration process, according to which "European integration was used by nearly the entire political spectrum as a way to legitimise their claim to governing the country" (Della Sala 2015, 6/11).
[187] Article 88 of the German Constitution: "[The Federal Bank – The European Central Bank] The Federation shall establish a note-issuing and currency bank as the Federal Bank. Within the framework of the European Union, its responsibilities and powers may be transferred to the European Central Bank, which is independent and committed to the overriding goal of assuring price stability."

allow for such delegation of powers, and it has been one of the controversial issues discussed in the BVerfG's 1993 Maastricht decision:[188]

> The concept of the Monetary Union as a '*Stabilitätsgemeinschaft*' (community of stability) is the basis and subject matter of the German Act of Accession. If the Monetary Union should be unable to continue to develop the stability existing at the beginning of the third phase in accordance with the agreed commitment to ensure stability, then it would abandon the contractual conception (BVerfG 89, 155, para. 90).

The BVerfG's consideration of the concept of *Stabilitätsgemeinschaft* as a fundamental element that has allowed Germany's accession to the EMU, plus the importance of the *Stabilitätspolitik* consensus forged by the Bundesbank in the formative phases of the ECB, shows how the concept of stability transcends mere monetary elements, but instead is part of deeper cultural aspects.

In Italy, the notion of stability has also acquired a broader meaning than a merely monetary one, but for different reasons. The fact that the Banca d'Italia concentrates both monetary and supervisory powers, helped building up a wider concept of stability that went beyond price stability and inflation control. Article 5 of the Consolidated Law on Banking (*Testo Unico Bancario*, TUB), identifies the "overall stability" (*stabilità complessiva*) as one of the key aspects that authorities should bear in mind when conducting supervision, together with a micro-oriented approach focusing on the soundness of individual institutions, and efficiency and competition considerations. One of the reasons that explains this unitary view can be found in the fact that, "until the 2005 reform, the Bank of Italy was one of the most centralised and hierarchical central banks in Europe. The Governor had wide powers and discretion . . . because all responsibilities in the field of *monetary, exchange-rate, and*

[188] BVerfG 89, 155.

supervisory policies were concentrated in his hands" (Quaglia 2015, 2/10, emphasis added).[189] These centralising features have been mitigated, first, by the EMU and joint monetary policy decisions, and second by the 2005 governance structure reform. Among other aspects, it increased "the influence of the government in the appointment procedures" (Quaglia 2015, 7/10), while establishing a six-year mandate for the members of the Executive Boards, which was *sine die* before 2005; it also rendered the decision-making process more pluralistic through a formal voting procedure.

This encompassing features of stability are closer to the current conception of financial stability. The Italian TUB dates back to 1993[190] and in the early Maastricht days, financial stability was not as popular as the price stability concept inherited from the Bundesbank, as pointed out above. Just to illustrate this point, the TFEU mentions the phrase "price stability" sixteen times, while "financial stability" does not appear at all; likewise, the ESCB and ECB Statute[191] mentions the former twice while the latter is absent. It was only after the global financial crisis and the European sovereign debt and fiscal crises, that financial stability started to be incorporated in the legislative texts. In fact, the SSM Regulation contains the expression twelve times, while other relevant Banking Union texts, such as the Banking Recovery and Resolution Directive (BRRD), mentions it fifty-six times.

[189] In the 2006 IMF's FSAP, the following question was raised by the report in connection with BdI's transparency and potential conflicts: "At the time of the assessment, BI was by law assigned at least three broad objectives, namely maintaining the stability of the financial system, enforcing Italy's antitrust laws, and promoting the efficiency and competitiveness of the banking sector. While the authorities indicated that, staff believe that BI should not be promoting "competitiveness" and recommend that the wording should be changed in the Banking Law."

[190] Section 5 has not been amended by the successive legislative modifications to the Decree; hence, its text corresponds to the 1993 version.

[191] Protocol (No 4) on the Statute of the European System of Central Banks and of the ECB OJ C 202, 7.6.2016, p. 230.

It is true that conceptualising financial stability is a challenging enterprise, as its boundaries and measurement are much more difficult to establish than those of price stability. However, it was only through the financial stability notion that the so called "unorthodox" monetary policy measures have been incorporated in the central bankers' toolbox, in tandem with the shift towards macroprudential policies in order to supplement the microprudential ones. Therefore, the shift towards financial stability made the interconnectedness between monetary policy design and the banking sector more explicit, which is reflected in the current developments of the monetary and banking unions. In fact, a money-centric view of the banking sector accounts for the way in which the banking and the so-called "shadow banking" sectors operate, and how money creation is in the hand of these institutions as well.[192]

This subsection has provided an overview of what economic cultures means, and its impact upon central banking activities. The next section focuses on how the characteristics that account for national specificities impact upon the development of specific supervisory practices. In fact, by looking at the evolution of the supervisory and regulatory tools in the hands of the authorities, it is possible to identify some traits of the supervisor-supervisee relationship, and more broadly, of the supervisory approaches.[193]

[192] See Ricks (2016) "The Money Problem", where the author explores the close ties and interconnection between the monetary and banking systems in the US. The insights provided by the book are fundamental to the present discussion for two reasons. First, the US case represents an illustrative comparison because it is also a monetary and a banking union; hence, it presents important similarities with the EMU and Banking Union at the euro area level. Second, the book points out the importance of what Ricks calls the "public-private partnership": this is no more than the institutionalisation of public risk sharing mechanisms that lay at the base of the intersection between the monetary and the banking systems. The most paradigmatic example of this partnership is given by the Federal Deposit Insurance Company (FDIC), which guarantees depositors' protection at the federal level. Its main policy aim, as attested by historical sources that account for its creation in the aftermath of the 1929 crisis—through the 1933 Banking Act—is that of preserving the stability of the financial system, and then protecting individual depositors as a complementary aim.

[193] This analysis should be complemented by the insights provided in Chapter 4, which also illustrates the underlying differences in supervisory and regulatory approaches. Said institutional specificities are an integral part of the legal and economic cultures.

3.3.3 Characterising supervisory practices

This final subsection draws upon the content of the previous two, in which questions concerning legal culture, public reason, and economic cultures have been addressed. The aim is to bring together some of the characteristics depicted above and additional documentary sources, in order to better understand differences between supervisory practices. In fact, culture and practices are interwoven concepts, since culture is expressed through performative action (Adler 2013). Due to space and technical constraints, this section focuses on a specific set of supervisory practices, on the basis of available documentation and secondary sources. The main official sources upon which this section is based, are the Financial Sector Assessment Program (FSAP) produced by the International Monetary Fund (IMF),[194] and the annual reports from the two institutions that are analysed in this subsection, Banca d'Italia and BaFin.[195]

As mentioned in the introduction of the chapter, the only attempt to conceptualise and characterise supervisory cultures—to the best of my knowledge—has been done by Carretta et al. (2015). In their empirical study, they draw upon Hofstede and Hofstede (2010), who identified six types of national cultures that in their view could also provide a helpful way to "determine a national banking authority's culture: *Power Distance*, *Collectivism*, *Masculinity*, *Uncertainty Avoidance*, *Normative* and *Indulgence*" (Carretta et al. 2015, 181) These cultural

[194] The FSAP "is a comprehensive and in-depth assessment of a country's financial sector" which analyses, among other aspects, "the resilience of the financial sector, the quality of the regulatory and supervisory framework, and the capacity to manage and resolve financial crises", in order to produce country-specific recommendations. For further details about the programme, see the official website: https://www.imf.org/external/np/fsap/fssa.aspx

[195] Bundesbank's annual reports have not been considered for the analysis because they refer to supervisory activities in a more incidental way as part of the overall activities developed by the German Central Bank.

categories are not mutually exclusive, although any of them could prevail under certain circumstances. *Power distance* refers to a supervisory culture mainly based upon an authoritative empowerment by the regulation, with little room for flexibility; *collectivism* refers to a culture that focuses on banking market structure and the achievement of overall stability; *masculinity* expresses a "social inclination for achievement, confidence and compensation for success" (Carretta et al. 2015, 182); *uncertainty avoidance* explores the degree to which a society is risk- and uncertainty- averse; *normative* supervisory cultures are characterised by a strong concern for establishing normative truth and the analysis of potential consequences of unexpected behaviour by supervised entities; finally, *indulgence* as a supervisory orientation is prone to a more flexible approach in the enforcement of rules, forbearance, and openness to accept supervisees' requests (Carretta et at. 2015). These supervisory cultures or approaches to supervision are neither immutable nor absolute.

The present subsection does not empirically test which of the six supervisory cultural models fits the practices of German and Italian authorities. Instead, on the basis of information gathered through background interviews, and the examination of official documentation,[196] the analysis compares a number of dimensions that are useful to characterise the supervisory practices.[197] The identified supervisory dimensions and their respective characterisations are summarised in Table 3.3:

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[196] The official documents were analysed with the assistance of the data analysis software MAXQDA, especially the MAXDictio function. The comparative analysis of the respective German and Italian official documents, was carried out by identifying 'key words in context', that helped characterised the supervisory practices and styles, such as: transparency, Pillar 2, add-on, SREP, contact, on-site, intensiveness, qualitative, quantitative, independence, reforms, intrusive/intrusiveness, discretion, flexible/flexibility, binding, non-binding, rules based, principles based, internal process, power, competences, mandate, enforcement (and the respective Italian translation).

[197] The characterisation provided in this subsection is complemented by the successive empirical chapters, particularly Chapter 4 and the evolution of the SREP governance at the national and supranational levels.

Supervisory practices dimensions		
Nature of the evidence/requirements	Quantitative	Qualitative
Nature of the instruments setting supervisory requirements	Rules-based	Principles-based
On-site supervision	Developed institutional practices	Less developed institutional practices
Reliance on external auditors	Low	High
Use of capital add-ons – Pillar 2	High	Low
Supervisory discretion	High	Low
Level of intrusiveness	High	Low

Table 3.3: Supervisory practices dimensions and their different characteristics. Own elaboration.

The previous section has broadly sketched the evolutionary path of banking supervision in Germany and Italy. One of the main differences between these two frameworks resides in the allocation of fully-fledged supervisory competences to the central bank. As anticipated, in spite of the existence of a separate Federal Supervisory Authority in Germany, the Bundesbank plays nevertheless an important role in the conduct of everyday banking supervision. Interestingly, in the midst of the debate surrounding the reform of the supervisory authorities in the early 2000s, the Bundesbank claimed that "the complete integration of the banking supervisory process within the Bundesbank would visibly strengthen surveillance of the German financial market as a whole and would result in the largest gains in efficiency" (Deutsche Bundesbank 2000, 42). This was an attempt to maintain its institutional status and increase its competences, in order to compensate for the loss of monetary policy powers in light of the creation of the ECB.

Although the 2002 regulatory battle was lost, the Bundesbank has ongoing supervisory duties and regularly reports to BaFin on its findings.[198] Given its technical expertise and the

[198] Section 7 (1) of the German Banking Act.

range of functions performed by the Bundesbank as part of its ongoing duties, it is no surprise that within the SSM's structure "the joint supervisory teams are led by the ECB but staff are mainly from the Bundesbank" (Lui 2017, 170), rather than BaFin.[199] Leaving aside the law-on-the-books aspects of the relationship between these two federal authorities, empirical research has been conducted in order to analyse how this institutional arrangement works in practice, and which are supervisees' perceptions of the roles played by the Bundesbank and BaFin, respectively. Paul, Stein, and Uhde (2012) conducted a survey in 2010, that replicated the methodology of a previous survey carried out in 2006, whose results have been published in Paul, Stein, and Uhde (2008). The aim of the new survey was to assess supervisory quality and banks' perception in the aftermath of the global financial crisis. The study claims that, in line with the 2006 survey, "interviewed banks point out that overall satisfaction with the Bundesbank's personnel is consistently higher than it is with supervisors from the BaFin" (Paul, Stein, and Uhde 2012, 103), a gap that has widened between the two surveys. The empirical results also stress that "supervisors acting on behalf of the BaFin are seen more critically during the recent Survey [2010]. Instead, banks particularly emphasize that Bundesbank's supervisors are more competent (exhibit more expert and practical knowledge) and act more pragmatically and faster" (Paul, Stein, and Uhde 2012, 103). Given the incorporation of the SSM in the current supervisory setup, it would be worth replicating the survey in order to asses banks' perception of the triadic relationship between BaFin, the Bundesbank, and the ECB.

[199] BaFin's annual reports, however, refer to the exchange of personnel between the SSM and this institution as well.

When characterising the supervisory approach followed prior to the adoption of Basel II, the Bundesbank (2000, 37) stated that

> So far banking supervision in Germany has largely been based on an evaluation of the institutional records . . . and on conversations with the representatives of these institutions . . . In this respect, the new Basle Capital Accords will result in a paradigm shift as on-site prudential audits assume greater importance within the supervisory review process and come to supplement the evaluation of reports and returns from institutions.

This statement highlights the importance of the changes that were expected from the (future) implementation of the Basel II framework, in contrast with the practices that were followed in Germany until then. What emerges from the September 2000 monthly report is that the most common supervisory practices were document evaluation and the supervisory dialogue; on-site supervision was considered an innovative element.

The first FSAP conducted in Germany in 2003 points out to the "heavy reliance on external auditors for on-site inspections, and the desirability of the supervisor becoming more involved" (IMF 2003, 12). The risk of relying too much on external auditors is that supervisors "will not always have full and timely information" (IMF 2003, 21). In their final recommendations, the international organism calls for a "more active involvement in on-site supervision" which, together with the increase in the supervisory staff, "will lead to more direct contacts with the supervised entities". In stark contrast to the assessment regarding the need for further institutionalised on-site inspections in Germany, the first IMF FSAP conducted in Italy in 2006 found that:

> There is a well-structured off-site analysis function based on very detailed statistical data requirements, frequent contacts with banks' management and staff, and smooth integration with the on-site analysis. BI [BdI] does not rely on external auditors for the purpose of on-site inspections. The cycle of on-site inspections is long; taking into account thematic inspections, the inspection cycle for large banks

> has recently been shortened to no longer than three years, as in the case of the small banks. (IMF 2006, 40).

As explained in the previous subsection, the fact that BdI has been performing supervisory tasks over a longer period of time, has contributed to the development of well-established supervisory practices. The passage above shows important characteristics of the Italian approach to banking oversight: supervisors tend to implement a quantitative-oriented approach to supervision; well-developed on-site practices, and ongoing supervisory dialogue. In order to shorten the longer inspection cycles and make them more dynamic, another passage of the FSAP explains that BdI "is increasingly relying on *focused and thematic inspections*" (IMF 2006, 39, emphasis added). An interesting point in light of the current practices carried out at the SSM level, relates to the focused thematic inspections: as further discussed in Chapter 4, the thematic reviews designed and performed by (mostly) DG MS IV are a fundamental tool for ECB banking supervision. Not only are they used to carry out benchmarking analysis but, also, as the basis upon which further ECB Guidance is developed. Therefore, as the next chapter shows, these thematic inspections do not fulfil a micro-prudential role only; instead, they constitute an important mechanism in order to strengthen supervisory consistency via policy making.

Another dimension that is worth considering when characterising supervisory practices is the quantitative-qualitative one. These two dimensions should not be seen as mutually exclusive nor opposites. In fact, a comprehensive supervisory approach should embrace both, and use them in a complementary way. As further developed in Chapter 4, however, the meaning and scope of qualitative and quantitative supervision is not univocal. First, the quantitative-qualitative dyad can refer to the type of requirements that banks have to comply

with and that, in turn, form the basis upon which supervisors examine and assess the situation of each institution. This meaning relates to the type of evaluation performed by supervisors, and the extent to which they are prone to be more statistically-driven, or rather give more weight to soft factors that cannot be measured.[200] Second, the qualitative and quantitative distinction can make reference to the difference between Pillar 1 and Pillar 2 requirements: the former would be considered as "quantitative" elements, given that Pillar 1 requirements are specified in the regulation; the latter would be deemed "qualitative", given that supervisors can use a broader range of data in order to assess the imposition of Pillar 2 requirements, that are to be adjusted according to the risk profile and size of the institution.[201]

As explained by the 2015 BaFin annual report in reference to the novel aspects introduced by the SSM's SREP, "until now, the primary focus has inclined towards a *more qualitative approach* that offered institutions *substantial leeway*, particularly with respect to the Internal Capital Adequacy Assessment Process (ICAAP), which is part of the SREP." (BaFin 2016, 89). One of the factors that has contributed to the development of a qualitative-oriented supervision relates to the approach taken by the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement*, MaRisk). It is important to highlight the characteristics of this administrative regulation within the qualitative and quantitative distinction: according to the preliminary remarks (para. 2), "this Circular provides a *qualitative framework* for implementing relevant articles of Directive 2013/36/EU (Banking Directive –

[200] To illustrate the point, when assessing Pillar 2 practices worldwide, the BIS (2019a, 15) explained that "the majority of supervisors use quantitative methods for assessing concentration risk, but other elements are factored in as well: elements from regulatory reporting, ICAAP, banks' analyses and reports, peer reviews and other qualitative information."

[201] These two characterisations highlight different aspects of the supervisory process. The problem with the second one is that, as later explained in Chapter 4, the concept of Pillar 2 has mutated with respect to its original 2004 conceptualisation. The qualitative aspects that characterised Pillar 2 requirements have been now transformed, and its imposition is as binding as Pillar 1 requirements; hence, the lines are more blurred in this domain.

CRD IV) on institutions' organisation and risk management . . . this Circular provides the regulatory framework for *qualitative supervision* in Germany". The qualitative approach followed by MaRisk incorporates risk identification indicators based on quantitative features too. The prevalence of a qualitative framework, however, should not be interpreted as a measure of supervisory quality and the capacity to manage the presence of risks in the banking sector.[202] The 2015 BaFin annual report highlights the differences that, so far, the German approach had in relation to the SSM's practices:

> So far, the SSM has pursued a supervisory approach that is *based on indicators* to a far greater extent than was customary in Germany. Although this improves comparability between institutions, good supervision has to prove its worth by looking at the detail: it will always need a *qualitative component* to assess and weigh up each individual case, because reality is not model perfect. The SSM, too, will therefore have to find the *right balance of quantitative and qualitative* supervision (BaFin 2016, 22, emphasis added).

This passage from the report clearly depicts the differences of supervisory styles, at least in the early days of the SSM. As attested by the following passage from the 2016 German FSAP, the diversity of supervisory styles is to be felt at the LSI level as well: "LSI supervision is changing from a *more qualitative and relationship-based* approach *to a more quantitative* approach. However, the increased reporting and monitoring requirements for LSIs need to be proportional to their systemic importance and available resources" (IMF 2016, 35, emphasis added). The fact that this subsection contains more information regarding the changes operated at the German level due to the SSM, is due to the fact that the last FSAP conducted in Germany

[202] However, the empirical assessment of Paul, Stein, and Uhde (2012, 98), highlights banks' critical assessments of the qualitative approach followed by MaRisk: "Until today the implementation of the MaRisk as an instrument of a higher level of "qualitative" banking supervision is controversially debated in Germany. In this context main contentious points were the transparency of the MaRisk-framework, the degree of specificity of MaRisk-regulations, the homogeneity of supervisory action according to these regulations and the depth of intervention into the banks rights of disposition."

was in 2016, while the last Italian FSAP was performed in 2013, hence, before the introduction of the SSM.[203]

The respective Reports on Operations and Activities of the Bank of Italy do not make reference to the disruptions introduced by the SSM in their appraisal of statistical indicators and quantitative data. One aspect that appears as a discontinuity in comparison to the previous practices is acknowledged in the 2015 report, when BdI explains the implementation of a common SREP for the SIs. Although inspections are still conducted with an in-depth, risk-oriented approach, differences were encountered in relation to the structure of the inspection reports and the allocation of decision-making competences.[204] These discrepancies might stem from the different organisation of the on-site inspection tasks, and different officials' involvement from those engaged in the bank's ongoing supervision.

As illustrated by the passages above, the quantitative and qualitative aspects of supervisory practices are closely related to the implementation of the SREP framework, and the imposition of Pillar 2 requirements as a consequence of the evaluation performed. Therefore, another dimension that helps characterise supervisory practices, relates to the ways in which NCAs have implemented the SREP and how they have managed the imposition of

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[203] In 2018, the first FSAP for the euro area was conducted. However, this report refers to the eurozone situation only, without references to individual member States.

[204] The relevant passage of BdI's report (2015, 94) explains the following: "L'utilizzo di una metodologia comune per la valutazione dei rischi bancari è un importante progresso nella costruzione della vigilanza europea. Gli strumenti adottati utilizzano le diverse prassi di valutazione sviluppate nel tempo dalle autorità nazionali competenti (National Competent Authority, NCA) partecipanti al Meccanismo di vigilanza unico (Single Supervisory Mechanism, SSM); in particolare, in ambito ispettivo vi è continuità con l'esperienza italiana nell'ampiezza e profondità delle indagini, nell'orientamento al rischio, nell'integrazione con la vigilanza a distanza; *fattori di discontinuità riguardano, invece, la struttura del rapporto ispettivo e l'attribuzione dei giudizi*." (emphasis added, translated in the text).

capital add-ons according to the Pillar 2 framework.[205] The following passage from the BaFin 2015 report referring to SREP harmonisation clarifies the link between these two dimensions:

> Other requirements of the EBA mean that the analysis will have to be conducted with a substantially more quantitative focus than in the past. A completely new requirement is that, as an outcome of the qualitative and quantitative review process, the competent supervisory authorities will have to specify in accordance with standard criteria what level of own funds they consider adequate for each individual credit institution (BaFin 2016, 17).

According to the 2016 German FSAP, "the establishment of the SSM has fundamentally changed the supervision of German banks, both large and small" (IMF 2016, 35). And this has been partly due to the fact that "both the ECB and BaFin can require banks to hold capital in excess of the minima under Pillar 2. However, the practice was not commonly used by German authorities" (IMF 2016, 79). As shown in Chapter 4, the changes in the concept of Pillar 2, eroded the qualitative and more flexible understanding that German supervisors had of this tool. In fact, the IMF report mentions further changes that impacted upon German banks: "for the smaller German SIs, the shift from local supervision to the SSM framework represents a deep change in terms of reporting, minimum level of engagement with supervisors, intrusiveness, and supervisory requirements—including capital add-ons resulting from the . . . SREP process" (IMF 2016, 35). According to the IMF's assessment, the differences between the previous supervisory style and the SSM's one goes beyond the qualitative and quantitative distinction; on the contrary, it extends to other supervisory practices that concern the "level of engagement" between the parties, and the imposition of capital add-ons.

[205] For a detailed governance evolution of the SREP and a critical assessment of the Pillar 2 concept, see Chapter 4.

The 2013 Italian FSAP contains a different assessment: "BI [BdI] has a strong supervisory review process and applies Pillar 2 capital add-on extensively. The core supervisory process is well-defined, strong, and integrated. BI has a well-established reputation for independence, professional excellence, and integrity" (IMF 2013, 36). Again, this corresponds to the pre-SSM era. Although the differences between the German and Italian approaches are clearer by now, it would not be accurate to conclude that BdI's practices are more aligned with those of the SSM and that therefore, the establishment of the SSM has had less impact, since there is still no FSAP addressing a post-SSM scenario in Italy. However, even in the absence of this a document, the contrary could be said in light of some of the supervisory action that has been taken by the SSM, which had an important impact on (at least a substantial part) of the Italian banking sector, as exemplified by the NPL saga analysed in Chapter 5. What is shown here is that the similarity in approaches or supervisory practices between the national and supranational levels, does not necessarily mean that local banks will have less of an impact, given that new factors at the Banking Union level start to have more weight.[206]

An additional factor considered by this subsection relates to the type of engagement and the relationship between supervisees and supervisors. The SSM has claimed that it performs a "tough but fair" supervision, also characterised by its "intrusiveness".[207] As cited above, the 2016 German FSAP considered that the level of intrusiveness was amongst the novel factors that represented a change of approach. However, when assessing the state of the

[206] For instance, as further explained in chapter 5, the ECB's 2017 "Stocktake of national supervisory practices and legal frameworks related to NPLs", the high NPL situation in Italy was related to other broader institutional factors such as long recovery and bankruptcy procedures.
[207] Former SSM's chair, Daniel Nouy, made reference to this "intrusive", "tough", but also "fair" supervision several times in her 2014-2018 public speeches.

recommendations put forth in the previous FSAP, the IMF concludes that "the Bundesbank and BaFin improved the intensity of on-site inspections and the level of expertise in all relevant topics over the years" (IMF 2016, 51). The 2013 Italian FSAP claimed instead that "gaps in the legal and regulatory framework *are largely mitigated by intensive and intrusive supervisory action on- and offsite*, on a bank-by-bank basis" (IMF 2013, 37, emphasis added). What emerges from the respective IMF reports is that, in the Italian case, the presence of a single authority responsible for banking supervision has led to a more assertive and intense type of engagement, and this approach can be used at times in order to make up for deficiencies in the legal framework. On the contrary, the 2011 German FSAP had pointed out that the relationship between the activities carried out by BaFin and the Bundesbank are not always clear: "in some regards responsibility is diffused. There is an unclear boundary between the implementation of policy and technical issues" (IMF 2011, 25).

A final aspect to be considered in this subsection concerns the nature of the instruments issued by the supervisors in the exercise of their regulatory powers, and the trend towards a more principles-based or a rules-based approach. The above-mentioned BaFin's Circular, known as MaRisk, is a regulatory tool that interprets and provides substantive content to Section 25a of the German Banking Act (*normeninterpretierende Verwaltungsvorschrift,* norm that interprets administrative regulation). Albeit not a hard law instrument, it is nevertheless legally binding, in light of the consequences at the supervisory level that can be triggered by non-compliance. MaRisk's provisions are reflected not only in banks' internal risk-management procedures, but also in their respective ICAAP exercises. Apart from the emphasis that the Circular places on qualitative aspects mentioned earlier, one of its first preliminary provisions accurately describes MaRisk's spirit and what it expected from its application:

> This Circular takes due account of the *heterogeneous structure* of institutions and the *diversity* which characterises business activities. It contains numerous *opening clauses* which enable simplified implementation depending on the institution's size, core business activities and risk situation. It can, therefore, be *implemented flexibly*, in particular also by smaller institutions. (MaRisk, Preliminary remarks, para. 5, emphasis added).

As Chapter 4 shows, this qualitative, more flexible approach that characterises MaRisk, is partly the consequence of the approach taken by the German supervisor at the time that the SREP and Pillar 2 requirements were initially crafted. As the 2015 BaFin annual report states, "supervisors worldwide have developed different concepts ranging from stringent general requirements to very flexible regulations that are heavily geared to the situation of the individual institutions. To date in Germany, the concepts have tended towards the second category" (BaFin 2016, 89).[208] German authorities have explained that "the essentially principles-based character of the MaRisk . . . enables BaFin to preserve its necessary scope for flexibility in implementing the requirements in practice" (BaFin 2016, 85). Therefore, this principles-based characteristic is a fundamental feature that allows the authority to deal with the diversity and the variety of credit institutions. As the next chapter shows, the Italian approach was different, since BdI adopted a Circular in 2006[209] that contained the methodological details of these new supervisory arrangements, which was subsequently replaced in 2013 by Circular no. 285 on "Supervisory provisions for banks",[210] a 721-page texts that gathers all the relevant prudential and supervisory provisions and displays the ample

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[208] This quotation has been also used in Chapter 4 when providing the details about the national transposition of these novel supervisory tools.

[209] *Circolare n. 263 del 27 dicembre 2006*, "Nuove disposizioni di vigilanza prudenziale per le banche" (see Chapter 4 for further details). A *circular* is a type of legal tool that can be adopted by Banca d'Italia when exercising the regulatory powers conferred to it by The Consolidated Law on Banking and the Consolidated Law on Finance. Circulars, together with other specific instruments, are of a financial and technical nature. Source https://www.bancaditalia.it/compiti/vigilanza/normativa/index.html?com.dotmarketing.htmlpage.language=1 Chapter 5 further discusses the regulatory powers conferred to supervisory authorities.

[210] *Circolare n. 285 del 17 dicembre 2013, Disposizioni di vigilanza per le banche.*

regulatory powers exercised by the Bank. In the supervisory realm, however, it would be inadequate to draw a hard boundary between principles- and rules-based approaches. In fact, supervision entails judgement, individual appraisals, and therefore a generous dose of administrative discretion.

Supervisory practices dimensions	Italy	Germany
Nature of the evidence/requirements	Quantitative	Qualitative
Nature of the instruments setting supervisory requirements	Rules-based	Principles-based
On-site supervision	Developed institutional practices	Less developed institutional practice
Reliance on external auditors	Low	High
Use of capital add-ons – Pillar 2	High	(Traditionally) Low
Supervisory discretion	High	(Traditionally) Low
Level of intrusiveness	High	Low

Table 3.4: Supervisory practices dimensions and their characteristics in a comparative perspective. Source: Own elaboration.

Table 3.4 does not provide an exhaustive picture of local supervisory practices. It is simply a heuristic device to show at a glance (some of) the dimensions that account for supervisory approaches and practices, and the indicators on the right-hand side are meant to provide an approximation of how these dimensions vary. Further analysis of the discoursive and adjudicative practices should be conducted in order to sharpen the supervisory dimensions and deepen the comparative exercise.

This section has provided an ample set of characteristics and conditions that account for existent differences at the national level. Its aim has been to highlight the complexities underlying the harmonising and convergence logic, which might simplistically assume that the same rules lead to similar results, and hence strengthen the much-sought after level playing field. By highlighting the differences in supervisory approaches and their potential reasons, the present section evinces the institutional richness underpinning the SSM's practices.

3.4 Diversity management and financial market governance in the EMU

3.4.1 Preliminary remarks

This chapter examined the question of diversity and how it unfolds at the banking and national levels. In order to better understand the role played by ECB banking supervision in managing this diversity, it is important to make a step back and focus on a major transformative juncture at the political, social, and financial-economic levels. The creation of the EMU is a milestone in the financial and broader EU integration project, and it provides an interesting precedent of how diversity was accommodated in bringing forward the single currency. Therefore, understanding how diversities are integrated in a context characterised by interdependent financial markets within which the SSM operates, should take into account the lessons learnt (or not) from the EMU process, for at least three reasons.

First, member States have undergone structural changes in the pre-EMU era due to "a framework of powerful systemic pressures for convergence" (Dyson 2000, 645), a convergence that resonates with the question on consistency and benchmarking within the SSM.[211] Second, just as "EMU exhibits a complex dynamic interaction between top-down and bottom-up effects" (Dyson 2000, 661), the SSM has also had top-down and bottom-up repercussions, which can be difficult to disentangle empirically, but that are nevertheless shaping an autonomous notion of banking supervision. Although the SSM has been and keeps on being influenced by national practices, it is developing an approach of its own, based not

[211] See Chapter 2 for a discussion on the concept of convergence and related concepts.

only on supervisory practices as such, but also on the exercise of its regulatory powers. Third, the making and unfolding of the EMU is intertwined with the subsequent creation of the SSM. In fact, in spite of the "Chinese walls" that are meant to separate the monetary policy and the ECB banking supervision domains, the bank's reputation and the institutional and technical capacity built up since its creation, made it a strong candidate to act as the supranational supervisory authority.

There are, however, important differences between the process triggered by Maastricht and the creation of the pan-European banking supervisor, which this section acknowledges. As a matter of fact, the former entailed the creation of a new and autonomous institution, the ECB, while the latter was established within this pre-existing institutional structure. Furthermore, the EMU implied a complete delegation of monetary policy competences to the supranational central bank, which implied a major transformation for both national central banks, which lost their full-fledge power, and national governments, especially in those cases where the link between the political power and the central bank was tighter.[212] For example, Article 88 of the Grundgesetz, the rule that establishes the Bundesbank, was amended in order to enable the transfer of competences to the European Central Bank. The creation of the SSM has also entailed the transfer of competences that were until 2013 jealously guarded at the national level. However, due to the Treaty constraints imposed by art. 127 (6) TFEU, delegation of supervisory competences was not total, different from the monetary policy case, since national authorities partly retain them in order to supervise LSIs.

[212] From a critical standpoint, the new monetary and fiscal frameworks have been crucial to reinforce this separation: "the rupture of the linkages between governments and national central banks was a strong incentive to maintain austere budget policies but was no real guarantee of the prospective sustainability of public debts and convergence of public policies, which were regarded as key to the success of the project" (Costantini 2017, 336).

The nature and scope of the ECB's competences within the SSM deserve some clarifications. Its powers have been subject to controversy in two court cases so far. The first case is the *Landeskreditbank Baden-Württemberg* v ECB (C-450/17 P) (*L-Bank*). According to the General Court's assessment, "the Council conferred on the ECB *exclusive competence, the decentralised implementation of which by the national authorities* is enabled by Article 6 of that regulation, under the SSM and under the control of the ECB, in relation to less significant credit institutions" (para. 49, emphasis added). The second is the "re-interpretation of the L-Bank [*Landesbanken*] judgment by the German Constitutional Court" (Smits 2019, 42). In fact, on 30 July 2019 the BVerfG has delivered a judgment,[213] which dealt with the legitimacy of the Banking union, including both the SSM and the Single Resolution Mechanism (SRM). According to the press release in its English translation providing the key elements of the decision, "the national supervisory authorities exercise their powers on the basis of their primary competences, *not on the basis of powers conferred by the ECB*. Such a re-delegation of powers by the ECB would entail that all supervisory tasks had fully been conferred on the ECB, which is specifically *not what Art. 127(6) TFEU allows* and what the SSM Regulation provides." (point 1 bb), emphasis added). However, the German Constitutional Court's stance can be hardly reconciled with the Court of Justice of the European Union (CJEU)'s and the General Court's understanding, since the European judges held in both instances in the *L-Bank* case "that the powers over LSIs exercised by NCAs are derived and a decentralised exercise of exclusive ECB competences" (Smits 2019, 42). Therefore, in spite of the BVerfG's efforts to make its understanding of the legal basis of the

[213] 2 BvR 1685/14, 2 BvR 2631/14.

Banking Union compatible with the previous *L-Bank* judgement, there seems to be no agreement on who is the original power-bearer.[214]

Moving forward with the differences between these two transformative moments, an obvious but nevertheless important aspect is the moment in time in which each of them unfolded. While the Maastricht Treaty and the transformations prompted by the EMU were the result of the "EU's political culture of total optimism" (Majone 2014, 2015), and one of the quintessential examples of the integration-through-law approach, the SSM, on the contrary, can be better understood as a crisis-led project, induced, among other factors, by the level of financial fragmentation within the EMU and the strong links between sovereigns and their respective banking systems, as explained in Chapter 1. The fragmentation along the national lines—also known as financial "Balkanization"—made clear that structural convergence around fiscal discipline could not do away with deep and fundamental divergencies among member States.

3.4.2 Making sense of diversity: EMU and supranationalisation of banking supervision

As explained above, there are at least three reasons that account for the importance and interrelation between the EMU and the SSM processes. First, the quest for convergence as a fundamental condition set forth in the Maastricht criteria in order to join the common currency, and the supervisory consistency objective pursued by the SSM, which were helped by benchmarking and horizontal analysis exercises. Second, the complex interrelationship between the national and supranational levels, depicted by the interaction between top-down

[214] Link to the English press release: https://www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2019/bvg19-052.html

and bottom-up elements characteristic of the EMU, which is also constitutive of the SSM architecture. Third, the links between these two integration projects and their mutual dependency.

The path towards EMU entailed fundamental and structural challenges for member States in order to comply with the convergence criteria agreed upon in Maastricht in 1991. The criteria focuses on four macroeconomic indicators: price stability, sound public finances, exchange-rate stability, and long-term interest rates,[215] which have been complemented by the "approval of the Stability and Growth Pact in 1997 that extended the convergence criteria as permanent requirements to maintain the membership" (Costantini 2017, 335). However, "systemic pressures for convergence" (Dyson 2000, 645) do not necessarily lead to policy convergence (Dyson 2002), for a series of reasons at the material, ideational, and cultural levels. The material level relates to the different national capitalisms briefly introduced in Section 3.3.2; the ideational aspect stems from the series of domestic beliefs about the "sound money paradigm" embraced by the EMU project, and the absence or presence of legitimising discourses regarding EU integration (Dyson 2000); the cultural level embraces the previous two, as shown above when examining the question on economic cultures, and refers to how historical aspects impact upon a country's legal, economic, and institutional architectures and vice versa.

During the convergence process prior to the adoption of the common currency, the EMU has been associated with "surprising effects" (Dyson 2000, 653). As a matter of fact, the "goodness of fit" between the German and the EU policy paradigm of 'sound money and

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[215] See European Commission: https://ec.europa.eu/info/business-economy-euro/euro-area/enlargement-euro-area/convergence-criteria-joining_en

finance', resulted in German policymakers' belief that complying with the convergence criteria would not be problematic. However, the transition to stage three revealed a series of problems inherent to the country's political economy, undermining its negotiating position during the final stages. As explained by Dyson (2000, 653):

> German attempts to negotiate economic change by tripartism in 1995–96 and after 1998 proved exceptionally difficult and frustrating. Also, post-unification, fiscal policy behaviour showed an absence of the discipline and order that are perceived as German hallmarks. In contrast, Italy utilized national social pacts to negotiate wage, labour-market and welfare-state reforms.

In Italy, "the 'sound finance' policy paradigm won the battle of ideas", and "the discourse of *risanamento* (fiscal adjustment) became a focal point in the debate on macroeconomic policy" (Radaelli 2002, 215). In this sense, by the time the Maastricht treaty was signed and Italy took the commitment to join the single currency, there was a broad consensus in relation to the main steps to be taken, and that both the single market and the single currency were key opportunities to revamp the country: "the *vincolo esterno* was not seen as an intrusion into the Italian sovereignty but as a necessary but not necessarily sufficient condition for a series of policy changes that would help the country 'modernize'" (Della Sala 2015, 4/11). In fact, the modernisation argument that has been tied up to the EMU question, has been applied to a different number of political and policy-related issues, hence reinforcing the idea that European integration was a tool that would help the country complete an unfinished process (Della Sala 2015). As these two cases prove, EMU has been a "complex force for change" (Dyson 2002, 21), in which the national and the supranational elements intertwined, and whose effects "are

contingent and political rather than the unfolding of either a logic of convergence or a logic of domestic institutional distinctiveness" (Dyson 2000, 654).[216]

The supranationalisation of banking supervision has not had such transformative effect upon national economic structures—at least so far. However, the EMU and the SSM make use of a similar tool in order to attain convergence or enhance supervisory consistency, i.e. benchmarking practices. In fact, "benchmarking is a potentially powerful tool of policy coordination. Its power is not primarily as a tool of convergence in domestic policy processes and outcomes . . . [but instead] serves to alter forms of discourse [as it] strengthens the technocratic element" (Dyson 2002, 356). In this way, benchmarking serves the purpose of redefining the way domestic actors see the problem, in such a way that 'objectifies' the need for change. Dyson (2002, 356/7) explains that this tool has two main functions: first, it "identifies how particular policy measures are linked to improved and superior performance in other contexts . . . second, and more important, [it] highlights the balance of political forces that support these policy measures in other states". Therefore, the transformative power of this tool lies not so much in the imposition of specific policies or measures across the EU, but, rather, on "questioning and challenging the basis for resisting change" (Dyson 2002, 357). The SSM makes ample use of benchmarking and peer review exercises, both as part of ongoing supervision and also when conducting enquiries on specific topics through thematic reviews.

[216] Together with these structural transformations, the German and Italian banking (and financial) sectors have also undergone a series of changes. However, these have not necessarily been triggered by EMU and the convergence criteria but, instead, by single market forces, which comprise the Commission's 1985 White Paper on 'Completing the Internal Market', the First and Second Banking Directives, and the transformation at the international regulatory level. For instance, "In 1993, Italy implemented the EU's Second Banking Directive (89/646/EEC) with the adoption of its Consolidated Law on Banking. The new law eliminated all the regional and functional restrictions and thus formally introduced the universal banking business model in Italy" (Ayadi et al. 2009, 158). In Germany, the universal banking system already prevailed; however, "starting with the First Financial Market Promotion in 1990, a range of legislative steps was taken to modernize financial markets to become more similar to their US and UK counterparts" (Detzer et al. 2017, 99).

It is indeed a fundamental tool in order to perform consistency checks, which are used to assess supervisory quality.

However, there is an important difference between the original use of these benchmarking practices in the EMU and the quest for supervisory consistency in our days.[217] Already in the early EMU days, the question of strengthening *economic policy coordination*—unlike monetary policy which is an exclusively supranational competence—was considered a sensitive issue, whose contours were unclear. In a context characterised by "national institutional diversity, euro economic governance is more likely to develop by concentrating on the development of procedural coordination at the European level than by pursuing detailed coordination of the contents" (Dyson 2002, 356). Hence, there was a difference between a procedural and a substantive coordination, in light of the different national interests that were at stake. In the case of the SSM, it is clear that the aim goes beyond coordination; in fact, the notion of supervisory consistency is more related to substantial aspects of the supervisory exercise than procedural or formal aspects. Therefore, the need to take into account national and banking diversity calls for a cautious approach, not so much when conducting benchmarking exercises, which are per se useful tools, but rather when drawing conclusions in relation to the existence of best practices or euro area-wide averages that should be fulfilled by all member States.

As anticipated in the first paragraph of this subsection, the second feature shared by the EMU and the SSM with regards to diversity management lies in the reciprocal top-down and

[217] I make reference to the "original" use of benchmarking, given that the EU post-crisis economic surveillance mechanisms have altered the previous coordination methods, by focusing instead on "monitoring, prevention and correction": https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction_en

bottom-up effects that characterise the relationship between the national and supranational components. The literature on Europeanisation provides the analytical tools to understand this twofold impact. In fact, social and political scientist started developing this conceptual framework in order to explain EU policies' effects on member States. The path towards the common currency project has represented the quintessential example of Europeanisation, as attested by Dyson's 2000 paper 'EMU as Europeanisation', and the concept of 'goodness of fit', i.e., the affinity between EMU and pre-existent domestic institutions and policy ideas. In summarising the German and Italian positions before the goodness of fit notion, Dyson (2000, 653) explains that:

> German state élites responded with a mixture of inertia and accommodation, assuming that no substantial modifications to domestic policies and structures were required . . . [In] Italy, by contrast, technocrats led a debate about EMU as a force for transformation of the state: in effect, for a radical change of domestic policy discourse. Consequently, the scale of change resulting from EMU has varied considerably, as has its timing and tempo.

