PhD-FHSE-2023-023
The Faculty of Humanities, Education and Social Sciences

DISSERTATION

Defence held on 27/04/2023 in Luxembourg

to obtain the degree of

DOCTEUR DE L'UNIVERSITÉ DU LUXEMBOURG

by

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Convergence of national prudential supervision under the European Single Supervisory Mechanism

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Abstract

This dissertation starts with an overview of the recent and ongoing efforts to achieve greater convergence in national banking supervision within the European Single Supervisory Mechanism (SSM). However, the persistence of distinct national preferences on banking supervision has resulted in ongoing differences in the practice of banking supervision at the national level. More specifically, the supervision of Less Significant Institutions (LSIs) has remained under the direct control of national supervisors and to, a certain extent, under national law, thus allowing significant ongoing margin of manoeuvre on supervision.

This dissertation examines the consequences of this margin for manoeuvre left to national supervisors, despite strong convergence pressures through post-financial crisis EU institutional developments. The analysis focus upon the national supervision of LSIs. The main research question guiding this work is, therefore: *under what conditions do pre-existing national institutional configurations continue to determine the trajectory of national supervisory practice in the context of European-level convergence pressures (through the European Banking Authority and the SSM)?*

To answer this question, I use a four-part analytical framework based on, first, Europeanisation which provides insight into top-down processes of integration, second, Historical Institutionalism which provides an understanding of path dependency from earlier policy decisions shaping national supervisory institutions and practice, third, the Epistemic Communities approach and fourth Transnational Policy Network framework. Based on this combined analytical framework, I formulate the following hypothesis: *the more discretion exercised by the national supervisor in relation to its government, the more likely the adoption of policies and practices that result in greater convergence with the rules and practices*

developed at the EU / Banking Union level. To test this hypothesis, I start with a broad assessment of the provisions that provide margin of manoeuvre to national authorities, specifically the options and national discretions (ONDs) explicitly granted to national authorities — member state governments or supervisors — in EU capital requirements legislation: the CRD IV/V and CRR I/II. This assessment provides an initial confirmation of my hypothesis, showing a more important degree of convergence in the cases where national supervisors benefit from full discretion with no intervention from national governments.

I then test the hypothesis on a typical case where NCAs can exercise discretion — the Supervisory Review and Evaluation Process (SREP) — and a typical case with national government intervention that limits supervisory discretion — Non Performing Loans (NPLs). Through an analysis of the French and German national cases with regard to SREP and NPLs, I conclude that the convergence of prudential supervision within the SSM was largely observed in cases where the national supervisor benefitted from discretion as a result of cooperation opportunities and socialisation processes.

Acknowledgements

This dissertation was accomplished with the constant support of many dedicated people. I would therefore like to express my gratitude to all of them.

First and foremost, I would like to express my deepest gratitude to my supervisor Prof. David Howarth for his time, advice, encouragement and enthusiasm. His guidance and considerable knowledge helped me during this journey. I am grateful for the opportunity to work with him on this project.

I am also profoundly grateful to the members of my doctoral dissertation committee, Lucia Quaglia, Aneta Spendzharova, Marta Božina Beroš and Lindsay Flynn, for all their help and advice with this dissertation. Thank you for believing in the project and offering your guidance and insight.

I would also like to thank the supervisors and experts I had the chance to interview for this research project who agreed to share their experience on banking supervision in the EU and provided me with invaluable input.

My appreciation also goes to my family and friends for their encouragement and support throughout these years. I would especially like to thank my parents, brothers and sister. It was only possible to finish my dissertation with their unwavering support over the past few years. Finally, I would like to offer my special thanks to my husband, Erwan Tanné, for his patience, love and encouragement.

Contents

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List of abbreviations

ACP	*Autorité de contrôle prudentiel*
ACPR	*Autorité de contrôle prudentiel et de résolution*
AQR	Asset Quality Review
BaFin	*Bundesanstalt für Finanzdienstleistungsaufsicht*
BAKred	*Bundesaufsichtsamt für das Kreditwesen*
BRDD	Banking Recovery and Resolution Directive
CEBS	Committee of European Banking Supervisors
CET1	Common Equity Tier 1
COREFRIS	*Conseil de Régulation Financière et du Risque Systémique*
CRD	Capital Requirement Directive
CRR	CRR Capital Requirement Regulation
DG FISMA	Directorate General Financial Stability, Financial Services and Capital Markets Union
DG MS III	Directorate General Microprudential Supervision
DGS	deposit guarantee scheme
Dpd	Days past due
DV	dependent variable
EBA	European Banking Authority
EBF	European Banking Federation
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs
EDIS	European Deposit Insurance Scheme
EFSF	European Financial Stability Facility

EIB	European Investment Bank
EMU	European Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
FBF	French Banking Federation
FINREP	Financial Reporting
GDP	Gross Domestic Production
GroMiKV	*Grosscredit- und Millionen- Kreditverordnung*
G-SII	Global Systemically Important Institution
HCSF	High Council for Financial Stability
HI	Historical Institutionalism
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IRB	Internal Rating Based approach
IT	Information technology
ITS	Implementing Technical Standard
IV	Independent Variable
JST	Joint Supervisory Team
KWG	*Kreditwesengesetz*
LI	Liberal Intergovernmentalism
LCR	Liquidity Coverage Ratio
LSI	Less Significant Institution

MaRisk	*Mindestanforderungen an das Risikomanagement*
NCA	National Competent Authority
NPB	National Promotional Bank
NPE	non-performing exposures
NPL	non-performing loan
OeNB	*Oesterreichische Nationalbank*
OND	Options and National Discretion
OCR	Overall Capital Requirement
ORAP	*Organisation et Renforcement de l'Action Préventive*
O-SII	Other Systemically Important Institution
P2G	Pillar 2 Guidelines
P2R	Pillar 2 Requirements
PSE	Public Sector Entity
Q&A	Question and Answer
RAS	Risk Assessment System
RCI	Rational Choice Institutionalism
ROW	Rest of the World
RTS	Regulatory Technical Standards
SA	Standardised Approach
SCOP	Standing Committee on Oversight and Practices
SME	Small and Medium Enterprise
SPE	Special Purpose Entity
SSM	Single Supervisory Mechanism
SRF	Single Resolution Fund
SREP	Supervisory Review and Evaluation Process

SRM Single Resolution Mechanism

SURFI *Système unifié de reporting financiers*

TFEU Treaty on the Functioning of the European Union

Chapter 1 Introduction

1.1 Creation of Banking Union in the aftermath of the financial and debt crises

European Banking Union was created in the aftermath of the international financial crisis and the Euro Area sovereign debt crisis that played out from 2007 through to the early 2010s (see for instance, De Rynck, 2016; Donnelly, 2014; Epstein and Rhodes, 2016; Howarth and Quaglia, 2016a; Schimmelfennig, 2016). Banking Union was seen as a tool to break the vicious nexus between the banks and sovereigns. Its creation was announced as a necessary objective at the Euro Area Summit on 29 June 2012. Following this announcement, on 12 September 2012, the Commission issued a Roadmap for a Banking Union, composed of three pillars — a Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Single Deposit Guarantee Scheme. All the Euro Area member states became members of Banking Union, and non-Euro Area member states could also opt in to participate in Banking Union through a close cooperation agreement with the European Central Bank (ECB). The main objectives of Banking Union are to ensure a stable, safe and reliable banking sector, which shall contribute to the financial stability of the European Union (EU).

