

**LUISS Guido Carli**  
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Mechanism  
to the Banking Union**

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and the EBA**

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# FROM THE SINGLE SUPERVISORY MECHANISM TO THE BANKING UNION

## The role of the ECB and the EBA<sup>1</sup>

**Concetta Brescia Morra**

*Professor of Financial Market Regulation, University of Sannio, Benevento*

*Adjunct professor of Financial Market Regulation and Law and Economics, LUISS Guido Carli, Rome*

### *Abstract*

The agreement on the Single Supervisory Mechanism (SSM) is an important step to create an integrated banking system in Europe. In this article we look at the powers attributed to the ECB, from a legal perspective, in order to evaluate the SSM in the broader European architecture of banking supervision. We focus on three issues: the coexistence of more authorities with the same functions on a different perimeter of intermediaries in Europe, due to the UK decision to remain outside the SSM; the creation of a supervisory authority with weak regulatory powers (since these remain in the hands of European institutions and national legislators); and ambiguity over the competence to carry out early intervention powers. These issues should be addressed to increase the effectiveness of supervision. To this end, first we need an “umbrella authority” to coordinate supervision among all European countries (those that do and do not adhere to the SSM); this role could be played by the EBA. Second it is crucial to strengthen the powers of the ECB, in the regulatory field as well as for dealing with an impending crisis.

**Keywords:** Banking Union, Financial Regulation

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## **1. Introduction. The Banking Union in Europe: objectives and legal framework**

The decision to start a process that has as its ultimate goal the creation of a single banking system in Europe is a sign of discontinuity in the history of European banking regulation. The evolution of European legislation until June 2012 had as its primary objective the implementation of the “single market” of banking services in Europe that was initiated in 1993. The Directives on the banking sector, since the first ones in 1977, sought to harmonise rules in order to create a level playing field and to eliminate obstacles to competition within the territory of the European Union.

The European Commission, with the “Road Map towards the Banking Union”, outlined in June 2012 (EC, 2012), recognises that further steps in the creation of a system of common rules for banks are important, but no longer sufficient.

As highlighted by the ECB, there is a fundamental inconsistency in banking supervision being carried out at a national level in a currency area with a single monetary policy (ECB, 2012). There are macroeconomic rationales for a banking union: the fragmentation of the European banking system and tensions in bank funding conditions at the national level have impaired the transmission mechanism of monetary policy and could contribute to negative loops between banking problems and sovereign funding. Under the current settings, fragility in national banking systems can be quickly transmitted to the national fiscal side and vice versa, triggering an adverse feedback loop between fiscal and banking problems. Therefore, price stability and financial stability are strongly interconnected (Visco, 2013).

In order to reduce fragmentation and foster the creation of a unified banking system in Europe, the European Commission approved a reform based on three pillars: a single mechanism of supervision over banks, referred to as the Single Supervisory Mechanism (SSM); a single mechanism for the “resolution” of troubled banks, the Single Resolution Mechanism (SRM), and the harmonisation and strengthening of systems of deposit guarantee schemes.

A strong political compromise on the first pillar has been achieved in a short time also because of the crisis of the Spanish banks and the difficulties of that country, due to the constraints of the public debt in dealing with it. The macroeconomic rationale behind the Banking Union is confirmed by the Regulation approved by the European Council on the SSM. Article 1 and recitals 1*bis*, 2, 3, 4 and 5 of its Regulation No. 1024/2013 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions underline that the integrity of the single currency and the single market may be threatened by the fragmentation of the financial sector.

The regulatory construction is currently incomplete, however; the most important weakness is the lack of a binding and comprehensive agreement on sharing the fiscal burden among European Union countries in case of banking crisis (Micossi, 2013; Darvas & Silvia Merler, 2013).

There is a deep discussion about the implementation of the second pillar of the Road Map of the Commission: the Single Resolution Mechanism (SRM). In March 2014 the European Parliament and the Council have reached a provisional agreement on the SRM and the Single Resolution Fund created by the intermediaries' contributions that will be governed by two texts: a SRM regulation covering the main aspects of the mechanism and an intergovernmental agreement related to some specific aspects of the Single Resolution Fund (SRF) (On April 15, 2014 the European Parliament adopted the regulation proposal). These tools may allow crises of one or more intermediaries to be dealt with. In the event of a crisis of systemic importance, public intervention would be necessary, but there is no formal commitment by European countries on this point, except as provided in the latest revision of the agreement on the European Stability Mechanism (ESM)<sup>2</sup> that will operate within very strong limits. The agreement of 20 June 2013 allows for the direct recapitalisation of banks, but provides stringent eligibility criteria. There is an ex-ante limit for the amount of financial assistance available for a direct recapitalisation instrument of EUR 60 billion; this amount may not be sufficient if a systemic crisis occurs. Moreover, a significant part of the cost of the recapitalisation mechanism falls on the country of the troubled bank, reducing the possibility of breaking the vicious circle between banks' fragility and the tension in the sovereign debt market.

The lack of an agreement on this crucial issue, however, do not necessarily imply a sceptical judgment about the chances of success of the initial project. As has often happened in European history, the first step towards deeper integration is represented by a compromise limited to just a few topics. A Europe of "different speeds" was always recognised by the EU Treaties. In the genesis of the European Union there were the proposals of 1950 by the French Foreign Minister Robert Schuman in order to prevent the risk of a conflict between France and Germany concerning the coal and steel resources of the Ruhr and Saar. The proposal to place Franco-German coal and steel production under a common High Authority "whose decisions will bind France, Germany and the acceding countries" laid the foundations for economic unification. The agreement was the first concrete tool of a European federation indispensable for the preservation of peace. The Treaty establishing the European Coal and Steel Community (ECSC) was signed two years later. The large investment pools made necessary by the commitment of member countries in the field of nuclear

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<sup>2</sup> The ESM was established with an ad hoc treaty between the same countries participating in the Euro area, signed on 2 February 2012, in order to preserve the financial stability of the Euro Area.

energy was the rationale for the start of the European Atomic Energy Community (EURATOM) in 1957. That same year the European Economic Community was born.

