

BLUEPRINT SERIES 25

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European banking supervision: the first eighteen months

Dirk Schoenmaker and Nicolas Véron

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Foreword

On 29 June 2012, the euro area's heads of state and government decided to create a European banking union. European banking supervision, established within the European Central Bank is one of the essential elements, the others being European bank resolution and European deposit insurance (Pisani-Ferry *et al*, 2012). European banking supervision became fully operational on 4 November 2014. Eighteen months on from its creation, the time has come for an initial assessment. This Blueprint provides the first in-depth review.

Looking back at the first eighteen months, I would identify three major debates around banking supervision. The first concerns non-performing loans in Europe's banking system. The ECB's asset quality review and stress tests prior to the establishment of European banking supervision uncovered large amounts of non-performing exposures in Europe's banks. Those loans were a major concern for banks' profitability and their ability to fund new profitable investments (Acharya and Steffen, 2014a). In particular, medium-sized banks were identified as a concern (Mody and Wolff, 2015). More recently, the debate has crystallised around non-performing loans in Italian banks and the question has arisen of why this issue was only raised in early 2016. A recurring question in policy circles was therefore whether or not European banking supervision was forceful enough in addressing the problem and whether its strategy for addressing it was appropriate. The editors of this volume conclude that European banking supervision is tough and broadly fair – but they also acknowledge that Europe is still far from addressing all its banking problems. The chapter on Italy provides a detailed analysis, but it might still be too early to reach

a final conclusion.

The second big policy discussion evolved around the Single Supervisory Mechanism's handling of the Greek situation in 2015. In particular, based on the ECB's handling of Greek banks, concern was voiced that banking supervision within the ECB was not sufficiently independent from monetary policy decisions. The chapter on Greece in this volume provides a nuanced description of the unfolding of the stand-off between creditors and Greece and the difficult role that European banking supervision had to play. The fast-deteriorating economic situation in Greece during the stand-off certainly left a gap in the balance sheets of Greek banks. But the size of the gap depended on what the final resolution of the conflict would look like – it was hard to assess it in real time. In my view, any European supervisor would have had a very difficult time taking decisions on Greek banks in such a situation that would have precluded their access to funding. Rather than manifesting a conflict of interest with monetary policy, the political stand-off in an incomplete and fragile monetary union made this supervisory decision difficult.

The third policy debate is more generally about the further institutional development of banking union. One important aspect is the separation of banking supervision from monetary policy. There are many good arguments for and against the central bank being in charge of banking supervision. It is fundamental that supervisory decisions should not be unduly influenced by monetary decisions and vice versa. In the euro area, it was only possible to establish European banking supervision so quickly because of the institutional and legal infrastructure of the ECB. Another aspect is how a centralised supervisor operates in a union, in which the resolution framework is not fully integrated and deposit insurance is still national. Can it and should it end ring-fencing of capital and deposits? What degree of independence does it have to take decisions that ultimately could imply fiscal costs at national level? How should sovereign debt be treated? European banking supervision in a fragile monetary union with an

incomplete banking union will remain a special and daunting task. The overall tone in this Blueprint is one of appreciation for how well the ECB has met this challenge. But we cannot content ourselves with the present situation and I would call on the European political system to finish the work started in June 2012.

The Blueprint provides an excellent review of the first 18 months of European banking supervision. It reviews the overall situation and the situation in a number of euro-area countries. In doing so, it provides important insights into the start of a new policy regime that involves profound change for the European banking landscape. Certainly one of the most important common themes is just how profound the regime shift from national supervision to European supervision is. The greater distance between European banking supervision and banks comes out strongly in all the chapters – and the greater independence is often highlighted, as is the fear of ‘one-size-does-not-fit-all’. The volume does not attempt to evaluate all the specific decisions of banking supervision. Arguably, such an evaluation is hard to do because it critically depends on assessing the information available to banking supervisors and forming a view of a counterfactual. The volume is therefore a critical review of the overall situation and outlines the emerging new European banking landscape under uniform European banking supervision.

The volume was edited by Bruegel scholars Dirk Schoenmaker and Nicolas Véron and I want to express my gratitude for their hard and successful work. Country chapters were mostly written by non-Bruegel scholars from nine countries who could offer deep insights into their respective countries. The scholars involved also acted as a group and discussed their findings. Let me thank them for their timely and insightful contributions, and for the collective work that makes for an insightful reading of the emergence of a new European banking landscape.

*Guntram Wolff, Director of Bruegel
Brussels, June 2016*

1 Introduction and executive summary

Dirk Schoenmaker and Nicolas Véron

European banking supervision (also known as the Single Supervisory Mechanism, or SSM¹) is, in many ways, the cornerstone of Europe's banking union, itself arguably the most ambitious European structural reform project of the past ten years (Véron, 2015; Schoenmaker, 2015a). The first firm policy announcement to initiate banking union was made on 29 June 2012. It was, in the words of European Central Bank President Mario Draghi that same day, "*the game-changer we need*" to trigger the ECB's Outright Monetary Transactions (OMT) programme and end the most disorderly phase of the euro-area crisis (Van Rompuy, 2014). On 15 October 2013, the enactment of the SSM Regulation (Council Regulation (EU) No 1024/2013), unanimously adopted by all EU member states including those outside of the euro area, for the first time enshrined the vision of banking union in EU legislation, followed by the Single Resolution Mechanism (SRM) Regulation ((EU) No 806/2014) on 15 July 2014.

European banking supervision was a logical first step for banking union because key stakeholders, not least the German government²,

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- 1 We follow the ECB's recent practice of generally referring to the new bank supervisory policy framework in the euro area as 'European banking supervision,' and to its own supervisory arm as 'ECB banking supervision': see ECB (2016a), page 4, footnote 1.
 - 2 On the German finance minister's key role in introducing European banking

saw a neutral and central point of oversight of all banks in the system as a prerequisite for any further steps that might involve financial risk-sharing. It may thus have been inevitable that the second big policy announcement of 29 June 2012, on the possibility of direct recapitalisation of banks by the European Stability Mechanism (ESM), was made conditional on the first, and framed as only possible “*when an effective single supervisory mechanism is established*”³. While the prospects for ESM direct recapitalisation were later shrunk to the point of near-meaninglessness, and the emphasis shifted to bail-in rules to minimise the public cost of future banking crises, it remains appropriate to see effective European banking supervision as the key to unlocking other advances towards a more complete banking union, including in the context of current debates about the European Commission’s proposal for a European Deposit Insurance Scheme (EDIS)⁴. In Mario Draghi’s words, European banking supervision “*was an essential precondition for the other pillars of banking union*” (ECB, 2016a, foreword).

It matters greatly, therefore, to what extent the new European banking supervisory system can be considered ‘effective.’ Some 18 months after its official start on 4 November 2014, now is the right time for an early assessment – not of the legal framework, on which there is already a burgeoning literature (eg Busch and Ferrarini, 2015), but rather of how it works in practice. To achieve this, we observe the SSM’s early development here, not only from the European (namely, euro-area⁵) perspective, but also closer to the ground at the level of

supervision into the euro-area crisis management discussion, see Peter Spiegel and Alex Barker, ‘Banking union falls short of EU goal’, *Financial Times*, 20 December 2013.

- 3 Euro Area Summit Statement, Brussels, 29 June 2012.
- 4 European Commission press release, ‘A stronger Banking Union: New measures to reinforce deposit protection and further reduce banking risks’, Strasbourg, 24 November 2015.
- 5 The ‘banking union area’ may go beyond the euro area if other EU member states

individual member states. This two-level perspective is justified by the fact that banking supervision used to be almost entirely national until 2014, and national idiosyncrasies will continue to shape the system for a long time, both in terms of banking models and structures and in terms of perceptions and politics – not to mention enduring differences in bank and corporate insolvency laws, tax, accounting and other key aspects of the banking policy framework.

Much of this Blueprint is descriptive. The dawn of European banking supervision has shed a new light on the euro-area banking sector and created a new environment with its own conventions (eg the distinction between significant and less significant institutions), its own jargon (of which there is no shortage) and its own politics. Instead of benchmarking themselves only against national competitors, banks in the euro area are increasingly compared to peers across the area's countries. Our European overview and country chapters examine Europe's highly diverse banking landscape in this new light.

For reasons of practicality, we have selected nine euro-area countries which together represent more than 95 percent of the euro area's total banking assets: Austria, Belgium, France, Germany, Greece, Italy, the Netherlands, Portugal and Spain. This selection is somewhat arbitrary – one obvious shortcoming is that it includes none of the thirteen EU member states that joined the European Union in 2004 and after, of which seven are now in the euro area. The selection is tilted towards larger countries, or more specifically those with the largest banking sectors. Among the smaller countries, we have given priority to Greece and Portugal given their ongoing transition out of situations of severe banking-sector fragility. For each of these, we have selected an author who is both well-informed and suitably independent. While we made

join it under the procedure known as close cooperation. No country, however, has so far taken this step. The Danish central bank has publicly recommended it for Denmark: see Danmarks Nationalbank, 'Participation in the Banking Union is in the interest of Denmark', 10 December 2014.

suggestions of themes to the nine country-chapter authors, they have been left free to focus on the issues they deemed important in their respective national contexts⁶. Their chapters, and our own overview section, are based not only on publicly available information but also on many conversations with a broad range of stakeholders including national and European policymakers, bankers and other market participants.

Summarised findings

We find the new European banking supervision system to be broadly effective and, in line with the claim often made by its leading officials, tough and fair. These are remarkable achievements given the complexity of the transition from the previous regime. That said, we also identify significant areas for future improvement. ECB banking supervision still lacks transparency, and there is evidence that the supervisors still have much to learn about the banks they oversee in order to better accomplish their mission. Mistakes have been made along the way. Perhaps most importantly, European banking supervision has not yet achieved the objective of creating a level playing field for banking in the euro area and decisively breaking the vicious circle between banks and sovereigns.

- **European banking supervision is effective.** Supervision of cross-border banking groups in the euro area is conducted in a joined-up manner that contrasts with the previous fragmented, country-by-country practice. The key mechanism is the operation of Joint Supervisory Teams (JSTs), which for each supervised banking group enable information sharing between the ECB and relevant national supervisors while providing a clear line of command and decision-making. The size of JSTs (up to several dozen examiners) also allows for specialisation on topics such as capital and governance.

6 A coordination workshop planned for 23-24 March 2016 in Brussels had to be cancelled because of the attacks of 22 March; the meeting was held via conference call instead.

- **European banking supervision is tough, at least when it comes to significant (larger) banks.** It is generally more intrusive than previous national regimes, with supplementary questions during investigations and more on-site visits. The ECB is less vulnerable to regulatory capture and political intervention. An early quantitative indication is that the ECB has not shied away from increasing capital requirements by imposing higher capital add-ons under its Supervisory Review and Evaluation Process (SREP). Fewer changes have been introduced so far for the supervision of less significant banks, which still varies significantly in different countries but appears generally less demanding than that of significant banks.
- **European banking supervision appears to be broadly fair, at least for significant banks.** Among these, we have not found compelling evidence of country- or institution-specific distortions or special treatment by the ECB, for example in the determination of SREP scores. The situation is more complex when it comes to less significant banks that remain subject to national supervision, including those tied together in what EU legislation calls Institutional Protection Schemes.
- **European banking supervision makes mistakes.** There have been cases of overlapping and redundant data requests. The ECB's communication on maximum distributable amounts was ill-prepared and contributed to volatility on bank equity markets in early 2016. The Supervisory Board appears to act as a bottleneck in some procedures and does not optimise its use of delegation for day-to-day decisions.
- **European banking supervision is insufficiently transparent.** The ECB's Supervisory Board and SREP process are seen as a black box by numerous stakeholders. Banks complain about the opacity of the determination of SREP scores, which are based on multiple

factors. European banking supervision still provides pitifully little public information about all supervised banks, in stark contrast to US counterparts.

- **European banking supervision has not yet broken the bank-sovereign vicious circle and created a genuine single banking market in the euro area.** Many lingering obstacles to a level playing field are outside European banking supervision's remit, including deposit insurance, macro-prudential decisions (beyond banking) and many other important policy instruments that remain at national level. But even within its present scope of responsibility, European banking supervision maintains practices that contribute to cross-border fragmentation, such as the imposition of entity-level (as opposed to group-level) capital and liquidity requirements, or geographical ring-fencing, and the omission of geographical risk diversification inside the euro area in stress test scenarios. It has not yet put an end to the high home bias towards domestic sovereign debt in many banks' bond portfolios. Nor have many cross-border acquisitions been approved by ECB banking supervision so far.

Overall, we are impressed by the achievements of European banking supervision during its first 18 months. However, what remains to be done to achieve the vision of European banking union is daunting. Much of the work ahead is beyond the remit of European banking supervisors' authority, but materially depends on their ability to establish credibility and trust. Almost four years after the inception of banking union in late June 2012, these are still very early days in a momentous transition. On the basis of the assessment presented in this Blueprint, we find grounds for cautious optimism.

2 European overview

Dirk Schoenmaker and Nicolas Véron

The new European banking supervisory framework

Advocacy in favour of a shift of banking policy to the European level long predates the euro-area crisis⁷. It was this crisis, however, and specifically what is now widely known as the bank-sovereign vicious circle, that forced euro-area leaders to jointly decide to initiate banking union in late June 2012 (Véron, 2011; Pisani-Ferry *et al*, 2012). This inevitably entails considerable risk-sharing, if only implicit, because systemic banking crises can happen and governments cannot leave them unaddressed. To contain moral hazard, a precondition for this risk sharing is the organisation of banking supervision at the euro-area level.

The European Commission's proposal for the SSM Regulation was published on 12 September 2012, less than three months after the initial political impetus of late June. It was adopted in Council on 13 December 2012 and, after some stalling in the European Parliament and a trilogue process, finally enacted on 15 October 2013. ECB banking supervision started shortly afterwards, with intense recruitment activity throughout 2014 and simultaneous work on the comprehensive assessment of 130 euro-area based banking groups, involving an asset quality review (AQR) and a stress test. The results of this

7 Academics and policymakers have long argued that the increasing intensity of cross-border banking would require a form of European banking supervision and/or resolution. See, for example, Folkerts-Landau and Garber (1992), Schoenmaker (1997), Padoa-Schioppa (1999), Vives (2001), Decressin *et al* (2007), Véron (2007) and Goodhart and Schoenmaker (2009).

assessment were published on 26 October 2014 (ECB, 2014a), days before the ECB assumed its supervisory authority on 4 November.

The 2014 comprehensive assessment resulted in downward adjustments of the reviewed banks' assets of €48 billion, or 2.2 percent of their assets at the time. The stock of their non-performing exposures (NPE) was increased by €136 billion, as NPE definitions were harmonised. The assessment identified capital shortfalls for 25 banks as of its cut-off date of end-2013, totalling €25 billion⁸. In absolute terms, Italy with €9.7 billion and Greece with €8.7 billion had the greatest capital shortfalls. As a percentage of risk-weighted assets, the countries with the greatest capital shortages were Cyprus (6 percent), Greece (4 percent) and Portugal and Italy (1 percent each).

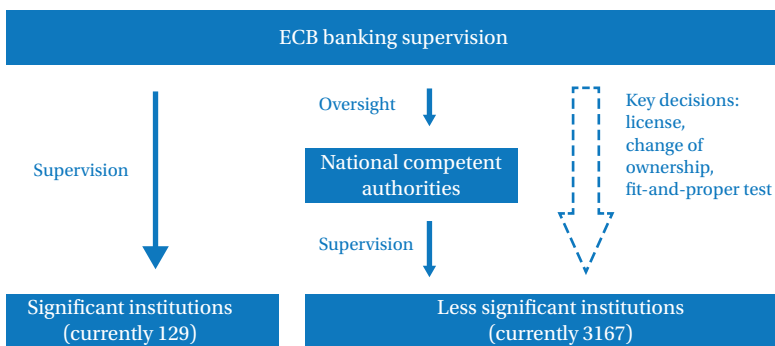
Under the SSM Regulation, the ECB is the single licensing authority for all banks in the euro area; it also has sole authority to approve changes of ownership and new management⁹. The ECB enforces supervisory laws and regulations that are substantially harmonised at the EU level, and known as such as the 'single rulebook'. The single rulebook, among other things, lays down capital and liquidity requirements for banks. Relevant EU legislation includes the Capital Requirements Regulation (CRR, (EU) No 575/2013) and four successive Capital Requirements Directives (CRD), the last enacted in 2013 (2013/36/EU). The European Banking Authority (EBA), created in early 2011 with its seat in London, prepares many of the lower-level delegated and implementing acts (broadly equivalent to what are called regulations in the United States), which require the European Commission's eventual approval. The EBA also maintains a single supervisory handbook to ensure consistency across the EU.

8 Twelve of these 25 banks had addressed the shortfall during the first nine months of 2014. The other 13 were asked to rapidly present recapitalisation plans for the shortfall to be addressed in the course of 2015.

9 On this, the euro-area framework is more centralised than in the United States, where many banks and credit unions are licensed by state authorities even though they are supervised by federal agencies.

The ECB directly supervises 129 banking groups, broadly speaking the largest in the euro area. They are labelled significant institutions (SIs)¹⁰. The euro area's more than 3,000 other banks (or less significant institutions, LSIs) are supervised by national competent authorities (NCAs), which are the national supervisors in the respective countries¹¹. The ECB does not conduct parallel supervision of the LSIs, but exercises oversight of the NCAs to ensure supervisory consistency, and gives them supervisory support. Figure 1 illustrates the framework.

Figure 1: European banking supervision



Source: Bruegel based on ECB (2016a).

10 Under the SSM Regulation, all banks with consolidated assets over €30 billion are automatically designated as SIs, and other banks may also be designated if they meet other criteria. The list of supervised institutions, including designation of all SIs and LSIs, is regularly updated by ECB banking supervision and published on its website. Unless otherwise indicated, all numbers in this Blueprint are based on the list as of 1 January 2016.

11 As of April 2016, for 12 of the 19 euro-area countries (Belgium, Cyprus, France, Greece, Ireland, Italy, Lithuania, the Netherlands, Portugal, Slovakia, Slovenia and Spain), the NCA is the national central bank (NCB). For the other seven (Austria, Estonia, Finland, Germany, Latvia, Luxembourg and Malta), the NCA is an independent supervisory authority, such as BaFin in Germany, but the NCB also participates in the relevant JSTs. In the latter cases, the exact division of labour between the NCA and NCB varies for different countries.

Operationally, the key unit for European banking supervision is the Joint Supervisory Team (JST), one for each of the 129 SIs. JSTs combine ECB banking supervisory staff with staff from the NCAs. Each JST is led by a coordinator from the ECB¹², always a national from outside the supervised bank's home country, in line with standing practice of surveillance by international organisations like the International Monetary Fund (IMF). Each JST also includes a sub-coordinator from the NCA of the bank's home country, and if the bank has major operations in other euro-area countries, additional sub-coordinators from the relevant NCAs. JSTs of the largest banks can have as many as 70 to 80 members, of which up to a dozen are ECB banking supervisory staff and the rest are from the participating NCAs.

The key decision-making body is the ECB's Supervisory Board, which includes a chair (currently Danièle Nouy), a vice-chair who is also a member of the ECB's executive board (currently Sabine Lautenschläger), four ECB representatives (currently Ignazio Angeloni, Luc Coene, Julie Dickson and Sirkka Hämäläinen), and representatives from all participating member states¹³. Apart from the Supervisory Board's secretariat, ECB banking supervisory staff work in four directorates-general for micro supervision (DGMS). DGMS I supervises the system's largest banking groups, currently numbering 30. DGMS II supervises all other SIs. DGMS III, the smallest of the four directorate-general in terms of headcount, oversees the supervision of LSIs by the NCAs. DGMS IV is in charge of horizontal functions, such as policy and common methodologies (eg for the SREP process), inspections and thematic reviews, for example on risk governance, horizontal analysis of internal models and IT and cybersecurity risks. There were 250 inspections in 2015 (of which

12 By contrast with, for example, the Federal Reserve system, in which each bank's supervisory team is led by one of the 12 regional Federal Reserve Banks, all JST coordinators are located at the ECB in Frankfurt.

13 For those member states where the NCA is separate from the NCB, there are two representatives (from the NCA and NCB respectively), but they collectively have only one vote.

42 targeted the seven largest banking groups), involving mostly NCA staff but also the ECB's centralised on-site inspections division with several dozen staff in DGMS IV (ECB, 2016a, section 2.4.3). Overall, the expenditure for ECB banking supervision in 2015, not counting supervisory expenditures at the NCAs, was €277 million (ECB, 2016a, section 5.1). This amount will grow in the next few years as the ECB is still recruiting new staff (ECB, 2016a, section 1).

Data requests are aligned with standards, which the EBA began to define well before the start of European supervision. The main standards for harmonised reporting by banks are COREP (common reporting for regulatory metrics, such as Pillar-1 capital¹⁴) and FINREP (financial reporting data, such as annual financial statements). While the NCAs are first in line for the collection of supervisory data and quality control, the ECB has established further quality controls to ensure consistent data quality standards across all supervised banks, and is gradually building up integrated information systems. The supervisory banking data system (SUBA in ECB lingo) allows for communication and data-sharing between the ECB and NCAs (ECB, 2016a, section 1.6).

The euro-area banking system

As of early 2016, the ECB directly supervises 129 SIs, listed and summarily described in Table 6 at the end of this chapter. Of these, 96 are designated as significant because they have more than €30 billion in assets; the other 33 are designated under other criteria set by the SSM Regulation (among the largest three banks in a country; assets above 20 percent of a country's GDP; significant cross-border operations; or banks with assets over €30 billion in the previous three years). The

14 The Basel capital accord (currently Basel III) defines Pillar-1 capital requirements as a minimum ratio of regulatory capital (eg common equity Tier1 or CET1 capital) over risk-weighted assets. Pillar-2 is based on supervisory review involving a greater degree of supervisory judgment, and may entail additional capital requirements ('Pillar-2 add-ons'). Pillar-3 is a framework for mandatory disclosure of regulatory information and risks, currently undergoing review by the Basel Committee because it has generally disappointed in the past.

breakdown of these banks and the 3,167 LSIs is shown in Table 1.

Table 1: Institutions subject to European banking supervision (end-2015)

Size	Number of banks	Assets (billions)	% of all euro area banks' assets	CET1 ratio in %	Leverage ratio in %
G-SIBs (> €800bn assets)	8	€ 10,866	39.2	12.3	4.5
E-SIBs (> €150bn)	22	€ 7,253	26.1	14.0	5.1
Other EA SIs (€3-150bn)	70	€ 3,999	14.4	16.6	5.6
Significant subs/branches (€3-302bn)	29	€ 940	3.4	n.a.	n.a.
LSIs (all < €30bn)	3,167	€ 4,689	16.9	n.a.	n.a.
All euro-area banks	3,296	€ 27,747	100.0	n.a.	n.a.

Source: Bruegel based on SNL data and ECB (2016a). Notes: The CET1 ratio and leverage ratio are calculated as an average weighted by total assets. The leverage ratio is defined as the ratio of Tier 1 Capital and total leverage exposure.

Table 2: Comparing the major banking systems, end-2015

Banking system	Total assets (billions)	Domestic assets (billions)	Activity abroad (%)	CR-5 Ratio (%)	Assets/GDP (largest, %)	Assets/GDP (top 3, %)	Assets/GDP (top 5, %)
China	€ 28,226	€ 26,999	4.3	40.4	30.1	76.9	113.6
Euro area	€ 27,747	€ 22,757	18.0	24.6	18.8	50.1	73.3
U.S.	€ 14,296	€ 13,044	8.8	40.4	10.7	28.7	38.3

Source: Bruegel based on SNL data and China Banking Regulatory Commission (CBRC) for China, ECB (2016a) for the euro area, and Federal Reserve for the United States. Notes: The total assets comprise consolidated assets of domestic banking groups and domestic assets of subsidiaries and branches of foreign banks. To calculate the size of the respective banking systems (labelled as domestic assets), the foreign assets of the domestic banks are deducted. The concentration ratio of the largest five banks (CR-5) is based on their domestic assets as a percentage of total domestic assets.

The SIs dominate the landscape, with 83 percent of the system's total assets; LSIs are more important in some member states (especially Austria, Germany and Italy), but unfortunately the ECB does not (yet) provide a split of LSI assets by country. The eight largest SIs are designated by the Financial Stability Board (FSB) as 'global systemically important banks' (G-SIBs)¹⁵. We use the label 'European systemically important banks' (E-SIBs) for the next 22 SIs with more than €150 billion in assets¹⁶. Together, the euro area's G-SIBs and E-SIBs represent almost two-thirds of the area's total assets.

Table 2 compares the euro area with the banking systems of China and the United States. Following rapid recent growth, China has become the world's largest banking system with €28.2 trillion in total assets at end-2015. The European banking union follows closely with €27.7 trillion, and the United States is about half that size with €14.3 trillion. Table 2 also shows that euro-area banks are much more internationally active (outside the euro area) than their US or Chinese counterparts (see Table 3 for more detail). It further indicates that the concentration ratio for the largest five banks (CR-5 ratio) is only 24.6 percent in the euro area, while for both the Chinese and US banking market it is 40.4 percent. Europe's banking union thus starts significantly less concentrated than its international counterparts, even though its banks have a heavier weight than those in the US when measured against euro-area GDP¹⁷. A crucial question is whether the euro area will witness the same merger-and-acquisition dynamics as

15 By decreasing order of total assets (Table 6): BNP Paribas, Crédit Agricole, Deutsche Bank, Santander, Société Générale, BPCE, UniCredit and ING.

16 The ECB does not explicitly disclose the split of SIs by supervision between DGMS I and DGMS II, but we presume that the 30 banks supervised by DGMS I are the eight G-SIBs and 22 E-SIBs. The E-SIB labelling is our judgment and does not appear in ECB communication.

17 The gap between Europe and the US is partly, but far from entirely, related to differences in accounting standards, which make the US banks appear comparatively smaller when measured by total assets. Accounting differences presumably have less of an impact between Europe and China.

the US experienced after the lifting of restrictions on interstate banking by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Stiroh and Strahan, 2003; Schoenmaker, 2015b).

Zooming in on the G-SIBs and E-SIBs, Table 3 shows their banking union market shares and cross-border footprints. The banking union market share is defined as a banking group's assets in the euro area divided by total domestic assets in the banking euro area (as shown in Table 2). While the euro area has very large banks with up to almost €2 trillion in assets, their banking union market share does not exceed 7 percent (Crédit Agricole). By contrast, large US banks, such as JP Morgan Chase and Bank of America, have 13 percent and 11 percent respectively of the US banking market¹⁸. This highlights the comparative fragmentation of the euro-area market when seen from a European perspective¹⁹.

Table 3 also provides the geographical segmentation of bank assets by home country, other euro-area countries, non-euro EU countries and non-EU countries. On (weighted) average, G-SIBs and E-SIBs conduct 58 percent of their business in their home countries, and 16 percent in other banking union countries. As a consequence, the euro area, which may be viewed as their new 'home' base, represents 74 percent of their total assets. The SSM is thus significantly better able to conduct supervision of these large banks at a consolidated level than individual country authorities were in the pre-banking union era.

Table 3 shows some major differences in the banks' internationalisation patterns. Three of them have a global reach with around 30 percent or more of their assets outside the EU: Deutsche Bank, Santander

18 US federal law prevents any bank from gaining more than 10 percent of national deposits in the United States through acquisition. So, JP Morgan Chase and Bank of America can only organically grow in the US. Lucas (2014) ranks the top five US banks by assets.

19 Compared to asset numbers, market shares are less affected by differences in accounting standards. Of course, the market landscape is very different when considered from a national perspective inside the euro area, as illustrated in several of this Blueprint's country chapters.

and BBVA. Next, several banks can be considered pan-European, with more than 30 percent of their assets in other European countries: BNP Paribas, UniCredit, ING, Commerzbank, KBC, Banco Sabadell and Erste. The remaining banks retain a strong domestic focus, with over 70 percent of their assets in their respective home countries²⁰.

Turning to the overall group of SIs, there is an important distinction between 100 banking groups headquartered in the euro area, or euro-area banking groups, and 29 subsidiaries and branches of other groups²¹. Figure 2 shows the distribution of the 100 euro-area banking groups by home country. France is a clear first in this ranking, with an aggregate €7.4 trillion in assets, followed by Germany (€4.4 trillion), Spain (€3.4 trillion), Italy (€2.4 trillion) and the Netherlands (€2.2 trillion). The other countries are all well under €1.0 trillion. While the German and French banking systems are more or less equal in size (around €8 trillion)²², this chart illustrates a major difference between the two largest banking union countries: France has a centralised banking system with a few relatively large banks, some with substantial international assets. By contrast, German banks are typically small and local (and thus categorised as LSIs), and even the larger German banks, with the exceptions of Deutsche and Commerzbank, tend to have a domestic focus. A similar contrast underlies the respective positions of Spain versus Italy, or the Netherlands versus Belgium.

If we look at cities instead of countries, Paris is by far the biggest banking centre with 11 of the 100 euro-area banking groups representing €7.4 trillion in assets, followed by Frankfurt (six groups, €2.9 trillion), Madrid (eight groups, €2.6 trillion), the Dutch Randstad (six groups, €2.2 trillion) and Milan (five groups, €1.8 trillion). Table 6 provides the details.

20 Dexia is left aside in this enumeration, because it is in a process of unwinding.

21 As Table 1 shows, the vast majority of SI assets belong to the 100 euro-area banking groups.

22 Source: Aggregate MFI balance sheets at the ECB Statistical Data Warehouse.

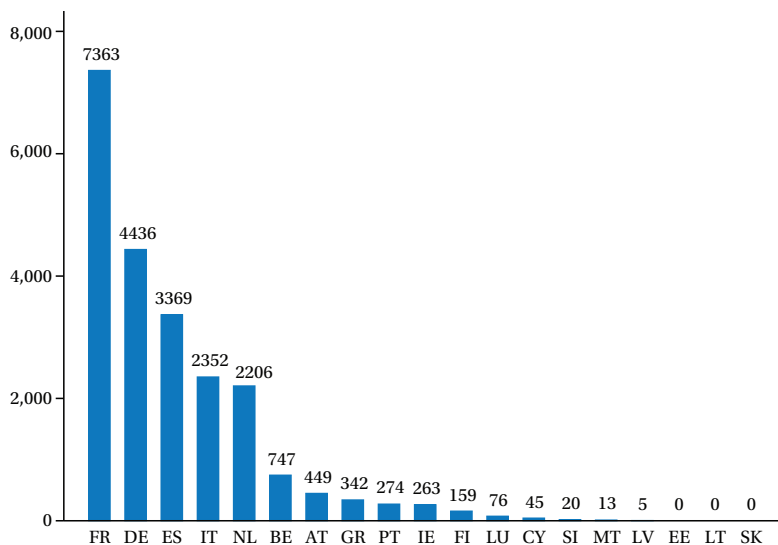
Table 3: Global and European systemically important banks (G- and E-SIBs), end-2015

				Banking union		Rest of world	
Banking groups		Total assets in € billions	% Banking union market share	% Home	% Other euro area	% EU non-euro area	% Non-EU
1	BNP Paribas (FR)	€1,994	5.3	25	36	11	28
2	Crédit Agricole (FR)	€1,699	6.7	81	8	2	8
3	Deutsche Bank (DE)	€1,629	3.2	26	19	9	46
4	Santander (ES)	€1,340	2.3	28	11	31	29
5	Société Générale (FR)	€1,334	4.7	72	8	10	11
6	BPCE (FR)	€1,167	4.8	91	2	1	6
7	UniCredit (IT)	€860	2.8	40	35	22	3
8	ING (NL)	€842	2.7	36	38	9	17
9	BBVA (ES)	€750	1.6	39	10	4	47
10	Crédit Mutuel (FR)	€707	3.0	89	8	1	3
11	Intesa Sanpaolo (IT)	€676	2.7	85	5	6	5
12	Rabobank (NL)	€670	2.3	74	5	2	20
13	Commerzbank (DE)	€533	1.7	52	19	16	13
14	DZ Bank (DE)	€408	1.6	82	7	5	5
15	ABN AMRO (NL)	€390	1.5	73	12	3	11
16	CaixaBank (ES)	€344	1.4	86	8	3	4
17	KBC Group (BE)	€252	0.8	52	21	22	5
18	LBBW. (DE)	€234	0.9	76	10	7	8
19	Dexia (BE)	€230	0.6	1	59	16	23
20	La Banque Postale (FR)	€219	1.0	99	1	0	0
21	BayernLB (DE)	€216	0.8	77	10	6	7
22	Banco Sabadell (ES)	€209	0.8	63	21	8	7
23	Bankia (ES)	€207	0.9	86	10	4	1
24	Erste Group (AT)	€200	0.6	44	18	36	1

25	NORD/LB (DE)	€181	0.7	85	8	3	4
26	Belfius (BE)	€177	0.7	70	20	8	2
27	Helaba (DE)	€172	0.7	86	5	3	6
28	Monte Paschi Siena (IT)	€169	0.7	95	3	1	1
29	Banco Popular (ES)	€159	0.7	92	6	0	2
30	BNG Bank (NL)	€150	0.6	88	8	3	0
Total G-/E-SIBs		€18,119	58.7	58	16	9	17

Source: Bruegel based on SNL Financial, annual reports and ECB SDW. Notes: The market share in the banking union is defined as the share of total assets in the banking union of the respective banking group over total banking assets in the banking union. The geographical breakdown refers to the share of assets in the home market, the banking union, the rest of Europe and the rest of the world over the total assets of the respective banking group. The home and banking union shares add up to the total banking union share. The bottom line is calculated as average weighted by assets. The data is for end 2015, except for Crédit Mutuel, which is end 2014.