The SSM was established as the first pillar of Banking Union through the adoption of the SSM Regulation of 15 October 2013,[1] and has been operational since 4 November 2014.[2] The SSM Regulation granted supervisory competence to the ECB. The creation of the SSM represented a significant and unprecedented transfer of supervisory competence from Euro Area member states to the European Union (EU) and, more specifically to the ECB (Epstein and Rhodes, 2016). However, as will be presented below, despite the labelling of this new

[1] Council Regulation (EU) No 1024/2013 (Council, 2013)
[2] Article 33(2) SSM Regulation

institution as 'single', the ECB did not benefit from a complete transfer of competence and national authorities remained involved in supervisory activities. As a consequence, the SSM — despite its name — is not completely unified and rather should be seen as a convergence trend in banking supervision. The contribution of this dissertation is to analyse the evolution over time of the SSM, since its creation in 2014, almost a decade ago, and to identify if there is an observable trend of convergence. Given the focus of this PhD thesis, the main characteristics of the SSM will be further detailed in Chapter 3. The SSM operates in accordance with the Single Rulebook, a set of legislative provisions applicable to all EU financial institutions including banks and is composed of:

- the Capital Requirements Regulation (CRR I[3] replaced by CRR II[4] in 2019), which mainly addresses Pillar 1 Requirements, thus specifying how to calculate bank capital and liquidity requirements (Alexander, 2015). It is directly applicable in all EU member states; and
- the Capital Requirements Directive (CRD IV[5] amended by CRD V[6] in 2019), which addresses capital buffers, Pillar 2, corporate governance issues, and risk management (Alexander, 2015). Pillar 2 authorises the application of stricter requirements when the specific situation of the bank justifies it. These specific cases are assessed under the Supervisory Review and Evaluation Process (SREP), as will be presented in Chapter 6 of this dissertation. The directive has to be transposed into national legislation to be applicable.

[3] Regulation (EU) No 575/2013
[4] Regulation (EU) No 2019/876
[5] Directive (EU) No 2013/36/UE
[6] Directive (EU) No 2019/878/UE

The second pillar of Banking Union — the SRM — is based on the SRM Regulation (EU No 806/2014) and has been in operation since 1 January 2016.[7] The objective assigned to the SRM Regulation is to establish 'uniform rules and a uniform procedure' for the resolution of non-viable banks and the Single Resolution Board which is in charge of implementing these rules and procedures.[8] The SRM Regulation also foresees the creation of the Single Resolution Fund (SRF), which was established by an International Agreement (No 8457/14) and had to be ratified by member states. Contracting parties must transfer national-level funds to the SRF. The contributions were then to be compartmentalised during the first eight years with a progressive mutualisation after the end of this transition period. In November 2020, Euro Area member states agreed to amend the European Stability Mechanism (ESM) Treaty to transform the mechanism into the financial backstop of the SRF — although by early 2023 some member states had yet to ratify this treaty change.

A European deposit insurance scheme was presented as the third pillar of Banking Union. A deposit guarantee scheme (DGS) is created to protect bank depositors up to a certain amount if their bank fails and their deposits become unavailable. The establishment of a DGS aims to avoid bank runs, which can occur when a large number of customers fearing bank insolvency simultaneously try to withdraw their money from a bank, which in turn can create financial instabilities. All EU banks had to be part of DGSs. In the EU, the European Deposit Insurance Scheme (EDIS) had to be enforced gradually based on national deposit guarantee schemes. It aimed to provide a more uniform and solid insurance cover than existing national DGSs for retail depositors up to a hundred thousand euros per person and per bank. However, the proposal to create EDIS failed because of the opposition from some member states. The main reasons invoked concerned the refusal to impose the guarantee costs on member states

[7] Article 99(2) SRM Regulation
[8] Article 1 SRM Regulation

with more stable banking systems, the perception of moral hazard that EDIS could create for banks and the failure of the harmonisation of national deposit guarantee schemes (Howarth and Quaglia, 2018; Quaglia, 2019a; b).

When using the term 'banks' in this dissertation, I will refer to credit institutions as defined by Article 4(1)(1)(a) of the CRR, described as 'an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account'. However, one should bear in mind that national definitions of credit institutions may vary. In some member states, institutions that do not receive deposits are also called credit institutions. For instance, French law defines credit institutions to include leasing, factoring and other specialized financing institutions. In contrast, the German Banking Act includes securities trading banks and other credit institutions which do not fall within the CRR definition. These institutions outside the CRR definition remain under the exclusive competence of the national supervisor with no intervention from the SSM.

1.2 The distinction between regulation and supervision

Before digging into the details of banking supervision convergence, I will clarify the main terminology used for this project: prudential regulation and supervision. Banking regulation is a prescriptive activity; it corresponds to the set of rules and standards prescribing predefined requirements and defining interactions between the supervisor and the bank to promote financial stability and ensure customer protection (de Larosière, 2009: 13; Dragomir, 2010; Gren, 2016). At the same time, banking supervision corresponds to the implementation of these rules to the specific entity, notably by monitoring their action when it comes to micro-prudential supervision and monitoring system-level risks and taking steps to limit or avoid such risks with regards to macro-prudential supervision (see also the distinction presented by

Dragomir, 2010). Prudential supervision refers to the activity of surveillance of banks by competent authorities in respect of prudential regulation.