Hence, the larger policy 'misfit' in the Italian case led to a more active response from national technocrats, who, as explained above, have used the *vincolo esterno* rationale to impose reforms at the national level that would have been otherwise very unpopular. In the case of banking supervision, the question of Europeanisation—i.e. the transformations and effects produced by the SSM on national supervisory institutions and vice versa—and goodness of fit has been, to the best of my knowledge, underexplored.[218] This is understandable, since "every time we look for the impact of 'Europeanisation' in financial market governance we find it entangled with the national and the global" (Moran 2002, 267). One of the few studies referring

[218] Although it can be argued that it is too early to empirically assess the effects of the SSM upon national supervisory authorities, studies addressing EMU as Europeanisation were conducted in concomitance with the launch of the project.

to “Europeanisation” of prudential banking supervision (Teixeira 2014) provides a detailed account of the establishment of the SSM within a broader historical perspective, but does not analyse Europeanisation as such. It does, however, explain that within the SSM structure “all levels of competences depend on each other and are recognised as a single system, a plywood of European and national layers” (Teixeira 2014, 579), which demonstrates the complexities to gauge and conceptualise these effects at the analytical and empirical levels. What has been largely explored, mostly by political scientists, is the legislative process behind the SSM Regulation, and the variety of country preferences in this regard, reflecting for the most part the structure of their respective national banking systems.[219]Albeit useful to understand the origins and the underlying logic behind the current framework, the prevalence of a country’s position throughout the legislative process lacks explanatory or predictive value in relation to the goodness of fit between the supervisory paradigm and the practices followed by the SSM, and those at the national level.

For instance, according to the analysis provided in the previous section, the Italian supervisory framework has tools and practices that were not completely absent from the German framework (e.g., the use of Pillar 2 capital add-ons, on-site inspections, a more quantitative approach to supervision). These activities were not normally conducted within the BaFin framework; however, some of the quantitative analytical tasks were closer to the tasks carried out by the Bundesbank, when supporting BaFin’s supervisory activities. What the differences between the German and Italian supervisory styles suggest, is that the former might have needed to make more adaptive efforts in order to adjust to the SSM’s tools and approach.

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[219] One of the key aspects of the legislative debate, revolved around the question of the thresholds separating those banks that would be under the ECB oversight, and those that under the national authorities. See Chapter 1 for further references.

The latter, on the contrary, already carried out practices that were closer to those conducted by the SSM. However, evidence collected from background interviews, especially those with Italian SIs and LSIs, have shown a certain level of dissatisfaction in relation to some of the SSM practices; in particular, some focused on the lack of dialogue, discussion, engagement between the parties, and insufficient feedback in relation to the SREP evaluation.[220]

Although this might sound contrary to the previous claim in relation to the greater affinity between the Italian and the SSM supervisory styles, there is a plausible explanation bridging both positions. Although the SSM follows a more quantitative and statistically-driven method, deploys an intrusive style, makes extensive use of on-site inspections, just as the Italian supervisory authorities do, the supranationalisation of the task has introduced at least two major new aspects that have redefined these tasks and consequently the supervisory approach. First, from a material stance, the fact that supervision is carried out by a mix of nationalities—and by officials that do not speak the language of the country, that might not know the institution and its history as their national counterparts—can widen the distance and relationship patterns between the supervisor and the supervisee.[221] This feature was introduced by design, as one of the alleged benefits from the supranationalisation of banking supervision was precisely to break the 'cosy' relationships between these parties. Although this can bring benefits in terms of "objectivising" supervisory tasks, it has the potential to backfire in relation to the development of an essential supervisory tool, the supervisory dialogue. Second, from a cognitive standpoint, it can be said that the overall perspective of supervisors has changed. Even if supervisory

[220] The issue regarding SREP feedback and transparency was common to both, German and Italian banks, and their respective banking associations.

[221] In the case of German credit institutions, the "distance" factor has its own particular features. For instance, for the largest institutions supervised by JSTs composed of Bundesbank and ECB officials, the *locus* has not changed, as all the activities remain in Frankfurt. In fact, the German banks and associations interviewed, have expressed their concerns about transparency and SREP feedback, but not necessarily on personal or communicational issues.

authorities from DG MS I and II maintain a micro-view that focuses on the health of single institutions, the common methodologies, horizontal thematic reviews, consistency checks and benchmarking exercises carried out by DG MS IV, exposes supervisors to a set of different and novel assessments, placing their single findings under pan-eurozone lenses.[222] On the contrary, national supervisors have never had access to these horizontal sophisticated tools. Therefore, the same tools can acquire different meanings considering these material and cognitive aspects that contribute to actively reshaping the supervisory style under broader perspectives.

The third and last aspect that this subsection aims to highlight is the link between EMU construction and the establishment of the SSM. To start with, although the single currency project has been framed on the basis of the distinction between *monetary governance* and *financial market governance*, "in practice the distinction between these two domains is difficult to maintain . . . [given that] understanding financial market governance in the Euro-Zone does indeed involve attending to institutions and cultural understandings which presently characterise the EMU system" (Moran 2002, 258). This intertwined relationship between monetary and broader financial market governance has been sketched above, when making reference to the money-centric view of the banking sector.[223] In fact, what Moran pointed out in the early 2000s materialised in the aftermath of the global financial crisis and the fiscal and sovereign debt crises in the EU. The unprecedent set of monetary policy measures that have been deployed by the ECB from that moment onwards, clearly show that, in order to make the channels of monetary policy transmission work, this area could not be separated from the

[222] In relation to this point, interviewees from credit institutions have highlighted the existence of data requirements received from their JSTs, but where it was not clear who drove the request. Since DG MS IV does not have direct contact with the bank, their data requests are mostly channelled through the respective JSTs. Hence, the interaction between the microprudential DGs and DG MS IV, contributes to the development of wider, euro area perspectives even in relation to the assessment of single institutions.
[223] See previous references to Ricks' *The Money Problem* (2016).

broader governance of financial markets. As anticipated, it was also the succession of these crises that acted as a catalyst for the creation of the Banking Union and the SSM.

In fact, "in order to lower the risk of financial instability and reverse the fragmentation of the Single Market in finance, euro area policy-makers moved to promote the completion of EMU by establishing BU" (Howarth and Quaglia 2019, 20). These "spill-over dynamics and path-dependence" created by monetary integration, provided a fertile ground for the establishment of supranational institutions.[224] One final aspect that should be considered relates to the "integration through capacity building" (Genschel and Jachtenfuchs, 2014) exercise carried out by the ECB throughout the last twenty years. The expertise and the established reputation that the institution has constructed since its establishment, acted as a facilitating factor towards the creation of a supranational banking supervisor. The debate surrounding the conferral of supervisory powers upon the ECB was not a post-crisis child, though. The vague formulation of Article 127 (6) TFEU, typical of compromise-driven legal provisions, made the delegation of supervisory competences to the ECB possible; other institutional alternatives would have been legally possible, but politically unfeasible, given that the creation of a separate EU institution would have required a unanimous consent to amend the TFEU.

This section has provided a broad-brush overview of how national and institutional diversities have been dealt with during the construction of the EMU, and how this integration juncture can be related to the SSM. It has also pointed out possible channels through which national supervisory practices and approaches are redefined at the supranational level in order

[224] Although formally speaking the SSM is not an EU institution.

to achieve consistent results in diverse contexts. The following part provides an overall conclusion of the chapter.

3.5 Conclusions: Towards a common supervisory culture?

This chapter has examined and described the features that account for diversity in banking supervision. By looking at these aspects, the aim has been to better understand the emergence of different styles and practices in the exercise of banking oversight. Furthermore, this was done in order to explore how the supranational supervisor can reap the benefits of this diversity when carrying out supervisory practices and understand the context in which different banks unfold their activities.

This chapter has not offered a full spectrum of supervisory styles and practices: the focus has been placed on Germany and Italy as two significant examples of different supervisory cultures. Further research can broadly explore the characteristics of other supervisory authorities and cluster those according to the presence of specific characteristics. In any event, the analysis has identified differences in supervisory styles, and how these differ in relation to the ECB's style too. By looking at the legal and economic cultural levels, the analysis has indirectly approached the question of *supervisory cultures*. In fact, as mentioned above, the aim to create a common supervisory culture predates the SSM, as it is explicitly acknowledged in the EBA Regulation adopted in 2010. Developing a common supervisory culture was only possible after the establishment of a centralised supervisory arrangement, capable of bringing together the knowledge, practices, and cultural baggage of all of the euro area NCAs. However, as this chapter has shown, national supervisory styles have been shaped by broader economic and societal features that relate to the role of banks within each country, the notion of stability

and what a central bank is expected to achieve, among others. Therefore, the achievement of a pan-European supervisory culture entails an unprecedented effort from national authorities' side, not only due to the material effects of working with a multi-cultural team of Frankfurt-based supervisors, but also for the Copernican shift of focus that these local institutions are required to perform, where the health of the financial system is seen not from a national perspective, but from a European one.

A question worth asking is how local knowledge can be employed within the supranational supervisory system in a balanced manner. In this sense, it has been claimed that

> There is a special need to recognize a principle of "epistemic subsidiarity," one that respects the "how" (and not merely the "what") of risk governance. A polity's commitment to particular policy styles reflects complex judgments about how to authorize rulership when of necessity many governmental decisions are highly technical and hence not accessible to the public as a whole. There are strong reasons to respect these historical settlements in administrative law and practice, and not to supersede them through homogenized procedural routines founded on mistaken beliefs about the scientific purity of risk assessment . . . Epistemic subsidiarity is the principle that protects legitimate local and national preferences for institutionalized modes of public reasoning. (Jasanoff 2013, 136).

Jasanoff's statement refers to a specific dimension of the subsidiarity principle that remains to some extent ignored.[225] The purpose of this quote is not to disregard the supervisory efforts at the supranational level, which aim to strengthen both a micro-view on single institutions, and a macro one based on horizontal analysis and wide-range comparison. Yet, this chapter has emphasised the links between the existent diversity in the banking sector and local economic features, that in turn have shaped national supervisory approaches. These features suggest the need to adopt a cautious approach toward the broad harmonising efforts

[225] In Jasanoff's analysis, there are "three possible modes of achieving epistemic subsidiarity: coexistence, cosmopolitanism and constitutionalism. These are not hypothetical frameworks but are empirically grounded in actual, current regulatory practices" (Jasanoff 2013, 136).

that affect SIs an LSIs equally. It is true that the wider the supervisory area, the greater the need to rely on benchmarking, quantitative approaches, and peer review assessments in order to have a comprehensive view. This should not become, however, a mechanistic exercise in which soft factors are disregarded within the supervisory assessment, factors which are mostly acquired during the supervisory dialogue exercise.

On a different note, although it is reasonable to promote banking diversity while at the same time trying to reduce some of the legal differences between national regulatory frameworks, this chapter has emphasised that these are two related aspects. The chapter does not claim the existence of causal relationships between banking diversity and national diversity, since that would require a deeper empirical study. This chapter, instead, focuses on the fact that banking and national diversities are not two independent features, given that the institutional heterogeneity responds to a set of complex social, economic, and legal factors. Although banks have lost long ago their special status as credit providers and are thus subject to competition and market forces as any other company, they have to be contextualised and understood within a specific environment. Even the largest cross-border credit institutions have turned to their national governments and the respective institutional framework during the crises, hence honouring the adage that says, "banks are international in life and national in death". However, "banks" do not belong to a single type that should be treated the same way. On the contrary, given the size, risk profile, and scope of operations, among other features, the weight given to national features should be greater the smaller the institution, and the more related to the local economy a bank is; cross border banks are thus less sensitive to national circumstances—but more vulnerable to the international ones, which entail a set of specific risks.

The sources of diversity that have been mapped and identified in the previous sections are key in order to understand the subsequent empirical chapters. Chapter 4 portrays the consistency challenges that arise in the context of the SREP activity carried out by supervisors, and the complexities faced in order to make banks' internal tools for capital adequacy assessment more comparable across institutions. These features are the result of the heterogeneity of prior supervisory approaches and, most importantly, of banks' diversity and their different internal assessments. Chapter 5, in its turn, focuses on the use of the ECB's regulatory powers in order to overcome consistency challenges non only in relation to the universe of SIs directly supervised by the SSM, but LSIs too. By focusing on supervisory activities *stricto sensu* in Chapter 4, and on regulatory ones in Chapter 5, the analysis provides an overview of the means and tools deployed by the SSM in order to overcome the supervisory consistency challenges arising from the multiple sources of diversity that have been described in this chapter. Chapters 4 and 5 also illustrate and empirically examine the notion of *public reason* explained above, and flesh out the adjudicative and discoursive practices that are central to understanding the relationship between law, culture, and science.

CHAPTER 4

Opening the "black box" of banking supervision

Introduction

This chapter aims to open the black box of banking supervision by focusing on two aspects. First, in line with the literature examined and the framework proposed in Chapter 2, the study focuses on the Supervisory Review and Evaluation Process (SREP) and the Internal Capital Adequacy Assessment Process (ICAAP) tools to trace supervisory governance evolution. Second, by considering the elements that define supervisory consistency (i.e., methodologies, practices, and outcomes) the analysis aims to identify the different levels of action and potential sources of tension between centralised and decentralised features in the conduct of banking supervision. The assessment provided in this chapter is complemented by the conceptual and empirical insights from Chapter 5.

These aspects are in turn examined at two different levels. First, the dimensions of governance change and the interactions between the authorities and relevant stakeholders, are studied through the SREP and its related ICAAP. This first part of the analysis, therefore, adopts a micro-level perspective, as it zooms in on one particular tool and its evolution over time. Second, the chapter proposes a macro-level view of the actors, aims, and tools, in light of the suggested consistency framework. Mapping these elements provides a better understanding of the activities and the processes deployed, in connection with the actors and levels in which these tools are put in practice.

The chapter is structured as follows. The first section explains the relevance of the SREP in light of the key concepts analysed in the course of the dissertation: supervisory consistency

and the management of diversity. Furthermore, this first section examines one of the components of the SREP: the ICAAP process. In spite of the highly-technical nature of both the SREP and ICAAP tools, the analysis focuses on governance issues that are evinced by their evolution over time. The second section is devoted to providing a detailed examination of the evolution of the SREP and ICAAP. The aim is to make sense of the evolution of banking supervision governance, by using the governance indicators specified in Chapter 2. This section also distinguishes between the different authorities that have intervened since then: CEBS, EBA, and ECB banking supervision. This longitudinal analysis of the SREP also examines the same stakeholders and their positions over time (EU-wide banking associations, Italian and German banking associations, and credit institutions). Preferences and positions of some of these actors reflect the differences that have been pointed out in Chapter 3, while exploring the set of diversities at both national and banking-related levels. The third section develops the integrative governance indicators introduced in Chapter 2, and offers an empirical assessment based on them. The fourth section develops a macro-level view, by analysing actors, aims, and tools, in light of the consistency framework. The last part concludes by summarising the key findings.

4.1 The Supervisory Review and Evaluation Process as a fundamental operational tool

4.1.1 The supervisory cycle and its characteristics

Before examining the specificities of the SREP and its governance evolution, it is worth highlighting some elements that are common to the whole supervisory process carried out by the SSM. A first element is the *cyclical nature* of the banking supervision process: “regulation

and supervisory policies provide the foundation for the development of supervisory methodologies and standards, which underpin day-to-day supervisory activities".[226] This sequence indicates three components of the supervisory cycle: first, the development of regulations and supervisory policies; second, the definition of methodologies and standards; and third, the implementation of day-to-day supervision. The three elements are complemented by a revision of the "lessons learned", and reinforced by quality checks that aim to improve the process. These characteristics are in line with the experimentalist governance approach, which envisions the application and redefinition of policies as a cycle, where past experience nurtures an ongoing learning process. Figure 4.1 illustrates and depicts the whole supervisory process as a cycle.[227] The phases of the supervisory cycle reflect the building blocks of the consistency framework developed in Chapter 2: methodologies, practices, and outcomes.

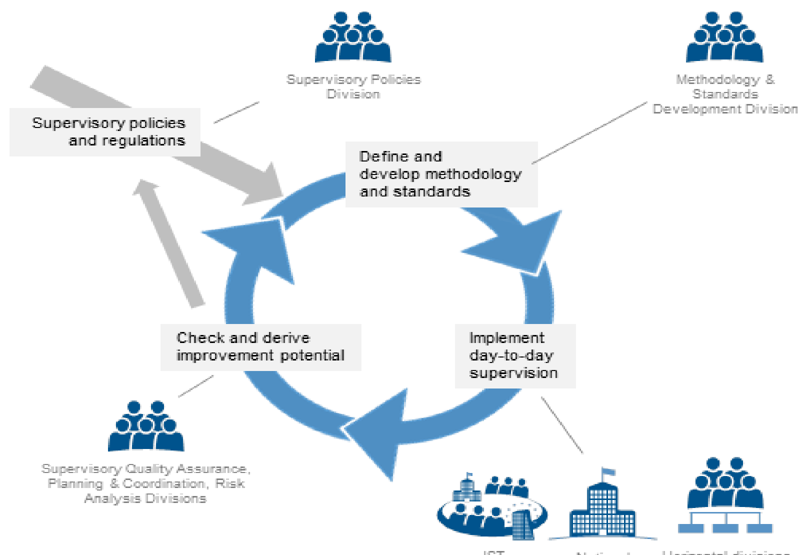

Figure 4.1: SSM banking supervision as a cyclical process. Source: ECB Banking Supervision website.

[226] ECB Banking Supervision website, text below the question "How does banking supervision work?" https://www.bankingsupervision.europa.eu/banking/approach/cycle/html/index.en.html

[227] The explanatory sections of the website are very clear on the cyclical nature of the supervisory activities. Source of Figure 4.1: https://www.bankingsupervision.europa.eu/banking/approach/cycle/html/index.en.html

An additional characteristic of the supervisory process is the interdependence of supervision and regulation, which is also explicitly acknowledged in the explanations provided in the institutional website. In fact, these two characteristics, cyclicality and supervision-regulation ties, are closely connected. For instance, the first element of the cycle, the development of regulations and supervisory policies, is carried out in close cooperation and coordination with other European and International bodies, which denotes not only the centrality of the learning process but also the feedback loop and blurred lines between rule-application and rule-making. Chapter 5 provides, in its turn, an in-depth analysis of these regulatory and quasi-regulatory tools.

Having pointed out these general characteristics, it is time to focus on the SREP, which is one of the most important manifestations of the second element of the cycle: the development of methodologies and standards. The analysis of the SREP and the development and use of this tool over time provides interesting insights to better understand governance changes in the banking supervision domain. The SREP embodies the main tension discussed in this dissertation: the achievement of consistency in diversified contexts.

To start with, as the SREP was born well before the establishment of the SSM, it used to be a nationally-defined instrument that to some extent mirrored the bank-supervisor relationship. Zooming on the SREP also allows for a diachronic comparison of the soft mechanisms that were put in place in order to strengthen cooperation and reinforce the mechanisms of convergence prior to the SSM. As explained in the next sections, these were mostly toothless tools that, albeit useful in terms of best practice exchanges, they did not tackle the fundamental problem of standards application and the development of common methodologies. These two aspects, application and standardisation of methodologies, have

been amongst the most fundamental changes introduced by the SSM. There has been a shift from soft ways of promoting convergence and cooperation, to harder and more direct tools.

The SREP also represents a key instrument in the third phase of the supervisory cycle: implementation of day-to-day supervision. This activity comprises, on the one hand, the strategic and operational planning and, on the other, implementation *stricto sensu*, which encompasses both ongoing supervision and ad hoc on-site inspections. The SREP is relevant during both planning and execution, since it enables the assessment of the current status of a specific institution, and provides an overview of high risk and vulnerable areas that deserve deeper examination, thanks to the information provided by previous SREP findings.[228]

4.1.2 Zooming on into the building blocks of SREP and ICAAP

The rationale behind the analysis of the SREP tool has been explained in Chapter 2. In short, the SREP is an encompassing tool that reflects, on the one hand, the importance of having consistent and common methodologies and, on the other, the need to embrace a proportionate approach in order to assess the specific situation of individual credit institutions. The current set up of the SREP is the result of pre-existing tools developed by the CEBS (predecessor of the EBA, before the introduction of the European system of financial supervision (ESFS) in 2010), in turn amended by the EBA, and subsequently refined by the ECB. In this sense, the

[228] The ECB Banking Supervision website provides the key elements to understand the SREP cycle. For further details, see https://www.bankingsupervision.europa.eu/banking/approach/cycle/html/index.en.html

current implementation of the SREP has been considered one of the most important changes in relation to the way in which supervision has been conducted. [229]

The SSM Supervisory Manual is a good starting point, as it provides practical characteristics of the instrument. A first aspect concerns *proportionality*, which "is integral to the manner in which the SREP is carried out" (ECB 2018a, 80), since it reflects the frequency, scope, and depth of the supervisory engagement that is considered to be necessary for each institution. The methodology adopted by the SSM is developed by DG MS IV with the support of the NCAs, and follows EBA Guidelines on the matter. In relation to the consequences it can trigger, the SREP results in concrete supervisory actions that can materially alter the legal situation of banks.

In spite of being a tool applied on a case by case basis, the SREP methodology and its implementation is constantly monitored by SSM horizontal divisions: "the consistency of assessments is ensured through several horizontal analyses conducted by dedicated horizontal functions in DG MS IV throughout the SREP" (ECB 2018a 2018, 81). The dialectics between the individual and the horizontal views is perhaps one of the most enriching aspects of the SSM supervision.[230] Another characteristic is the SREP's "holistic" approach, which aims to reduce the complexities arising from multi-faceted risks in institutions, and capture "an overall picture

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[229] Stakeholders have been clear in this regard. In the case of banks, both the Italian and German institutions interviewed have pointed out the exercise of SREP as one of the main changes in the pre and post SSM context. As it will be explained below, the impact might have been even larger in the German banking sector, given that national authorities hardly ever used their capital add-on powers, whereas in the Italian case, the supervisor made wide use of this possibility

[230] The internal dialectic process is explained in the Manual (ECB 2018a, 84/5): "The SREP assessment results are checked in two different steps. As a first control, the risk assessment results are regularly discussed and challenged within the core or whole JST. Possible modifications and supporting justifications are recorded in the supervisory IT system. As a second control, the ECB's intermediate structures receive regular updates on the assessment results and may also challenge the outcome. In the context of the annual SREP cycle, the MSD Division prepares several horizontal analyses as a support tool for peer comparison and decision-making."

of the institution's risk profile" (ECB 2018a, 81). This aspect, as further explained in the next section, has been and still is a source of criticism from supervised entities, who claim that such holistic view triggers transparency concerns.[231]

The horizontal analysis referred to so far is a powerful and comprehensive feature that provides the SSM with an almost unique view on the universe of banks under its oversight. These horizontal tools comprise thematic analyses, peer analyses, comparison with SREP outcomes of the previous years or even banks from other jurisdictions, and comparison of SREP decisions in relation to supervisory measures, among others (ECB 2018a, 85). The horizontal analysis, however, is not simply performed to enlarge the theoretical perspective and knowledge of the euro area banking sector. The analyses conducted by the horizontal divisions are part of the supervisory cycle earlier mentioned. Hence, these findings are a key input to the development of complementary regulations and supervisory policies, to the improvement of common methodologies, and to the setting of supervisory priorities and expectations. All of these supervisory tools that are the product of the implementation of day-to-day supervision have not been foreseen in the SSM Regulation and Framework Regulation. As Chapter 5 shows, some of these soft law instruments are tantamount to hard law ones, and in some cases have raised criticisms against the SSM for its quasi-regulatory role.[232]

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[231] One of these concerns are the risk-related aspects that banks are meant to improve, which are not clear in most cases given the imprecision of the feedback received from the supervisors. Another important concern is the lack of clarity in the link between the Pillar 2 decision taken by the supervisor and the SREP result, as further developed in the next section.

[232] It is worth reminding that the ECB has been conferred regulatory powers in Art. 4 (3) 2nd paragraph of the SSM Regulation. The issuance of regulation as such is restricted to the needs to "organise or specify the arrangements for the carrying out of the tasks" that have been conferred. The adoption of guidelines, recommendations, and decisions is not specified in its scope, but it is the case that the ECB through the activities of the SSM is not meant to create new substantive supervisory or prudential rules.

In the final phase of the SREP cycle, the JSTs organise an informal dialogue "with the management body of the supervised parent institution and the relevant subsidiaries" (ECB 2018a, 85) in order to discuss the SREP assessment". Thereafter the JSTs elaborate a draft SREP decision which is submitted to the Supervisory Board for approval. The Manual also states that JSTs facilitate dialogue with the industry, in addition to the dialogue with each of the supervised entities. The aim of this communication channel is to provide institutions with "the necessary clarity on the methodology and risk assessment and the necessary context to inform their capital planning." (ECB 2018a, 87). A recent analysis of the SREP tool carried out by Banca d'Italia also highlights the increasing level of supervisory disclosure regarding the SREP methodology. In their view, disclosure has two aims: "first, accountability towards the market and the relevant stakeholders, which is particularly important when a degree of judgement is exercised in making the supervisory assessment; second, the need to make banks aware of the rationale underlying the supervisory assessment so they can improve and be encouraged to correct possible deficiencies." (Bevilacqua et al. 2019, 22). These two issues are fundamental and complementary: in spite of being a highly regulated activity, banking supervision is ultimately discretionary and based on experts' judgement; this could not be otherwise, given the nature supervisors' tasks and the need to provide bespoke assessments. However, supervisory motivations have to be clear enough for the institutions to get useful and concrete feedback, in order to make the supervisory dialogue a meaningful exchange of views between the authority and the supervised institutions. In spite of these positive assessments, interviews conducted with banks, their representative associations, and position papers

submitted in the context of SREP-related public consultations, suggests that communication is not always clear.[233]

After having provided the main characteristics of the SREP tool, it is important to focus on its key elements. Figure 4.2 belongs to the latest version, at the time of writing, of the SSM SREP Methodology Booklet (2019), which is based upon the building block approach from the EBA Guidelines.[234] The legal basis for the conduct of the SREP is set forth in Article 97 of the Capital Requirements Directive IV[235] (CRD IV, amended in May 2019)[236]. According to the methodology booklet, all four elements follow a common logic that aims to ensure a sound risk assessment. In this sense, supervisors have a duty to assess institutions business models, their governance and risk management arrangements, risks to capital, and risks to liquidity and funding.

[233] The SSM has been recently undertaking institutional efforts to make the SREP exercise more transparent. See Enria's speech entitled "The case for more transparency in prudential supervision", delivered at the EBI Global Annual Conference (February 2020): https://www.bankingsupervision.europa.eu/press/speeches/date/2020/html/ssm.sp200220~6f0ae3acde.en.html

[234] Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing (EBA/GL/2018/03).

[235] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176/338, 27 June 2013.

[236] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, OJ L 150/253, 7 June 2019.

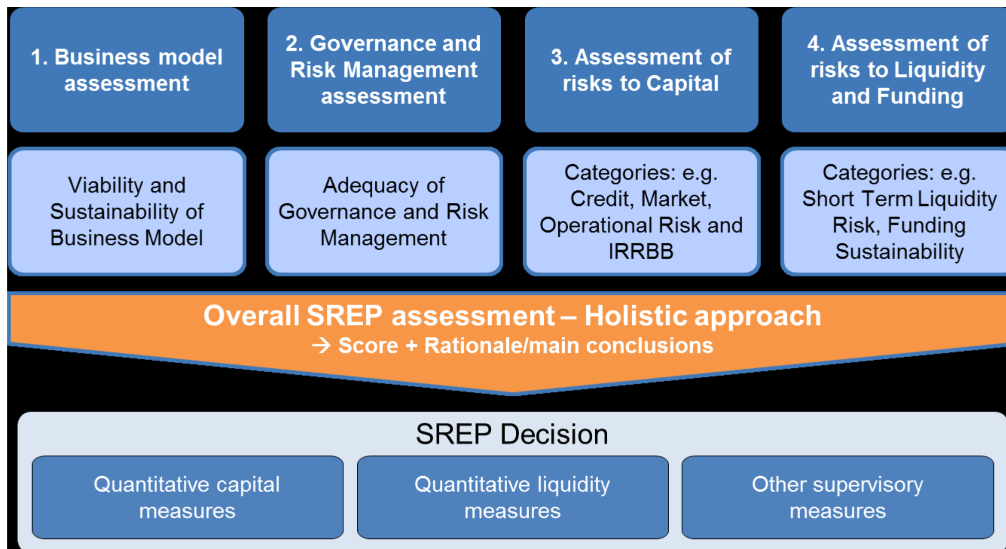

Figure 4.2: SREP building block approach in line with EBA's Guidelines. Source: SSM SREP Methodology Booklet (2019, slide 7).

In light of both technical and space constraints, this chapter does not examine all four SREP elements. Instead, the following section focuses on the evolution of one of the building-blocks: the risk to capital assessment. Amongst the tools available to examine this risk, the focus is here placed on the ICAAP, given its interdependence with the overall SREP exercise. According to the SSM's supervisory Manual, the ICAAP comprises the "strategies and processes which banks are required to establish to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed" (ECB 2018a, 117/8). Hence, the ICAAP is an internal process developed by the bank with the aim to identify the amount and quality of internal capital in relation to the institution's risk profile (Enria 2008), which is reviewed by the supervisor within the SREP exercise.

Apart from technical and length-related limitations, the choice for ICAAP over the other building blocks is motivated by the fact that this element was part of the SREP tool since its

original conception in 2006, and has been recently updated and developed by an SSM Guide in 2018, to improve banks' internal assessments and achieve greater consistency in an area characterised by a considerable variety among banks. Therefore, its evolution over time provides some useful hints to better understand pre-SSM national supervisors' approaches and to examine the supervisor-bank relationship over time.

Before moving on to the longitudinal analysis of SREP and ICAAP, there is an additional element that underscores the importance of the SREP tool since the establishment of the SSM. Although the primary target of the SREP assessment are the significant institutions directly supervised by the SSM, from 2018 onwards the NCAs started to implement a SREP methodology adapted to the less significant institutions they supervise.[237] This has been one of the most far-reaching attempts in order to ensure a *consistent application of high supervisory standards* across the LSIs universe. The consistency challenge here is given not only by the diversity within the LSI sector, but also the institutional diversity from the NCAs in charge of implementing this uniform methodology. The supervisory manual devotes its fifth and last chapter to LSI supervision. In connection to the SREP, the Manual explains that in order to enhance a common understanding and coordination within the SSM, NCAs need to apply a consistent methodology: "the SREP methodology developed for SIs is used as a reference and is developed for LSIs, taking into account the proportionality principle and LSIs' specific characteristics" (ECB 2018a, 109). The manual goes on to explain that the proportionality principle is articulated in relation to the priority rank of the LSI in question.

[237] See 2019 methodology booklet: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_lsi_2019~15ce18ff7f.en.pdf?2e33cff10a3115ea7ce685de4a309402

In the same way as DG IV concentrates some of the horizontal functions for the SIs, DG MS III fulfils a similar role in relation to the oversight of the activities deployed by the national authorities for their respective LSIs. This is done through the monitoring of the so-called 'joint supervisory standards', which contribute to the development of common approaches and a consistent application of these standards (ECB 2017f). DG MS III collects feedback from the NCAs and their experiences, and then reports back to the NCAs and the Supervisory Board; furthermore, "DG MS III can propose follow-up actions, such as the revision of the joint supervisory standards or the adoption of a (binding) ECB legal act if one has not yet been issued" (ECB 2018a, 108). Therefore, supervisory action feedbacks into the development of additional and refined standards, in light of the implementing experiences.

This section has provided an overview of the SREP and one of its components, the ICAAP. The next section complements it and focus on the evolution of the tool, in order to identify patterns of change over time, and provide a better understanding of the governance changes in banking supervision. The change of governance dimensions is examined through the governance indicators set forth in Chapter 2, which are explained in greater detail below.

4.2 SREP evolution and modes of governance change

The analysis of the SREP over time is a useful way to better understand the bank-supervisor dynamics in a pre- and post- SSM scenario; it provides some hints in order to identify different supervisory approaches, and how different governance dimensions have evolved over time. Industry stakeholders have in fact pointed out that the way the SREP is currently implemented represents one of the main changes since the implementation of the SSM.

In order to accomplish these aims, the first part of the section provides an overview of the origins of the tool, how it has been initially interpreted and implemented at the local level in the German and Italian cases. The second part takes each of the regulatory milestones that impacted upon the SREP's development and analyses the position papers of the same stakeholders over time, in order to capture the changes in governance dimensions. Section 4.3 analyses the evolution of SREP in light of the proposed governance indicators and outlines the most important changes.

4.2.1 Origins, evolution, and national reception

The SREP was first introduced with the adoption of the Basel II Accord in 2004. It was indeed this instrument that introduced the "three pillar approach" to supervision, in order to update and complement the original 1988 Basel I Accord and its amendment in 1996, which were not adaptable enough to the changing and more sophisticated tools used by banks to calculate their regulatory capital. The first pillar comprises the *minimum capital requirements*, the second the *supervisory review process*, and the third pillar refers to *market discipline* (BCBS 2004). For the purposes of the analysis, the focus is placed upon the second pillar and the development of the supervisory review process.[238]

Before going deeper in the analysis of the second pillar, it is important to understand the elements included in Pillar 1, i.e., capital adequacy requirements. The passages below from an

[238] One of the antecedents of the 2004 Accord and its three-pillar approach is a document released in June 1999 entitled "A New Capital Adequacy Framework", a consultative paper on the three-pillar structure. This document already stated that supervisors treated the Accord's capital requirements as a minimum, above which banks were expected to hold more. The document also contained a first outline of what was expected from banks' internal assessment of capital adequacy, a sort of proto-ICAAP.

ECB press release on capital and operational relief in response to the coronavirus crisis,[239] is useful to get a glimpse of the capital stacking order, and anticipates the regulatory and supervisory changes that the concept of Pillar 2 has been experiencing in the last decades. In this sense, ECB Banking Supervision explains that

> European banking law defines three elements of own funds. Common Equity Tier 1 capital (CET1) is the highest quality of own funds and is mainly composed of shares and retained earnings from previous years. Additional Tier 1 capital (AT1) and Tier 2 capital can be equity or liability instruments and are of lower quality.
>
> Pillar 2 capital consists of two parts. One is the Pillar 2 Requirement or P2R, covering risks which are underestimated or not sufficiently covered by Pillar 1. The other is the Pillar 2 Guidance or P2G, which indicates to banks the adequate level of capital to be maintained in order to have sufficient capital as a buffer to withstand stressed situations, in particular as assessed on the basis of the adverse scenario in the supervisory stress tests.

The distinction between Pillar 2 Requirements (P2R) and Pillar 2 Guidance (P2G) explained in the last paragraph, being the latter a relatively recent element added to the second pillar approach, is important to understand some of the tensions arising between the industry and the supervisor, as explained later on in the chapter.

The Pillar 2 approach brought about important changes in the way supervision has been conducted ever since. Its objectives were ambitious: first, it aimed to make capital requirements more risk-sensitive in comparison with the previous approach; second, it aimed to close the gap between the "regulatory capital" and the "economic capital" (Bevilacqua et al. 2019), which would be possible thanks to the development of an internal assessment tool that enabled banks to identify all their material risks, and the quality and amount of capital in relation to

[239] See press release entitled "ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus", 12 March 2020 available at https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html (last accessed 13 April 2020).

their risk profile and activities. These are indeed the aims of the ICAAP. The role of the supervisory authority was meant to be indirect (Resti 2008b), in the sense that its intervention took place once the bank has carried out this internal comprehensive examination.

One of the aspects that was reported to have a significant impact upon the supervisory style and culture, was the continuous confrontation and dialectic relationship between supervisors and supervisees through the so-called "supervisory dialogue" (Bignami and Pilati 2008). This supervisory dialogue is the "glue" that ties the ICAAP—which is a product of the bank's internal governance—and the SREP, which is the supervisor's identification, review, and evaluation of all risk factors (Enria 2008) and the capital adequacy in light of the bank's internal structure.

However, when dealing with supranational banking supervision, it is important to consider how these principles and global guidelines developed by the BCBS were transposed to the EU framework. This incorporation was done in two steps. First, Directive 2006/44 (CRD) transposed Basel II into EU law, and it included broad outlines for ICAAP and SREP, in arts. 123 and 124, respectively. Second, the CEBS[240] was in charge of specifying the content of these tools in order to contribute to a more consistent implementation of the Directives. The incorporation of these EU-level instruments within each national frameworks could take place according to two fundamental options: either transposing the content of Directive 2006/48 only, leaving methodological and policy-related aspects to additional guidelines outside the main body of law, or transpose in a single set of rules the more detailed methodological aspects too, not just the substantive content (Bignami and Pilati 2008).

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[240] As the predecessor or the EBA, the CEBS fulfilled the functions of the so-called 'Level 3 Committee' for the banking sector in the application of the "Lamfalussy" Process. For further historical details, see Chapter 1.

The Italian regulator opted for the second choice, and hence it incorporated in Circular no. 263 of 27 December 2006[241] not only the content of Directive 2006/48, but also most of the additional methodological aspects developed by the CEBS. The idea behind this legislative choice was to provide a clear normative status to both principles and more detailed methodological provisions, which was not always the case for other member States, where these additional guidelines and instruments were not deemed as having a hard law status. In Germany Pillar 2 principles were incorporated in the 2005 MaRisk, which sets the requirements for banks to implement effective risk management frameworks to measure and manage risk through ICAAP and SREP (IMF 2016b). The German approach considered that Pillar 1 was not enough to safeguard the health of credit institutions; therefore, these initial mandatory regulatory requirements were supplemented by *ex-ante* and *ex post* risk mitigation measures, which were implemented at the internal procedural level and are contained in MaRisk.[242]

The extent to which the supervisory principles introduced by Basel II and the incorporation of SREP and ICAAP represent a departure from past approaches depends on prior local experiences and practices. When explaining the coordination challenges related to the implementation of the second pillar, the then secretary general of the CEBS, Andrea Enria, stated that the divergent supervisory practices among member States are due to different

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[241] *Circolare n. 263 del 27 dicembre 2006*, "*Nuove disposizioni di vigilanza prudenziale per le banche*". This Circular is now part of the comprehensive supervisory framework contained in the *Circolare n. 285 del 17 dicembre 2013*, *Disposizioni di vigilanza per le banche*. As explained in Section 3.3.3 above, a *circular* is a type of legal tool that can be adopted by Banca d'Italia when exercising the regulatory powers conferred to it by the Consolidated Law on Banking and the Consolidated Law on Finance.

[242] I am grateful to one interviewee from the Bundesbank who had the opportunity to comment on this chapter and helped me clarified some ambiguous points, such as this one. The fact that German supervisors did not rely on the imposition of Pillar 2 measures did not mean that supervision was less stringent. In fact, the experience of prior bank failure scandals, made the authorities aware of the need to have better internal risk management and governance procedures in order to mitigate the occurrence of catastrophic consequences.

national traditions and approaches. For instance, the more or less 'hands-off' nature of the supervisory style, the different modes of interaction between the authorities and banks, the type and frequency in the use of specific supervisory powers, including the imposition of additional capital requirements (Enria 2008). [243]

It has been pointed out that in spite of the innovative element at the international level, some of the Pillar 2 principles were enforced in specific jurisdictions already before 2004: "in Italy, for example, non-binding target capital ratios had been set in 2001 for the largest banks and the 'supervisory dialogue' between supervisors and institutions was a cornerstone of national supervisory practices" (Bevilacqua et al. 2019, 5). In the same vein, it has been recognised that one of the main innovative aspects introduced by Basel II was the possibility for the supervisors to apply specific and additional capital requirements that go beyond the regulatory minimum, which was a principle that Banca d'Italia had put into practice in the course of the previous years precisely through these target ratios that acted as capital thresholds (Bignami and Pilati 2008).

Other important elements considered by the Italian supervisor were the autonomy granted to the banks in designing their own ICAAP and, once again, the dialectic process between supervisors and supervisees, with a view to reinforcing mutual understanding and exchange of views. The principle of proportionality was also embraced by the Banca d'Italia, when classifying banks into three different groups in relation to the ICAAP requisites. It is important to have in mind that the Basel principles are originally conceived for large

[243] Enria is aware of the existing differences in this last domain: "sappiamo che su questo terreno le pratiche delle autorità nazionali muovono da tradizioni diverse e dispongono di differenti strumenti amministrative". However, in his view, the existence of large differences in the application by national authorities would not be acceptable in the mid-term: "se confrontate con una medesima situazzione esse dovrebbero sviluppare il medessimo "riflesso" europeo" (Enria 2008, 66).

institutions that have a significant impact at the international level; then the legislator at the EU level embraces and transposes those principles, making them applicable to all credit institutions. Therefore, the role of the NCAs in "filtering" or adapting some of these requirements to the situation of local smaller credit institutions is fundamental in order to materialise the proportionality principle. The current situation is slightly different, given that, as argued in Chapter 5, the establishment of the SSM has modified these NCAs' adaptive dynamics, reducing in many cases their interpretative scope.

Different sources indicate that the regulatory situation in Germany was different. In fact, the establishment of the SSM and the implementation of its SREP framework brought about important changes in relation to a tool that had been hardly used by the German supervisor in the precedent years: the use of Pillar 2 capital additional requirements, or capital add-ons. This aspect is illustrated and will become clearer in the next subsection, where the position of German banks and their associations in the public consultations denote aversion and concern about the imposition of additional capital requirements.[244] Apart from the relevant stakeholders' positions and background information from the interviews, other official documentary sources account for this supervisory approach.