Next, Table 4 ranks the banking groups according to their governance. We distinguish three main categories: commercial banks, cooperative-governed banks, and government-owned banks (see the notes to Table 6 for definitions). Remarkably, and in sharp contrast to both the United States and the United Kingdom, commercial banking groups with dispersed ownership are barely more than half of total assets (€11.9 trillion, or 54 percent of the total), making up only 30 out of 100 banking groups. Cooperative groups are almost as numerous (27 out of 100) and total €6.3 trillion in assets, or 28 percent of the total. There are no fewer than 32 government-controlled banking groups, including some owned by local governments, banks nationalised during the crisis, and policy banks; they represent €3.6 trillion in assets, or 16 percent of the total. The remaining banks (2 percent of the total) are privately-controlled commercial banks.

Figure 2: Significant euro-area banking groups, total assets by country (€ bn)

Source: Bruegel based on SNL Financial for the 100 euro-area-headquartered SIs. Note that all SIs in Estonia, Lithuania and Slovakia are branches or subsidiaries of groups headquartered elsewhere (see Table 6).

Table 4: Governance of euro-area banking groups (end-2015)

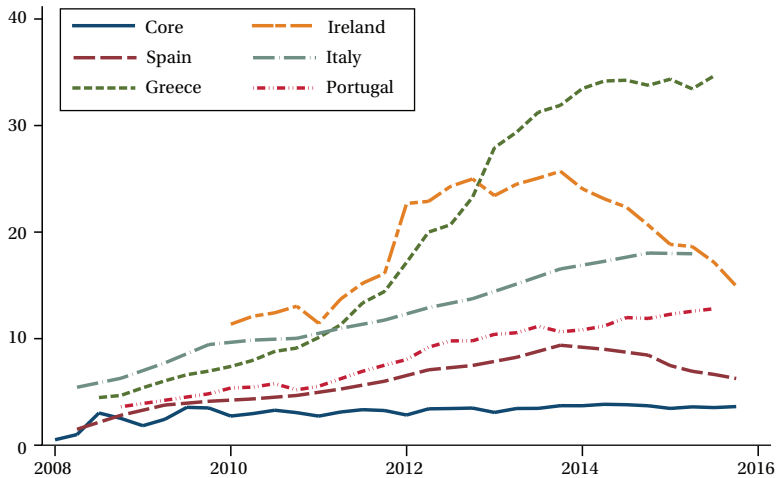
Governance	Number of banks	Total assets (€ billions)	CET1 ratio in %	Leverage ratio in %
Commercial	41	€ 12,258	12.4	4.9
- Dispersed ownership	30	€ 11,892	12.4	4.8
- Privately held	11	€ 366	13.7	7.3
Cooperative	27	€ 6,269	13.6	5.2
Government	32	€ 3,591	17.9	4.9
- Public sector banks	22	€ 2,279	19.2	4.9
- Nationalised	10	€ 1,312	15.7	4.8
Total	100	€ 22,118	13.6	5.0

Source: Bruegel based on SNL data and ECB (2016a). Notes: The CET1 ratio and leverage ratio are calculated as an average weighted by total assets.

While the government-controlled banks appear to be better capitalised with an average CET1 ratio of 18 percent compared to around 13 percent for commercial and cooperative banks, the average leverage ratio hovers around 5 percent for all three categories. This illustrates the zero/low risk-weights for sovereign and semi-sovereign exposures as input to the risk-weighted CET1 ratio calculations, combined with the fact that government-owned banks often hold a lot of sovereign and semi-sovereign assets. The unweighted leverage ratio corrects for these low risk weights.

Only 41 of the 100 euro-area banking groups are publicly listed at the parent-entity level, representing €15 trillion, or 68 percent of total assets of these 100 groups. This has implications in terms of transparency, since disclosure requirements are more stringent and better enforced for listed groups than for unlisted ones. The branches and subsidiaries of non-euro area banks are comparatively more ‘commercial’, with 22 out of 29 banks, representing €798 billion out of €940 billion in assets (85 percent), being part of commercial banking groups with dispersed ownership.

Finally, 18 of these 29 branches and subsidiaries (representing €744 billion in assets, or 77 percent of total assets of the 29 branches and subsidiaries) are held by EU-based groups, including by far the two largest, Nordea Finland and HSBC France. The largest euro-area bank with a non-EU parent is Abanca (formerly Novacaixagalicia, sold by the Spanish Fund for Orderly Bank Restructuring to Venezuela’s Banesco), which comes a distant third with €47 billion in assets. In other terms, non-EU foreign penetration in the euro-area banking system is very low. One reason for this is that large American and other non-EU banks tend to concentrate their EU operations in London and use their EU internal market ‘passport’ from there (Goodhart and Schoenmaker, 2016). There is essentially no US presence in European retail banking, in marked contrast to US retail banking where several euro-area groups (in particular BBVA, BNP Paribas and Santander) have significant regional positions.

Figure 3: Non-performing loans (% of total gross loans)

Source: Bruegel based on IMF Financial Soundness Indicators database. Note: ‘Core’ refers to a simple average of Austria, Belgium, France and the Netherlands (Germany is omitted for lack of data availability).

The euro-area banking system is not only heterogeneous in terms of bank size, governance, and ownership; it is also characterised by significant variations in bank strength. The strength of the banking sectors in different countries also varies notably. Figure 3 illustrates this heterogeneity by comparing non-performing loan (NPL) rates in several member states. This picture has to be taken with a grain of caution, because it is based on national NPL definitions that are not necessarily harmonised, and an increase in reported NPLs is itself an ambiguous signal: it might signify a deterioration in the quality of loans, but might also result from better measurement and curbs on practices variously referred to as loan forbearance, ‘evergreening’ or ‘extend-and-pretend’ (Advisory Scientific Committee, 2012). Nevertheless, Figure 3 provides support for the view that Greece, Italy and Portugal, in particular, are still far from having brought their banking systems back to soundness, while Ireland and Spain are, after major restructuring and

recapitalisation of their banking systems, more advanced on the path towards recovery²³.

Assessing European banking supervision

Our assessment is based on three criteria. The first is effectiveness: is European banking supervision able to fulfil its mandate? The second is toughness: is the supervision rigorous enough to ensure the stability of the banking system? The third is fairness: is it consistent across supervised banks and countries? Where relevant, we use quantitative indicators to underpin the assessment. Our aim is to assess the performance of the overall system of European banking supervision, including the ECB and all NCAs²⁴. At times, it is nevertheless helpful to differentiate between the performance of the ECB, which is ultimately in charge, and those of the NCAs. This split is unsurprisingly even more apparent in the subsequent country-specific chapters of this Blueprint.

Effectiveness

In the short period from the June 2012 political decision to embrace banking union to the effective start of European banking supervision in November 2014, the ECB and NCAs managed a generally smooth transition from the previous national frameworks. The size of the task is illustrated by the ECB hiring by the end of 2014 approximately 900 staff for banking supervision and related shared support services²⁵. The reliance on existing ECB infrastructure, including human-resources support, information systems and facilities, was crucial in realising

23 The picture looks fairly similar if one uses aggregate NPL ratios based on the sample of supervised banks in Table 6, which is based on SNL Financial, instead of national data collected by the IMF.

24 In line with many others, our collective reference to ‘the NCAs’ also encompasses national central banks that play a role in their respective countries alongside the NCA, eg the Deutsche Bundesbank or Austrian National Bank.

25 See ECB (2016a, page 15). Around three-quarters of the new staff came from the NCAs.

this. Our assessment is that the ECB has successfully mobilised its own resources and those of the NCAs to set-up an effective supervisory organisation, on time as mandated by EU law²⁶.

The following country-specific chapters, combined with our own observations across the euro area, lead us to the view that the JSTs work much better than the previous supervisory colleges for cross-border banks, because there is a clear line of command and decision-making. Next, both home and host NCAs in the euro area are fully engaged in the same supervisory effort. Information-sharing between home and host supervisors in the pre-banking-union era was limited by many factors that became particularly acute in times of stress, notwithstanding the memoranda of understanding. One consequence was that host supervisors tended to err on the side of caution and add local requirements that were unnecessary and suboptimal from a consolidated prudential perspective. By contrast, the ECB and the NCAs now use connected databases with a common data format, and the legislative framework guarantees the adequate pooling of supervisory information. The larger size of the JST for a euro-area-headquartered banking group, compared to the previous separate teams in individual countries, also allows for specialisation within the team on topics like solvency, liquidity, asset quality and governance. In sum, the JST framework enables European banking supervision to form a consolidated view at the euro-area level. European banking supervision also greatly facilitates international supervisory cooperation. As Tables 2 and 3 illustrate, many euro-area banks have significant activities outside the area as well as in several euro-area countries. The ECB, as their single home supervisor, makes coordination easier in European and global supervisory colleges with peers in the UK, United States and other jurisdictions. The ECB also participates as host in the supervisory colleges of at least some of the 16 banks that hold significant

26 The SSM Regulation gave the ECB discretion to extend the deadline of 4 November 2014, but the ECB did not use that option.

branches and/or subsidiaries in the euro area²⁷.

The JST framework can also, inevitably in our view, generate tensions. While the head (coordinator) of the team, who is always from ECB staff, is ultimately in charge, the sub-coordinators from the NCAs have dual reporting lines, to the JST coordinator at the ECB and to their local manager. This may lead to conflicts of interests or loyalties, for example if the ECB advocates a tougher stance than the NCA leadership. Another case is ring-fencing (see below), over which the ECB may take a softer stance on additional capital requirements at the local entity (as opposed to group) level than the respective NCAs.

Based on interviews with supervisors and supervised entities, we find that the internal culture of ECB banking supervision has coalesced rapidly and is stronger than might be expected of such a young institution. The hard deadlines and operational complexity of the comprehensive assessment appears to have acted as a ‘crucible’ in this respect, forging a sense of shared experience and common belonging among the initial cadre of ECB supervisory staff. There is little doubt that the hosting of the central supervisory function by the ECB, with its organisational strength and independence (buttressed by a single working language), has helped enormously in this outcome, as has the overall quality of the new recruits. The country chapters illustrate that most (though not all) member states accept that stronger supervision is needed compared to the pre-banking union situation. The ECB is paying attention to the challenge of strengthening the common feeling of belonging among its supervisory staff, as illustrated by its repeated references to the ‘SSM team spirit’ and ‘SSM community’ (ECB, 2016a).

The effectiveness of European banking supervision is still hampered by a lopsided legal and regulatory policy framework. Even assuming completion of the ongoing effort to minimise so-called

27 As documented in Table 6, these are: five Scandinavian banks (Danske, DNB, Nordea, SEB, Swedbank); three UK banks (Barclays, HSBC, RBS); three US banks (Bank of New York Mellon, JP Morgan, State Street); and Banesco (Venezuela), RBC (Canada), Sberbank and VTB (Russia), and UBS (Switzerland).

options and national discretions, the vision of a single rulebook is far from fulfilled. One area in which this is particularly evident is the accounting and auditing framework, which is a significant component of the banking supervisory infrastructure even though it also serves other purposes. Listed banks in the euro area, as in the rest of the European Union, must use International Financial Reporting Standards (IFRS) for their consolidated financial statements²⁸. For unlisted banks, however, IFRS is mandatory under national law in Belgium, Cyprus, Finland, Estonia, Greece, Italy, Latvia, Lithuania, Malta, Portugal, Slovakia and Slovenia, but not in Austria, France, Germany, Ireland, Luxembourg, the Netherlands or Spain (Pacter, 2015). Small banks in Austria and Germany, in particular, vigorously oppose the prospect of having to use IFRS in the future, as documented in our respective country chapters. In this, the euro area is an outlier from international practice, since most non-EU jurisdictions which have required IFRS for listed companies also require them for banks irrespective of size or listed status, and the United States similarly imposes US Generally Accepted Accounting Principles on all federally supervised banks (Pacter, 2015). Similarly, in auditing, national legal regimes vary considerably, as does audit quality, and attempts at EU harmonisation have not progressed far. Whether this heterogeneity in accounting and auditing is compatible with the effectiveness of European banking supervision on a steady-state basis will surely be further debated in the years to come.

There is a longstanding debate on the possible conflicts between monetary policy and prudential supervision when conducted in the same institution (eg Goodhart and Schoenmaker, 1995; Whelan, 2012), and the ECB is no exception. To address this challenge, the SSM Regulation creates a functional separation between the Supervisory Board and the Governing Council (even though the former remains

28 With the exception of a limited change introduced by the European Commission when adopting the IAS 39 standard on financial instruments accounting in late 2004, known as the IAS 39 carve-out.

subordinate to the latter); at a more practical level, the ECB has chosen to keep the separate arms in separate buildings. Our observation is that, notwithstanding the intrinsic tension between loose monetary policy and strict banking supervision, the Supervisory Board's supervisory stance so far has not been distorted or softened by the ECB's monetary policy objectives, as we discuss in the next subsection.

Toughness

As is evident from this Blueprint's country-specific chapters, European banking supervision is more intrusive than most of the national regimes it replaced, with more questions from the supervisors and more effort to verify the banks' answers. The country chapters also suggest that there is less capture of the supervisors by the banks than before November 2014. It has become more difficult to address supervisory matters through informal negotiation or political intervention with the supervisor's top leadership. The supervisory coordinator is now at a distance in Frankfurt, and from a different nationality. Supervision has thus not only literally but also figuratively become more distant from the banks in the euro area. Moreover, the independence of ECB banking supervision, enshrined in the SSM Regulation²⁹, appears to be stronger than supervisory independence at the national level, where it is easier to change the relevant financial services legislation. This is arguably particularly meaningful for the many government-controlled banks in the banking union. The corresponding tensions have been alluded to in several official speeches and interviews³⁰, but so far we are not aware of them erupting directly into the public space, with the exception of Italy³¹.

29 Article 19 of the SSM Regulation. The SSM Regulation, being based on Article 127(6) of the Treaty on the Functioning of the European Union, can only be modified by unanimity among member states.

30 For example Danièle Nouy, interviewed in *Handelsblatt*, 1 April 2015 (English translation on the ECB website); Dombret (2015).

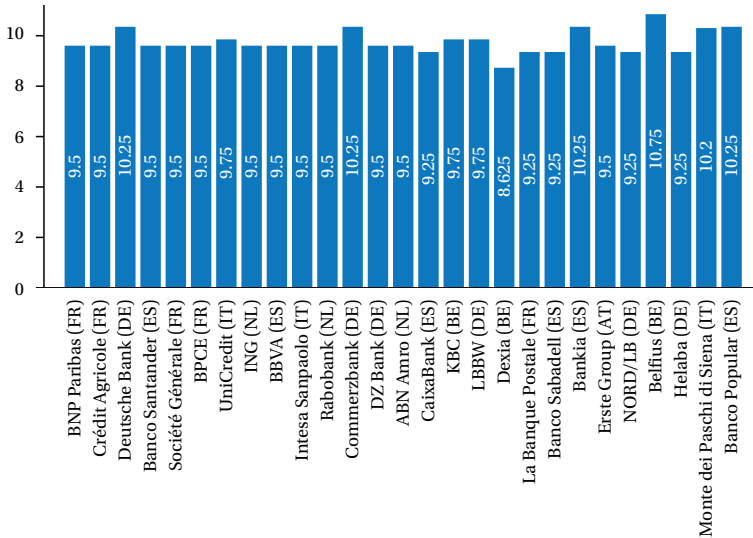
31 See for example Patrick Henry (2015) 'Bank of Italy Letter Slams 'Arbitrary' ECB

The toughness of a supervisor is ultimately revealed by her or his actions. For European banking supervision, the most prominent among these so far include the 2014 comprehensive assessment, the 2014³² and 2015 SREP decisions, and *ad-hoc* assessments made in particular in the context of the Greek crisis of summer 2015. In our view, this experience demonstrates the fact that the new supervisory regime is tougher than most (perhaps all) of the national regimes it replaced. In stark contrast to the 2010 and 2011 rounds of European stress tests, which were coordinated respectively by the Committee of European Banking Supervisors and by its successor the EBA, but for which the main inputs came from the NCAs, the 2014 comprehensive assessment has not been followed by embarrassing failures of banks that were given a clean bill of health a few months earlier³³. It has also been perceived as overly demanding in several member states, as this Blueprint's chapter on Italy illustrates. The decisions made by European banking supervision on Greek banks during the spring and summer of 2015 were vindicated by subsequent developments, as analysed in the chapter on Greece. The criticism – not least from Germany – that was directed at the ECB for being too sanguine on the solvency of Greek banks was shown with hindsight to be excessive.

As for the 2015 SREP process, it represented the first round of capital requirements (applicable from 1 January 2016) that was fully prepared under the new European regime. These requirements are a combination of a CET1 capital requirement of 8 percent (as used in the October 2014 comprehensive assessment, and thus higher than the

Over Capital Demands', *Bloomberg*, 21 September 2015.

- 32 The 2014 SREP decisions were communicated to supervised banks in early 2015. They were largely based on the 2014 comprehensive assessment, which is why we don't analyse them in any depth here.
- 33 In 2010, for example, Allied Irish Banks passed the stress test in July but needed a rescue as part of the Irish assistance programme later that year. In 2011, Bankia in Spain and Dexia in Belgium and France passed the July stress test but experienced massive problems a few months later.

Figure 4: Pillar-2 capital requirements (end-2015 SREP decisions, in %)

Source: Bruegel based on annual reports. Note: does not include three E-SIBs that have not disclosed SREP requirements: Crédit Mutuel Group, Bayerische Landesbank and BNG Bank; they are unlisted and thus subject to less demanding disclosure requirements.

Pillar-1 minimum resulting from the application of the CRR) and of a Pillar-2 add-on. The latter is based on a qualitative and quantitative assessment of a bank's business model, internal governance and risk management, and risks to capital and liquidity. Based on EBA guidelines (European Banking Authority, 2014), the ECB has developed a common methodology and a common database to ensure a consistent process of determining the eventual SREP decision. Even so, the latter remains a judgement call of the supervisor. Figure 4 shows that the resulting Pillar-2 capital requirements range from 8.625 percent to 10.75 percent for the 27 G- and E-SIBs that have disclosed them. The average score for these is 9.6 percent, both on a weighted and unweighted average basis. The average requirement for the full SI population is around 9.9 percent for 2015, which is an increase of 30 basis points compared to the average for 2014 (ECB, 2016e). These

figures reveal that the ECB has not shied away from setting core capital requirements at a high level.

This should be seen in the context of gradual strengthening of euro-area banks' capital ratios over the last few years, driven both by market pressure and by new regulations and predating the establishment of banking union. Figure 5 shows this trend for the 100 euro-area banking groups supervised by the ECB³⁴.

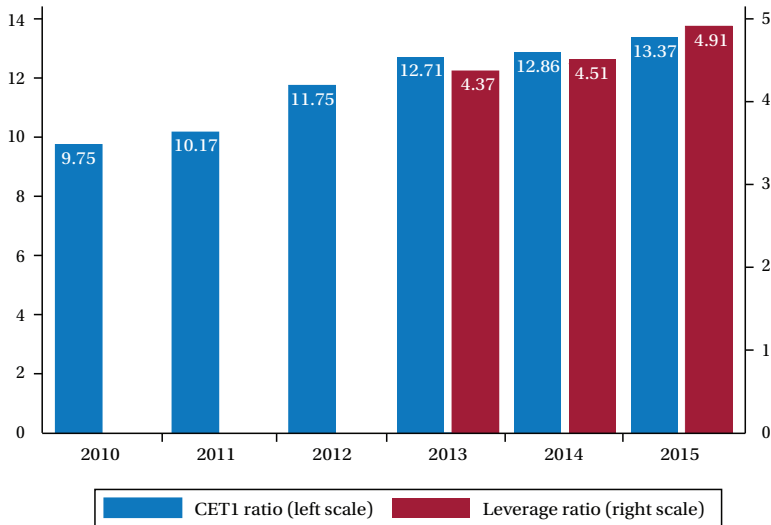
A bank's governance is important for determining its risk appetite, risk management and internal controls. Commercial, cooperative and government-owned banks all face specific governance challenges. Commercial banks could have too strong a focus on return on equity, neglecting the interests of depositors and financial stability. While cooperative banks in principle have incentives to put clients' interests first, their internal decision-making can be too decentralised and fuzzy, or captured by special-interest groups, as illustrated by cases such as Banca Popolare di Vicenza³⁵. For some large cooperative banking groups, ECB banking supervision has acted to strengthen and streamline their governance (see eg the case of Rabobank in the chapter on the Netherlands). Finally, government-controlled banks could be too responsive to politics, losing sight of the need for efficiency and cost-effectiveness. Now that capital requirements have been raised to a reasonably high level, the focus of European banking supervision appears indeed to be shifting towards 'softer' matters of governance,

34 Note that for Figures 5 and 7 we used balanced samples within each variable, ie we exclude banks for which at least one data point is missing (after imputing) during the time period. This is why 2015 values in Figure 5 slightly differ from those in Tables 1, 3, and 4. We impute missing values by using a simple average if data is missing in between two values in a series of three consecutive years. If an average cannot be taken - ie if more than one data point is missing in between available observations or data point missing at beginning (end) of available time series - the previous (former) value is taken. Otherwise, the missing value remains.

35 Valentina Za, 'Blind faith turns to disbelief in Italian banking's heartland', *Reuters*, 26 April 2016.

risk management and risk appetite (ECB, 2016a).

Figure 5: CET1 capital ratio and leverage ratio for the significant euro-area banking groups (in %)



Source: Bruegel based on SNL Financial. Note: CET1 capital ratios and leverage ratios are aggregated by computing an average of banks' ratios weighted by total assets, for the 100 euro-area-based SIs. See also footnote 34.

This overview does not include supervisory decisions on LSIs, which are still made by NCAs under ECB oversight. The vast majority of the euro-area LSIs are in only three countries: Austria, Germany and Italy. In Austria and Germany, they are typically covered by institutional protection schemes (IPS), which are arrangements under which small banks may provide each other with financial assistance within a network (eg the German or Austrian savings banks, or Sparkassen)³⁶. From the relevant country chapters of this Blueprint, the perception

³⁶ Lautenschlaeger (2016) calculates that half of all banks in the euro area (SIs and LSIs), and four-fifths of those in Germany, are IPS members.

that emerges is that LSI supervision by NCAs is typically laxer than the supervision of SIs by the ECB. This discrepancy could be a source of future supervisory failures, as illustrated by the chapters on Greece (the case of Attica Bank) and Italy. In early 2016, the ECB conducted a consultation on IPS that might be followed by new supervisory initiatives in this area, an issue which is developed at more length in the chapters on Austria and Germany.

Overall, there is no doubt that European banking supervision is generally tougher than the national supervisory regimes it has replaced in all countries reviewed in this Blueprint. Whether that makes it tough enough is of course a different question. At this point we are inclined to think that it does, but a better-informed assessment will be provided by the observation of future developments in the euro-area banking system.

Fairness and consistency

We have not found evidence of a country- or institution-specific pattern in the SREP process that would suggest favouritism, discrimination or other forms of undue distortion. In fact, the question might aptly be raised whether there is sufficient dispersion in the SREP requirements shown in Figure 4, given the differences in the quality of the banks in general and the problems at some banks in particular. Our impression is that European banking supervision has initially erred on the side of not enough differentiation, precisely to avoid being accused of displaying an inherent bias.

One additional layer of complexity for European banking supervision is that NCAs retain a separate competence on the application of macro-prudential buffers, comprising systemic and countercyclical buffers. The systemic risk buffer is an additional capital charge for systemically important banks to address the ‘too-big-to-fail’ issue. The Financial Stability Board has started this process with the suggestion of additional loss-absorbing requirements for G-SIBs. In addition, the

CRD IV (Article 131) empowers NCAs to designate other systemically important institutions (or O-SIIs, also known in Basel parlance as domestic systemically important banks) and apply to them a capital surcharge of up to 2 percent. Finally, the CRD IV (Article 133) also allows NCAs to set systemic risk buffers of at least 1 percent. The last column of Table 5 calculates the domestic systemic buffer as the higher of the latter two buffer requirements, which are set by the NCAs. Figure 6 shows the same numbers as a map, illustrating the differences in toughness among NCAs.

Most northern member states generally apply higher systemic buffers of up to 2 or 3 percent, while southern member states (except Cyprus and Malta) apply low systemic buffers of up to 1 percent. Remarkable cases are Italy and Latvia, which have set the systemic buffer for other systemically important institutions at 0 percent, with only a G-SIB surcharge of 1 percent for UniCredit following the Financial Stability Board's guidance.

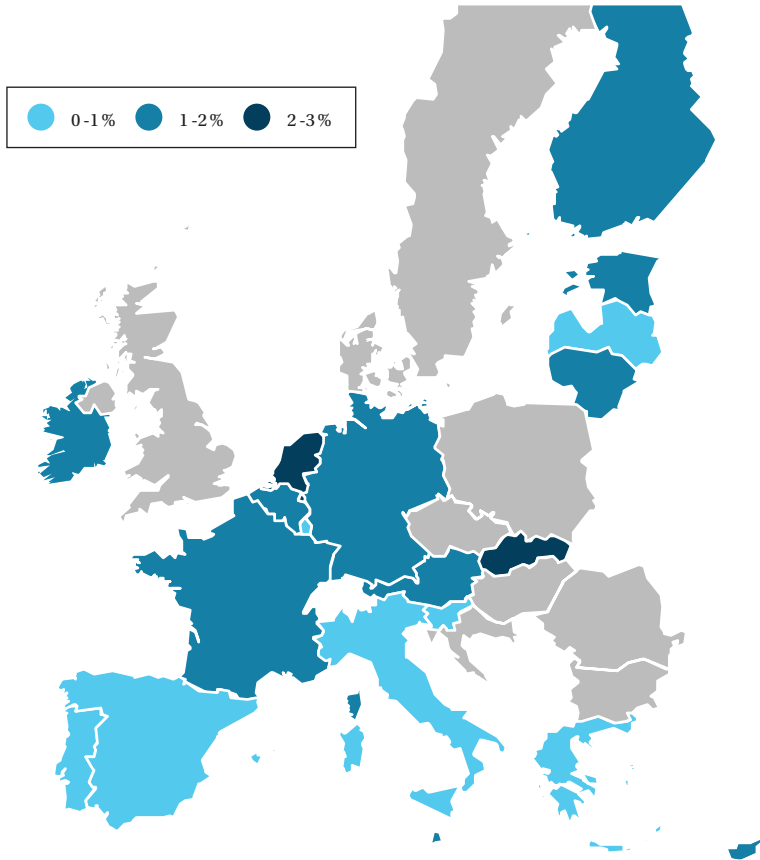
While national authorities have the primary responsibility for such macro-prudential requirements (Article 5.1 of the SSM Regulation), the ECB has the ability to set more stringent requirements (Article 5.2). So far, it appears that the ECB has chosen to not use this option, perhaps to avoid opening a new front in its already complex relationship with national central banks and other NCAs. Nevertheless, it appears desirable that systemic buffer requirements should be harmonised across the banking union area at some stage. Meanwhile, the variation of macro-prudential stances in different countries is bound to generate perceptions of unjustified differential treatment.

Table 5: Application of systemic risk buffers across banking union countries (fully loaded)

Country	G-SIB buffer	O-SII buffer	Systemic risk buffer	Domestic systemic buffer
Austria	n.a.	1.0%-2.0%	1.0%-2.0%	2%
Belgium	n.a.	0.75%-1.5%	none	1.5%
Cyprus	n.a.	0.5%-2.0%	none	2%
Estonia	n.a.	2.0%	1.0%	2%
Finland	n.a.	0.5%-2.0%	none	2%
France	1.0%-2.0%	0.25%-1.5%	none	1.5%
Germany	2.0%	0.5%-1.5%	none	1.5%
Greece	n.a.	1.0%	none	1%
Ireland	n.a.	1.5%	none	1.5%
Italy	1.0%	0.0%	none	0%
Latvia	n.a.	0.0%	none	0%
Lithuania	n.a.	0.5%-2.0%	none	2%
Luxemburg	n.a.	0.5%-1.0%	none	1%
Malta	n.a.	0.5%-2.0%	none	2%
Netherlands	1.0%	1.0%-2.0%	3.0%	3%
Portugal	n.a.	0.25%-1.0%	none	1%
Slovakia	n.a.	1.5%-2.0%	1.0%	3%
Slovenia	n.a.	0.25%-1.0%	none	1%
Spain	1.0%	0.0%-1.0%	none	1%

Source: Bruegel based on ECB (2016c), ESRB (2016) and ESRB National Policy database. Notes: G-SIB buffer is the global systemically important bank buffer set by the FSB and the Basel Committee on Banking Supervision; the O-SII buffer is the other systemically important institution buffer set by the NCA based on the CRD IV; the systemic risk buffer is set by the NCA based on the CRD IV. The domestic systemic buffer is the higher of the latter two buffer requirements, except for Slovakia that sums its O-SII and systemic risk buffers. The maximum of the domestic systemic buffer is shown in the last column.

Figure 6: Domestic systemic buffer requirements across the banking union (fully loaded)



Source: Bruegel based on ECB (2016c), ESRB (2016) and ESRB National Policy database; see Table 5.

As emphasised in the previous subsection, a potentially more serious asymmetry is the lingering one between LSIs and SIs, whereby LSIs are subject to a national supervisory stance even though the ECB's oversight (and specifically its DGMS III) could bring a degree of convergence over the medium term. In particular, national networks of local banks bound together in an IPS, such as the German or

Austrian Sparkassen, are not fundamentally different from groups of mutuals that co-own a consolidating central entity (such as the large French cooperative groups, the Netherlands' Rabobank or Finland's OP group), and in principle should compete on equal terms including in terms of the supervisory regime. This will certainly remain a widely debated issue over the next few years. More generally, a consistent SREP methodology for LSIs across euro-area member states remains a somewhat distant objective. The ECB acknowledges that risk assessment systems that underpin SREP scoring, in particular, are far from harmonised (ECB, 2016a, section 2.4.5). There is still work to be done within European banking supervision to ensure consistency, even for significant institutions.

Overall, we find no evidence of blatant unfairness in the current European banking supervisory regime for significant institutions, but more observation will be needed to conclude that it is genuinely fair.

Areas for improvement

European banking supervision has experienced many teething problems, and there remains much scope for improvement. Examples of problems are overlapping and redundant data requests, which have generated considerable frustration among supervised banks, as illustrated by many of this Blueprint's country chapters. Further coordination is needed with the gradual implementation of the ECB's AnaCredit project, a detailed euro-area-wide bank loan dataset which predates banking union but has become even more important in the context of European banking supervision. Another, perhaps more serious, unfortunate episode was the sequence of communication about what has come to be known in European banking jargon as maximum distributable amounts (MDA), also discussed in the chapter about France. In summary, ECB banking supervision took a long time to reach the conclusion that MDAs would be based on Pillar-2 capital requirements, and that these requirements should therefore be disclosed publicly by the supervised banks (in contrast to most prior

and international practice). The combination of this decision with high Pillar-2 capital add-ons (see above) is likely to have contributed to European bank stock market volatility at the beginning of 2016. The later revision of the stance (with the introduction of a distinction between Pillar-2 requirements and additional Pillar-2 'guidance', which hints at a possible softer future approach) gave an impression of insufficient preparedness, even though we have no objection against the new stance on substance³⁷.