The past experience in the building of the European Union prompts us to be confident about the possibility of a gradual expansion of the commitments of member countries for the realisation of a unified banking system. The project on banking union is based on strong political grounds. It is not a “technical report”, produced by a study commission of experts. We do not believe that this phase can be seen in the light of “functionalist” theory. “Functionalism” holds that European integration is driven by “elites” and interest groups without the political consensus of national governments on the progress of European integration. According to this view, transferring some policy functions to the supranational level creates pressure for more integration. Europe integration is boosted by elites of “technocrats”, who support proposals that provide for the transfer of certain functions into the hands of European authorities to create pre-conditions, at a later time, for further transfers of sovereignty from Member States to the European institutions (“Jean Monnet’s Chain Reaction”) (Spolaore, 2013).

The project defined by the European Commission in the Road Map in September 2012 stands as an important convergence of the governments of the Euro Area countries, who are aware that it is the only possible solution to the problems arising from the global financial crisis. The political agreement preceded the technical solution in the preparation of the SSM regulation as well as in the draft regulation on the single mechanism for resolution of banking crises. The signing of the Treaty to set up the European Stability Mechanism shows the strong political interest of governments to support European integration, even if there remain disagreements on technical solutions and on the distribution of the burdens of the banking failures.

We can conclude that the financial crisis has led to a new phase of European integration. The Treaties of Maastricht (1992), initiating the European Monetary Union, and Lisbon (2009) underlined the evolution of the European Community into the European Union.<sup>3</sup> The evolution in the banking sector from the common market to a banking union is a natural consequence of those steps. The decision to create a banking union cannot be explained only in the light of the objectives of safeguarding the soundness of the banking system and financial stability; we regard the banking union as a path towards a more complex programme of reforms aimed at restoring confidence in the euro, which in the long-term seeks the attainment of economic and fiscal integration in Europe.

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<sup>3</sup> With the Treaty of Amsterdam of 1997 the mechanism of “enhanced cooperation” was officially enshrined in the Treaties.

In this paper we focus on the first pillar, the SSM, as outlined in the Regulation No. 1024/2013. We consider two issues that could pose obstacles to the reduction of the fragmentation of European banking and might threaten financial stability. First, the UK has ruled out the possibility of joining the Single Supervisory System; consequently, a significant part of European intermediaries are out of the SSM. Second, although a political compromise on a single system for the management of banking crisis has been reached, some uncertainties concerning the implementation of the new rules still remain.

These two factors led to sub-optimal solutions in the definitions of the new supervisory architecture in Europe. We shall first address the sub-optimal solutions of the current agreement, suggesting some corrections. In more detail, we try to identify the instruments that are already in place in the European Union regulatory system, which could be useful to streamline and strengthen the functioning of the SSM to ensure integration and stability of the banking system.

The paper is organised as follows. Section 2 provides a brief overview of the SSM institutional framework. Section 3 analyses the issue of the coexistence of many supervisory authorities over banks in Europe, comparing the new European institutional framework with the experience of the United States. Section 4 discusses the problems arising from the lack of strong regulatory powers in the ECB. Section 5 deals with the need to concentrate in European institutions the remit for early intervention supervisory powers. Section 6 provides some conclusions.

## **2. The structure of the supervisory model**

Council Regulation No. 1024/2013 establishes a Single Supervisory Mechanism among Euro Area countries. The mechanism is open to other European Member States wishing to “opt-in” with an agreement of close cooperation. The Euro Area countries have chosen to confer on the ECB prudential supervision tasks as set out in Article 127(6) of the TFEU (Treaty on the Functioning of the European Union). Despite the fact that this legislative base seems to allow the attribution only of “specific tasks” on supervisory policy, the Regulation conferred on the ECB the entire set of instruments of prudential supervision (Capriglione, 2013; Guarracino, 2013). In particular, the remit of the ECB will include controls on requirements needed to access the banking sector (authorisation to carry out banking activities and assessment of applications for the acquisition and disposal of qualifying holdings in credit institutions); powers to ensure compliance with prudential requirements (capital adequacy, large exposure limits, liquidity and leverage); powers to ensure compliance with regulation on the internal control system (corporate governance arrangements,

including fit and proper requirements for the persons responsible for the management of credit institutions, risk management processes, internal control mechanisms, remuneration policies and practices, and effective internal capital adequacy assessment processes); tasks to carry out supervisory reviews and stress tests in order to determine whether arrangements, strategies and processes put in place by credit institutions ensure a sound management and coverage of their risks; powers to impose on credit institutions specific additional own funds requirements, specific publication requirements, liquidity requirements; investigatory powers (the ECB may require banks to provide all necessary information in order to carry out its tasks and may conduct all necessary on-site inspections); powers to carry out supervision on a consolidated basis and to participate in supplementary supervision of a financial conglomerate; tasks to carry out supervisory reviews in relation to recovery plans and early intervention to prevent financial stress or failure, excluding any resolution powers.

To identify the boundaries of the ECB powers, the central bank has a clear mandate to perform all tasks of prudential regulation in “good times”. It is less clear what the ECB’s powers are in “bad times”, e.g. in a pre-crisis situation. We will examine this problem in more depth in Section 5.

The ECB is mandated carry out its tasks within a single supervisory mechanism composed of the ECB and national authorities. It shall be responsible for the effective and consistent functioning of the SSM. Both the ECB and national competent authorities shall be subject to a duty of cooperation in good faith and an obligation to exchange information.

The ECB will not carry out prudential supervision on the entire banking system of the Euro Area. The banks within the participating countries will be divided into two categories: “less significant banks” and “banks of significant relevance”. The significance is based on certain criteria: the size, the importance for the economy of the EU or any participating Member State, and relevance of cross-border activities. Moreover there will fall within the remit of the ECB banks that have requested or received financial assistance from the ESM and the three most significant credit institutions in each of the participating Member States notwithstanding they do not meet the conditions to be considered “of significant relevance”.