Under Banking Union, prudential regulation primarily relies on the EU's Single Rulebook. Its main objectives are to eliminate divergence in national legislation, guarantee the same level of consumer protection and ensure a level playing field for all banks across the EU. The Single Rulebook is a uniform regulatory framework composed of three legislative layers of rules governing the financial sector. It includes Level 1 legislation composed of the banking package (CRD IV/V, CRR I/II), the amended DGSs directive and the Bank Recovery and Resolution Directive (BRDD I/II). This Level 1 legislation is complemented by Level 2 measures and the Level 3 regulatory framework. The former is composed of quasi-legislative provisions such as delegated and implementing acts (e.g. Regulatory Technical Standards (RTSs) and Implementing Technical Standards (ITSs)) issued by the European Banking Authority (EBA) which then need to be adopted by the European Commission; and the latter includes provisions fully delegated to the EBA and non-binding provisions issued by the EBA such as guidelines and recommendations, and eventually national implementing provisions (de Larosière, 2009; Ferrarini and Recine, 2015; Enria, 2015). In its initial proposals for the establishment of the Single Rulebook, it was foreseen that the Level 1 legislation should include only high-level political principles and the operational provisions with specific requirements should be delegated to technical authorities such as the EBA (Enria, 2015). In the same vein, according to the EBA Funding Regulation, the scope of these technical standards was determined by the legislative provisions on which they were based and could not be used to make strategic or policy choices. In reality, the banking package often delegated strategic decisions to the technical standards and, in practice, delegated legislation includes political provisions which should require the intervention of EU legislators (Commission, European Parliament and the Council) (Cappiello, 2015; Enria, 2015). Prudential regulation increasingly

includes detailed technical risk-sensitive and process-oriented measures, which makes it increasingly interrelated with prudential supervision (Dragomir, 2010; Ferrarini and Recine, 2015). Some overlap between supervision and regulation can be observed with regard to the case of Options and National Discretions (ONDs) that will be presented in Chapter 4. The Single Rulebook still provides room for regulatory flexibility when transposing directives and ONDs under the CRR addressed to national governments and supervisory discretion through ONDs addressed to National Competent Authorities (NCAs), further demonstrating the overlap between regulation and supervision (Maddaloni and Scopelliti, 2019). On the contrary, the ECB can also issue regulations, guidelines and recommendations; therefore, the supervisory authority exercises, de facto, some prudential regulation activities (Ferrarini and Recine, 2015). Chapter 3 of this dissertation provides a more detailed overview of the interaction between EU prudential supervision and regulation.

1.3 On the convergence of prudential supervision

The current structure of prudential supervision in the EU did not eliminate divergent supervisory practices. The convergence of prudential supervision is expected to achieve consistent outcomes and a level playing field in the EU. However, the objective of this dissertation is not to discuss whether convergence is needed but to analyse why and under what conditions it occurs. The level of required convergence depends on a bank's location and size. At the EU level, banks headquartered in non-Banking Union member states remain under the supervision of their NCAs with the legally-enshrined possibility to maintain divergent implementation of some prudential provisions such as ONDs. At the same time, the SSM created an integrated and convergent supervisory regime which has increased the complexity of the overall structure of prudential supervision. The new prudential framework set up a two-level supervisory system to replace a member state-based system. The SSM Regulation

introduced a distinction between Significant Institutions and Less Significant Institutions (LSIs). This distinction was an issue of considerable disagreement during the negotiations leading to the agreement on the SSM design. Some member states — France, the Netherlands, Italy, Spain and Luxembourg — were in favour of direct supervision of all Euro Area banks by the ECB.[9] In contrast, some other member states, led by Germany, preferred to transfer to the ECB only the supervision of systematically important banks (Howarth and Quaglia, 2016a). Eventually, the Euro Area member states agreed to define a Significant Institution as a bank in participating member states that meets one of the criteria listed below:[10]

- the total value of assets of the bank is over €30 billion; or
- the total value of assets represents 20 per cent of its home gross domestic production (GDP) and whose total value of assets exceeds €5 billion; or
- the total value of assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating member state to the total of its assets/liabilities is above 20 per cent; or
- the bank is one of the member state's three most significant banks, even if it does not reach the thresholds presented above (Council, 2013).

Moreover, a bank is considered a Significant Institution if it has received financing from the European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM). The remaining banks are considered LSIs.

The supervision of Significant Institutions was transferred to the ECB within the SSM, creating new centralised supervision (Kudrna and Puntscher Riekmann, 2018). However, even in the case of Significant Institutions, full convergence was not guaranteed because in some

[9] Some of these countries also wanted to delegate de facto supervision to member state NCAs, which would be monitored by the ECB (Howarth and Quaglia, 2016a: 93)
[10] Article 6(4) of SSM Regulation

cases the ECB had to apply different national legislation (Enria, 2015).[11] The supervision of LSIs remained ensured by NCAs, whereas the ECB was in charge of overseeing NCAs' supervision and could also prescribe supervisory priorities or evaluation principles.[12] Moreover, in exceptional circumstances, to ensure the consistent application of prudential requirements, the ECB could assume the direct supervision of LSIs (Council, 2013).[13] To the time of writing (early 2023), the ECB has never used this possibility and assumed control of the direct supervision of LSIs for convergence purposes. At the start of the operation of the SSM in November 2014, 19 national varieties of prudential supervision co-existed with additional centralised supervision by the ECB. Consequently, the SSM allowed divergence at the cross-border level and potentially contributed to divergence at the national level among Significant and Less Significant Institutions.

On the one hand, Significant Institutions depended on the EU's converged prudential supervision; on the other hand, LSIs were subject to the different national practices of NCAs and national governments. As a consequence, banks headquartered in the same member state could be subject to different supervisory treatment. The distinction between LSIs and Significant Institutions created the risk of further diverging supervision of LSIs. This risk motivated the focus of this research project on the convergence of the prudential supervision of LSIs.

The number of Significant Institutions was 120 in 2014, 117 by the end of 2019 and it decreased to 110 as of mid-2022.[14] The number of LSIs in the Euro Area also shrank from 3000

[11] Regulation 1024/2013 (articles 4(3), 9(1), 18(5), 21(4))
[12] According to the CJEU, NCAs only implement supervisory tasks and the competence for supervision remains exclusively with the ECB (L-Bank case C450-17)
[13] article 6(5)(b) of SSM Regulation
[14] Data from ECB website, https://www.bankingsupervision.europa.eu/banking/list/html/index.en.html, consulted on 20/08/2022

institutions at the creation of the SSM to approximately 2400 institutions in 2022.[15] This decrease in the number of institutions corresponds to the consolidation of the sector, which was also reinforced by structural changes that occurred in some of the participating member states. For instance, in Italy, 228 cooperative banks were incorporated into two significant banks — Iccrea and Cassa Centrale Banca. Despite their consolidation, LSIs are still less profitable than Significant Institutions[16] and their supervision depends mainly on NCAs which were less subject to convergence pressure and are often considered less stringent.