There appears to be scope for streamlining the internal decision-making procedures, data requests and related reporting formats. Decision-making processes in the Supervisory Board appear overly burdensome. There were no fewer than 38 Supervisory Board meetings in 2015, of which 22 were in Frankfurt and 16 by videoconference (ECB, 2016a), many of which lasted more than one full day. In addition, many authorisation procedures (on which 921 decisions covering more than 2,000 individual procedures were taken in 2015) need approval by the ECB's Governing Council, adding further delays. The existence of a long backlog of fit-and-proper authorisations is acknowledged by the ECB (ECB, 2016a, section 3.1.2) and, there appears to have been significant adverse operational consequences in some banks. While some of this burden is inherent in the governance framework set by the SSM Regulation³⁸, our assessment is that the operation of the Supervisory Board should be revised, and more decisions delegated from the Supervisory Board to ECB banking supervision staff. This in turn requires constructive engagement from at least a critical number of the NCAs.

Transparency, or the lack thereof, is another area that calls for significant improvement in the near future. To its credit, the ECB

37 See Boris Groendahl and Jeanna Smialek, 'ECB's Nouy Says Legal Change Is Needed to Provide CoCo Clarity', *Bloomberg*, 24 March 2016.

38 Unless there are changes to the European treaties, there is no way to avoid the constraint that many of the Supervisory Board's decisions only take effect after formal approval by the Governing Council.

has provided a lot of public information on the implementation of European banking supervision since late 2013, with regular and detailed reports on the build-up of its own banking supervisory capacity, the execution of the 2014 and 2015 comprehensive assessments and initial rounds of SREP decisions, and related issues of governance and operations. NCAs also generally produce increasingly detailed activity reports. Where European banking supervision falls short, however, is on transparency about the banks themselves. As we have observed, only a minority of SIs, let alone LSIs, are publicly listed and thus subject to the corresponding demanding disclosure obligations under EU legislation³⁹. In principle, banks also need to make disclosures under the so-called Pillar 3 of the Basel framework, as transposed into EU and national legislation by the successive Capital Requirements Directives and the CRR, but the quality and comparability of such Pillar-3 disclosures leave considerable scope for improvement⁴⁰. In practice, therefore, supervisors have an irreplaceable role in collecting, aggregating and disseminating quantitative and qualitative data about banks. In the United States, very rich data on all federally supervised banks is publicly available through the Federal Financial Institutions Examination Council (FFIEC), an umbrella organisation of all federal supervisory agencies⁴¹. By contrast, in the euro area, bank-level information is generally not disclosed by national supervisors. The ECB's regularly updated list of supervised entities only gives highly imprecise indications of consolidated balance sheet size, and only for SIs. The EBA's regular transparency exercises provide much richer

39 Even though the enforcement of these obligations by securities market regulatory authorities is of variable effectiveness across member states.

40 The Basel Committee's Pillar-3 framework is currently undergoing revision, and significant new proposals were published for consultation by the Basel Committee in March 2016.

41 These include the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Consumer Financial Protection Bureau.

information, but are insufficiently institutionalised and don't even cover all SIs. Overall, the euro area's level of supervisory transparency is pitifully low⁴².

As for institutional transparency and accountability, an interinstitutional arrangement between the European Parliament and the ECB specifies the modalities of democratic accountability and oversight of the ECB's supervisory tasks, covering elements such as submitting reports, attending hearings, responding to parliamentary questions and providing access to confidential information⁴³. One area for improvement is the European Court of Auditors' mandate for the audit of the operational efficiency of the ECB's management. This does not seem to encompass policies and decisions related to its supervisory tasks (Contact Committee, 2015). Public auditing of supervisory effectiveness is an accepted practice in countries such as the United States, Canada, Australia, Denmark, Sweden, France and Germany (Contact Committee, 2015).

The fact that European banking supervision remains a work in progress is starkly illustrated by the mixed market judgment on (listed) euro-area banks. Figure 7 shows wide fluctuations in price-to-book (P/B) ratios in selected countries covered in this Blueprint (grouped in two charts for better readability). While all suggest lacklustre valuations, with P/B ratios generally less than 100 percent, some countries (Austria, Belgium, the Netherlands and Spain) are better regarded by the markets than France, Italy and Portugal, let alone Germany and Greece⁴⁴. In general, the banks' P/B ratio in the United States is 1.4

42 See Gandrud and Hallerberg (2014) and Gandrud, Hallerberg and Véron (2016) for a more in-depth analysis of supervisory transparency in the European Union.

43 The ECB's written responses to questions from MEPs are published on its website and occasionally provide useful information about European banking supervision.

44 The low average P/B ratio observed for German listed banks cannot be solely attributed to market concerns about Deutsche Bank (which has a high weight in the calculation because of its large size). The German ratio without Deutsche Bank is equally low. Most German banks, however, are unlisted and thus not included in this calculation.

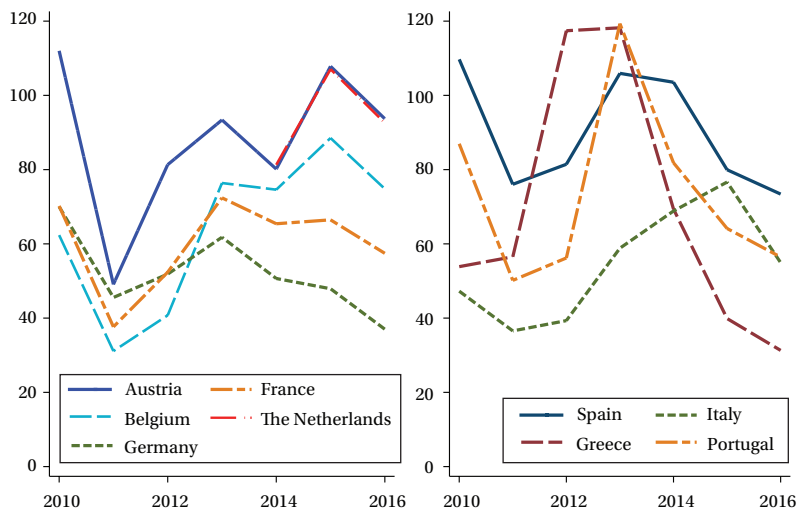
times higher than in the EU (IMF, 2016). This market indicator suggests deeper problems. The euro area remains significantly ‘overbanked’, with an insufficiently efficient banking sector and insufficiently developed capital markets (Véron and Wolff, 2015; Langfield and Pagano, 2016)⁴⁵. European banking supervision still has to deal with significant excess capacity in European banking, and must encourage further consolidation, restructuring and renewal of the European banking sector over the coming years.

Finally, the country chapters (eg on France, Germany and Spain) highlight concerns about the multiplicity of EU-level agencies, including ECB banking supervision, the EBA, the European Commission (not least in its state aid control capacity) and the Single Resolution Board (SRB) that started work in 2015 and acquired its full resolution authority on 1 January 2016. While some mechanisms exist in the EU legal framework to avoid overlapping information requests and diverging policy stances, the coordination between these agencies is inherently difficult, and appears to be less than optimal in at least some cases. It is likely that this challenge will not be solved any time soon, but proactive efforts should be made to minimise the resulting frictions and dysfunction.

A single banking market?

The aim of Europe’s banking union was to break the bank-sovereign vicious circle, by decoupling banks from their respective home countries. This decoupling should in principle lead to a seamlessly integrated single market for banking services in the entire banking union area. Evidently, this remains a distant vision, as mirrored in several of our country chapters (see for example the chapter on France).

45 See also Advisory Scientific Committee (2014) and more recently the IMF (2016).

Figure 7: Price-to-book ratio of the listed SIs (in %)

Source: Bruegel based on SNL Financial. Notes: P/B ratios are aggregated at the country level by computing an average of listed banks' P/B ratios weighted by total assets of listed euro-area SIs included in the sample. Cr dit Agricole SA was taken as a proxy for Cr dit Agricole Groupe, as the latter is not listed. 2016 values correspond to 29 April 2016. Also see footnote 34.

European banking supervision has initiated a major effort to reduce the number of options and opportunities for national discretion in the various country banking regulations (ECB, 2016a and 2016f). When completed, this project will make supervision easier and also contribute to the single market, but it stops well short of addressing all national idiosyncrasies.

There is no longer any liquidity supervision of branches within the banking union. Moreover, the liquidity coverage ratio (LCR) will be moved, as of October 2016, to 75 percent at subsidiary level if the parent bank's ratio is 100 percent or more, which allows for some, but not unrestrained, circulation of liquidity among a group's entities within the euro area (ECB, 2016f). But there are no apparent plans to phase out such subsidiary-level LCR requirements entirely, nor are there any clear signs of phasing-out of extra capital requirements at the

subsidiary level, imposed both by European banking supervision and, in some cases at least, also by NCAs under a national-law mandate (such as deposit insurance or resolution authority). There is still ample evidence of such geographical ‘ring-fencing’ of capital in national subsidiaries⁴⁶.

Several of this Blueprint’s country chapters also note some ambiguity about supervisors’ stances on mergers and acquisitions, especially those that take place cross-border. While the fact that the ECB is not expected to hamper cross-border M&A will foster better market integration, it is not clear whether all NCAs are prepared to let their ‘national champions’ go. The ECB has the final say on approving changes of control and acquisitions of/by all supervised banks (SIs and LSIs), but the NCAs receive the applications from banks and have a role in the preparation of decisions. Also, some aspects of the current supervisory approach could create unnecessary obstacles to the emergence of sustainable pan-European banking business models. For example, stress tests tend to favour scenarios of correlated downturns in all euro-area countries (and beyond), thus negating the stability benefits of geographical diversification even though these have been amply documented during the recent years of crisis (see in particular the chapter on Spain on this).

Many large cross-border banks complain about NCAs’ tendencies to keep introducing local requirements, limitations or distortions – at their national level, and also occasionally through their collective majority of the ECB’s Supervisory Board – thus preventing the vision of a single market from being realised. These local requirements apply only to cross-border subsidiaries, which are licensed by the host NCA and are thus subject to local rules. Cross-border branches fall legally under the parent company in the home country and are thus under the control of the home NCA. Banks might thus take action by converting subsidiaries into branches to bypass such local distortions, a

46 For an overview of geographical ring-fencing measures, see Beck *et al* (2015).

process that is likely to be much more feasible in the new context of European banking supervision. Recent examples of such conversions are the conversion of Deutsche Bank's subsidiary in the Netherlands into a branch in February 2016 (Deutsche Bank, 2016), and the announcement by Sweden's Nordea that it would turn its large Nordic subsidiaries into branches, including the one in Finland (thus in the banking union); this is still subject to regulatory approval⁴⁷. Both the Finnish central bank and national banking supervisor have criticised the Nordea plan to convert its Finnish subsidiary into a branch, on the grounds that Nordea Bank Finland is systemically important in Finland with a market share of about 30 percent (Rosendahl, 2015)⁴⁸. While national supervisors might thus want to block these conversions, the ECB might base its decision on the Second Banking Directive (89/646/EEC), which allows freedom of cross-border establishment through a branch or subsidiary, and thus permit such conversions that foster the single market. At the time of writing (May 2016), the outcome is not clear, and might be an interesting indication of the future direction for European banking supervision in this respect.

Barriers to the completion of the single market, of course, are not only or even mainly down to supervision. Interestingly, the planned merger of Nordea's Nordic subsidiaries into the Swedish parent as branches highlights the problems with national-based deposit insurance in an integrated market, as discussed in the country chapter on Belgium. While banks increasingly operate on a European level, only the locally incorporated banks, including subsidiaries of foreign groups, contribute to the local deposit insurance fund, with a fiscal backstop provided by the national government (Gros and

47 Nordea (2016), 'Decisions by Nordea's AGM 2016', press release, 17 March, available at <http://www.nordea.com/en/press-and-news/news-and-press-releases/press-releases/2016/03-17-19h20-decisions-by-nordeas-agm-2016.html>.

48 As Table 6 shows, Nordea Finland, with €302 billion in assets, is by far the largest national entity of any non-euro-area banking group in the banking union area, followed by HSBC France (€168 billion) and Abanca (€47 billion) in Spain.

Schoenmaker, 2015). Local deposit insurance funds might run into problems, as recently witnessed in Iceland and in the 1930s in the United States, when many of the state-level deposit guarantee schemes went bankrupt because of a lack of geographic diversification and size (Golembe, 1960). This is one of many ways through which the bank-sovereign nexus still exists, along with domestic home bias in banks' sovereign-bond portfolios, government-owned banks, bank and corporate insolvency law, taxation, housing finance, pension frameworks, lender-of-last-resort operations and more. The European Commission's European Deposit Insurance Scheme (EDIS) proposal of November 2015⁴⁹ has triggered a debate on some (but not all) of these obstacles, and it is to be expected that this debate will remain active for many years.

Even with such obstacles firmly embedded in national legislation and politics, there is some evidence of a reversal since mid-2012 of bank market fragmentation in the euro area. The dispersion in the cost of borrowing from banks for non-financial corporations and households across the euro area, which increased substantially in 2011-12, had shrunk markedly by 2015 and early 2016 (ECB, 2016b). Nevertheless, cross-border credit provided by local affiliates of foreign banks stagnated in 2015. The share of total assets and total loans of non-domestic affiliates remained at low levels of around 14 percent (ECB, 2016b).

Our overall assessment is that banking union is only half-finished as an overarching policy framework (Posen and Véron, 2014). European banking supervision is by far its most integrated component, the SRM being significantly less centralised. The continued absence of EDIS and of a common backstop for the Single Resolution Fund (SRF), which was decided on in principle by the European Council in late 2013 but not implemented, are key aspects of this incompleteness,

49 The EDIS proposal is available at http://ec.europa.eu/finance/general-policy/banking-union/european-deposit-insurance-scheme/index_en.htm.

as is the lack of harmonisation of national bank insolvency regimes, which implies that the Single Resolution Mechanism is ‘single’ in name only.

Future outlook

European banking supervision, with its start in 2014, was the first step towards the banking union. The SRM started in January 2016, and it is still too soon to convincingly assess its effectiveness as long as there is no actual case of resolution. The European Commission’s proposal for EDIS was published in November 2015, but its adoption is far from certain, as with other necessary and still missing components of a complete banking union, as we have discussed.

The banking union needs to be completed to ensure the strength and stability of the euro-area banking system (see for example Hellwig, 2014). A swift handling of the banking fragility that Italy is experiencing at the time of writing is a prerequisite (Véron, 2016). At the European level and in the short term, we support a balanced policy package including EDIS, effective limits on banks’ exposures to each sovereign including their home country, bank insolvency law harmonisation and reform of the Capital Requirements Regulation (eg prohibition of deferred tax credits as capital, and fuller compliance with Basel III)⁵⁰. Collectively, euro-area banks will benefit from more demanding supervisory standards, and might thus in future reverse their recent relative decline compared to their more stringently supervised US rivals on the European and international market for investment banking services (Goodhart and Schoenmaker, 2016). Simultaneously, risk sharing through adequate European arrangements is needed to eliminate economically damaging geographical ring-fencing and make the euro area resilient to future shocks.

⁵⁰ See, for example, ECB (2016b).

Table 6: List of significant institutions (1 January 2016)

Banking group	Country code	Headquarters	Governance	Public listing (ownership)	Total assets (in € billions)	CET1 ratio (%)	Leverage ratio (%)
8 G-SIBs (assets>€800bn)							
BNP Paribas	FR	Paris	Commercial	Listed (dispersed)	1,994	11.05	4.00
Crédit Agricole	FR	Paris	Cooperative	Listed (controlled by mutuals)	1,699	13.52	5.70
Deutsche Bank	DE	Frankfurt	Commercial	Listed (dispersed)	1,629	13.19	3.50
Banco Santander	ES	Madrid (Santander)	Commercial	Listed (dispersed)	1,340	12.55	4.73
Société Générale	FR	Paris	Commercial	Listed (dispersed)	1,334	11.42	4.00
BPCE	FR	Paris	Cooperative	Unlisted (owned by mutuals)	1,167	13.02	5.00
UniCredit	IT	Milan	Commercial	Listed (dispersed)	860	10.59	4.63
ING	NL	Randstad / Amsterdam	Commercial	Listed (dispersed)	842	12.94	4.40
22 E-SIBs (assets>€150bn)							
BBVA	ES	Madrid (Bilbao)	Commercial	Listed (dispersed)	750	12.10	5.98
Crédit Mutuel	FR	Paris	Cooperative	Unlisted (owned by mutuals)	707	15.32	6.40
Intesa Sanpaolo	IT	Milan	Commercial	Listed (dispersed)	676	12.98	6.80
Rabobank	NL	Randstad / Utrecht	Cooperative	Unlisted (owned by mutuals)	670	13.49	3.90
Commerzbank	DE	Frankfurt	Commercial	Listed (dispersed)	533	13.77	4.50

DZ Bank	DE	Frankfurt	Cooperative	Unlisted (owned by mutuals)	408	13.85	4.00
ABN AMRO	NL	Randstad / Amsterdam	Government	Listed (nationalised)	390	15.53	3.80
CaixaBank	ES	Barcelona	Cooperative	Listed (controlled by foundation)	344	12.90	5.20
KBC	BE	Antwerp	Commercial	Listed (dispersed)	252	15.16	6.27
LBBW	DE	Stuttgart	Government	Unlisted (local government)	234	16.36	4.70
Dexia	BE	Brussels	Government	Unlisted (in resolution)	230	15.91	4.37
La Banque Postale	FR	Paris	Government	Unlisted (French post office)	219	13.20	5.20
BayernLB	DE	Munich	Government	Unlisted (local government)	216	15.14	4.70
Banco Sabadell	ES	Sabadell	Commercial	Listed (dispersed)	209	11.50	4.81
Bankia	ES	Madrid (Valencia)	Government	Listed (nationalised)	207	13.89	5.00
Erste Group	AT	Vienna	Commercial	Listed (dispersed)	200	12.35	5.70
NORD/LB	DE	Hanover	Government	Unlisted (local government)	181	13.07	4.38
Belfius	BE	Brussels	Government	Unlisted (nationalised)	177	15.90	4.90
Landesbank Helaba	DE	Frankfurt	Government	Unlisted (local government)	172	13.79	4.55
Monte dei Pas- chi di Siena	IT	Siena	Commercial	Listed (dispersed)	169	12.01	5.22
Banco Popular	ES	Madrid	Commercial	Listed (dispersed)	159	13.11	6.07
BNG Bank	NL	Randstad / The Hague	Government	Unlisted (policy bank)	150	23.35	2.80

70 other euro-area SIs							
NRW.BANK	DE	Düsseldorf (Münster)	Government	Unlisted (local government)	141	42.58	11.00
Raiffeisen Zentralbank	AT	Vienna	Cooperative	Unlisted (owned by mutuals)	138	10.58	4.50
Bank of Ireland	IE	Dublin	Commercial	Listed (dispersed)	131	13.30	5.70
OP Financial Group	FI	Helsinki	Cooperative	Unlisted (owned by mutuals)	125	19.55	7.20
VW Financial Services	DE	Braun- schweig	Commercial	Unlisted (Volkswagen)	121	11.97	11.10
Banco Popolare	IT	Verona	Cooperative	Listed (Popolare)	121	13.15	4.70
UBI Banca	IT	Milan (Ber- gamo)	Cooperative	Listed (Popolare)	117	12.08	5.81
National Bank of Greece	GR	Athens	Commercial	Listed (dispersed)	111	14.52	8.21
HSH Nordbank	DE	Hamburg (Kiel)	Government	Unlisted (local government)	110	9.17	5.02
DekaBank	DE	Frankfurt	Government	Unlisted (owned by Savings Banks)	108	13.51	4.20
Allied Irish Banks	IE	Dublin	Government	Listed (nationalised)	103	15.86	7.90
Caixa Geral de Depósitos	PT	Lisbon	Government	Unlisted (govern- ment-owned)	101	10.80	6.10
Rentenbank	DE	Frankfurt	Government	Unlisted (policy bank)	93	20.19	
Nederlandse Waterschaps- bank	NL	Randstad / The Hague	Government	Unlisted (policy bank)	91	64.07	2.00
WGZ Bank	DE	Düsseldorf	Cooperative	Unlisted (owned by mutual)	90	14.57	3.34
Piraeus Bank	GR	Athens	Commercial	Listed (dispersed)	88	17.49	10.90

Erwerb- gesellschaft der S-Finanz- gruppe	DE	Neuhard- enberg	Government	Unlisted (owned by Sparkassen)	87	12.83	
SFIL	FR	Paris	Government	Unlisted (policy bank)	84	24.74	1.88
Millennium BCP	PT	Lisbon	Commercial	Listed (dispersed)	75	13.33	5.60
Eurobank Ergasias	GR	Athens	Commercial	Listed (dispersed)	74	17.03	9.07
L-Bank	DE	Karlsruhe	Government	Unlisted (local policy bank)	73	16.38	4.13
Mediobanca	IT	Milan	Commercial	Listed (dispersed)	71	11.98	12.02
Alpha Bank	GR	Athens	Commercial	Listed (dispersed)	69	16.65	12.30
PBB Deutsche Pfandbrief- bank	DE	Munich	Commercial	Listed (dispersed)	67	18.90	3.90
SNS Bank	NL	Randstad / Utrecht	Government	Unlisted (nationalised)	63	25.33	4.80
Banca popo- lare dell'Emilia Romagna	IT	Modena	Cooperative	Listed (Popolare)	61	11.24	6.90
Unicaja	ES	Malaga	Cooperative	Unlisted (foundations)	60	12.84	5.06
Ibercaja	ES	Zaragoza	Cooperative	Unlisted (foundations)	59	11.95	5.16
Bankinter	ES	Madrid	Commercial	Listed (dispersed)	59	11.77	5.42
Kutxabank	ES	Bilbao	Cooperative	Unlisted (foundations)	58	14.61	7.71
Novo Banco	PT	Lisbon	Government	Unlisted (nationalised)	58	13.47	
Aareal Bank	DE	Wiesbaden	Commercial	Listed (dispersed)	52	13.75	4.90
Banca Popo- lare di Milano	IT	Milan	Cooperative	Listed (Popolare)	50	11.53	7.67

Iccrea Holding	IT	Rome	Cooperative	Unlisted (owned by mutuals)	50	11.45	3.00
HASPA	DE	Hamburg	Government	Unlisted (local government)	46	13.11	7.65
BpiFrance	FR	Paris	Government	Unlisted (policy bank)	45	9.60	
Banque et Caisse d'Epargne de l'Etat	LU	Luxem- bourg	Government	Unlisted (government)	43	17.84	5.48
AXA Bank	BE	Brussels	Commercial	Unlisted (AXA Group)	43	16.51	3.22
CRH	FR	Paris	Cooperative	Unlisted (JV of large French banks)	43	11.68	1.33
Liberbank	ES	Madrid	Cooperative	Listed (cooperative)	42	13.66	5.49
Banco Mare Nostrum	ES	Madrid	Government	Unlisted (nationalised)	41	11.12	5.06
Banco BPI	PT	Lisbon	Commercial	Listed (dispersed)	41	10.86	6.40
Grupo Cooper- ativo Cajamar	ES	Madrid	Cooperative	Unlisted (owned by mutuals)	40	11.30	6.00
Banca Popo- lare di Vicenza	IT	Vicenza	Commercial	Unlisted (Atlante fund)	40	6.65	4.4
Argenta	BE	Antwerp	Commercial	Unlisted (private)	39	19.90	4.80
Münchener Hypothecken- bank	DE	Munich	Cooperative	Unlisted (mutual)	38	17.30	
Credito Emiliano	IT	Reggio Emilia	Commercial	Listed (dispersed)	37	13.52	5.22
Raiffeisen- landesbank Oberösterreich	AT	Linz	Cooperative	Unlisted (mutual)	37	13.83	
RCI Banque	FR	Paris	Commercial	Unlisted (Renault)	37	15.64	8.40
apoBank	DE	Düsseldorf	Cooperative	Unlisted (mutual)	36	22.00	5.10

Agence Française de Développement	FR	Paris	Government	Unlisted (policy bank)	36	8.70	
Banca Popolare di Sondrio	IT	Sondrio	Cooperative	Listed (Popolare)	36	10.49	6.22
Promontoria Sacher / BAWAG	AT	Vienna	Commercial	Unlisted (private)	36	13.80	6.20
Kuntarahoitus	FI	Helsinki	Government	Unlisted (policy bank)	34	41.49	3.15
Veneto Banca	IT	Montebelluna	Cooperative	Unlisted (Popolare)	33	7.23	5.20
Precision Capital	LU	Luxembourg	Commercial	Unlisted (private)	33	14.72	4.36
Banca Carige	IT	Genoa	Commercial	Listed (dispersed)	30	12.19	7.74
Permanent TSB	IE	Dublin	Government	Unlisted (nationalised)	29	17.08	6.00
Raiffeisenlandesbank Niederösterreich-Wien	AT	Vienna	Cooperative	Unlisted (mutual)	28	13.75	
Bank of Cyprus	CY	Nicosia	Commercial	Listed (dispersed)	23	13.97	11.32
Cooperative Central Bank	CY	Nicosia	Government	Unlisted (nationalised)	14	15.61	8.80
Nova Ljubljanska Banka	SI	Ljubljana	Government	Unlisted (government-owned)	12	16.20	9.11
Volksbank Wien	AT	Vienna	Cooperative	Unlisted (mutual)	10	12.47	
Bank of Valletta	MT	Valletta	Commercial	Listed (dispersed)	10	11.26	5.00
Hellenic Bank	CY	Nicosia	Commercial	Listed (dispersed)	7	14.75	8.60
Banque De-groef	BE	Brussels	Commercial	Unlisted (private)	6	15.08	
ABLV Bank	LV	Riga	Commercial	Unlisted (private)	5	10.64	4.06

Nova Kreditna banka Maribor	SI	Maribor	Commercial	Unlisted (private)	4	25.13	13.04
Abanka	SI	Ljubljana	Government	Unlisted (government-owned)	4	23.03	10.64
Mediterranean Bank	MT	Valletta	Commercial	Unlisted (private)	3	11.28	5.90
29 branches & subsidiaries							
Nordea Finland	FI (SE)	Helsinki	Commercial	Listed (dispersed)	302		
HSBC France	FR (UK)	Paris	Commercial	Listed (dispersed)	168		
ABANCA (Banesco)	ES (VE)	Betanzos	Commercial	Listed (private)	47		
State Street Europe	DE (US)	Munich	Commercial	Listed (dispersed)	36		
Bank of New York Mellon	BE (US)	Brussels	Commercial	Listed (dispersed)	35		
Ulster Bank (RBS)	IE (UK)	Dublin	Government	Listed (nationalised)	31		
Danske Bank Finland	FI (DK)	Helsinki	Commercial	Listed (dispersed)	30		
State Street Luxembourg	LU (US)	Luxembourg	Commercial	Listed (dispersed)	30		
Barclays plc, French branch	FR (UK)	Paris	Commercial	Listed (dispersed)	30		
Barclays plc, Italian branch	IT (UK)	Rome	Commercial	Listed (dispersed)	28		
SEB Germany	DE (SE)	Frankfurt	Commercial	Listed (dispersed)	22		
RBS Netherlands / RFS Holdings	NL (UK)	Amsterdam	Government	Listed (nationalised)	16		
RBC Investor Services	LU (UK)	Luxembourg	Commercial	Listed (dispersed)	15		
Slovenska Sporitelna (Erste)	SK (AT)	Bratislava	Commercial	Listed (dispersed)	14		
Sberbank Europe	AT (SE)	Vienna	Government	Listed (government-owned)	13		

VUB Banka (Intesa San- paolo)	SK (IT)	Bratislava	Commercial	Listed (dispersed)	13
JP Morgan Luxembourg	LU (US)	Luxem- bourg	Commercial	Listed (dispersed)	12
Tatra Banka (Raiffeisen)	SK (AT)	Bratislava	Cooperative	Listed (mutual)	11
Swedbank Estonia	EE (SE)	Tallinn	Commercial	Listed (dispersed)	10
VTB Austria	AT (RU)	Vienna	Government	Listed (govern- ment-owned)	10
UBS Luxem- bourg	IU (CH)	Luxem- bourg	Commercial	Listed (dispersed)	10
RCB Bank (VTB)	CY (RU)	Limassol	Government	Listed (govern- ment-owned)	8
HSBC Malta	MT (UK)	Valletta	Commercial	Listed (dispersed)	7
SEB Lithuania	LT (SE)	Vilnius	Commercial	Listed (dispersed)	7
Swedbank Lithuania	LT (SE)	Vilnius	Commercial	Listed (dispersed)	7
Swedbank Latvia	LV (SE)	Riga	Commercial	Listed (dispersed)	5
SEB Estonia	EE (SE)	Tallinn	Commercial	Listed (dispersed)	5
DNB Lithuania	LT (NO)	Vilnius	Commercial	Listed (dispersed)	4
SEB Latvia	LV (SE)	Riga	Commercial	Listed (dispersed)	4
Total 129 significant institutions					23,058

Source: Bruegel based on ECB List of Supervised Entities as of 1 January 2016; online sources and company reports (headquarters, governance, ownership); SNL Financial (assets, CET1 and leverage ratios).

Notes: bank names are based on the banks' own branding and common usage, and may differ from the names of parent legal entities as listed by the ECB (eg L-Bank refers to Landeskreditbank Baden-Württemberg-Förderbank). Country codes are based on the ECB list; for branches and subsidiaries, the home country of the parent bank is indicated in parentheses (we use standard two-letter ISO codes, eg CH for Switzerland

and IE for Ireland). Headquarters refers to the operational head office; where relevant, the separate place of incorporation is indicated (eg Bilbao for BBVA).

‘Governance’ includes three categories: (1) ‘Government’ governance applies to all banks owned or controlled by government at the national or local level, and also to those jointly controlled by a group of such banks (such as DekaBank in Germany). (2) ‘Cooperative’ governance applies to a range of non-commercial models, which are not government-controlled. These include cooperative banks in a narrow sense and their central/national bodies (eg Crédit Agricole, Crédit Mutuel, DZ Bank, Rabobank), banks controlled by non-profit foundations (eg successors of Spain’s savings banks), a joint venture majority-owned by cooperative banks (France’s CRH), and Italy’s ‘popular banks’ (see below). (3) ‘Commercial’ governance applies to all other banks, which are organised on a joint-stock basis. Euro-area branches or subsidiaries of other banking groups are classified according to the governance of their parent group.

‘Public listing (ownership)’ indicates whether the bank is listed or not at parent-entity level, and gives an indication of ownership structure. ‘Dispersed’ ownership, in this context, only means that no shareholder holds an absolute majority, but it should be kept in mind that this category covers a wide variety of situations, which may in some cases involve de-facto control by minority shareholders, acting on their own or as part of shareholders’ agreements. Among the banks under government control, we distinguish between ‘nationalised’ banks (which were in the private sector before the start of the crisis in 2007), ‘policy banks’ (which have a specific public-interest mission, such as financing local government in the case of the Netherland’s BNG Bank, Finland’s Kuntarhoitus or France’s SFIL), and other (such as Germany’s Landesbanken). ‘Popolare’ refers to the specific case of Italian popular banks, which currently follow a one-person-one-vote principle (as opposed to one-share-one-vote) even when publicly listed. This information is updated as of May 2016.

All financial metrics are as of end-2015, except Crédit Mutuel, HSH Nordbank, Erwerbgesellschaft der S-Finanzgruppe, Iccrea Holding, HASPA, AXA Bank, Precision Capital, Banque Degroof, Sberbank Europe, VTB Austria, Bank of New York Mellon, RCB Bank (VTB), UBS Luxembourg, JP Morgan Luxembourg, all of which are as of end-2014, and State Street Luxembourg, as of end-2013. In addition, the leverage ratio is as of end-2014 for Dexia, NRW.BANK, WGZ Bank. We made estimates for Barclays’ branches in Italy and France, based on the Barclays plc annual report, since these branches are not specifically included in the SNL database.

3 Austria

Thomas Gehrig

Austrian banking groups are characterised by different degrees of complexity in their organisational structure. ‘One-tiered’ banks are stand-alone joint-stock banks, such as Bank Austria (controlled by UniCredit since 2005)⁵¹, savings and loan institutions, local mortgage banks (Hypo Landesbanken) and special-purpose banks. There are two ‘two-tiered’ groups, the savings banks (Erste Group Bank, Zweite Sparkasse and 46 other Sparkassen) and cooperative banks (41 Volksbanken and Apothekerbank Sparda Banken), within which individual entities are financially linked through central coordinating banks on a second tier (respectively Erste Bank der Österreichischen Sparkassen AG, and Volksbank Wien). The Raiffeisen group is ‘three-tiered’, with 473 independent local Raiffeisen (cooperative) banks, eight regional Raiffeisen Landesbanken, and a central entity, Raiffeisen Zentralbank (RZB).