With respect to “less significant banks”, supervisory decisions will be taken by national competent authorities. With respect to “banks of significant relevance”, national competent authorities shall be responsible for assisting the ECB with the preparation and implementation of any acts relating to the ECB tasks.

The ECB will adopt a detailed framework for the practical modalities of supervisory cooperation within the SSM, specifying operational arrangements. There are some risks associated



with the structure of the SSM. In the initial period the main problem could be that the ECB will have inadequate resources, especially in a lack of personnel with professional expertise in the banking supervision field. In this case the SSM could be excessively dependent on national authorities; if national authorities retain real power they may favour national banking systems, with unclear accountability.

A more relevant risk comes from the operational structure outlined: in the European Council agreement, the ECB's regulatory powers are limited to operational aspects. As set out in Article 5 Regulation No. 1024/2013, the ECB shall apply all relevant European Union law and where this is composed of Directives, the national legislation transposing those Directives. The ECB shall adopt guidelines and recommendations subject to and in compliance with the relevant European Union law. The ECB may adopt regulations only to the extent necessary to organise or specify the modalities for carrying out those tasks. If the ECB has to apply national legislation there is a risk that the new system would not be able to solve the current fragmentation of the European banking systems. I will deal with these issues in Section 4.

Council Regulation No. 1024/2013 establishes detailed supervisory internal governance. It proposes the establishment of a Supervisory Board within the ECB. The Governing Council of the ECB, which is responsible for monetary policy, would remain formally responsible for making decisions prepared by the Supervisory Board. The Supervisory Board carries out preparatory supervisory tasks and proposes draft decisions to the Governing Council which formally adopts these decisions. This complex internal governance has been established because the European Council wanted to limit the problem of conflict of interest between the monetary policy task and the banking supervisory task. This is reason why the task of supervision has been delegated to an independent internal body of the ECB. However, the Supervisory Board cannot have "decision-making powers". Under the Treaty, the Governing Council is the only deciding internal body of the ECB.

As underlined before, the regulation is based on the idea of creating a comprehensive supervisory system for the entire European banking market. The single market for banking services started in 1993, based on the principles of "minimum harmonisation", "mutual recognition" and the "single passport". This allowed a "credit institution" legally established in one Member State to establish itself and provide services in other Member States without any further authorisation requirements. Therefore home country authorities are responsible for the prudential supervision of foreign established branches ("home country control"). The efficacy of the new SSM could be hampered if some European countries fail to join the mechanism. This is the rationale behind the decision of the European Council to allow non-Euro Member States to opt in to the SSM, the "pre-

ins”, and to encourage their participation. The Council agreement grants the “pre-ins” participation in the Supervisory Board, through the representatives of their national authorities. Considering that non-Euro countries cannot be represented on the Governing Council, Regulation No. 1024 provides pre-ins with some procedural safeguards in case the Governing Council objects to or amends a draft decision of the Supervisory Board. Eventually, in case of disagreement, the Member State can request the ECB to terminate the close cooperation with immediate effect.

Even if most of the European Member States will adhere to the SSM, besides the 17 Euro countries, the decision of the UK to “opt out” could not be considered irrelevant. The UK banking system is of crucial importance because intermediaries established in that country have relevant dimensions compared with the European financial market (Ferran & Babis, 2013; Darvas & Wolff, 2013). As the location for an important part of the EU’s financial services business, the UK national strategies in the banking supervision field are closely tied up with those that will be adopted by the ECB as the prudential supervisory authority of the Euro Area countries (Capriglione, 2013). I will address this problem in Section 3.

### **3. More authority with the same functions in the European banking single market: insights from a comparison with the US system**

In the new European banking supervision more than one authority will be competent to carry out, for prudential purposes, the same tasks on a different perimeter of intermediaries: banks established in the UK will be supervised by the authority of that country (which currently is the Prudential Supervisory Authority within the Bank of England); “less significant banks” of Euro Area countries will be supervised by national competent authorities; “banks of significant relevance” established in the Euro Area will be supervised by the ECB.

This situation is not dissimilar from the one built up in the United States, where there is a system of multiple regulators with tasks partly overlapping. We must of course take into account the differences due to the fact that the US is a federal state; and while Europe can no longer be considered a mere free trade area, but a “community of law”,<sup>4</sup> it is far from being a federal system.

The supervisory system with a plurality of authorities with different tasks has not been abandoned in the US even after the reform approved in 2010 in response to the financial crisis – the Dodd-Frank Wall Street and Consumer Protection Act. This reform was not a simplification. It did not reduce the number of financial authorities, but merely entailed a reorganisation of the

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<sup>4</sup> “A community based on the rule of law”, as indicated by the European Court of Justice of 23 April 1986: Case 294/83, *Les Verts v. Parliament*.

supervisory system. The only authority abolished was the Office of Thrift Supervision (OTS) whose responsibilities were distributed among other authorities. The OTS was created in 1989 after the savings and loan crisis of the late 1980s and specialised in monitoring the safety and soundness of federal saving associations and their holding companies.

The US system has many weaknesses. Numerous authors have expressed critical opinions on the efficacy of a supervisory system of multiple regulators with overlapping jurisdictions (Greene, 2011, Masera, 2010; Ferrarini & Chiodini, 2012). The US government tried to improve the supervisory architecture but was forced to take into account the strong political objections that would have been raised against a fundamental simplification in the number of authorities. The US reform provides useful suggestions for Europe.

In the US there is a “dual banking system” in which each intermediary is subject to multiple controls. Banks can be state-chartered or federally-chartered (national banks); some special categories of banks, like thrifts or credit unions, can be state or federally chartered. Each credit institution is subject to supervision by its chartering authority, state or federal, and in addition is subject to at least one federal “primary regulator”, a federal authority responsible for prudential purposes and for ensuring compliance with federal banking law. Primary regulators are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FED) and the Federal Deposit Insurance Corporation (FDIC). An important feature of the system is that all of these institutions, because their deposits are covered by FDIC deposit insurance, are also subject to the FDIC’s regulatory authority (the only credit institutions beyond the remit of FDIC are “credit unions” that have a distinct deposit insurance fund at federal level). The FDIC was created in 1933 to provide insurance to small depositors. It is an independent agency that, as well as insuring the deposits, examines individual institutions and issues regulations for all insured depository institutions to monitor and enforce safety and soundness, manages the receivership and plays an important role in the liquidation process. The fund is used for supporting failing institutions too. The Dodd-Frank Act expanded the FDIC’s powers in liquidating troubled financial institutions, banks and other intermediaries, which are designated as systemically important.