Perhaps one of the most telling documents is the 2015 BaFin annual report. The federal supervisory authority, in line with the explanation provided above, states that when national supervisors needed to adapt Basel rules to the local situation, the responses ranged from "stringent general requirements to very flexible regulations that are heavily geared to the

[244] Interviews conducted with different EBA officials that provided background information on pre-SSM supervisory approaches consistently pointed out important differences between the Italian and the German styles. In the former, the authorities were said to follow a more data-quantitative driven approach, and the imposition of additional capital requirements. In the latter, supervision was mostly qualitatively-driven, and supervisors did not impose additional capital requirements, while relying for the most part on banks' own ICAAP calculations.

situation of the individual institutions. To date in Germany, the concepts have tended towards the second category. Until now, the primary focus has inclined towards a more *qualitative* approach that offered institutions substantial leeway, particularly with respect to the . . . ICAAP" (BaFin 2016, 89, emphasis added). The same report highlights that in order to function smoothly, the SSM needs to develop "uniform administrative practices", which from their perspective might imply "a paradigm shift in the approach to supervision", given that the SSM "is more focused on quantitative methods than was the case in Germany in the past" (BaFin 2016, 86).[245] For the purposes of the quantitative and qualitative distinction drawn in this chapter, the difference is mostly a matter of supervisory practices, methodologies, and the type of data that is gathered from financial institutions and how it is assessed. In fact, another way of understanding the quantitative and qualitative distinction is through the difference between Pillar 1 and Pillar 2 approaches: the former is closer to the quantitative side, since the supervisory assessment is based on quantitative regulatory requirements, whereas the latter needs to consider other features that might include qualitative aspects of banks' governance.

Another important change concerns the supervisory power to impose capital requirements beyond the minimum Pillar 1. The federal supervisory authority acknowledges that the EBA's approach—the expectation that national supervisors will determine the adequacy of the overall capital as a result of the SREP exercise—is one of the most important innovations, given that the German supervisor has avoided this method in the past. The point here is that, according to BaFin's report, capital requirements are no longer set on a holistic

[245] Other excerpts from the report referred to the need to adapt to a more "quantitative" approach to supervision, in contrast with the previous qualitative approach. For instance, in relation to the business model analysis, one of the SREP's building blocks, it is mentioned that even if these aspects are not completely new, "they do require a significantly more quantitative approach than the methods previously employed by the German supervisors" (BaFin 2016, 90).

basis; instead, they are determined separately for each risk type. The key aspect and the main departure from the local approach is that "the Pillar I capital is taken as given, and SREP capital is determined as an add-on to this Pillar I capital" (BaFin 2016, 90). This aspect has also been highlighted by the latest IMF's "Detailed Assessment of Observance on the Basel Core Principles for Effective Banking Supervision" for Germany, which is done in the broader context of the Fund's FSAP. The report explains that both the ECB and BaFin can require banks to hold capital above the minimum requirements under the Pillar 2 framework; "however, the practice is not commonly used by German authorities, which in general prefer to address these through direct discussion with the banks on the adequacy of ICAAP" (IMF 2016b, 174).[246]

It is important to clarify that this analysis does not intend to evaluate or judge supervisory approaches. Whether methodologies and principles are incorporated within the national framework as hard or soft law tools, or whether the authority relies more or less on banks' own calculations, are not indicators of good or bad supervisory styles. These differences reflect local practices and experiences, shaped by national institutions and the configuration of the banking system and its players, as examined in Chapter 3.

The last part of the section provides an overview of the regulatory milestones in the evolution of the SREP and ICAAP. As explained above, the SREP first sketched in the Basel II Accord in 2004 (although some jurisdictions already made use of similar measures beforehand). In that year, the CEBS conducted the first public consultation in relation to the first Guideline on the topic. The Guidelines were finalised in January 2006. From early 2011, the CEBS has been replaced by the EBA, who in 2014 conducted a new public consultation to

[246] These are normally referred to as qualitative supervisory measures.

develop updated SREP guidelines, in order to make them workable for the recently established SSM. Once the SSM has been set up, the evolutionary process speeds-up and the concern for a more consistent approach is clearly shown by the supranational supervisor. In fact, in 2016 the SSM published its first "Supervisory expectations on ICAAP and ILAAP and harmonised information collection on ICAAP and ILAAP". This instrument was published through a "Dear Management" letter from the former Chair of the Supervisory Board. The letter and the corresponding annexes were twenty six pages long, which suggests the level of detail contained in the document. In the same year, the EBA launched a public consultation on the Guidelines on ICAAP and ILAAP information collected for SREP purposes, which were finally published in February 2017.

Just a few days after the publication of these EBA Guidelines, the ECB published another "Dear Management" letter—this time a twenty four-page long letter—entitled "Multi-year plan on SSM Guides on ICAAP and ILAAP". Later on that year, the EBA launched another public consultation in order to update the 2014 SREP Guidelines, a work that was completed in 2018 with the publication of the new regulatory product. Finally, in 2018 the ECB published two Guides on ICAAP and ILAAP respectively, after conducting a public consultation via conference call. In addition to these tools, the SSM publishes SREP methodology booklets, which are normally annually updated, and has also developed the corresponding methodology booklets for LSIs SREP too.

What emerges from this account of the events is that, since the introduction of the SSM, there has been a burgeoning interest in strengthening the consistency of banks' ICAAPs in the euro area. This is also mirrored in the inclusion of ICAAP and ILAAP among the 2019

supervisory priorities, within the broader category of "risk management". As summarised by KPMG,

> For much of the SSM's existence, approaches to ICAAP have continued to vary significantly between member States—partially a legacy of different national supervisors' historical approaches. The ECB has always been keen to harmonise ICAAPs and make them more comparable. But it's only been during the past three years that their efforts in this area have really taken hold. (KPMG 2019, 1)

The question regarding the ongoing divergencies in the approaches to ICAAP should be no surprise, considering the "legacy" of national supervisors and their respective styles and the fact that the ICAAP is meant to be an internal exercise, in which banks had been given considerable leeway and autonomy in how to implement it. The consistency problem arises for the SSM due to the connection between this purely internal ICAAP and the broader SREP, given that the former is a fundamental element of the latter, as it provides key input in the assessment of risks to capital (KPMG 2019). The ultimate aim is to refine the role of ICAAP in determining Pillar 2 requirements.[247]

To conclude with the evolution of the SREP framework, it is important to analyse how the tool itself has evolved over time, which in turn provides some hints to better understand the changes in the modes of governance. As explained in a paper concerning the evolution of the Pillar 2 framework:

> In general terms, the content of Pillar 2 has mutated from the original Basel concept. This is not surprising given that the implementation of Pillar 2 has coincided with the eruption of the financial crisis and the greatest regulatory reform of the financial sector in the last few decades.

[247] KPMG's (2019) short piece concludes in a not so positive fashion, by stating that "the ECB's ultimate goal of making ICAAPs more comparable will take time to achieve. For banks, the immediate priority should be to prepare for the enhanced scrutiny and increasingly demanding data requirements that are likely to be major themes over the next two years". The downside of the increasing scrutiny levels and the growing data requirements is meant to be offset by a more bespoke assessment of the bank concerned, hence, a more accurate Pillar 2 assessment.

> Indeed, the Basel principles were designed in a pre-crisis environment, when a set of key concepts seemed to be rock solid: market-friendly regulation and (in some cases) light-touch supervision, reliance on banks' self-assessment, and the idea that major banking risks are adequately covered by Pillar 1 capital requirements and that possible capital add-ons can intervene in a flexible way only when the latter are insufficient. In the post-crisis environment, Pillar 2 implementation (at least in the EU) has moved in a direction where: Pillar 2 requirements are as binding as those of Pillar 1, capital measures represent the main response to banks' shortcomings, it has been a struggle to integrate banks' self-assessments (ICAAP) into the framework, and Pillar 2 risks that are not covered in Pillar 1 are material. (Bevilacqua et al., 2019, 26).

This new concept of Pillar 2 as a 'natural' additional capital requirement, coupled with the need to streamline diverse ICAAP assessments and apply substantially uniform SREP methodologies, lies at the core of the SSM's consistency challenge. Pillar 2's change of nature is relevant from both formal and substantive perspectives. In fact, from the early Basel II days where the concept of Pillar 2 was initially conceived, to the developments brought about by the EBA's approach in 2014, and finally by ECB Banking Supervision (see section 4.2.2. below), the meaning assigned to Pillar 2 is no longer the same.[248] According to a specific understanding—mostly the German approach—what is called Pillar 2 now, is actually a "Pillar 1 plus", given that it leads to the imposition of binding requirements. Hence, this makes it different from the 2004 initial conception of Pillar 2, which referred to non-statutory requirements. As shown below, this understanding can explain the German stance in fierce opposition to this understanding of Pillar 2, whose content started to mutate with the post-crisis regulatory and supervisory architecture. This passage from the EBA SREP Guidelines provide the rationale for this change, which is closely connected to the consistency challenge and comparability across institutions:

[248] For a recent worldwide overview of Pillar 2 supervisory practices and approaches, see BCBS (2019a). See "Annex A" on page 25 of the report, for a selective list of the definitions given to the variety of local Pillar 2 practices, which shows the challenges faced by the SSM in order to achieve consistency in this field.

> With the composition of own funds instruments and Pillar 1 calculations now harmonised as far as possible under Regulation (EU) No 575/2013, *variations in the treatment, quantification and composition of Pillar 2 requirements are the main source of variations in the prudential treatment of institutions with similar risk profiles in different Member States* within the Union. The variation can be stark and create an uneven playing field as well as, potentially, lowering prudential standards, with consequent impacts for financial stability within the Union. Adoption of the guidelines should help to drive convergence of prudential outcomes across the Union, improving the functioning of the single market and helping to ensure greater financial stability. (EBA 2014, 200, emphasis added)

The next sections zooms in on the regulatory battlefield in which the content of these tools have been defined and redefined over time.

4.2.2 A longitudinal analysis of stakeholders' perspectives

After analysing the origins and the milestones in the SREP evolution, this subsection provides an analysis of the position papers submitted in the different public consultations that have taken place between 2004 and 2018. In line with the general framework of the dissertation,[249] the analysis focuses on the position papers submitted by Italian and German industry representatives, banks, and EU-level banks associations.

The brief account of the regulatory evolution of the SREP and the ICAAP provided in the previous subsection, suggests not only an increasing interest from the SSM's side in order to harmonise and streamline these tools, but also an attempt to "formalise" the interaction with their supervisees over time. In fact, the situation has evolved from the publication of two extensively detailed letters, to hold a public consultation via conference call, after which two ECB Guides were published. The 2016 "Supervisory expectations on ICAAP and ILAAP and

[249] Most importantly, the analysis of the diversities that takes the Italian and German cases as illustrative examples, and the analysis of additional public consultations and the empirical work carried out in Chapter 5.

harmonised information collection on ICAAP and ILAAP", and the 2017 "Multi-year plan on SSM Guides on ICAAP and ILAAP" letters, are not included in the analysis of the present section, because there was no formal public consultation carried out, and therefore no way to examine stakeholders' positions. The second letter, however, provides a rudimentary way of collecting stakeholders' feedback, by creating an ad hoc email address to submit it, and two templates to comment on the ICAAP and ILAAP Guides, respectively. These templates, however, are not part of the publicly available letter, nor has the feedback received been disclosed. An interesting question that exceeds the analysis of the present chapter relates to the reasons behind this shift from a more informal to a formal interaction.

Sections A to E below provide a summary of the main issues raised by German, Italian, and EU level associations representing the interests of diverse members of the banking sector. Some parts contain quotes that explicitly refer to the position of the actors in question, while others contain a brief explanation paraphrasing the key content.

A) CEBS 2004 consultation for the "Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised)", published on 25 January 2006.

Germany: Zentraler Kreditausschuss (ZKA), now the German Banking Industry Committee (GBIC)	• Fears the imposition of more requirements from the supervisors; • Highlights the "Rule-exception" relation between Pillar 1 and Pillar 2 requirements, and the ultima ratio nature of Pillar 2; • Claims the need to respect the "dialogue" element between supervisors and banks; • Calls for a balanced approach between supervisors' tasks and banks' management.
Italy: Associazione Bancaria Italiana (ABI)	• Does not react to the possible imposition of Pillar 2 requirements. The only point raised in relation to capital requirements is the possibility to make a downward adjustment, as opposed to the imposition of additional capital charges only.

European Banking Federation (EBF)	• Stresses the difference between the compulsory nature of Pillar 1 and the approach to be taken regarding Pillar 2: "The proposals set out in the paper should deliver a less mechanistic and more holistic approach to risk management both for supervisors and for financial institutions. Pillar 2 is different, and should be different from Pillar 1: It should be a challenge process and not a compliance exercise"; • Reiterates similar observations regarding the exceptional nature of Pillar 2.
European Association of Cooperative Banks (EACB)	• Stresses the importance of proportionality: "though the proportionality is included in the principles, however in most cases the wording is such that it is very difficult to know how compliance can be ensured for small institutions. The SREP seems to address issues which can be reviewed mostly at on-site inspections and require considerable resources from supervisors. It would be desirable if the simplifications for less complex institutions would be also highlighted in the principles"; • Expresses concern about some risk taxonomy having a "regulatory status"; • Expresses concern that management decisions may fall under supervisory discretion: "The EACB has permanently pointed out that the SREP should not lead to a scenario in which supervisors take over the role of a bank's management, which is equally supported by the substance of the Basel document;" • Points out the existence of national differences: "EACB's members … strongly suggests that supervisory authorities should standardise the reporting formats in order to reduce cost. Other members, however, underline that the standardisation of reporting formats will bring disadvantage for banks that act on a national level only. Standardisation would increase their cost burden only. Possibly, the size of banks could become a decisive factor for a standardisation exercise"; • Points out to the complex analytical tasks that cannot be carried out by smaller institutions given the lack of expertise.
European Savings Banks Group (ESBG)	• States that the guidelines contain too many details and definitions; problems of an overly prescriptive approach; • Stresses the importance of flexibility in order to cope with national differences: "The ESBG believes that it is of the utmost importance to strike the right balance between a *consistent implementation* of the new Basel Framework throughout the European Union, and to grant Member States *sufficient room for manoeuvre* to implement the new framework at their national level. In this context, we believe that in some areas of the new Framework, Member States should be permitted to use flexible solutions to address specificities in their national fiscal or legal regime. This flexibility will be necessary in the identified areas

> as long as these differences continue to exist. As such, when deciding whether a national discretion clause is necessary or not, the objective of creating a level playing field at the EU or international level needs to be weighed against the functioning of the national market" (emphasis added).

These positions deserve some attention. The critical stance form the German association ZKA reflects the differences in supervisory styles that have been highlighted in Chapter 3 and the previous section. In fact, the "rule-exception" relationship that in their view should exist between Pillar 1 and Pillar 2 requirements, and the insistence upon the *ultima ratio* nature of it, is in line with the fact that the German supervisor did not make use of the imposition of additional capital requirements, and that banks were given broad discretion in the elaboration of their ICAAP.[250] These differences are also in line with the evolution of the role of the Pillar 2 framework explained above. Before the crisis, the German "exceptional" approach to Pillar 2 would have been deemed acceptable; however, after the global financial crisis and the uncovering of the different practices that have been abused due to the lack of a proper framework, Pillar 2 has become a non-negotiable and much complex aspect of the capital requirements, although these requirements have to be calibrated to each institution's characteristics and risk profile.

The CEBS published a feedback statement document to reflect the main points of criticism raised during the consultation: the high level of detail and prescription; the redundancy of the guidelines; the prescriptive tone of the document, which went from high-level principles to a more rigid supervisory 'checklist'; the concern about supervisors engaging

[250] Apart from the documentary sources referred to in the previous section, the information provided by different interviewees draw attention to the same issues. The explanations from EBA officials in relation to the fact that German supervisors relied more on banks' own assessments (ICAAP), whereas Italian supervisors relied more on their own calculations. Two large financial institutions from Germany pointed out the fact that one of the main changes was the operationalisation of SREP and the Pillar 2 requirements, which were not applied before by the German supervisor.

in a sort of shadow management; are among the most important ones. In any event, those criticisms were to some extent diluted in the course of the implementation of the Guidelines, given that national authorities still had a generous margin of interpretation and action.

The feedback statement has an overall apologetic tone, in the sense that the criticisms raised by the stakeholders were for the most part uncontestably accepted, and the authority provided the necessary explanations regarding the changes made to the text in order to better reflect the incorporation of the comments. For instance, "CEBS recognises that more emphasis should be placed on the nature of the guidelines, explaining that they represent a common understanding of supervisors clarifying their expectations for internal governance, rather than prescriptive rules to be complied with." (CEBS 2006a, 1/2). Another example of the authority's attempt to lower the tone of the document stated that "it was not CEBS' intention to establish overly prescriptive guidelines, and CEBS agrees that there should be flexibility in how the guidelines can be met. To avoid confusion the guidelines have been amended to adopt a higher level perspective." (CEBS 2006a, 2).

The interplay between comments and responses provides a clear picture of how the prior supervisory arrangement worked: in spite of explicitly acknowledging the need to foster convergence and consistency in the supervisory practices, the mechanisms and the tools that CEBS had at its disposal were too feeble to steer national supervisors' approaches and practices. It is interesting to see that stakeholders raised one usual criticism regarding the "excessively detailed and prescriptive" tone of the 2006 document. In 2018, the requests went exactly in the opposite direction, when some stakeholders requested more clarifications, more details, and more examples, in order to have a more accurate view on supervisors' expectations. This is one of the differences between the pre- and post-SSM times, as explained later on.

B) EBA 2014 consultation for the "Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)" (EBA/GL/2014/13), published on 19 December 2014.

EBF

- Stresses the need of proportionality in order to deal with banks' diversity: "we are keen that this does not result in a standard 'tick box' approach and the highly interactive and qualitative approach operated in some jurisdictions is maintained. Given the diverse nature of Europe's banking and financial industry, we consider that proportionate judgment-based SREP practices are essential to ensure that risk is effectively addressed under the SREP framework";
- Claims that business model analysis should be a mere informative element for the supervisor where no powers should be exercised;
- Stresses the need to preserve the dialogue: "Our understanding is that the SREP was conceived to promote understanding and dialogue between the parties involved. The proposed guidelines barely mention a dialogue and challenge session with it looking more like a one-way process in which there is little recognition of the role of banks";
- Points out the missing elements in relation to ICAAP and the need for additional guidelines on the topic;
- Highlights the impact of the starting of operations of the SSM and the need to foster dialogue;
- Stresses business model diversity and the impact of the scoring system: "Setting a score risks driving banks to all have the same business model. There are as many business models as banks and all of them are, in principle, legitimate and serve a need in the financial market and the broader economy. The diversity of business models contributes to the stability of the financial system. The use of scores to discriminate between business models would lead, inevitably, to the presumption that certain segments, products, geographies, credit grades or financing purposes are worse than others. Inputting this factor into the SREP scorecard could mar the credibility of the system";
- Stresses the problems in relation to benchmarking and peer review exercises, given institutional differences and the presence of ONDs.

GBIC

- Stresses the need not to interfere with banks' decision with the inclusion of new instruments: "Including an **analysis of business models and of the sustainability of business strategies** in the SREP guidelines introduces an important new element to banking supervision. The benefit of this new element will lie above all in the information which will assist in planning and support the other elements of the SREP. We would strongly oppose any inference that supervisors should have a say in banks' business policies. Supervisors should not see themselves as "better bankers" than the banks themselves" (emphasis in the original);

- Stresses that the proposed guidelines "**significantly extend the authority** of supervisors in a number of areas" (emphasis in the original);
- Mentions the fact that the EBA was exceeding its mandate "**We therefore strongly advocate both retaining the existing ability for banks to select their own risk management methods in Pillar 2, since this is essential to holistic management processes, and continuing to recognise internal capital and diversification effects across risk types**" (emphasised in the original);
- Emphasises the missing references to proportionality;
- Mentions the risk of standardisation and losing view of specific situations: "We see a danger of the standardised analysis and associated **scoring** creating a deceptive impression of precision and triggering the automatic introduction of measures. This is not in keeping with the spirit of Pillar 2, in our opinion. The peer group approach should also be flexible enough to allow a proper assessment of individual banks. It should be possible for supervisors to overrule the formal results of the scoring process if there are sound grounds, such as qualitative considerations, for doing so";
- Highlights the need for transparency in the development of benchmark models and peer review comparison: "this needs more disclosure in relation to how these benchmarks were calculated, and the reason for assigning banks to specific peer groups";
- Defends the principles based approach: "Principles-based approaches that cover all material types of risk are far preferable to rules-based approaches under Pillar 2 because they facilitate a more comprehensive coverage of banking practices. It is virtually impossible to cover all conceivable types of banks with a rules-based approach, and regulatory gaps inevitably open up [. . .] Experience has been positive, on the other hand, in member states which apply a principles-based SREP framework. It is fair and right that the SREP should be applied as consistently as possible across the EU. This should not, however, lead to a situation in which the ability of management and the supervisory board to take risk and business management decisions is restricted by excessively detailed rules";
- Mentions that, given the diverse nature of Europe's banking and financial industry, proportionate, principles-based SREP practices are essential if all institutions and their business and risk profiles are to be covered by one and the same framework;
- Stresses that EBA's draft guidelines contain a high degree of regulatory detail, and that some of the processes are spelled out exhaustively;
- Points out the situation of LSIs and NCAs: "As a result of the envisaged degree of detail, we anticipate that national supervisors will have to put significantly more resources into the SREP. Banks which are not directly supervised by the ECB will have to be regularly reviewed with a thoroughness that is possibly neither necessary nor appropriate, especially for smaller retail institutions with comparatively simple business models";
- Criticises the usefulness of benchmarks and peer group comparisons: "Another major new element of the SREP is the proposed comparison with benchmark

models and peer group results. This approach is based on the assumption that the benchmark or peer group results can be considered an objective measure for judging an individual bank's calculations. In reality, however, benchmarks of this kind may deliver only limited objectivity and comparability." They also mentioned that in the absence of a standardised ICAAP across Europe, these comparisons are of no use because each bank will use its own methodology;

- Highlights the variety of the banking system and the implicit benefit that the new framework grants to universal banking models as opposed to more specialised banks: "Judging by the 'considerations', the universal banking model will generally obtain a better score than will specialist institutions";
- Stresses the changing nature of the Pillar 2 instrument, and question the EBA's approach which, in their view, takes Pillar 2 as a "Pillar 1 plus" tool, disregarding the freedom of Pillar 2 methods that had been used until then.

ESBG

- Raises the need to strengthen the dialogue: "In particular, ESBG believes that within Pillar 2 it is important that supervisory authorities hold an extensive dialogue with the supervised institution so as to better understand the particular characteristics of the institutions. In our view, SREP is best conducted by incorporating both top-down as well as bottom-up elements";
- Stresses that the scoring elements are not granular enough and might fail in considering institutional particularities;
- Mentions additional consideration on standardisation and objectiveness through benchmarks and peer reviews: "The SREP GL also establish that the national competent authorities (NCA) should pay close attention to atypical performance compared to peers by conducting peer analyses and benchmark calculations (for instance, in respect of Business Model Analyses). This requires more or less objective standards in each part of the specific assessment of an institution. However, there are doubts that objectiveness and comparability can always be guaranteed. Hence, ESBG believes that the use of peer-group analyses and benchmark calculations might not be appropriate if the peer groups do, for instance, not reflect the individual institutions' operating environment (geography, segments, etc.). More details on the determination of benchmarks and the categorisation into certain peer groups would also be needed to be communicated to the institutions in advance";
- Stresses the importance of principles-based approach: "Bearing mind the need for a consistent and coherent regulatory framework, in pillar 2, principle-based approaches have often proven to be more suitable than rule-based approaches as the former can easier adapt to all different types of banking institutions . . . The very diverse banking sector in Europe calls for proportionality and a principle-based approach in order that all institutions, having different business models and risk profiles, are covered in an appropriate way by one common supervisory framework, namely the SREP GL";
- Points out the importance of consistency and banks' autonomy: "It is clear that more consistency in the supervisory methods across Europe needs to be achieved. However, more consistency should at the same time not impose restrictions on the management bodies by establishing too detailed rules. It

might be dangerous that a too uniform and rule-based framework leads to having very similar institutions, which could finally increase systemic risks and procyclical effects";

- Stresses the compatibility between Pillar 2 and standardise approaches: "ESBG believes that a standard approach is difficult to align with the CRD IV's and the Basel framework's understanding of Pillar 2. Under the proposed standard approach for the assessment of an institution's capital adequacy and for the articulation of additional own funds requirements, pillar 2 as such would cease to exist and be replaced by a "pillar 1+" or "pillar 2A" perspective."

EACB

- Stress the increase of supervisors' powers: "The draft GL considerably widens the competences of supervisors, ranging from the direct investigation of the business and risk management, participation in capital allocation to intervention in the management and business policies. We believe that these tasks are beyond a Pilar 2 approach";
- Reiterates the criticism towards the benchmark and peer review approach;
- Highlights the disconnection between the SREP requirements and the banks' current ICAAPs: "due to the fact that it only describes the SREP, banks will have to identify for themselves what this means for their ICAAP as the complement to the SREP. While this may already be a challenge, the very high degree of abstraction of the paper make it even more difficult to identify the room of flexibility in the individual situation";
- Points out to the changes in supervisory styles: "All in all the draft GL represent a completely new supervisory approach, beyond supervisory convergence. While a strong emphasis is placed on benchmarking (48 references), there is hardly any room for qualitative assessments. The proposed methodology focuses the review process on score values and automatic measures, triggering capital requirements as the only solution. This seems far from the spirit of Pilar 2";
- Mentions the risk that the scoring element might give supervisors "a perceived sense of accuracy" and therefore use these scores to justify the automatic introduction of additional measures;
- Stresses that the assumption that peers' values are based on objective criteria is misleading and the resulting comparability should be relativized. It is advisable that the entities disclose not only the benchmark values, but also the method followed for determining those values;
- Mentions the need to maintain the level of supervisory dialogue existing so far, which has been almost neglected in the draft guidelines: "the proposed guidelines on the SREP procedures and methodologies are remarkably silent on this dialogue and on the procedures that should support it";
- Acknowledges the need for greater harmonisation and convergence, but believes this can be done via a principles-based approach, in line with the other associations' claims;
- Criticises the use of benchmarks in the ICAAP assessment: "The use of supervisory benchmarks is strikingly promoted in the guidelines overall, especially to assess the ICAAP reliability, as stated in paragraphs 317 to 329

> ("competent authority should further assess the reliability of the ICAAP calculations by comparing them against the outcome of the supervisory benchmarks for the same risks…").

There are some aspects that are worth pointing out, beyond the stakeholders' wide claims and most predictable positions. First, there were no Italian submissions in this public consultation. In line with the pre-existing differences between supervisory styles referred to in the previous section, the German position heavily criticised the proposed guidelines and the extent of the powers and competences that they confer to supervisors. Another criticised aspect was the question of the "corporate culture" as an element to be included as part of the SREP scoring, given the lack of a precise definition and therefore of an objective way to measure it.

In any event, Germany was not alone in complaining about the range of powers in the hands of supervisors and the greater discretion they have been conferred in order to conduct the SREP, given that the EU level associations highlighted the question too. As interviewed EBA officials have explained, they have elaborated these Guidelines to pave the way for the SSM to start operating on a more "harmonised basis". But this is not the whole story: the EBA draft guidelines were easing the SSM's way not just by widening the range of supervisory powers and tasks, but also by significantly shifting the supervisory focus, from a more qualitatively and dialogue-oriented to a quantitative and standardise one. This was especially acknowledged by EU-level banks associations. In fact, this observation was heralding the importance that the SSM would later give to these comparative benchmarking tools in the course of its supervisory activities.

An additional important aspect concerns the preservation of the qualitative aspects that should be pondered by the supervisors. This potential loss of qualitative elements was pointed out during interviews conducted with different stakeholders from Italian and German sectors,

as being one of the most perilous aspects of a data-driven, quantitative approaches to supervision. The question of the qualitative and quantitative ways of conducting supervision is not just a matter of methodology. The underlying issue here is that, as a rule of thumb, NCAs are probably better positioned to qualitatively assess banks in their respective jurisdictions, due to the local knowledge and experience they possess. The supranationalisation of supervision, therefore, needs to complement this type of knowledge with more standardised tools that allow for comparisons across jurisdictions.

Furthermore, the speed with which this instrument was adopted was quite remarkable: the deadline for comments' submission was on 20 October 2014, and the final text of the Guidelines was published on 19 December 2014.[251] As mentioned earlier, this was motivated by the need to provide an already functioning SSM with the necessary tools to start with its SREP cycle.

One criticism that run across the submissions was the lack of a proportionality criteria. This is also connected to the claim for a clear "definition" of proportionality and the lack of intervention from DG III in this respect, in order to articulate broader requirements directed to SIs and adapt those to LSIs, which was expressed by some interviewees.[252] It is true that proportionality criteria tend to be vague, since official documents make reference to the fact that *size*, *complexity*, and *riskiness* of the individual institutions are to be taken into account by the supervisor. The question here is that proportionality is a matter of implementation and the way supervision is carried out in practice; therefore, it is not necessarily an issue that can be largely anticipated by the regulator, as there is always the risk of creating empty and useless

[251] Normally, EBA public consultations take longer

[252] Especially from the Italian LSI sector and German Public banks association.

categories. In any event, the question of proportionality is crucial in the EU context, given the high level of uniformity in the requirements, and the variety of institutional contexts in which these have to be applied. For this reason, the adoption of the banking package in April 2019—CRR II, CRD V, and the amendments to the resolution framework comprised by the Bank Recovery and Resolution Directive (BRRD)[253] and the Single Resolution Mechanism Regulation (SRMR)[254]—foresees measures to reduce the regulatory and reporting burden on the so-call "small non-complex institutions".[255]

C) EBA 2015/2016 consultation for the "Guidelines on ICAAP and ILAAP information collected for SREP purposes" (EBA/GL/2016/10), published in November 2016.

GBIC

- Stresses the importance of NCAs' autonomy: "We expressly welcome the proportionality clauses contained in the draft Guidelines. In our view, their effectiveness will, however, depend on whether competent authorities are actually given the proposed discretion in the supervision of LSIs referred to in paragraph 14, among others. In this context, a notable positive is that the EBA has not drafted any proposals for reporting formats so as to allow national supervisors broad scope for implementing the principle of proportionality";
- Complains about the great amount of required information.

EBF

- Claims that the EBA should limit the amount of information requested to elements that are actually relevant and manageable for an ICAAP/ILAAP;

[253] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12.6.2014, p. 190–348

[254] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 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 and amending Regulation (EU) No 1093/2010
OJ L 225, 30.7.2014, p. 1–90

[255] Albeit an improvement in order to ease the situation of smaller institutions, the problem behind thresholds, classification criteria, and specific definitions is that they foster one of the oldest and most fundamental problems of financial regulation: what Charles Goodhart has characterised as "the boundary problem", which happens because "effective regulation, one that actually bites, is likely to penalise those within the regulated sector, relative to those just outside, causing substitution flows towards the unregulated" (Goodhart 2008, 48).

- Stresses on the ambiguity of the instruments: "It is often unclear whether the information specified is requested or suggested";
- Points to a "gold-plating" mechanism: "Content-wise the data collection GL sets different and additional priorities compared to the SREP GL. This means that the data collection GL is effectively "gold-plating" the SREP GL, a result not necessarily intended by the data collection GL and not favoured by the banking industry given the already demanding standards of the SREP GL. Such an approach will be detrimental to a consistent SREP assessment by NCAs and endangers the overall objective of EU-wide harmonisation";
- Requests clarifications on the level of detail: "Banks' ICAAP and ILAAP assessment should remain an internal process and it is important that the approach should reflect the internal management model of the bank, e g the ILAAP must follow the appropriate one due to the Liquidity Management Model of each Financial Group. Clearer guidelines would be appreciated on the scope of the ICAAP and ILAAP on the level of granularity of the information required (for instance, what is the materiality criteria to be considered in the information disclosure? Size, belonging to the perimeter of the SSM?)."

EACB

- Stresses potential problems arising from too much data requests: "The information required should be maintained to elements that are actually relevant and manageable for an ICAAP/ILAAP. The suggested approach is likely to result in an excessive documentation/information exercises challenging for both competent authorities to analyse and assess and for institutions to produce";
- Stresses the need to streamline the guidelines with the ECB's 2016 communication of expectations: "The ICAAP and ILAAP supervisory expectations issued by the ECB on January 8th, 2016, in order to perform the SREP-process 2016, are ambitious with respect to both, time and content. We believe that a more coordinated and aligned procedure on the gathering of information and the required content should be envisaged between the EBA and the ECB";
- Stresses the importance of NCAs' discretion: "Much will depend on whether competent authorities will actually dispose adequately of the proposed discretion in the supervision of LSIs as referred to in paragraph 14. In this respect we particularly welcome that the EBA has not proposed standardised reporting formats so as to allow competent supervisors sufficient scope for implementing the principle of proportionality."

ESBG

- Stresses the need to provide better and more comprehensive feedback: "In ESBG's members' experience, there have been cases when the observations of the competent authorities regarding ICAAP and ILAAP are done at very high level and consist of rather vague terms, making any follow-up rather difficult . . . Therefore, we suggest that the EBA's guidelines provide guidance to competent authorities regarding a clear and uniform formulation

of their observations in a manner that can be easily followed and acted upon by the institutions."

The EBA provided a detailed feedback on the comments received. In most cases, modifications were not made and, in others, clarifications were provided. Regarding the relationship between the 2016 ECB's supervisory expectations communicated via letter and the EBA document, no clarification were made, and it was explained that the ECB has to abide by the "comply or explain" framework, as any other NCA. Another question that emerged concerns the coordination between EBA and ECB banking supervision requests. Finally, the issues related to risks and mitigation of uncertainties, or the normative and economic perspectives that are thoroughly dealt with in the 2018 ECB's Guide, are not present in this document.

D) EBA 2017 consultation for the "Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing" (EBA/GL/2018/03), published on 19 July 2018.

GBIC

- Stresses the need for transparency and better communication: "In cases where peers are used to assess institutions, they should be explicitly notified to the institutions, together with the methodology used to select them. Transparency is necessary in this step so that institutions are given an opportunity to comment on their assignment and on any relevant differences compared with peer banks";
- Highlights the need for transparency and communication with the affected institutions in relation to Pillar 2 measures: "The GBIC is seeking considerably greater transparency about the determination of individual P2G. As a general principle, institutions should be able to base their capital planning and actions on the supervisory dialogue regarding P2R/P2G, which demands sufficient transparency about the reasons for defining supervisory actions and P2R/P2G."

ABI

- Mentions the need to have an overall view of the risks: "We consider the approach to Pillar II should not be just a Pillar I plus some add-ons, but a comprehensive overview of the risk profile of an institution";
- Stresses the importance of transparency: "Finally, we also note that further transparency on the setting and communication to institutions of P2R should be prescribed by the Guidelines";

- Stresses the need to clarify the nature of the instruments and their consequences: "the draft Guidelines should also clarify the implications of breaching the P2G vis-à-vis other requirements. In this regard, it would be welcomed that the Guidelines establishes the proper framework to understand the **"binding degree"** of this guidance/recommendation and in the same vein to include a menu of options available to supervisors in case banks breach the P2G." (emphasis on the original).

EBF

- Stresses the need for proportionality in practice: "It is important that the SREP process reflects differences in size, complexity and business models. We are still missing specific improvements in terms of proportionality for stress testing";
- Points out to specific elements that should be considered in relation to SREP transparency: "clarifying the relation between the score of each SREP area of analysis and the overall score and the relation between the overall score and the SREP final capital and liquidity requirements; disclosing the clustering of the peer groups a bank belongs to, in order to have a better understanding of the relative positioning which is a key pillar in the SREP assessment";
- Mentions the problems related to the imposition of "binding" international standards: "International standards per se should not be imposed on institutions as if they were binding legal instruments, nor should they be equated to EU or national laws and other regulations, especially if the latter allow institutions a degree of discretion in their application which international standards do not [. . .] Including international standards as part of competent authorities' assessment tools poses much uncertainty for institutions – especially for cross-border Groups - given that the Guidelines do not specify the framework of application of said international standards";
- Stresses the need to better communicate peer groups formation: "With regard to the use of peer groups, these should be explicitly communicated to the institutions, including the methodology for peer group formation. Transparency is important in this step so that institutions may have the opportunity to comment on their classification and possible relevant differences with peer banks. This approach would also enable institutions to gain a better understanding of the regulatory approach and promote the learning of best practices within their peer group";
- Highlights the need to account for national legal differences: "It is important that the SREP assessments are conducted taking into account the wide-array of national differences that may exist within subsidiaries of CRD institutions";
- Mentions the importance of clarifying the bindingness of the tools: "The draft Guidelines should also clarify the implications of breaching the P2G vis-à-vis other requirements. In this regard, it would be welcomed that the Guidelines establishes the proper framework to understand the "binding degree" of this guidance/recommendation and in the same vein to include a menu of options available to supervisors in case banks breach the P2G."

The consultation for the revised SREP guidelines are enlightening because they point out emerging elements from the bank-supervisor relationship and the respective transformation

emerging from the SSM era. In the analysis of the 2014 first Guideline consultation, stakeholders expressed their concerns on *potential* issues that might arise from the wide set of tasks that the SSM was meant to conduct. The concerns expressed in this new consultation stem from actual supervisory experiences.

The EBA provided feedback on the responses received. On several occasions, the regulatory authority acknowledged that the substance of the comments were directed to practices and concerns that fall within the realms of supervisory activities and that therefore were outside the scope of the EBA's consultation.[256] In fact, the EBA clearly explained that methodological issues—for example those related to the determination of Pillar 2 requirements (P2R)—were outside the scope of the review, and that "the level of transparency remains at the discretion of the individual competent authority", which was a clear message to the SSM and the criticism regarding the lack of transparency when applying the holistic SREP approach.

The question of transparency was again raised by different stakeholders in the context of the revision of the SREP guidelines: "Some respondents noted a strong legal need for more transparency in relation to the allocation of total additional own funds to single risks" (EBA 2018a, 121). The EBA stated that questions regarding the transparency of the risk assessment methodology was outside the scope of the Guidelines review, but that it has been discussed in the EBA Convergence of Supervisory Practices report. The EBA dealt with additional requests and comments regarding transparency between supervisors and supervisees: "One respondent proposed that the benchmarks used for the assessment should be made transparent to

[256] For instance, "some respondents remarked that supervisory approaches in terms of determining the levels of P2R and P2G, as well as the scoring rules, were not sufficiently transparent for banks, which presented an obstacle to efficient capital planning. They suggested explaining the exact methodology so that banks would be able to manage their P2R and P2G expectations in a forward-looking manner." (EBA 2018a, 151). These observations are all directed to the supervisory authority.

institutions, so that the latter can comment on them and so that best practices are promoted across the peer group." (EBA 2018a, 121). Again, the EBA explained that this point was outside the scope of the SREP GL consultation and that it remained at the discretion of the corresponding competent authorities; exactly the same considerations were put forward by the EBA in relation to comments regarding the transparency in the use of peer groups by the supervisor.

What emerges from these observations and the corresponding feedback from the EBA is that, in many cases, the industry was complaining about current supervisory practices and expressed their views in the public consultation, in order to "pass on" the message. The EBA replied by explaining that those issues were a matter of supervisory discretion and therefore not for discussion in the public consultation. Another source of criticism concerned the need to identify the "binding degree" of the Guidelines, as it was not clear which would be the consequences of not complying with Pillar 2 Guidance (P2G), a new element incorporated to the Pillar 2 family. This example points out to the interconnectedness between regulatory and supervisory activities in these fields.

E) ECB 2018 consultation for the "ECB Guide to the internal capital adequacy assessment process (ICAAP)", published on 9 November 2018.

GBIC	• Raises criticism towards the "conservative approach" imposed by the ECB: "In our view, CRD IV does not provide the basis for the conservative approach required in this section and throughout the remainder of the guideline. Instead, Article 73 refers to adequate risk cover"; • Asks for clarification of concepts regarding context, scope, and reformulation in order to avoid misunderstandings: "The exact meaning of the "overall level of conservatism" is unclear: is this some kind of 'security level' that a bank defines itself (i.e. most likely comparable to a confidence level), or is it a conservative approach for individual models?

In the latter case, it is worth noting that conservative modelling merely for the sake of conservatism is inappropriate – managing a bank requires an assessment of the risks involved that is as realistic as possible. We therefore ask for clarification of the concept of "overall level of conservatism", taking into account the points mentioned here";

- Highlights a risk-assessment concern: "The identification or risks should not be based on a 'gross' approach, as this would prevent a focus on actual, material risks. It is conceivable, for example, that unauthorised access (intrusion) is identified as a significant risk without taking security mechanisms into account. An assessment of the materiality of risks is only reasonably possible on the basis of a 'net' approach";
- Highlights the difference between risk measurement and risk appetite: "We propose to delete the phrase 'The institution is expected to apply a high level of conservatism under both perspectives'. Instead of being conservative, measurement of risks in both perspectives must be accurate. Institutions want to understand the true extent of their risk exposure. The instrument to bring conservatism into the picture is not risk measurement – it is the risk appetite framework, whereby the institution must determine the degree of conservatism."

Commerzbank

- Criticises the lack of transparency from the ECB's side: "We believe that a normative and an economic perspective in the context of risk bearing capacity concepts is fundamentally meaningful. The concept can't be entirely implemented though due to the practice of the ECB. In order to put all capital components consistently in perspective to the single risks and valuation types, banks would need transparency on the exact amounts and constituents of P2R for all risks."