The group ownership structures of the Erste and Raiffeisen groups are Austrian particularities deserving further comment. Erste Bank AG is the group central entity and manages the foreign subsidiaries and capital market activities. It evolved as a subsidiary of the Sparkassenverband (Savings Banks Association), which remains the main shareholder via the Erste Foundation, jointly owned by the ‘tier-1’ Sparkassen. Similarly, Raiffeisen Zentralbank AG (RZB) is the ‘tier-3’ centre of the Raiffeisen group, conducting international

51 Bank Austria used to be part of the national savings banks system (Sparkassenverband), but left it in 2004.

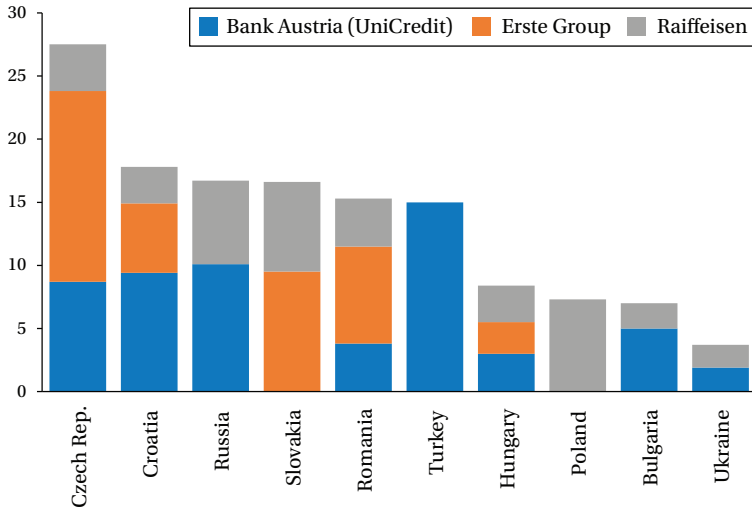
business (through its listed subsidiary Raiffeisen Bank International) and most of the group's capital market activities. About 88 percent of its share capital is owned by a joint entity of the eight 'tier-2' Raiffeisen Landesbanken, the rest being held by a handful of external shareholders.

The two- and three-tiered groups are structured as institutional protection schemes (IPS), which imply mutual risk sharing, though without mutual or centralised control. In addition to the mandatory deposit insurance system administered by the Österreichische Raiffeisen-Einlagensicherung eGen (ÖRE), the Raiffeisen group has a longstanding mutual insurance scheme, the Solidaritätsgemeinschaft der Raiffeisen Bankengruppe, and also, since 2000, an institutional protection scheme (Raiffeisen Kundengarantiegemeinschaft Österreich) which has been joined so far by about 85 percent of Raiffeisen banks. Similarly, the Volksbanken are members of an IPS named Österreichische Genossenschaftsverband (Schultze Delitzsch). The IPS that covers the Sparkassen and Erste Bank is the Haftungsverbund der Sparkassen.

The Austrian national supervisory authority is the FMA (Finanzmarktaufsicht), an independent federal agency. The national central bank (OeNB, for Österreichische Nationalbank) provides consulting and information services to the FMA but does not control it, in a relationship similar to that between Bundesbank and BaFin in Germany.

According to FMA's 2015 notification to the ESRB (ESRB, 2015), the Austrian banking sector can be characterised as large in relation to the Austrian economy, and as highly exposed to emerging markets (mostly EU member states in central and eastern Europe, and Russia, Turkey and Ukraine). Austrian banks are also insufficiently prepared for the reduction/removal of the implicit government guarantee and under-capitalised in relation to their European peers. The Austrian banking sector's very specific ownership structure (with a high share of non-joint-stock companies) renders re-capitalisation difficult in times of crisis.

Figure 8: Gross loans to central and eastern European countries by Austrian banks (end-Q1 2014, € billions)



Source: Bruegel and Raiffeisen Bank International (2015). Notes: For Bank Austria the following applies to net loans: Turkey: pro-forma (41 percent stake at-equity since 2013); Slovakian unit merged into the Czech unit in 2013; Fitch assumption for Ukrainian unit (booked as available-for-sale since 2013).

While generating higher returns on equity relative to lending in the euro area, the banks' CEE exposure results in asset quality problems as indicated by a relatively high proportion of non-performing loans. The Austrian subsidiaries of Sberbank and VTB have achieved substantially lower NPL ratios and loan impairments⁵².

Exposure to central and eastern European (CEE) countries

A specific feature of the Austrian banking market is its substantial CEE exposure mainly through the three largest banks: Bank Austria, Erste

⁵² See Gehrig (1998) for an explanation of domestic advantage in cross-border lending because of the presence of local information. In his model cross-border banks face an adverse selection problem highlighted by higher NPL ratios, loan impairments and provisioning.

Bank and Raiffeisen International (see Figure 8). Together these banks comprise the largest group of cross-border banks in the CEE area. Erste Bank and Raiffeisen International together account for about 20 percent of total CEE lending from the 15 countries that formed the European Union before the 2004 enlargement, while Bank Austria together with Intesa Sanpaolo account for about another 17 percent.

Overall the CEE markets still appear underbanked⁵³. For example, collateralisation in the CEE area in 2014 typically is still below 20 percent of GDP, compared to the euro-area average, which grew from 30 to 40 percent of GDP between 2002 and 2014. Some euro-area countries have collateralisation levels of up to 40-50 percent of GDP. This suggests the existence of further unexploited banking opportunities in the CEE area.

Despite improvements on the asset side, Austrian banks started to reduce their CEE exposures in 2014. Partly this was a reaction to the SSM and the resulting increasingly conservative supervisory environment in their home countries, Austria and Italy⁵⁴. In particular, Erste Group CEO Andreas Treichl has repeatedly complained about unfair treatment of CEE engagement and supervisory bias in the ECB's comprehensive assessment⁵⁵, in the face of which the ECB felt compelled to justify its asset quality review and stress testing procedures⁵⁶.

53 'Underbanked' is understood here in terms of services provided, not as a measure of banks per customer. In the latter sense, the euro area is largely viewed as overbanked.

54 Among the SIs supervised by the ECB since 2014, only Santander and KBC increased their CEE exposure in 2014 markedly, despite growing NPL ratios.

55 See for example *Bloomberg*, 'ECB stress tests biased', 25 April 2014, or *Reuters*, 6 June 2014. On Austrian TV (ORF, Zib2) Mr Treichl said on 26 October 2014: "In Brussels and Frankfurt they haven't yet engaged intensely enough with this region, and especially they haven't grasped how strong the Czech Republic, Slovakia and Poland have become" (author's translation from German), implying a serious lack of expertise on, or knowledge of, regional CEE fundamentals at the ECB and the European Commission.

56 *Bloomberg*, 'ECB defends stress test from Erste's criticism of design', 24 May 2014.

Austrian banks continued to reduce the CEE exposures in 2015.

Comprehensive assessment and stress tests

The 2014 comprehensive assessment was criticised by the Austrian banking industry and Austrian regulators. There was a widespread sense that the ECB was modifying the fair-value accounting of impaired assets according to its own excessively restrictive interpretations or preferences, and, as widely claimed, in contradiction to Austrian accounting standards, and even IFRS⁵⁷. In late 2014, ECB officials had to defend themselves repeatedly in the Austrian public debate against the charge of unduly interfering in the banks' accounting practices. The details of the definition of non-performing loans, or merely impaired loans, and their implementation was a key issue in that debate, because it significantly affected CEE exposures⁵⁸. In aggregate, the large Austrian banks had to adjust their required Tier 1 capital by less than 1 percentage point because of the differential accounting treatments (0.65 percent in case of RZB).

A common feature of SSM supervision became evident in those early days. In attempts to implement equal standards and to be fair in this respect to all euro-area countries, standards would converge to the

57 For example, Raiffeisen CEO Walther Rothensteiner insisted of the legality of the accounting procedures chosen by his bank, versus the ECB's insistence on reclassifying loans for asset quality review purposes (*Salzburger Nachrichten*, October 2014). In their discussion on the innate tensions in the treatment of NPLs and impaired assets in different accounting regimes, Bholat *et al* (2016) and Roaf (2014) also highlight the particularly conservative ECB approach. They also imply that the standards agreed in the 'Vienna Initiative' with respect to problematic exposures in CEE and south-eastern Europe were significantly laxer than the recent ECB policies.

58 While it appears to be closer to the Austrian perspective that renegotiating loans is a characteristic feature of doing business within the CEE area and not necessarily an indication of bad performance, the ECB - in their attempt to implement equal treatment throughout the euro area - as a matter of principle prefers to treat any such renegotiations as indicators of non-performance (relative to the initially agreed contractual terms). Accordingly, the discretionary choices were treated more conservatively by the ECB during the asset quality review.

toughest, most conservative levels. Already within these first months of negotiations, Austrian members felt they were being deprived of opportunities to attract good business for the sake of fending off risky business. These views have been reiterated regularly in more recent disagreements between Austrian stakeholders and the ECB.

The stress test results themselves did not come as a surprise, and Austria banks performed according to expectations. Only ÖVAG (Österreichische Volksbank AG, by then the central entity of the Volksbank system) failed the stress test. But this problem was already being taken care of at the time, and in June 2015 the Volksbank system was reorganised into eight regional groups with Volksbank Wien taking the lead function. The bad assets were transferred into a part-government owned bad bank, Immigon Portfolioabbaugesellschaft AG.

Significant institutions (SIs)

In June 2015, the Financial Market Stability Board (FMSB), a newly established institution at the FMA to implement macroprudential regulation, decided that banks with significant CEE exposures (namely Erste Group, Raiffeisen and Bank Austria) would be subject to an extra 3 percent systemic risk capital buffer. This requirement will be phased-in by mid-2017. It is worth noting that these systemic risk buffers were added despite the fact that the systemic risk exposures of the Austrian SIs were declining, according to various measurements of systemic risk such as SRISK (see Gehrig and Iannino, 2016). While the CEE lending business has been largely profitable (especially in the Czech Republic, Russia and Turkey), and significant risk premia had been earned, considerable losses, non-performing loans and tail risks also remain on the books (Romania, Ukraine).

Because of their extensive cross-border activities, two Russian subsidiaries were determined to be significant by the ECB in 2015: Sberbank Europe AG and VTB Bank (Austria) AG. These two, and seven other banks in other euro-area countries, were subjected in 2015 to a comprehensive assessment that complemented the one carried

out in 2014. While both banks passed the asset quality review, they failed to meet the 5.5 percent CET1 ratio under the adverse stress test scenario (reaching levels of 4.1 and 4.2 percent respectively). Both banks were able to make up the shortfall through capital injection by their respective parents before the conclusion of the stress tests.

Less significant institutions (LSIs)

The FMA maintains responsibility for supervising about 550 less significant institutions in Austria. The FMA argues that this arrangement provides sufficient flexibility to account for local and regional specificities.

The largest group of less significant banks comprises most local Raiffeisen banks, which are organised in the form of cooperatives. These institutions are formally independent. As cooperatives, however, they guarantee each other's obligations, and therefore share each other's risks. Despite their less significant status, these banks are very concerned about the possible current intention of the ECB to merge them into larger, possibly systemically important players. There is considerable mistrust in the industry about the FMA's ability to effectively protect them against such schemes. The FMA is seen as executing Frankfurt's orders and implementing the instructions of the ECB.

Perception and debate

In the first 18 months of European banking supervision, the public debate about banking in Austria has been dominated by the resolution of the Carinthian bank Hypo Alpe Adria (and the related bad bank HETA) and that of ÖVAG (see below). The restructuring of Bank Austria, with the transfer of its CEE exposure to the Italian head office of Unicredit Group in Milan, announced in October 2015, also attracted much publicity.

Within the financial community, there are strong rumours about the ECB's possible intention to restructure the Raiffeisen banks and Volksbanken, and their possible inclusion in the common European

deposit insurance scheme. Banks feel their traditional lending activities are being held back by excessively intrusive regulation, and also by an excessively accommodating monetary policy⁵⁹. The financial sector is disappointed with the FMA, which does not seem to defend national interests against Frankfurt's dominance, and is seen as giving in prematurely to questionable requests from the ECB.

There is also a widespread feeling among the the Raiffeisen banks and Volksbanken that both the ECB's monetary policy and its supervision unnecessarily constrain profitable traditional and hitherto resilient business models. This comes on top of an Austrian bank levy introduced in 2011 in order to recoup some of the cost to taxpayers of the banking sector bailouts of previous years. This bank levy was introduced as a permanent rather than a temporary measure. The ECB's additional efforts at harmonisation of options and national discretions (ONDs) and its 'strengthening' of supervision standards and attempts to create a level-playing field, might reduce (traditional) lending while effectively making it less risky. Accordingly, many observers, especially within the LSIs, sense a strong connection between what they argue is excessively conservative supervision, and low growth and lacklustre economic activity. According to this view, all these developments seriously undermine the competitiveness of the Austrian banking sector, both internationally and at home.

Deposit insurance

The 2015 Austrian law transposing the EU Deposit Guarantee Scheme Directive of 2014⁶⁰ leaves the basic depositor protection unchanged at the level of €100,000, and in special cases even at €500,000.

Contributions according to the new law will have to be fully funded by the banking sector. In the previous regime, contributions were shared

59 Laura Noonan (2014) 'Interview - Erste chief sees bank regulation as biggest constraint on lending', *Reuters*, 6 June.

60 Bundesgesetzblatt 159/2015: Einlagensicherungs- und Anlegerentschädigungsgesetz.

equally between the banking sector and the government at a guarantee level of €50,000 each. Accordingly, explicit partial former funding of deposit insurance by the taxpayer has been transferred to the banking sector in the wake of the creation of the banking union⁶¹.

Cooperation between the FMA and the ECB

The relationship between the FMA and the ECB is portrayed as cooperative in both institutions' public communications. ECB Supervisory Board chair Danièle Nouy and vice chair Sabine Lautenschläger have been repeatedly invited to present their views at FMA annual conferences, which receive widespread attention from the financial community. The annual conferences meetings in 2014 and 2015 focussed on demonstrating complete supervisory harmony. Even so, Nouy did not shy away from emphasising that the ECB would have the final say in case of a stalemate.

Hans-Jörg Schelling, Austria's finance minister since September 2014, has strongly supported the SSM in public speeches. In his address to the 2014 FMA annual conference (Schelling, 2014), he clearly invited the cooperation of the financial sector. At the same time he emphasised the need to evaluate the SSM in due course, in particular its roles to improve financing for small and innovative firms and to increase the resilience of the banking sector.

Among regulators, however, the sense of harmony with Frankfurt has increasingly been replaced by an attitude of fatalistic cooperation. Conflicts with the ECB 'higher-ups' are carefully avoided. The feeling is that, whenever Frankfurt-based JST members turn a deaf ear to issues voiced by FMA members, the latter will not insist on making their points. ECB supervisory staff members are viewed by more and more of their FMA counterparts as dominant and insisting on their self-attributed expertise, including on local Austrian matters.

61 Article 25 (3) of the new law allows for additional discretionary government guarantees on a case-by-case basis.

The cooperative banking sector (Raiffeisen banks and Volksbanken) largely regards the FMA attitude as one of appeasement that too easily surrenders the interests of the cooperative banks and of LSIs more generally. In particular, attempts by the ECB to transform cooperative banks into systemically important institutions via forced mergers are a major source of concern. The argument is that the ECB has effective control. The FMA is viewed as having been degraded to a local subsidiary of the ECB, effectively forced to cooperate in implementing the orders from Frankfurt.

Resolution of systemic banks: HETA and ÖVAG

While the Austrian banking market is heavily over-banked, structural reform is slow. Because of its connections to political parties, the exit of the failed Hypo Alpe Adria (HAA), however, has attracted public attention.

HAA's banking license was withdrawn in October 2014 and the remaining assets were managed by HETA under FMA supervision. An independent commission headed by former high-court judge Irmgard Griss, in a report (Griss, 2014) that was widely considered as unusually frank and detailed, attributed HAA's problems to its close political relationships and supervisory failure, including by the OeNB and the FMA. The report, commissioned in May 2014 and delivered in December 2014, deeply dented the reputation of the Austrian supervisors. The impact of this report is seen by some industry observers as one of the reasons for the eagerness of the FMA and OeNB to cooperate with the ECB in SSM matters, as an attempt to restore their public reputations.

Less dramatic was the exit of ÖVAG, which, as mentioned, failed the 2014 stress test. Its banking licence was relinquished in July 2015. ÖVAG had got into trouble with bad investments in derivatives and stocks, prior to and during the subprime crisis. In this case too, it appears that Austrian supervisors were slow to close the failed bank, adding to the costs ultimately borne by the taxpayer.

One important result of the restructuring of HAA and ÖVAG has

been an increasing willingness to use bail-in instruments. Austrian policymakers are increasingly prepared to implement forms of burden-sharing that include bail-in instruments, even at the cost of legal risk⁶².

Overall assessment and prospects

The introduction of the SSM has clearly changed the supervisory culture in Austria. It is too early for a definitive assessment, however. The publication of the Griss report on Hypo Alpe Adria, which uncovered massive supervisory failures by both the OeNB and FMA, dominated 2015. After the denting of their reputations, both supervisors have tried to restore their good names and public confidence by cooperating closely with the ECB and by avoiding any public conflict with it.

Given Austrian banks' substantial CEE exposures and relatively low capital levels, Austrian supervisors are not likely to support local interests to the extent expected by domestic banks. The signs are that there will be massive sector concentration, and reduced horizontal or geographical diversity in the Austrian banking industry. Banks appear to be gradually continuing to reduce their role as major financiers of smaller and medium sized, and especially, of innovative and risky companies. A widely discussed report on SMEs by the Ministry of Science, Research and Economics, showed that the value of newly granted loans per SME applicant dropped by about 20 percent from €7,120 in 2009 to €5,930 in 2014 (BMWWF, 2015, Fig. 59), despite significantly enhanced public support in line with the European Small Business Act of 2008. Moreover, while funding conditions have improved in the euro area since 2011, the spread between lending rates for small business and the ECB rate (or 6-month Euribor) has widened from less than 150 to more than 200 basis points (BMWWF, 2015, Fig. 54)⁶³.

62 In May 2016, after several failed attempts, the Austrian Federal Finance Ministry reached a settlement with HETA creditors in order to avoid lengthy and costly legal proceedings.

63 This increase in spreads for SMEs cannot be explained by refinancing costs.

Many Austrian observers see the real test of SSM's success as its ability to attract the under-banked non-euro CEE countries to opt into banking union through the close cooperation procedure and, thus, to maintain if not increase the competitiveness of euro-area based banks in eastern Europe⁶⁴. Currently there is no sign of this, causing concern among Austrian banks and economic players that they will lose competitiveness in eastern Europe and neighbouring countries because of the SSM.

Overall, it seems that banking union has already contributed positively to speed up the resolution of failed banks in Austria. In this regard, the SRM in particular will help to restructure European banking markets and to enable market forces to determine the viability of banking business models. While concerns about the (increasingly) intrusive character of the SSM might admittedly reflect self-serving interests of the banking industry, it remains debatable how conservative and standardised European banking supervision ultimately should be. If supervision is too tight, it might be successful in almost eradicating the problem of failing banks, but it might also impede the ability of the banking system to fund (small) risky and innovative ventures. Recent evidence from the United States (Götz *et al*, 2016) suggests that geographical diversification can be an important substitute for (excessively active) supervision. In Europe, significant diversification benefits could, for example, be gained by hedging risks between over-banked core countries and underbanked CEE countries. In this sense it would seem appropriate that future SSM policies should be put in place with a view to future growth and development, and not only

Increasing risk premia are also an unlikely explanation, given improved government guarantees as a consequence of the implementation of the European Small Business Act. Given the high intensity of competition throughout this period, the apparent explanations for the spread increase are heightened regulatory costs and reduced competitiveness.

64 See the panel contribution of Erste CEO A. Treichl at the 42nd Economics Conference of the OeNB in 2014 (Oesterreichische Nationalbank, 2014).

calibrated on what was the most serious crisis in decades. After all, the *raison d'être* of banks as delegated monitors of risk requires them to acquire social information, especially about risky entrepreneurial ventures.

4 Belgium

André Sapir

The Belgian banking landscape

Belgium is special among the nine countries described in this Blueprint. It is the only one for which the importance of foreign banks, via branches or subsidiaries, was greater (in terms of assets) than that of domestic credit institutions at the start of European banking supervision⁶⁵. According to the ECB (2015a), banking groups headquartered outside Belgium accounted for 65.6 percent of banking assets in Belgium in 2014. This is far more than in the other eight countries, where the share of foreign banks averaged only 12 percent in 2014 and ranged between 2.5 percent (Greece) and 24.7 percent (Austria). Belgium is also the country with the greatest share of bank assets held by subsidiaries (43.1 percent of total) and by branches (22.5 percent) of foreign banks.

The reasons for the large share of foreign banks in Belgium include the financial crisis of 2007-08, which resulted in the demise of Fortis (the largest bank in Belgium) and its acquisition by BNP Paribas. Another important reason is the large pool of surplus savings in Belgium. According to the High Level Expert Group on the Future of the Belgian Financial Sector (HLEG, 2016), the net financing of the resident banking sector by Belgian households (ie surplus savings)

65 This feature, however, is shared by several other SSM countries which are not included in the project, such as the Baltic countries, Finland and Luxembourg. Portugal is also likely to join the group shortly.

amounted to 46 percent of GDP, roughly €180 billion, in 2015. A significant part of these surplus savings is channelled abroad by foreign banking groups, mostly in the context of intra-group operations. The total of net intra-group interbank claims of resident banks in 2015 was estimated at about €90 billion, a large part of which was channelled by branches or subsidiaries of foreign banks.

Immediately before the creation of the SSM, the National Bank of Belgium (NBB) was the supervisory authority for all Belgium-based banks, ie all domestic credit institutions and subsidiaries of foreign credit institutions. Belgian branches of foreign credit institutions were supervised only by their home supervisory authorities. With the creation of the SSM, the NBB retains supervisory responsibility for the less significant institutions (LSIs).

Table 7 at the end of this chapter shows the top 20 Belgium-based banking groups, which account for 99 percent of all banks (excluding foreign branches) in terms of assets, and the situation in terms of supervision following this shift⁶⁶. Seven different cases can be distinguished, four for significant and three for less significant institutions:

- Significant institutions:
 1. Domestic credit institutions: KBC, Dexia, Belfius, Argenta, Degroof Petercam;
 2. Subsidiaries of foreign credit institutions from non-SSM countries: Bank of New York Mellon;
 3. Subsidiaries of foreign non-credit institutions: AXA Bank (subsidiary of French insurer AXA);
 4. Subsidiaries of foreign significant institutions from SSM countries: BNP Paribas Fortis, ING Belgium, bpost bank (another subsidiary of BNP Paribas), Santander, BKCP and Beobank (both fully-owned by Crédit Mutuel Nord Europe, itself a mem-

⁶⁶ Data reported in Table 7 is consolidated, and might include therefore non-banking (mainly insurance) activities, and non-euro-area banking activities that fall outside SSM responsibility.

- ber of France’s Crédit Mutuel cooperative group);
- Less significant institutions:
 5. Domestic credit institutions: Crelan, Finaxis, VDK, CPH;
 6. Subsidiaries of foreign institutions from non-SSM countries: Euroclear (owned by Euroclear UK);
 7. Subsidiaries of foreign non-credit institutions: Nagelmakers (owned by Chinese insurer Anbang).

Among the top 20 Belgium-based banks, there are therefore: 13 that are, or belong to, significant institutions, seven considered as Belgian (cases 1-3) and six from another SSM country (case 4)⁶⁷; six less significant institutions, all considered Belgian (cases 5-7); and BHF Kleinwort Benson, which currently has no SSM-supervised banking activity in Belgium⁶⁸.

Assessing the working of the SSM from a Belgian perspective

All SIs operating in Belgium are directly supervised by the ECB, with participation of the NBB in their Joint Supervisory Teams (JST). All Belgian LSIs remain directly supervised by the NBB, as before the creation of the SSM. Branches of SSM-headquartered foreign banks are now supervised by the ECB if the parent group is a SI, or remain supervised by the relevant national supervisor if the parent group is a LSI.

This assessment of the working of the SSM can therefore focus primarily on the SIs operating in Belgium, for which the creation of the SSM has shifted supervisory responsibility to the ECB. This means focusing on the 13 banks listed above as being, or belonging to, significant institutions.

The seven Belgian-headquartered SIs (cases 1-3 above) were all subjected to SSM comprehensive assessments in 2014 (Argenta, AXA,

⁶⁷ Outside the top 20, there are seven subsidiaries of foreign significant institutions.

⁶⁸ Outside the top 20, there are dozens of less significant institutions, mainly Belgian domestic credit institutions but also some subsidiaries of foreign credit institutions.

Belfius, BNY Mellon, Dexia and KBC) or 2015 (Degroof, in anticipation of its merger with Petercam) to help ensure that they were adequately capitalised and could withstand possible financial shocks. The result of the 2014 comprehensive assessment indicated a capital shortfall for two of the Belgian banks: AXA Bank (€200 million shortfall) and Dexia (€339 million shortfall). AXA Bank has since been fully recapitalised by its parent group. Regarding Dexia, the Belgian authorities had argued that it should be excluded from the comprehensive assessment altogether, since it has been in orderly resolution since December 2012⁶⁹. The ECB Supervisory Board rejected this on the grounds that Dexia is a significant institution with full access to ECB liquidity. Nonetheless, the ECB stated after the comprehensive assessment that, in view of the orderly resolution plan for Dexia, which benefits from a Belgian federal state guarantee, there was no need to proceed with capital raising.

As far as significant non-Belgian institutions with important activities in Belgium (ie those listed under case 4 above) are concerned, none of the parent groups was identified by the SSM as having a capital shortfall. The sole significant foreign institution operating in Belgium found to have a capital shortfall was Monte dei Paschi di Siena, the Belgian subsidiary of which is rather small with €1.2 billion in assets at the end of 2014.

How have relevant Belgian stakeholders, in particular bankers and supervisors, reacted to the creation of the SSM? All of them seem to strongly support the creation of the banking union and of European banking supervision as a matter of principle. This is because they regard the banking union as an important step forward in reinforcing the economic governance and financial stability of the euro area, but also because the Belgian banking sector is so interconnected with the rest of the euro area. Given the cross-border dimension of the Belgian banking industry, extending bank supervision beyond domestic

69 Since December 2012, Dexia has been majority-owned by the Belgian state (50.02 percent), with the balance held by the French state (44.40 percent) and other shareholders (5.58 percent). Source: Dexia website.

borders is generally viewed as crucial to align responsibilities and ensure coherent and harmonised implementation of supervisory and regulatory practices (HLEG, 2016).

This does not mean, however, that Belgian stakeholders directly involved in supervision (bankers or supervisors) have no criticisms of the actual working of European banking supervision during its first year of operation. A comment often heard among Belgian stakeholders is that JSTs are very centralised, with little room for manoeuvre left for the NBB's sub-coordinators. In other words, responsibility for the supervision of significant institutions seems to have really shifted, as intended, from the NBB to the ECB. Belgian bankers seem to miss the cosy relationship they enjoyed with their Belgian supervisor. There is a strong feeling that informality has been replaced by anonymity and that this carries a cost: less dialogue leading to less nuanced, more bureaucratic and more 'one-size-fits-all' supervisory decisions.

There is also a feeling among some Belgian bankers that the small size of Belgium translates into less influence over decisions taken in Frankfurt, compared to banks from larger countries. Here the situation obviously differs according to whether or not the Belgian bank is a subsidiary of a foreign bank headquartered in a large country (as is the case for the six banks in case 4). For subsidiaries of foreign banks from large countries, European banking supervision might actually give a stronger voice to the concerns of Belgian bankers via their parent companies.

What is less clear at this stage is how what is described by some as the ECB's more bureaucratic and less subtle approach, compared to the pre-SSM regime and the allegedly more strategic NBB approach, translates into actual supervisory decisions. The only example so far seems to concern the 'fit and proper' requirement for new bank administrators and board members, which requires approval by the ECB for both SIs and LSIs. However the complaint here seems to be more in terms of the length of the process than its results.

Another issue, which is likely to have far more systemic

implications for the Belgian banking landscape than the replacement of supposedly ‘friendly’ NBB supervisors by ‘faceless ECB bureaucrats’, concerns so-called ‘gold-plating’ and ‘ring-fencing’ practices and their implication for subsidiaries of foreign banks operating in Belgium, in particular BNP Paribas Fortis and ING Belgium, two of the big four banks in Belgium (which also includes KBC and Belfius)⁷⁰. Gold-plating refers to national regulatory and/or supervisory requirements that go over and above EU or other international standards, whereas ring-fencing refers to actions by national authorities aimed at retaining capital or liquidity within national borders by limiting intra-group transfers. These two practices are justified by national authorities on grounds of financial stability.

Subsidiaries of foreign banks have been fighting gold-plating and ring-fencing practices in Belgium⁷¹. By shifting power from national authorities to the ECB, the creation of the SSM is bound to enhance the centralisation of capital and liquidity within cross-border groups, thereby weakening gold-plating and ring-fencing possibilities in countries like Belgium. While this development is generally regarded as both inevitable and even potentially welfare-enhancing by Belgian authorities, there are also worries that it could generate some risks for Belgium given its persistent surplus savings. The risks concern mainly national taxpayers because of the incomplete nature of the banking union, and in particular the absence of a common deposit insurance scheme.

The expectation of the relevant stakeholders (bankers and public authorities) in Belgium is that the creation of a full banking union will take time and that, during the interim period, some gold-plating and ring-fencing will continue. The question then is what will be the strategy of foreign banks that operate in Belgium via subsidiaries.

⁷⁰ Dexia is not included in this group since it has ceased operating activity. Belfius is the new name of what used to be the Belgian operations of the Dexia group, which were separated from the Dexia parent entity in 2011.

⁷¹ Of course, Belgium is far from the only euro-area country with such practices.

One option could be the transformation of (or more simply the shift of activity from) subsidiaries into (to) branches, which would also address the complaint of banks in Belgium that seem to be subject since the financial crisis to higher taxes than in other EU countries⁷². From a Belgian perspective, this option would have the advantage of reducing the risks for the national deposit insurance scheme and therefore for domestic taxpayers, but it would also have two disadvantages. First, it would reduce the amount of taxes paid by banks to the Belgian government. Second, it would risk reducing strategic activities and knowledge centres in Belgium, which are important in the case of BNP Paribas and ING.

Before the creation of the SSM, the transformation of subsidiaries into branches for one of the big four would probably have been prevented by the NBB and the national political authorities. Today, it is less clear that they could interfere. An interesting parallel is with the situation in Finland, a country where the share of foreign banks is about the same as in Belgium, but is almost entirely accounted for by subsidiaries⁷³. Nordea (headquartered in Sweden) and Danske Bank (headquartered in Denmark), the two groups whose Finnish subsidiaries are, respectively, the first and third-largest banks in the country, have long considered converting their Finnish subsidiaries into branches, raising some concern from the host-country authorities. In March 2016, Nordea's Annual General Meeting voted to convert its subsidiary banks in Denmark, Finland and Norway to branches of the Swedish parent company, subject to approval by the relevant authorities.

The situation with respect to the possible transformation of their Belgian subsidiaries into branches would be different for BNP Paribas

72 HLEG (2016) reports that, although no information is available on the corporate taxes effectively paid by banks across countries, bank charges and levies seem to be somewhat higher in Belgium than in most other EU countries.

73 According to the ECB (2015a), foreign banks accounted for 67.2 percent of banking assets in Finland in 2014, with 61.5 percent held by subsidiaries and 5.7 percent by branches.

compared to ING. The reason is that the Belgian state holds a participation of ten percent in the capital of BNP Paribas, the parent company of BNP Paribas Fortis, which it would likely try to use to discourage the transformation.

On the subject of state ownership, it should also be noted that the Belgian state fully owns Belfius, the country's third-largest bank, which emerged in 2011 from the dismantling of the Dexia group. In this case, European banking supervision has created a change in paradigm by greatly reducing the possibility for the Belgian state to intervene in the supervisory oversight.

Finally, two comments on branches. First, in case BNP Paribas and/or ING decided to transform their Belgian subsidiaries into branches, it is clear that the NBB would remain involved in their JSTs since the new cross-border branches would be significant. Second, in most current cases, cross-border branches operating in Belgium are not significant, and therefore the NBB is not directly involved in their supervision, despite the creation of the SSM. This does not mean, however, that the SSM has not changed anything in this respect. The NBB, like its counterparts in other SSM countries, can now take to the ECB any problem it might have with the behaviour of a bank operating as a branch within Belgium's borders or offering cross-border services there, even if that bank is classified as less significant and therefore not directly supervised by the ECB. For instance, there are rumours that, in 2015, the NBB raised with the ECB the issue of Nemea, a Maltese online bank that was offering unusually high interest on bank deposits and advertised in Belgium⁷⁴. According to the Belgian press, where the issue was much discussed in 2015, Nemea is jointly owned by two Finnish bankers who were involved in Kaupthing, an Icelandic bank that went bankrupt in 2008. It is unclear, however, whether the alleged intervention by the NBB was successful in changing the behaviour of

74 Being a purely online bank, Nemea does not have a physical presence in Belgium and does not therefore operate in the country via what would be considered *stricto sensu* as a branch.