The convergence process was in particular triggered by multilevel legislation, as presented above. Firstly, the convergence was facilitated by the Level 1 legislation of the Single Rulebook, particularly its Banking package for prudential supervision.[17] Convergence was further encouraged by Level 2 measures, with delegated and implementing acts from the European Commission or, exceptionally, the Council[18] and RTSs and ITSs from the EBA endorsed by the European Commission.[19] The EBA could also issue Level 3 guidelines and recommendations. The EBA promoted the coordination of supervision and drafted technical standards in favour of the convergence of prudential supervision. As will be presented in Chapter 3, EBA guidelines and recommendations were soft law provisions. Still, national authorities had 'to make every effort to comply' with the guidelines and explain the reasons in case of non-compliance.[20]

[15] Data from ECB website, https://www.bankingsupervision.europa.eu/banking/list/html/index.en.html, List of all supervised entities (cut-off date for changes: 1 July 2022), consulted on 20/08/2022

[16] LSIs Return on Equity was 4.7 per cent in 2018 compared to 6.2 per cent for Significant Institutions (data from ECB website)

[17] Banking package includes both CRD IV/V and CRR I/II

[18] Article 291 of the Treaty on the Functioning of the European Union (TFEU)

[19] Articles 10 and 15 of Regulation No 1093/2010 establishing a European Supervisory Authority

[20] article 16 of Regulation No 1093/2010

The SSM introduced another level of regulation and assigned two roles to the ECB. At the EU level, the ECB could be seen as one competent authority among others, and in this respect was expected to follow the Single Rulebook provisions. This was confirmed by the inclusion of the ECB in the EBA Regulation as one of the competent authorities. However, the ECB was not only one of the competent authorities but was assigned oversight authority in relation to NCAs in the SSM with additional powers to promote supervisory convergence. Article 4(3) of the SSM Regulation conferred some regulatory power to the ECB, which could adopt guidelines, recommendations and regulations. The purpose of ECB regulations was limited to organising or specifying the arrangements for carrying out its tasks which was to exclude the regulation of prudential matters (Ferrarini, 2015). For the supervision of LSIs, the NCAs were thus subject to the ECB's regulations, guidelines and general instructions in addition to the Single Rulebook provisions.

The consistency in EU and Banking Union measures required the cooperation of the ECB with other EU institutions, particularly with the EBA (Ferrarini, 2015; Navaretti, et al. 2015). The ECB took the EBA provisions as its point of departure in its convergence work. This was, for instance, the case for non-performing exposures (NPEs), as will be presented in Chapter 5. In 2013, the EBA published an ITS which developed a common EU definition of NPE. In March 2017, the ECB issued a 'Guidance to banks on non-performing loans', with an objective to standardise supervisory practices on how to handle NPEs and the definition of NPEs, as referred to in the EBA's ITSs.

Despite the objective of the Single Rulebook and the SSM, differentiated implementation with different actors involved in the process undermined convergence. The lack of convergence can be seen in the outcome of the first SSM's comprehensive assessment, which was undertaken by the ECB in the summer and autumn of 2014. The comprehensive assessment evaluated the financial health of banks supervised by the ECB. It included the risk assessment

by the supervisor, the Asset Quality Review (AQR) of banks by the ECB and a stress test undertaken by the EBA. The comprehensive assessment demonstrated significant discrepancies in the quality and quantity of capital required across all supervised banks. The differential implementation of European capital requirements legislation was identified as the main explaining factors for these discrepancies (Angeloni, 2015). There was a significant divergence in the transposition of the CRD IV into national legislation. Even though the use of a directive allowed differences in national transposition, the analysis of the transposition of CRD IV by the ECB mentioned 'unjustified differences' in some member states (ECB, 2016a).

Moreover, some regulations remained national, such as deposit and taxation legislation. The role played by national governments is another important element which will be analysed in this doctoral dissertation. Indeed, it is expected that the active role played by national governments in some areas of prudential regulation will limit the discretion of NCAs, which in turn could limit the convergence of national prudential supervision. Divergence also stemmed from the possibility offered under the banking package to use ONDs. As will be outlined in this dissertation, achieving convergent prudential supervision was a long-standing objective of the EU. Since its creation, the EBA has issued reports on the convergence of supervisory practice in the EU. Even before that, the predecessor of the EBA — the Committee of European Banking Supervisors (CEBS) — presented the convergence of banking supervision practice in the Single Market as its main priority. The ECB also stressed the importance of the convergence of prudential supervision, claiming that it would promote the 'soundness of credit institutions and the stability of the financial system' (ECB, 2018b).

The objective of this research project is twofold: to contribute to the analysis of the process of convergence of prudential supervision in the EU and to provide an analysis that combines Europeanisation, Historical Institutionalism, an Epistemic Communities approach and Transnational Policy Network framework to examine the role of national authorities —

governments and supervisors — in the convergence of prudential supervision to EU standards. The main research question I aim to answer in this doctoral dissertation is: *Under what conditions do pre-existing national institutional configurations continue to determine the trajectory of national supervisory practice in the context of European-level convergence pressures* (through the European Banking Authority and the Single Supervisory Mechanism)? The core argument of this dissertation is that where national supervisors have more autonomy with regard to their supervisory rules and procedures, there will be more convergence. Where national governments have control, there will be less convergence.

As such, this dissertation challenges initial expectations. First, it is surprising to find that national authorities — supervisors and governments — have different positions on prudential supervision. Officially, national governments are also committed to supervisory convergence in the SSM. For instance, Olaf Scholz, as German Minister of Finance argued that Banking Union needs to be achieved via harmonisation of prudential regulation and supervision in member states and that this harmonisation cannot just be based on similar regulations across member states but should also rely on a European authority with intervention power (Deutsche Bundesbank, 2020). In the same vein, the French Ministry of Finance issued a position that the SSM shall be based on the homogenised practice of banking supervision of all banks, including the alignment of EU standards for LSIs and elimination of national regulatory biases (Directorate General of Treasury, 2017). Second, EU institutions such as the ECB, the EBA and the European Commission exercise considerable pressure to encourage convergence, as will be examined in Chapter 3 of this dissertation. One would therefore expect both governments and supervisors to accept convergence. At the same time, third, some supervisors have longstanding practices which might be interpreted as resistance to change. For instance, Lombardi and Moschella (2016) — based on the German and Italian cases — argue that the

supervisors express resistance to the SSM when they are assigned only micro-prudential powers and lack control over monetary policy.