Deutsche Bank

- Criticises the lack of transparency from the ECB's side: "While we generally agree that the normative and the economic internal perspective should mutually inform each other, this would only be possible in practice if regulators provide more transparency on their pillar 2 requirement setting, e.g. a risk-by-risk decomposition. The paragraph should therefore be amended such that banks are only expected to implement such a mutual information process to the extent possible given the information provided by regulators";
- Criticises the level of conservativism requested: "We disagree with the view that the economic internal perspective should be expected to be highly conservative/the overall level of conservatism to be at least on par with the pillar 1 internal models. The economic internal perspective is supposed to give an economic and accurate view on the bank's risk";
- Reiterates throughout the text the fact that some of the requests cannot be performed due to a lack of transparency in the communication of the Pillar 2 requirements (P2R).

DekaBank

- Highlights the limits to the consistency and harmonisation agenda due to internal procedural differences amongst institutions: "Management concepts differ significantly between institutions. Each institute applies its institution-specific ways to comply with the agreed risk boundaries set out in the risk appetite statement. Each (risk-taking) division has to comply with its respective stipulations. Whether those stipulations/targets refer to financial and other outcomes should be a free choice of each institute."

EBF

- Criticises the vague references to the implementation of the principle of proportionality and requests more specific guidance on the ECB's expectations;
- Stresses the possibility of these guidelines to be applied for LSIs: "Although the guide is principally aimed at SI banks, as stated under "scope and proportionality", the probability that national supervisors apply this guide to LSIs is high. In this sense, we recommend specifying that in this case, a level playing field must be ensured across the EU";
- Stresses the need to clarify the "economic" and "normative" perspectives as they are cornerstones in the new Guide;
- Expresses concern about the level of detail: "These guidelines are supposed to be only principles. Why to mention shadow banking and EBA guidelines? It is too much detailed for principles";
- Highlight the overlap with the regulatory authority: "These guidelines should not supersede the European regulation. The definition of the internal capital from an economic point of view should be entity specific. The normative perspective already provides a definition of the regulatory own funds, no additional regulation should describe what economic capital is";
- Criticises the conservativism question and stresses banks' autonomy: "The supervisory approach should be to measure risks correct. It should be on the discretion of the institutions to determine the level of conservatism by means of the RA." [risk appetite]

EAPB

- Criticises the lack of transparency from the ECB: "It is still unclear how the P2R and P2G are determined by the ECB. Thus it is difficult for the banks to perform appropriate projection for the P2R & P2G for the remaining part of the 5 year horizon. The ECB should provide more details on this to allow banks to better forecast".

EACB

- Stresses the need for more clarity on proportionality criteria: "We believe it is necessary to elaborate further on the criteria used by the ECB to determine the proportionality of the ICAAP to allow institutions to have a comprehensive outlook on whether/how their internal processes would meet supervisory expectations."

The responses submitted by the stakeholders during the consultation and the content of the ICAAP Guide itself deserve close scrutiny. One emergent issue is that of "uncertainty": the set of requirements that institutions need to comply with as part of their internal ICAAP, suggests that supervisors aim to reduce as much uncertainties as possible. Apart from the specific elements that have to be included in the assessment, banks are "expected to implement a proportionate ICAAP that is *prudent and conservative*" (ECB 2018e, 12, emphasis added). These short excerpt from the 2018 ICAAP Guide summarise the ECB's stance on the point:

> In the SREP, it is acknowledged that a good ICAAP reduces an institution's and its supervisors' uncertainty concerning the risks that the institution is or may be exposed to, and gives supervisors an increased level of confidence in the institution's ability to continue operating" (ECB 2018e, 2).

Supervisory expectations are also clearly defined: "*uncertainties* arising from *risk quantification* methodologies are expected to be addressed by an increased level of *conservatism*." (ECB 2018e, 32, emphasis added). The word "conservativism"[257] matters here, as it is not a mere qualifier but rather has a specific meaning in terms of investing and accounting.[258] What these quotes suggest, is that the supervisor expects a prudent treatment and management of uncertainties, given that by definition uncertainties cannot be measured and, hence, reduced.

[257] The issue of the ECB suggesting a more conservative approach was also a point of discussion in the EBA Guidelines on ICAAP and ILAAP requirements consultation, where some stakeholders pointed out potential differences between the EBA regulatory product and the expectations communicated earlier that year – 2016 – by the ECB in a "Dear CEO" letter, which was referred to in the previous section.

[258] It is possible to distinguish, on the one hand, *investing* conservativism, which makes reference to investment strategies that prioritise the preservation of capital instead of market returns (see Investopedia for a detailed explanation: https://www.investopedia.com/terms/c/conservativeinvesting.asp - last accessed August 23, 2019). On the other, *accounting* conservativism comprises a "set of bookkeeping guidelines that call for a high degree of verification before a company can make a legal claim to any profit." This means that uncertain liabilities are recognised as soon as possible, whereas revenues or profits are only recorded when effectively materialised (see the Investopedia description for more information: https://www.investopedia.com/terms/a/accounting-conservatism.asp - last accessed August 23, 2019).

The question of uncertainty is also related to the risk-regulation literature introduced in Chapter 2. Although this dissertation does not rely on risk-regulation as its main analytical framework, it nevertheless acknowledges that this literature, which deals with a vast set of policy domains, provides key insights for interpretation. Interestingly, the ECB expects that banks take into consideration two complementary perspectives when developing a sound ICAAP, namely the *economic* and the *normative* ones. According to the risk regulation literature, the normative element is there to manage the emergence of social rules and the generation of innovation that, in turn, creates uncertainty: "Uncertainty, in this view, is not a lack of knowledge which can be remedied, but is instead the inescapable consequence of the process of the self-creation of society beyond tradition, which has to be accepted as a precondition of societal operations." (Ladeur 2015, 56). In general terms, uncertainty refers to those events which cannot be predicted or measured, while risks can be quantified and probabilities can be assigned to them. However, the text of the ECB Guide seems to suggest that the uncertainties arising from risk/quantification should be reduced to a minimum. The question is the extent to which uncertainty can be managed in this context and whether its suppression might compromise innovation.

Another link between the risk regulation literature and the analysis of governance evolution is related to the *objectives* of risk regulation. In fact, *prevention* and *suppression* have been identified as the main overarching goals. However, these general aims are not enough, since legal interventions should identify more specific goals under these umbrella terms, in order to accomplish a better balancing exercise between risks and societal interests (Micklitz and Tridimas 2015): "A correlation may be drawn between the mode of risk regulation (self-regulation, shared regulation, and mandatory regulation) and the types of risk

posed or the sector where they arise" (Micklitz and Tridimas 2015, 2). In fact, the Guide's attempt to offset uncertainties arising from risks calculations through a more conservative approach, is directly related to the type of risks that should be mitigated, and the ultimate goal that supervision aims to achieve: the health of the banking system. These objectives, however, need to be balanced against other economic freedoms.

In any event, it should be recalled that regulating risk constitutes a political exercise, not merely a technical one. One of the mechanisms identified in the 'recursivity of law' framework (Carruthers and Halliday 2007), the *diagnostic struggles*, mirrors the knowledge-related conflicts and the ways in which problems have been framed, classified, and understood throughout public consultations. As much as the tasks of the supervisor are informed by technical analyses and their priorities are based upon carefully designed horizontal assessments that aim to capture the overall picture, the room for administrative discretion and prudential judgement suggest that the activity can be hardly fully objective.

4.2.3 Some considerations on the ECB ICAAP Guide and its feedback statement

The ECB ICAAP Guide is structured upon seven principles which, according to the initial explanation provided by the document, were developed together with the NCAs in order to "ensure high standards of supervision by fostering the development of common methodologies in this important supervisory area". Since Art. 73 of CRD IV (not amended by Directive 2019/878) is a minimum harmonisation provision, its transposition into member States' legislation has differed, and thus its application and use by supervisory authorities. In light of

both the normative and practice diversity, it should be of no surprise that the ECB has been dealing with a highly diversified tool.

The ECB provided a detailed feedback statement upon the submissions received from the stakeholders, in which it addressed in a detailed fashion several comments and criticisms (ECB 2018g).[259] The table below facilitates the visualisation of the issues raised and the supervisor's responses. In spite of the highly detailed and technical discussions, examining the ECB's reaction is important in order to support the analysis of the subsequent section, and have a clearer view on the interaction between the supervisor and the supervisees in the current scenario.[260]

On the request to remove the term "conservative"	"The ECB accepts that an institution may consider a range of different levels of conservatism to produce a range of risk quantifications in order to comprehensively inform strategic decisions, pricing and capital management" (p. 8). But in relation to the use of the term "conservatism" regarding capital supply, the ECB expressed: "No change has been made. While the ECB agrees that institutions may apply different levels of conservatism in the determination of internal capital, the range of these levels of conservatism is expected to be from high to extremely high." (pp. 116/7).
On SREP-ICAAP Relationship	"The role of the ICAAP in the SREP is a separate topic and is described in other communications like the SREP booklet. Please note that the ECB has already indicated several times that the role of the ICAAP and the ILAAP in the SREP will become more important and the ECB is working internally on this topic." (p. 10)
On the proportionality principle	"No change has been made because the ECB is of the opinion that institutions are so different in many respects that a general concept of what proportionality means in detail is not meaningful. Institutions are responsible for implementing ICAAPs and ILAAPs that are adequate for their individual situations." (p. 10)
On risk appetite statements	"The wording has not been changed. The risk appetite statement is expected to contain motivations for taking on or avoiding certain types of risks, products or regions. A more detailed description may follow in the documents on specific risk types." (p. 36).

[259] Let us remember that this was the consultation held via conference call.
[260] Page numbers belong to the document containing the ECB's responses (2018g).

On the distinction between quantitative and qualitative framework	"The text has not been changed. It is stated that the quantitative and qualitative aspects of the ICAAP (which together form the ICAAP) are expected to be consistent with each other. This implies that they should not be dealt with independently" (p. 44)
On the clarification of unlikely future events but with high impact on capital adequacy	"No change has been made, as the wording is illustrative, intentionally leaving responsibility for deciding how to treat regulatory changes in specific cases with the institution. Limiting institutions' considerations to changes that are certain or highly likely could leave institutions with less time to prepare for the regulatory changes." (p. 49)
On ICAAP's proportionality criteria	"No change has been made, as it is not possible and not our intention to further differentiate our expectations between different types of institutions, because a) institutions are too heterogeneous to be categorised in a meaningful way for ICAAP/ILAAP purposes, and b) we have intentionally given the responsibility for implementing adequate ICAAPs/ILAAPs to individual institutions". (p. 83/4)
On P2R, P2G and transparency of the assessment	"The ECB is working on the enhancement of the risk-by-risk determination of P2R. At present, institutions should not expect to receive information on P2R amounts by risk type". (p. 97)
On the Guide's level of detail	"The Guide follows a *principles-based approach* with a focus on selected key aspects from a supervisory perspective. *It is not meant to provide complete guidance on all aspects* relevant for sound ICAAPs. However, institutions and supervisors *are reminded* of important aspects to consider, including aspects that are sometimes overlooked (e.g. shadow banking-related risk, outsourcing risk), but this does not amount to a deviation from the principles-based approach and leaves the *full responsibility for the ICAAP and ILAAP with each individual institution*. The Guide is, for instance, not prescriptive with regard to the risk taxonomy . . . The implementation of an ICAAP that is adequate for an institution's particular circumstances remains the responsibility of the institution. The ECB assesses institutions' ICAAPs on a case-by-case basis." (p. 110/11/14, emphasis added).
On the need to reconcile own funds under the normative perspective and internal capital under the economic perspective	"No change has been made because the ECB is of the opinion that internal capital definitions can vary significantly between institutions and it is therefore not possible to capture all the different settings in a common guidance on how to perform a reconciliation between regulatory own funds an internal capital. A convergence of the levels of capital under the two perspectives is not the objective of the Guide. Rather, there can be fundamental differences between them, driven by the very different concepts and assumptions underlying the perspectives" (p. 134).
On expected risk quantification	"No change has been made *because the ECB does not see how it could be more specific* at this stage. It is the responsibility of institutions to deal with all such risks in an adequate manner" (p. 145, emphasis added).

What emerges from the responses is a tension between, on the one hand, an increasing interference in the way banks have to comply with the ICAAP requirements and, on the other, the fact that each institution is granted the necessary autonomy in order to deal with its internal

needs. Given the level of details required, the specificities of the expectations, and the manifold examples used to illustrate some of the principles, stakeholders tend to ask for more guidance or clarification whenever some questions remain open or not clear enough. In providing a reply to these requests, the supervisor explains that the assessment of the ICAAP is done on an individual basis, due to the inherent institutional diversity and therefore, it is not possible to provide "complete guidance on all aspects relevant for sound ICAAPs" (ECB 2018g, 110/111).

The tension relates to the fact that it is no longer clear to the supervised credit institutions which is the desired level of scrutiny. Hence, the ECB's principles are called to strike a fragile balance between, on the one hand, the need to strengthen supervisory consistency and the level of comparability of the different ICAAPs and, on the other, the acknowledgement that this tool responds to different regulatory and supervisory realities, and that it constitutes an internal assessment that reflects the specificities of each institution. One final element that nurtures the tension between the actors, concerns the response provided by the ECB in connection to the lack of transparency in the determination of Pillar 2 requirements: the supervisor was clear in the sense that its approach would not be altered in the short to medium term. It should be recalled, however, that enhancing SREP transparency is one of the policy aims in which the SSM is working on.

The next section analyses and "translates" the content described so far with a view to tracing the changes of governance along three dimensions. The governance indicators presented in Chapter 2 are further developed and illustrated.

4.3 Governance indicators in action: Analysing changes in governance dimensions

The previous section examined the reactions and position papers of specific stakeholders over time, in response to the SREP and ICAAP/ILAAP-related consultations. In spite of the technicalities and specific issues concerning capital requirements, the aim of the analysis is to trace the evolution in the modes of governance, that in turn helps better understand the ways in which integration unfolds. In order to track governance evolution, this section relies on indicators that have been developed taking into consideration theoretical and empirical literature on new modes of governance and their dimensions of change.

4.3.1 Developing integrative governance indicators

> Modes of governance are understood as closely interrelated to the systemic evolution of the institutional architecture of the EU and the specific features of its institutional and procedural functioning. We assume that new modes of governance are interrelated with the legal and living architecture of the EU, by adding new dynamics and dimensions to the integration process. (Diedrichs, Reiners and Wessels 2011, 21).

In order to analyse the SREP and ICAAP evolution over time, this subsection proposes a series of indicators based on the governance literature examined in Chapter 2. The analysis combines the dimensions of change that account for governance and decision-making evolution in the EU (Diedrichs, Reiners and Wessels, 2011), with insights derived from experimentalist theory (Sabel and Zeitlin 2008, 2010; Rangoni 2019), and a more granular conceptualisation of policy instruments based on Schelkle (2007) and Abbott et al. (2000). The three dimensions of governance change and their operationalisation, which were anticipated in Chapter 2 (Table

2.4), are used to empirically trace and compare the evolution of banking supervision governance.[261]

1. The sphere of authority between the public and the private

This first dimension is central to the supervisor-supervisee relationship, and it can be seen at two different levels. First, the public-private relationship is present at the decision-making or regulatory level, during the public consultation processes and the interaction between the parties (comments received and the feedback provided). Second, this dimension unfolds during the exercise of banking supervision: in fact, the previous sections have shown that the supervisory dialogue and a fluid communication were crucial elements in the exercise of supervision. Transparency[262] and the feedback received from the authority are also important features of this dialectic process. There are potentially different ways of operationalising this dimension; however, in light of the policy area under analysis and the literature referred to above, the focus is placed on the following indicators:

a) Level of stakeholders' involvement in the consultation process;
b) Level of consideration of industry's views expressed in public consultations;
c) Level of communication between authorities and the industry during the supervisory activities.

[261] When describing the three dimensions and their operationalisation, the text indistinctly refers to the "industry", "non-governmental stakeholders" or simply "stakeholders" to make reference to the positions hold by credit institutions and their representative associations at the national and EU levels, in accordance with the actors analysed in the previous section.
[262] The previous section has also pointed out the lack of transparency raised by different stakeholders in relation to the SSM's use of peer groups or other benchmarking tools, and the need to increase transparency in relation to the SREP assessment and its holistic treatment. Even if transparency is in fact one of the elements that accounts for a good dialogue between the parties, the question is much more delicate and complex in the banking supervision realm. In fact, supervisors gather confidential data and perform their own analysis in the course of their activities; hence, full transparency towards the institution might compromise the activities carried out by the authority too. In distressed times, full transparency towards market players might be counter-productive in case one or more financial institutions are in economic trouble, as it might end up reinforcing a self-fulfilling prophecy and therefore contributing to the destabilisation of the system.

2. Institutional forms and patterns of decision-making

The second dimension aims to capture the variation between centralisation and decentralisation in the governance of banking supervision, by focusing on existing institutional arrangements and decision-making patterns deployed in the interface between supervision and regulation. The supranationalisation of banking supervision is expected to exert a centripetal force not only in supervisory matters, but also in additional governance-related domains. In light of the policy domain under analysis and the theoretical and empirical considerations, the following indicators are examined:

a) Level of national involvement and local interest representation during the decision-making process (from national to supranational control over it).
b) Level of local discretion granted to NCAs in the supervisory process.
c) Level of coordination between the regulatory authority (EBA) and supervisors when conducting regulatory activities (from coordination to overlap).

There is an important aspect of the analysis that falls in between the first and the second indicator: public consultations. In fact, the evolution and the transformations that public consultations went through entail aspects directly related to the quality and the nature of the relationship between the authority and the industry, and other aspects that concern decision-making patterns. This is also related to the way in which the SSM communicates its expectations to the industry and the quality of this interaction.[263]

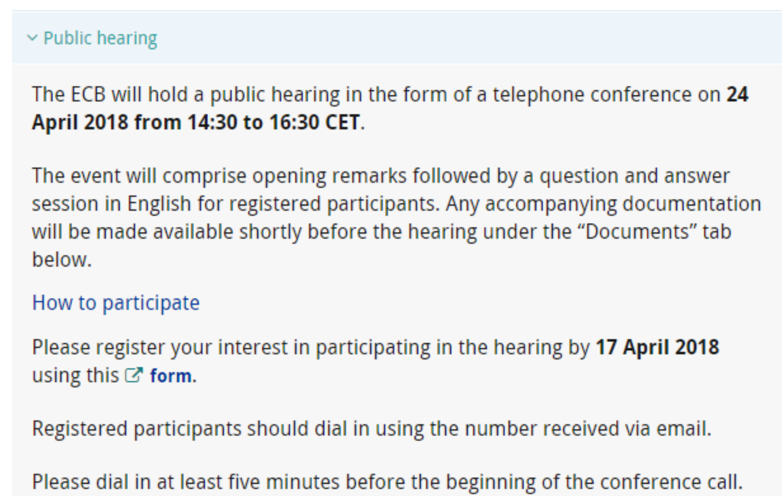
An example of the different communication channels used by the SSM has been the case of ICAAP and ILAAP letters in January 2016 and February 2017, mentioned in the previous section, in which the Supervisory Board Chair provided for a detailed list of supervisory

[263] These considerations are not unique to the SREP or ICAAP cases; for instance, Chapter 5 refers to similar dynamics of the communication of expectations in the context of the NPL saga.

expectations. In the meantime, the EBA launched a public consultation for the "Guidelines on ICAAP and ILAAP information collected for SREP purposes", which lasted from December 2015 to March 2016, and the Guidelines were finally published in November 2016. The letter and the Guidelines are not necessarily overlapping tools, given that the former falls within the competence and discretion of the supervisory authority for communicating specific expectations to the industry, while the latter aims to strengthen the consistency of the assessment of the institutions' internal tools over the EU. In any event, the time-gap between the supervisor and the regulatory action is apparent, which reflects the more consensual and hence lengthy nature of the consultation processes carried out by the EBA, in contrast to those held by the ECB, as also shown in relation to the NPL case in Chapter 5.

Regarding the "innovative" aspects of public consultations, the public hearing of the ECB's ICAAP and ILAAP Guides in 2018 was hosted via phone conference. As suggested by the advertising of the public hearing, the event has been conceived as a Q&A session, and participants have not been able to access the consultation material in advance, since relevant documentation was made available only shortly before the start of the call. In fact, as mentioned by one interviewee that actively participates in public consultations hosted by both the SSM and the EBA, the quality of the interaction between the SSM and the stakeholders has been changing, and not necessarily for good. In fact, the participant described that the SSM went from organising public hearings in "press conferencing settings",[264] to alternative remote ways of interaction with interested parties, as the 2018 ICAAP/ILAAP Guide case suggests. The website of the ECB contains the following information:

[264] This aspect of the public consultation quality is further analysed in Chapter 5 when exploring the NPL case.


Public hearing

The ECB will hold a public hearing in the form of a telephone conference on **24 April 2018 from 14:30 to 16:30 CET**.

The event will comprise opening remarks followed by a question and answer session in English for registered participants. Any accompanying documentation will be made available shortly before the hearing under the "Documents" tab below.

How to participate

Please register your interest in participating in the hearing by **17 April 2018** using this **form**.

Registered participants should dial in using the number received via email.

Please dial in at least five minutes before the beginning of the conference call.

Figure 4.3: SSM's website describing the elements of the public consultation on ICAAP and ILAAP Guide. Source: ECB Banking Supervision website.

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3. Different types of policy instruments in the space between hard and soft law

This third dimension of change is fundamental to understand supervisory governance evolution, but it is also elusive. It has been mentioned that the tasks deployed by the SSM while exercising its supervisory powers fall in a grey area between regulation and supervision, which are difficult to disentangle. The need to provide the industry with concrete supervisory expectations and detailed requirements, triggers policy-makers' need to develop interpretative tools where it is difficult to see draw the line between market transparency and rule-making.

In order to assess the characteristics and the changes in the regulatory tools, this third part draws upon a "framework that distinguishes hard law from soft law along a continuum in three dimensions of governance: obligation, delegation, and precision" (Schelkle 2007,

705).[265] This framework, in turn, is based on the work developed by Abbott et al. (2000), in which the authors propose these three dimensions to characterise *degrees of legalisation*, which are interpreted in a broad sense, as the shift from soft to hard law in international agreements. The idea behind the use of this triple characterisation is not to confine the indicator to the hard vs. soft law dichotomy, which might not be useful in the case of banking supervision. Instead, the use of these indicators focuses on the *effectiveness* of these regulatory and quasi-regulatory tools, and provides a more nuanced way of understanding legalisation, or the hardening of a governance framework, by going beyond the question of having more or less strict obligations (Schelkle 2007). The analysis of the pre- and post-SSM scenarios along these three elements caters for a subtler characterisation of the instruments available for banking supervision, where greater effectiveness might not be directly related to a higher level of 'obligation'. In fact, allegedly softer tools that show no traces of the obligation element, can harden via the other two indicators related to precision and delegation, as shown below.

Obligation means that States and other non-State actors are "*legally* bound by a rule or commitment in the sense that their behaviour thereunder is subject to scrutiny under the general rules, procedures, and discourse of international law, and often of domestic law as well" (Abbott et al. 2000, 401, emphasis in the original). *Precision* is characterised by rules that specify "clearly and unambiguously what is expected of a state or other actor (in terms of both the intended objective and the means of achieving it)", by narrowing the scope for reasonable interpretation (Abbott et al. 2000, 412). The bracketed proviso is not a minor reference, as the distinction between objective and means proves useful in the characterisation of the SSM tools,

[265] Schelkle (2007) applies this framework to assess the fiscal governance and the changes brought about by the revision of the SGP. Albeit these three elements are called "dimensions" in her paper, for the purposes of this chapter these are used as indicators, or ways of operationalising the third governance dimension.

as seen below. *Delegation* is defined by the "extent to which states and other actors delegate authority to designated third parties . . . to implement agreements" (Abbott et al. 2000, 415). The authors first focus on dispute resolution powers granted to specific authorities, and then move to the rule-making and implementation domain, in which different institutions intervene in the elaboration, implementation, and enforcement of norms. In fact, there is a relevant distinction between *administrative* or *operational* delegation, from *adjudicative* delegation, which provides wider powers related to the possibility to assess levels of compliance (Schelkle 2007).

In order to trace and compare the evolution of this governance dimension, the study develops empirically-driven measurements for the three indicators drawn from the literature. Since obligation, precision, and delegation have a specific connotation in the context of banking supervision and its regulatory tools, the research advances specific ways to calibrate them:

a) Obligation (need to abide by rules due to behaviour constraints/consequences)
- Level of use of non-binding language in the documents;
- Level of certainty about the legal and supervisory consequences triggered by the SREP process and horizontal assessments.

b) Precision (clear expectations of intended objectives and means to achieve them)
- Level of detail and accuracy of the supervisory expectations;
- Level of certainty about the means that banks should use to avoid supervisory and legal consequences;
- Level of transparency and communication of P2R and SREP holistic assessment.

c) Delegation (operational/administrative and adjudicative)
- Level of exercise of regulatory powers;
- Level of use of peer reviews and benchmarking tools in conducting supervision;
- Level of national powers exercised by the SSM.

4.3.2 Empirical assessment

The three governance dimensions described so far are examined through qualitative indicators; therefore, this section does not deal with measurement. The rubric in Table 4.1 below provides the scoring guide against which the governance dimensions are assessed.[266] For each of them, three levels have been ranked: high, medium, and low, which have specific connotations in relation to each of the dimensions and their respective indicators.

[266] The high-medium-low criterion in order to assess these governance dimensions was inspired by Schelkle (2007). It is important to mention that these are universal criteria and provide only a broad-brush overview. The aim of the present analysis is to capture the trends and dimensions that are evolving in the governance of banking supervision, without pretence of quantitatively measuring these aspects.

Dimension	Level	Description
Public-private sphere	**High**	Stakeholders are involved throughout the consultation process and their views are taken into account; real discussion and engagement in public consultations. Communication between supervisors and supervisees is characterised by a constant dialogue and it is possible to challenge supervisors' assessments on the basis of a healthy dialectic process.
	Medium	Stakeholders are still involved in the consultation process but the quality of the discussion is partly compromised for different reasons. Considerations put forward by the industry are considered but in a more elusive way. The level of communication between the parties is not bad but is affected by less informative feedback from the supervisor; the industry sees the need to strengthen transparency in order to understand supervisors' assessments.
	Low	Public consultations are not necessarily held in person; the process is limited to Q&A, without a real dialogue among the parties. Stakeholders' positions are formally but not substantially taken into account. Supervisory dialogue is limited to exchanges in which no feedback is provided and supervisees cannot challenge measures imposed, given a lack of information and transparency.
Decision-making & institutional forms	**High**	National interests and involvement throughout the decision-making process. NCAs are granted full discretion in the conduct of LSIs supervision. The tasks between supervisors and regulators are effectively coordinated.
	Medium	National interest are partially affected by supranationalistation of supervision. NCAs work closely with DG MS III in the development and application of high-quality standards. Tasks between supervisors and regulators overlap in certain situations, especially when there is a time gap between the needs of the former in relation to the tasks of the latter.
	Low	Complete supranational control in the decision-making process. NCAs are still responsible for the oversight of the local LSIs, but the scope for adaptation and interpretation of tools is minimised. The number of topics in which supervisory tasks overlap with regulatory concerns is frequent; supervisor often engages in quasi-regulatory activities.
Nature of the instruments	**High**	Obligation: use of binding tools; substantial certainty about legal consequences triggered by supervisory process. Precision: supervisory expectations define clear goals and clear means to achieve them. Substantial transparency about SREP methods and results. Delegation: full-blown use of supervisory and regulatory powers. Administrative and adjudicative powers are exercised also upon LSIs (including national powers)
	Medium	Obligation: hard law instruments coexist with supervisory expectations communicated in different ways. "Horizontal products" are part of the ecosystem of supervisory tools. Precision: industry claims more transparency in the assessment and more feedback within the supervisory dialogue framework. Delegation: supervisory and regulatory powers are used, but the level of contestation is high.
	Low	Obligation: the tools developed by the supervisor are principled-based, and more is communicated through supervisory expectations. Precision: unclear consequences of breaching supervisory expectations, and hence the impact of potential breach in the SREP process. Objectives may be clear but the means are not. Delegation: operational and adjudicative powers use a softer approach. Limited use of national powers.

Table 4.1: Scoring guide to assess the evolution of the governance dimensions. Source: Own elaboration.

Governance dimension	**Indicators**	**2006 CEBS SREP GL**	**2014 EBA SREP GL**	**2016 EBA ICAAP ILAAP GL**	**2018 EBA SREP GL**	**2018 ICAAP ILAAP ECB Guide**
Sphere of authority between private-public	• Level of stakeholders' involvement in the consultation process • Level of consideration of the industry's view expressed in the public consultations • Level of communication between authority-stakeholders along supervisory activities	High level of stakeholders' involvement and consideration of their views. In the pre-SSM era, the role of CEBS was limited to fostering convergence but implementation was in the hands of NCAs. Supervisory dialogue was a key element of the relationship.	High level of involvement of stakeholders in light of the setting up of the SSM. Consideration levels cannot be assessed because there is no feedback document. Risk that the emphasis on benchmarks and quantitative tools would hamper the dialogue, which was not fully considered.	High level of involvement. Medium to low level of consideration of the comments. Medium to low level of communication between the parties: partially compromised by the lack of feedback when formulating supervisors' observations.	High level of involvement. Medium level of consideration; in most cases EBA did not take comments into account, as they concern supervisory practices, i.e. SSM. Medium to low communication: stakeholders show the need for transparency and clarity in the use of peer assessment.	High level of involvement. Medium to low level of consideration of industry's responses. Low level of communication and transparency, in light of the several requests for a clearer feedback and transparency in the determination of additional capital requirements.
Decision-making and institutional forms	• Level of national involvement/local interests representation during decision-making process (from national to supranational control) • Level of local discretion granted to NCAs in the supervisory process. • Level of coordination with EBA and their regulatory activities (from coord/overlap).	High level of national interest-representation in the decision-making process. High level of national discretion in the application process. No need to coordinate supervisory activities with other regulatory bodies; some NCAs had regulatory powers that were exercised within their	Local interests representation compromised by powers delegated to the SSM. Low level of national discretion in relation to SIs. High discretion in relation to LSIs. The level of EBA SSM coordination is still high, but the ECB started to prepare the first framework	National interest control of the process remains at a mid-level. Fear of losing local discretion in LSI supervision. Low level of coordination in relation to the ECB's 2016 and 2017 letter, issue that was not address in the feedback statement.	Since 2018, the SREP methodology was adapted and applied to LSI. Local discretion has not disappeared, but margins of discretion have been reduced, given standardised methodology to be followed. Medium to low level of coordination. Methodological issues regarding P2R determination.	Low level of national control, decision-making process controlled by the SSM, since there are no in person public hearing; only a conference call was held. Local discretion: the ECB made clear these Guides are

		supervisory competences.	instruments to operate.			relevant to SIs.[267] It is likely that NCAs have to comply with similar standards for LSIs.
Nature of the instruments (space of hard and soft law) .	• Obligation/O: - use of non-binding language - legal & supervisory consequences triggered by SREP • Precision/P: - Accuracy of supervisory expectations & means - SREP transparency • Delegation/D: operational & adjudicative - Exercise of reg. powers - Exercise of nat. powers	O: Low to medium: Guidelines gather collective views of EU supervisors on the standards that the industry is expected to observe and the supervisory practices that supervisory authorities will apply P: High in terms of aims, but low for means. D: Low (operational and adjudicative).	O: high: "competent authorities and financial institutions must make every effort to comply with the guidelines" (p. 15): *comply or explain* principle. P: medium (means) to high (aims)[268] D: medium (operational) to low (adjudicative)	O: high: comply or explain principle. P: medium: In spite of providing a detailed list of document requirements, it was not clear the extent to which they were all biding; EBA was accused of "gold plating its own SREP GL, suggesting a misalignment of requirements. D: medium (operational) to low (adjudicative).	O: Comply or explain but: P: the consequences of breaching capital requirement obligations were clear (e.g. P2G). High for means, medium in terms of objectives. D: medium (operational) to low (adjudicative).	O: Low: the purpose is to provide transparency to the public of the ECB's understanding of the requirements.[269] P: High (objectives) low (means & SREP transparency); ECB sets normative and economic perspective.[270] D: High (both operational and adjudicative).

[267] "The ICAAP and ILAAP Guides do not establish any regulatory requirements but rather convey the ECB's understanding of ICAAP and ILAAP requirements stemming from Articles 73 and 86 of the CRD IV. The ILAAP and ICAAP Guides are relevant for significant credit institutions which are directly supervised by the ECB" (ECB 2018e, 11).

[268] These considerations are expressed in both the 2014 and 2018 EBA SREP Guidelines: "The aim of the guidelines is to harmonise the SREP framework, which currently varies significantly at the national level, as far as possible, but *not to impose restrictive granular SREP procedures and methodologies* . . . In any case, these guidelines, as any other EBA guidelines, should be seen as *guiding and not as restricting or limiting supervisory judgment* as long as it is in line with applicable legislation. Competent authorities should, however, *apply these guidelines in a way that will not compromise the intended harmonisation and convergence* thereof, particularly ensuring that higher supervisory standards are implemented across the EU." (EBA 2014, 2018, 10, emphasis added) .

[269] The Guide's language is quite soft in this regard: "The Guide is aimed at assisting institutions in strengthening their ICAAPs and at encouraging the use of best Practices"; "The Guide deduces from the CRD IV ICAAP provisions seven principles that will be considered"; "The Guide does not substitute or supersede any applicable law implementing Article 73 CRD IV. Insofar as the Guide is not in line with applicable law, the applicable law prevails. The Guide is intended to be a practical tool that is updated regularly to reflect new developments and experience." (ECB 2018e, 3).

[270] However, there is an element stemming from the supervisory cycle and its regular update that cast doubts on the level of precision of supervisory objectives, given that "the principles and expectations laid out in this Guide will evolve over time. It will be reviewed in the light of the ongoing development of European banking supervision practice and methodologies." (ECB 2018e, 3).

Table 4.2: Changes in governance dimensions through the SREP and ICAAP/ILAAP regulatory evolution. Source: Own elaboration.

Table 4.2 presents a mixed picture in relation to the three governance dimensions, which is to be expected in light of the complexities arising from the amount of participants from both private and public spheres, and the periods of time analysed. Concerning the first dimension, the public-private sphere of authority, the industry has consistently expressed the need for more transparency in relation to the holistic approach to SREP and the way in which Pillar 2 requirements are determined, which would be beneficial to them in order to understand in greater detail the areas or risk assessments that need to be improved. More transparency and clarity was required in terms of the "horizontal analysis" that are carried out by, chiefly, DG MS IV. As Section 4.4 below shows, these horizontal assessments are not just performed in order to gather data but are, instead, the basis of supervisory priorities that in turn can trigger the development of additional supervisory tools and SSM policies. Therefore, in light of the consequences that this sequence of events has on specific institutions, there is a demand for better dialogue and transparency in the way assessments are carried out.

Regarding this first governance dimension, it is interesting to note that in some cases, while industry participants used to complain about the highly detailed guidelines and their prescriptive tone, in the 2018 ECB's consultation the industry was actually asking for more precision, more guidance, and further details related to particular ICAAP expectations. This shift in the demands voiced by the industry might suggest a change in the supervisor-supervisee relationship and banks' decisional autonomy, most importantly when considering that ICAAP

is an internal exercise, whose responsibility lies in credit institutions.[271] The question, however, goes beyond communication and mutual understanding of the parties. Since under Pillar 2 (or "Pillar 1 plus" according to the German interpretation) there will be additional requirements by default, institutions demand more supervisory expectations in order to better calibrate their internal parameters that will determine the additional capital requirements.[272]

The analysis of stakeholders' statements and submissions over time, and the multi-dimensional evaluation of governance changes, can additionally be interpreted as follows. First, the variation of strategies deployed by banks responds to a complex institutional and regulatory context that has been reinforced in the aftermath of the financial and eurozone crises. The active reinterpretation of Pillar 2 by both regulators and supervisors and the respective adjustments to the SREP framework, have had influenced on this strategic shift from the industry. Echoing the premonitory words taken from a 2004 submission by the EBF, it can be said that Pillar 2 has been evolving from a *challenge-oriented process* to a *compliance exercise*. This change in the nature of the tool has prompted a transformation in stakeholders' strategies, which went from complaining about the far reaching supervisory powers to demanding greater specificity about SSM's expectations and guidance.

As far as the supranational supervisor is concerned, there is one potentially contradictory aspect worth emphasising, as it also sheds light on the changes in governance analysed in this chapter. On the one hand, it has been pointed out that *precision* and *delegation* have contributed

[271] Back then, the CEBS (2006b, 2) explained in the first SREP Guideline that "the ICAAP belongs to the institution and supervisors should not dictate how it is applied. The task of the supervisory authority is to review and evaluate the ICAAP and the soundness of the internal governance processes within which it is used." This statement clearly differs from the current approach, in which the tool is still in the industry's hands but the supervisor provides a detailed picture of how this should be done.
[272] This complementary point has been raised by the Bundesbank official interviewed in the course of 2018 who has also commented on this chapter.

to the hardening of some of the policy tools developed by the SSM. As this chapter shows and the next one illustrates, these tools do not fall short of details and quantitative indicators to make supervisory expectations explicit. On the other hand, the extensive response provided by the ECB in the ICAAP public consultation analysed above, reveals a different attitude, since various passages stress the need to leave the decision-making responsibility up to each bank.[273] It has to be recalled that the ICAAP is a tailored-made instrument that reflects the situation of individual credit institution. However, it is telling that the ECB expressed that it "does not see how it could be more specific", in a clear attempt to offset banks' requests for further expectations. This situation pictures the challenge represented by the achievement of supervisory consistency within a diversified banking sector and, most importantly, stakeholders' awareness of the legal consequences triggered by ECB Banking Supervision policy instruments.

Concerning the institutional forms and patterns of decision-making (the second dimension), one clear trend is the lower level of local discretion in conducting banking supervision, which is to be expected in the case of SIs, but less in the case of LSIs, given that national authorities are still responsible for the oversight of the latter. In any event, the industry is well-aware of the fact that NCAs need to increasingly adapt and align their assessments to those requirements originally set for SIs. The coordination between the activities carried out by the EBA and the SSM has been increasingly compromised in several instances. For instance, the EBA was "behind schedule" in certain situations—also shown in Chapter 5 in relation to NPL governance—being unable to meet the SSM's immediate needs. The reasons

[273] This explains why Table 4.2 above has differentiated between *objectives* and *means* within the "precision" element in the third dimension, when explaining the governance evolution in the case of the ECB ICAAP Guide.

for this time-mismatch can be explained by the fact that the EBA needs to coordinate its regulatory activities with a larger number of authorities and, hence, its public consultations tend to last longer. Furthermore, the EBA does not regulate for the SSM only. The SSM plays a significant role within the EBA's regulatory activities, as the SSM is the largest EU supervisor. However, the EBA is there to provide the necessary tools to other non-SSM authorities; hence, the EBA cannot act in the interest of a single supervisory authority. This time-mismatch also helps understand the SSM's increasing development of its own supervisory and quasi-regulatory tools. One final issue regarding the lack of coordination is exemplified by the fact that the EBA had to deal with criticisms arising during some public consultations which were not related to its tasks but, instead, concerned the activities carried out by the supervisor. For the third governance dimension—nature of the tools—focusing on precision and delegation, rather than simply obligation, provides a more accurate and complete picture beyond the hard vs. soft law dichotomy.[274] In the case of the EBA Guidelines on SREP and ICAAP, although these are not binding instruments, the obligatory component is high due to the "comply or explain principle", according to which NCAs and the industry must make every effort to comply with them, or otherwise state the reasons for non-compliance. The ECB Guide on ICAAP, on the contrary, employed imprecise notions regarding its degree of bindingness. However, when precision and delegation are incorporated into the analysis, it is apparent that the instrument is meant to have a stronger impact, no matter how vague the language is. In fact, the Guide specifies the content of the *economic and normative internal perspectives* in detail which, albeit not completely new for industry participants who have been

[274] A more detailed analysis of the instruments available for banking supervision and potential legitimacy concerns is provided in Chapter 5, section 5.4.1.

developing the tool for years, requires additional aspects to be considered.[275] With regards to delegation, since the ECB is the implementing authority, both the operational and adjudicative sides of it have been reinforced.

Looking at the overall picture, the main takeaways from the governance evolution analysis can be summarised as follows: supranationalisation of banking supervision has compromised the level of communication between authorities and credit institutions, in terms of both the feedback banks receive, on the one hand, and the transparency of SREP results and peer-group comparisons, on the other. Supranationalisation has also diminished local autonomy in relation to LSI supervision in some cases, as consistency comprises both SIs and LSIs, and has increased the overlap of activities between supervisors and regulators, as there is a need to provide additional rule-interpretation and transparency to the market. Finally, supranationalisation has led to a "hardening" of the nature of supervisory tools, not so much via obligation, but, rather, through precision and delegation, which evinces the different channels through which policy instruments can subtly acquire a hard or soft law characterisation. The importance of distinguishing between hard and soft law tools lies not on the label attached to it but, instead, on the production of legal effects capable of altering a bank's situation and triggering supervisors' liability.[276] This conclusion reflects the complex interdependencies between these three governance dimensions, and also highlights the

[275] By focusing on the distinction between normative and economic perspectives, the ECB Guides reinforce the Pillar 2 concept that deviates from its original conception, as pointed out above. In fact, the normative perspective requires a projection into the future that takes into account Pillar 1 and Pillar 2 measures. The need to strengthen banks' normative and economic perspectives as part of their ICAAP exercise, entails a reallocation of resources within credit institutions, which now need to devote more human and technical capital to these assessments, at the expenses of other areas dealing with ex-ante risk mitigation.

[276] This is not to suggest that the supranationalisation of supervisory competences has been the only or main factor that accounts for governance changes. The post-crisis regulatory and institutional overhauling at the international (chiefly through Basel and the FSB), and EU levels (ESAs creation, Banking Union, new regulations based on the international framework), have actively contributed to these wider governance transformations.

underlying dynamics of banking supervision in order to move from the assessment of its institutional design, to a deeper understanding of its actual deployment and operation.