Nemea, which still offered in April 2016 interest of 3.5 percent on five-year deposit accounts, by far the highest rate advertised in Belgium at that point.

Conclusion

The first year of operation of the SSM has been rather uneventful as far as the Belgian banking sector is concerned. However the sector has two features that will probably raise interesting issues for European banking supervision in the future. One is the high share of foreign banks operating in Belgium through subsidiaries and branches. The other is the full or partial ownership by the Belgian state of two of the big four banks.

Table 7: Top 20 Belgium-based banking groups (latest date available)

Rank	Company name	Total assets (€bn)	End period for balance sheet data	Group's home country	SI or LSI (SSM home country)	Belgian state share (percent)
1	BNP Paribas Fortis	275.2	30/06/2015	FR	SI (FR)	10.00*
2	KBC Group	252.4	31/12/2015	BE	SI (BE)	0.00
3	Dexia	230.3	31/12/2015	BE	SI (BE)	50.02
4	Belfius	179.6	30/06/2015	BE	SI (BE)	100.00
5	ING Belgium	151.8	31/12/2014	NL	SI (NL)	0.00
6	AXA Bank Europe	42.6	31/12/2014	FR	SI (BE)	0.00
7	Argenta	37.7	31/12/2014	BE	SI (BE)	0.00
8	Bank of New York Mellon	34.8	31/12/2014	US	SI (BE)	0.00
9	Euroclear	25.9	31/12/2014	UK	LSI (BE)	0.00
10	Crelan	23.3	31/12/2014	BE	LSI (BE)	0.00
11	bpost	9.5	31/12/2014	FR	SI (FR)	10.00*
12	BHF Kleinwort Benson	9.4	30/09/2015	BE	-	0.00
13	Santander Benelux	8.6	31/12/2014	ES	SI (ES)	0.00
14	Nagelmackers	6.9	31/12/2014	China	LSI (BE)	0.00
15	Degroef Petercam	5.6	30/09/2014	BE	SI (BE)	0.00
16	Finaxis	5.0	31/12/2014	BE	LSI (BE)	0.00
17	BKCP	3.9	31/12/2014	FR	SI (FR)	0.00
18	VDK	3.4	31/12/2014	BE	LSI (BE)	0.00
19	Beobank	2.6	31/12/2014	FR	SI (FR)	0.00
20	CPH	2.3	31/12/2014	BE	LSI (BE)	0.00

Source: columns 2-4: SNL database.

Note: *Belgian state ownership of the parent group, BNP Paribas.

5 France

Philippe Tibi

The French banking landscape

For historical reasons (Jacobinism, nationalisation waves in 1946 and 1981), the French banking system is highly concentrated. Seven parent banks own the near-totality of retail banking networks: Banque Postale (state-owned), BNP Paribas, BPCE (formed in 2009 through the merger of the Banques Populaires and Caisses d'Épargne cooperative groups), Crédit Agricole, Crédit Mutuel, HSBC France, and Société Générale. Apart from Banque Postale, which specialises in retail services, they are all universal banks with significant operations in retail, commercial and investment banking, and life insurance and asset management⁷⁵.

HSBC is the only foreign bank in this group, following its 1999 take-over of Crédit Commercial de France. The presence of other foreign banks is almost negligible. The largest of them, the French branch of Barclays, has less than €50 billion in assets according to the ECB's list of supervised institutions, in the context of €8.5 trillion, or about four times French GDP, for all French banks⁷⁶.

BNP Paribas and Société Générale developed an acquisitive strategy outside France, with the ambition to build leadership positions in selected countries, primarily but not only within the euro area. The

75 Caisse des Dépôts et Consignations, a large state-controlled financial institution, is not a bank.

76 https://acpr.banque-france.fr/fileadmin/user_upload/acp/publications/rapports-annuels/20151007_Rapport_chiffre_2014_Banque.pdf.

same is true to a lesser extent of *Crédit Agricole* and *Crédit Mutuel*.

France is the home country of half of the top ten significant institutions (SIs) in the euro area. Among the six euro-area banking groups with assets in excess of €1 trillion, four are French (the others being *Deutsche Bank* and *Santander*). A related feature is that LSIs collectively make up a smaller share of the French banking system than in other large euro-area countries, especially Germany and Italy. In another contrast to other large countries, all French SIs are headquartered in a single metropolitan area, namely Paris.

The French national supervisory authority is the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR), a semi-autonomous institution within the central bank (*Banque de France*). ACPR results from the 2010 assumption by the banking supervisor (formerly known as *Commission Bancaire*) of further prudential authority over insurers, nonbank credit institutions and investment firms, to which resolution authority was added in 2013.

Overall assessment

The implementation of the SSM has been positive for the French banking system. It has clarified its relationship with its various regulators and opened a welcome path towards a single European banking market and cross-border consolidation. It has also brought a more international perspective to supervision, and has been instrumental in recent governance transformations of France's mutual banks.

Looking back at the rationale for European supervision, however, it is very problematic that the SSM so far has not changed the market assessment and rating of the European (including French) banks, as measured for example by price-to-book-value ratio. The sector remains fragile, almost ten years after the beginning of the subprime crisis. Reasons for this may include stringent capital rules inconsistent with banks earning their cost of capital; unpredictable rules, or rules in the making, which justify a very large risk premium; a lack of credibility of stress tests and/or of the quality of banks' balance sheets; banks

paying only lip service to the new regulatory requirements; anaemic growth in the euro area; and the risk of another situation like Greece, including in a larger country. All of these factors, with the exception of economic growth, are at least partly within the remit of European banking supervision. More work has to be done to persuade market participants and the public about the quality of the reforms and the endgame of banking union, both in terms of market outcomes and of the architecture of the various agencies.

Furthermore, it is vital to demonstrate that European banking supervision will not be unduly influenced by political factors. But it is also increasingly difficult to understand the ECB's dual strategy: encourage banks to take risks in order to finance the economy, while simultaneously adding new layers of capital to mitigate risks. It is very difficult for the ECB to please three constituencies at the same time: the economy, public opinion and the shareholders and bondholders who finance banks. European banking supervision's future success will partly depend on its ability to steer the right macro-prudential policy course, a concept that has very limited substance and effectiveness at the moment.

Another trade-off must be managed. The post-crisis European paradigm is that markets should increase their share of the financing of the economy, at the expense of more constrained banks (capital markets union). This can only be true if markets are liquid. The under-recognised reality is however that bond markets are very illiquid at the moment, even for government bonds, because banks have massively reduced the capital they allocate to market-making activities (AMAFI, 2015) in order to improve their CET1 ratios. Banking regulations also affect market structures.

Many French stakeholders are concerned that the SSM and ECB may be losing sight of their fundamental mission: ensuring a productive financing set-up in the euro area, with the most efficient and secure supervisory arrangements. This is seen in France as entailing quality of judgement and strategic handling of trade-offs, and also

having a clear view of the endgame, formulated and managed by a strong leadership. French institutions worry that existing trends might not play in this direction. In addition, they worry that the original *quid pro quo* – loss of sovereignty against a level playing field – might be lost on the way.

France and the SSM concept

Banking union is the child of the euro-area sovereign debt crisis and the idea that more federalism was necessary to restore the healthy functioning of the European financing system, beyond the objective of breaking the bank-sovereign vicious circle. The concept has been strongly supported in France, for three main reasons:

- First, it required strong political traction, which only Germany and France were able to exert. Banking union was seen as an opportunity to leverage French ideas at the European level.
- Second, French banks are among the largest and the most internationalised in Europe. As a consequence, they supported plans to level the playing field and establish a unified banking system in Europe. They would be significant beneficiaries of a radical simplification of the competitive and regulatory landscapes.
- Third, European banks were penalised by low valuations, as illustrated by price-to-book ratios. Proper supervision was seen as an efficient tool to reduce uncertainty and risk premiums, and to enhance balance sheet credibility, in particular in a market environment influenced by scepticism on the part of American investors.

European banking supervision is the first pillar of the banking union, complemented by the more recent SRM and the still-to-come European deposit insurance scheme (EDIS). It has a clear mission to ensure the safety and soundness of banks, and to contribute to the

financial integration of the euro area. As such, it is unanimously welcome by those in the French financial community, be they regulators or banks.

It is agreed in France that these objectives make sharing a significant amount of financial sovereignty worthwhile. This 'sacrifice' is viewed as material. Unlike several other euro-area countries, almost all French banks are SIs and thus directly supervised by the ECB. Unlike in some other countries, the transfer of sovereignty is not seen as justified by past supervisory failures: French banks fared comparatively well during the crisis, and the reputation of French banking supervision emerged almost unscathed from this sequence. (In France, the case of Dexia is not generally seen as a failure of French supervision).

In short, the French financial elites are now pro-Europe and pro-European supervision.

The positives of European banking supervision

The dominant view in France is that the recapitalisation of Greek banks by private investors in late 2015 was successful, and was an important test for the credibility of European banking supervision. Tougher capital and liquidity requirements are also seen as a positive in principle, because they help to restore trust in the sector. This statement however has to be nuanced in practice, given French banks' frequent criticism of overshooting in the form of excessive capital thresholds.

French bankers are generally positive on the quality and effectiveness of Joint Supervisory Teams (JSTs), which are seen as displaying the right blend of regulatory, consulting and banking backgrounds and skills. They are appreciative of the fact that teams have been hired, trained and assembled within a very short timeframe. Day-to-day contacts are easy even though communication with the ECB is much more formal than it used to be with APQR, and is more systematically based on templates. Banks generally understand that JSTs methodically request additional data, in comparison to the national framework in which regulators had more *ex-ante* knowledge of their processes

and people. Coordination with supervisors outside of the euro area is perceived as continuing along the same path as before the SSM, in both situations: supervision of the non-euro area operations of French banking groups, and of the French operations of non-euro area banks. The expectation is that the creation of the SSM as a strong pan-European institution will enhance Europe's global influence, in particular within the Basel Committee, which is seen as having been greatly influenced by American arguments in recent times.

The new European supervision is also reckoned to be an agent of positive transformation within the French banking sector. It has brought a fresh and international view on controls and governance. The granularity of banks' in-house information has been improved. Information systems have been upgraded. Governance has been enhanced in order to:

- Clarify structures: major changes have taken place in mutual banks;
- Train and empower directors in subsidiaries and branches, and ensure the effectiveness of board committees;
- Qualify and quantify risk in a more systematic way, with a focus on business models, guarantees and collateral, and comparisons with peer banking groups.

The SSM's thematic programmes are viewed as useful in terms of generating new ideas and in order to anticipate forthcoming inspections.

All the aforementioned issues are not common to all banks and certainly not applicable at every level of each bank, but they provide some idea of the positive influence of European banking supervision, as seen by the top level of French banks.

French banks' specific interests

All national financial systems have local idiosyncrasies, reflected in the 167 'options and national discretions' (ONDs) identified by the

SSM. France is no exception. The financial framework historically was designed to optimise the use of scarce capital. In particular:

- French banks are very large, with a significant international footprint. The sector is very concentrated, with limited foreign presence;
- Banks are truly universal, with investment banking arms very relevant at European or global levels in certain lines of business;
- Bancassurance is a strong component of the product mix, in a country in which life insurance represents a massive 75 percent of GDP;
- Specific rate-regulated (and tax-favoured) savings products (*'épargne réglementée'*) represent a total around €840 billion⁷⁷;
- Mutual banks have structures that are more centralised than in other countries, and the French believe that this feature should be properly taken into account in supervisory risk assessment.

The SSM's willingness to eradicate all ONDs has been a cause for concern, even though worries are less acute now than at the outset of the process. The 2012 'Danish compromise' for the EU implementation of Basel III, which acknowledged the inclusion of insurance subsidiaries' capital into the consolidated group capital ratio and thus supports the bancassurance model, has not been reversed by the SSM so far. French banks adamantly defend their view that intra-group exposures (at national level for mutual banks or at the international level) should

⁷⁷ *'Épargne réglementée'* savings products are collected by banks, but their yield is decided by the government. Within this category, Livret A, LDD and LEP (€410 billion in total) have a special status: about three-fifths of the inventory is 'centralised' (ie in mandated custody) at Caisse des Dépôts et Consignations. The calculation of CET1 ratios takes all of these savings into account, although only part of them is effectively managed and put at risk by the banks. The impact is particularly strong for mutual banks, because they used to have a monopoly on the distribution of Livret A and still play a major role in this segment. See <http://www.fbf.fr/fr/files/9NJCEC/Rapport-observatoire-epargne-reglementee-2014-BDF.pdf>.

not be limited. The unique features of épargne réglementée are seen as legitimate and in need of being defended, even though bankers also acknowledge that they are difficult to explain in an international context.

Shortcomings

Of course, it is not all rosy. Several aspects of European banking supervision have been identified by the French financial community as needing improvement.

First there is the risk of bureaucratic drift. Bank workloads to comply with SSM requests are extremely heavy, and continue to increase. Very detailed demands may arrive at short notice. Duplication and contradictions (between the ECB's DGMS I and DGMS IV, and between the ECB and other agencies) are unwelcome in this context, all the more because few executives have a full grasp of top-level issues, information systems and details.

The review of models is a much-debated question in terms of timing, because it takes place at the same time as the Basel Committee's Fundamental Review of the Trading Book, and because it creates uncertainties inside banks and slows the development of new businesses.

Bankers recognise that much centralisation of decision-making in Frankfurt is unavoidable, but they feel that some of the rules should be changed. Delegation should be made possible for lower-level decisions, such as the vetting of new directors, and changes at small subsidiaries. More generally, the view prevails that the principle of proportionality should be better applied by European banking supervision. Small subsidiaries are currently subject to the same supervisory controls as group-level entities.

Delays in ECB decision-making (eg more than six months to produce a follow-up letter) are perceived as undermining the effectiveness of supervision. By contrast, SSM-imposed deadlines for remediation plans are very short. More fundamentally, bankers expect that

substantive feedback should be provided by European banking supervision in exchange for the very detailed information they provide. They understand that the SSM is young and that its doctrine is still in the making, so that its staff might not wish to publicise views that they might subsequently have to amend. Even so, the current situation is not considered satisfactory.

Another cause for concern is that all SSM initiatives in the first year have been seen as opportunities to add new layers of capital in a systematic way, with little consideration of previous efforts. This perception, however, might be alleviated by Danièle Nouy's recent declarations that capital requirements will not increase beyond their current level.

At a more fundamental level, French stakeholders worry about an overly prescriptive European supervisory approach to banking business models. They generally welcome harmonisation as a way to create a level playing field, as noted before. But they are wary that the ECB might promote a normalised banking model, on the basis that it would be easier to monitor and control. The argument is that several banking models should coexist. For example, European banking supervision has to adapt to different ways of considering housing risk (which is very much shaped by national legal systems), or the way mutual banks manage their base of shareholders.

A specific episode has been the SSM's wobbly stance on Pillar-2 capital requirements and maximum distributable amounts (MDA), which is seen by several French stakeholders as having partially contributed to the surge of volatility in bank share prices in early 2016.

Although this bout of volatility was triggered by questions about Deutsche Bank's ability to pay down dividends on its additional Tier 1 debt (AT1, including contingent convertible instruments known as CoCos), an issue linked to the application of country-specific German law, investors started to look at the European regulatory framework relevant to the situation. They found that the MDA definition was not entirely clear, nor the stacking order of various instruments.

Scandinavian, UK and euro-area banks seemed to operate under different regimes in terms of Pillar-2 constraints and disclosure obligations. In particular, the SSM had asked banks not to publish MDA information, in order to enhance the quality of its dialogue with banks. This situation was perceived as having been particularly detrimental to French banks, which manage their MDA buffer tightly.

A common view in France is that a distinction should be made between what is required (and published) by the supervisor, and what is part of the private dialogue between it and the supervised bank. This position seems to have been eventually endorsed by the European Commission and the ECB. The SSM's communication, however, was less than clear. In its SREP methodology booklet (published on 19 February 2016), the ECB stated that AT1 instruments were not taken into account in SREP 2015 decisions; but the following week, it added that AT1 may be taken into account in SREP 2016. The ECB's clarifications were interpreted by market participants as implying some future relaxation of automatic AT1 coupon cancellations and a move towards the UK approach to Pillar-2 requirements, currently the most advanced and transparent within the EU. This approach entails Pillar-2 specifications across all capital tiers, and a split of Pillar-2 into a 'hard' component, before all buffers, and a 'soft' component, on top of the buffers for, for example, adverse stress test scenarios and initially not binding for MDA restrictions⁷⁸. In the same vein, later in March, the Commission asked regulators to differentiate between capital 'guidance' they give to individual banks, and enforceable capital requirements⁷⁹. In the light of this episode, it is plain that European banking supervision should intensify its dialogue with market participants in order to prevent unnecessary differences in perception.

78 BIHC, 'Commission review raises hopes after EBA bombshell', March 2016, <http://bihcapital.com/2016/03/commission-review-raises-hopes-after-eba-bombshell/>.

79 <http://washpost.bloomberg.com/Story?docId=1376-03TZG16TTDSH01-4EM7T-KL4BD0ENAC4BGPU64T4CL>.

Last but not least, European banking supervision is blamed for having failed so far to deliver a genuine single euro-area banking market. As previously emphasised, French stakeholders understand the promise of banking union to be a loss of sovereignty in exchange for a level playing field in Europe, including further expansion of acquisitive French banks. They also feel uncomfortable with the fact that the SSM's governance model gives significant influence to countries where the approach to banking and financial security tends to be more parochial and more supportive of geographical ring-fencing for domestic political reasons. They believe that European institutions should oppose countries reincorporating harmful ONDs, idiosyncratic treatment of deferred tax assets or obstacles to cross-border liquidity into national legislation.

Another strong belief in France is that supervision by the SSM should not be restricted to the current 129 SIs, and should be extended to all LSIs as soon as possible for at least three reasons:

- Smaller banks can be systemically dangerous, as recently demonstrated by the 2008-11 crises, recent bankruptcies and the non-performing loan situation in Italy;
- National supervision of LSIs creates barriers to cross-border M&A;
- Unresolved issues at smaller banks create can damage the reputation of the whole euro area, in particular in the minds of investors in the US and Asia. It should be noted in this respect that all banks that failed since the inception of European banking supervision (BANIF in Portugal, the four Italian banks resolved in late 2015) were LSIs.

The dominant view in France is that the same rules should apply to all banks irrespective of size, even if reporting formats may be adjusted. Large banks are frustrated with the idea that their competitive positions are more constrained by regulation than those of others. This may lead to adverse consequences for the financing of European corporates (Goodhart and Schoenmaker, 2016).

Prospective issues

Looking ahead, one significant challenge is the multiplicity of partly overlapping regulators after the wide-ranging European reforms of the past few years. Banks face six different regulators which pursue at least partly self-defined objectives: the SSM, SRB, Basel Committee, EBA, the European Commission and their local supervisor (ACPR in France). Compliance with the prescriptions of these regulators requires resources and the parallel management of complex projects critically based on IT resources (the upgrade of legacy IT systems being a persistent challenge in many banks) and concentrated expertise.

In this respect, bankers are concerned that well-staffed agencies might want to start unnecessary projects. They understand that the ECB and SRB are independent from each other, but are concerned that the SRB develops its own methodology on risks, creating an unwelcome discontinuity between supervision and resolution. If a resolution case fails for whatever reason, fingers will point at the supervisor, and the ECB position could be weakened as a consequence. Another concern is that confusion about minimum requirements for eligible liabilities (MREL) under the EU Bank Recovery and Resolution Directive (BRRD) might replicate the difficulties encountered by European banking supervision with the definition and publication of Pillar-2 and MDA, for similar reasons. Hence a stronger dialogue with market participants is necessary, on this as on other issues.

Of course, French bankers and officials also express worries about the perceived trade-off between efficient financing of the economy and secure risk management. This issue predates European banking supervision. Basel III requirements have incentivised banks to reduce their market-making activities, and bankers argue that this has increased market volatility, which is ironic given that EU policymakers simultaneously pledge to promote a more disintermediated financial system (capital markets union).

Regulators and European banking supervisors would ignore this worry at their peril. They must understand markets. A widespread concern in French banking circles is that the ECB and other European-level authorities have not developed a broad enough network of contacts in order to grasp the reality of markets, despite ongoing efforts such as road-show-type meetings with (mostly European) investors.

The SSM could magnify the issue, with its insistence on capital, and given the inherent difficulty for investors to understand newly created institutions, especially when in a different time zone. The problem with markets is that they tend to materialise self-fulfilling prophecies once a trigger point has been reached. Orderly resolution might be difficult to execute past this point.

The recent market turbulence highlights the fact that regulators cannot act in a political vacuum. In the US, federal regulators have become extremely powerful but also answer to a healthy dose of scrutiny from Congress. Efforts should be made in Europe to fill this vacuum (see also Villeroy de Galhau and Weidmann, 2016).

The above-mentioned failure of the SSM to trigger a decisive improvement in banks' average valuation (in price-to-book terms) should act as a wake-up call, and serve as a reminder to the financial policy community that banking union has not yet fulfilled its initial promise.

6 Germany

Sascha Steffen

The German banking landscape

Germany hosts the largest number of significant institutions (SI) among banking union countries (even though the French SIs are larger in aggregate when measured by assets). Germany also has almost half of the euro area's less significant institutions (LSI). The 22 German SIs include the euro area's third-largest banking group, Deutsche Bank. The LSIs finance about 70 percent of the country's small and medium enterprises (SMEs) (Lautenschläger, 2016). Cooperative and savings banks are usually bound to a specific region and cannot engage in business activities anywhere else in Germany, under what is referred to in German banking circles as the 'regional principle' (Regionalprinzip). The regional principle is a rule within the savings bank sector and ensures that savings banks do not compete with each other. While these banks develop ties to the companies and households in their regions, they also face concentrated risks with regard to specific local industries, which might make them vulnerable.

Germany has two large institutional protection schemes (IPS), covering 80 percent of the banks and representing about 40 percent of total assets of the German banking sector (Lautenschläger, 2016): the savings banks sector (Sparkassen), and the cooperative sector (Verbundstrukturen, including Volksbanken and Raiffeisenbanken). The regional public banks (Landesbanken), most of which are SIs, and regional 'building savings banks' (Landesbausparkassen), all of which

are LSIs, also belong to the public-sector IPS, together with the savings banks. The central bodies of the cooperative banking sector (DZ Bank and WGZ Bank, which are in the process of merging) are members of the cooperatives' IPS. These protection schemes raise potential issues from a financial stability perspective, as detailed later in this chapter.

It is common in Germany to describe the system as based on three pillars: (1) the public banks, including all Sparkassen and Landesbanken; (2) the cooperative banks; and (3) the commercial banks. While the latter do not have a formal IPS, they also rely on contingent risk-sharing mechanisms such as the German Banking Association's Deposit Insurance Fund, which can be used to guarantee not only deposits but also bank bonds.

The German bank supervisory authority is BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht). BaFin also regulates Germany's insurers and securities markets, and conducts banking supervision in cooperation with the national central bank (Deutsche Bundesbank), which also has certain supervisory tasks as explained below. Germany's representatives on the ECB's Supervisory Board are from both BaFin and the Bundesbank, whereas only BaFin has voting rights.

Some of the German SIs (eg Hamburger Sparkasse, also known as HASPA) have no cross-border business at all, and are SIs only on the basis of their balance sheet size. One criticism made by some German stakeholders is that size alone should not trigger SI status, and that a bank's business model should also be taken into account so that banks like HASPA should be directly supervised by BaFin in cooperation with the Deutsche Bundesbank.

The initial impact of European banking supervision

Banking supervision in Germany has changed under the SSM, for both SI and LSI banks. Before the late-2014 transition, banking supervision was institution-specific, a tailor-made approach for each bank or group of banks. This approach was based on the structure of the German banking system, with hundreds of small banks with a

region-specific focus. BaFin and the Bundesbank as supervisors have accumulated substantial knowledge about the banks and the institutional environment, and used this information in a highly individualised and qualitative approach to the supervision of German banks.

This relationship has changed – partly because the people who are responsible for supervision have changed. ECB supervisory staff typically lack the institution- and region-specific knowledge, and might also have a different approach to banking supervision. This obviously affects the SIs, eg through the Joint Supervisory Teams (JSTs), but also the LSIs which experience direct requests (eg for data) from the ECB via BaFin.

Banking supervision under the SSM has become more template-driven. Reporting requirements have expanded and supervision has therefore become more quantitative in nature. An advantage of this approach is comparability of institutions and the possibility to benchmark them in order to identify their main strengths and weaknesses and to assess their interconnectedness. However, supervision that is purely based on numbers can also be problematic. First, numbers only make sense if they are put into context, and it will take some time for ECB banking supervision to understand the context. Second, an institution-specific view is necessary to spot risks that cannot be identified based on numbers only. A recent example is Maple Bank, which was closed by BaFin in February 2016. This Frankfurt-based bank had to set up provisions for tax payments because of illegal share purchases around dividend payment dates, which rendered the bank insolvent. These types of risks cannot be identified based on quantitative data alone.

Banking supervision has also become more complex. The number of supervisors, particularly for SIs, has increased and has become more international. The JST for Deutsche Bank, for example, comprises almost 70 individuals of at least 12 nationalities. Almost 40 of the JST members are German and work for BaFin and the Bundesbank; the rest are from countries in which Deutsche Bank has significant

branches or are ECB employees. Whereas the number of staff from the different national supervisory authorities in this team is by and large the same as before the start of European supervision, the ECB staff members have been added on top. The team is headed at the ECB by a French national. BaFin and Deutsche Bundesbank each have appointed a sub-coordinator of the JST.

Banking supervision used to be less formal and more direct, with sustained conversations between the banks and their German supervisors. Under the SSM the relationship between bank and supervisor has become both more formal and less direct.

Many decisions, such as introducing a new board or supervisory board member, which used to be made by BaFin, must now be prepared by the ECB Supervisory Board and adopted by the Governing Council. More than 4,000 of these decisions had to be made in 2015 alone (Europe-wide), and the Governing Council cannot fully delegate these decisions on the basis of current law. So far, the possibility of delegation has not been used. This, of course, is leading to substantial delays in taking some decisions and is also associated with more work for the national supervisor, such as filling out templates for the ECB. In some cases, the delays amount to several months or even a full year. These delays have the potential to cripple the implementation of bank's management decisions (eg the installation of a new board member, the transfer of assets from one of the banking group's legal entities to another, or strategic decisions on business projects). That said, in most cases the decisions are taken in a timely manner by the ECB.

Another important aspect of complexity is the increasing number of relevant capital ratios. There are too many different capital ratios and regulatory metrics that investors have to look at. As a result, some banks now increasingly focus on regulatory capital instead of economic capital, because regulatory capital and ratios are the only ratios of interest for investors. The use of regulatory capital ratios might be problematic given the inclusion of risk-weighted assets as part of the ratio. Risk weights that are out of sync with the actual risk of these

assets might create incentives for banks to arbitrage these risk weights, leaving them severely undercapitalised (Acharya and Steffen, 2014a and 2014b; Korte and Steffen, 2016).

Regulation overall has become more complex. One important issue is the interdependence of different regulatory requirements coming from different agencies. Currently, different regulators have only partial overviews of the applicable regulations, and work largely in isolation from each other. An example is the definition of the maximum distributable amount (MDA)⁸⁰ by regulators, which involves the European Banking Authority (EBA), the European Commission and ECB banking supervision. The automatism of restrictions on distribution policies, envisaged by Article 141 of CRD IV, is intended to be a minimum common measure applicable to all banks authorised in any EU member state. But the implementation of the concrete calculation of the MDA differs between the euro area and other EU jurisdictions (eg Denmark and the United Kingdom). As a consequence, there is not always a level playing field in the European Union, or between the EU and the US, with negative consequences in particular for large banking groups with global competitors. Moreover, we know relatively little about how the regulatory requirements set by microprudential (eg Pillar-2 capital requirements) and macroprudential authorities (eg systemic risk buffers) work in combination, and whether and how they balance the policy objectives of financial stability and economic growth.

BaFin vs Bundesbank

BaFin was created in 2002 through the merger of separate supervisory authorities for banks, insurers and securities firms. The Bundesbank

80 Pursuant to Article 141 of the CRD IV, on breaching the combined buffer requirement (defined by Article 128(6) of CRD IV), banks face distribution restrictions. The restrictions have the objective of capital restoration when capital buffers are breached, in contrast to the minimum requirements under Pillar-1 and Pillar-2 capital, which are to be met at all times. The MDA is the payout amount that must not to be exceeded in order to restore capital buffers.

and BaFin share tasks related to banking supervision. While BaFin is primarily responsible for issuing administrative acts such as licenses, authorisations and fines, the Bundesbank does most of the ongoing supervision of institutions. With the start of European banking supervision, the separation of tasks between BaFin und Bundesbank remains unchanged, including in relation to their cooperation with the ECB's direct supervision of SIs⁸¹.

All 1,600-odd German LSIs are still directly supervised by BaFin and the Bundesbank, with the same division of labour as pre-SSM.

Supervision of SIs

German SIs report delays in approvals of, for example, changes to their internal models. They complain that supervisors responded much more quickly pre-SSM. The consequence is that banks have to operate under greater uncertainty.

More broadly, market participants (including investors and banks) complain about the lack of transparency of European banking supervision. Investors feel they do not have the information they need to value bank equity or bank debt. Despite an enormous amount of data collection by the ECB, the information that is released to investors is very limited. For example, information remains scarce at best on how much bail-inable debt is available within each large institution. Genuine market discipline is not possible if the market cannot assess the risks of (and price) banks' liabilities and equity.

Among banks, a widespread complaint is that the supervisory review and evaluation process (SREP) is not transparent at all. Banks complain of not receiving information about interim SREP scores or about what factors contributed to their eventual scores. Also, the ECB has some discretion to adjust scores at each step of the SREP process. Banks receive a final score between one and four, and a regulatory

81 German regulation specifies this in Section 7, 1a of the Banking Act (KWG, Kreditwesengesetz).

capital ratio that they have to meet. Naturally, banks want to know how the scores have been calculated and make some effort to reverse engineer the individual SREP scores. While reverse engineering might lead to perverse incentives for regulatory arbitrage, more SREP transparency could help banks mitigate identified weaknesses.

Some banks are concerned that the ECB uses the lack of transparency of the SREP process and exerts some discretion over how target bank capital ratios are set. For example, the ECB might already incorporate buffers that are supposed to come into effect only in 2018-19, making it more difficult for banks to meet their capital requirements.

The ECB is also competent to decide on the application of the capital and the liquidity waiver for significant institutions. One aim of the ECB's project on options and national discretions was to ensure a level playing field across the euro area that would allow the granting of these waivers to the greatest extent possible. The ECB might also raise the large exposure limit for cross-border intra-group transactions, in line with the German Large Exposure Regulation. In a crisis situation and as a residual power, however, the decision to limit the flow of capital and liquidity within a banking group across borders remains with the BaFin.

Differences in accounting standards are another important topic for the German SIs. Of the 22 SIs in Germany, seven prepare their financial statements using German national accounting standards (known as HGB for *Handelsgesetzbuch*, or German commercial law) and not IFRS. These institutions are: Deutsche Apotheker-und Ärztebank, Erwerbsgesellschaft der S-Finanzgruppe (Landesbank Berlin), Hamburger Sparkasse, L-Bank, Münchener Hypothekenbank, State Street Europe Holdings and NRW.Bank. Given the amount of data that SIs must deliver to the ECB, some of these banks might consider switching to IFRS. But German bankers are concerned that the ECB wants all SIs to eventually switch to IFRS; they view this as outside the scope of the mandate of European banking supervision.

Bankers are also concerned that they do not have enough time to implement the new rules and regulations and to raise capital. This

process requires a substantial amount of new resources, in particular specialists (IT, lawyers, consultants) who need to be hired. If all banks start this process at the same time, there might be a shortage of skilled experts in the market.

Raising capital is particularly challenging in a low (or negative) interest rate environment. German banks have long suffered from low profitability, but low interest rates and resulting declines in net interest margins aggravate this problem. SIs worry that they cannot attract sufficient interest from investors who require a high return on equity.

Supervision of LSIs

The ECB plans SREP guidance for LSIs as of 2018, but BaFin decided to take the first SREP capital decision in 2016, in line with the EBA SREP Guidelines. Capital add-ons will be common practice in the future because of the requirements set out in the EBA Guidelines, which define a 'Pillar-1-plus' approach for the quantification of Pillar-2 risks.