In the next chapter (Chapter 2), I will introduce the analytical framework of this dissertation based on the Europeanisation framework which provides insight into top-down processes of integration, combined with Historical Institutionalism which provides an understanding of path dependency from earlier policy decisions shaping national supervisory institutions and practice. I combine these frameworks with the Epistemic Communities approach and the Transnational Policy Network framework. I mainly focus on the convergence of supervision of LSIs, which are still directly supervised by NCAs. I present the overview of main areas providing discretion to national authorities – ONDs and then explain the selection of case studies on the convergence of NPLs and SREP in Germany and France and present the dissertation's research design.

Chapter 3 outlines the development of the EU and national supervisory institutional framework which despite granting EU institutions — the ECB and the EBA — supervisory competences left room to manoeuvre to national competent authorities. The NCAs have been able to upload their preferences to the EU level, which in turn has facilitated the implementation of EU prudential requirements at the national level. Subsequent chapters present the empirical analysis of convergence. In Chapter 4, I will test the presented hypothesis on numerous provisions that provide discretion to national authorities — NCAs and national government — through Options and National Discretions. I will then examine the two thematic case studies, which provide variation in independent variable through an analysis of the French and German country cases. One thematic case is largely dependent on government legal intervention — NPLs (Chapter 5) — while the other mainly on the national supervisor — SREP (Chapter 6). From the analysis of these case studies, I will note that supervisory convergence was largely observed in cases where national supervisors benefitted from discretion from national

governments as a result of cooperation opportunities and the socialisation process. A significant dichotomy will be observed between the position of the national government and the national supervisors. The last Chapter (7) summarises the main findings of this dissertation using the combined Europeanisation, Historical Institutionalism and Epistemic Community approach/ Transnational Policy Network framework. Providing national supervisory authorities with discretion fosters the convergence of prudential supervision — which is mainly explained by socialisation pressures on NCAs and learning — whereas the involvement of national governments is more likely to create *inertia* and therefore limit change.

I then present control cases through a succinct analysis of the Estonian and Luxembourgish cases. Both control cases also confirm the initial hypothesis, showing that Estonian and Luxembourgish supervisors have implemented EU requirements on SREP, but the implementation of NPLs provisions varied, with Estonia maintaining its national specificities according to its national pre-existing legislation and Luxembourg implementing the EU provision in the absence of legal intervention. Eventually, I presented some policy recommendations, strengthening socialisation mechanisms between the ECB and NCAs, and favouring the involvement of national non-elected supervisory officials in banking supervision.

Chapter 2 Analytical Framework and methodology – understanding the influence of national institutional framework on the convergence of national prudential supervision under the SSM

2.1 Introduction – the objective of the study – explaining the convergence of national prudential supervision in Banking Union

This research project starts with observing the current efforts to achieve greater convergence of banking supervision in the SSM. This desire is expressed by the European Commission, but also by the European Parliament and the Council in accepting the use of both - the regulations (Capital Requirement Regulation (CRR) I and II) and the directives (CRD IV and V), which means that the current supervision is not fully converged. Moreover, the regulation contains Options and National Discretions, a source of divergence embedded in the EU legislation. In this dissertation, I will study the factors that explain this lack of convergence of prudential supervision despite solid pressures to convergence in the context of significant post-crisis EU institutional and legislative changes. I will study these factors from a national perspective, focusing on those that explain the national supervisory practice and influence national authorities' position towards European integration in banking supervision and supervisory convergence. I thus aim to address the following research question: *Under what conditions do pre-existing national institutional configurations continue to determine the trajectory of national supervisory practice in the context of European-level convergence pressures (through the European Banking Authority and the Single Supervisory Mechanism)?*

In this research project, I will focus on the convergence of the prudential supervision of Less Significant Institutions (LSIs). More specifically, I will analyse the national

implementation of specific supervisory rules and mechanisms for which there is still a margin of manoeuvre for member states allowed by the Single Rulebook. The convergence of prudential supervision at the national level for these non-converged provisions requires the modification of existing institutional frameworks in member states — organisations, laws and established policies and practices. This research project aims to analyse how existing domestic settings will impact the convergence of national systems officially encouraged through Banking Union. The selected case studies are part of the flexibility allowed in the banking package. Their choice was motivated by the importance of these provisions for financial stability in the EU. I will first present a large overview of cases where EU legislation explicitly left discretion to national authorities – Options and National Discretions (ONDs). Then I will present two thematic cases that offer a variation in the independent variable, with a typical case with legislative/ executive intervention that limits supervisory discretion and a typical case where the NCAs exercise discretion.

The first case presented in this dissertation is the convergence of national non-performing loans (NPLs) definition and treatment. Indeed, this is a politicised issue that may have a major impact on financial stability. After the financial and debt crises, the NPL ratio in the EU member states increased significantly. Despite improving the economic situation up to early 2020, the proportion of NPLs remained too high in several Banking Union member states. For instance, the NPL ratio to balance sheet across Banking Union reached 7.5 per cent in June 2015 and 3.4 per cent end of 2019. This is up to three times higher than in other regions of the world (ECB and World Bank data).

Moreover, the distribution of NPLs was highly unequal among member states; by the end of 2019, Greece reported 37.4 per cent and Cyprus 17.5 per cent of NPLs in their balance sheets, whereas Germany and France reported below three per cent (ECB dataset). The high level of NPLs is an issue for banks, which face difficulties lending because of lower

profitability, higher capital requirements and increased funding costs. It is also an issue at the macroeconomic level with the limitation of available capital and a decrease in credit growth (EBA, 2016a; EIB, 2014; IMF, 2015). To provide investors and supervisors with sufficient information about the quality of assets, the European Commission encouraged transparency on NPLs and member states were required to disclose information on their exposures (European Commission, 2017; EBA, 2013a). However, this obligation was not followed by a common definition of NPLs at the EU level. Different terms designating non-performing assets could coexist at the national level (d'Huelster et al., 2014).

The following case is the convergence of Supervisory Review and Evaluation Processes (SREPs). SREP allows a supervisory review of the capital and liquidity situation of the banks more continuously than the evaluation of pillar I risk limits and considers banks' internal governance and risk management practices. The reason for choosing this case study is also based on the importance of this process for the supervision of banks. As a holistic approach, it allows a supervisory review of the capital and liquidity situation of the banks in a more continuous way that considers banks' internal governance and risk management practices (Baglioni, 2016; Dragomir, 2010). The objective of SREP is to continuously review and evaluate the risk profile of supervised institutions and consider all types of risks and the specificities of each bank. The introduction of SREP by CRD I reinforced the autonomy of NCAs, which could use different types of evaluation processes with more focus on qualitative and/or quantitative elements in their assessment (McPhilemy, 2014). This means that the supervision of banks could be highly divergent depending on the countries in which they are located.