After having examined the governance evolution of both SREP and ICAAP, the following section broadens the scope of analysis in order to provide a macro-level view on the tools and actors within the SSM that play an active role in strengthening supervisory consistency.

4.4 A macro-level analysis of the SSM's tools through the consistency framework

Chapter 2 has introduced the analytical lenses through which supervisory consistency can be studied, in terms of the development of common methodologies, which would in turn lead to more uniform supervisory practices that produce comparable outcomes. The previous sections have zoomed in on the SREP and ICAAP tools and how they have evolved in light of the need to have a more consistent approach to supervision. This section aims to provide an overview of different tools and link them with each of the "building blocks" of supervisory consistency: methodology, practices, and outcomes.[277] However, this analysis does not aim to cover all the areas and divisions that are part of the supervisory process, as this would be excessively lengthy and not central to the argument.

[277] The table draws on the tasks and processes description from the ECB Supervisory Manual 2018; therefore, page numbers refer to this document.

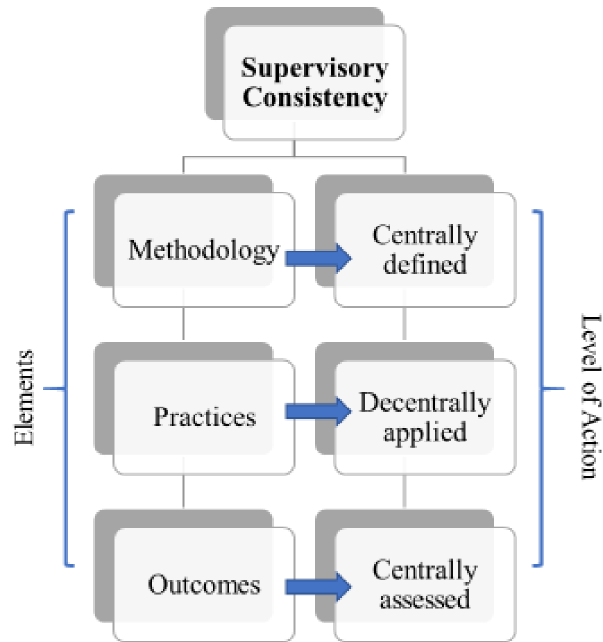

Figure 4.4: Supervisory consistency: elements and levels of action (presented in Chapter 2). Source: Own elaboration.

Consistency Element	Actors	Aims & facet of supervisory cycle	Supervisory tools
Methodology	**Horizontal and specialised divisions DG MS IV**	Ensure the development of a common understanding and coordinate approach. Provide expert support to JSTs and NCAs (p. 14)	–
	Methodology and Standards Development (MSD) Division	Regular review and development of supervisory methodologies under Pillar 2. **BUT: "In areas not covered by the set of rules developed by the international standard-setting bodies, or if a need for developing a common understanding and a coordinated approach arises in the conduct of the day-to-day supervision, the ECB-- to the extent covered by the supervisory tasks conferred on it – may issue its own regulations, guidelines and instructions on supervisory methodologies and common standards." (p. 43).**	SREP performance: the SSM has developed a common methodology for the ongoing assessment of supervised entities' risks, their governance arrangements, and their capital and liquidity situation. The methodology ensures a level playing field across supervised institutions, while taking into account their specific features (pp. 43/44).
	Authorisation (AUT) Division	Development of the methodology for assessing authorisation applications, proposals for withdrawing authorisation, proposals for the acquisition of a qualifying holding in a credit institution and the fit and proper procedures. Assessment of fit and proper procedures (p. 44).	Common procedures (any time of the supervisory cycle).
	Internal Models (INM) Division.	Ensure the consistency of methodologies and processes related to the review of internal models for the calculation of minimum capital requirements (Pillar 1). Monitoring the development of international standards related to internal models on international fora (e.g. the BCBS), in liaison with the Supervisory Policies (SPO) Division.	
	Centralised On-site Inspections (COI) Division	Development and update of on-site inspection methodology; interaction with the JSTs, other ECB horizontal divisions, the inspection teams, the Heads of Mission and the NCAs; in particular, coordinates with MSD and the NCAs.	On-site inspections are mostly carried out by NCAs. Hence, the development of common methodologies is key to align different approached to on sites.

Consistency Element	Actors	Aims & facet of supervisory cycle	Supervisory tools
	Risk analysis division (RIA)	Coordinates data-collection and the quality assurance of its process (p. 46). Defines stress-testing methodology and other relevant aspects together with the EBA and other ECB division (p. 67).	
Practices	**JSTs**	Most of the ongoing supervisory activities are reflected in the SREP exercise. Practices are risk-based and proportionate, in order to account for institutional specific features.	JSTs analyse the supervisory reporting, financial statements and internal documentation of supervised entities. They hold regular and ad hoc meetings with the supervised entities at various levels of staff seniority; they conduct ongoing risk analyses of approved risk models and analyse and assess banks' recovery plans (p. 45).
	JSTs + Planning and Coordination of SEP Division	Set out the main supervisory tasks and activities for the following 12 months, tentative schedules, and the need for on-site inspections and internal model investigations (p. 15).	A Supervisory Examination Programme (SEP) is produced for each SI.
	Directorate General Secretariat to the Supervisory Board (DGSSB)	With the assistance of the Decision Making Division, as well as Authorisations, Quality Assurance and Enforcement and Sanctions, the DG supports and ensures efficient decision-making, guaranteeing the institutional quality of the decision-making process.	Supervisory actions/tools:[278] - Supervisory decision (individual-binding) - Operational act (no legal form, nonbinding) - Recommendation (non-binding expectations) - Instructions (to NCAs) - Decisions of general application - Guidelines - Regulation - Guide/Guidance

[278] A detailed analysis of these tools is provided in Chapter 5.

Consistency Element	Actors	Aims & facet of supervisory cycle	Supervisory tools
	Supervisory Board	Defines the supervisory priorities on an annual basis. Also sets the topic for the thematic reviews	Essential tool to align the supervisory activities to be applied to supervised entities and to foster a harmonised approach; provides guidance to ensure the coherence and consistency of SIs' SEPs and helps NCAs setting their own priorities for the supervision of LSIs in a proportionate way (pp. 62/3).
	Risk analysis division (RIA)	Conducts horizontal in-depth risk analysis activities in various formats and with various frequencies, covering all relevant risk categories and topics; provide expertise to JSTs and help in peer review analyses (pp. 64-66).	**Horizontal analyses** and an overall assessment of the key risks and vulnerabilities in the participating member States (p. 66). They are complemented **by in-depth analyses, stress-testing exercises, impact analyses of existing or forthcoming regulation, and selected thematic analyses.** In-depth analyses can entail ad hoc data-collection, and they usually result in horizontal reports and institution-specific tools (for example peer benchmarking exercises) which support JSTs in their ongoing supervisory work.
	Planning and Coordination of SEP Division (PCS) (in liaison with other SSM stakeholders: DGs, JSTs or other ECB business areas, NCA horizontal divisions and	Coordinates the identification of potential topics for a thematic review. The sample of institutions for a thematic review is chosen so as to allow for **sound horizontal analysis and benchmarking**, with the purpose of gaining valuable **insights into the risk patterns** across the participating member States. The thematic reviews aim to achieve in-depth knowledge of the selected topics by focusing on fact-finding.	The ECB performs thematic reviews on topics that typically affect groups of institutions from several jurisdictions operating with different business models of differing size and complexity. Depending on the topic and findings, **the outcomes of thematic reviews may be used for developing SSM guidance, contributing to the identification**

Consistency Element	Actors	Aims & facet of supervisory cycle	Supervisory tools
	international bodies (p. 79).		**and/or promotion of best practices, or even in institution-specific qualitative and/or quantitative measures**. For institutions included in the sample for a thematic review, the outcomes of the analysis are taken into account in the annual SREP.
	DG MS III	Capture common risks and vulnerabilities across LSIs.	Thematic review for LSIs.
Outcomes	**PCS Division**	Checks regularly whether the tasks specified in the Supervisory Examination Programmes (SEPs) have been fulfilled by the JSTs and **requests corrective action if necessary.** LSIs supervisory planning is carried out by the NCAs and, when necessary, overseen by DG MS III.	
	The Supervisory Quality Assurance (SQA) Division	Acts as part of a second line of defence in the ECB's internal control framework with regard to the tasks conferred on the ECB by the SSM Regulation (p. 47). Ensures that supervision is consistently performed under the SSMR.	All along the cycle

Table 4.3: SSM actors, aims, and tools in the process of defining methodologies, practices, and outcomes, according to the Supervisory Manual. Source: Own elaboration

The key aim of Table 4.3 is to show the actors involved in each of the three phases that add up to supervisory consistency according to the framework developed in Chapter 2. In fact, this framework not only refers to methodology, practices, and outcomes, but also links each of these elements to the level of action in which they unfold. The table suggests, in fact, that the centralised horizontal divisions play a fundamental role along the three elements. However, the role of these divisions becomes particularly relevant in relation to the development of methodologies and assessment of outcomes.

In connection with supervisory practices, apart from the crucial role played by the JSTs, a point that is worth highlighting relates to the horizontal activities and analyses performed by the Risk Analysis Division (RIA). In fact, this division has a vast set of tools at its disposal in order to identify and assess existing and emerging risks, "complemented by in-depth analyses or thematic reviews on selected topics, stress-testing exercises, and impact analyses of existing or forthcoming regulatory initiatives" (ECB 2018a, 65). What at first sight seems a list of highly sophisticated analytical tools, is in fact more than that. In order to carry out these examinations, the corresponding horizontal divisions channel ad hoc data requests through the JSTs. These data collection activities have been described by interviewed authorities and industry participants as a rather haphazard process, in which the aim of the request is usually not fully understood, and which normally entails filling in templates that might not necessarily reflect the institution's situation. The manual also explains that "these in-depth analyses usually result in horizontal reports and institution-specific tools, for example peer-benchmarking exercises, which support JSTs in their ongoing supervisory work" (ECB 2018a, 66). The results of these analyses are also used as supervisory data and input for the SREP assessments, which leads to the imposition of supervisory measures. Hence, it is possible to see that these horizontal assessments and the tools that derive from them, have material consequences, even when the legal value of these

instruments is unclear. The next chapter aims to provide more clarity on this question by zooming in on the wide array of supervisory instruments and potential legitimacy concerns.

Table 4.3 and its distinction between methodologies, processes, and outcomes, combined with the internal divisions intervening in each of these phases, is not only intended to show the centralising features of the supervisory governance architecture. This is in fact apparent and does not add new analytical features. What is more interesting to highlight from the cycle description is the detachment between, on the one hand, the activities carried out by the JSTs as part of the ongoing supervisory tasks and, on the other, the methodological standardisation efforts occurring, ex ante and ex post, by horizontal divisions that are not in direct contact with the supervised credit institutions. There are, however, two important caveats: first, the Frankfurt-based JSTs also work "remotely" from their respective credit institutions (although they might travel with a certain frequency to meet their national counterparts to discuss particular issues); second, staff from horizontal divisions from DG MS IV can be appointed to be part of an on-site inspection team,[279] given that their expertise might be needed to fulfil the mission's objectives. Therefore, the point is not necessarily related to physical presence, but rather to the lack of a continuous relation and dialogue with the institutions in question. Hence, some key features that enhance supervisory consistency such as methods standardisation, are performed remotely from banks' realities.

Conclusions

The empirical analysis developed in this chapter has applied the conceptual framework presented in Chapter 2. It has first traced and compared supervisory modes of governance and their evolution, by focusing on three key dimensions: the public-private sphere, the

[279] Chiefly from INM and COI Divisions.

institutional and decision-making patterns, and the nature of the policy instruments. The indicators used to operationalise these dimensions have been both literature- and empirically-driven. The study shows how, through the evolution of the SREP and ICAAP tools, supranational supervision in the hands of the SSM has reshaped the relationships with industry participants and fellow NCAs. The analysis has also provided a primer on the changing nature of the supervisory instruments, and has offered a way to examine the hardening of soft law tools; a more detailed perspective on this last point is given in the following chapter.

Second, the chapter has provided an overview of the supervisory tools and actors that intervene at the level of methodologies, practices and outcomes, which are the building blocks of supervisory consistency. By adopting both a micro- and macro-perspectives, the chapter has focused on the operational side of the supervisory machine. What emerges from this analysis is the latent disconnection and differences between what happens, on the one hand, on the ground and during the actual performance of the supervisory activities—either on- or off-site—and, on the other, the centralisation in the development of methodologies and the presence of horizontal divisions all along the process.

From the perspective of the SSM's internal organisation, and due to the large and diverse SI sector, it is reasonable to expect a considerable number of horizontal divisions that develop and define common methodological standards. It also seems logical that, being the euro area supervisor, the SSM needs to capture old and new risks affecting various jurisdictions at the same time. Yet, decoupling the supervisory groundwork, on the one hand, from the analytical and decision-making centre may compromise the unity and consistency of the system, in light of the different interests that have to be reconciled along the cycle, where central actors' stances prevail.

CHAPTER 5

SSM decision-making powers in action: Legitimacy issues and institutional overlaps

Introduction

> First of all, we do not and should not design rules; this is up to the legislators and the technical authorities delegated by legislators. The ECB has a supervisory task, not a rule-making one. That said, there should be a feedback loop. Supervisors and regulators must talk to each other, and the experience of supervisors must inform the work of regulators. (Enria 2019a, 3)

After having examined the evolution of supervisory governance and its interrelation with supervisory consistency, this chapter delves into the regulatory powers conferred to the ECB as part of the SSM framework. Apart from the supervisory tasks *sensu stricto*,[280] Article 4 (3), para. 2, last sentence, of the SSM Regulation grants the ECB the power to "adopt regulations only to the extent necessary to organise or specify the arrangements for the carrying out of the tasks conferred on it by this Regulation". In addition to regulations, the SSM is entitled to issue other types of instruments, such as guidelines, recommendations, and decisions. As this chapter shows, the supranational supervisor has been actively applying its regulatory powers in order to issue binding and non-binding legal acts, instruments, and different types of policy documents.

This chapter explores how these regulatory competences and the resulting supervisory instruments are also geared towards the achievement of consistency. Albeit necessary in order to address supranational concerns, the regulatory activity deployed by the ECB within the SSM has contributed to rule-making complexity in the EU. This is partly because of the institutional and regulatory overlaps between Banking Union

[280] Specified in Articles 4, 5, and 9 to 18 of the SSM Regulation.

activities and those pursued at the EU-wide level. As the introductory quote suggests, the SSM takes the necessary precautions to insure it is not regarded as a regulator, given that its main task is that of applying the existing rules. However, the *feedback loop* referred to in Enria's speech, is indicative of these blurred lines between supervisory and regulatory tasks, which are empirically analysed throughout this chapter.

When considering the exercise of supervisory powers as part of the SSM framework, another debated aspect concerns the legal effects of these regulatory instruments on Less Significant Institutions (LSIs), indirectly supervised by the supranational authority. Albeit being *less significant* in terms of total assets' size compared to the SIs, the situation of these banks is nevertheless important: on the one hand, they are still directly supervised by their corresponding NCAs at the national level, on the other, the ECB is the ultimate responsible for the overall functioning of the SSM, and it can—if deemed necessary—reacquire supervisory competence from its national counterparts. This hybridity is intensified when the regulatory instruments issued by the SSM for the SI sector are taken into account. In fact, it is not entirely clear what the scope for regulatory harmonisation and supervisory convergence with regard to LSIs is. Chapter 3 has explored the diversity in the banking sector, how these smaller credit institutions differ from larger ones, and the role LSIs play in the local economy. Given these local particularities, the proportionality and subsidiarity principles are key to interpreting the level of intrusiveness from the supranational supervisor in the LSI sector. Apart from principles-based considerations, practical limitations such as SSM's human resources or language barriers[281] can create obstacles to

[281] Language barriers have also hindered the work carried out for Significant Institutions, especially in the early days of the SSM, as banks are allowed to choose whether to submit the required documentation in English or in their local language. These idiosyncrasies, however, are more apparent in the case of LSIs, as they tend to operate locally, compared to larger institutions that do so on a cross-border basis, and thus might have stronger incentives to issue key documents in English.

a wider prudential oversight of LSIs. However, the logic of risk-based supervision does not necessarily abide by conceptual distinctions between the SI and LSI universe.

The chapter is structured as follows. The first section analyses the existing regulatory powers in the hands of central banks, by considering the rule-making competences that the ECB already possesses with reference to monetary policy, and by zooming in on the German and Italian cases. The second section examines the deployment of these regulatory powers in the supervisory domain in two cases. The first subsection focuses on the "Guidance to banks on non-performing loans (NPLs)" and its "Addendum"; the second explores the "Guide on the approach for the recognition of institutional protection schemes (IPS) for prudential purposes".[282] The third section analyses the NPL and IPS phenomena from the perspective of the LSIs in the Italian and German contexts.[283] The fourth section provides a comprehensive picture of the instruments adopted by ECB Banking Supervision, and raises critical considerations in relation to the balance achieved between supervisory consistency and legitimacy. Before concluding, section four additionally discusses institutional overlaps between the rule-making activities performed by the ECB/SSM and the banking regulatory authority at the EU level, the EBA.

5.1 Nothing new under the sun? Central banks' regulatory powers in a broader context

This section aims to provide an overview of the regulatory powers in the hands of central banks, in order to better understand the regulatory action taken by the ECB within the SSM

[282] The rationale behind the case selection and their relevance for the analysis of supervisory consistency has been explained in Chapter 2.

[283] The majority of the LSI sector is, indeed, concentrated in Austria, Italy, and Germany (for further details see ECB 2017f).

context. It first considers these competences in the Treaty (TFEU) context, and then it focuses on the regulatory powers granted to fellow European central banks or (NCAs).[284]

Prior to analysing the regulatory competences assigned to the ECB in the supervisory realm, it is important to consider this capacity in relation to the main policy area in the hands of the ECB. When setting the basis for the conduct of monetary policy (arts. 127 and ff.), the TFEU confers upon the ECB the power to issue regulations "to the extent necessary to implement the tasks" it has been assigned, take decisions, recommendations, and deliver opinions (art. 132 (1)).[285] As mentioned in the introductory remarks, Article 4 (3), 2nd paragraph of the SSM Regulation contains a similar provision, since regulations can be adopted "only to the extent necessary to organise or specify" supervisory arrangements, while it also provides for the adoption of guidelines, recommendations, and decisions. However, the "specific tasks"[286] related to prudential supervision of euroarea credit institutions, have a different nature from those tasks performed by the ECB in its monetary role. Therefore, our understanding of its regulatory powers cannot be identical under these two different scenarios.

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[284] The reason why central banks and NCAs are differentiated here, is because euro area member States have different institutional arrangements in the banking supervision domain. Some countries, such as Italy, have concentrated prudential supervision within the central bank, while others, as for instance Germany, have both their central bank and a separate authority that supervises the whole financial system, including banking, insurances, and securities markets' sectors. For further considerations about the relationship between BaFin and the Bundesbank in the banking supervision realm, see Chapter 3.

[285] This is also provided for in article 34 (1), Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank, when enumerating the legal acts that the ECB is allowed to issue. For further details on the ECB's legal instruments in the monetary policy domain, see ECB (1999).

[286] As per the words of article 127 (6) TFEU, which served as the legal basis for the creation of the SSM and the delegation of supervisory tasks to the ECB.

First, the conduct of monetary policy embodies a set of technical practices that have a wide impact on citizens' everyday life.[287] Although both monetary and supervisory policies are meant to strengthen the stability of the financial system as a whole, the instruments and tools used in each of these domains are different. When conducting monetary policy, the ECB's "decisions may not amount to a challengeable legal act" (Smits 2017, 9), while in the realm of prudential supervision it performs its activities mostly through legal acts (for instance, when approving or withdrawing banking licences, when assessing the 'fit and proper' of bank managers, among others). This difference is not merely conceptual: the main consequences are related to the possibility of judicial review of these acts.[288] Therefore, while it could be to some extent unusual that either a physical or a legal person sues the ECB for its interest rates decision while in charge of the eurozone's monetary policy under normal circumstances, this is not the case in the banking supervision domain, where credit institutions can be directly affected in their subjective rights as a consequence of an ECB legal act.[289]

Furthermore, when analysing regulatory powers exercised by the ECB in its supervisory role, it has to be considered that the post-financial, fiscal, and sovereign debt

[287] Following the rich description provided by Smits (2017, 4), who makes a detailed analysis of the key policy differences across the ECB's "Chinese Walls" that are meant to divide these two areas: "'monetary policy' stands for all the "basic" and "other" tasks and functions of the Eurosystem which do not involve prudential supervision (Article 127(2), (5); 128; 138 and 219 TFEU; Articles 3.1; 3.3; 5; 16; 17-24; 25.1 ESCB Statute), including foreign-exchange operations, foreign reserve management and payment systems oversight". For a detailed analysis of the ECB's performativity in the conduct of monetary policy and euro area governability, see Braun's doctoral thesis (2014).

[288] The question of judicial review could be taken further, when considering the role that the CJEU has played in assessing the ECB's actions during the financial and sovereign debt crises, and (to a more limited extent, so far) in connection to its prudential tasks. As pointed out by Mendes (2016) when analysing the way EU courts have assessed administrative discretion in the so-called ESMA and Gauweiler cases (Case C-270/12, *United Kingdom v. European Parliament and Council* (ESMA), EU:C:2014:18; Case C-62/14, *Gauweiler and Others v. Deutscher Bundestag*, EU:C:2015:400), the highly complex and technical nature of the reviewed decisions has overlooked the possibility of seriously pondering the public interest that was meant to be protected in these cases. The fact that these technical matters fall outside the scope of review and therefore are not balanced against public interests, entails serious normative consequences, as the distributional effects of these technical decisions are left aside and not properly considered.

[289] The broader and more intricate question that judicial review poses is whether this mechanism could replace or be used as a remedy to make up for the lack of accountability in other fora (for an analysis of the judicial and political accountability of the ECB see Dawson et al. 2019).

crises institutional arrangement at the EU level, has distinguished between *regulatory* and *supervisory* authorities.[290] As shown below, this policy choice that differentiates regulation from supervision is neither self-evident nor shared by other national central banks. In reality the sharp distinction between regulatory and supervisory authorities is not such, given the overlaps between the SSM and the EBA that are further discussed in the last section of this chapter. In fact, the institutional practices deployed by the SSM have reinforced its capacity to regulate in the absence of EBA's binding RTS and ITS.

For instance, apart from the cases analysed below, the exercise of *options and national discretions* (ONDs)[291] has raised questions about whether the ECB was entitled to do so or not. These regulatory powers were in the end exercised not only in relation to SIs, but LSIs too.[292] The controversies surrounding the exercise of ONDs came to light with the public consultation that was launched in relation to the first Draft ECB Regulation on the topic. Among the thirty submissions received, one was particularly critical about the extent of such powers, which should be confined to *operational* aspects only; accordingly, it could not be concluded that the ECB has been granted broad regulatory powers in order to enact new banking legislation.[293] Dawson et al. (2019) evidence a similar episode during this public hearing, but focusing on the ECB's response to why it was necessary to harmonise options and discretions to such an extent. The ECB did not provide a substantive explanation of why this was done but, rather, referred to the obligation to do so in order to

[290] See Chapter 1 for further details.

[291] ONDs are conferred upon member States' competent authorities under EU Level 1 legislation. For a more specific discussion on ONDs, see Biondi and del Barrio (2018).

[292] "Guideline of the ECB of 4 April 2017 on the exercise of options and discretions available in Union law by national competent authorities in relation to less significant institutions (ECB/2017/9), and "Recommendation of the ECB of 4 April 2017 on common specifications for the exercise of some options and discretions available in Union law by national competent authorities in relation to less significant institution (ECB/2017/10)".

[293] For the full set of observations in relation to the legality of the proposed measure, see the joint submission by Università degli Studi Roma Tre and Prof. Avv. Gian Michele Roberti, available at https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/reporting/od_comment_6.pdf (last accessed March 16, 2019).

fulfil its mandate. The SSM's praxis in the last years has swept away any doubt about the possibility to issue both binding and non-binding regulatory instruments. As summarised by Annunziata (2018, 30),

> The growing weight that the ECB has acquired in the overall SSM landscape raises the very serious issue of the regulatory powers of the ECB far beyond the limits set out above, and, in particular, that of the nature, and relevance, of soft law instruments. Interpretations, guidelines, opinions, Q&As, supervisory practices—all areas in which the ECB is heavily involved—end up, in fact, by having a stronger impact as their source is, or becomes, more and more 'authoritative'.

As anticipated, the analysis focuses now on the regulatory competences in the hands of NCAs: whether LSI supervision is carried out within the central bank or by a separate authority, some national legal frameworks confer regulatory powers to them. To illustrate these two institutional arrangements, examples are drawn from the Italian and German cases, respectively.[294]

Banca d'Italia, other than being part of the ESCB and hence participate in the decision-making process of the monetary policy, is the supervisory authority in charge of Italian banks' and other financial institutions' oversight. In the latter role, the Consolidated Law on Banking[295] empowers BdI to regulate a myriad of aspects related to banking activities, and the main source of its supervisory activities is Circular No. 285 of 17 December 2013, already alluded to in Chapters 3 and 4.[296] In Germany, BaFin, which works in close cooperation with the Bundesbank in the banking supervision domain, can also issue an ample set of general administrative acts, circulars, interpretative decisions and guidance

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[294] Thomson Reuters provides an interactive tool to compare different regulatory frameworks, classified by country and specific topic, on banking regulation. The following link provides some useful comparisons between the German and Italian frameworks: https://uk.practicallaw.thomsonreuters.com/qacompare/report/country/9229b18e672d4593abf1c1d9b2b98212?comp=pluk&transitionType=Default&contextData=(sc.Default) (last accessed 4 January 2020).

[295] *Testo Unico Bancario - Decreto legislativo 1° settembre 1993, n. 385*. Article 4 (1) of the Consolidated Law on Banking is the specific source of these powers, which allow the Bank to issue a diverse set of instruments: "La Banca d'Italia, inoltre, emana regolamenti nei casi previsti dalla legge, impartisce istruzioni e adotta i provvedimenti di carattere particolare di sua competenza".

[296] *Circolare n. 285 del 17 dicembre 2013. Disposizioni di vigilanza per le banche*.

notices.[297] These NCAs, therefore, enjoy a wide set of regulatory powers when conducting their supervisory activities, which reinforces the idea of the conceptual and practical difficulties in distinguishing supervision from regulation.

A relevant aspect that ties up national and supranational regulatory powers concerns LSIs and the extent to which ECB banking supervision instruments directly impact on them. In the *Landeskreditbank Baden-Wüttenburg v. ECB case*[298], the General Court has characterised the supervisory exercise of the NCAs as a "decentralised implementation" of an exclusive competence conferred upon the ECB (paras. 41 and 49 from the 2019 decision). It is therefore pertinent to question whether the Court's reasoning and conclusions concerning the scope of supranational supervisory activities, can be extended by analogy to NCAs' regulatory powers. A first rough answer should be negative, since there are no specific legal provisions in the SSM Regulation to support such conclusion; "however, this is without prejudice to the ever-increasing weight that the ECB's soft law may have within the entire system, including practice by NCAs and interpretation of EU Banking law in general" (Annunziata 2018, 31/2). These are in fact concrete channels through which the SSM reinforces its position against the LSI sector.

After having examined supervisory regulatory powers from a conceptual stance, the following section is devoted to examining how decision-making actually occurs within the SSM, and how is consistency dealt with.

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[297] Specifically, the power to issue Guidelines according to Article 7, para. 2 of the German Banking Act (*Gesetz über das Kreditwesen*). The legal basis for BaFin's administrative and regulatory discretion is also wide. A list of the relevant provisions can be found here: https://www.bafin.de/EN/RechtRegelungen/Rechtsgrundlagen/Verordnungen/verordnungen_artikel_en.html?nn=8236218 (last accessed March 16, 2019).

[298] Ruling of the European Court of Justice of 16 May 2017, T-122/15, upheld by case C-450 17 P on 8 May 2019.

5.2 From institutional design to decision-making in action: The Non-performing Loans and Institutional Protection Schemes cases

The aim of this section is to move from a static view of the SSM's institutional architecture and its decision making procedures, to one that considers the dynamics of the internal policy-making processes. The following subsections examine the regulatory endeavours by the supranational supervisor in the cases of non-performing loans (NPLs), and the recognition of institutional protection schemes (IPS) for prudential purposes.

5.2.1 Integration through guidance and supervisory expectations: The Non-performing Loans saga

In the exercise of ECB's supervisory regulatory powers, an episode that did not go unnoticed is the NPLs one. Non-performing loans have been a concern for the SSM since its inception. Indeed, before taking up supervisory responsibilities, the ECB conducted, together with the NCAs, a *comprehensive assessment* between November 2013 and October 2014. This 'financial health check' consisted of two pillars: The Asset Quality Review (AQR), and the stress tests, which revealed some fundamental weaknesses in the banking sector, chiefly related to credit risk management and its impact on the sluggish growth in the euroarea. The large amount of non-performing exposures (NPE), a term that is interchangeably used with NPLs for the purposes of the instruments issued by the ECB, was identified as a supervisory priority. NPL reduction from banks' balance sheet was

deemed necessary not just in light of the SSM's duties, but also considering the "risk reduction" condition, upon which the completion of the Banking Union rests.[299]

A longitudinal analysis of the events that have taken place after this seminal financial check was conducted, illustrates the technical and political difficulties in dealing with the NPL situation. The details of the case reveal the policy-entrepreneur stance adopted by the ECB and the institutional frictions raised by the need to define the scope of the supervisor's regulatory competences. At the same time, the NPL saga mirrors the challenges to the achievement of supervisory consistency, which are different from those related to the need to harmonise the regulatory framework.

The Guidance to Banks on non-performing Loans ("the Guidance"), provides background context in order to understand the importance of the topic from a supervisory perspective. In its first pages, the ECB explains that JSTs have identified varying approaches to the identification, measurement, management, and write-off of NPLs. It has to be recalled that the EBA was back then simultaneously working on the harmonised definition of 'forbearance' and 'non-performing exposures'. The EBA Final Draft ITS on supervisory reporting on forbearance and non-performing exposures under Article 99(5) of Regulation (EU) No 575/2013, was issued on July 24, 2014; the following Commission's Implementing Regulation (EU) 2015/227 of 9 January 2015 was based on it.[300]

[299] As exemplified by this passage from an IMF FSAP conducted in Italy in 2006, lengthy judicial procedures in the case of borrowers' default have represented a deep institutional concern: "The Italian corporate insolvency regime results in lengthy and costly judicial proceedings, and a slow realization of collateral in the event of borrowers' default. The government at the time of the assessment had proposed a legal reform aimed at simplifying legal proceedings and maximizing the value of the distressed enterprise through restructuring, which was approved in December 2005. In contrast, the insolvency regime for banks, based on administrative procedures led by B[d]I, is fast and efficient, supported by deposit insurance and a framework for public intervention designed to prevent the distress in one bank resulting in systemic stress". (IMF 2006, 38, para 60)

[300] Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 48, 20.2.2015, p. 1).

Once the problem has been identified, a High-level group on NPLs, chaired by Sharon Donnery, Deputy Governor of the Central Bank of Ireland, was set up in July 2015. This taskforce comprised representatives of the ECB and the NCAs, and it ended its mandate by late 2018 (ECB 2019a). Among the activities carried out by the NPL Task Force, there had been two stocktakes on national supervisory practices. The first one was published by the ECB in September 2016 (ECB 2017d), and the second one was released in June 2017. The aim of these activities was to map the variety of supervisory guidance and practices throughout eurozone countries, and identify those "best" practices thanks to the "judgement-based exercise largely completed by the NCAs on behalf of the ECB" (ECB 2017d, 5). This second stocktake, indeed, provides a rich account of the different phases of NPL management across euroarea countries, and classifies the jurisdictions into 'high' and 'low' NPL levels, a classification that will be relevant to the scope of application of both the Guidance and the Addendum.

The outcomes of the stocktake are a fundamental component of the NPL Guidance, given that those "practices are intended to constitute ECB banking supervision's supervisory expectation from now on" (ECB 2017b, 5). An additional characteristic of this soft law instrument is that its content is meant to be dynamic, in the sense that its scope can be extended on the basis of the on-going monitoring of the NPL situation.[301] This characteristic is in line with experimentalists' rule-making expectations and the revisability of the tools. Another element relates to the fact that "the JSTs will engage with banks regarding the implementation of this guidance" (ECB 2017b, 5), statement immediately followed by another that implies a generous leeway when it comes to implementation: "it is expected that banks will apply the guidance *proportionately* and with *appropriate*

[301] Which was what actually happened with the issuance of the Addendum in 2018, which expanded the scope of the original Guidance.

urgency, in line with the scale and severity of the NPL challenges they face" (ECB 2017b, 5, emphasis added). Both the proportionality and the urgency requirements have been left to the banks' judgement.

In order to better understand the content and the characteristics of the Guidance published in March 2017, it is important to make a step back and examine the public consultation phase, which ran from 12 September to 15 November 2016, and the public hearing that took place at the ECB premises on 7 November 2016, in parallel with the stocktake exercise. The draft document included detailed mechanisms on how banks should manage their stock of NPLs, following the "NPL life cycle". This first public consultation already exposed stakeholders' concerns in relation to the ECB's regulatory competence on the matter.

For instance, the Federation of European Accountants stated that "the Federation has the clear expectation that the ECB understands that it does not have the authority to establish requirements for financial statements";[302] the GBIC considered that "this guidance goes largely beyond pure interpretation and application of existing rules".[303] Additionally, the GBIC pointed out the importance of keeping a principle-based approach on the Guidance, typical of German Supervisors and in the spirit of MaRisk, as explained in Chapters 3 and 4. Given the importance of LSIs in Germany, the GBIC insisted on the importance of clarifying the application of the Guidance to this whole sector, in order to ensure its compliance with the proportionality principle.

On the contrary, the ABI has not specifically mentioned the need to clarify the application for the LSI case, although it made general considerations about proportionality.

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[302] See https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_comment_10.pdf

[303] See https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_comment_18.pdf

Given that the proportion of LSIs in Italy was by then still relevant, it is worth asking who represented the interest of the LSI sector, especially the cooperative banks (BCC). Although ABI was not explicit on this issue, and the Association of Italian Co-operative Banks (*Federcasse*) did not submit individual observations to the Draft, the European Association of Co-operative Banks (EACB) expressly raised concerns from LSIs. An additional aspect that emerges from stakeholders' responses is the clash between the requirements established by the ECB and current banks' practices and capabilities. This is exemplified by the highly detailed provisions regarding NPL classification, IT requirements, centralized information, and the need for specialized human resources and additional divisions within the existing structures in order to cope with the Guidance's requirements. Banks associations and banks themselves, pointed out the severity and inconveniences stemming from automatic classification triggers that do not take into account individual debtor's considerations, and the relevance of specific national legal frameworks.

An additional feature emerging from the comments submitted by participating stakeholders, the public hearing, and the analysis of the track changes file that compares the Draft version to the Final Guidance[304] concern its Chapter no. 5 on NPL recognition. Leaving aside its technical content, it is important to highlight the following: the overall aim of the chapter was to align the definition of "non-performing loans" used throughout the ECB Guidance with the existing definitions of "non-performing exposures". This mirrors not only the existing institutional overlap between the ECB and the EBA, but also the challenges to achieving a common and coherent set of regulations, given that these definitions are related both to prudential and accounting requirements. The search for

[304] See https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/comparison.en.pdf

coherence and consistency in the interpretation and application of the rules is a fundamental responsibility of the SSM. While the EBA is mandated to strengthen the Single Rulebook and monitor convergence of supervisory practices, the task of the SSM goes beyond harmonisation: achieving consistency at the supervisory level is about rule application and its outcomes. This is why the Guidance insisted on the alignment of prudential and accounting definitions.

Likewise, some participants to the public hearing have raised concerns about the potential overlap between SSM requirements and related accounting provisions. While the SSM acknowledged the sensitivity of these issues and the blurred lines between the two areas, it is interesting to see the reply from a DG MS IV official during the hearing: although "the SSM is not formally entitled with accounting powers", the Guidance only represented a continuation of the on-going Pillar 1 supervisory activities.[305] The complex interconnectedness between prudential and accounting standards, was solved by justifying its exercise as part of the normal scope of supervisory activities. Other differences that emerge from the track changes version of the Guidance is the replacement of the words: *requirements* for *expectations*; *are required* for *are expected*; banks *need to* for *should*, in an attempt to decrease the prescriptive tone and align it with its non-binding nature.

A key point that has been highlighted throughout the consultation process concerns the "horizontal" view that the SSM applies to achieve consistency and comparability, which is exemplified in the present case by the "EU average NPL level" as the dividing line between high and low NPL banks. The concerns towards this horizontal view is concisely explained by the European Banking Industry Committee (EBIC)'s representative, when mentioning that it is "important to ensure that the NPL strategy and methodology adopted

[305] The video is publicly available on YouTube: https://www.youtube.com/watch?v=L32Nwwh25jo. See the References.

are consistent with firms' business models, local market conditions and other external factors. The establishment of an 'EU average NPL' as a benchmark is inappropriate as credit institutions' business models differ substantially".[306] Despite this criticism and additional comments raised both in writing and orally during the public hearing process, the EU average notion was kept.

In the period between the publication of the Guidance in March 2017, and the opening of the public consultation process for the NPL Addendum in October of that year, the 'Council's Action plan to tackle non-performing loans in Europe' was issued in July 2017.[307] The Action Plan set an EU-wide NPL reduction strategy, as opposed to the ECB's efforts, which were directed to SSM countries only. The Council's Action Plan invited the EBA and the Commission to develop the necessary tools to advance regulatory measures in this area, and it specifically entrusted the SSM with the task of implementing, together with the NCAs, a Guidance similar to the one issued in March 2017 to be applied to the LSIs. In spite of the launching of the EU-level strategy, the SSM moved forward with the publication of the 'Draft Addendum to the ECB Guidance to banks on non-performing loans', with a consultation period from 4 October to 8 December 2017, and a public hearing held on 30 November 2017. While it was a brief document in comparison to its predecessor, it nevertheless caused wide institutional perplexity, as it reinforced those aspects that have been criticised during the first public consultation. This time the track-changes document reveals that several amendments were made to the draft version.[308]

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[306] See page 2 of the letter to Mr. Siani: http://www.ebic.org/Position%20Papers/EBIC%20comments%20on%20the%20ECB%20draft%20guidance%20to%20banks%20on%20non-performing%20loans%20(NPLs).pdf

[307] See https://data.consilium.europa.eu/doc/document/ST-11173-2017-INIT/en/pdf

[308] See: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_compare.en.pdf

A first thing to note is the concept of *supervisory dialogue* introduced in Chapter 4, which was addressed several times in the course of the first public hearing as it is a key element in the supervisor-supervisee relationship, but which does not appear in the Guidance document. The Addendum, on the contrary, incorporates the supervisory dialogue on various occasions, sometimes used as a means to ease the original prescriptive tone (e.g. to replace words like *compliance* or *assessment*). As Figure 5.1 below shows, the supervisory dialogue acts as a transitional element between *supervisory expectations* and SREP outcomes. The sequence of steps implies that supervisory expectations have concrete consequences. Given that the aim of the SREP is to make sure that individual banks have proper risk management processes in place, as well as adequate levels of capital and liquidity, the result of not meeting supervisory expectations and not being able to come to an agreement during the supervisory dialogue, is reflected in the additional Pillar 2 requirements that the SSM can impose (P2G and P2G, as explained in Chapter 4).

Another important word that was present throughout the text of the Draft Addendum but disappeared from the final version was "backstop". The backstop language was replaced by *expectations*. However, these prudential backstops were specifically considered in the Council's 2017 Action Plan, and in fact have been recently approved by the Council in the Capital Requirements Regulation's last amendments, concerning minimum loss coverage for non-performing exposures. The fact that these prudential backstops are now part of the EU regulatory framework, might give the impression that the question regarding the legality of the Addendum has been overcome. Yet, the episode is still important because of the institutional dynamics it has triggered, and it also reveals an additional channel through which the ECB fosters integration, albeit in an indirect way. In this regard one of the comments submitted by the Association for Financial Markets in Europe (AFME) in its position paper is illustrative: "we are concerned that the present ECB

proposal is frontrunning the ongoing, broader reflection at European level on NPLs, while at the same time potentially conveying the signal that the provision levels of the banks the ECB supervises are not adequate."[309]

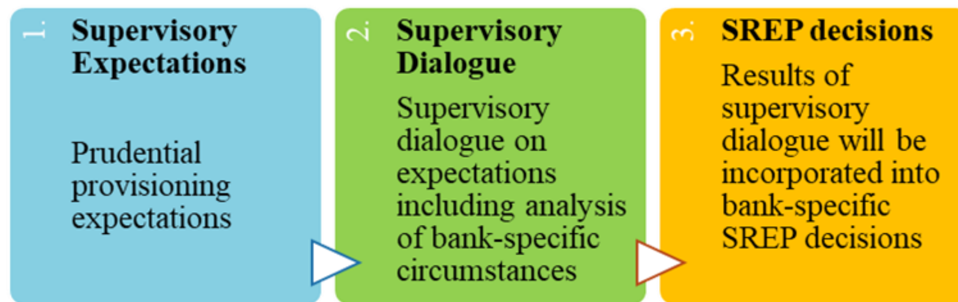

Figure 5.1: Bank-specific supervisory three-step approach. Source: Adapted from ECB (2018b, 5).

Further challenges that banks had to overcome during this period concerned the measures prescribed in the Guidance that was still in the process of being implemented by the time the Addendum consultation took place. Adding new requirements on top of pre-existent ones was a source of regulatory uncertainly among industry participants. The need to incorporate LSIs within the scope of the Addendum's application was raised by different stakeholders, in most cases due to 'level playing field' concerns, given that the burden created by the implementation of these provisions should be equally distributed between SIs and LSIs. The final document, however, does not refer to this issue.[310]

As anticipated, the question of the Addendum's legality is still important as it touches upon a sensitive issue: the scope of the SSM regulatory powers. Indeed, while the Addendum's public consultation period was still open, both the European Parliament's and the Council's Legal Services issued their legal opinions on 8 November and 23 November

[309] See page 2 of the position paper https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_comment_21.en.pdf

[310] Indeed, the adaptation of the SSM's NPL framework to the LSIs is part of the aforementioned Council's Action Plan.