Beyond the SREP minutiae, the major challenge facing the SSM is to balance the objective of a single rulebook for the euro area with the principle of proportionality. LSIs in Germany are concerned that the ECB eventually wants to apply the same rules for SIs and LSIs, which might threaten their business models.

As mentioned, most German LSIs are part of one of the two German institutional protection schemes. The CRR provides significant advantages to banks that are in such schemes with respect to liquidity requirements, capital requirements and concentration limits.

It should be noted, however, that all German banks have to meet the liquidity coverage ratio requirement at the individual bank level. While Article 7 of CRR provides for a possible waiver, this is associated with strict requirements that are not met by the two German IPSs. Importantly, neither the savings nor the cooperative banks are part of a holding company that owns a majority of the voting shares and is able to actively intervene in the individual savings or cooperative banks.

Banks that are part of an IPS have advantages in terms of capital

requirements and limits on their exposures to banks that are part of the same IPS (CRR Art. 113, 6 & 7). They do not have to hold capital against these exposures (zero risk-weights), and there are no large exposure limits (as opposed to, for example, corporate exposures which are limited to 25 percent of Tier 1 capital). Advantages in terms of zero risk-weights and concentration limits apply to exposures to banks within Germany. Exposures to subsidiaries outside of Germany are not affected.

IPSs, however, can also carry risks. Savings banks were particularly affected because of their investments in Landesbanken during the 2007-09 financial crisis. These Landesbanken (WestLB, Sachsen LB and Bayern LB in particular) took large risks in the US subprime mortgage market that eventually spilled over to the savings banks⁸².

HSH Nordbank is another example, and as a Landesbank, is also part of the IPS of the savings banks. It is publicly owned, 95 percent jointly by the states of Hamburg and Schleswig-Holstein and 5 percent by the Sparkassen- und Giroverband Schleswig-Holstein. HSH Nordbank had to be bailed out by the federal government during the global financial crisis of 2008-09. In 2008, it reported a group net loss of €2.70 billion, along with dramatically higher loan loss provisions. Poor asset quality has continued to be an issue – its nonperforming loan ratio was 23 percent at the end of September 2015, based on data from its annual and quarterly reports. In March 2016, the German government and the European Commission came to an agreement on how the problem loans should be dealt with. This agreement also stipulates that HSH Nordbank has to be privatised by 2018 or to be wound down. Because it might prove difficult to find a buyer, the latter is not an unlikely scenario, and it is unclear how losses might then be shared. It might be that the IPS will have to bear considerable losses in order to

82 Puri, Rocholl and Steffen (2011) show that affected savings banks reduced consumer lending substantially after the Landesbanken incurred these losses. Fischer *et al* (2016) link those losses to the elevated risk taking behaviour of Landesbanken associated with the loss of their government guarantee in 2005.

avoid the imposition of losses on bondholders.

It is thus critical that IPSs are supervised not only at the individual bank level, but also at the combined IPS level, and that the interconnectedness of these banks is taken into account. SIs and LSIs that are in the same IPS require additional coordination from all relevant supervisors. In early 2016, the ECB conducted a consultation on IPSs (ECB, 2016d). The ECB's consultation document *“sets out the ECB's approach concerning the assessment of the eligibility of IPSs for prudential supervisory purposes. It aims to ensure coherence, effectiveness and transparency regarding the policy that will be applied when assessing IPSs [...]”*. In this approach, the ECB is not questioning the advantages in the CRR associated with IPSs, but rather investigates how effectively to supervise IPSs.

LSIs are also confronted with an increasing number of data requests, though to a lesser extent than the SIs. Cooperative banks and savings banks have centralised their IT systems, and created IT centres throughout Germany to manage data and processes such as the calibration of internal ratings models. The data requests from the ECB usually contain new information and are ad hoc and have to be met within a short period of time, sometimes within days. LSIs have to react to these requests at individual bank level, which increases administrative and IT costs for individual LSIs. If data requests were standardised, the IT centres could better implement these requests and centrally collect the data from the individual institutions. LSIs are concerned that standardised data requests (including for Financial Reporting (FINREP) and AnaCredit) will not replace the ECB's ad-hoc requests.

LSIs complain about a lack of transparency in this process. They do not receive feedback on how the ECB uses the data. The LSIs are worried that the data is not only used in the supervisory process, but that the standardised data requests (FINREP and AnaCredit) will be used by the ECB to unduly modify and fine-tune their business models.

As with SIs, the data requests raise issues of accounting regimes. Germany, like several other European countries, requires banks to

use national accounting standards, not IFRS, for entity-level financial statements, and also allows national accounting standards for the consolidated financial statements of banking groups that are not publicly listed. Because of potential problems in translating financial statements drawn up according to national (ie German) accounting standards so that they meet the IFRS requirements, data quality and the extent to which the data can be used in the supervisory process might be concerns.

There is increasing consolidation among smaller institutions in Germany. In 2014 (the last official statistic available from the Bundesbank before the start of the SSM), the number of banks was 1.9 percent less than in 2013. Since 1990, the number of banks in Germany has decreased from more than 4,500 to 1,990 in 2014 (Bundesbank, 2014). But this is unrelated to European banking supervision or the costs associated with new regulations. This trend started before the start of the banking union, and reflects, amongst other things, that some savings banks or cooperative banks do not have a viable business model and thus merge with other banks, usually in the same region.

How much progress has European banking supervision brought?

The SSM is the first pillar of the banking union, and its completion is of great importance for further integration in the euro area. Some of the problems and concerns highlighted in this chapter (such as those related to supervisory complexity and accounting issues) are predictable frictions at the beginning of European banking supervision. While it will be a huge task to implement a single supervisor for a diverse set of countries, there is an expectation that many issues will be solved as time passes and supervisory processes improve⁸³. Such issues are not critical for the success of European banking supervision.

83 Saunders (2014) argues that even though the US implemented its first national banking regulation in 1863, it might still fall short of what might be viewed as a banking union. Implementation of a banking union in Europe might be even more challenging.

Communication and transparency in the supervisory process, on the other hand, are important because shortcomings in these areas might increase uncertainty on the part of market participants and erode market discipline.

More generally, the banking union was supposed to help address the shortcomings of the regulatory framework, which became obvious during the financial crisis of 2008-09 and the euro-area crisis since 2010 in the context of an incomplete monetary union. Government bonds are not risk-free and affect banks whose balance sheets are bloated with these bonds; regulation has not been harmonised across the 19 euro-area member states; and the fact that bank solvency was a national problem led to the emergence of 'zombie banks' in several parts of the euro area.

European banking supervision is an integral part of the banking union, and is supposed to harmonise supervision throughout the euro-area countries and to reduce the linkages between sovereigns and the financial sector. Acharya and Steffen (2015) argue that there are substantial risks to the stability of the banking union ahead, despite significant reform progress, such as through the SSM. They argue that the asset quality review conducted by the EBA and the ECB before the start of the banking union in October 2014 did not achieve a genuine cleaning up of the balance sheets of an over-leveraged banking sector in Europe, posing substantial challenges to the credibility of the ECB as a central bank and single supervisor and to sustainable growth in Europe. The ECB's non-standard policy measures and the associated asset price inflation incentivise banks to shift portfolios into these securities, crowding out lending to the real economy and making these securities systemically important. Whether the banking union is eventually able to address these shortcomings remains to be seen.

7 Greece

Miranda Xafa

The Greek banking landscape

Banking sector consolidation has been particularly intense in Greece since the onset of the crisis in 2010. As noted by the ECB⁸⁴, Greece has recorded the largest relative decrease in the number of banks among euro-area countries, followed by Cyprus and Spain. From 2009 to 2014, the workforce in the banking sector shrunk by more than 30 percent; a third of branches were closed and foreign ownership of assets nearly disappeared.

Piraeus Bank absorbed Geniki Bank (a subsidiary of Société Générale), Millenium Bank (a subsidiary of Portugal's Millenium Group), the Greek branches of three Cypriot banks and the 'healthy' part of the Agricultural Bank of Greece. Alpha Bank absorbed Emporiki (a subsidiary of Crédit Agricole). National Bank of Greece (NBG) and Eurobank acquired smaller Greek banks and cooperative banks. BNP Paribas closed its branches in Greece in early 2012. Following this wave of consolidation, the four systemic banks that emerged have a combined market share of 98 percent of total assets: 32 percent at NBG, 25 percent at Piraeus Bank, 21 percent at Eurobank Ergasias and 19 percent at Alpha Bank⁸⁵. The remaining 2 percent is split between a small bank (Bank of Attica) and cooperative banks.

84 ECB (2015a) *Report on Financial Structures*, October.

85 As of 31 December 2015. Source: banks' annual reports.

During the same period, bank deposits have halved, from €238 billion to €120 billion, and banks have lost access to wholesale funding, while NPLs remain a drag on credit growth and a key risk factor for capital adequacy. Greek bank exposure to the sovereign was reduced substantially to just 7.2 percent of total assets by end-March 2016, following the 2012 Greek debt exchange (known as PSI, for private-sector involvement) and buyback, and subsequent recapitalisations. However, about one-half of bank capital consists of deferred tax assets (DTAs) and deferred tax credits (DTCs).

The Greek supervisory authority is the Bank of Greece, which is also the country's national central bank and bank resolution authority.

Developments after the start of European banking supervision

The 2014 comprehensive assessment found Greek banks well capitalised, after they had raised a total €8.3 billion in capital from private investors in April 2014. This came on top of €28 billion (of which €25.5 billion was from the official assistance programme) raised in the aftermath of the March 2012 PSI, which generated large losses for Greek banks.

Soon after the comprehensive assessment report was issued, however, a deadlocked Greek presidential selection process and the associated likelihood of new elections that would be won by the Syriza party, triggered large-scale deposit withdrawals, funding pressures and an increase in NPLs as a result of further deterioration in payment behaviour. Syriza won the January 2015 election on a defiant platform rejecting austerity and vowing to 'tear up' Greece's existing agreement with official creditors (ESM, IMF and ECB). After a five-month standoff, the Greek government abruptly called a referendum on Friday 26 June, four days before the programme was due to expire, urging the Greek people to vote against a proposed new assistance agreement. Although 61 percent of Greeks followed this stance by voting no on the day of the referendum (5 July 2015), the Syriza-led government agreed to a third assistance programme at an EU Summit on 12 July 2015, under

the threat of imminent economic and financial collapse. Agreement on an ambitious three-year programme backed by €86 billion of ESM financing was finalised and a memorandum of understanding (MoU) was signed on 19 August, after the Greek parliament passed several prerequisite laws, including the national transposition of the EU Bank Recovery and Resolution Directive (BRRD).

The agreement sought to restore fiscal sustainability, promote growth, improve public sector efficiency and safeguard financial stability. To improve bank viability, the agreement set aside €25 billion for potential bank recapitalisation needs by end-2015, and called for immediate steps to tackle NPLs and to improve bank governance. The Bank of Greece was tasked with assessing the capital needs of non-systemic banks. The financial sector strategy also included an assessment of the bank restructuring plans approved by the European Commission in 2013-14 in light of the changed circumstances of the financial system, and a plan to return the banks to private ownership in the medium term. Liquidity would be monitored through quarterly funding plans submitted to the Bank of Greece.

Liquidity vs solvency

As the ECB Supervisory Board's chair Danièle Nouy has stated, the need for recapitalisation had little to do with the Greek banks themselves, which were found to have sufficient capital in the 2014 comprehensive assessment. In her testimony to the European Parliament on 31 March 2015, she argued that political uncertainty was overshadowing the progress made by Greek banks. She also opined that Greek banks were better equipped for this political episode than in the past, thanks to the recapitalisation and restructuring efforts that had taken place. She added that the SSM was monitoring deposit outflows on a daily basis and had asked the banks to invest in assets that could be used as collateral in order to safeguard their liquidity.

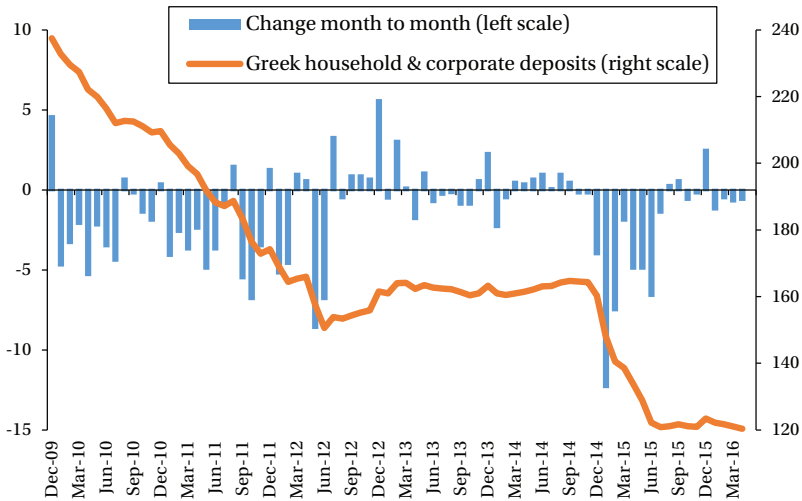
In early February 2015, almost a full month before the programme was due to expire, the ECB Governing Council withdrew the waiver

that allowed Greek government debt to be used as collateral despite its speculative-grade credit rating, because there was no credible programme implementation⁸⁶. Although the programme was subsequently extended to the end of June, Greek banks henceforth had to rely on more expensive emergency liquidity assistance (ELA) from the Greek central bank instead of the ECB's lending window. Appropriately, the SSM set limits on lending to the government and to public enterprises, in order to prevent deficit financing through ELA. The ECB continued to approve liquidity provision through ELA until the Greek referendum was announced on 26 June, after which a three-week bank holiday was declared and capital controls were imposed. ELA provision was frozen between the bank closure and the agreement reached on 12 July, but resumed as soon as the Greek government implemented the first round of prior actions. ELA peaked at €88 billion in mid-July 2015 and gradually declined to €69 billion by early March 2016. Between September 2014 and June 2015, when capital controls were imposed, bank deposits declined by 41 percent to €120 billion, and stabilised thereafter (Figure 9).

The ECB acted throughout on the assumption that Greece would remain in the euro area, and thus continued to approve liquidity provision through the ELA even as the banks' solvency ratios deteriorated together with the Greek economy. According to President Draghi, the ECB had to walk a tightrope between ensuring sufficient liquidity for Greek banks and putting euro-area financial stability at risk: *"I don't want to underplay the difficulty that the ECB and the Governing Council of the ECB had in the last few weeks about having to take decisions between making sure the payment system continued to work, liquidity provision, monetary policy and not to amass excessive risk for the euro system all at the same time"*⁸⁷. Whether Greek banks were

86 ECB press release (2015) 'Eligibility of Greek bonds used as collateral in Eurosystem monetary policy operations', 4 February, <https://www.ecb.europa.eu/press/pr/date/2015/html/pr150204.en.html>.

87 ECB press release (2015) 'Introductory statement to the press conference (with

Figure 9: Greek household and corporate deposits (€ billions)

Source: Bank of Greece.

still solvent by mid-2015 is debatable. President Draghi confirmed the SSM assessment that they were solvent on a static basis, since they fulfilled the minimum requirements of common equity Tier 1 (CET1) capital of 4.5 percent and a total capital ratio of 8 percent. However, he implied that on a forward-looking basis Greek banks were *“failing or likely to fail”*:

“However, [...given] the enormous influence that the quality of the government paper has on the solvency of the banks⁸⁸, well, you

Q&A), 16 July, <https://www.ecb.europa.eu/press/pressconf/2015/html/is150716.en.html>.

⁸⁸ Draghi was referring not only to government paper in bank portfolios but also to DTAs and DTCs, which constituted over 50 percent of Greek banks' Tier 1 capital. In March 2015, SSM chair Nouy said she might need the European Parliament's support to close loopholes in EU bank capital rules that provide countries leeway in the definition of capital, but so far the Commission has not ruled that legislative changes that permit DTAs to be transformed into DTCs in banks in Greece, Italy, Portugal and Spain constitute state aid. The EU Capital Requirements

question their solvency in prospective terms because you look at how things go, how the policy dialogue develops, and therefore how the quality of the government paper changes according to these developments [...] It's on the basis of this prospective assessment that looks at the quality of the government paper, but also at the quality of the overall banks' balance sheets after such a protracted recession, and therefore with a foreseeable increase in non-performing loans [...] an overall envelope of €25 billion, out of a programme of €86 billion, was earmarked for the Greek banking system"⁸⁹.

Bank recapitalisation

All parties (Greek government, ESM, IMF in its programme monitoring role, and the ECB) agreed that bank recapitalisation should be concluded before the BRRD's bail-in rules became mandatory on 1 January 2016, to avoid haircutting uninsured deposits belonging to healthy Greek corporates, which would further set back the economic recovery. This aggressive timeline required the rapid conclusion of an asset quality review (AQR) and stress tests to assess capital requirements – a task the SSM addressed efficiently, by all accounts. However, requiring all four systemic banks to raise funds simultaneously, in a risk-off market environment ahead of the US Federal Reserve's tightening cycle, and before the Greek government had implemented bank-related reforms including a strategy to deal with NPLs, could only be achieved at fire-sale prices: the recapitalisation was concluded at a price-to-book ratio in the range of 0.30-0.35 for all four banks.

Regulation (CRR) does not count DTAs as capital because they are contingent on future profits, but counts DTCs as capital because they constitute a claim on the sovereign regardless of whether the bank makes a profit or a loss. Insofar as they constitute a liability for the state, large DTCs go obviously against the objective of breaking the link between banks and sovereigns.

89 ECB press release (2015), 'Introductory statement to the press conference (with Q&A)', 16 July, <https://www.ecb.europa.eu/press/pressconf/2015/html/is150716.en.html>.

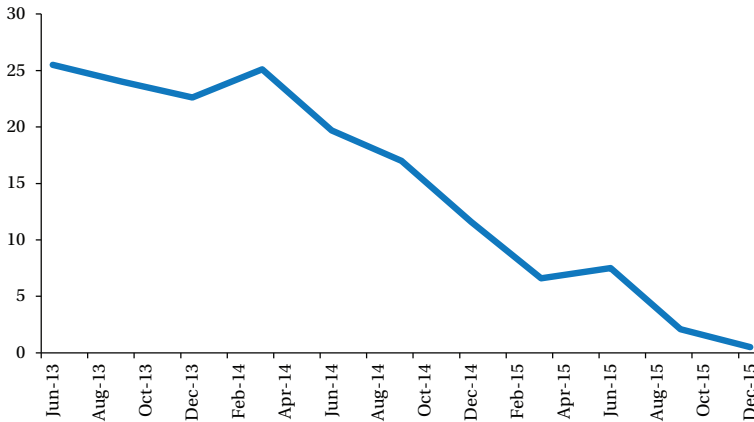
European banking supervision found that the four systemic banks needed a total €14.4 billion of additional capital, comprising €4.4 billion under the baseline stress test scenario and an additional €10 billion under the adverse scenario. The shortfalls included AQR adjustments of €9.2 billion, partly covered by existing capital buffers and baseline scenario profitability. “Covering the shortfalls by raising capital would then result in the creation of prudential buffers in the four Greek banks, which will facilitate their capacity to address potential adverse macroeconomic shocks,” the ECB said in a statement⁹⁰, adding that a minimum of €4.4 billion, corresponding to the baseline shortfall, was expected to be covered by private investors. By implication, any bank that failed to attract private capital to cover the shortfall of the baseline scenario would be considered ‘failing or likely to fail’ and would thus be resolved.

As it turned out, Greek banks were able to raise as much as €9 billion from private investors. Senior and junior bond instruments contributed €2.8 billion either through a voluntary liability management exercise or through bail-in; €5.2 billion was raised from new equity investors; and €1 billion mainly from asset sales. The chosen book-building process, with no effective minimum price set, helped attract private capital as share prices fell to new lows ahead of the November 2015 offering, with the consequence that existing shareholders were effectively wiped out. The €25.5 billion initial stake acquired by the Hellenic Financial Stability Fund (HFSF, a national entity set up under the first Greek assistance programme) in May 2013, worth just €2.1 billion in September 2015, was further diluted to €750 million at the prices of the November 2015 offering (Figure 10). Once this process was completed, residual capital requirements of €5.4 billion – largely resulting from adverse-scenario stress test results for two out of the four banks – were filled by the Greek state (via the

90 ECB banking supervision press release (2015) ‘ECB finds total capital shortfall of €14.4 billion for four significant Greek banks,’ 31 October, <https://www.bankingsupervision.europa.eu/press/pr/date/2015/html/sr151031.en.html>.

HFSF) using ESM funding. Three-quarters of the capital contributed by the HFSF, or €4.1 billion, was in the form of contingent capital instruments (CoCos), and the remaining €1.3 billion as common equity. The use of CoCos helped minimise the state shareholding in the banks.

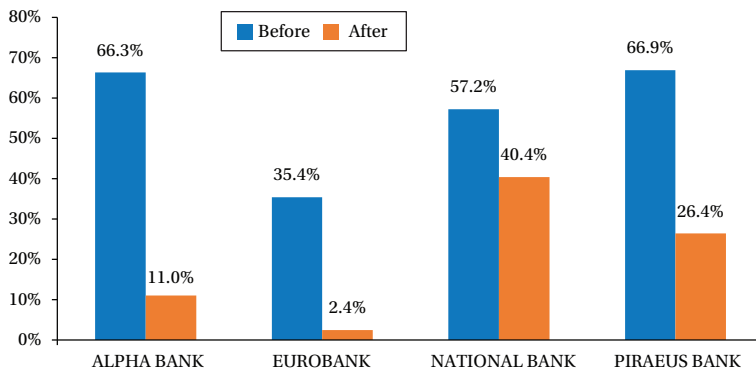
Figure 10: Market value of HFSF shares in the four systemic banks



Source: Hellenic Financial Stability Fund.

The Greek state's share was diluted to minority stakes in all four banks, as shown by Figure 11. The HFSF's stake in Alpha and Eurobank fell to just 11.0 percent and 2.4 percent, respectively (from 66.3 percent and 35.4 percent), as these two banks managed to fully cover their capital requirements from private investors. The MoU specifically stated that *“the recapitalisation framework will be developed with a view to preserving private management of recapitalised banks and to facilitating private strategic investments”*. Maximising the capital raised from private investors was therefore a key objective, even if it implied massive dilution of existing shareholders.

Figure 11: Greek state ownership of banks, before and after the 2015 recapitalisation



Source: Hellenic Financial Stability Fund.

As had been noted by President Draghi, uncertainty about the impact of capital controls and recession on NPLs, but also political uncertainty (snap elections on 20 September 2015 were called as soon as the MoU was signed), pointed to the need to err on the side of caution in deciding how much official funding to set aside for the recapitalisation. Although the recession in 2015 turned out to be more shallow than feared, with GDP growth estimated at -0.3 percent versus -2.3 percent underlying the programme, the outlook remained highly uncertain. The announcement of a €25 billion buffer took markets by surprise, coming so soon after the 2014 comprehensive assessment, but ultimately provided comfort that an adequate backstop would be available if needed. Uncertainty about the economic outlook and MoU implementation probably also explain why the SSM required higher capital ratios in Greece in 2015 than those underlying the 2014 pan-European comprehensive assessment: 9.5 percent for the baseline scenario (vs. 8.0 percent in 2014) and 8.0 percent for the adverse scenario (vs. 5.5 percent). Presumably European banking supervision targeted higher capital ratios for Greek banks than for their European

peers because their Pillar-2 SREP ratios are higher, reflecting their exposure to Greek sovereign risk and high levels of NPLs. Despite the higher standard, the big gap between the initial estimated need for public funds of €25 billion and the final outcome of €5.4 billion suggests that the SSM had underestimated the loan asset quality of Greek banks, as well as their ability to attract private capital.

Non-performing loans

When the MoU was agreed, provisions covered 40 to 45 percent of non-performing exposures (NPEs = NPLs + performing restructured loans), which themselves represented half of total gross loans – an unusually high level resulting from six years of recession, fears of exit from the euro area, and the general erosion of the payment culture in Greece, including strategic defaulters who took advantage of a 2010 law intended to shield primary residences from foreclosure. Comprehensively resolving the NPL issue before the bank recapitalisation in late 2015 would have required a ‘bad bank’ scheme, which would be hard to set up in a country with weak institutions like Greece. Moreover, NPLs in Greece were recession-driven and broad-based, rather than focused on real estate as they had been in Ireland or Spain. By sector, NPEs in agriculture, manufacturing, construction, food services, telecoms IT and media, and commercial real estate exceeded one-half of loans at end-2015. By type of loan, NPEs to very small companies and SMEs, and consumer loans, all exceeded one-half of all loans, while large corporate loans and mortgage loans fared better. Asset quality deteriorated during 2015, with NPEs rising by 9 percent to €117 billion. MoU conditionality helped clean up bank balance sheets by suspending the state’s super-seniority in asset sales and liquidation, and by permitting home foreclosures of the primary residence of borrowers who meet certain income and wealth thresholds. However, further steps are needed to improve loan recoveries, accelerate bankruptcy procedures and clarify which loans banks are allowed to sell to distressed debt funds or service companies. Further delay in

resolving the NPLs would undermine the ability of banks to lend.

Governance

MoU conditionality required a modification in October 2015 of the HFSF's founding law⁹¹ to spell out strict criteria for the qualifications of bank executives. The criteria exclude former politicians and require extensive banking sector experience for board members, including inter alia fifteen year's international experience in banking for members chairing committees. These extremely prescriptive guidelines, which are additional to the usual 'fit and proper' requirements imposed by the SSM (Gortsos, 2015, p.175) were imposed by the troika to avoid government interference in a country where clientelism is extreme. It appears that the SSM is currently applying tough criteria in their assessment of board members in order to signal the end of state involvement in the banking sector. That said, finding candidates who meet the criteria will be difficult. Remuneration is modest by international standards and legal risks are high, so Greek banks are unlikely to attract applications from many high-calibre professionals.

Business plans

A Restructuring Framework Agreement between the European Commission and Greek banks was signed in 2014, in the aftermath of the 2013 recapitalisation. The agreement was based on EU state aid rules, which require banks to sell assets held abroad and non-core businesses if state aid exceeds 2 percent of risk-weighted assets. The business plans were revised in 2015 in view of the banks' changed circumstances, with plans to divest foreign subsidiaries in the Balkans and non-core assets brought forward and broadened for the two banks that relied again on state aid. These banks considered that they were given tight deadlines to divest assets, and that ongoing sales were not taken into account in assessing capital requirements. However, they

91 Law 3864/2010.

recognised that the implementation of the BRRD's bail-in provisions as of 1 January 2016 did not provide banks with sufficient time to meet capital requirements through asset sales, and therefore viewed the restructuring plans as broadly appropriate. The baseline scenarios of the SSM stress tests of both 2014 and 2015 were based on the assumption that the asset sales assumed in the bank business plans would be implemented.

The case of Attica Bank

Attica Bank, a bank majority-owned by the Greek engineers' union pension fund, failed to raise the full amount of additional capital required (€0.8 billion under the adverse scenario), even after a large capital injection by its main shareholder. It also appears that state-controlled enterprises were strong-armed into participating in the Attica offering, including Athens Airport and the Athens Water Company – a move that went against the effort to break the link between banks and the Greek state. Partly as a result of this alleged state aid, Attica Bank managed to raise 91 percent of the needed capital, reaching a CET1 capital ratio of nearly 20 percent. However, the recapitalisation was concluded at a price-to-book of 0.82, far above the 0.30-0.35 range for the systemic banks, presumably to avoid near-full dilution of the equity holdings of the Greek Engineers' Fund in Attica Bank. In early March 2016, European banking supervision started an audit of Attica Bank over possible irregularities in its capital-raising efforts. Discussions between European supervisors and the bank's management have been ongoing regarding corporate governance and the bank's business model, which relies heavily on the construction sector that has been hard-hit by the crisis. All of the above suggest that Attica Bank may end up in resolution. If so, the ECB should have taken it under its direct supervision sooner, before public sector entities sunk in €0.7 billion of new capital and before bail-in rules took effect.

Conclusion

Overall, European banking supervision is viewed as justifiably strict by Greek bankers and supervisors. They consider it to be tough but fair, and believe its involvement lends credibility to bank balance sheets and helps banks to raise private funding. The SSM handled well the challenges arising out of the Greek crisis: it very closely monitored the situation on a daily basis, and acted quickly to assess capital requirements as soon as a new bailout agreement was reached. Even though the size and modalities of the recapitalisation may be questioned *ex post*, *ex ante* they seemed eminently sensible in view of the uncertainties involved, as well as the need to minimise the cost to taxpayers (including through CoCos) and the state's equity participation. Thus, European banking supervision can be assessed as having done a good job so far in supervising the systemic banks. The ECB may, however, have been too slow to take over the supervision of Attica Bank from the Bank of Greece.

8 Italy

Marcello Messori

The Italian banking landscape

Italy's banking system is less concentrated than those of most other euro-area countries, especially when the absence of large institutional protection schemes such as those in Germany or Austria is taken into account. Following a series of mergers in the 1990s and 2000s, two groups, UniCredit and Intesa Sanpaolo, are positioned ahead of their peers, with combined assets representing 47 percent of the Italian total. All other Italian SIs combined add up to only 25 percent of this same total, and about 500 LSIs account for the remaining 28 percent. In other words, the Italian banking system can be described as two large pan-Italian banks (even though, with less than €1 trillion each in assets, they are not among the very largest in the euro area), and a 'long tail' of small banks, most of which only have a regional or local footprint⁹².

Italy had historically relied on strong local and regional public savings banks (Casse di Risparmio or Monti di Pietà), and a number of national state-owned banks from nationalisations during the first half of the twentieth century. In the 1990s and early 2000s, the savings banks were transformed into commercial entities and the state-owned banks were privatised, triggering a wave of mergers that led to

92 The figures in this paragraph are based on data from different sources. The consistency of these sources has been checked with the Bank of Italy.

the formation of Intesa BCI, UniCredit, SanPaolo IMI and Capitalia. As a result of the savings banks reform and bank mergers, the local public interests in the biggest banks were managed through foundations, which retained controlling stakes in the consolidated groups. In 2007 Intesa and SanPaolo merged, and Capitalia was absorbed by UniCredit. Meanwhile foundations typically became minority shareholders, and Italy's central government almost entirely exited the banking sector⁹³.

Among the medium or small-sized banks a number are cooperatives (Banche Popolari and Banche Cooperative) with governance historically based on a one-shareholder-one-vote principle, as opposed to the usual one-share-one-vote – ie all shareholders, large or small, have identical voting power, even for those Banche Popolari (SI or LSI) that are publicly listed. The Banche Cooperative are local banks, often very small.

The national central bank, Bank of Italy (Banca d'Italia, often referred to as Bankitalia), is the Italian national supervisory authority and also the national resolution authority.

The 2014 comprehensive assessment and its interpretation

From mid-2012 to the end of 2013, Italian banks started a process of recapitalisation and continued the deleveraging process started in the second half of 2011, when Italian sovereign spreads rose significantly. However, this was insufficient to align Italian banking indicators with European ones in terms of risk-weighted capitalisation and profitability. Crucially, the Italian banks were unable to reduce their stockpile of non-performing loans (NPLs), which instead kept growing. These are the main reasons for the Italian banking sector's poor performance in the 2014 comprehensive assessment, which involved an asset quality review (AQR) and stress tests.

93 Cassa Depositi e Prestiti (CDP), a large government-controlled entity, is not a bank but a special financial institution supervised by the Bank of Italy.

The final report published on 26 October 2014, identified 25 banks as failing the assessment as of the end of 2013, with an aggregate capital shortfall of €24.6 billion and an additional asset value adjustment (from the AQR) of €37 billion, adding up to a total impact of €61.6 billion. Of these 25 banks, nine were Italian, or three-fifths of the 15 Italian banks reviewed⁹⁴. Italy thus contributed 36 percent of all banks failing the assessment, with a total capital shortfall of €9.7 billion (around 39 percent of the total), far higher than any other euro-area country.

By the beginning of 2014, the majority of these banks realised they would not meet the capital adequacy conditions. They therefore intensified their recapitalisation efforts during the first three quarters of that year. By the end of September 2014, 12 of the 25, including five of the nine Italian banks, were able to overcome their capital shortfall by implementing recapitalisations during 2014 for an aggregate amount of €15 billion (€8.2 billion for the five Italian banks). Conversely, the other 13 banks, including four Italian banks, still had inadequate capital by the time of publication of the comprehensive assessment's results. The four Italian banks accounted for an aggregate capital shortfall of €3.3 billion or a third of the €10 billion total for the 13 remaining 'outliers'. The four Italian banks were: Banca Popolare di Milano (BPM), Banca Popolare di Vicenza (BP Vicenza), Cassa di Risparmio di Genova (Carige) and Monte dei Paschi di Siena (MPS).