In the US there are also many interagency task forces for coordination and data sharing among different supervisors. These are named the “regulatory umbrella”. Three interagency organisations have permanent status: the Financial Stability Oversight Council (FSOC), the Federal Financial Institution Examinations Council (FFIEC), and the President’s Working Group on Financial Markets (PWG). For our purposes the FSOC is the most interesting, created in 2010 with the Dodd-Frank Act. The Council is chaired by the Secretary of the Treasury. Other voting

members are the heads of the agencies competent for regulating and supervising the financial sector (therefore FED, FDIC and OCC are voting members). The FSOC has no direct supervisory responsibilities of financial institutions, nor regulatory power. Its tasks include identifying and monitoring systemic risks, proposing to Congress regulatory changes to promote stability, competitiveness and efficiency, facilitating the exchange of information between financial authorities, providing a forum for the resolution of jurisdictional disputes among council members. In addition, the FSOC may designate a financial institution (bank or non-bank) as relevant from the systemic point of view, with the consequence that it will be subject to a supervisory regime more stringent than that required for other intermediaries.

From the overview of the US supervisory architecture, after the Dodd-Frank reform, notwithstanding its excessive complexity and cumbersome regulations, we can identify some strong points: the crucial role in the supervisory system of the FDIC having powers of intervention during the crisis and pre-crisis over all systemically relevant financial institutions; and the need for a powerful regulatory umbrella in systems of multiple regulators with overlapping jurisdiction.

We believe that in the European system there is one authority that can exercise a coordination role effectively: the European Banking Authority. The EBA could be considered an “umbrella” authority, due not only to its strong regulatory remit but also to the capacity, provided by the European regulation (Regulation. No. 1093/2010 of 24 November 2010), to mediate and settle disagreements in cross-border situations between competent authorities with binding effect (Article 19); to participate actively in the development and coordination of effective and consistent recovery and resolution plans (Article 25), procedures in emergency situations and preventive measures to minimise the systemic impact of any failure, especially of cross-border banking groups (Article 18); and to ensure a coherent functioning of colleges of supervisors (Article 21). Moreover, Regulation No. 1022/2013, enacted to ensure a balance in the EBA decision-making structures between the Euro Area and other Member States, strengthens its “coordination role”.<sup>5</sup>

Based on the current legislation, the EBA is the most appropriate actor to close the gaps in the banking supervision at European level and to achieve a fruitful negotiation on supervisory practices with British authorities (see IMF, 2013; Ferrarini & Chiodini, 2012).

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<sup>5</sup> Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No. 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No. 1024/2013.

#### **4. Splitting supervision into regulatory function and controls on the banking activity in order to monitor sound and prudent management (authorisations, collecting and examining data etc.)**

The scheme proposed by the Regulation No. 1024/2013 provides a clear distinction between “regulation” and “supervision”; they are intended as different tasks that could be carried out by different subjects (Wymeersch, 2012). This approach is a novelty that has not been experienced by the legislation of any one country so far. Actually, in some jurisdictions, as in the UK, from a terminological point of view, the word “regulation” is even used as substitute for “supervision”.

The regulation of banks remains essentially a competence of national laws, implementing EU rules, as pointed out in several provisions of Regulation No. 1024/2013. According to Article 4(3), the ECB

shall apply all relevant Union law, and where this Union Law is composed of directives, the national legislation transposing those directives. Where the relevant Union law is composed of Regulations and where currently those regulations explicitly grant options for Member States, the ECB shall apply also the national legislation exercising these options. To that effect, the ECB shall adopt guidelines and recommendations, and take decisions subject to and in compliance with the relevant Union law.

Moreover the ECB shall be subject to “binding regulatory and implementing standards developed by the EBA”.

Under this rule it is clear that the ECB has no regulatory powers over banking activities. In carrying out its supervisory tasks the ECB shall apply EU laws and national provisions implementing EU rules. The ECB may adopt regulations “only to the extent necessary to organise or specify the modalities for the carrying out of those tasks...”. It is therefore a regulatory power limited to “self-organisation” of the exercise of ECB powers. The most important example of “self-organisation” rules is the “framework” that the ECB shall adopt (and make public) in consultation with national authorities “to organise the practical arrangements” relating to the cooperation within the SSM (Article 6(7)) (a draft regulation was published for consultation by the ECB in February 2014).

The picture is less clear if we continue reading the same Article 4(3), where it is stated that “before adopting a regulation, the ECB shall conduct open public consultations and analyse the

potential related costs and benefits”. The need for a public consultation, normally required for the adoption of rules in the proper sense, i.e. provisions binding on third parties, suggests that in the remit of the ECB there are also regulatory powers. As the first part of the same article (Article 4(3)) does not seem to assign such powers to the ECB, except to the extent necessary to self-organise the supervisory function, it is unclear what the source of these powers is. Thus we can conclude that Regulation 1024/2013 does not confer on the ECB a formal regulatory power. The central bank may just issue guidelines and other non-binding provisions.

This division between regulation and supervision is particularly dangerous for the proper functioning of the new SSM. Despite the long process of harmonisation and the efforts made by directives and guidelines of the European authorities, especially the EBA, there remain important differences in the rules and supervisory approaches between Member States.