2017, respectively. Both EU institutions reached the conclusion that the ECB lacks the competence to issue rules of general applicability, as opposed to supervisory measures that are imposed on a case by case basis. In fact, according to the analysis provided by the Parliament, even if the Addendum was meant to be a non-binding instrument, given the language used, participants' expectations, and the circumstances surrounding its issuance, the document should be deemed to have legal effects, no matter the label or name the supervisor has attached to it. The Commission, on the other hand, displayed a more ambiguous position, which mirrored the opposing stances taken by, on the one hand, the Commission's Vice President Valdis Dombrovskis, who backed Parliaments' view regarding the need for the ECB to act on a case-by case basis and, on the other, Commissioner Pierre Moscovici, who supported the ECB's action. Nevertheless, in spite of the institutional tensions and criticisms raised against the adoption of the Addendum, the document was finally adopted.

It is also worth highlighting some general features that stem from the public hearing's format: keeping a balance between an open and transparent public hearing, on the one hand, and preserving a serious dialogue and exchange of opinions, on the other, is not simple. Publicity and transparency can reach a tipping point, after which its benefits are less clear. Indeed, the "press conference setting", as described by one interviewee that frequently participates in these meetings, is an accurate picture of the context in which these measures were publicly discussed. However, the aim of a press conference differs from that of a public hearing, in which different stakeholders' address their interest and concerns. The public hearing recordings reflect this approach, which is more in line with a Q&A session than a debate of the proposed measures.

The Addendum-s public hearing, indeed, reveals some aspects that are important to better understand the SSM's rationale and modus operandi. Contrary to the first public

hearing, this one featured the presence of Daniel Nouy, former Chair of the SSM's Supervisory Board. In her introductory remarks, she stressed that the draft clarifies their expectations, and that its main aim is to make their approach transparent: "our expectations are firm but there are not automatic actions attached to them, we will discuss provisions with affected banks".[311] in the same vein, Sharon Donnery highlighted that the Addendum reinforced the qualitative Guidance, and communicated their expectations in a clear and transparent way, based on international best practices.

Some of the stakeholders referred to the need to consider specific local circumstances, mostly related to national legal frameworks, lengthy court proceedings, and the lack of alternative out-of-court mechanisms, to tackle the NPL problem in a more efficient way. In general, ECB officials explained that, on the one hand, their expectations, even those quantitatively defined, are based on best practices' experiences and, on the other, that national authorities are also responsible for these differences, which should not be tolerated in the context of the Banking Union, where the same tools and solutions should be available in all jurisdictions. The Association of German Banks asked for clarifications in relation to the scope of application of the addendum—i.e., if it was primarily addressed to high NPL banks, they believed those who do not belong to this category would be "punished" (sic) by having to implement these measures. Nouy was clear that the SSM needs to be *consistent*, so in the interest of preserving a level playing field they expected everyone to be ready, albeit the supervisory dialogue would be more intense with those banks that had manifest NPL issues.

To conclude with this first subsection, the NPL case illustrates some key elements that depict the SSM's modus operandi, supervisory rationale, and consistency mechanisms.

[311] Recordings publicly available on YouTube: https://www.youtube.com/watch?v=9F72l1nS2Cg

The case reveals fundamental tensions between the horizontal view of the SSM and the careful calibration to local specificities and circumstances. The need for standardised information and outcomes should be balanced against the existence of diverse institutional frameworks that go well beyond banking supervision, such as the organisation and efficiency of national judicial systems, and alternative out-of-court remedies. The other aspect that has caused major tensions concerns the level of detail of the documents and its intrusiveness, which can interfere with the banks' decisional autonomy.

In order to show that this has not been an isolated case, but rather part of a broader institutional approach, the next case deals with the recognition of IPS for prudential purposes.

5.2.2 Further challenges to consistency and ECB-NCAs cooperation: The case of Institutional Protection Schemes

IPSs are defined by the European regulator as a "contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary" (Article 113 (7) CRR). Within the SSM context, IPSs regulation has been part of a broader regulatory project related to the exercise of ONDs. Although in a more indirect fashion, this case has triggered controversies, too. In fact, the NPL and the IPS cases trigger similar supervisory concerns, i.e., the achievement of consistency in diverse and heterogeneous contexts, and the need to strengthen financial stability. An important difference, however, is that the instruments issued in the NPL case—the Guidance and the Addendum—are *not* listed among the ECB's

list of legal acts, while Guideline (EU) 2016/1994[312] on IPS recognition is. This is in line with the approach that emphasises the non-binding nature of such instruments.[313]

As far as the decision-making process is concerned, the consultation period lasted from February to April 2016, and the public hearing took place on 31 March 2016.[314] The authorities, again, highlighted the importance of the publication of the draft for transparency considerations. It was also explained that the interest of the ECB derives from the presence of both SIs and LSIs within this framework. In general terms, one key element from the IPS is that it can be officially recognised as a Deposit Guarantee Scheme (DGS). This means that IPSs perform a double function: on the one hand, as a pure IPS, its funds will be devoted to the support of its members; on the other, the funds of the DGS serve to protect depositors. The SSM's role is not to supervise the DGS, but to protect solvency and liquidity of IPSs' members and help reduce the risk of failure. The main objective from a supervisory perspective, as stated by an SSM official during the public hearing, was to develop a common approach for the recognition of the IPS to ensure supervisory consistency. The need for a common approach stems from the coexistence of both SIs and LSIs within the same network, and the need to coordinate action with the corresponding NCAs.

Regarding specific stakeholders' observations, the German Savings Banks Association (*Deutscher Sparkassen- und Giroverband*, DSGV), posed two fundamental

[312] Guideline (EU) 2016/1994 of the ECB of 4 November 2016 on the approach for the recognition of institutional protection schemes for prudential purposes by national competent authorities pursuant to Regulation (EU) No 575/2013 of the European Parliament and of the Council (ECB/2016/38), OJ L 306, 15.11.2016, p. 37. The "Guide on the approach for the recognition of institutional protection schemes (IPS) for prudential purposes", however, is not listed among the legal acts.

[313] The list of all the SSM-related legal acts can be found in https://www.bankingsupervision.europa.eu/legalframework/ecblegal/date/2019/html/index.en.html

[314] Recordings publicly available at https://www.youtube.com/watch?v=8nFvqZGHSYU – These paragraphs draw upon the material from the recordings.

issues. DGSV is the umbrella organisation of the Savings Banks Finance Group (*Sparkassen-Finanzgruppe*), which has an IPS recognised as a DGS under Germany's Deposit Guarantee Act in 2015, so it was already organised and recognised as having the double function alluded to, prior to the ECB's regulatory efforts. The DSGV's representative addressed the need to make the IPS Guide compatible with the DGS Directive and the corresponding EBA Guidelines on the topic, which shows that the rules proposed by the ECB have to be examined in the context of pre-existing binding and non-binding instruments, issued at the national and supranational levels. The second remark concerned moral hazard, which is an essential point that deserves to be analysed in the context of these schemes, since an ill-designed IPS can create the so-called 'free-rider problem'. In the DSGV's view, the current wording of the Draft should be amended. First, while it is important to ensure a proactive risk-management to detect potentially disruptive issues and intervene in a timely fashion, the association believed that the expressions coined suggested the need for uniform risk management processes. Furthermore, although they acknowledged the need for comparability, IPS members are by definition autonomous institutions, therefore, such a high level of uniformity could hamper this feature.

Second, the wording also suggested some sort of automatic mechanism for members' protection, which is not in line with the way IPSs actually work. The SSM authorities clarified that they want to avoid any automatic interpretation. Likewise, another participant addressed the issue of uniform risks management, not from an autonomy perspective, but from a proportionality one, considering the different sizes of the members belonging to the same IPS, and the "naturally non homogeneous" situations within each of them. Again, these comments pointed to the need to accommodate consistency in inherently diverse scenarios.

Another association that raised concerns in relation to the confusing wording adopted in the draft was the EACB: in its view, the commitment of the IPS to support their members in case of default was limited and could not be understood as unconditional. The Association of German Cooperative Banks (*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken*, BVR), stressed another issue that had been raised in the NPL case too. The association got the impression that "some of the points might go too deep into detail on a level of a single bank, which is a micro-management level".[315] In their view, the ECB's Draft was going beyond the criteria set in Article 113 of the CRR. Given that these provisions are to be applied on a case by case basis and are highly dependent upon the supervisory dialogue, the responses by the SSM representatives tended to be elusive, in the sense that authorities knew that not all circumstances could be anticipated at the time of discussing the draft.

As mentioned earlier, IPSs represent an important feature for the SSM, not just given the presence of SIs within these networks, but also in connection to the risk-monitoring functions they perform. In fact, IPSs are "primarily based on prevention, which involves structured risk monitoring aimed at identifying potential risks and applying prevention measures" (Semenyshyn 2017, 184). This double function as a deposit protection scheme and, at the same time, a way to enhance the stability of the network and preserve autonomy, highlights the importance of their coordinated recognition. Together with the NPL case, they both illustrate supervisory concerns about both risk-reduction and risk-management, and mirror the need to learn from the existing practices in the euro area countries. In fact, IPSs show that cooperation between the ECB and the NCAs is necessary, given the usual mixed composition of SIs and LSIs belonging to the same network.

[315] See minute 44 of the YouTube video.

To conclude this section, the two cases show that the need for supervisory consistency goes beyond legal harmonisation and policy convergence. Consistency is about common *methodologies*, which aim to foster systematic *practices*, that in turn result in comparable *outcomes*, in an attempt to preserve the much sought-after 'level playing field', but at the same time avoiding 'one-size-fits all' approaches that do not take into account specific circumstances. Although these two cases concern different aspects of banking supervision and regulation, it is possible to underline some common features (see Table 5.1 for a comparison between them). The first one is of a procedural nature, and it refers to the processes by which the instruments monitoring both NPLs and IPSs were drafted and subsequently approved. It is true that there is a delicate trade-off between transparency and publicity, on the one hand, and the chance to deeply discuss industry's concerns, on the other (e.g. the EBA does not publish recordings of their public consultations, while the ECB in some cases has). However, the public consultations were held under a particular format that was closer to a press-conference setting, with the usual Q&A, than a space for discussion and exchange of views among the parties.

A second element is more substantial, and relates to *consistency* and *comparability* as key policy objectives that supervisors aim to achieve, and the need to balance these requirements against a wide array of local scenarios and legal frameworks. The third element relates to the level of detail of these instruments, which has raised concerns not only in relation to the competence of the ECB to adopt such instruments, as exemplified by the NPL Addendum case, but also in relation to banks' decisional autonomy. This last element can be related to the operationalisation of the governance dimension that was used in Chapter 4 to assess the changing nature of the tools, which distinguished between *obligation*, *precision*, and *delegation*. The cases examined in this section have shown that one of the main elements that accounts for the 'hardening' of these instrument is not their

obligatory characteristic but, rather, their precision in relation to what the supervisor expect from the credit institutions (even in the presence of non-binding instruments).

The next section analyses the question of prudential regulatory powers from an LSI perspective. As mentioned above, the fact that ECB banking supervision has been characterised by the CJEU as an exclusive supranational competence that is decentrally applied at the national level, this should not, in principle, affect NCAs' regulatory competences. However, enhancing supervisory consistency implies developing and fostering common methodologies, practices, and the achievement of comparable outcomes in the LSI world as well.

	NPLs (Guidance + Addendum)	**IPSs (Guide)**
Aim	• G: **Clarify supervisory expectations** regarding NPLs life cycle in areas where **existing rules are silent or lack specificity** (addressed to banks) • A: supplements Guidance by **specifying supervisory expectations** when assessing banks' levels of **prudential provisions** for NPLs.	Develop a common approach for the recognition of the IPS to ensure **supervisory consistency** given the presence of SIs and LSIs (addressed to JSTs)
Respondents	44 Guidance + 33 Addendum	10
Main industry concerns	• Beyond interpretation and application of existing rules • Application to LSIs? → Proportionality vs. playing level field • Clash with banks' operational and material possibilities • Overlap between SSM's requirements and accounting provisions • "EU average NPL level" as a dividing line between high and low NPL banks: benchmark that does not fully acknowledge diversity • Binding? Legal? • Frontrunning the broader reflection at European level (Commission & EBA)	• Moral hazard: a) Autonomous risk management vs uniformity ; b) member protection against individual assessment • Proportionality & non-homogeneous IPS structures • "Too deep into detail on a level of a single bank, which is a micro-management level": interference with banks' management?
ECB responses	• Continuation of the ongoing measures that are part of Pillar one measures • Transparency towards the market and need to act quickly (clean post crisis balance sheets) • Expectations based on best practices	• Transparency considerations • Some criticisms were differed to the implementation phase; not possible to assess ex ante.
Application to LSIs & Role of NCAs	Not directly applicable, but ECB + NCAs have to formulate similar Guidance for LSI, taking account of proportionality.	"The specifications included in this document will be extended to the supervision of less significant institutions by the NCAs".

Table 5.1: Main characteristics of the NPL and IPS cases from a comparative perspective. Source: Own elaboration.

5.3 Zooming in on LSIs: Less or diversely significant?

The LSI sector has been actively involved in the consultation processes of both NPLs and IPSs. Regarding the former, the main concerns revolved around proportionality issues and how the detailed NPL management procedures were to be implemented in smaller institutions. Concerning the latter, the question of IPS recognition was of the utmost importance, even for those existing IPSs that had already been recognised by their local supervisors. The focus was placed on how supervisors would handle proportionality, in order to preserve the autonomy of different institutions belonging to the same IPS—contrary to the situation of other organisational models, such as banking groups, where single institutions are not autonomous. Although the NPL instruments refer to their applicability to SIs only, there are different channels through which these supervisory tools can be applied to LSIs too. First, the Council's Action Plan to tackle NPLs tasked the ECB in collaboration with the NCAs, with the drafting of a similar instrument adapted to the LSI sector.[316] Second, some of the associations representing the interest of mostly SIs, raised level playing field concerns should those instruments not be applied to LSIs too—chiefly

[316] For instance, Banca d'Italia has published the corresponding document in January 2018 entitled "Linee Guida per le banche Less Significant italiane in materia di gestione di crediti deteriorate", available in English and Italian, which is further analysed below: https://www.bancaditalia.it/compiti/vigilanza/normativa/orientamenti-vigilanza/Linee-Guida-NPL-LSI.pdf

in the Addendum case, which requires a higher level of provisioning, thus incrementing banks' costs.[317]

A third mechanism through which these instruments, conceived for SIs, can also be applied to LSIs, stems from legal and operational aspects of the SSM. Regarding the former, Article 6 (5) (b) of the SSM Regulation allows the ECB to directly exercise its supervisory powers upon LSIs, "when necessary to ensure consistent application of high supervisory standards". This does not mean that the LSI in question can be requested to comply with provisions that are applicable to SIs; however, the intensity and intrusiveness of the supervision would be higher, thus potentially leading to more extensive requirements. Concerning the latter, operational aspects are related to the actual way in which supervision is carried out in the LSI sector: the ECB, together with the NCAs, adopted a methodology that classifies these institutions into low, medium, or high priority, on the basis of their intrinsic riskiness and probable impact on the domestic financial systems (ECB 2017f). Even if the effect of being considered a high priority LSI does not per se imply the application of standards imposed to SIs—as it can trigger proportionality concerns—it nevertheless leads to an intensification of the supervisory activities (ECB 2017f), which might lead to additional information requirements and a more intense supervisory dialogue, similar to what happens under the aforementioned Article 6 (5) (b).

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[317] To illustrate the point, in its submission to the Addendum consultation process, Unicredit expressed that "Concerning the scope of application of the Addendum, only the Significant Institutions under the SSM supervision are required to comply with the Addendum, while the Less Significant Institutions and the banks outside the SSM are excluded, at least until the national supervisors do not decide to adopt similar measures. This would mean that, should the misalignments with the proposed Pillar I measure not be addressed, *SSM's supervised banks will have to adapt their level of provisioning much earlier than banks outside the SSM perimeter*. Moreover, the ECB Addendum is more stringent not only in terms of perimeter but also in terms of calibration of the backstop (seven vs eight years threshold for full provisioning of collateralized exposures and different criteria for collateral treatment) compared to the European Commission proposal. Therefore, *should the two backstops be in place simultaneously in their current form, the burden for SSM significant banks (Pillar I plus Pillar II backstops) would be much higher than for other banks, posing a significant level playing field issue*" (emphasis added).

As far as interest representation is concerned, LSIs act either through their national or European associations. Although LSIs are still under the direct oversight of their respective NCAs, banking regulation has been increasingly shifting from national to supranational spheres, as Chapter 1 has shown. Thus, banks belonging to the LSI sector are aware of the need to diversify their strategies and channels of influence. This is facilitated by the associations that represent interests at the European level, such as theESBG in the case of saving banks, and EACB, for the co-operative sector. For instance, the German savings banks' (*Sparkassen*) association (DSGV), has mobilised to enter the European lobbying channels as a consequence of the growing influence of EU legislation on the national banking system.[318] Their close collaboration with the ESBG[319] provides them with fundamental support at the supranational level, to counterbalance the power wielded by the banking sector's main lobby association at the European level: the European Banking Federation (EBF) (Semenyshyn 2017).[320]

In order to strengthen their mutual interests, the *Sparkassen* establish alliances with other locally-focused credit institutions, such as cooperative banks. An instance that has triggered this reciprocal support is given by the European Deposit Insurance Scheme (EDIS), which was meant to be the third pillar in the completion of the Banking Union. "Cooperative and savings banks fear a double burden of additional costs, as they will need to pay the contributions to their own IPS as well as provide funds to the European deposit insurance fund (DIF) under the … EDIS" (Semenyshyn 2017, 184). This concern highlights the need to balance mutualistic aspects derived from the Banking Union with local specificities. The question is whether there is a connection between the recognition of IPSs,

[318] Another example of the diversification of influence channels is the case of *Federcasse*, who has an additional office in Brussels apart from the one in Rome.
[319] This is confirmed by interviews conducted with DSGV and ESBG.
[320] See Chapter 4 for a detailed analysis of the position of these associations in connection to the SREP and ICAAP cases.

not only in relation to the exemptions provided for in the prudential framework, but also as guarantee schemes, and the firm opposition of the *Sparkassen* to the creation of EDIS, in order to avoid this funds duplication. Far from being merely a technical discussion, this is at the heart of the risk reduction v. risk sharing conundrum that has dominated the narrative about finalising the Banking Union.

In spite of the shift towards the European level in both banking regulation and supervision, the LSI sector cannot overlook the national lobbying channel. In fact, the *Sparkassen* have strong ties to the local governments, thanks to their presence in most of German municipalities, which create an additional channel of influence when it comes to EU rule-making via national authorities (Semenyshyn 2017). In the case of Italian LSIs, most of them belong to the co-operative banking sector (*Banche di Credito Coopearativo*, BCC), represented by *Federcasse*. This sector, however, is undergoing an important transformation by way of the BCC reform, effective as of 1st January 2019, which aims to integrate the sector by forcing individual cooperative banks to merge into two cooperative banking groups (*Gruppi Bancari Cooperativi*: *Iccrea Banca* and *Cassa Centrale Banca*). From a supervisory perspective, there are two key issues. First, given the size of these new cooperative banking groups, they will fall within the scope of the SSM's oversight. Thus, Banca d'Italia ceases to be the supervisor of a large part of the BCC sector. Second, the reform was not without its controversies at both the banking and political level, which initially delayed its entry into force. The fact is that a specific sector, the South Tyrolean *Raiffeisen*, decided not to adhere to these cooperative groups and thus have started the corresponding procedure to create their own IPS.[321]

[321] The reform has foreseen the creation of three groups, being the third *Cassa Centrale Raiffeisen*, which in the end has not been created given the choice for an IPS form. No matter what the organisational arrangement adopted by the banks is, i.e., the cooperative banking group or the IPS form, *Federcasse* continues to act as the common association.

Leaving aside associations and lobbyists' perspectives, the LSI sector has another important channel that should be able to 'translate' or adapt those requirements initially envisaged for SIs, to LSIs. These are the NCAs, whose regulatory powers have been referred to earlier in this chapter. What has not been mentioned yet, is the exercise of such regulatory powers in the context of previous decisions adopted by the SSM for SIs, which have to be applied in a proportionate fashion to LSIs. The conditions under which NCAs operate are not easy: on the one hand, their decisional autonomy and administrative discretion have been curtailed by the SSM's regulatory and supervisory powers; on the other, they have the duty to cooperate, provide the necessary information and assistance to the supranational authorities, and also work in line with the proportionality criterion to implement tools originally foreseen for SIs.

In order to assess the capacity to act as a 'buffer' between the requirements of the supranational supervisor and the situation of local credit institutions, the last part of this section examines the case of the "Guidance on the management of non-performing loans for Italy's 'less significant institutions'", issued by BdI in January 2018, which was meant to adapt the content of the NPL Guidance (the Addendum was not in force by the time BdI's instrument was out, as it was applicable from April 1st, 2018) to the Italian LSIs.[322] The analysis of the content of BdI's Guidance, together with the industry's views on the issue, suggest that proportionality is still the missing holy grail.

First, the document explains that it contains *similar guidance* and highlights that the content "is in line with that published by the SSM, to which banks are invited to refer

[322] In compliance with the Council's Action Plan to tackle NPLs described in the previous section, by means of which the SSM and NCAs were required to adapt the NPL Guidance's content to the LSI sector. The situation of the German NCA will not be considered given that, to the best of my knowledge, there was no Guidance issued to cover the LSI sector. This is to be expected given the low NPL ratio of 1.7 % according to the last stocktake carried out by the European Parliament in October 2018, thus it is unlikely to be a supervisory priority for the German supervisor.

as regards operational details" (Banca d'Italia 2018, 1). The case is that some of these 'operational details' were challenged by the industry in the course of both public consultations related to NPLs (Guidance and Addendum), due to their excessive level of detail, prescriptive character, and the practical difficulties that some of the provisions entail in terms of human and material resources. In this sense, LSIs are asked, for instance, to conduct a quarterly review on the progress made, which is the same frequency imposed on SIs. On this point, ABI has asked to amend this provision, in order to submit these assessments on a bi-annual basis in line with the request made by another Italian SI, Intesa Sanpaolo. In other sections, such as valuation of real estate collateral, the same requirement of an annual update was kept. This requirement has been heavily criticised during the consultation period, but has been kept in the final text. Banca d'Italia was nevertheless aware of proportionality concerns, and thus clarifies in the Guidance that some adaptations have been considered, taking into account the situation of smaller banks. For example, the governance and operational arrangement section does not contain the thorough arrangements that are present in the SSM Guidance, whose content was criticised by banks and associations given the clash with existing practices and the operational difficulties to implement them.

In spite of these organisational exemptions, the industry is concerned about the degree of autonomy and decision-making leverage that BdI has.[323] Even if LSIs continue to be under the direct supervision of NCAs, the SSM's impact is increasingly important and materialises not so much via *supervisory* actions per se, but through interpretative *regulatory* requirements that, once applicable to SIs, have to be transposed to LSIs. NCAs end up in a Catch-22 situation, given that they have to adapt these requirements to LSIs but, if some requirements are eased, SIs or the SSM itself, could raise level playing field

[323] Conclusions mostly drawn from interviews with Federcasse and the LSI sector.

concerns. Therefore, the simplest way out is to maintain the same requirements by referring to the original text or apply a cosmetic proportionality.

The inadequate room for manoeuvre in the adaptation of supervisory instruments is thus reflected in the way supervision is exercised over LSIs. A factor that can help explain this deficit is the role played by the DGMS III, which is in charge of overseeing LSIs' supervision. Since the primary responsibility for LSI supervision is held by the NCAs, cooperation between national and supranational authorities is critical within DG MS III. During the first years of the SSM's operations, this DG has been apparently more "silent", compared to the ostensible work carried out by DG MS I and II, in charge of supervising SIs, and DG MS IV, which was considerably active in developing common standards and fostering a horizontal view. In fact, the first comprehensive document from DG MS III was the "LSI supervision within the SSM", issued in November 2017 (ECB 2017f). This delay can be explained in light of the more ambiguous role played by DG MS III in the early days of the SSM, when the situation of SIs was clear, but not so much that of LSIs. An important element that reinforced the role of this DG was the *L-Bank* case since, in the CJEU's view, the supervision conducted by the NCAs in relation to LSIs is the decentralised implementation of exclusive powers in the hands of the ECB, therefore emphasising the centralised features of the mechanism.

Since the ECB has to "exercise oversight over the functioning of the system",[324] the need to achieve supervisory consistency arises again, this time between SI and LSI supervision. Therefore, DG MS III needed to strengthen its dialogue with the NCAs and also with the relevant divisions of DG MS IV in order to develop standards for LSIs, following analogous methodologies as those used for SIs. In spite of these changes, the

[324] Article 6 (5)(c) of the SSM Regulation.

industry has stressed the lack of concrete output or activities from DG MS III's side.[325] Interviewees indicated that one of the biggest problems for smaller credit institutions is the lack of clear proportionality criteria, a problem that is strengthened by the lack of specific guidance from DG MS III. Interviewees from the LSI sector also mentioned the weak cooperation between this DG and the local supervisors, which leads to a limited discussion in order to better adapt these instruments from SIs to LSIs. These factors concerning the SSM's internal dynamics, shed light on some of the problems faced by the NCAs when regulating and subsequently supervising LSIs.

To conclude, this section has shown the LSI situation in relation to both interest representation and adaptation of SSM rules. Regarding the former, LSIs need to swiftly move between the national and supranational levels in order to channel their interests and main concerns. Concerning the latter, when it comes to SSM rules that are not meant to be directly applicable to them, LSIs need to be ready to make their positions clear, given that sooner or later those tools will have an impact on them. However, adaptation of the instruments and the quest for proportionality are not straightforwardly achieved for the following reasons. First, a proportional approach does not mean less stringent rules, i.e. differentiating between SIs and LSIs does not entail that the latter are to be regulated in a less stringent manner. Therefore, a "lazy" approach focused on reducing or removing some rules is not appropriate to tackle the problem. Second, NCAs that aim to create a more proportionate regulatory space for LSI are likely to face resistance from SIs, which claim that such approach can alter the level playing field, given the risk of differential rules over SSM countries. Proportionality, therefore, is meant to be achieved via the application of these rules, i.e. through the exercise of supervision. However, supranationalisation of banking supervision means that the SSM is the ultimate responsible for the whole Banking

[325] An interviewee from a bank association expressed that "they have been sleeping for years".

Union, not just SIs. Therefore, NCAs no longer enjoy the same level of autonomy even in relation to LSIs supervision, which is also mirrored by the reasoning followed by the CJEU in the above-cited *L-Bank* case, by characterising the supervisory exercise of the NCAs as a "decentralized implementation" of the original powers held by ECB.

5.4 Balancing the exercise of prudential regulatory powers: Legitimacy of supervisory instruments and institutional overlaps

After having analysed the conceptual, operational, and LSI perspective on the supranational supervisor's regulatory powers, this final sections offers a comprehensive outlook by focusing on two fundamental issues. The first one concerns the characterisation of the regulatory instruments available for banking supervision, and a critical appraisal of latent legitimacy issue that these tools can trigger. The aim is to move beyond the hard vs. soft law dichotomy, since it does not echo the underlying tensions of the prudential realm. The second question relates to the functional overlaps between ECB prudential regulatory powers and the EBA, which mirrors the different institutional paths followed by these two authorities.

5.4.1 Beyond the hard vs. soft law dichotomy of supervisory instruments

While Section 5.2 has examined the dynamics of the regulatory processes that resulted in the adoption of specific tools, the focus is here placed on the bigger picture. The aim of this subsection is twofold: first, it classifies the instruments drawing upon a typology developed by the ECB, but it does so from an epistemological perspective, i.e., the tools are arranged along a continuum that describes how knowledge is derived for each of them.[326] The

[326] Figure 5.2 below does not limit its graphical analysis to the instruments mentioned in the ECB taxonomy document (2019b). For instance, in order to have a richer spectrum of the sources, Article 127 (6) TFEU is incorporated, given that it is the ultimate legal basis for the SSM.

vertical axis moves from *abstract* to *concrete*, implying that some instruments are based on concrete prior experience, while others are not. The horizontal axis ranges from *general* to *specific*, in the sense that some tools apply to the whole sector/all cases, while others have effects upon a particular case only. The second aim of the section is to use these epistemological insights to go beyond the hard and soft law dichotomy and link these considerations to the legitimacy of these tools.

This analysis is inspired by the work carried out by Larouche (2000) in the competition law domain, where he develops a model for the legitimacy in this field of law based on the analysis of its sources and epistemology.[327] Although the aim of this section is more limited than his proposed analytical framework, the similarities between competition law and banking supervision highlight interesting points that are worth examining. As a matter of fact, when analysing the nature of competition law, Larouche (2000) concludes that this is a domain characterised by a case-bound approach, given that each case entails the definition of a relevant market in which specific circumstances have to be appraised. Banking supervision has a similar feature, given its "bank-bound" characteristic. In fact, the aim of the whole SREP analysis is to assess the financial health of a single institution, and consequently apply additional capital requirements based on the specific risk profile of that institution.

Larouche (2000) explains that legitimacy of individual decisions in light of the case-bound nature of competition law is of an *adjudicative* nature, considering the procedural guarantees that the authorities need to comply with, chiefly the duty to give reasons and the

[327] In developing this legitimacy model, he analyses the main sources of competition law at the time (his work was done before the enactment of Regulation 1/2003, which changed the enforcement system of competition law). His analysis draws on the following sources: basic principles from the Merger Control Regulation (MCR), substantive MRC and procedural notices, sector specific regulation (including the 1991 Guidelines, Cross-border Transfer Notice, Postal Sector Notice, 1998 Access Notice), Block exemptions and Individual decisions (either form the Commission, the ECJ, or national court or authorities) (Larouche 2000, 118).

possibility of judicial review.[328] This is so because in the competition law field the gap between principles and individual decisions was much more apparent that in the banking supervision case. In fact, prudential regulation is a field in which principles or abstract considerations have been subsequently regulated through different tools. Yet, adjudicative legitimacy and procedural guarantees are useful instruments to examine the ECB's action in the supervisory realm. The other type of legitimacy identified in Larouche's work is the *legislative* one; however, this is of limited explanatory value in the case of the ECB, given that, although it has "some regulatory powers to fulfil its supervisory tasks, [but] it can only exercise them within the scope granted to it by the legislator" (ECB 2019b, 11).

Larouche notes that the Commission has also issued other instruments that deal with the application of competition law in a specific economic sector. These documents are different from the case-bound decisions and thus raise "new issues concerning epistemology and legitimacy", given that, in spite of being soft law instruments, "it cannot be denied that they are meant to influence the application and interpretation of competition law in individual cases" (Larouche 2000, 127/128). Even if the Commission has conducted wide public consultations, "these cannot replace the experience gained through processing concrete cases, where standards of *evidence-gathering*, *assessment* and *reasoning* must be respected" (Larouche 2000, 128, emphasis added). In conclusion, Larouche (2000, 128) considers that "the Commission was moved by the worthy intention of providing a measure of legal certainty to market players", yet, what was gained in certainty was lost in freedom to depart from the preestablished courses of action if the circumstances of the case require so—the latter happens because the institution binds its own discretion through the issuance of soft law.

[328] "Adjudicative decision-making counter-balances the broad room for decision, providing a form of restraint in that the decision-maker is bound to the case." (Larouche 2000, 122).

The similarities between these non-binding tools adopted by the Commission and the non-binding ones issued by the ECB, whose aim is to provide transparency to market players by defining supervisory expectation, are apparent. The case-bound approach and the adjudicative legitimacy nature of both the competition law and supervisory domains, are examples of these commonalities. The analysis below examines each of these binding and non-binding tools and discusses potential legitimacy issues.

In September 2019, the ECB published a taxonomy of ECB instruments,[329] in order to classify the set of tools for ECB banking supervision. The ECB's publication provides a thorough list of binding and non-binding tools, identifies addressees and provides concrete examples of each of these documents. However, some critical points emerge from the taxonomy and its description. First, the document acknowledges the difficulties in distinguishing some types of documents from others, and the *sui generis* nature of some of them, meaning that even when they are classified as one specific type, the document can in fact fulfil other policy purposes. For instance, the SSM thematic review on profitability, albeit labelled as a "Report", also contains supervisory expectations. Most importantly, the ECB has explicitly acknowledged that "the distinction between legally binding acts containing prudential requirements, on the one hand, and non-binding legal acts and documents, on the other, needs to be carefully applied by the ECB when adopting legal acts or when publishing policy documents." (ECB 2019b, 10). It also recognises that there is a

> Very fine line between *adopting rules of general application*, on the one hand, and *providing transparency on the consistent application* of relevant Union law and equal treatment [therefore] . . . the ECB must *make adequate efforts to be clear on the non-binding nature* of its stances in this respect. (ECB 2019b, 11, emphasis added)

[329] Bax, Rinke, and Andreas Witte. 2019. "The taxonomy of ECB instruments available for banking supervision". *ECB Economic Bulletin*, Issue 6/2019.

This becomes even more difficult in the context of financial markets and their reactions to ECB's communication, since market players do not distinguish between what is legally binding and what it is not. In fact, when the ECB sets its supervisory expectations via non-binding tools, the effects on its supervisees is tantamount to the adoption of a binding document, since credit institutions are aware of the consequences of not meeting said expectations.

The acknowledgement of the "very fine line" between rules of general application and the provision of transparency for the sake of consistency is of particular relevance in the context of this work, given the centrality given to supervisory consistency. In fact, according to the taxonomy document, the attainment of consistency is linked to the publication of "Policy documents", which is a wide category comprising policy stances, Guidances, joint supervisory standards, methodologies, Guides or Letters: "these policy documents are to be distinguished from non-binding ECB legal acts, such as recommendations." (ECB 2019b, 9). The taxonomy of ECB instruments available for banking supervision groups them according to two fundamental categories: binding and non-binding.

A) *Binding*

1. **Regulations**: general and directly applicable.
2. **Decisions**: binding legal effects, but applied to specific objects.
   - Decision *with* addressee: binding only on the specified addressees (imposing supervisory measures for instance). Figure 5.2 below includes one example of this tool, given its analytical relevance in the course of Chapter 4: the SREP decision.
   - Decisions *without* addressee: binding but do not affect the legal situation of a party. They are used to establish organisational arrangements.
3. **Instructions and Guidelines**: they are not legal acts,[330] but are legally binding instruments for the NCAs.
   - Case-specific instructions: command NCAs to take action regarding an individual case (SIs).

[330] This is so because guidelines and instructions "are not included in the catalogue of legal acts defined in Article 132 (1) of the TFEU and Article 34.1 of the Statute of the ESCB" (ECB 2019b, 5).

- General instructions: related to a subject rather than a case, to be applied in all future related cases (LSIs).
- Guidelines: addressed to all NCAs (while instructions are addressed to one NCA only), of a general nature and binding on the addressees, prescribe in an abstract way what is expected from the performance. They are not addressed to credit institutions; therefore they are only binding upon NCAs. The ECB adds that national law should also be applied "in a manner which gives the best possible effect to the guidelines" (ECB 2019b, 7), in a clear reference to the '*effet utile*' doctrine.[331]

B) *Non-binding*: the main purpose is to provide transparency to the credit institutions and the public. Interestingly, "while not imposing any obligations on third parties, [they] do bind the ECB and therefore create legitimate expectations as to how European banking supervision will perform its supervisory tasks" (ECB 2019b, 8).

1. **ECB Recommendations**: legal acts without binding effect.
   - Recommendations I: are used to recommend legislative procedures at the Union level.
   - Recommendations II: are used to recommend actions to be taken either by credit institutions or NCAs. For instance, the ECB has issued a recommendation in 2017 addressed to all NCAs on common specifications for the exercise of options and national discretions (ONDs) in relation to LSIs (this tool is meant to be soft law, but in practice its nature is not so clear).
2. **Supervisory disclosure obligations**: the most relevant example is the disclosure of the SREP Methodology, both for SIs and LSIs.
3. **Policy documents**: "are not legal acts and are not legally binding on third parties, [issued] with the purpose of clarifying supervisory practices and expectations and ensuring the consistent application and equal treatment of supervisory entities" (ECB 2019b, 9). They come under different names: "policy stance", "guidance", "joint supervisory standard", "methodology", "Guide", or "letter". The "Addendum" may be considered as part of these tools, too, although it is not mentioned. The authors classify these instruments into three main categories:
   - Guides (and Guidances): "typically aim to ensure consistency between and equal treatment of significant credit institutions" (ECB 2019b, 9). These tools cannot impose new obligations or requirements on credit institutions. The document points out that after the initial phase of the SSM, it is to be expected that most of the interactions between the ECB and the institutions (and the broader public too), will come under the form of "Guide" and "Guidance". This point is further discussed in the analysis below.

[331] The allusion can be understood as follows: "In the same way that the national judiciary—in line with the so-called *effet utile* doctrine—should rely on interpretations that best guarantee the practical effects of EU law, the ECB is expected to opt for an application of national legislation that maximises the level playing field within the SSM and fosters harmonisation. From this perspective, it is clear that *national law cannot be applied in a way that would undermine the effectiveness and the uniformity of EU law or serve as a tool for protectionist purposes*" (Senkovic 2015, 100, emphasis added).

- Reports: their aim is to inform the public of the supervisory activities performed by the ECB. These are also the result of the horizontal analysis and exercises referred to in Chapter 4.
- Letters to CEOs: addressed to all credit institutions and containing general, non-confidential information. Their aim is also to provide transparency to the public on the existing activities.
- Some of the documents produced by the ECB do not perfectly fit within these categories. This is the case of the SSM thematic review on profitability, which, albeit being labelled as a "report", also contains supervisory expectations (referred to as "reports 2.0").[332]

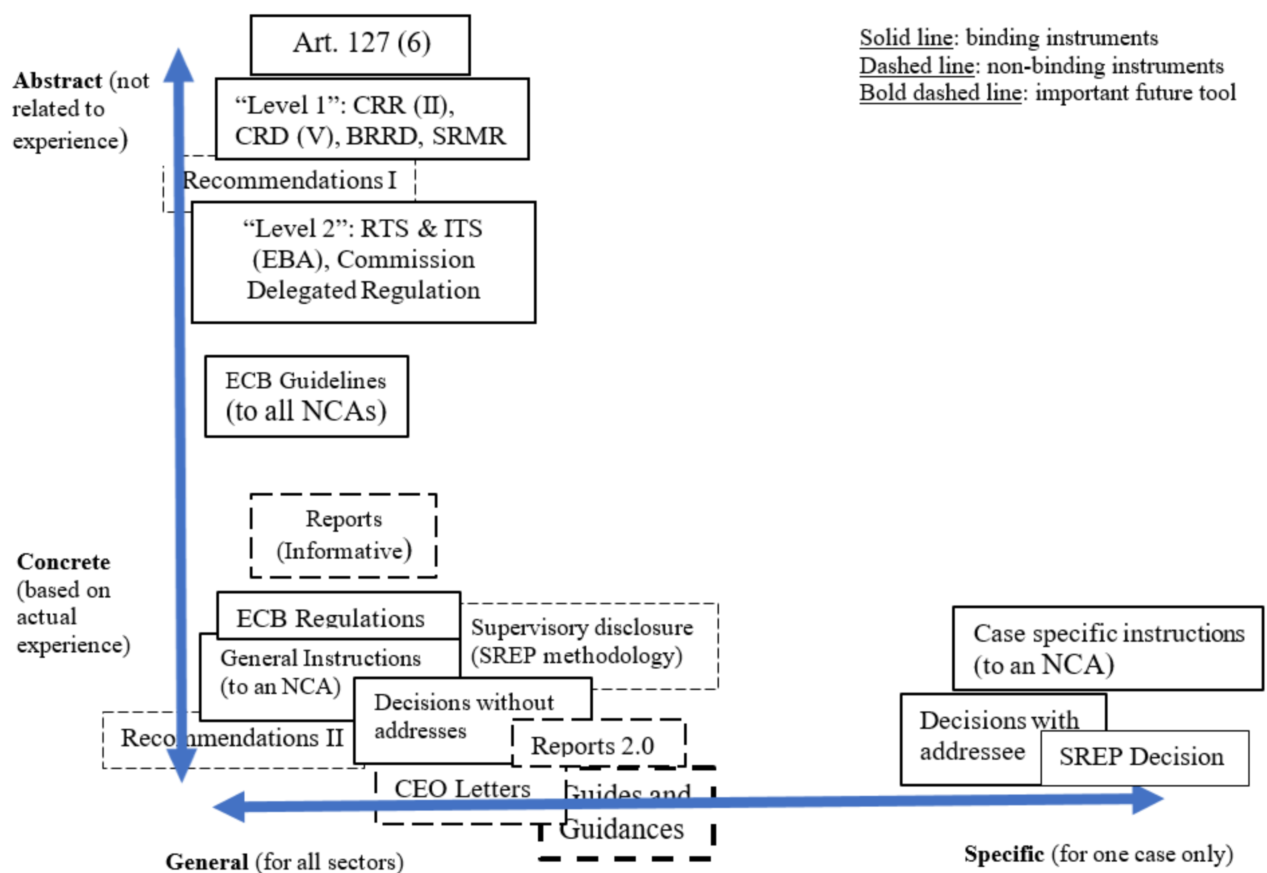

Figure 5.2: ECB banking supervision instruments and main prudential regulation sources along the abstract-concrete, and general-specific dimensions. Source: own elaboration, inspired by Larouche (2000, 118).