These four, together with the other nine negative outliers from other countries, were given two weeks to establish capital plans that would rectify their capital gaps within nine months. BPM and BP Vicenza had approved but not yet implemented capital adjustments

94 See ECB (2014a) and Bank of Italy (2014a). The list of 130 banks participating in the comprehensive assessment in 2014 does not completely match the list of SIs euro-area-wide. This also applies to Italy. Banca di Credito Valtellinese and Credito Emiliano were assessed in 2014 but are now designated as LSIs. The 15 Italian banks assessed accounted for 11.5 percent of the total number in the comprehensive assessment, making up 10.4 percent of total assets.

sufficient to meet these conditions as of September 2014. Thus, by the end of October 2014, only MPS and Carige failed to meet the new requirements, with a shortfall of €2.92 billion still representing slightly more than 30 percent of the total residual capital shortfall in the euro area.

The ECB and Bank of Italy presented different public interpretations of the results. The ECB (2014a, 2014c) focused on the final results based on bank balances at the end of December 2013. Conversely, the Bank of Italy (2014b, 2014a) focused on the updated AQR results, taking into account the recapitalisation efforts during 2014. It also emphasised that the capital shortfall of Italian banks according to the AQR at the end of 2013 was only €3.25 billion out of their total shortfall of €9.68 billion, or in other words, the major part of the shortfall arose from the stress test results, the adverse scenario in particular. Moreover, the updated bank balances at the end of September 2014 showed that none of the 15 Italian banks (even MPS and Carige) had any capital shortfalls resulting from the AQR and that all the late-2014 shortfalls came from the stress tests, especially the adverse scenario⁹⁵.

This different emphasis framed a three-pronged narrative promoted by the Bank of Italy. First, the AQR was also a measure of the effectiveness of previous supervision; hence, the overall compliance of Italian banks with respect to AQR requirements meant an absence of past supervisory failures in Italy. Second, Italian banks did not represent a problem for the European banking sector – their limited capital shortfall involved only two banking groups and was mainly a consequence of the severity of the Italian adverse scenario. Third, as opposed to most other European countries, these results were attained with minimum public financial support since the start of the crisis.

95 Of course, stress tests are not a forecast of a country's economic evolution. Moreover, according to the Bank of Italy, the Italian adverse scenario was particularly severe because it under-assessed the effects of the double recession characterising the Italian economy (pro-cyclicality bias: see also the Bank of England's position).

Thus the ECB and Bank of Italy had starkly different interpretations of the same events.

The Bank of Italy's view is supported by the fact that the Italian economy was one of the euro area's worst performers in terms of growth and sovereign spreads. Italian banks consequently faced deep increases in borrower insolvency and bankruptcy, and an increase in the cost of their liabilities, which were often independent of their specific riskiness. In light of this negative legacy, the average performance of the Italian banking sector was not that poor. Apart from cases such as that of MPS, the Bank of Italy had been able to guarantee stability during a tumultuous period characterised by more than six years of national recession. That said, if one ignores the legacy problems and takes a snapshot of the Italian banking sector at the end of December 2013 or even at the end of September 2014, the comprehensive assessment's results unambiguously demonstrated that Italian banks represented one of the biggest problems for the European banking sector as a whole.

Four additional points deserve mentioning with respect to the comprehensive assessment:

- First, as the ECB (2014c, 2014b) partially acknowledged, the capital definitions were generally sounder in Italy than in other member states. The comprehensive assessment, being based on the national transposition of the European CRR/CRDIV, suffered distortions because of different national definitions and measures of capital often deriving from heterogeneous accounting rules of banking sectors. All Italian banks applied IFRS, unlike a number of German banks. On the other hand, since 2015, Italian banks have been allowed to count deferred tax credits (DTCs) as capital. Full implementation of the single rulebook could complete transitional arrangements and overcome these problems and other harmonisation deficiencies.

- Second, traditional credit risk was treated more harshly than risk from capital market activities. The Italian banking sector is characterised by a dominant weight of loans as a share of total assets. It can be argued that European regulation is biased against bank loan risks in favour of financial asset risks. As a consequence, Italian banks could have been penalised by the emphasis on credit risks relative to market and operational risks. However, even though the ECB did increase capital requirements in one go by 100 basis points during the comprehensive assessment, it only applied CRR/CRDIV regulation in assessing different types of risk. The ECB cannot be blamed of any bias inherent in the EU legislation.
- Third, and in relation to the previous point, Italy was penalised by the European emphasis on risk-weighted assets. Italian banks had an average CET1 ratio below the European mean, but also had among the soundest leverage ratios on average. A number of scholars (Haldane, 2012; Acharya and Steffen, 2014a; Dermine, 2015) have highlighted weaknesses in the risk-weighted regulatory approach underpinning CET1 ratio calculations, eg pro-cyclicality and excessive complexity. Moreover, econometric exercises such as Barucci *et al* (2015) suggest that the leverage ratio tends to be more effective than risk-weighted measures in controlling for the riskiness of banks in the stress tests. From this point of view, the methodology used for the comprehensive assessment may have been too focused on risk-weighted measures. It would be a stretch, however, to argue that the leverage ratio could entirely replace the risk-weighted capital framework.
- Fourth, Italian banks suffered from their lack of use of internal ratings-based (IRB) risk models. IRB models are costly to build, complex to manage, and thus only affordable for large and sophisticated banking groups. On the other hand, IRB models often allowed the introduction of devices to disguise the riskiness of assets (Behn

et al, 2014; Barucci *et al*, 2015). Thus, their comparative under-utilisation may have penalised Italian banks in the comprehensive assessment. However, it should be noted that, starting in 2010, international banking regulation has tended to strengthen risk management and internal controls instead of cutting down IRB.

In sum, one can identify many shortcomings in the comprehensive assessment, but these do not conclusively add up to the identification of a negative bias against the Italian banking sector, only that a level playing field has yet to be built for banks across the euro area. With a lack of trust between member states, and weak cooperation between European institutions and national governments, this can explain why the first moves of the new European supervision were characterised by a certain rigidity. In this sense, the ECB and SSM behaved more as rule-setters than supervisors (see also European Parliament, 2016, point 16).

The evolution of supervision

Once in place, European banking supervision shifted its attention to the SREP process, using a methodology based on a common set of rules (ECB 2015b, 2015e). In principle, the SREP methodology follows EBA guidelines, with an overall risk control framework that frames the SSM's constrained judgement of each examined bank. Every judgement implies the inclusion of the bank under assessment in one of the four score categories. However, the evaluation is too complex to be reduced to a simple score, so European banking supervision retains discretion for modulating the requirements for each bank's risk-weighted capital. This discretionary margin also applies to governance requirements.

The first full-fledged SREP exercise under the new European supervisory framework started in February 2015 and ended in November of the same year. It is difficult to summarise its overall result, since each bank case was different. European banking supervision urged various

banks to strengthen their organisation and improve their governance. Above all, it imposed increases in capital requirements that ranged from 60 to 120 basis points for all banks that met the comprehensive assessment's minimum requirements; these increases were mainly due to a further tightening of Pillar-2 requirements⁹⁶. The Bank of Italy was reported to disagree with the ECB on this approach, by means of a letter sent to the ECB's Supervisory Board⁹⁷. The Bank of Italy's argument was that the new increases in capital requirements arbitrarily overlapped with those of the comprehensive assessment, and thus risked harming the banks' operations and stability.

A recent unofficial note of the European Commission (2016; see also Draghi 2016) aimed to limit the SSM's discretionary power to tighten Pillar-2 capital requirements⁹⁸. An analogous approach is suggested by the European Parliament (2016, points 21-25). Hence, the next SREP exercise, which started at the end of February 2016 and will be concluded later in 2016, might have to introduce substantial changes in methodology.

Despite the rigidity of the adopted criteria, the major Italian banks performed better in the late-2015 SREP than in the 2014

96 In contrast to Pillar-1 requirements which are standardised (under CRR in the EU), Pillar-2 capital requirements address risks that are specific to each bank and involve supervisory discretion. The supervisor may also impose Pillar-2 capital guidance, if the capital requirements can be unmet under specific circumstances (European Commission, 2016).

97 Patrick Henry, (2015) 'Bank of Italy slams 'arbitrary' ECB over capital demands,' *Bloomberg*, 21 September.

98 At the end of the 10 March 2016 press conference, Draghi said: "...I want to point your attention to a communication by the Commission [...] that does clarify the nature of Pillar-2 requirements". This Communication acknowledges that "competent authorities may impose additional Pillar-2 capital requirements to address the more specific risk profile of each institution". However, it adds that these same authorities have to "provide clear and detailed justification to the institution of why Pillar-2 capital guidance is transformed in a Pillar-2 capital requirement" and "the institution concerned should have the right to appeal the decision" (see European Commission, 2016).

comprehensive assessment. The latter's unflattering picture of the Italian banking sector triggered various initiatives by the Italian banking sector or imposed by the government, which included more recapitalisations, attempts to restructure or liquidate part of the NPL stockpile, and changes in corporate governance. On this last point, in March 2015, the Italian Ministry of Economy and Finance signed an agreement with the Italian banking foundations to reduce the foundations' stakes in each bank, and separately conducted a normative reform of the largest Banche Popolari (over €8 billion in total assets), requiring them to move towards a one-share-one-vote framework by July 2016. More recently (April 2016) the ministry implemented a normative reform of the Banche Cooperative to consolidate them into a few banking groups or to transform them into joint-stock companies. Meanwhile, despite their persistent weaknesses in terms of organisation and governance, MPS, Carige, BP Vicenza and Veneto Banca were able either to meet the specific capital requirements set by European banking supervision, or to commit to a sufficient recapitalisation within an agreed timeframe (see below).

As mentioned above, LSIs are important in Italy. They currently represent more than a quarter of total assets, with no large institutional protection schemes. Some of these smaller banks either came under special administration (an Italian form of corrective action) or were otherwise in need of significant restructuring. The SREP process shed light on their most pressing problems. However, EU competition policy rules that entered into force in August 2013 (European Commission, 2013) limited the Bank of Italy's ability to address LSIs' weaknesses in its role of direct supervisor. These rules mandate losses on shareholders and junior bondholders as a precondition for state aid, and thus severely restricted state guarantees on the securitisation of NPLs, as detailed below. On this basis, the European Commission Competition Directorate-General placed constraints on the utilisation of an Italian inter-bank fund to resolve bank crises. Moreover the BRRD, approved in 2014, extended the principle of bail-in to all types of bank bonds and

deposits above €100,000 from the beginning of 2016 but, at the same time, set the normative framework for banks' crisis management⁹⁹. The Italian Parliament was late in transposing BRRD into national legislation, which was only done in mid-November 2015¹⁰⁰.

Recent developments and prospects

In November 2015, these constraints crystallised in the Italian approach to addressing the weaknesses of four small banks (three regional savings banks and one cooperative bank) which, combined, held around 1 percent of total Italian banking deposits. The impossibility of finding solutions through the national inter-bank fund brought the structural fragilities of the Italian banking sector to the fore. The Italian government spun off the NPLs of these failing banks into a single 'bad bank' at around 18 percent of their nominal value, as required by the European Commission, and formed four new viable banks. In the process, the value of shares and subordinated bonds previously issued by the failing banks was wiped out. Since the Italian banking sector had sold an abnormal amount of different types of bank bonds to retail investors between 2001 and 2012, the obliteration of the value of subordinated bank bonds created alarm. It also affected the market values of all listed Italian banking groups¹⁰¹.

99 See Visco (2015, 2016). In these works, the Governor of the Bank of Italy compares the application of these new European rules with the introduction of total loss absorbing capacity (TLAC) requirements for the systemically important banks. TLAC was decided by the Financial Stability Board in 2015 and must be implemented before 2022; conversely, the new European rules have very short transition periods and retroactive effects on outstanding debt. Visco argues that this hasty European implementation has a distortionary impact.

100 This late transposition implied that the Italian authorities were left with little time to implement the new rules on crisis management before the full implementation of the bail-in.

101 The negative market reactions at the beginning of 2016 were worsened by the spreading of false news. For instance, an ECB Supervisory Board inquiry at a number of European banks on their NPL stock was interpreted as a sign of a further and generalised strengthening of capital requirements for the Italian banks.

At the beginning of 2016, the Italian government reached a controversial agreement with the European Commission to offer a partial and costly guarantee to Italian banks securitising their NPLs (Italian Ministry of Economy and Finance, 2016). It soon became apparent that this guarantee, limited to the senior tranche, would be ineffective to reduce significantly the gap between the average value of NPLs accounted for by the Italian banks (around 41 percent) and the benchmark value set in the case of the four failing banks (around 18 percent). The size of this gap meant that Italian banks would have been unable to liquidate a significant portion of their NPLs without resorting to further recapitalisation. In the European context of a still unfinished banking union, these events highlighted the fragility of the Italian banking sector. They further jeopardised the scheduled recapitalisations of BP Vicenza and Veneto Banca which had still to meet their SREP capital requirements and were charged with administrative misbehaviour in previous liquidity raisings; and put the other banking groups with the highest weight of NPLs – MPS and Carige – under strain. Separately, at the beginning of April 2016, the ECB approved the first significant bank merger under its supervision, between Banco Popolare and BPM¹⁰². This piece of good news, however, failed to counterbalance the bad news on other fronts.

In April 2016, the Atlas fund (Atlante in Italian) was launched as Italy's response to this situation. The fund, endowed with an initial capital of €4.25 billion by a large majority of the Italian financial institutions, has two aims: to underwrite new recapitalisations by Italian banks (up to 70 percent of its capital), playing the role of 'shareholder of last resort', and to act as a purchaser for the junior tranches of

102 ECB banking supervision approved this merger after a lengthy negotiation on NPL liquidation, the re-capitalisation of Banco Popolare and changes to the governance of BPM. Italian newspapers complained about the Supervisory Board's rigidity because both banks had already met the 2015 SREP requirements. However, the new banking group will be stronger thanks to these additional requests being met.

securitised Italian NPLs (up to 30 percent of its capital).

The governance and operation of this fund have at least three weaknesses. First, Atlas's endowment is insufficient to pursue its double aim, even under optimistic assumptions of its possible leverage ratio; the two recapitalisations of BP Vicenza and Veneto Banca could consume 85 percent of the capital devoted to this task, almost extinguishing Atlas's capacity. Second, Atlas's design implies that the stronger financial institutions subsidise those in trouble: it is debatable whether this solution should be chosen over a new round of consolidation. Third, Atlas's ownership structure is such that its main shareholders, the Italian banking groups, are also its contracting parties, meaning that the same set of agents will act on the two opposite sides of the market, which can hinder competition and generate conflicts of interest. Despite these weaknesses, Atlas might effectively temper financial instability in the short run. At the beginning of May 2016, it acquired full ownership of BP Vicenza, whose capital call had attracted demand from market investors for less than 10 percent of the amount requested. Without this intervention, either Unicredit as a formal guarantor of the capital increase would have had to buy the new shares, with a negative impact on its CET1, or BP Vicenza would have had to enter into a resolution procedure. At the time of writing, the same could happen in the case of Veneto Banca and its guarantor, Intesa-San Paolo. Moreover, Atlas still wants to increase the market prices of Italian NPLs, and thus to allow banks such as Carige and MPS to reduce the expected losses from the gradual liquidation of their NPLs.

The threat of financial instability does not imply that the Italian banking sector is on the brink of bankruptcy. Moreover, given the ECB's policy of quantitative easing and other non-conventional initiatives, the Italian banking system has never faced serious risks of illiquidity. Even so, Italian banks will be unable to play a significant and efficient role in intermediating financial wealth and lending to the Italian economy without restructuring and consolidation. The implementation of these processes is not made easier by the lack of

trust among euro-area countries, and between them and the European institutions. This mistrust risks making European banking regulation and supervision excessively rigid; an excess of rigidity could hinder the actual construction of a single financial market.

9 The Netherlands

Casper de Vries and Dirk Schoenmaker

The Dutch banking landscape

The Dutch banking system is highly concentrated. There are three very large banks: ABN AMRO, ING Group and Rabobank. ABN AMRO was formerly part of Fortis and is still 77 percent government-owned following nationalisation in October 2008 and relisting in November 2015. ING Group is now predominantly a banking group after spinning off most of its insurance activities (under the name Nationale Nederlanden) in 2014, as requested by the European Commission following state aid received in 2008. Rabobank is a non-listed cooperative group.

There are three medium-sized banks: SNS, BNG and NWB. SNS Bank, originally a savings bank, is wholly government-owned following the nationalisation of failing group SNS Reaal in February 2013. When SNS was nationalised, the Dutch government separated the insurance subsidiary, which was renamed Vivat and subsequently sold to the Chinese insurer Anbang in 2015, and the property subsidiary, which had large non-performing commercial property investments. Now that the remaining SNS Bank is healthy again, the Dutch government is considering privatisation and will send its proposals to the Dutch parliament before the summer of 2016.

Table 8: The Dutch banking system (end 2014)

Category	Total assets (billion)	Status	Percentage
Significant institutions	€ 2,230		88.1%
ING Bank	€ 828	Domestic	32.7%
Rabobank	€ 681	Domestic	26.9%
ABN AMRO	€ 387	Domestic	15.3%
Bank Nederlandse Gemeenten	€ 154	Domestic	6.1%
Nederlandse Waterschapsbank	€ 88	Domestic	3.5%
SNS	€ 68	Domestic	2.7%
RBS Netherlands / RFS Holdings	€ 24	Foreign	0.9%
Less significant institutions	€ 302		11.9%
NIBC	€ 23	Domestic	0.9%
LeasePlan Corporation	€ 20	Domestic	0.8%
Van Lanschot	€ 17	Domestic	0.7%
Other domestic LSIs	€ 96	Domestic	3.8%
Foreign LSIs	€ 146	Foreign	5.8%
Total SIs and LSIs	€ 2,531		100.0%

Source: DNB and annual reports.

BNG Bank (Bank Nederlandse Gemeenten, Dutch Municipal Bank) and NWB (Nederlandse Waterschapsbank, Dutch Water Bank) are also publicly-owned (50 percent by the central government and 50 percent by local governments for BNG; and 81 percent by the local water authorities, 17 percent by the central government and 2 percent by local governments in the case of NWB). BNG and NWB mostly lend to municipalities, provinces and polders administered by the local water authorities. The government intends to divest all shares it holds in ABN AMRO and SNS Bank. Meanwhile, the Dutch government has benefitted from dividends from ABN AMRO. Lately, there has been some public advocacy in favour of keeping SNS as a state-owned bank

(Financieele Dagblad, 2016).

There are several smaller banks (LSIs), which amount to 12 percent of the Dutch banking system's total assets. The largest players among the LSIs are NIBC, LeasePlan Corporation and Van Lanschot, with total assets ranging from €15 to 30 billion. Table 8 provides an overview of the Dutch banking system, indicating that only 7 percent is foreign owned. The Dutch national supervisory authority is the National Central Bank, De Nederlandsche Bank (DNB), which also has resolution authority.

Comprehensive assessment

In 2012 DNB started to raise public awareness of potential valuation problems in the commercial real estate sector and asked for better risk management. DNB stepped up its supervision by starting an in-depth investigation of banks' real estate portfolios. In 2013 DNB conducted an asset quality review of all major banks, which resulted in higher provisions and adjustments in internal risk models. The supervisor also requested additional capital for commercial real estate exposures.

This sectoral asset quality review helped the Dutch banks to prepare for the ECB's comprehensive assessment of 2014. The comprehensive assessment did not lead to substantial adjustments for the Dutch banks.

More recently, DNB has again been warning commercial banks to take heed of the new Basel Committee proposals regarding residential mortgages. As discussed below, these proposals will have a material impact on Dutch banks that have relatively large mortgage portfolios with high loan-to-value (LTV) ratios. DNB is asking banks to anticipate these new measures and take action now.

Significant institutions

The government aims to sell its remaining shares in ABN AMRO in later tranches. While there is political agreement on full privatisation, there is no indicative timetable. Following the IPO in November 2015,

there was a lockup period until May 2016.

ING is an international bank, with operations across Europe and beyond. These include significant activities in the euro area, particularly in Belgium, Germany (ING DiBa), Netherlands, Luxembourg and Spain. While the supervisors in the Joint Supervisory Teams (JST) are still learning, early experiences suggest that (1) the joint supervisory process is working; (2) the SSM approach is more intense than the former DNB-led regime; (3) there is useful specialisation on topics such as capital and liquidity within the JST; and (4) the JST approach enables the SSM to have an overall, consolidated, view of the banks that was not achievable under the pre-SSM system. Nevertheless, the metrics that the SSM is using and the benchmarking against other banks are not (yet) transparent. A case in point is the SREP process, in which the SREP score is announced to the banks, but the underlying factors that contribute to this score are not.

Rabobank underwent a major change of governance in 2015, which could have implications for the governance of other cooperatives in the euro area. Until 2015, the local member banks were owned by their customers (only those that chose to be a member). The local member banks were in turn members and owners of Rabobank Nederland, the central institution. The central institution of the Rabobank Group and all 106 local member banks merged into one entity, Cooperatieve Rabobank U.A., with one banking licence and one consolidated balance sheet as of 1 January 2016. There are several reasons for this merger:

- **Internal:** the Rabobank group wanted to improve its governance structure. The goal of the new structure is to more effectively serve customers, markets and society, while strengthening the cooperative identity.
- **Supervision:** the central institution and the local member banks held individual banking licences. In the previous arrangement, the

DNB (and later the ECB) used to supervise the central Rabobank institution in Utrecht, which in turn supervised the local member banks under a special clause in Dutch financial services law. The DNB, and more recently the ECB, wanted direct access to the local banks, particularly because the ECB acts as the licensing authority for all banks under the SSM Regulation.

- Resolution: for regulatory purposes, the group's capital was divided between the central institution (€7 billion) and the local banks (€20 billion) as of end-2015. The Rabobank entities had explicit cross-guarantees. But the question remained open whether capital, for example, would be up-streamed from the local banks to the central institution in the case of a big loss in the central institution, and vice versa. Such questions are particularly relevant for the triggering of contingent convertibles (CoCos), which Rabobank issued for the first time in 2010, and the implementation of resolution plans, which now require debt holders to take the first hit.

Since 1 January 2016, the ECB and DNB have had full supervisory access to the whole Rabobank group, and regulatory capital is consolidated in the newly-merged Rabobank entity. The Rabobank has kept a cooperative structure, however. The local business is organised through about 100 local banks. These local banks are no longer separate legal entities, since they are part of the unified Rabobank legal entity, but their governance arrangements maintain strong relationships with their customers and local communities. The cooperative customers (leden, or 'members') of Rabobank are organised into about 100 departments (afdelingen), based on geographical and other criteria. The chairman of each department's supervisory body (lokale raad van commissarissen), who is also the chairman of the local members' council (lokale ledenraad), represents the members from that department in the general members' council (algemene ledenraad), Rabobank's highest governing body. Both Rabobank's executive board

(raad van bestuur) and its supervisory board (raad van commissarissen) are accountable to the general members' council.

Less significant institutions

The experience of Dutch LSIs is that the scope for DNB to follow its own policies has been reduced. The heavy shadow of the ECB is felt in the supervision of LSIs. DNB follows the formats and templates of the ECB, because it has to report to the ECB. DNB also receives instructions from the ECB.

As LSIs generally have higher funding costs than larger institutions, the business model is more challenging for them. Supervision, as a result, has become more intrusive. One noteworthy matter in the Netherlands is wholesale funding. A large part of Dutch household savings goes to pension funds, since participation is mandatory. As a result, there are fewer retail deposits available for banks than in other euro-area countries. The loan-to-deposit ratio in the Netherlands rose rapidly in the past two decades and is currently at 180 percent, way above the euro-area average (around 130 percent) and much higher than in the US or Japan (Jansen *et al*, 2013). Some LSIs rely for up to half of their funding on wholesale funding, and the larger banks rely heavily on this channel as well. The loss of the asset-based-securities market due to the credit crisis still hurts the Dutch banking sector, and Dutch banks have a considerable funding gap. Secured funding is cheaper than unsecured, but results in asset encumbrance, which is monitored closely by DNB.

Dutch experiences with European banking supervision

The new supervisory framework is generally well respected by the Dutch banking community, because the ECB has managed to attract qualified supervisors. However, the banks have had to get used to on-site visits, which are a new feature in the Netherlands, and the multiple data-requests. In fact, it is felt that the ECB acts in a formal and legalistic way. It is also not always clear whether the ECB or DNB

is in charge of certain issues. While the functioning of JSTs is improving, occasionally decisions are not taken in due time. There are delays between the enquiries conducted by supervisors and the feedback on the results. Also, the follow-up on data requests can be rather long. More widely, bankers perceive a lack of transparency in the decisions taken by the ECB. Nevertheless, the Dutch banking community is engaging with the ECB to improve processes. Dutch banks fully support further harmonisation of the single rulebook.

Our own assessment is that the ECB is indeed more intrusive than the DNB was previously. This was to be expected, and strengthens the supervisory process. Regarding the multiple data requests, delayed feedback and lack of transparency, the ECB could streamline its own procedures in cooperation with the banks. Notwithstanding the teething problems of the JSTs, the working of the JSTs is a major improvement for the quality and efficiency of cross-border supervision of Dutch banking groups.

Risk weights on residential mortgages

Dutch households have a higher exposure to the financial sector than the euro-area average. This is for two reasons. First, the Dutch pension system is capital-based, and pension savings are currently running at 178 percent of gross national product; this excludes life insurance policies which, if added, would amount to 200 percent of GNP (CBS Statline, own calculations). Second is the high proportion of interest-only mortgages with a high LTV. Early in one's career, these high LTVs are needed since mandatory pension premiums run high at around 20 percent of one's income. Over one's lifetime, the two exposures may net out, but they expose Dutch households to considerable uncertainty regarding their future flow of funds during the period of the mortgage. This is one of the reasons why Dutch consumption is more pro-cyclical than in other euro-area countries where pensions are based on a pay-as-you-go system (SER, 2013). However, with the baby boomers now retiring, pro-cyclicality may become a problem in

those countries with a pay-as-you-go system because of pressures on government budgets.

Before the 1990s, Dutch mortgages were primarily funded by life insurers and pension funds. Given the long duration of the liability structure of these institutions, it is only natural that this should be matched on the asset side with mortgages of similarly long duration. More recently, Dutch pension funds have massively shifted their investments outside the Netherlands for purposes of diversification. Banks have stepped in and built up large mortgage portfolios over the past two decades. The demand for mortgages also grew because of considerable pension premium hikes and the favourable income tax treatment of debt financing, which explains the high proportion of interest-only mortgages. Demand was further spurred by the growth in two-income households, which can typically apply for larger mortgages. As a result, Dutch banks have come to hold large portfolios of mortgages with high LTV ratios, which are often interest-only mortgages.

Until recently, Dutch banks under the internal ratings-based (IRB) approach were operating with a capital weight of around 18 percent for mortgages. This is considerably lower than the standardised approach under current Basel regulations, which requires a 35 percent risk weight up to 80 percent of the market value and a 75 percent risk weight for the part of the exposure above 80 percent. Under the current standardised approach, KPMG (2015) estimates that the capital requirements of all Dutch mortgages would have a risk weight of about 30 percent.

The combination of high LTVs and low risk weights caught the attention of the ECB, which started to ask questions about the mortgage portfolios of Dutch banks. This did not lead to adjustments in the comprehensive assessment in October 2014, but the ECB is closely monitoring Dutch mortgages. To gain further evidence about the risks and performance of Dutch mortgages, European banking supervision (spurred by DNB) has started an on-site review of mortgage portfolios.

Prompted by the US supervisors, who prefer simplicity over internal models, the Basel Committee is currently reviewing risk weights for mortgages and has proposed a floor in the IRB approach based on a revised standardised approach. For the Dutch banks, this would increase the risk weighing to 40 percent (KPMG, 2015), a considerable hike from the current 30 percent given the large mortgage portfolio.

For this reason, Dutch banks are currently selling parts of their mortgage portfolios, partly to pension funds and insurers, and have reduced the supply of mortgages. In anticipation of this, and of other housing-related regulation, which requires new homeowners to repay the loan through an annuity, the Dutch housing market has stalled for a number of years. It is only now recovering thanks to the very low interest rates.

Two years ago, about 30 percent of mortgages were in negative equity according to CBS (2015), but that number is declining. Furthermore, mortgages with negative equity are concentrated in the more recent mortgages of younger families. Nevertheless, the loss rates are less than 0.1 percent, and foreclosures are even lower. The number of households in arrears is also very low. Expected default rates are among the lowest in the EU. One reason for the low loss rates on mortgages is the strong legal position of lenders in relation to borrowers under the Dutch civil code. For this reason, Dutch banks complain that the new rules do not take into account the high-quality payment history on Dutch mortgages and the legal environment. Here the one-size-fits-all approach, which mainly comes from Basel and EU legislation in the aftermath of the credit crisis, is biting. The DNB, however, has not (yet) been able to convince the Basel Committee to take the specific situation of Dutch mortgages into account. It appears that banks will have to live with this new reality, and should continue slimming down their exposure to residential housing or increase their capital. Given this, a revision of the Dutch bankruptcy law might also be considered to make defaults on mortgages easier, which would arguably contribute to the EU objective of capital markets union. In

this sense the one-size-fits-all supervision in the banking union is not promoting the best standards, and supervisors appear to promote a race to the bottom with their unconditional approach that neglects local institutional factors. Recently, DNB has threatened to block stronger capital requirements (in the form of capital floors for mortgages) in the Basel Committee.

Macro-prudential aspects

The euro area now has a single monetary policy and a (still incomplete) banking union. The outlines of a capital market union are still being drawn, but the difficulty of harmonising insolvency laws holds back progress in this direction. In such an unbalanced environment, monetary policy can wreak havoc. The ECB, given its responsibilities for monetary policy and banking supervision, has an in-built incentive to support the banking sector without taking due account of the whole financial sector. In a country with high pension savings like the Netherlands, the current low rates pose a problem for pension funds and life insurers. Future liabilities in these entities are discounted at market interest rates. Since these rates are near zero, their solvency is under pressure.

During the gold standard era between 1871 and 1905, countries such as Germany, the UK, the United States and the Netherlands experienced prolonged periods of deflation, but interest rates always remained positive. The current negative interest rate environment is unprecedented, and at least partly policy-induced. It effectively allocates subsidies to dithering governments and weak banks, while creating heavy distortions in parts of the financial markets.

In the Dutch system, tinkering with interest rates has an immediate effect on aggregate demand. A balanced approach should take such ramifications into account. This is why a macro-prudential framework has been developed. Unfortunately, this is left to each country separately. For example, the Netherlands, Sweden and the Czech Republic are the only countries that apply a systemic risk buffer of 3 percent to

the largest institutions (see Figure 6 in the European Overview). This uneven playing field suggests a race to the bottom. As a result, frictions arise between monetary policy and bank supervision, which are conducted at the euro-area level, while the insurance and pensions sectors remain supervised at the country level. A more balanced evaluation would examine the challenges faced by these financial sub-sectors and monetary policy. This requires establishing European banking supervision within a proper framework of macro-prudential policy for the financial system as a whole. The current preoccupation with the inflation goal overlooks the explosion of credit in other areas of the financial sector. Negative nominal interest rates are hurting insurers and pension funds and are historically unprecedented. A similar process was at work in the run-up to the credit crisis. A reform of the European macro-prudential policy framework is needed to rectify such imbalances.

10 Portugal

António Nogueira Leite

The Portuguese banking landscape

As of September 2015, Portugal had 159 credit institutions, of which 67 were banks, 88 were mutual agricultural credit banks and four were savings banks. On 30 September 2015, they had total assets of €452.7 billion, €261.5 billion in loans and advances to customers, €250.9 billion in deposits, and an average loan-to-deposit ratio of 104.2 percent. Borrowing from the European Central Bank (ECB) was €25.1 billion. In September 2015, the aggregate Common Equity Tier 1 (CET1) ratio for the system was 11.6 percent¹⁰³.

In contrast to the euro area as a whole, growth of the assets of Portuguese banks continued well beyond the start of financial crisis: the average growth rate between 2009 and April 2011 was 8.7 percent, against a mere 1.8 percent for the euro area. Between the start of the Portuguese assistance programme in May 2011 and September 2015, however, total assets in Portugal's banking sector decreased by 20.8 percent¹⁰⁴.

There are currently four institutions designated as significant, representing roughly 60 percent of the market by any of the usual indicators. The largest is Caixa Geral de Depósitos (CGD), a state-owned

¹⁰³ CET1 ratio calculated in accordance with the new CRD IV/CRR transitional arrangement. Most numbers in this paragraph are from the Portuguese Banking Association (November 2015 Report) and ECB.