The objective of the research is also to evaluate ongoing national differences in SREP and NPLs and the national institutional frameworks that explain these differences. In order to achieve this, I will use an analytical framework based on Europeanisation which provides an

insight into top-down processes of integration — and precisely supervisory convergence — and Historical Institutionalism (HI) which provides an understanding of path dependency from earlier policy decisions shaping national supervisory institutions and practice. I combine these frameworks with the Epistemic Communities approach and Transnational Policy Network framework, demonstrating how banking supervision can be shaped by non-elected actors such as supervisors. The next section presents the analytical framework applied to this study (2.2). I then introduce complementary and alternative approaches to explain national resistance to convergence pressures within the SSM (2.3). The following sections present dependent (2.4), antecedent (2.5) and independent (2.6) variables used for this study. The subsequent section (2.7) explains the selection of case studies and the research design (2.8). And eventually, the last section concludes (2.9).

2.2 The analytical framework applied to this study

To come up with the analytical framework, I used an inductive and iterative process. I started by looking at the empirical evidence and then at a range of possible explanatory frameworks. I then tool elements from different theoretical frameworks that are useful to combine and that provide the most effective analysis and that will work best to answer the research question. In this subsection, I start by presenting the Europeanisation framework, which is an analytical tool for understanding the integration process and different levels of integration (2.2.1). This framework will identify the convergence processes occurring in Banking Union member states. Then I will introduce Historical Institutionalism (HI), which focuses on existing national legal/ political frameworks that will shape Europeanisation (2.2.2). It is expected that change is most likely to happen when supervisors have a policy-making margin of manoeuvre with no or limited restrictions from majoritarian institutions (political executives and parliaments). Subsequently, I present the Epistemic Communities approach and

Transnational Policy Network framework that I adopt to explain why supervisory authorities are more likely to modify national policies and practices to converge to commonly agreed EU / Banking Union policy and practice (2.2.3).

Such an analytical framework leverages the long-standing debate about the role of structure and agency in institutional change as developed in political science (Dessler, 1987; Wendt, 1987). This analytical framework shows how structure and agency are interrelated and how we can endogenise agency in HI and Europeanisation. We could consider that HI and Europeanisation are used to shed light on institutions and, therefore on structure-based arguments (see, for instance, Börzel and Risse, 2012; Fioretos et al., 2016; Hay and Wincott, 1998). In contrast, the Epistemic Communities approach and Transnational Policy Network framework fit with agency argument of how national and EU actors – members of the NCAs, the ECB and EBA – create and/or respond to the EU convergence pressure. The latter also shows how they interact with each other and share ideas and practices.

2.2.1 Europeanisation

This research project aims to analyse the convergence of national supervision under the SSM. I start the analysis with Europeanisation, which studies European integration processes from EU and national perspectives. Different definitions of Europeanisation coexist. In its earlier version, Europeanisation referred to the transfer of domestic policy to the EU level (e.g., Börzel, 1999). Later, scholars also used this term to refer to the impact of the EU at the national level and thus Europeanisation as a top-down process (Ladrech, 2010; Schimmelfennig and Sedelmeier, 2005). Börsel and Risse (2000) studied the impact of EU institutions on national political institutions and policymaking, whereas Haverland (1999) and Duina (1999) focused on the implementation of EU legislation at the national level. Europeanisation also refers to a

'two-way' process where the member states upload their national policies and institutions to the EU level and adapt to the top-down pressure from the EU (Börzel, 2002; 2012; Bandov and Kolman, 2018; Radaelli, 2003).

Horizontal Europeanisation or cross-loading was also introduced, with member states uploading their domestic policies to have them downloaded elsewhere (Börzel, 2002; Schimmelfennig et al., 2005; Vale, 2011). In its broader meaning, Europeanisation can be described as 'a shorthand term for a complex process whereby national and sub-national institutions, political actors, and citizens adapt to and seek to shape the trajectory of European integration in general, and EU policies in particular' (Bomberg and Peterson, 2000:7). Such a definition includes top-down or downloading of EU influence at the member state level, the bottom-up influence of national actors on EU policies and cross-loading influences of the integration process. This framework is often used as a broad concept depicting the process of national politics being increasingly affected by European integration. It has been applied broadly to a range of EU policies (Boasson, 2020; Graziano and Vink, 2006; Haverland, 2003; Knill and Lenschow, 2001; Lenschow, 2006).

In this dissertation, I focus on the downstream process by analysing the integration of EU-level provisions into national systems. In both thematic case studies selected for this research project, member states must adapt their domestic institutional settings to comply with EU pressures. Yet, this adaptation does not always mean a complete convergence of national institutional settings. This change can be described as a 'domestic adaptation with national colours' with national specificities influencing the outcome of the change despite EU pressure (Risse et al., 2018). In this dissertation, I refer to Europeanisation as an interactive process of change in national politics and policies. Europeanisation introduces a new approach to the study of European integration by giving primacy to the domestic level instead of the European level (Buller and Gamble, 2002).

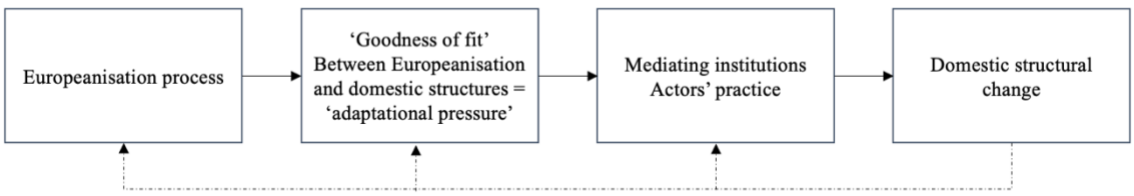
Europeanisation can have a differentiated impact on domestic policies through positive, negative or framing integration (Buller and Gamble, 2002). Positive integration corresponds to the changes occurring in a situation of concrete coercive pressure for change from the European level. In contrast, negative integration corresponds to the changes in opportunity structures for domestic actors (Buller and Gamble, 2002). Finally, 'framing integration' corresponds to the adaptation of existing institutions through the changes in domestic beliefs occurring because of changes at the European level (Buller and Gamble, 2002).