Figure 5.2 provides a graphical representation of the instruments listed above, and adds others such as article 127 (6) TFEU, which is the legal basis that has been used to set

[332] The Supervisory Manual anticipated the point by explaining that "aggregated outcomes of thematic reviews may also be communicated to the industry by issuing SSM expectations" (ECB 2018a, 79).

up the SSM, and the so-called "Level 1" and "Level 2" instruments adopted by EU regulators, according to the Lamfalussy architecture. As mentioned earlier, the vertical axis "concerns the degree to which the source in question draws from concrete experience", while the horizontal axis "denotes how broad or narrow the scope of application of a given source is" (Larouche 2000, 118). Drawing upon Larouche's discussion on the legitimacy of the case-bound decisions and the more generally applicable soft law tools adopted by the Commission, this final part focuses on the interaction between legitimacy and consistency in the case of the ECB banking supervision tools. The underlying assumption is that greater supervisory consistency is contingent on the proliferation of non-legally binding policy documents,[333] while sources of legitimacy have either a legislative or an adjudicative nature. In the case of non-legally binding policy documents ("Guidance", "Guide", "Letter", etc.), the taxonomy does not clearly explain how the ECB deals with the "very fine line" between adopting general rules, and providing transparency on how Union law is consistently applied (ECB 2019b, 11).

The distinction between binding and non-binding tools, albeit useful from a conceptual perspective, is not of substantial explanatory value in order to address supervisory consistency issues. As noted above, the instruments that are used to clarify supervisory practices, expectations, and ensure a consistent application and equal treatment are for the most part non-binding *policy documents*. The ECB has been clear about an expected increase in the use of Guides and Guidance as key policy tools to interact with credit institutions and the public. The question here is the extent to which these non-binding instruments can be used in order to clarify expectations and practices to be undertaken by the supervisor. The empirical chapters have shown that Guides can be comprehensive

[333] This issue is explicitly acknowledged in the ECB's bulletin article (2019b, 9) when pointing out that "it may be expected that, with the initial phase of the SSM behind it, future ECB publications on its supervisory policies would increasingly be labelled with names such as "Guides" or "Guidance".

documents containing precise descriptions of both means and ends. This characteristic, combined with the operational and adjudicative capacity in the hands of the ECB, accounts for a "hardening" of the tool itself, albeit labelled as a non-binding one.

In fact, the ECB is well aware of this very thin line: "since case-law . . . has made it clear that acts with legal effects are subject to actions for annulment and may imply *liability* on the part of the ECB, *irrespective of how they are titled*" (ECB 2019b, 10, emphasis added), the supervisor has to make sure that these tools are *not* regarded as legally binding by any interested party. The question of ensuring a non-binding perception by supervisees,[334] however, is challenging—if not implausible—for at least two reasons. First, "while not imposing any obligations on third parties, [the non-binding documents] *do bind* the ECB and therefore create legitimate expectations as to how European banking supervision will perform its supervisory tasks" (ECB 2019b, 8, emphasis added). Second, and closely related to the first point, the consequences of not meeting certain expectations can lead to the imposition of case-specific measures from the supervisor, reflected in the SREP decision. Hence, if the ECB is bound by the content of a (non-binding) document describing the way in which supervision is to be conducted, then it is not clear how an interested party will not deem it binding, too. This shows that, in spite of being framed as a matter of *perception*, the underlying issues here are the *efficacy* and *effectiveness* of these tools, since they manage to steer behaviour and therefore can produce the desired effect on the supervised entities. The proposed distinction by the ECB's taxonomy between binding and non-binding tools, and the inclusion of Guides and Guidances within the latter category, is to some extent elusive. In fact, the non-binding nature of these policy

[334] "The ECB shall ensure that such instruments are not perceived as having any binding effect on third parties" (ECB 2019b, 8).

documents is based on the feeble assumption that the supervisor has to make sure that these "are not perceived as having any binding effect on third parties" (ECB 2019b, 8).

Given the complexity of the supervisory policy domain, it is useful to distinguish two dimensions of the hard vs soft law dichotomy. A first *procedural* dimension focuses on the *decision-making* activities carried out by the supervisor and the legal effects that these decisions have on individual credit institutions. Under this first dimension, supervisors abide by due process requirements, and therefore references to soft law tools are made to support and interpret pre-existing hard law tools. Soft law tools by themselves are neither adequate nor sufficient to impose legal duties on specific entities; otherwise, supervisory authorities could be challenged through administrative and legal means.

A second *substantive* dimension refers to *policy-making* activities developed within the supervisory governance architecture. Under this broad label, it is possible to include those activities in which supervisory policies are discussed and defined, usually with the participation of NCAs and other relevant stakeholders. Examples of these are the public consultations such as those analysed in this and the preceding chapter, or more informal exchange structures, such as expert networks. These policy-making activities are also meant to communicate supervisory expectations and provide transparency to the wider public—they do not concern the relationship with specific credit institutions, which are considered under the decision-making dimension.

It is under this second 'substantive' dimension that the differences between hard and soft law are more blurred, compared to the procedural one. This is so because of the practical unfeasibility of distinguishing between regulation and supervision. In fact, the institutional and regulatory evolution analysed in Chapter 1, and the insights on the regulatory powers held by national supervisory authorities at the beginning of this chapter, underline the policy mix that prevails in the prudential field. First, at the international level,

central bankers have been exchanging practices and developing common understandings since at least late 1970s. Let us remember in this sense Kapstein's words (1992, 274), according to which central bankers "have not always been able to wait for an academic consensus to develop before they launched regulatory initiatives". Second, the distinction between regulation and supervision was institutionally crystallised at the EU level only in 2011 with the creation of the ESAs and the establishment of the EBA as a regulatory body (even as a Lamfalussy Level 3 Committee, the CEBS was too weak to be deemed a supranational regulator). At the national level, the clear cut distinction between regulation and supervision was not an accurate representation of local practices. Finally, the empirical analysis carried out in this work shows that the inevitable institutional and domain overlaps between the EBA and the SSM, and how under certain circumstances the former was outpaced by the latter.

The analysis provided in this subsection highlights the supervisory consistency challenge in light of legitimacy concerns. If we go back to the distinction between adjudicative and legislative legitimacy (Larouche 2000), it is clear that the ECB possesses the former but not the latter.[335] The taxonomy document acknowledges how difficult it is for the supervisor to actually put this distinction in practice.[336] Supervisory consistency, therefore, embodies a legitimacy challenge, given that the case-bound approach—comprised in the adjudicative legitimacy—inevitably has to be supplemented by the disclosure of documents; although they "are not legal acts" (ECB 2019b, 11), these documents clearly set the tone for supervisory practices and expectations, which makes it highly likely that addresses will deem them binding. The overlapping non-binding

[335] At least in the broader sense of what legislative legitimacy entails.
[336] The document does not use the legitimacy terminology though.

documents included in the lower left (and mid) corner of Figure 5.2, depict the supervisory tools that in fact play an informative, clarificatory, and quasi-regulatory role.

This subsection has put forth the difficulties that supervisors face not only in performing a consistent supervision, but also in justifying it. The key tension is not so much between hard vs. soft law but, rather, the fine line between rule-making on the one hand, and rule implementation and interpretation, on the other, which takes us again to the dichotomy between legitimacy and consistency. In the end, it is both the experience gained through implementation and the technocratic work carried out by the horizontal divisions of the SSM that provide the supervisory rationale for the adoption of non-case-bound tools, through which moral suasion acts upon interested parties. The ultimate aim is to render these vast set of non-legally binding (and non-legal acts) supervisory instruments effective.

The following subsection explores the delicate balance between institutions whose functions overlap.

5.4.2 Managing institutional overlap

The chapter has earlier referred to the coexistence between the SSM and the EBA as part of the post-crisis institutional arrangements, the former being in charge of the oversight of credit institutions, and the latter of the provision of a single and harmonised set of rules. What the preceding sections have highlighted, however, is that this distinction of competences clashes with current institutional practice.

The analyses of the cases in the previous sections, especially those concerning the NPL situation, have pointed to the complex relationship between the SSM and the EBA. The former has insisted, for example, during the public hearings in which the Guidance and the Addendum were discussed, that it worked in close cooperation with the latter, and that

there was a fluid dialogue between them. Cooperation and *coordination* are key issues, given the complexity, the overlaps, and sometimes the loopholes as well, that characterise banking regulation. In spite of these institutional efforts, the cases hint at two circumstances that can lead to a bumpier relationship between the two. First, the institutional aims pursued by the SSM and the EBA are different. Even if their tasks are aligned—since both acknowledge the importance of the Single Rulebook and the much sought-after rule harmonisation and convergence of supervisory practices—their respective mandates and scope of action are different. The EBA works at the EU-level, while the SSM focuses on Banking Union consistency; the EBA proposes and assesses common methodologies, and fosters convergence of supervisory practices, but does not bear institutional responsibility for the achievement of consistent outcomes across member States. These differences can trigger dissimilar policy incentives. The achievement of supervisory consistency—which operates at the methodological, practice, and outcome levels, as seen in Chapters 2 and 4—is different from the *ex-ante* harmonisation or *ex post* assessment of supervisory convergence, two of the tasks performed by the EBA. The "black box" between the issuance of harmonised standards and the subsequent assessment of how those were put into practice in different jurisdictions, is what the SSM does through the attainment of supervisory consistency.

These different incentives for consistency in the application of rules lead to a second element that indicates another cleavage between the SSM and the EBA: time. In fact, the analysis of the public hearing recordings of the NPL cases suggests that the SSM "cannot wait" for other EU institutions to react. This was explicitly said in the analysed hearings and confirmed during interviews with ECB officials.[337] However, it is important to

[337] One ECB legal counsel expressed that it was not possible "to wait till the EBA or the legislator comes up with the instruments".

understand why this has been the case. It does not seem a plausible explanation to simply claim that the ECB has overridden its institutional mandate, disregarding the EBA's role and the Council's Action Plan which have foreseen a series of coordinated actions among different EU institutions. The need to act was fuelled by SSM's practical concerns, not only due to the disparity of NPL ratio levels across Banking Union countries, but also given the legal and institutional differences in treatment among them.

This first-mover approach made the ECB a *de facto* regulator; indeed, the Council's NPL Action Plan indicates that the EBA should "issue, by summer 2018, general guidelines on NPL management, consistent with the aforementioned Guidance, with an extended scope applying to all banks in the entire EU" (Council of the European Union 2017a, 4). This means that the EBA was mandated to adapt its regulatory instruments to what had been done by the ECB in advance, which seems a sensible decision considering that SSM banks were already undergoing the necessary organisational and operational adjustments in order to comply with the Guidance. However, the inversion of the regular institutional order that took place in this case—ECB instruments coming first, followed by the Council's Action Plan and finally the intervention of the EBA—can be avoided in the future by prompting quicker action by the regulator, or by fostering a better dialogue between the SSM and the EBA, to avoid transforming the exception into a rule.

This episode exemplifies the complexities arising from both institutional and regulatory overlaps. It also illustrates the difficulties to balance and maintain institutional boundaries against urgent practical needs. Finally, the EBA-SSM relationship epitomises the difficulties in drawing clear cut lines between the exercise of regulatory and supervisory competences, and thus in keeping the distinction between rule formation and rule application in the supervisory domain.

Conclusions

The chapter has examined the regulatory powers granted to the ECB in the supervisory realm from both an empirical, policy-making perspective, and a broader conceptual one. The aim has been to move from a static analysis focused on institutional design, to one that examines the "operational management of divergence and friction in standard implementation, the coordination of supervisory approaches, and mutual regulatory and supervisory learning" (Moloney 2017, 139).

The ways in which the SSM has been deploying its supervisory competences, shares some features with post-crisis 'new' economic governance at the EU level described in the introductory chapter. First, the question of 'revisability', one of the characteristic emphasised by the experimentalist literature: this feature entails the possibility of regularly update the content of the tools in question (for the most part, non-binding policy instruments) based on local experiences arising from their implementation. Revisability epitomises the fluctuation and fuzzy lines between supervision and regulation: this characteristic alludes to the 'feedback loop' mentioned by Enria (2019a) in the speech quoted at the beginning of this chapter. Second, the use of "malleable notions" (Chalmers 2016), which refers to the adoption of an ample set of tools which do not correspond to specific legal forms, and whose consequences in case of breach are not fully clear. Figure 5.2 above mirrors this vast set of regulatory choices.

The chapter might have fallen short of providing a more accurate and richer picture of the multiple feedback effects between actors and the regulatory tools. However, in spite of the limitations, it has shed light on these complex policy processes, with a view to better understand how consistency and diversity are balanced by the supranational supervisor. In doing so, it has identified two areas that can potentially compromise the system. First, the achievement of consistency and comparability across institutions can backfire if NCAs are

not given a proper level of decisional autonomy, especially in the case of LSIs. Second, the strengthening of consistency through a growing number of non-binding policy documents, has to be balanced against the sources of legitimacy of said instruments, especially due to the existence of a ‘very fine line’ between rules of general application, and non-legal supervisory tools that are geared towards providing transparency to the market.

Having completed the conceptual and the empirical analysis of the dissertation, the following chapter concludes the work.

CHAPTER 6

Conclusion

This final chapter aims to wrap up and link the analytical observations and empirical findings discussed throughout the dissertation. By putting the different pieces together, this conclusion is geared towards answering the overarching *so what* question, in order to "identify what is it that makes the whole greater than the sum of the parts".[338] In order to achieve these aims, the conclusion is organised as follows. The first section goes back to the research aims and questions outlined in the introductory chapter, and recapitulates the explanations given along the empirical chapters. The aim is to make the connection between the overall aims of the research and the proposed answers more explicit. The second section discusses the question of *generalisability* in the context of both qualitative research in general, and in relation to this work in particular. The second section, furthermore, aims to distil the literature and more practical, policy-oriented implications of the research. The third section discusses the limitations of the study, and offers some reflections about the research process. The final part of the third section raises new questions and explores future research directions.

6.1 Back to basics

6.1.1 Underlying problems, research aims, and research questions: A quick recap

[338] Aitchinson, Claire. 2016. "How to make a great conclusion." Blogpost, *DoctoralWriting* SIG, 11 July. https://doctoralwriting.wordpress.com/2016/07/11/how-to-make-a-great-conclusion/ (last accessed 27 December 2019).

Before exploring the findings and broader implications of this work, it is worth making a step back in order to summarise the fundamental problem addressed by the research. A substantial part of the introductory chapter is devoted to the institutional and legal evolution in the field of prudential regulation, and it shows the interdependencies between the international, European, and national levels in financial governance. The evolutionary approach presented in Chapter 1 exposes the intricacies between European integration and the internal market-building project. The interaction between these two enterprises has been systematically addressed for the first time in the ambitious "Completing the Internal Market" 1985 White Paper, which resorted to a wide set of measures in order to foster the establishment of the single market and remove physical, technical, and fiscal barriers between member States. In the financial services domain, liberalisation and the "free circulation of 'financial products'", together with "a minimal coordination of rules" (Commission 1985, 27), was meant to provide a desirable level of harmonisation in order to enhance financial integration.

It is unnecessary to explore once again the way in which the regulatory and institutional milieu have unfolded since then. What has to be emphasised is how the minimum harmonisation approach was slowly turned into a maximum harmonisation one, and how prudential supervision went from national to supranational implementation, at least for a substantial part of the banking industry. The efforts to ensure a 'level playing field' among national prudential frameworks have been intensified, both discursively and practically. In spite of the early epistemic consensus, it has been claimed since Basel I times that "level playing fields can be never achieved by a worldwide agreement that all banks will be subject to the same capital adequacy supervision" (Norton 1991, 116). Norton (1991, 117) believes that the whole idea of "competitive equality is a chimera", hard to conceive and even harder to achieve in practice, as it is not clear who is the addressee of

the competitive equality considerations. In fact, by highlighting the importance of achieving a level playing field, supervisors accentuate the competitive side of prudential regulation, which has to be balanced against a financial-stability aim.

As explained in the introductory chapter, the global financial crisis and the fiscal and sovereign debt crises in the EU, have dramatically impacted upon both the regulatory and institutional architecture of supervisory governance. The harmonisation logic has been strengthened in the post-crisis context, fuelled by two major concerns: financial fragmentation along national lines (or financial 'Balkanisation'), and the adverse feedback loops between sovereigns and banks. In 2009, the European Council coined the term "Single Rulebook" to refer to a "unified regulatory framework for the EU financial sector that would complete the single market in financial services".[339] The aim of these consolidated rules is to guarantee a uniform application of the Basel III framework—and subsequent amendments—across member States. Within this "multi-tiered structure of legal sources", authorities have asserted that "differentiated national practices for the implementation and application of the common rules" threaten the existence of the Single Rulebook, and thus "options and discretions should be limited in the regulatory field and governed at the EU level" (Enria 2015, 5). In the same speech, Enria (2015, 11), the current chair of the SSM's Supervisory Board, stated that in his experience,

> Regulatory harmonisation is a 'black or white' concept: either you have it or you don't. If we really want to re-establish a well-functioning Single Market we need to go all the way to a true Single Rulebook.

A binary understanding of harmonisation, albeit conceivable from a strictly legal perspective, overlooks the fact that it will be the implementation of these uniform rules in diversified contexts, and the practices developed 'on the go', that determine the

[339] See the EBA's Single Rulebook explanatory website: https://eba.europa.eu/regulation-and-policy/single-rulebook

effectiveness of a corpus of harmonised legislation. There is indeed an ample literature by EU scholars that criticises these sweeping harmonisation assumptions (Legrand 1996, Teubner 1998, Scharpf 2010; Joerges 2007, 2012; Everson and Joerges 2012; Ladeur 2014, among other scholars cited in Chapters 1, 2, and 3), highlighting the tensions between supranational law and the historical evolution of local rules and practices:

> In the face of *normatively salient diversity across national institutions* or policy legacies, no general rule could establish a fair vertical balance. It is, thus, entirely understandable that the Court never tried to define general criteria for a European-national balance. (Scharpf 2010, 241, emphasis added)

The relevance of this passage lies in the fact that diversity management and the tensions between national and supranational interests can be hardly dealt with at an abstract legal level, by predefined standards. The experimentalist literature referred to in Chapter 2 aims to make sense of these tensions, not by contraposing the national and supranational institutional layers, but, instead, by focusing on the cyclicality between the centralised definition of goals and frameworks, and the discretionary and decentralised implementation. However, the implementation of a supranational framework for banking supervision creates a tension between, on the one hand, the need to consider the ample variety of credit institutions under the ECB oversight—and also those that are indirectly supervised by the ECB—and, on the other, the achievement of *supervisory consistency* in order to reduce (unnecessary) differences between member States and account for the existence of a supranational supervisor. Given the particular operational characteristics of the SSM that have been exposed in the empirical chapters and are recapped in the next subsection, a fully-fledged experimentalist cycle might not be applicable to the case.

In light of these considerations, the research problem that has been addressed throughout the dissertation relates to diversity management within the SSM, in a post-crisis context in which it became apparent that rule harmonisation, cooperation, and

exchange of information among home and host supervisors was not enough. The quest for supervisory consistency has become central to the development of this work, as it was a rupture from previous supervisory aims, focused on the national level. Although the level playing field issue has been roaming around since at least the endorsement of the 1988 Basel I Accord, it was not until the supranationalisation of banking supervision that it started being taken seriously. From a policy perspective, the EBA "Reports on the convergence of supervisory practices" (2015-2019), have consistently highlighted the challenges inherent in the development of common supervisory practices, mostly derived from the different approaches adopted by local authorities, in spite of having (relatively) harmonised legal frameworks. From a conceptual standpoint, while the literature on harmonisation, policy convergence, isomorphism, and policy and norm diffusion is a useful starting point, it does not provide clear ways of operationalising or simply understanding the characteristics of supervisory consistency. Hence, the research purposes have been confined to the exploration and description of the phenomena. While these purposes do not preclude the identification of plausible relationships that shape the phenomenon under analysis, they are not geared towards specific causal claims. In relation to this point, it has been claimed that "it is better to have a solid 'what' question that describes a social phenomenon for which little is known and which serves as prerequisite for explanation and or inference" (Paré 2019, slide 28, citing King et al. 1994).

The research questions addressed in this work are therefore the result of an in-depth literature analysis, complemented by an inductively derived understanding of the challenges faced by the implementation of supranational banking supervision. In this contexts, the questions explored throughout the dissertation have concerned: (i) the supervisory and regulatory tools used by the SSM in order to achieve supervisory consistency; and (ii) the ways in which the balance between supervisory consistency and

diversity at the banking and national levels, is managed by the SSM. The following subsection offers a unified picture of the plausible answers that have been examined in different parts of the work.

6.1.2 Tying things up: Matching questions to answers

After providing a refresher of the essential questions addressed by this work, the focus is now placed on how the different parts of the dissertation have contributed to answering the research questions, and how the pieces fit together. The first element to consider is the structure of the dissertation, which is aligned with the exploratory and descriptive research aims detailed in Chapter 1. In this regard, Chapter 2 is devoted to operationalising the notions of supervisory consistency and governance evolution, which are subsequently applied in Chapter 4. Chapter 3 identifies and classifies two fundamental sources of diversity faced by the SSM, i.e. diversity of national institutional structures, and diversity in the banking sector, and links them to the development of specific local practices. The chapter also focuses on the construction of the EMU, since it represents a key historical juncture in which structural diversities among member States have been managed. After providing the foundations of the analysis through the exploration of consistency and diversity, Chapters 4 and 5 develop the empirical content of the dissertation. Although the rationale underpinning the case selection has been put forth in Chapter 2, it is worth recalling that these cases have represented—and still represent—policy priorities that mirror existing divergencies in supervisory practices, which have prompted action from both regulators and supervisors, in order to boost consistency. The evolving dynamics surrounding the SREP and NPLs cases (and IPSs to a lesser extent), are analysed to identify

emergent patters of diversity management, and how the balance between the need for consistency in integrated markets and diversity is stricken.

After providing a brief outlook of the overall structure, this subsection now zooms in on the analyses provided in the empirical chapters in order to extract those patterns and plausible relationships referred to above. Before moving on, it is necessary to clarify the scope of the word *mechanism*, which has been used under specific circumstances throughout the empirical chapters. This work has focused on *exploratory* and *descriptive* research purposes; *explanatory* purposes seeking specific causal mechanisms have not been included. Although this dissertation has undoubtedly *traced processes*, it has not deployed a fully-fledged process-tracing method, meaning a Bayesian-inspired evidence-evaluation framework in order to gather mechanistic evidence (Beach and Pedersen 2019). In this sense, references to *mechanisms* in this work do not imply the assertion of causal claims in the mechanistic sense of the word.

The analysis presented in Chapter 3 primarily helps identify and classify sources of diversity in the supervisory domain. However, the chapter can be interpreted more broadly once the content of the empirical analysis (Chapters 4 and 5) is also considered. In fact, a joint reading of these three chapters suggests the existence of not only two ample categories of diversity (national- and bank-related), but also two dimensions, *internal* and *external*, that account for the consistency challenges faced by supervisors. Figure 6.1 below aims to graphically clarify the relationship between these elements, and links them to a specific governance dimension. The idea is that there is an internal and an external dimension of supervisory consistency: the former relates to intra-SSM aspects, and therefore focuses on the challenges stemming from the differences between central and local authorities, which is represented by the 'national diversities'; the latter refers to extra-SSM consistency challenges that arise from diversity in the banking sector.

In turn, the national diversity/internal aspect can be associated with the governance dimension that focuses on the changes in decision-making patterns and institutional forms. The rationale behind this choice is that, throughout its supervisory and regulatory decisions, the SSM has attempted to eliminate vestiges of "national interests" or local concerns.[340] The bank diversity/external aspect can be connected, in its turn, to the dimension that deals with the sphere of authority between private and public actors. The logic behind this association stems from the fact that the patterns of interaction between banks and the supranational supervisor have ostensibly changed since the establishment of the SSM. This is so not only from the most obvious point of view, i.e. the conduct of supervisory activities, both off- and on-site, but also from the internal dynamics that have emerged in the context of public consultations.[341] In the middle, and as a by-product of the interaction between the internal and external consistency dimensions, the third governance aspect emerges: the development of novel instruments adopted by the SSM, which are for the most part non-legally binding policy documents lying at the crossroads between supervision and regulation. Chapter 5 offers a comprehensive graphical representation of the instruments available for banking supervision, and provides some critical insights about the distinguishing criteria between binding and non-binding tools put forth by the ECB.

[340] One clear examples of this trend has been the "ECB Guide on options and discretions available in Union law", which aimed to harmonise the interpretation of those national options and discretions that were under NCA's competence. The NPL saga is also a representative case of this trend to eliminate national traits from the supervisory framework and practices.
[341] Chapters 4 and 5 have provided an ample overview of the tensions between credit institutions and the SSM in the context of these public consultations.

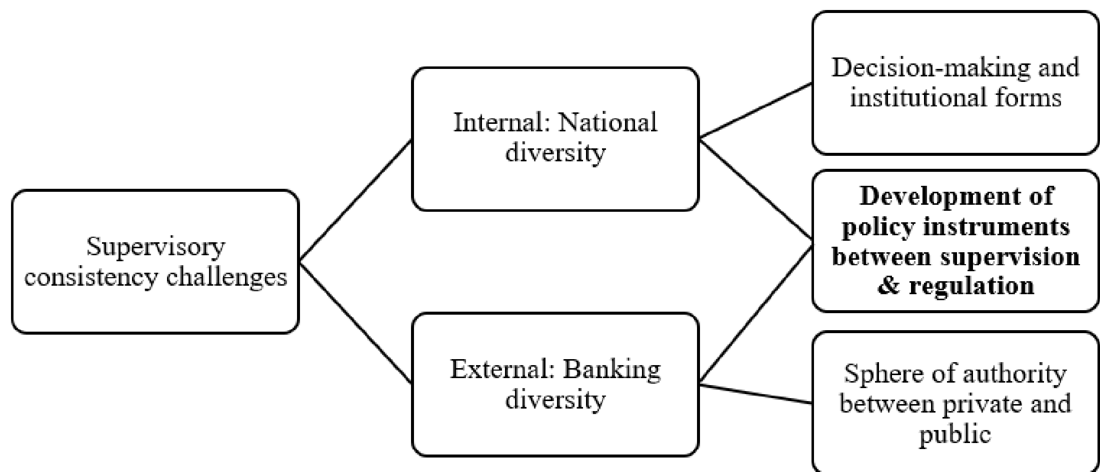

Figure 6.1: Internal and external dimensions of supervisory consistency and their relationship with the sources of diversity and governance dimensions. Source: Own elaboration.

One final remark about Chapter 3 relates to its section 3.3 and the question of national idiosyncrasies, legal cultures, and public reason. These theoretical concepts have been limitedly supported by additional analytical insights in that chapter. This is another feature that requires a holistic reading of Chapters 3, 4, and 5, in order to make sense of the elements that account for these national peculiarities. For instance, the notion of 'public reason' entails a series of features that can only be grasped when analysed in specific cases. In fact, according to Jasanoff (2013, 134),

> Nations differ systematically in their strategies of public reasoning—that is, how policy-relevant knowledge is generated, how it is evaluated for policy purposes, how scientific disputes are resolved, and how lay publics are engaged in decision-making. These public epistemic practices, which constitute an important (if often overlooked) dimension of political culture, have a significant impact on citizens' perceptions of the reliability of the state's regulatory actions.

In order to make this notion applicable to the case at hand, references to "the state's regulatory actions" should be replaced by SSM efforts in this direction—and the allusion to "lay publics" by banking stakeholders. The analytical insights from Chapters 4 and 5 help understand how policy-relevant knowledge is converted into regulatory decisions (Jasanoff 2012, 2013). However, the study of how policy-relevant knowledge has been

created, evaluated, and translated into applicable regulation was conducted at one of the many levels of analysis that characterise the current regulatory and institutional web. For instance, this work has not looked into the decision-making process and the public reason features present in the adoption of CRR and CRD IV, or other national or supranational regulatory processes, as they were not directly related to the aims and questions of this research. The interdependence highlighted by Jasanoff between knowledge production, evaluation, and its transformation into regulatory tools, has wider implications that go beyond technical rule-making. In fact, these "pubic epistemic practices" impact upon what citizens expect from supervisors, which in turn shape and define the contours of different 'supervisory styles'—which resembles the concept of supervisory cultures, discussed in the conclusion of Chapter 3.

The final part of this subsection focuses on patterns of diversity management identified through the analysis of the practices conducted by the SSM at the supervisory and regulatory levels. The governance evolution of the SREP and ICAAP discussed in Chapter 4, and the analysis of the decision-making processes and stakeholders' concerns expressed in relation to the NPLs and IPSs cases examined in Chapter 5, provide the material to make these patterns more explicit. Before moving forward, it is important to highlight that, apart from the regulatory and supervisory action deployed by the SSM to strengthen consistency, its capacity-building and centralising efforts have been officially endorsed by other EU institutions, chiefly the CJEU. Although SSM-specific jurisprudence is still in its infancy, there have been a few interesting cases that support, mostly through the preliminary ruling procedure, a centralised understanding of the mechanism. The landmark *Landesbanken* case, already referred to in other parts of the work, highlighted the question of the division of competences between the ECB and the NCAs, stating that NCAs decentrally apply supervisory powers that are in principle in the hands of the ECB,

according to the delegation of competences provided for in the SSM regulations.[342] Furthermore, the so-called *Berlusconi* case[343] has contributed to a centralised reading of the mechanism, by ruling that national preparatory acts and draft decisions by the NCAs, whose final decision-making powers lies within the ECB, are subject to a *single judicial review* (paras. 49 and 51). In this case, the object of dispute was a draft decision by Banca d'Italia opposing Berlusconi's acquisition of qualifying holdings in credit institutions, a decision that was upheld by the ECB as the ultimate decision-maker. The CJEU's reasoning has thus contributed to the supervisory consistency purposes, by stating that in a multi-level decision-making process a single judicial review at the EU level enhances the effectiveness of the mechanism and avoids potential divergent assessment between national and supranational authorities.[344]

In order to systematise the main findings that link the conceptual and the empirical parts of this work, Table 6.1 below cross-tabulates the internal and external dimensions of the consistency challenge—which correspond to the national and banking diversity features respectively, as explained above—with the building blocks of supervisory consistency—methodology, practices, and outcomes. The empirical observations have been arranged and classified to better account for the patters of diversity management, and the relationships that shape the balance between consistency and diversity. One relevant aspect that should be recalled about the internal and external dimensions of the consistency challenge—and hence the national and banking related diversities—concerns the underlying meaning attached to them, respectively. While diversity in the banking sector is a desirable feature of the financial system, diversity along national lines has a different and not so positive

[342] See section 3.4.1 for further details about the inconsistencies between this ruling and a recent re-interpretation of it by the German Constitutional Court in a case that challenged the legal basis for the SSM and the SRM.
[343] Berlusconi and Fininvest v. Banca d'Italia (Case C-219/17, 19 December 2018, ECLI:EU:C:2018:1023)
[344] For a comprehensive perspective on the "judicial building" role played by the CJEU in the context of the Banking Union, see Chiti (2019).

connotation. The following quotes from the former Chair of the SSM's Supervisory Board, Danièle Nouy, illustrate these divergent supervisory perspectives:

> One of the major assets of the SSM is the capacity to compare banks' situations across countries through benchmarking, peer reviews and horizontal functions. We are dedicated to tough supervision; we strive to be fair and even-handed in our actions, while avoiding a one-size-fits-all supervision approach. By balancing uniform supervisory anchor points with constrained supervisory judgement, we *ensure both consistency across institutions and supervision tailored to banks' specific circumstances*. With this approach *we also accommodate banking diversity which I consider very desirable* from a financial stability perspective. (Nouy 2015a, 2, emphasis added)

On the contrary, diversity among member States' rules and practices can be deemed unjustified and detrimental to the creation of a genuinely European banking market:

> These ONDs [options and national discretions] were inserted to cater for specific national features, but many of them merely reflect *unquestioned traditions*, *pure national interests* and *regulatory capture*. That is why we seek to harmonise their treatment where we can. (Nouy 2015c, 4, emphasis added)
>
> This joint European approach brings many benefits. Most importantly, it allows us to take a broad view. We can see across national borders, and we can compare banks from all over the euro area. This allows us to spot common problems and address them in time. And we can treat all banks equally, according to the *same high standards and unbiased by national interests*. This helps to make banks safer and sounder; it helps to level the playing field; and it helps to bring about a truly European banking sector. (Nouy 2017, 3, emphasis added)

These diametric standpoints towards national and credit institutions' diversities, give room to different policy responses in order to strengthen supervisory consistency within the SSM. While supranational authorities have been focusing on narrowing the gap between member States' divergent rules and practices, they have been also emphasising the importance of the principle of proportionality and its central role throughout the supervisory cycle. This does not mean, however, that banks and their associations have been fully satisfied with the approach of the SSM, as Chapters 4 and 5 explain. Although criticism and concerns from the banking sector should be taken seriously, it should not be

overlooked the fact that these stakeholders have specific sectorial interests. Table 6.1 below schematises the patterns of diversity management and relationships shaping the balance between consistency and diversity.

Types of Diversities

Supervisory consistency elements	(Internal consistency challenge) **National Diversity**	(External consistency challenge) **Bank Diversity**
(common) **Methodology**	- Horizontal & specialised divisions DG MSIV - Strengthen quantitative approach - Development of common methodologies: • SREP • authorisation, withdrawals, qualifying holdings • fit & proper assessment • Internal models review • On-site inspections • **Pillar 2: Reinterpretation & refinement**	- Benchmarking - Peer review assessments - Common methodology for LSI classification: NCAs + DG MS III - Refined SREP methodology: bespoke assessment of credit institutions but more complying costs (rule interpretation begets further requirements for banks)
(convergent) **Practices**	- Supervisory examination programme (SEP): jointly created by JSTs + Planning and Coordination of SEP division - Supervisory Board defines supervisory priorities + sets topics for thematic reviews - Supervisory quality assurance division: • Assesses impartiality of supervisors	- **Proportionality principle**: different level of supervisory engagement (frequency and intensity) based on: • Risk profile • Size • Complexity - **Supervisory dialogue**: analysis of situations based on banks' ICAAP within SREP - **Constrained judgement**
(comparable) **Outcomes**	- Supervisory quality assurance division: • Feedback on use of methodological framework + need for enhancement • Identifies best supervisory practices • Identifies risks and operational weaknesses - Regular monitoring of JSTs' activities by planning and coordination of SEP division	- Supervisory feedback based on SREP (limited, more transparency needed according to the industry) - Specific SREP decision imposing: • Capital measures • Liquidity measures • Additional qualitative measures
	LSI supervision: at the crossroad between reducing national differences and preserving banking diversity	

Table 6.1: Patterns of diversity management and relationships between sources of diversity and supervisory consistency elements. Source: Own elaboration.

The dotted arrows flowing from practices back to methodology, and from outcomes to methodology, represent the feedback effects between these elements: their redefinition and interaction depend on the implementation experience and their subsequent

incorporation into the supervisory toolbox. Table 6.1 reveals important features that are worth spelling out, and leaves room for addressing further aspects that have not been included in the graphic representation, but which have been discussed throughout this work and are relevant to the argument built in this subsection. As the table shows, horizontal divisions and horizontal analysis are equally important to strengthen both the internal and external dimensions of consistency. However, the need to harmonise national authorities' performance stimulates centralised monitoring of supervisory activities all along the cycle, intervening at the three consistency levels. In the case of banking diversity, benchmarking and peer review assessments have been a (controversial) novelty, which have helped the SSM cluster banks according to their profile similarities and detect common risks and concerns that constitute the basis for thematic reviews. As pointed out in Chapter 4, these thematic reviews and other types of in-depth analysis are important for two reasons. First, in the case of the credit institutions included in the analysed sample, the outcomes of the reviews are considered for their respective SREP assessments; hence, supervisory measures can be imposed as a result of these additional studies, which run parallel to the ongoing supervisory activities. Second, thematic analysis are also used to develop SSM guidance and other policy instruments, especially "in areas not covered by the set of rules developed by the international standard-setting bodies, or if a need for developing a common understanding and a coordinated approach arises in the conduct of the day-to-day supervision" (ECB 2018a, 43).

What emerges from these considerations is the importance and power of horizontal analyses, which normally entail data collection requests in addition to the regulatory reports that banks routinely comply with. In this sense, there is potentially a 'competence creep' element to these horizontal analyses, given that they are not meant to be just statistical or research-oriented exercises, but instead can lead to the creation of additional ECB tools in

areas where there are no legal provisions, or where there is an interpretative void. However, when there are specific issues that become visible only at the implementation level and that could not be foreseen, it is likely that the ECB will make use of its regulatory powers. There is nonetheless a very fine line, as acknowledged by the ECB (2019b, 10), “between rules of general application . . . and providing transparency on the consistent application of relevant Union Law and equal treatment”.

Before concluding this subsection, there is one further element key to banking diversity management that should be mentioned: proportionality at the regulatory and supervisory levels. Proportionality and diversity can be considered two sides of the same coin. In fact, the question of proportionality has been and still is hotly debated in the EU. On the one hand, small and medium-sized banks use the argument to refer to the regulatory burden created by post-crisis measures, and the fact that in this way they are being penalised due to the big players’ excessively risk-taking behaviour. On the other, regulators and supervisors normally agree with the views of large credit institutions, which claim that applying a differential set of rules can undermine financial stability (Joosen and Lehmann 2019). In this sense, it is important to distinguish the regulatory and the supervisory dimensions of proportionality. Concerning regulation, the fundamental question relates to the purposes of the so-called “Single Rulebook”:

> If its goal was to eliminate legislative differences between the Member States, then it would have sufficed to harmonise banking law in the EU, leaving open the possibility of providing different rules for different institutions. If the goal was to level the competitive playing field for banks across the EU, then it may seem to require at first sight the imposition of a uniform set of rules. (Joosen and Lehmann 2019, 72)

The interpretative tensions regarding the Single Rulebook’s purpose mirror the internal and external dimensions of the consistency challenge: levelling—or eliminating—national differences, or levelling competition for banks—which means doing away with

institutional diversity.[345] In light of these divergent views, Joosen and Lehmann (2019, 73) propose to reconceptualise the term “Single Rulebook”:

> Its goal is to strengthen supervision and regulation in the EU by eliminating differences between the Member States and between supervisory agencies, thus combatting regulatory arbitrage in the EU. This *does not in any way exclude the possibility of distinguishing between different types of institutions* as long as all institutions are treated the same regardless of their origin. The Single Rule Book can therefore have several chapters, each of which addresses different types of institutions. (emphasis added)

It is under these circumstances that the supervisory dimension of the proportionality principle kicks in. Absent a generic definition of proportionality, supervisory practices and the application of prudential rules play a fundamental role. In fact, the SSM Supervisory Manual (ECB 2018a) insists in different passages on the importance of considering each institution’s risk profile, size, and complexity, as these factors are key to determine the level of supervisory engagement, measured in terms of frequency and intensity of the supervisory relationship. This is not, however, an ECB invention: these characteristics are basic requirements set forth in the EBA SREP Guidelines (EBA 2018b), which classify banks into four categories according to their systemic importance and level of cross-border activities, which in turn shape a differentiated supervisory engagement. One of the remaining proportionality challenges for the SSM relates to transparency in the SREP feedback and disclosure of how Pillar 2 requirements are established for each bank.[346] In spite of the technicalities of the SREP process, this particular issue can be indicative of deficiencies in the supervisory dialogue and the exchange of views between the parties.

One final aspect about proportionality concerns LSI supervision, and the curly-bracketed sentence included at the bottom of Table 6.1. The supervision of less significant

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[345] In line with this view, Joosen and Lehmann (2019, 72) add that “imposing uniform requirements on all types of institutions does not in reality level the playing field, but tilts it in favour of large institutions, which are most likely to emerge from the once diversified banking landscape.”

[346] Highlighted by several industry interviewees and the analysed position papers, as explained in Chapter 4.

institutions synthetises the internal and external consistency challenges. Leaving aside the integration endeavours by the CJEU and the evasive stance of the national highest courts (e.g. the BVerfG and the Banking Union cases), the SSM's methods and practices have been increasingly impacting upon LSIs supervision. This reflects, on the one hand, the need of the ECB to level and enhance the supervisory practices of NCAs over the institutions directly supervised by them. On the other, these smaller institutions are not exempt from those horizontal analysis described for SIs above, not so much through the work of DG MS IV but, rather, from DG MS III and the collaboration from the national counterparts. As the supervisory manual explains (ECB 2018a, 112):

> DG MS III adds value to national supervisory analyses by bringing an SSM-wide view, by providing NCAs with cross-border benchmarks and by identifying sectoral and systemic risks.

This section has recapped the fundamental research aims, purposes and questions, and has linked them with their respective answers in order to provide a comprehensive view of the work. The next section explores the research from a broader perspective, suggesting literature and policy-related contributions.

6.2 Zooming out: The research in its broader context

The broader implications of a study can be examined from two distinct perspectives. The first criterion concerns *generalisability*, or the extent to which the findings of a given research can be applied outside its specific circumstances. The question of generalising qualitative research, which normally focuses on the examination of a handful of cases and does not rely on statistically relevant data, is hence addressed in the first subsection. The second way to assess the research from a broader perspective is by linking it to different strands of the literature that have shaped the course of the study, and by drawing possible

policy lessons from this more comprehensive viewpoint. This feature is discussed in the second subsection.

6.2.1 Generalisability: Mission impossible in qualitative research?

Before moving on the contribution and broader implications of the research, this first subsection takes a step back in order to discuss the question of generalisation in qualitative research, i.e. "whether a study's findings can be said to be of relevance beyond the sample and context of the study itself" (Lewis et al. 2014, 348). This concern takes us to the methodological and philosophical issues raised in the introductory chapter. The first chapter has framed this work within a methodological tradition known as *analyticism*, which entails the organisation of empirical sources belonging to specific cases into coherent stories, and the distinction between case-specific and analytically general factors (Jackson 2011); the research product is a 'case-specific analytical narrative'. Under this *case-specific* scenario, it is worth questioning the extent to which and how qualitative research can be generalised.