Up to now the differences were mainly due to the provision of EU directives that left discretionary options to Member States in transposing EU law. On this issue, the recent European legislation on capital requirements introduced important innovations. The new regulatory framework replaces the Capital Requirements Directive with two different legislative instruments (Capital Requirements IV package – CRD IV): a directive governing access to deposit-taking activities (Directive 2013/36/EU of the European Parliament and of the Council 26 June 2013 – CRD) and a regulation establishing the prudential requirements (Regulation No 575/2013 of the European Parliament and of the Council of 26 June 2013 - CRR). The regulation is directly applicable; this means that it will take immediate effect in all Member States without any further action on the part of the national authorities. This should reduce divergences between European legal systems that result from the transposition of directives. The new rules cancel a large number of national options and discretions. They allow Member States to apply stricter requirements only where these are justified by national circumstances, needed on the grounds of financial stability or because of a bank’s specific risk profile.

The new rules concerning “prudential supervision” may be regarded as a “single rule book”, but we should consider that even the CRR allows some options to Member States in its implementation. Moreover whatever the letter of the law, different authorities in different EU jurisdictions can adopt different approaches to perform their supervisory duties. The former CEBS (Committee of European Banking Supervisors, which has been replaced by the EBA) in its documents made a clear distinction between “option” and “discretion” in implementing EU directives. An “option” refers to a situation in which “competent authorities or Member States are given the choice on how to comply with a given provision, selecting from a range of alternatives set forth in Community legislation”, whereas a “discretion” refers to a situation in which



“competent authorities or Member States are given a choice as to whether to implement, or not implement, a given provision” (Guidelines on Supervisory Disclosure, January 2010). The term “discretion” means that the supervisory authorities have a choice as to how they go about performing their day-to-day supervisory duties. “When directives refer to the need for an institution to obtain a competent authority’s approval or authorisation for various purposes, such authorisation or approval might be discretionary, but it does not constitute a national discretion in the sense described above” (CEBS Guidelines on Supervisory Disclosure, January 2010). The exercise of this discretion (as opposed to a “national discretion”) can lead to different regulatory outcomes notwithstanding the wording of the legislation relied upon being the same or similar in different Member States.<sup>6</sup>

Studies and research reports on behalf of the EU Commission (see the De Larosière Report, 2009, and Liikanen Report, 2012) have shown that in Europe banking authorities have adopted different approaches to banking supervision. One may refer to the regulatory proposals, in response to the global financial crisis, on “structural measures”, i.e. institutional separation between banks that carry out traditional banking business (collecting deposits and lending activity) and intermediaries engaging in proprietary trading and other securities activity (Gambacorta & van Rixtel, 2013). There have been various initiatives in the US and in some European countries. The “Volcker rule” is contained in the Dodd-Frank Act 2010 in the US; the proposals of the Vickers Commission have been implemented in the UK with the Banking Reform Bill of 2013; the Liikanen Report (2012) proposed for banking groups a mandatory separation of certain trading activities from the deposit bank (on January 2014, the European Commission adopted a proposal for a regulation based on the Liikanen report). The rationale for this proposal is to insulate certain types of financial activities, that need a special protection (deposit taking), or are important for the real economy (loans to firms), from risks that could originate in “less important activities”, such as investment banking business. Beyond the basic idea, the reforms present some similarities, but they differ in scope and in the severity of the rules. Moreover the structural reform proposals are far from being considered a common standard for European countries.

The regulatory differences between European countries are not limited to important topics such as those related to structural measures. Member States would like to maintain the styles of supervision they have adopted up to now. The reasons for national resistance to change are various.

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<sup>6</sup> This point is recognised by the CEBS Guidelines on Supervisory Disclosure – revised, dated January 2010 (Introduction, paragraph 2) when citing the “The Revised Framework for International Convergence of Capital Measurement and Capital Standards” (Basel II agreement) to the effect that “the supervision of banks is not an exact science, and therefore, discretionary elements within the supervisory review process are inevitable”.

In some cases, governments would like to protect the competitiveness of their national intermediaries and national financial system; in some other cases, the conservative approach refers to the national regulatory framework (which could even be subject to constitutional limits) and administrative traditional culture.

The different approaches to supervision led to regulatory arbitrage, giving a competitive advantage to intermediaries established in countries with a “light touch approach” in banking supervision (such as the UK, before the financial crisis; see FSA, 2009).

The regulatory differences could have even more problematic consequences in the perspective of SSM. There may be difficulties for the ECB to adopt a common standard in the exercise of supervision due to the legislative constraint stated in the regulation to implement the “national rules”. This situation could undermine the ECB’s capacity to carry out its task, complying with one of the key principles stated in the first article of the proposed regulation on SSM: “... duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage” (Regulation No. 1024/2013, Article 1(1)) (Wymeersch 2014; D’Ambrosio, 2013)<sup>7</sup>. Moreover different supervisory approaches could hinder the ECB’s oversight of cross-border groups (Ferrarini & Chiarella, 2013).

Without common supervisory standards the possibility of different treatment of intermediaries is amplified by the complex procedural system adopted for the SSM’s functioning. Although the ECB shall be responsible for the effective functioning and consistent supervision mechanism, the SSM is composed by the ECB and national competent authorities. Under Article 4 of the proposed regulation on SSM, national authorities shall be responsible for assisting the ECB with the preparation and implementation of any acts relating to the ECB’s prudential supervisory tasks having regard to credit institutions “of significant relevance”. On the contrary, with respect to “less significant banks” supervisory decisions are adopted by national competent authorities. The ECB shall issue regulations, guidelines or general instructions to national competent authorities. If necessary, to ensure consistent application of high supervisory standards, the ECB may decide to exercise directly itself all the relevant powers also with respect to “less significant banks”. The decisions have to be taken after consulting with national competent authorities or upon request by a national competent authority (Article 6(5)(b)).