EU-level adaptational pressure is considered a necessary condition – although not sufficient in itself – for change at the domestic level (Börzel and Risse, 2003). To introduce a change, Europeanisation must fit 'adaptational pressure' at the national level (Cowles et al., 2001; Radaelli, 2004), which will also explain differences in the degree and pace of integration (Börzel and Risse, 2000). These adaptational pressures can be seen as policy misfits between EU and domestic policies and/or institutional misfits of rules and procedures at the national level (Börzel and Risse, 2000; Cowles et al., 2001). Europeanisation at the national level can occur when there are strong adaptational pressures at the EU level which result in change in national practice (Risse et al., 2018). The change at the EU level will exercise an adaptational pressure when it differs strongly from what already exists at the national level (Risse et al., 2018). At the same time, the pressure is expected to be limited when the EU-level change corresponds to the pre-existing national setting. In the meantime, when the adaptational pressure is strong, the costs of national change are higher, and the member states are more likely to experience resistance to change which could also limit change. This analytical focus determined the selection of case studies in this dissertation intending to highlight differences between the EU and national institutional settings, which result in adaptational pressure. The two distinct cases allow us better to assess Europeanisation's impact on national institutional change.

The presence of adaptational pressure will not necessarily lead to Europeanisation, which depends on the presence of mediating factors (Cowles et al., 2001). Five factors are considered as intervening variables: multiple veto points, facilitating formal institutions, organisational and political cultures, differential empowerment of domestic actors and learning (Cowles et al., 2001). The first three variables correspond to the structural elements that will facilitate or impede the domestic response to adaptational pressure, and the latter two are related to agency (Risse et al., 2018). Multiple veto points correspond to the situation where the political system is based on power dispersion and difficulties in building coalitions. In such circumstances, policy-making structures will struggle to obtain a consensus to introduce the change at the national level (Tsebelis, 1995). In opposite situations, facilitating formal institutions will provide national political actors with material and ideational resources to achieve national institutional and policy change (Risse et al., 2018). Organisational and political cultures correspond to the collective understandings attached to institutions and appropriate behaviour in a given situation (Risse et al., 2018).

When it comes to the mediating factors related to agency, domestic actors have differential empowerment because of structural changes. The transfer of power at the EU level can therefore strengthen the power of specific national actors in relation to others (Moravcsik, 1994; Risse et al., 2018). However, Marks (1993) and Sandholtz (1996) consider that the empowerment of specific national actors in the context of Europeanisation is mainly due to the possibility of bypassing national executives with no additional prerogatives. And eventually, the fifth mediating factor is learning. The authors refer here to ‘double-loop learning’, which corresponds to the situation that might influence changes in national actors' interests and identities, which would lead to Europeanisation (Risse et al., 2018). Consequently, as illustrated in Figure 1.1. below, change is possible when there is a combination of the development of EU-level rules, strong adaptational pressure and beneficial mediating factors.

Europeanisation introduces the measurement of policy change according to the degree of 'fit'. Scholars consider four distinct degrees of Europeanisation: *inertia*, *absorption*, *transformation* and *retrenchment* (Börzel, 1999; Héritier, 2001; Radaelli, 2001). *Inertia* indicates an absence of change, with national actors producing resistance to implementing EU reforms. This situation is often unbearable in the long term and risks creating an abrupt change (March and Olsen, 1996). *Absorption* is an intermediate situation when some adjustments are introduced to accommodate EU requirements, but the core of institutional structures remains unchanged (Héritier, 2001). *Transformation* involves a significant change at the national level. Eventually, *retrenchment* corresponds to the radical rejection of the EU order by a member state, with national policy becoming 'less European' than before (Héritier, 2001; Radaelli, 2003). Therefore, in this dissertation, I consider that only the cases of *absorption* and *transformation* will correspond to change in national practice towards Europeanisation.



Source : Risse et al., 2018

Figure 2-1Europeanisation and domestic structural change

a. Application to banking supervision

Few studies apply Europeanisation to banking supervision. Quaglia (2008) applies the framework to analyse banking supervision reform in the United Kingdom, Germany and Italy. The author argues that national factors — the existing configuration of the financial sector and the confirmation of national political institutions — played the role of mediating factors which

influenced the outcome of reforms at the national level. Howell (2004a; b) uses a Europeanisation framework to assess the interaction between uploading and downloading European integration and their impact on financial services regulation in the UK. The author argues that the achievement of uploading a member state position at the EU level, such as the formulation of directives, influenced the outcome of downloading in the domestic environment (Howell, 2004a; b).

b. Limits of Europeanisation

Europeanisation studies mainly focus on European-level pressure for domestic change. They seek to explain how EU-level institutions shape national politics and policies (Cowles et al., 2001). They assume EU-level factors are the main explaining factors of change at the domestic level. Even though *adaptational pressures* also introduce national-level conditions, the Europeanisation framework does not primarily focus on domestic-level independent variables. Therefore, it introduces but does not explain the divergence of change at the national level. I propose focusing this study on the national mediating factors of change.

Europeanisation does not study the factors resulting in variation in impact. The level of change due to Europeanisation is also difficult to measure. Using this framework, it is possible to base change assessment on a standard set at the EU level — the 'synthetic EU prototype' (Harmsen, 1999). Europeanisation can be used to observe a correlation between EU stimuli and national policy changes. For example, in a study of the Europeanisation of macroeconomic policy and financial regulation in Italy, Quaglia (2013) concludes that the degree of Europeanisation depends on the nature of EU rules prescribing domestic institutional change. When the EU rules prescribing change consist of 'hard' rules, domestic change is more likely to be transformative (Quaglia, 2013). Whereas 'soft' EU rules often lead to *inertia* (Quaglia, 2013). However, the framework does not establish a clear causal relationship, and the link

between these two events cannot necessarily be explained by the framework (Featherstone, 2003; Haverland, 2006; Moumoutzis and Zartaloudis, 2016; Radaelli, 2012 Vale, 2011). This is especially the case when EU provisions are not binding and leave a margin of manoeuvre to member states.