First, generalisability is closely related to two concepts that define the strength and credibility of the research: *validity* and *reliability*. The former refers to the 'replicability' of the reported findings, while the latter applies to how well-justified these findings are, and the accuracy with which they reflect the phenomenon under analysis. These concepts, which were initially developed in the natural sciences, have also been applied to qualitative research in "overly rigid" ways that might not be suitable for this type of enquiry (Lewis et al. 2014, 354). Therefore, if generalisation in qualitative research differs from that belonging to quantitative studies, it is important to understand the factors that account for a meaningful qualitative enquiry:

> The value of qualitative research is in revealing the breadth and nature of the phenomena under study. It is this 'map' of the range of views, experiences, outcomes, etc., and of the factors and circumstances that shape and influence them, that can be generalised to the parent population. (Lewis et al. 2014, 351)

Therefore, instead of adopting a statistically significant criterion, qualitative research can be generalised on the basis of whether the 'mapping exercise' carried out in order to understand the phenomena under analysis can be applied to other situations. A similar discussion about samples and their statistical representativeness concerns the conduct of qualitative or in-depth (élite and experts) interviews as data collection methods. The breadth and depth provided by this method in the context of qualitative enquiries, makes statistically representative samples irrelevant to examine the soundness of the research and its generalisability potential.[347] In this sense,

> Qualitative research studies can contribute to social theory by providing evidence about underlying social processes and structures that form part of the context of, or explanation for, behaviours, beliefs and experiences. The particular value of qualitative research lies in its ability to explore issues in depth, from the perspectives of different participants, with theories and explanations developed inductively from the data. (Lewis et al. 2014, 353)

Two fundamental elements that should be pondered when assessing research credibility are the depth of the analysis and the consideration of different stakeholders' or participants' perspectives and viewpoints. Although it is not the author of this work who should evaluate the quality of the research conducted, it is helpful to briefly discuss whether the analytical insights provided by this work are aligned with the qualitative research value criteria exposed above. This work has attempted to identify, describe, and uncover specific social dynamics in the context of supranational banking supervision, characterised by a variety of stakeholders and opposing interests, and a complex web of

[347] For further insights about qualitative approaches in empirical legal studies see Webley (2012), and Mason (2010) for a discussion about the saturation principle in interviews conducted by doctoral students in the context of their dissertations.

actors and decision-making processes. In order to thoroughly explore these phenomena, the research has complemented the analysis of a wide set of documentary sources with forty-two in-depth interviews, which have served a mapping purpose in order to have a wide outlook on the different experiences and perspectives towards this socially- and economically-sensitive topic.[348]

Further considerations about the implications and limitations of this research are discussed in the subsequent parts of the chapter; this subsection has aimed to emphasise the possibility or generalisation in qualitative enquiry and the fundamental elements to be considered.

6.2.2 The forest and the trees: Literature and policy-related contributions

After discussing some of the criteria for generalising qualitative enquiry, this subsection focuses on the literature and policy-related contributions of the research, in order to analyse the broader implications of the work beyond the specific area of study. There are three wide strands of the literature to which this research and its findings can be related. First, integration and governance literatures, and especially the post-crisis transformations at the EU level. Second, the evolutionary analysis of how the banking sector and the conduct of supervision have been transformed over time. Third, the expansion of tasks at the ECB level, and the effectiveness of EU law and its application by supranational authorities; the emergence of new instruments that lie at the crossroads between hard and soft law is also considered.

[348] The literature on quality criteria in qualitative research is much broader that what this subsection has been able to discuss. See Guba (1981), Lincoln and Guba (1985), and Lincoln (1995), for a deeper examination.

6.2.2.1 Integration and governance

One of the essential conundrums addressed by the research relates to the accommodation of diversity, and how this aim is balanced against the need to achieve supervisory consistency, due to the legal, financial, and institutional interdependencies among member States—or, more precisely, Banking Union countries. In order to shed light on these issues, the work draws upon governance and integration literatures, since diversity management is a topic that has been widely explored by EU scholarship from both theoretical and empirical perspectives. The aim of the research has been to connect the analytical tools offered by this literature with banking-specific concerns, in order to address the diversity problem from an empirical perspective.

By drawing on integration, governance, and diversity scholarship, the findings of the research resonate with EU post-crisis 'new' economic governance literature. This vast scholarship has highlighted instances of 'integration by stealth' (Majone 2005, Héritier 2014; Meunier 2017), a reconceptualization of 'competence creep' (Garben 2019), the increasingly redistributive and not merely regulatory functions of EU institutions (Chalmers 2012), the integration of 'core state powers' (Genschel and Jachtenfuchs 2014, 2016, 2018), the supranationalised implementation of decisions, and the development of non-binding tools whose softness cannot be taken for granted (Dawson 2015a,b). As demonstrated by the empirical analysis carried out throughout this work, ECB Banking Supervision has been following some of these post-crisis patterns. For instance, it has been shown that the SSM has been operating under a strong *capacity building* logic, as opposed to a simply *regulatory* one (Genschel and Jachtenfuchs 2014), thanks to the creation of a plethora of supervisory resources, in parallel to the supervisory structures of NCAs—or, sometimes, to the detriment of NCAs, in the case of the starting phase of the SSM, where

many human resources were transferred from the national to the supranational level. A second point relates to the 'stealthy' processes accounted for in the empirical analysis, epitomised by the NPL Addendum and the fine lines between the competence to adjust prudential requirements and the amendment of accounting rules related to loan loss provisioning. This stealthy mode can also be observed in the redefinition of Pillar 2 as a supervisory tool to impose bank-specific measures, which has evolved from its early 2004 version to our days. As shown in Chapter 4, these Pillar 2 "transformations" have been facilitated by the changes to the SREP framework introduced by the EBA in 2014, right after the SSM was launched. Therefore, the question of Pillar 2 reinterpretation has not been a purely 'stealthy' act from the ECB, but, instead, it was acquiesced by the banking regulator.

In connection with post-crisis governance transformations and from a potentially original research angle, it should be noted that most of the literature addressing these aspects has either focused on the role played by the monetary policy side of the ECB—mandate stretching and its increasing politicisation—or, in the case of the SSM, on its creation phase and how national and supranational forces have shaped the final institutional arrangement. The most recent and comprehensive legal literature from the SSM (e.g. Lackhoff 2017, Bassani 2019), focuses on the regulatory framework and its interaction with other legal orders.[349] Although it is true that the SSM is a relatively recent arrangement, there is already enough material to explore supranational supervisory practices, which have not been widely addressed by the literature so far.

The question of supervisory practices and governance calls for additional reflections in relation to the experimentalist literature referred to in Chapter 2 (Sabel and Zeitlin 2008,

[349] Other recent studies have explored the SSM from the perspective of its accountability duties (Dawson et al. 2019).

2010; Zeitlin 2015, 2016). Experimentalism provides a comprehensive framework that covers the whole policy cycle, starting from a standard setting phase, to the discretionary application of rules, and their redefinition in light of comparative and practical experience. The experimentalist literature advances two scope conditions under which this governance architecture is likely to be developed: strategic uncertainty and a polyarchic setting. These two features widely resonate with the SSM: the former due to the multiple sources of risks that supervisors have to deal with and make judgements on; the latter because of the structure of the SSM, characterised by an ongoing collaboration and exchange of information between national and supranational authorities.

By delving into operational and policy-making aspects that go beyond the architecture of supervisory governance, this research contributes to a more fine-grained experimentalist understanding of the SSM. As pointed out in Chapter 2, an early assessment of the supranational supervisor under the experimentalist architecture's perspective, concluded that 'learning from difference' practices entailing a "contextual adaptation of common rules and processes to banks' individual risk profiles, and recursive revision of supervisory methods on the basis of comparative benchmarking and review appear to be flourishing, at least for now, under a hierarchical veneer" (Zeitlin 2016, 1090). This assessment was based on a simplified understanding of the experimentalist architecture, which is in line with the present findings. In fact, there are two steps from the experimentalist policy cycle that are not reflected in the current supervisory practices, being those the establishment of framework goals and the discretionary implementation by lower-level or national units. Regarding the former, the supervisory tools analysed in Chapters 4 and 5 are not limited to setting framework goals only. Although they establish specific metrics to be complied with, the content of the instruments is more detailed than what could be expected from a framework-setting tool. Concerning the latter, the discretion of national

authorities has been reduced not only in relation to SI supervision, but regarding LSIs as well, as pointed out in Chapter 5. One of the clearest examples of this phenomenon is the development of a SREP methodology applicable to LSIs, which has been made in the image and likeness of that for SIs; the Guideline on the exercise of national options and discretions in relation to LSIs is another important case.[350]

On the contrary, the reporting from national units (mostly done through JSTs' interaction) and the regular revision of adopted measures, are key elements of the cycle that support the early findings related to the development of 'learning from difference' practices under hierarchical institutional arrangements. However, before moving forward, it is important to mention one final aspect that this work has emphasised along its empirical analysis, which can contribute to further refining an experimentalist understanding of the SSM. Despite the experimentalist criticism concerning the differentiation between hard and soft law, SSM practice deems this distinction important as pointed out in Chapter 5 when distinguishing between *substantive* and *procedural* dimensions in this dichotomy. From a substantive governance perspective, both hard and soft law tools contribute to shaping the supervisory policy-making arena; however, from a legal and procedural standpoint, the difference is relevant for the following reasons. First, given their non-binding legal nature, soft law tools are not deemed enough to impose legally-binding requirements on supervised entities by themselves. Soft law can nevertheless produce certain legal effects, provided that its scope is that of *interpreting* binding legal requirements and not override them. Thus, for the purposes of drafting supervisory decisions that can materially alter the situation of credit institutions, the hard-soft law distinction matters, as denaturalising the interpretation of the former through the latter, or light-heartedly consider that labelling some tool as 'soft'

[350] Guideline (EU) 2017/697 of the ECB of 4 April 2017 on the exercise of options and discretions available in Union law by national competent authorities in relation to less significant institutions (ECB/2017/9), OJ L 101, 13.4.2017, p. 156.

is enough to avoid legal implications, could trigger supervisory liability. From a broader perspective, the research has emphasised some of the challenges to the convergence of supervisory practices and, hence, the areas in which integration can be more difficult. A plausible explanation of these difficulties relates to Ladeur's 'diversity management' paradox (2014), according to which the deeper EU law goes, the more it needs to deal with pre-existent societal norms at the local level, which the supranational framework is meant to complement or replace. The banking supervision domain is no exception, as the German and Italian cases in Chapter 3 illustrate, which show the development of divergent practices and supervisory styles.

On a final note, integration in the supervisory domain largely depends on the future of the Banking Union, since the SSM is one of the pillars that conforms this framework of rules and actors. As pointed out by Teixeira (2019, 151), the sustainability of the Banking Union hinges upon the credibility of risk-sharing mechanisms at the EU level, and the perceived democratic legitimacy of the project:

> Legal and technical output legitimacy will not be sufficient to sustain the Banking Union. First, the Banking Union leads to much deeper market integration than ever before, with distributive implications spread over space and over time. Second, the exercise of banking supervision and resolution competences have also distributive consequences, as acknowledged explicitly in the SSM and SRM Regulations. Third, in the case of a banking crisis, these competences will allocate burdens and costs, the more so in a systemic crisis. At the limit, there could be disintegration if the distributive impact of the policies of the Banking Union is not perceived as legitimate and fair both at the European and national levels.

It is particularly telling that these words come from the former Director General Secretariat and Secretary to ECB decision-making bodies, and current Director General Secretariat and Secretary to the Supervisory Board (DGSSB), which are in sharp contrast with the more light-hearted views on EU and banking integration expressed by other ECB

officials when referring to the achievement of a ‘truly European banking sector’, once the Banking Union is completed (Hakkarainen 2018a).

6.2.2.2 Evolutionary insights from the banking sector and supervisory activities

The second aspect to be highlighted in this subsection concerns the evolutionary perspective offered by the research in connection to both the concept of banking and the exercise of supervisory activities. As section 6.3.2. below argues, banks are currently undergoing a series of fundamental transformations due to the advancement of new technologies, which have caused credit institutions to deeply rethink their business models and their role in society. These changes, as claimed below, are forcing supervisors to reconsider their activities as well.

Chapters 1 and 3 have shown the interconnectedness between alternative philosophical and theoretical understandings of banking activities—as financial firms or institutions for patient capital, as Tables 1.2. and 3.1 respectively demonstrate). As a matter of fact, way before banking regulation and supervision have acquired a supranational status, national rules have shaped the characteristics of the banking sector. For instance, the 1936 Italian Banking Act explicitly acknowledged the public interests nature of the activities performed by banks, consistent with the fascist economic conception that credit allocation played a fundamental role (Donato and Grasso 2014); similar patterns have been found in the German case in the same historical period.[351]

The internationalisation of banking and financial activities has brought about fundamental regulatory and institutional transformations, as the need to strengthen

[351] See Chapter 3.

coordination and achieve a desired level of rule harmonisation at the supranational level became apparent. This internationalisation reinforced the detachment of banking activities from their broader social dimension—except for 'alternative banks'. There is in fact an analogous optimistic view between, on the one hand, the integration through law perspective and, on the other, the creation of a pan-European level playing field and a 'truly' European banking sector that allows for more competition among credit institutions. The common denominator between these conceptions of how (financial and legal) integration unfolds, is that they do not fully consider concrete factors that might hinder the creation of a single banking jurisdiction, e.g. the fact that savers and borrowers tend to *bank on* their respective local credit institution, usually for a prolonged time.[352] In fact, financial integration is geared to a greater extent towards the non-household sector, given that these players—companies, entrepreneurs—are those who can more clearly reap the benefits of cross-border services and the market-oriented view, reinforced by the CMU project:

> Financial integration would benefit Europe's economy and its people. Companies and entrepreneurs across the euro area would have a level playing field for financing their businesses. (Hakkarainen 2018b, 3)

It is no coincidence that, as shown in Chapter 3, the number of credit institutions has been steadily declining in Germany and Italy—a trend that is widely shared across Europe. This phenomenon is caused by a series of complex and interrelated factors, mostly at the regulatory and macroeconomic level, that are not further discussed in this conclusive chapter. The Chair of the SSM's Supervisory Board has stated that the Banking Union should actually facilitate consolidation and cross-border M&As, which are deemed scarce within the EU; most of the deals are domestic and among smaller institutions. In spite of

[352] A 2018 report from the UK's Financial Conduct Authority (FCA 2018, 19), has found that the "median tenure for PCA [personal current account] account holders was 10 years", which shows that banks' customers do not change their provider easily. Although this is changing with the advent of technology, there is still some "stickiness" in the banking business.

the “neutral stance towards M&A” taken by the ECB (Enria 2019b, slide 19), supervisors are highly concerned about market and regulatory fragmentation even after the strengthening of the Single Rulebook. This is a clear sign that, in spite of the internationalisation of banks’ activities and the detachment from their local socio-economic role, financial integration is a much deeper and complex enterprise, that depends upon a wide set of non-financial factors.

These developments in the banking industry are also closely interrelated with the changes in supervision and regulation. Chapter 4 traces three main dimensions that help explain the governance evolution in the supervisory domain. However, although these are analytically different domains, regulation and supervision are strongly interwoven. This means that the assessment of the SSM’s governance cannot be viewed in isolation, without considering broader regulatory and, in the case of the post-financial crisis scenario, political pressures. For instance, to understand the ‘intrusiveness’ or ‘tough and fair’ stance from the supranational supervisor, it is important to make a step back to understand which were the prior failures at the local level that have led to different treatment among jurisdictions:

> One of the key features of Basel 2 was its extensive reliance on national options and discretions. This may have been inevitable in the drive to achieve consensus within the Basel Committee but paved the way for widely different national implementation and hence variation in application of supervisory standards between banks. (Lastra 2019, 10)

Therefore, the divergent and variable implementation of allegedly common standards, has paved the way for ECB banking supervision to take assertive policy action not only at the supervisory, but at the regulatory level, too. The so-called “light touch” approach, characteristic of the Financial Services Authority (FSA) in the UK,[353] was no longer the supervisory paradigm. Governing banking supervision from a supranational

[353] Replaced by the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) since 2013.

perspective also entailed important transformations at the methodological and operational levels. For instance, a stronger quantitative approach to supervision has been developed, sometimes at the expenses of qualitative-oriented assessments. This is not to sweepingly imply that the supranational supervisor does not take into account qualitative elements, which still play a role within the SREP framework. However, the combination of this quantitative-oriented trend[354] and the relevance of horizontal functions within the SSM, have reinforced the centralising features of banking supervision in order to strengthen consistency. However, this comes at a cost:

> Centralized methodologies of risk analysis tend to reduce the diversity of standpoints and perspectives that might make policymakers more robustly democratic. (Jasanoff 2012, 14)

This quote from Jasanoff's *Science and Public Reason*, carries a relevant policy message. In spite of the highly-technical activities that are centrally developed by the horizontal and specialised divisions within the SSM (mostly in DG MS IV), it is crucial for them to incorporate feedback from a wider set of stakeholders, in order to avoid a supervisory monoculture. Furthermore, it should be recalled that the activities carried out by these divisions are not merely research-oriented; on the contrary, the outcomes of the in-depth analyses and thematic reviews, are subsequently incorporated into the wide range of binding and non-binding instruments issued by the ECB. The point in question is not the democratisation of these tools; what this recommendation stresses is the need to make these internal processes clearer and make the transition from the analysis to the final regulatory product more transparent.

[354] The advancement of artificial intelligence (AI) and other supervisory technologies (SupTech) at the forefront of innovation, might accentuate even more the quantitative approach to supervision. See https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl191113_4.en.html for further details about the ECB's SupTech hub initiative.

6.2.2.3 The (ever-rising) role of the ECB and the effectiveness of supranational law

The third and final aspect related to the broader implications of the research concerns the role played by the ECB in the dynamic supervisory landscape, and how the effectiveness of supranational regulatory instruments has been managed so far.

Regarding the role the SSM, the question addressed in this subsection does not relate to the expansion of tasks in the post-crisis context and the stealthy integration concerns discussed above. The point here is subtler, and it is directly related to this work, due to the increasing level of diversity among industry actors and the challenges inherent to the achievement of supervisory consistency. As a matter of fact, the so-called "banking package" that resulted in the adoption of CRR II and CRD V, has expanded the SSM's supervisory boundaries by including systemic investment firms (Allen & Overy 2019).[355] The aim has been that of

> Ensuring that systemic investment firms do not escape the requirements of the CRR/CRDIV, avoiding the *regulatory arbitrage and risks for financial stability and the fragmentation of the Single Market* which this would entail, by vesting key decisions over the authorisation and supervision of these firms with the ECB and creating a level playing field with the centralised supervision of credit institutions, subject to the same rulebook. (European Commission 2017f 26, emphasis added)

Leaving aside the technicalities behind the review of the prudential treatment of investment firms, the main takeaway is that financial stability, regulatory arbitrage, and single market concerns, including the much sought-after level playing field, have resulted in an expansion of tasks and powers in the hands of the SSM. The criticism here is not directed towards the increasing levels of supranational powers, or the potential democratic deficit if the SSM is not properly hold to account in light of its novel and broader

[355] For further details, see: Opinion of the ECB of 22 August 2018 on the review of prudential treatment of investment firms (CON/2018/36) https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2018_36_f_sign.pdf. The banking package has also reinforced the national powers applied by the ECB.

responsibilities. In fact, given the blurred lines between risk management in the banking and financial sectors, it seems logic and even desirable to place all of these players under the same supervisory and regulatory conditions—let us remember that the so-called "shadow banking" sector has emerged precisely due to the existence of regulatory loopholes. What is pointed out here is that the expansion of prudential powers over institutions other than banks, requires not only more specialised supervisors, capable of fully understanding and implementing a complex and highly dynamic set of tools, but also a more contextually-sensitive approach, in order to make sense of the diversity of actors and their institutional and local characteristics. It would fair enough to challenge this conclusion and ask why the supranational supervisor should bother to be more context-wise, if most of these big players act on a cross-border basis, and are in fact benefited from the Europeanisation of rules and supervision. While this is true, it is nevertheless important to consider the nuances embedded in the 'diversity management' paradox, and hence the need to be attentive to the deeper entrenchment of social, non-written norms, which are fundamental to understand specific institutional practices.

The second aspect to be examined in this subsection concerns the effectiveness of supranational (supervisory) tools, and the interconnectedness between regulation and supervision, as the analysis of the SSM's practices has suggested. As a matter of fact, the institutional and regulatory evolution depicted in Chapter 1 shows how the developments in prudential regulation have been marked by the need to ensure the effectiveness of supranational policy-aims, i.e., financial integration. In order to achieve it, a wide set of legislative and non-legislative acts have been adopted. In the early days of the 1985 White Paper, "the basic type for implementing the internal market programme is [was] the directive" (Dehousse et al. 1992, 67), which meant that these Directives had to be transposed and subsequently enforced at the national level. This disassociation between

supranational policy goals and national implementation impacted directly upon *effectiveness* of Community law:

> The enforcement of Community law is part of a more general conceptual domain of the effectiveness of Community law. Effectiveness may refer not only to enforcement but also to implementation, impact or compliance. (Dehousse et al. 1992, 66)

With the FSAP and the Lamfalussy process, which foresaw a four-level regulatory structure as explained in Chapter 1, the amount and the typology of tools according to the level in which they were enacted started to rise. However, in spite of the increasing collaborative efforts amongst supervisors, enforcement and implementation took place at the national level. The post-crisis phase, on the contrary, deploys different mechanisms to overcome effectiveness problems and deal with member States' diversity (Dawson 2015a). As far as this research is concerned, Chapters 4 and 5 show how the ECB adopted a series of binding and non-binding supervisory tools. In the case of the latter, these are not meant to alter the content of pre-existing and generally applicable rules; on the contrary, non-legally binding instruments aim to contextually interpret hard law tools and provide transparency towards market actors, with a view to making supranational supervisory expectations clearer and explicit.

More specifically, Chapter 5 maps the regulatory tools that are broadly used in order to strengthen supervisory consistency. In addition to the mapping and classificatory exercise, the analysis raises some legitimacy questions due to the different nature of the instruments adopted: those having a general scope should be assessed differently from more specific ones. Perhaps the biggest legitimacy challenge raised by this broad range of instruments has been put forth by the ECB itself, when commenting that

> The distinction between legally binding acts containing prudential requirements, on the one hand, and non-binding legal acts and documents, on

> the other, needs to be carefully applied by the ECB when adopting legal acts or when publishing policy documents. (ECB 2019b, 10)

Although the ECB will "ensure that such instruments are not *perceived* as having any binding effect" (ECB 2019b, 8, emphasis added), this is not a matter of perception but, rather, of efficacy and effectiveness of supranational instruments, which in turn help accomplish supranational policy aims, such as supervisory consistency. As pointed out in the introductory chapter, "the growth in soft law has two dimensions: the rules or standards themselves and the standard setters" (Goodhart 2011, 542, citing private correspondence with Kern Alexander). This distinction is relevant to our analysis: as explained above, the proliferation of soft law instruments in the prudential domain had started before the SSM was established. The difference between the past and the present, however, lies in the fact that the new *standard setter* is also in charge of enforcing these soft law tools. Effectiveness of supranational tools and policy aims is hence strengthened.

Effectiveness leads us to the consideration of two concluding points. First, in spite of the clear separation between supervision and regulation within the EU post-crisis institutional architecture, the unfolding of supervisory practices reveals that the distinction cannot be strictly maintained. The difficulty in separating these two activities is not just related to the broad exercise of regulatory powers within the SSM framework; it also concerns the opposite scenario, i.e., quasi-supervisory powers granted to the EBA, for instance, in the case of the settlement of disagreements between competent authorities in cross-border situations, provided for in Article 19 of the EBA Regulation. Furthermore, beyond the direct exercise of its regulatory powers, it is important to acknowledge the relevance of ECB legal opinions which, in a subtler but effective fashion, shape the content

of EU legislation and help expanding the bank's supervisory scope, as shown by the systemic investment firms case above.[356]

The second final point concerning the increasing role played by the ECB in the prudential arena relates to the (growing) distributive consequences of its policy action. This issue has been partly dealt with in Chapter 1, but is nevertheless important to wrap it up in these concluding reflections. Although the SSM describes itself as 'neutral' in relation to policy choices that are bound to have a wide impact on the banking sector, the reality is that structural changes have occurred since the establishment of the SSM:[357] the reduction in the number of credit institutions, the increasing domestic M&As due to consolidating pressures, and the alteration of ownership and governance structures due to national concerns about the health of the local banking systemic, chiefly the LSI sector, as the case of the Italian BCC shows. The (bold) regulatory action taken by the SSM within the NPL saga is another example of the wide impact of these non-binding measures. The ECB can undoubtedly take credit for the reduction of NPLs and the progress that has been made in the last years; however, the problem is still pressing for small and medium-sized banks, which remain in a weaker situation compared to the larger players. The NPL issue, however, is not only a matter of specifying loan loss provisioning for banks and adventuring the SSM into uncharted (quasi-accounting) waters. The problem is related to deeper institutional, structural, and judicial deficiencies in the countries that have been affected the most. In fact, "ample divergence exists among countries in the speed of recovery, largely due to country-specific factors" (Montanaro 2019, 220).

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[356] Another example of the importance of ECB legal opinions concerns the debate on whether regulatory powers should be conferred to the SSM within the framework of the European Market Infrastructure Regulation (EMIR), in connection to the central counterparty clearing (CCPs). See the opinion at https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2017_42_f_sign.pdf

[357] However, as mentioned above, the causes of these structural changes can only be explained through the combination of different factors, and not the SSM regulatory and supervisory intervention only. Furthermore, some of these circumstances are part of member States' idiosyncrasies.

As pointed out by a high-level official interviewee from the ECB, the SSM is not guided by supranational political institutions that define a socially desirable level of risk in the banking sector, because such institution does not exist: none of the supranational actors decides on strategies related to the optimal banking system that would be expected at the European level. This reasoning explains the SSM's 'neutrality' when it comes to policy choices. However, policy action does not happen in a political vacuum, and therefore the SSM's decisions will inevitably yield winners and losers.

6.3 Research boundaries and future directions

6.3.1 Limitations of the research

Although it is up to the readers to discuss and comment on limits and research flaws, it is useful to address some of the limitations of this work, as this helps set the boundaries of what has been done and what has not, and allows for the identification potential research paths, as discussed in the following subsection.

To start with, this research has not explored the consistency challenges of the Single Resolution Mechanism (SRM), the second arm of the Banking Union. In fact, both the SSM and SRM regulation pursue parallel objectives in terms of consistency, as this comparison of their respective legal texts show:

SRM Regulation	*SSM Regulation*
Art. 7 (1): The Board shall be responsible for the effective and consistent functioning of the SRM.	Art. 6 (1): The ECB shall be responsible for the effective and consistent functioning of the SSM.
Art. 7 (4): Where necessary to ensure the consistent application of high resolution standards…	Art. 6 (5) b: When necessary to ensure consistent application of high supervisory standards…

Table 6.2: Correspondence between the consistency aim in the SRM and SSM regulations.

Apart from the legislative similarities in connection to the consistency aim, both the SRM and the SSM share the distinguishing criteria between SIs and LSIs, which plays an essential role in the distribution of competences in both mechanisms. Those banks that fulfil the SSM significance criteria and are hence directly supervised by the ECB, are also under the Single Resolution Board's (SRB) authority. (Iglesias-Rodríguez 2019). This last circumstance (SIs directly supervised by the SSM which are also under the SRB's authority), refers to the case of *pre-resolution stages* carried out by the SRB. On the contrary, the significance criteria that are relevant to define the *resolution phase* and the intervention of the SRM, are not the same. This creates inconsistencies in the way the notion of significance is applied by the SSM and by the SRB:

> Whilst in the EBU's supervisory and pre-resolution stages, the systemic importance of a bank constitutes a key element for the allocation of responsibilities between the EU and Member State levels, this is not the case in the resolution stage. The fact that a failing or likely to fail bank—in relation to which no alternative private or supervisory measures have been identified—is directly supervised by the ECB or, more particularly, under the direct remit of the SRB, *does not automatically entitle it to SRB's resolution*. The latter is conditional on the satisfaction of the public interest test, which is linked to the accomplishment of the resolution objectives. (Iglesias-Rodríguez 2019, 199, emphasis added).

In spite of the affinity between the SRM and the SSM's objectives in relation to the achievement of (resolution or supervisory) consistency, there are two main grounds that

account for the SRM's absence. First, for the purposes of diversity management and the means used to strengthen consistency, the SRB is a less relevant case, given that the crisis-management experience of this mechanism has been far more limited than that of the SSM. As explained above, in spite of both the SSM and the SRM employing the same distinction between SIs and LSIs, the application of the resolution tools and the activation of the supranational apparatus depends on whether the *public interest* test is fulfilled by the bank in question, according to the resolution authorities. Therefore, the only way to assess the consistency challenge in the SRM would have been through the analysis of pre-resolution phases, as the rest of the crisis management procedures are still largely in the hands of National Resolution Authorities (NRAs) applying national law. Furthermore, to provide an in-depth and focused analysis it is necessary to restrict the object of study; therefore, the analysis of supervisory consistency and diversity has concentrated on the SSM case, avoiding Banking Union-wide comparisons that would have shifted the focus away from the main research concerns.

Another source of limitation concerns the selected and analysed cases. First, the empirical analysis has not fully considered, for instance, the public consultation and the regulatory action taken in the case of options and national discretions (ONDs). They have been addressed in Chapter 5 as part of the broader analysis, but a deeper examination of the ONDs and how they have been defined by the SSM can be useful to refine the supervisory consistency notion, and how diversity is managed.[358] Second, technical limitations have prevented me from further analysing other supervisory initiatives that have had a fundamental impact on consistency, such as the targeted review of internal models (TRIM) exercise. Internal models and their misuse have been in fact one of the 'culprits' of the financial crisis , and have been one of the most criticised aspects of Basel II. Third,

[358] Further details about the ONDs can be found in Biondi and del Barrio Arleo (2018).

another limitation, this time from the cases that have been included in the empirical chapters (SREP, ICAAP, NPLs, and IPSs), relates to the documentation analysed from the respective public consultations. In fact, the study has focused on the position papers from German and Italian banks (either SIs and LSIs), their respective bank associations, and European-wide bank associations—the analysis has not considered, for instance, official positions from other member States participating in the consultations. This approach can be explained in light of the focus of this research: to use the German and Italian cases not as rigid comparative devices, but, instead, as illustrations of the diversity phenomenon, and how divergent supervisory practices and styles can be developed on the grounds of different institutional and cultural traits, as elucidated in Chapter 3.

6.3.2 Future avenues of research and final reflections: *Quo vadis* banking?

As anticipated earlier in this chapter, the banking and financial sectors are currently undergoing a process of digital transformation, which includes the phenomena of digitisation and datafication (Arner, Buckley, Selga, and Zetzsche 2019). These changes have highlighted the close interrelationship between finance, data, and technology. In the banking realm, this phenomenon has materialised in *open banking,* which can be defined as "the sharing and leveraging of customer-permissioned data by banks with third party developers and firms to build applications and services" (BCBS 2019b, 4). The concept of open banking represents a radical rupture from the traditional banking business, for at least two reasons. First, it requires credit institutions to share 'customer-permissioned data': customers' data have so far represented a fundamental exclusive source of advantage over competitors. Second, it introduces a key 'third party': developers and firms that build applications and services. The presence of additional parties acting as intermediaries

between banks and their customers is a disruptive feature, as it compels credit institutions to rethink their business models and role within the broader financial and economic sectors.

These third parties develop new products and services through the so-called *application programming interfaces* (APIs), which is simply a "way for two computer applications to talk to each other over a network using a common language" (Zachariadis and Ozcan 2017, 5, citing Jacobson et al., 2012). The presence of APIs developed by actors other than banks themselves, and the use made of these interfaces by customers, entails a new banking paradigm called "Banking-as-a-Platform", which

> Describes the premises upon which banks can adopt a platform strategy model and change the rules of competition. In doing so, banks will need to *revisit their role as financial intermediaries and prepare to become re-intermediaries* by providing "online automated tools and systems that offer valuable new goods and services to participants on [all] sides of the platform". (Zachariadis and Ozcan 2017, 11, citing Parker et al., 2016; p.71, emphasis added)

In the EU, with the entry into force of the Second Payments Services Directive (PSD2),[359] banks are required to transfer customer data to these third parties, with a view to fostering competition. As mentioned above, open banking is deeply changing banks' role as financial intermediaries, since banking activities have to move from a relationship- to a platform-based activity. The present research has shown that the changing conception of banks and their societal purposes has impacted upon the role assigned to supervisors. Therefore, open banking's potential to transform the financial ecosystem can have fundamental consequences in relation to the activities carried out by banking supervisors, and hence on the broader EU economic and financial governance. In conformity with the governance evolution approach undertaken in the present work, it could be further explored how the SSM is bound to be transformed, in light of the challenges posed by open banking.

[359] Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

Just to mention two key aspects: first, the emergence of new risks that are not fully addressed by the current supervisory toolkit. The SREP has traditionally focused on credit, market, operational, and liquidity risks; however, these technological changes beget new sources of systemic risk, such as Cyberrisks, data risks, and technology risks or *tech risk* (Arner, Buckley, Selga, and Zetzsche 2019). Second, given the strong connection between data protection and financial services, there will be an increasing need for better coordination and information-sharing between banking supervisors, competition, and data protection authorities, which is prone to alter the current institutional ecosystem in the EU.

It is hence to be seen and further studied how the growing interconnectedness of various players involved in the provision of financial services—not all subject to the same rules, therefore affecting the 'level playing field'—, and the more dynamic interaction between data and finance, have the potential to incorporate non-market aims in the development of supervisory practices. In fact, to better understand the new ecosystem created by open banking, it might be necessary to take into account not only market-oriented considerations, but broader competition and privacy societal concerns, too.

On the other side of the spectrum, the other major technological transformation that is impacting upon supervisors, relates to the incorporation of Artificial Intelligence (AI) into supervisory tasks, through what is known as RegTech and SupTech. In this context, supervisors need not only to be updated, but also understand how these technologies unfold—if they know less than their supervisees, this could be problematic. The question regarding the use of AI as part of supervisors' everyday activities, triggers the need to rethink and refine some basic legal concepts and their (new) boundaries. For instance, who

can be held responsible in case of wrong-doing derived from technical flaws and biases in algorithms? As the ECB (2019c, emphasis added) recently explained:[360]

> There are two sides to every coin: the more supervision relies on IT solutions, the more exposed it becomes to the risks associated with complex technologies. Early adopters of AI have found that complex computations are sometimes hard to comprehend. Supervisors should therefore approach AI with caution. Regardless of whether or not the algorithms used in machine learning have been constructed in a transparent way, *supervisors are still responsible for their work, even if part of it is performed by a computer*.

The final question is, how does the impact of new technologies on the banking sector and supervisors alike, relate to the concepts developed in this work? More bluntly: are *consistency* and *diversity* of any relevance within the process of digital financial transformation? In my view, the answer is *yes*, they matter. As far as the former is concerned, the new kids in town that will be within the regulated perimeter, are thus a challenge to supervisory consistency. This does not imply that this policy aim has to be abandoned or disregarded; on the contrary, it needs to be redefined and adapted to the new types of *platform* business models, new types of infrastructures, and chiefly the emergent new risks stemming from these technology-driven activities. Open banking requires a more attentive and sensitive supervisory approach towards data treatment and privacy concerns, other than financial stability. Concerning the latter, diversity, the emergence of digital platforms as financial intermediaries is likely to create a new type of institutional diversity within the banking ecosystem. Furthermore, the rising of large technology companies in financial services, the so-called *BigTechs*, e.g. "Alibaba, Amazon, Apple, Baidu, eBay, Facebook, Google, Microsoft, Tencent" (FSB 2019, 1), has been characterised by the provision of data in a highly concentrated market (Arner, Buckley, Selga, and Zetzsche

[360] See the SSM newsletter article available at: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2019/html/ssm.nl191113_4.en.html?utm_source=newsletter&utm_medium=email&utm_campaign=basu_newsletter_November_2019&utm_term=article_ai&utm_content=image

2019). As pointed out by the Financial Stability Board (FSB 2019, 2) in connection with BigTechs and their potential financial stability implications,

> A further overarching consideration is that a small number of BigTech firms may in the future come to dominate, rather than diversify, the provision of certain financial services in some jurisdictions. If this were to occur, the failure of these firms could lead to widespread disruption.

In light of these potential—and partly current—threats to diversity and concentration of power in the hands of dominating data-driven firms, it is essential that policymakers, academics, and citizens alike, are fully aware of the privacy and financial stability concerns that can be triggered by these innovative technologies.

In all, this research has shed light on a complex and sensitive real-world problem, which requires a prudent balancing exercise from supervisory authorities. The achievement of supervisory consistency appears as an imperative in the context of market and banking sector integration. At the same time, prudential oversight requires a bespoke assessment that considers the specificities of each credit institution. In order to cope with the ticklish equilibrium between consistency and diversity, the SSM has developed sophisticated tools aimed at easing cross-national comparisons. However, the banking sector is still far from being fully Europeanised. The near-future scenario depicted above, with the emergence of open banking and a reconceptualization of the role of banks as financial intermediaries, could be a way to (truly) level the playing field and introduce a healthy dose of competition, which could enhance the cross-border dimension of banking. There is a risk yet, that these innovations widen the gap between more and less tech-friendly member States. Since the SSM has a privileged position as a supranational rule-enforcer, it is uniquely well-placed to understand the diversity of scenarios under which this common framework is applied. Strengthening sensitivity to diversity is an essential tool to cope with the imminent supervisory challenges.

ANNEX: List of Interviews

Interviews conducted between February 2018 and April 2019.

No.	Institution	Interviewees' profile	Date	Interview modality
1	BaFin	Legal expert, economist, and public relations official (3)	27/02/18	Meeting Bonn - recorded
2	European Commission	Legal expert, DG for Financial Stability, Financial Services and Capital Markets Union	19/03/18	Telephone call
3	SSM-DG MS I (JST)	Supervisor	22/03/18	Background interview – meeting Frankfurt
4	SSM-DG MS I (JST)	Supervisor	February-July 2018	Informal meetings in Frankfurt
5	Bundesbank	Responsible for Strategic Office SSM-Supervision / JST Coordination	27/03/18	Meeting Frankfurt
6	ESBG	Head of Regulatory Affairs	03/04/18	Skype call – recorded
7	Banca d'Italia	On-site supervision expert	04/04/18	Telephone call – meeting in Trento
8	Bruegel	Senior Fellow	10/04/18	Telephone call
9	ECB DG Legal Services, Supervisory Law Division	Head of Section	29/05/18	Telephone call
10	ECB DG Legal Services, Supervisory Law Division	Legal Counsel	20/04/18	Background interview – meeting Frankfurt
11	ECB DG III	Supervisor	25/04/18	Background interview – meeting Frankfurt
12	ECB DG IV	Supervisor	7/05/18	Background interview – meeting Frankfurt
13	ECB DG IV - BdI	Supervisor	10/05/18	Background interview – meeting Frankfurt
14	ECB DG IV	Deputy Director-General	12/06/18	Meeting Frankfurt
15	ECA	Lead Auditor	2/05/18	Telephone call
16	EBA	Head of Banking Markets, Innovation and Products	16/05/18	Skype call
17	EBA	Official, Department of Banking Markets, Innovations and Consumers	23/05/18	Telephone call
18	ABoR	Academic member of the ABoR	21/05/18	Meeting Rome

19 **19 (i)**	German Savings Banks Association	Director, Regulatory Relations ECB-EBA	29/05/18 23/10/18	Meeting Frankfurt Meeting Berlin
20	Bundesbank	DG Banking & Financial Supervision	2/08/18	Meeting Frankfurt
21	ECB	DG Secretariat and Secretary to ECB decision-making bodies	13/07/18	Meeting Frankfurt
22	EBF-ABI	Project Manager	25/06/18	Meeting Frankfurt
23	SSM – DG MS I	Head of Division	2/07/18	Meeting Frankfurt
24	Association of German Banks (BdB)	Director	11/07/18	Meeting Frankfurt
25	BdB	Division Manager	05/09/18	Meeting Berlin
26 **26 (i)**	Intesa SanPaolo Bank	Head of Supervisory Affairs	28/09/18 01/10/18	Skype calls
27	Banco Popolare (BPM Group)	Chief Risk Officer	05/10/18 06/10/18	Telephone calls
28	BNP Paribas	Head of Group Prudential Affairs	11/10/18	Telephone call
29	Commerzbank	Legal Counsel	13/11/18	Conference call
30 **30 (i)**	Bundesbank	Division Chief Banking and Supervision	16/11/18 26/11/18	Meeting Berlin
31	ECB Directorate General Legal Services, Supervisory Law Division	Senior Legal Counsel	19/11/18	Telephone call
32	Deutsche Bank AG	Risk experts (2)	19/11/18	Telephone call
33	DSGV	Ex Chief Economist Norddeutsche Landesbank (Consultant) and DSGV official (2)	20/11/18	Meeting Berlin
34	PJT Partners	Senior Legal Counsel	22/11/18	Telephone call
35 **35 (i)**	Federcasse	Head Research Department	10/12/18 17/04/19	Telephone calls
36	ECB DG Legal Services, Supervisory Law Division	Legal Counsel	11/12/18	Telephone call
37	DSGV	IPS experts (3)	12/12/18	Meeting DSGV's Berlin
38	ECB DG III	Senior Adviser	17/12/18	Telephone call
39	Banca Sella	Chief Risk Officer	17/12/18	Telephone call
40	VöB – Assoc. German Public Banks	Director, Head of Banking Supervision	17/01/19	Meeting Berlin
41	Centro Europa Ricerche	President	25/03/19	Meeting Rome
42	Federcasse (International Relations Service, Brussels)	Policy Analyst	23/04/19	Telephone call

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[361] Only the most relevant legal texts have been included (in alphabetical order).

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6. ECB Banking Supervision consultation on IPSs:

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