The relationship between national authorities and the ECB cannot be compared to that between the European Commission and national authorities in the antitrust field. The TFUE

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<sup>7</sup> According to Article 1, par. 1 of the SSM regulation: “This Regulation confers on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions, with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the Union and each Member State, with full regard and duty of care for the unity and integrity of the internal market based on equal treatment of credit institutions with a view to preventing regulatory arbitrage”.



established a clear primacy of EU law. National legislation may apply to agreements impeding competition, alleged abuses of dominant position and concentrations that do not fall within the scope of the EU. Moreover in the antitrust field both the European Commission and national authorities apply the same discipline. Under Article 1(4) of Law 287/90, Italian legal provisions on antitrust shall be interpreted in accordance with the principles of EU law. The regime for enforcing European competition law provides a decentralised decision-making system, in accordance with the “subsidiarity principle” (Article 5 of the European Treaty). This case is different from that outlined by Regulation No. 1024/2013 for the ECB oversight of credit institutions “of significant relevance”. In the latter, the law does not provide a “decentralisation” of powers enforcing the rules. National authorities have only the duty to carry out the investigation and the implementation phases of the administrative process. National supervisors are considered as an integral part of the SSM in the Regulation No. 1024/2013 (Wymeersch 2014). The decision-making responsibility remains within the remit of the BCE, but the latter has to apply the “national legislation” implementing EU rules.

As previously underlined, the absence of a common regulatory framework could lead to undesirable outcomes: different treatment of Euro Area credit institutions and problems in the cooperation between ECB and national authorities.

One way to try to overcome these problems is to support the setting-up of “supervisory teams” of national competent authorities, as provided in Article 25(2) of the proposed regulation. The teams, taking supervisory actions regarding a credit institution, could lead to a “common culture” in the supervisory field in the long run.

To accelerate convergence in the supervisory approaches we need to confer more powers on the ECB to produce common standards in order to perform its tasks properly and to be independent in its decisions from the influence of national authorities. The legal instruments could be recommendations and guidelines, implementing the new prudential regulation contained in the CRR regulation. We should consider that many articles of the new CRR confer discretionary powers in applying the rules; for instance, the CRR gives to competent authorities the power to derogate a rule, to waive a provision or to exercise an option. The ECB, by the end of 2014, will be the “competent authority” for a large number of European banks; the power to exercise these options is in the remit of the ECB if we do not interpret the notion of “competent authorities” as limited to that of the “national authorities”. According to the wording of the CRR (Article 4(40)), “‘competent authority’ means a public authority or body officially recognised by national law, which is empowered by national law to supervise institutions as part of the supervisory system in operation in the Member State concerned”. The ECB will be the public authority empowered to exercise the

supervision over banks “of significant relevance” by the national laws of Member States adhering to the SSM when Regulation No. 1024/2013 enters into force. Such an interpretation is confirmed by recital 34 of Regulation No. 1024 which provides that the ECB should apply the material rules relating to the prudential supervision of credit institutions; those rules are composed of the relevant Union law, in particular Regulations or Directives. Where the relevant material rules are laid down in Regulations and in areas where those “Regulations explicitly grant options to member States the ECB should apply the national legislation exercising these options”. The national legislation is not binding on the ECB if options are “available only to competent or designated authorities.” Therefore, the Regulation identifies the ECB as the “competent authority” according to the relevant Union Law (D’Ambrosio, 2013).

Increasing the ECB’s regulatory capacity could lead also to a new equilibrium decision system among Member States in the EBA (Lener & Rulli, 2013), reinforcing the possibility of reaching an agreement on a bilateral negotiation between the ECB and the UK authorities.

## **5. The need to concentrate pre-crisis powers in the ECB’s competence**

The split of the supervisory function into different tasks, regulation and controls on the banks’ management, falling within the remit of different authorities, creates serious problems in pre-crisis situations, because the regulatory framework in this field is not well defined. Moreover the misalignment between the European Union supervision of banks and the national treatment of banks in the resolution proceedings could hinder the capacity of the ECB to act promptly to avoid the difficulties of one large bank being transmitted to other intermediaries, affecting the whole financial system (De Grauwe, 2013).

The rules on banking crisis management have been recently harmonised. The EU Directive 2001/24/EC on the reorganisation and winding up of credit institutions that have their headquarters in one Member State and branches in other Member States, while affirming the principles of unity and universality of the procedures, did not harmonise them. The directive established a mutual recognition of national measures that are fully effective throughout the European Union territory without any further formalities. The proposal for a directive providing a common framework for the recovery and resolution of credit institutions and investment firms has been adopted by the European Parliament on 15 April 2014. Moreover, the Commission made a proposal for a Regulation on a Single Resolution Mechanism (SRM) and a Single Bank Resolution Fund to complete the banking union among Euro Area countries (Presidency compromise, dated 17

December 2013 adopted by the EU Parliament April 15, 2014).<sup>8</sup> Some technical and political obstacles to the adoption of the proposal have been overcome with the provisional agreement reached in March 2014 by the European Parliament and the Council. The proposal creates a new European agency designed pursuant to Article 114 of TFEU, the Single Resolution Board. The board will share the responsibility of resolution tasks with the ECB, the Commission and the Council. The SRM regulation entrusts the ECB with the power to activate the resolution upon assessing “whether a credit institution is failing or likely to fail and whether there is no reasonable prospect that any alternative private sector or supervisory action would prevent its failure within a reasonable timeframe” (recital 16 of the proposed Regulation). The ECB shall communicate that assessment to the Commission and the Board. The Resolution Board after assessing if there is a systemic threat and if there is no private alternative solution will then adopt a “resolution scheme” including the relevant resolution tools and any use of the Fund. Before the Board adopts its decision, the Commission will assess its compliance with State aid rules. The Commission is responsible for assessing the discretionary aspects of the decision of the Board and endorsing or objecting to the resolution scheme. The Council could object the Commission’s decision if there is no public interest in resolving the bank or under certain circumstances involving the use of the Single Fund.<sup>9</sup>

In this legal framework two problems may arise. First, the lack of a clear and uniform definition of “early intervention measures” at European level could lead to different treatments of Euro Area banks. The ECB will not have the same set of tools to react to a bank in distress in all the Euro Area countries, due to the lack of harmonisation in this field. Second, when the legal framework on bank resolution is in place, there will be a plurality of authorities with overlapping powers in some circumstances. This could slow down the reactions of authorities that are needed to prevent panic.