¹⁰⁴ Source: ECB.

bank with a significant footprint outside Portugal – it owns banks in Brazil, South Africa, Macao, East Timor and all former Portuguese colonies in Africa with the exception of Guinea-Bissau. Millennium BCP is the largest private-sector group, with significant operations in Poland and also in Mozambique and Angola. By end-2015, Angola's Grupo Sonangol was its main shareholder with 18 percent, followed by Spain's Banco Sabadell with 5.1 percent. Novo Banco is the 'good bank' that emerged from the resolution of Banco Espírito Santo (BES) in August 2014. Banco Português de Investimento (BPI) is the smallest of the four. As of April 2016, BPI's main shareholders were Spain's CaixaBank (44 percent) and Angola's Isabel dos Santos (close to 20 percent)¹⁰⁵, and it in turn owned a controlling position (51 percent) in Angola's largest and most profitable bank (Banco de Fomento de Angola). In addition, Spain's Santander Group has a significant presence in Portugal through its wholly owned subsidiary Santander Totta, which also in late December 2015 bought the performing operation of Banco Internacional de Funchal (Banif), a smaller bank that had gone through a resolution process¹⁰⁶.

The Portuguese supervisory authority is the national central bank, the Bank of Portugal, which now also has resolution authority.

The 2011-14 assistance programme

In April 2011, the Republic of Portugal sought assistance and obtained a three-year assistance programme from the European Union, the ECB and the IMF. The package was agreed in May 2011 and included a €78 billion loan, split equally between the European Financial Stabilisation Mechanism, the European Financial Stability Facility and the IMF. Of these funds, €12 billion was to be reserved for the country's

105 On 18 April 2016, Caixa Bank announced a preliminary offer to take full control of the bank. It was the second announcement in less than a year.

106 In addition to this sale, a vehicle (Oitante) for non-performing assets (mostly NPLs, secured and unsecured) and a residual bad bank, which retained the name Banif, were created.

banks, which had to raise their CET1 ratios to 9 percent in 2011 and to 10 percent by the end of 2012¹⁰⁷. The programme also included a fully-funded capital backstop facility of €35 billion, as well as “*safeguards to support adequate banking system liquidity and for strengthening the supervisory and regulatory framework*”¹⁰⁸. The backstop facility was independent from the aforementioned €12 billion capital facility and was meant to facilitate the wholesale financing of Portuguese banks in the presence of the downgrading of their respective ratings below investment grade. These measures were intended to create the conditions for an orderly deleveraging of private-sector balance sheets while preserving financial sector stability.

The banks’ dependence on ECB funding had increased sharply in the months before the programme. As a result, the programme required all major banks to produce quarterly updates of their funding and capital plans.

The Portuguese economy had accumulated imbalances in the decade prior to 2011. During this period, the economy became ever more dependent on bank credit, posting substantial accumulated deficits on the part of both the government and non-financial corporations. The adjustment initiated in 2011 noticeably changed this trend, with the total financing needs of the economy decreasing by 13 percent of GDP in the six years ending in December 2015¹⁰⁹.

As a result of the accumulated borrowing prior to 2011, which was mostly bank lending, private corporations started a significant deleveraging process which led to a decline in their accumulated debt in excess of 20 percent of GDP between the start of the programme and December 2015¹¹⁰. However, at the end of 2015, the debt of

107 Only half the amount, ie €6 billion, was used to recapitalise Portuguese banks during the three-year bailout programme.

108 Portugal’s Letter of Intent to the IMF, May 2011.

109 Source: Statistics Portugal and IGCP (Portugal’s Debt Management Agency).

110 Source: Bank of Portugal.

non-financial corporations still represented more than 145 percent of GDP, the same level as in December 2008¹¹¹. Because most of the financing of corporate debt had been done through bank lending, this trend was followed by the very substantial deleveraging of the balance sheets of banks operating in Portugal.

The adjustment of Portugal's economy after 2011 had a significant impact on banks. This, together with increased capital requirements and a new institutional framework for regulation and supervision, led to a major overhaul of the competitive landscape in Portugal's banking sector, leading to its greatest transformation in decades¹¹². The deleveraging process after the beginning of the adjustment programme led to a 19 percent reduction in total banking assets between May 2011 and June 2015. The equivalent figure for the euro area was a mere 2.8 percent decrease¹¹³.

Credit-to-deposit ratios for the system had been rising steadily since 2000, when the ratio was 115 percent, reaching a maximum of 161.5 percent at the end of 2009¹¹⁴. With the implementation of the adjustment programme and following the troika's instructions, the Bank of Portugal recommended that the (then) eight largest banking groups reduce their loan-to-deposit ratios to 120 percent by the end of 2014. The credit-to-deposit ratio decreased steadily, from 158 percent at end-2010 to 140 percent at end-2011, and 104.2 percent at the end of September 2015. Even so, the downgrading of Portugal by the three main credit rating agencies, which occurred during 2010 and 2011,

111 Deleveraging of non-financial corporations continued throughout 2015 at a slightly slower pace than in the previous years.

112 In March 1975, all Portuguese-owned banks were nationalised, while foreign banks then operating in Portugal were left untouched. Everything else was kept unchanged. This time, there was a smaller change in the ownership structure of banks but the change in the sector's structure was much more pronounced, and likewise the regulatory framework faced by banking institutions.

113 Source: ECB.

114 Credit net of impairments, including securitised and non-derecognised loans. Source: Bank of Portugal.

adversely affected the ratings of Portuguese banks¹¹⁵ and led to a substantial increase in the amount they borrowed from the ECB, from €10 billion in December 2008 to €60.5 billion in June 2012¹¹⁶. This amount started to decrease in mid-2012, and was €25.1 billion in September 2015. Correspondingly, the share of Portuguese banks in total funding granted by the ECB fell from 8.1 percent in April 2011 to 3 percent in June 2015¹¹⁷.

The rise in credit risk led to a substantial increase in the impairments recorded by banks, which rose from €3.56 billion in 2010 to €6.6 billion in 2011, €7.2 billion in 2012, €6 billion in 2013, €8.2 billion in 2014 and €8.5 billion in 2015¹¹⁸. The simultaneous decrease in net interest income, from €7.9 billion in 2011 to €5.6 billion in 2014, affected the profitability of banks¹¹⁹. As a result, in recent years the return on Portugal's banking assets fell sharply. In aggregate, Portuguese banks only returned to profit in the first half of 2015. In December 2015, NPLs represented 12 percent of total loans. In spite of this significant deleveraging, however, households and non-financial corporations have remained more dependent on bank loans than the euro-area average: in December 2014, loans to private customers were 72 percent of GDP in Portugal versus 51.7 percent for the euro area, while loans to non-financial firms were 50.4 percent in Portugal and 42.4 percent in the euro area¹²⁰.

Portuguese deposits have remained more stable than in some other countries facing economic and financial adjustment. Deposits from

115 Among major banking groups, only Santander Totta retained investment-grade status.

116 Source: Bank of Portugal.

117 Source: Bank of Portugal, ECB.

118 Source: Bank of Portugal.

119 At the time of writing there is no equivalent figure for 2015.

120 Source: AMECO, ECB. It includes only loans and not debt-issued securities. Although there are no more-recent figures for Portugal it is clear that the relative assessment did not change meaningfully in 2015.

the non-monetary sector were €208 billion in May 2010, reached a peak of close to €240 billion in early 2012, and stood at €219 billion in June 2015¹²¹.

Efforts to ensure the capitalisation of most banks led to an improvement in the quality of banks' own funds. Core Tier 1 (CET1) ratios were 8.7 percent in December 2011, 11.5 percent in December 2012, 12.3 percent in December 2013, 11.3 percent in December 2014 and 11.6 percent in September 2015¹²², ¹²³.

In accordance with the programme, from 2011 the Bank of Portugal conducted several inspections of the largest Portuguese banking groups to assess whether the accounted impairments were adequate. The first exercise occurred in the second half of 2011 and was intended to perform an assessment of credit portfolios, the validation of credit risk capital requirements and the assessment of parameters and methods used in stress testing. It concluded that there was a need to reinforce impairments by €596 million¹²⁴. The second exercise took place in the second half of 2012 and assessed credit exposure to real estate, leading to the need to reinforce impairments by €474 million. The third inspection, in June and July 2013, assessed €93 billion of credits and led to a need to reinforce impairments by €1.1 billion. The fourth and final inspection occurred between October 2013 and March 2014 and centred on 12 large clients across the system, producing a further need to reinforce impairments by €1 billion.

From the beginning of the programme until mid-2015, six banks used €16.53 billion of the €35 billion state guarantee facility, totalling

121 Source: ECB.

122 Source: ECB, using data from bank groups and domestic banks on a consolidated basis, excluding the insurance business, when applicable.

123 Since the beginning of 2014, Portuguese banks have had to follow the new CR-DIV/CRR transitional arrangements for the adequacy of own funds (CET1 ratio of 7 percent). The Bank of Portugal obliged Portuguese banks to meet a minimum CET1 ratio of 10 percent by December 2013.

124 Source: Bank of Portugal.

16 new operations¹²⁵. This line was created to mitigate banks' financing pressures and to support collateral buffers. That is, the government extended guarantees on bank bonds to be used as temporary collateral for Eurosystem financing¹²⁶. In addition, to strengthen the capital position of specific banks, between 2012 and 2014 public injections of new capital through issuance of new shares were made into CGD (€750m) and Banif (€700m). State-sponsored convertible bonds (CoCos) were allocated to Banif (€400m), Millennium BCP (€3 billion), BPI (€1.5 billion) and CGD (€900m). Of these, only €3.75 billion has been repaid¹²⁷. In 2014, the newly-established Portuguese Resolution Fund injected €3.9 billion into Novo Banco in the process of resolving BES.

Supervision during the programme and beyond: the Bank of Portugal and European banking supervision

Problems in the Portuguese banking sector started to emerge before the 2011 programme. In 2008, a small bank (BPP, Banco Privado Português) was liquidated, but the government nationalised ailing BPN (Banco Português de Negócios) for fear of destabilising the sector. This near-bankruptcy and subsequent nationalisation prompted a parliamentary inquiry and several criminal cases, which uncovered several episodes of apparent excessive leniency (maybe naiveté) towards BPN by the supervising authorities in the years prior to nationalisation. These events and subsequent losses at BPN post-nationalisation generated unprecedented pressure on the Bank of Portugal, which was seen as lacking initiative and demonstrating excessive caution prior to action: for close to ten years BPN had been seen by the market as a non-compliant institution although it benefited from apparent complacency on the part of the supervisor, who followed the old-time

125 Source: Portuguese Ministry of Finance, Directorate General of Treasury and Finance.

126 Similar schemes have been implemented in several other euro-area countries.

127 In any event, a substantial part of the recapitalisation facility was left unused.

common practice of ‘trusting a banker’s word’. In spite of this, and before the case was made public, the supervisor was already taking steps to increase its ability to effectively regulate the Portuguese banking sector. After years of preparation and study, the Bank of Portugal had promoted internal changes, separating solvency and capital adequacy supervision from behavioural supervision, reinforced the supervision area with new specialists and, after 2008, started supervising *in situ* all major banks, with permanently embedded teams monitoring their day-to-day activity. In other words, the Bank of Portugal’s supervisory approach was to a great extent proactive, even though the effectiveness of the changes in terms of the daily supervisory and regulatory practice fell below everybody’s expectations.

In spite of this reinforcement and of the collaboration with the troika’s experts during the programme, the Portuguese authorities were unable to avoid the failure of BES, then the third-largest bank operating in Portugal, in July 2014. This event, occurring after years of allegedly tight scrutiny and examination involving the Bank of Portugal, the ECB (as part of the troika even before the start of European banking supervision in 2014), the European Commission and the IMF, was clearly detrimental to the public perception of the effectiveness of bank supervision and regulation¹²⁸. The negative public perception in Portugal of the effectiveness of banking regulation concerns all relevant players, although local politicians (especially members of parliament) have singled out the Bank of Portugal as the source of the lack of effectiveness and inadequate pre-emptive measures that these cases arguably illustrate.

The ECB’s comprehensive assessment of euro-area banks happened at the same time as the BES debacle. The assessment initially included CGD, BPI, Millennium BCP and Espírito Santo Financial Group, but the BES resolution led to the latter being removed from

128 In spite of this lack of confidence expressed in the media and via opinion polls, total deposits in Portugal were not affected, with most of the deposits departing BES/Novo Banco going to other Portuguese banks, notably state-owned CGD.

the list. CGD and BPI passed the test, while Millenium BCP failed the stress test under the adverse scenario¹²⁹. The asset quality review of 2014 strengthened confidence in the Portuguese banks' balance sheets. Nevertheless, some evidence indicates that, though it was demanding and fairly rigorous, the examination failed to take into account the fact that some of the banks' assets are parked at above-market prices in so-called 'restructuring funds'. From 2011 onwards, some of the major banks, notably BES and Millenium BCP (and to a lesser extent Montepio, a smaller bank, and only residually CGD), transferred NPLs and other soon-to-be-troubled loans to nominally independent funds at close to book value, in exchange for participating units in these funds, becoming the sole participants of each of these funds. It seems that, as of the time of writing, these units are still valued above market prices, in spite of recent adjustments. Although the Bank of Portugal has placed a capital surcharge on such holdings, there is an obvious potential for further capital consumption in case they are brought to market prices, or if the funds fail to generate the additional value necessary to bring the assets' intrinsic value close to the current balance sheet valuation¹³⁰. Total amounts parked exceed €3 billion. A mark-to-market valuation of the banks' holdings in some of these independent vehicles could enhance the size of their capital needs, especially for those that had most recourse to such schemes. True sales of NPL portfolios have been small in number, thus making it more difficult to provide a market test of the value of problematic assets.

129 The Bank of Portugal added that BCP had already identified a set of measures to fully cover the shortfall detected, and that, in the particular case of BCP, the stress test did not fully reflect the globally positive developments resulting from the implementation of the restructuring plan negotiated with the European Commission.

130 The market sentiment is that, in most cases, these values are currently above market levels, thus implying a hidden loss.

Another controversy arose with the resolution in December 2015 of Banif (designated an LSI by European banking supervision). As mentioned above, the bank benefited from state support in 2012, but the operation's approval by the European Commission's Competition Directorate-General never took place because DG COMP maintained that Banif had failed to demonstrate sustainable economic viability. In the week prior to the resolution, leaks appeared in the Portuguese press that the bank had to be resolved. The subsequent bank run led to its application for emergency support, which was denied, and resolution mechanisms were then activated. The operation resulted in the separation of the original bank into a bad bank, a platform managing NPLs (named Oitante), and the sale of branches, deposits and performing loans to Santander Totta for €150 million. Public support from the Portuguese authorities amounted to €2.255 billion, to cover future contingencies, of which €1.77 billion came directly from the Treasury and the remaining €489 million was provided through Portugal's resolution fund, benefitting from a government guarantee¹³¹.

The Bank of Portugal's supervision of Banif has been called into question by many politicians and commentators. As noted previously, the Bank of Portugal has established permanent teams in the most relevant institutions and has been showing a more proactive stance than in the past. Nevertheless, the Banif case – notably the lengthy and inconclusive period of discussions involving the bank's management, the Bank of Portugal, the Government of Portugal and DG COMP – was seen by many as further evidence of the supervisor's lack of effectiveness, and thus reignited criticism of the Bank of Portugal's allegedly dovish approach. This has led the public to take a more favourable attitude to the direct role of the ECB in supervising Portuguese banks, although, as noted before, more sophisticated analysts have raised doubts about the ECB's ability to effectively supervise the system

131 When the resolution occurred, the Portuguese state was already creditor for €825 million, €700 million of which was shares of the bank and €125 million was unpaid CoCos.

at this juncture, since the ECB was involved in the monitoring of Portuguese banks during the 2011-14 assistance programme and was unable to pre-empt the problems in BES and in Banif. There has been great pressure, especially from politicians, for changes in the appointment of the Bank of Portugal's top officials, especially the governor, and their accountability to elected representatives. On 2 May 2016, the government announced the creation of a working group including the governor of the Bank of Portugal, the president of the insurance regulator and the president of the securities regulator, to propose new institutional arrangements for financial markets regulation, including bank supervision. In addition, the pressure on the Bank of Portugal from politicians and public opinion might have smoothed the ECB's entry into direct regulation of local players, by indirectly fostering a collaborative approach between the staff of the two institutions: there are absolutely no reports of any problems in the daily relationship between the supervisory staff of the ECB and Bank of Portugal.

There is, however, a growing sentiment that the Bank of Portugal is, in practice, being led by the ECB (and, in some cases, also by DG COMP) in addressing some of the most delicate situations, such as the recent resolution of Banif. In the Banif case, the Portuguese press made express reference to an email sent by Danièle Nouy to Portuguese Finance Minister Centeno¹³² allegedly promoting Santander as the purchaser of the 'good bank' and mentioning her knowledge that alternative offers from US funds were found not to be compliant with European state aid rules by the European Commission. This episode reinforced the perception of a de-facto secondary role played by the Bank of Portugal, although the latter publicly assumed responsibility for the resolution.

One argument that is often made in Portugal is that the approach to bank problems taken by the Bank of Portugal during the 2011-14

132 See among other reports Bernado Ferrão and João Pereira, 'Bruxelas ordenou venda do Banif ao Santander,' *Expresso*, 22 January 2016.

assistance programme was gradual, avoiding the upfront capitalisation of banks that had been suggested by the troika. In January 2016, Governor Costa stated that he opposed the upfront approach *“since that would imply resources not available in Portugal’s rescue package”*. He added that *“an exercise performed at the time showed that such front loading would have a financial impact between 28 percent and 33 percent of GDP”*¹³³. There is a sense in the market that the scrutiny became gradually more demanding and rigorous and that the advent of European banking supervision in 2014 was an obvious incentive for improved procedures at the Bank of Portugal. Greater proactivity, first by the Bank of Portugal and now with direct ECB intervention, has improved the quality of the banks’ balance sheets. Gradual recognition of impairments, as seen above, has had a direct effect on the quality of bank statements but has also generated increased stress on gradually worn-out capital ratios. At the time of writing, there are great expectations about the handling of the forthcoming recapitalisation of state-owned CGD, seen by depositors as a cornerstone of Portugal’s banking sector (with more than four million private clients, most of them depositors, in a country of 10 million inhabitants), and about the positions of DG COMP and the ECB on the issue.

It is also expected that the ECB will be more demanding on the suitability of the shareholders of banks large and small. This is an area in which the ECB has clearly increased compliance requirements. In the case of BPI, the ECB forced the separation of Portuguese activities from its large Angolan exposure. This resulted in negotiations involving the bank management, the Santoro company of Angola (owner of close to 20 percent of BPI and 49 percent of Angola’s BFA, in which BPI has a 51 percent controlling stake), CaixaBank (BPI’s main shareholder with 44 percent of the capital, but voting rights that were until recently restricted to just 20 percent), an envoy from Portugal’s prime minister, and even the President of the Republic. After an agreement

133 University of Lisbon, January 2016.

was announcing to the market, the situation became confused and the government of Portugal eventually published a decree eliminating restrictions on voting rights in banks, including BPI. CaixaBank then launched an offer for 100 percent of BPI's shares, and negotiations between BPI's shareholders subsequently resumed at the end of April 2016.

All in all, the start of SSM regulation in Portugal has been well accepted, at least for daily supervisory activities, and the day-to-day joint work with the Bank of Portugal seems to be running smoothly. But it is perceived differently by Portuguese public opinion and the business community when there are large one-off interventions, because the sequence of such interventions (BPP, then BPN, then BES and most recently Banif) has generated public resentment towards banks and the use of public money or public guarantees to rescue them. The business community expects that improved regulation could reduce the risk of such occurrences, and understands that guaranteeing financial stability in an unstable environment comes at a cost.

In political terms, the most talked-about issue at time of writing is the ownership of banks and the apparent bias of the ECB in favour of a consolidation path that could allow major Spanish banks to take over all of the major Portuguese banks except CGD, the privatisation of which is not currently being considered. Although there is no direct evidence of an actual bias, this theme has been on the political agenda since Santander Totta's involvement in the resolution of Banif. It has led to calls from a number of prominent individuals, including Novo Banco's first CEO (for a brief period in the summer of 2014) and several past finance ministers, for the cancelation of the current process of selling Novo Banco, though a cancelation remains highly unlikely. Unlike the previous government, which insisted on non-interference, the current government has openly defended direct intervention in supposed coordination with supervisors and market players, as the BPI case illustrates. The president, who constitutionally has no say

in these matters, has admitted to being involved at least in the BPI shareholder dispute, something that would have been highly unlikely under the previous president Cavaco Silva. On 1 May 2016, a manifesto signed by several previous ministers, business leaders and top executives of the Bank of Portugal, including a former governor, called for caution in the process to avoid “*dominance by one single country*”, an obvious reference to the possible scenario in which Spanish banks might end up owning most of Portugal’s banking sector. The situation remains highly fluid at the time of writing, meaning the lessons for European banking supervision are not yet clear.

11 Spain

David Vegara

The Spanish banking system

The financial crisis has profoundly changed the Spanish banking system. The housing boom prior to the crisis, accumulated macro-economic disequilibria, the disruption in euro-area sovereign debt markets and the sharp reversal of private external financing flows beginning in the second half of 2011 all combined to put the whole system under severe stress.

The most affected subsystem has been the savings banks (Cajas). The crisis revealed several weaknesses in many of them. Savings banks previously had no actual shareholders; they were governed by a broad range of public and private stakeholders, and they did not distribute profits. Consequently, their ability to raise external equity was limited, contributing to inadequate capital buffers in the run-up to the crisis. Political interference by the savings banks' public-sector stakeholders also adversely affected financial stability, while a division of supervisory responsibilities between the Bank of Spain and regional governments undermined the effectiveness of oversight of the savings banks (IMF, 2014).

An ESM-financed financial sector programme was adopted in July 2012 amid a deep recession, severe financial market turmoil, sharply rising NPLs, falling bank capital, soaring borrowing costs for banks and the sovereign, tighter credit conditions for households and firms, shrinking economic activity and rising unemployment. All

these left a significant portion of the banking system undercapitalised, which in turn further undermined confidence and the already very difficult outlook.

The programme provided around €40 billion to support the recapitalisation process. An independent asset quality review and stress testing exercise identified those banks that were sound, those that were weak but viable (and were subsequently recapitalised), and those that were unviable (for which restructuring/resolution plans were adopted). Additional measures included the bail-in of unviable banks' subordinated debt and preference shares, the transfer of loans and other assets to a newly incorporated asset management company (SAREB, Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria) and private capital-raising efforts. The legal regime for savings banks was improved, and the Bank of Spain's regulatory and supervisory powers and procedures were strengthened.

As a result of this process and of previous injections of public capital, the Spanish government (via its Fund for an Orderly Restructuring of the Banking System, or FROB) became the controlling owner of a significant part of the banking sector, holding an estimated 18 percent of all loans in the system, with plans to gradually divest. Ten institutions have been resolved and the number of savings banks reduced to eight, from 45 at the beginning of the crisis. The ESM-supported programme was completed in January 2014, and Spanish banks passed the SSM's 2014 comprehensive assessment with only minor capital needs identified (only one Spanish bank, Liberbank, was among the 25 that failed the assessment as of end-2013, and it had no capital shortfall left as of September 2014).

Even so, the Spanish banking sector has not completed its recovery. The sector-wide return on equity was around 5 percent in 2015, well below the cost of capital. Credit growth has been negative in Spain since the beginning of the crisis and only in early 2016 did it start to show timid signs of positive year-on-year growth, while the sector has

seen a decrease of over 25 percent in its labour force and number of branches since 2010 (Banco de España, 2014). The total consolidated assets of Spanish banks, including Spanish and foreign operations, reached €3.66 trillion, or 3.6 times GDP (Banco de España, 2015).

In the wake of the consolidation of savings banks, there are now 14 significant institutions. These include the two large international groups, Santander and BBVA; three domestic medium-sized private-sector groups, namely Banco Sabadell, Banco Popular and Bankinter; seven groups resulting from the consolidation of savings banks, namely Caixabank, Bankia (still owned by FROB), Unicaja, Ibercaja, Kutxabank, Liberbank and Banco Mare Nostrum (owned by FROB); Abanca, a former savings bank acquired in 2014 by Venezuela's Banesco group; and Cajamar, a cooperative group. Less significant institutions include small rural savings banks and subsidiaries of international banking groups.

The Bank of Spain (Banco de España) is the national supervisory authority while the FROB acts as the national resolution authority.

Overall assessment

The establishment of European banking supervision and its initial steps are generally seen in a positive light by the Spanish banking community. With the advent of the SSM, the European project followed the route of increased economic and financial integration in difficult times. Together with improved fiscal surveillance (the fiscal compact) and the creation of the ESM, the banking union is seen as having enabled the euro area to increase its financial and economic ties significantly, even though it was done in the middle of a severe financial crisis.

European banking supervision, which was difficult to imagine not long ago, is now a reality and has achieved significant successes in the face of the main challenges that confronted it. On the organisational front, it had to establish itself and hire hundreds of highly qualified professionals. On the institutional front, it had to develop a brand and

a reputation quickly and in difficult times.

In general, private-sector participants in the Spanish banking system point out that the SSM has contributed decisively to the financial stability of the euro area and has established itself as a professional and reputable supervisory institution, and is on its way towards establishing a genuine European supervisory culture. All are impressive achievements, especially given the diversity of the previous supervisory cultures of euro-area member states. Both private and public players underline that before European banking supervision was born, there seemed to be less consensus among national supervisors on how and what to supervise, than among monetary policymakers before the creation of the euro.

Furthermore, on top of all these achievements, the SSM begins its second year at full speed with a general consensus among private-sector participants that it has been able to design a framework that is broadly perceived as fair by the supervised entities, with no critically relevant biases.

As in any process of such complexity and ambition, there are still areas where full speed or a steady-state situation has not yet been achieved. On this, comments can be grouped in four areas:

Ex-post versus forward-looking supervision

Pre-SSM, supervision by the Bank of Spain had a reputation of being quite intrusive (including through on-site supervision), with a focus on data, asset valuation, classification for accounting purposes, credit risk analysis, collateral valuation and provisioning. The main objective was to identify potential provisioning deficits. The central bank was also responsible for defining the accounting framework for banks. This approach could be labelled *ex-post* supervision. By contrast, the forward-looking focus of the SSM has been a real change.

The SSM has tended to focus on elements with a forward-looking component: sustainability of the business model, corporate governance, risk management and risk appetite, whether procedures and

reporting are adequately established and clear, and deadlines fulfilment, among others. It seems to focus more on how the institution is organised internally, and on whether it is well prepared for unexpected events, being quite hands-on in this regard. It also leads a process of convergence towards best practices in these areas. Thus, the SSM-led change for Spanish banks, unlike in other countries, has not been so much an issue of the intrusiveness of supervision, but rather an issue of its focus and scrutiny.

The new approach has arguably improved the quality and broadened the scope of supervision, with internal implications for the banks, from the organisation of credit committees all the way up to their top management and boards. The new system is more based on rules and procedures, but also on significant amounts of information being provided by the banks at the ECB's request without full understanding of its purpose and final use, an area in which the ECB could provide some further feedback.

While this broader and more systematic approach is welcome, it would benefit from incorporation of more elements of *ex-post* supervision, with a focus on asset valuation, classification or provisioning policies. Admittedly, such issues are still to a great extent under the umbrella of national supervisors, but a framework for a common methodology and interpretation could be established. In fact, this is what was done in the 2014 asset quality review or, more recently, in the review of NPL definitions. The implementation of the IFRS9 standard for financial instruments accounting will be another good opportunity for this, in a context in which member states will also have to limit the use of national exceptions.

From a legal perspective, many of the tools for both *ex-post* and forward-looking supervision will be kept in the hands of national authorities and policymakers, at least for a while (for example some interpretations of accounting standards). But even so, there should be scope for convergence towards best practices and a broadening of the scope of supervision. This would also help mitigate the risk of a

one-size-fits-all model of supervision (see below).

Communication issues

Communication issues are always a challenge when new institutions are set up, and European banking supervision has been no exception. It has not helped that deadlines have been very tight, and that the initial steps took place in the middle of a difficult situation with a European banking sector emerging from the financial crisis.

Investors' appetite for Spanish banks' securities, and hence their cost of capital, have been affected by uncertainties about the final treatment of deferred tax assets and, more recently, about the framework to determine banks' maximum distributable amounts. Lack of clarity on whether and how to communicate SREP exercise results has not helped either. More generally, there has also been uncertainty about whether the current levels of capital were seen as sufficient by ECB banking supervision, or whether additional requirements were still lying ahead. In this context, the recent ECB clarifications that capital requirements would not increase further have been very welcome, as have been a series of clarifying workshops held by the SSM on a variety of issues that have improved communication and feedback to and from banks.

There is concern about the results of several ongoing discussions, including those on potential changes in risk weights for public debt, IFRS9 implementation and internal models. All of these could have significant impact, and hence communication will continue to be very relevant.

Finally, while the whole institutional setup of the banking union is rather complex, with several European-level institutions (such as the ECB, SRB and EBA) interacting with national authorities, it is essential to maintain adequate coordination among the different institutions and to ensure consistency of messages and criteria.

Subsidiaries, diversification and the risk of a one-size-fits-all approach

The Spanish international banks' expansion into Latin America and other regions was undertaken via local subsidiaries with a high level of autonomy. Supervision is undertaken at local level, as is capital and liquidity management in most cases.

Some elements of this model seem not to have been taken sufficiently into account in the SSM's supervision of international groups. The subsidiary model is less common among intra-EU or intra-euro-area cross-border banking operations, where branches and a less decentralised framework are more widely used. This latter model can certainly be seen as more in line with an ideal EU single market for banking services, because it is likely to reduce fixed costs, enhance financial integration and generate economies of scale. But it is less common in the context of non-EU retail banking operations.

In addition, it would seem reasonable to accept that the risk profile and correlations (macro, but not only) are not the same intra-EU and with Latin America, for example. Together with the different levels of risk, these differences should be taken into account in various supervisory areas. Among others, the design of stress test scenarios should consider the lower correlation of economic cycles and other specific issues: for example, not assuming a simultaneous deflationary process in several big Latin American economies as a likely scenario. If correlation is not perfect, then there should be some benefits arising from geographical diversification. This can also be true of geographical diversification inside the EU or euro area.

This geographical diversification and different legal structures could also be considered in the context of potential resolution scenarios (single or multiple point of entry). Recognising and analysing different banking models on the basis of their own merits might make supervision more complex, but would help to avoid risks embedded in a one-size-fits-all approach. This risk is not immaterial, especially if one adds to the equation the fact that a more structured supervisory

framework allows less flexibility and discretion to the supervisors.

Internal challenges

Setting up an institution like the SSM inevitably involves less-public, more-internal challenges, the addressing of which also critically affects the institution's credibility. The establishment of Joint Supervisory Teams, which is now a reality on the ground, with JST leaders from outside each bank's home country and involving different cultures and languages, is certainly a success. JSTs seem to be working efficiently, though alignment of working methods and focus among different JSTs is not yet fully achieved.

Furthermore, and perhaps at least partly because of the legal framework under which European banking supervision was established, there is a view among Spanish bankers that procedures are very heavy and time consuming. Approvals and decision-making processes take a long time, and the perception is that these delays are excessive, for example for the vetting of a bank's board members.

Finally, European banking supervision will have to strike the inherently difficult balance when it comes to rotating supervisory staff between different banks. If teams spend long periods supervising a particular bank, they can become too close to the supervised entity. But quick rotations do not allow the supervisors to fully benefit from the knowledge that is acquired with experience and time. This is an issue that other institutions have had to confront, for example the IMF with its country teams. Some rotation within teams is probably part of a reasonable solution.

All in all, the SSM has been a success. Broadening the scope of supervision, improving communication, avoiding a one-size-fits-all supervisory approach and tackling some internal issues and procedures will improve it even further.

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EUROPEAN BANKING SUPERVISION: THE FIRST EIGHTEEN MONTHS

Dirk Schoenmaker and Nicolas Véron, editors

European banking supervision, also known as the Single Supervisory Mechanism, is the first and arguably the main component of European banking union. In late 2014, the European Central Bank became the supervisor for the region's largest banking groups; the ECB also oversees the supervision by national authorities of smaller banks.

This Blueprint is the first in-depth study of how this ground-breaking reform is working in practice. It includes a euro-area overview and chapters on nine countries covering 95 percent of the area's banking assets, illustrating the diversity of experiences, situations and perceptions in different member states.

Despite teething troubles and occasional misjudgements, this assessment finds that overall European banking supervision has been effective, demanding and broadly fair, at least for the banks under the ECB's direct watch. Even so, achieving a truly single market in banking services will require more time, further supervisory initiatives and new Europe-wide regulatory and legislative steps.

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