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<sup>8</sup> Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No. 1093/2010 of the European Parliament and of the Council (2013/0253).

<sup>9</sup> This complicated system of tasks and responsibilities has been chosen due to the urgency of putting the SRM in place within a reasonable period of time, considering the SSM will start to operate within one year. Other solutions entailed a change of the Treaty. The current proposals have been scrutinised by the legal service of the European Council which concludes that some of the provisions conferring resolution powers on the Board “need to be further detailed in order to exclude that a wide margin of discretion is entrusted to the Board, unless the legislator decides to involve in the exercise of those powers an institution of the Union vested with executive competences” according to the *Meroni* doctrine (Case 9-56, *Meroni & Co., Industrie Metallurgiche, SpA v High Authority of the European Coal and Steel Community*. Judgment of the Court of 13 June 1958 (Jur523, 7 October 2013). On this point, however, we must take into account the innovative decision of the European Court of Justice of 22 January 2014 (Case C-270/12, *United Kingdom of Great Britain and Northern Ireland v European Parliament and Council of the European Union*) on the powers conferred on the ESMA under Article 28 of Regulation No. 236/2012, finding that these powers “are precisely delineated and amenable to judicial review in the light of the objectives established by the delegating authority”, thus they “comply with the requirements laid down in *Meroni v High Authority*”.

To better understand the first point it is useful to analyse the ECB's "early intervention powers". Regulation No. 1024/2013 on SSM assigns to the ECB important tasks in pre-crisis situations with regard to "banks of significant relevance". According to Article 4(1)(k), the ECB has the exclusive power to carry out

supervisory tasks in relation to recovery plans, and early intervention where a credit institution or group in relation to which the ECB is the consolidating supervisor, does not meet or is likely to breach the applicable prudential requirements and, only in the cases explicitly stipulated by relevant Union law for competent authorities, structural changes required from credit institutions to prevent financial stress or failure.

The only exceptions are the powers of resolution. The ambiguity of the provision is mitigated by Article 16 of the Regulation which contains a list of measures that the ECB shall have "at an early stage to address relevant problems", where there is a breach of the rule regarding sound and prudent management. Among these measures there is the power to require banks to hold their own funds in excess of the minimum capital requirements, to restrict or limit their business, to require the institution to limit the managers' remuneration, and to remove at any time from the management body of credit institutions members who do not fulfil the requirements set out in the banking supervision regulation.

This list cannot be considered exhaustive. Some useful hints to identify the notion of early intervention measures are given in the Capital Requirements Directive (Dir. 2006/48 and 2006/49, now replaced by the Capital Requirements – CRD IV package: Directive 2013/36/EU and Regulation (EU) No. 575/2013). According to Articles 102–104 of the Directive, competent authorities shall require an institution to take the "necessary measures" at an early stage to address relevant problems when the institution does not meet the requirements of CRD requirements or the competent authorities have evidence that the institution is likely to breach the requirements within the following 12 months. "Necessary measures" are identified through a long list that describes the powers of authorities. The list includes the power to require institutions to hold own funds in excess of the minimum requirements; to require the reinforcement of the arrangements, processes, mechanisms and strategies implemented; to require institutions to present a plan to restore compliance with supervisory requirements; to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements; to restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive

risks to the soundness of an institution; to require institutions to use net profits to strengthen own funds; and to restrict or prohibit distributions or interest payments by an institution to shareholders.

The measures contained in the list established by Article 104 in large part correspond to those set out in Article 16 of the SSM Regulation, but one can assume that all the powers described as Articles 102–104 of the CRD directive fall within the competence of the SSM. None of these powers can be considered as a “resolution power” which, as mentioned, is certainly a power outside the remit of the SSM.

The intervention powers of the ECB, however, cannot be considered confined to measures included in this extensive list. Member States implementing the provision of a directive, such as Articles 102–104 of the CRD IV, may add additional powers to the list of “early intervention powers” and the ECB is granted the same powers that national authorities have. To understand this point better, an example from Italian experience is useful. According to the Italian Banking Law, the Bank of Italy has a wide range of instruments for corrective action, such as to convene the directors, require intermediaries to adopt corrective measures on their organisation, risk or capital, impose strengthening of the organisation or restrictions on its operation, and prohibit it from carrying out certain transactions. Furthermore, the Bank of Italy may prohibit banks authorised in Italy from undertaking new transactions or order the closure of branches for violation of laws, regulations or bylaws governing their activities, for management irregularities. As a matter of urgency the Bank of Italy may provide for one of its own officers to take over the provisional management of the bank; this provisional management may not last for more than two months. In Italy the supervisory authority makes the proposal to the Minister of the Treasury to issue a decree of “special administration” of the bank.

The Italian case shows that just a part of the powers granted by Italian law to the supervisory authorities in the phase of “early intervention” reproduce those identified in the regulation in CRD IV. This could lead to a different treatment of the banks subject to supervision by the ECB. Moreover, if the ECB has to apply national rules and the “early intervention powers” are not regulated exhaustively by the specific banking laws, but by commercial or bankruptcy laws too, the ECB could face severe problems in using these powers in an effective manner. The harmonisation of rules regarding “early intervention powers” by the European directive becomes more urgent than it was in the past when this phase was in the remit of national authorities. To some extent the compromise reached in June 2013 on the proposal of a directive establishing a framework for the recovery and resolution of credit institutions and investment firms (EU Council 11148/1/13, 28 June 2013, adopted by the EU Parliament on 15 April 2014) harmonises some crisis prevention measures, such as the appointment of one or more special managers to a bank with a deteriorating financial

situation or that has committed serious irregularities (Article 24 of the proposal), but we believe it is necessary to make a stronger effort to reach a deeper integration of European laws on this point.

The second problem refers to overlapping powers between the ECB and the Resolution Board set up by the SRM regulation (Micossi S., Bruzzone G. & Carmassi J. 2013). The Board has to intervene when “a bank is failing or likely to fail” but even the ECB could adopt a broad range of corrective and extraordinary intervention measures in the early intervention phase. Moreover, in the ordinary supervisory activity carried out by national authorities there is a close link between the evaluation process and the correction phase. The latter is a result of the evaluation and consists of the determination of the measures appropriate to the characteristics of the anomalies found. There is a graduation of the forms of intervention of supervisory authorities; the range of interventions goes from “preventive measures”, such as warnings, to “corrective measures”, such as changes in the internal organisation. “Extraordinary measures”, such as restriction on operations or prohibition from carrying out certain transactions, are usually taken in a subsequent phase. There is a continuous line from “preventive measures”, “corrective measures” and “extraordinary measure” (Boccuzzi, 2011). The extreme form of intervention consists in removing the shareholders’ control over the company (as happens in special administration or liquidation procedures generally regulated by bankruptcy laws).

These considerations suggest that the key role in the bank pre-crisis phase should be played by the supervisory authorities, the ECB or the national competent authorities (Carmassi, Di Noia & Micossi, 2012; Micossi S., Bruzzone G. & Carmassi J. 2013). This is consistent with the legal framework designed by the SSM regulation. However it is important to avoid the ECB becoming involved in the responsibility for decisions adopted to resolve a failed bank, considering that currently the burden of the crisis still falls at the national level (Nieto & Garcia, 2012). The solution could be to identify clearly two different phases: the pre-crisis phase and the resolution phase. The latter starts when there is a declaration of the ECB that the bank is no longer viable. This could split the technical responsibilities from those with political features<sup>10</sup> (ECB, 2013).

### *5.1. Emergency liquidity assistance (ELA)*

A fundamental instrument to protect financial stability along with oversight, crisis resolution procedures and deposit insurance, is “emergency liquidity assistance” (ELA). The “lender of last

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<sup>10</sup> During the ECB press conference in October 2013, the president, Mario Draghi, answering a question on the SRM, saying that “...we view the two phases, namely that of assessing the non-viability of a certain bank in question and that of deciding which action should be undertaken as clearly separate tasks. The SSM would take care of the first phase and the SRM would take care of the second. Also the draft proposal on this very same topic gives the ECB the status of a voting member. The ECB believes that it should only be an observer, just to make sure that two phases are completely separate.”.



resort” is a liquidity support to a solvent firm that can provide good guarantees, but cannot receive credit from the market because the latter is not able to properly assess the situation. It is a form of public intervention grants, as in the case of other bail-outs. This tool, acknowledged among the functions of central banks since the end of the eighteenth century, as described in *Lombard Street* by W. Bagehot, is not mentioned in the regulatory provisions examined. Until the recent financial crisis it was exercised by national central banks in the absence of explicit European provisions (Broyer & Lenmangne, 2013; Darvas & Merler, 2013). The ELA is a tool to prevent the difficulties of an intermediary from leading to its default and, in certain circumstances, generating a domino effect. The silence of laws regarding this task carried out by central banks is justified to preserve the “constructive ambiguity” necessary to limit moral hazard by intermediaries. The discretion of central banks using this tool prevents intermediaries relying on liquid facilities increasing the risk appetite. Only few years ago, the lender of last resort was explicitly acknowledged in the Italian legislation (Law of 9 October 2008, no. 155). In the European context, ELA is mentioned in the European Commission’s decisions in the field of state aid. The lender of last resort is compatible with state aid rules if certain conditions are met (European Commission Communication of 25 October 2008): funding must not be part of a wider package of state aid; the intermediary must be solvent, according to the evaluation of supervisory authorities; funding must be fully guaranteed by appropriate assets; the interest rate should be penalising; the decision is taken by the central bank; there is not a guarantee of the state.

Until now, as noted by the ECB itself,<sup>11</sup> competent exercise of this power has remained at the national level, because of its close connection with the supervisory function attributed to the national central bank of the state where the bank is incorporated. Considering ELA as a key component of the system of safety net banking and its close connection with the supervisory function (Gorton & Metrick, 2013), we have to conclude that this power should be exercised by the ECB for banks participating in the SSM (De Grauwe, 2013). The proposal for a directive on recovery and resolution of credit institutions confirms that ELA from a central bank to a troubled bank is not a resolution measure; ELA is one of the tools that authorities could adopt when a bank is solvent (Proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms, recital 24 and Article 5(3)).

However, it is very likely that as long as there is no agreement on how to allocate the burden of banking crises in Europe it will be hard to find a solution to the problem of which authority should offer the ELA.

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<sup>11</sup> ECB, *Annual Report*, 1999, p. 102.

## 6. Conclusion

The project of the SSM was developed within a few months to set up a tool to deal with the adverse consequences of the vicious circle between the tensions in the market for public debt and the fragility of some European banks. As often happens when reaching a political compromise among countries with different national interests and various cultural approaches, the solutions show difficulties of implementation. We highlighted three major problems. First, there are possible inconsistencies in applying the new rules resulting from the presence of multiple authorities with different tasks. Second, the supervisory function is split into distinct tasks: the regulatory activity and the oversight activity, assigning the responsibility for each of them to different authorities. Third, there are some ambiguities in the legal framework having regard to the early intervention measures.

To limit the negative consequences of the plurality of authorities we believe that it is necessary to assign a strong role of coordination to one of them; the most suitable being the EBA. In order to avoid the supervisory tasks of the ECB failing to work properly due to the lack of regulatory powers, it is necessary to clarify that within the supervisory responsibility of this authority is included the definition of regulatory standards. Having regard to the third problem, we think that it is very important for the ECB to play a crucial role in the early intervention phase.

The inconsistencies in the architecture of the new system could be overcome by assigning broad and discretionary powers to the institutions entrusted with the supervisory tasks, as we learned from the history of central banks (Giannini, 2004/2011). According to general theory (Romano, 1918), a legal system is not the outcome of just the will of the legislator, but most of the institutional apparatus and instruments that ensure the implementation of rules. The SSM, despite all the weaknesses identified, could strongly contribute to financial stability, if the supervisor has appropriate powers to reassure markets.



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