Europeanisation also does not explain preferences and identities. In their book, Cowles et al. (2001) conclude that there is not a single convergence but a 'domestic adaptation with national colours' (Cowles et al., 2001), which points to the importance of national characteristics. To more effectively analyse the importance of national institutional settings to explain Europeanisation, I complement the Europeanisation framework with Historical Institutionalism. Convergence is a continuous process occurring in time and for which national institutional features matter. Applying Historical Institutionalism (HI) helps explain the integration process's impact over time. HI endogenizes national preferences and identities. The combination of Europeanisation with HI to analyse the factors contributing to and hindering convergence in supervisory practice allows me to highlight the stability and *inertia* of institutions (Cowles et al., 2001). While the Europeanisation framework addresses whether or not convergence occurs, HI provides insight into how this process occurs. HI also helps to explain the lack of change and, therefore, of convergence because if there are insufficient forces to trigger change, institutions will face *inertia* caused by existing arrangements which reflect path dependency (Sewell, 2005). In the next section, I will explain the contribution of HI to my analysis. In both selected case studies, national authorities (politicians/ governments and supervisors) benefit from important discretionary powers, specific supervisory settings and institutional differences which can influence the convergence processes. It is expected that supervisors will be more likely to shift their supervisory practice where they have a margin of manoeuvre than politicians are to modify national legislation. However, Europeanisation and HI do not explain how these national authorities use their discretionary power to reinforce or

inhibit the convergence process. To respond to this question, I will introduce an additional intervening variable at the level of national supervisory authorities. I propose complementing the HI and Europeanisation framework with an analysis of Epistemic Communities approach and Transnational Policy Network framework.

2.2.2 The development of HI

a. Presentation of HI

HI is a middle-range theory — as are other variants of institutionalism. It allows the analysis of changes in institutional systems over time. Institutions play a central role in HI in explaining political and policy outcomes. Institutions are defined not only as formal rules but also as informal procedures, norms, standards, routines and conventions embedded in the organisational structure (Hall and Taylor, 1996; March and Olsen, 2006). By following these institutional rules, political actors do not need to assess the optimality of each decision to be taken (Powell and DiMaggio 2012; Steinmo et al., 1992) which can explain that — unlike what is claimed by Rational Choice Institutionalism (RCI) — decisions taken are not always Pareto optimal. These non-optimal arrangements are often complex and contradictory, creating potential tensions and conflicts. Institutional and political change results from these tensions and conflicts triggered by the existing systems (Lesniak, 2013).

The HI framework focuses on two phases in the development of institutions. First, institutions face stability during relatively long path-dependent periods. Then, in a relatively short time-lapse, called *critical junctures*, tensions or conflicts within the institutions may lead to changes with new institutional settings being developed (Lesniak, 2013). Events occurring during this period then crystallise and influence in a *path-dependent* way the next stable period (Capoccia and Kelemen, 2007; Krasner, 1984). According to HI and as opposed to rationalist claims, the accidental events are not cancelled out but instead have a strong influence on the

direction of the path, mainly if they occur at the beginning of the new path (Capoccia and Kelemen, 2007; Pierson, 2000). During *critical junctures*, institutional factors have less influence and decision-makers benefit from a larger spectrum of choices for decisions. The consequences of their decisions last, influencing the institutional setting during the *path-dependent* period. In these circumstances, the period during which an event analysed by the researcher occurs, matters. Further, *critical junctures* do not always lead to a change and can remain 'near misses' (Capoccia and Kelemen, 2007). In this case, change is possible and can be considered but is rejected.

Once a path is entered, institutional change becomes increasingly unlikely because of self-reinforcement and the lock-in effect (Pierson, 2004). The outcome of the decision taken at this point in time depends on a decision taken previously which may have 'fixed' the institution on a specific path. This *inertia* and determinism are explained by reinforcing sequences (Fioretos, 2011) or feedback effects (Lesniak, 2013). First, decision makers in a privileged position can benefit from veto power in order to protect the design of existing institutions. The existing setting can be self-reinforced and benefit from positive externalities and network and coordination effects. The determinism can also be explained by increasing returns (Pierson, 2000). In a situation with fixed costs, learning processes, coordination and adaptive expectations, the benefit of a decision will increase if similar decisions are taken (North, 1990: 94). Finally, existing institutions create complementary relationships with other institutions and enhance the benefits associated with the existing set-up.

Path dependence explains why institutions are resistant to change but can also trigger subsequent developments of institutional change through path inefficiency (North, 1990; Pierson, 2000; 2004; Thelen, 1999). An institutional and self-reinforcing path in the short run can have self-destructing characteristics in the long run, which means that change occurs incrementally and therefore is not necessarily based on a *critical juncture* and does not always

require an exogenous shock. Incremental change is experienced when a gap arises between rules and their enforcement. This can be explained by the process of *intercurrence* in which different authorities and a multiplicity of institutions can produce incompatible and contradictory policy outcomes (Orren and Skowronek, 1996). Change corresponds to the result of the interaction of institutions and actors in such a system, with instabilities in a given institution affecting others (Orren and Skowronek, 1996).

Change does not always and only occur dramatically during *critical junctures.* The idea of punctuated equilibria, which corresponds more to a 'punctuated evolution', leaves the possibility for incremental change, which at some point culminates and is punctuated by short periods of dramatic change (Krasner, 1984; Hay, 2002; Grief and Laitin, 2004; March and Olsen, 1996; Steinmo et al., 1992). Five types of institutional change have been identified: 'displacement, layering, drift, conversion, and exhaustion' (Mahoney and Thelen, 2009; Streeck and Thelen, 2005). Displacement is the emergence of new models that challenge existing and well-established institutions. This first mode of institutional change can be assimilated with the critical juncture; in other situations, however, institutions can follow a gradual and transformative change. Layering is the emergence of new institutions alongside existing ones. Drift refers to the changes in external conditions which require adaptation from the existing institution. The conversion consists in changing the purpose of the existing institution. Exhaustion is when the action of the existing institution will lead to its destruction. All these types of change describe agency's role in institutional development and base change on social and political interactions (Capoccia, 2016). Different types of institutional change are produced by the combination of three different independent variables, which are: the characteristics of the political context with strong or weak veto possibilities; types of targeted institutions with a low or high level of discretion; and basic change agents (i.e., insurrectionaries, symbionts, subversives and opportunists) (Mahoney and Thelen, 2009).

b. Application of HI to banking supervision and linked areas

Few studies have used HI to explain national positions on prudential regulation. Lütz (2004) studies the historical development of banking regulation and supervision in the United States, the United Kingdom and Germany and explains the influence of national social structure, legal system and regulation cultures in setting prudential regulation. Baker (2013) focuses on macro-prudential regulation and its incremental transformation mainly in the UK, using Peter Hall's (1993) three orders of policy change framework. Baker (2013) argues that ideational shift introducing macro-prudential ideas emerged rapidly and refers to third-order change, whereas practical change occurs gradually and corresponds to the process of layering. HI has also been applied to examine the development of supranational prudential supervision. The development of financial regulation is presented as an incremental process in which timing and sequencing matter to influence the outcome of the regulation (Farell and Newmann, 2010; 2014; Lall, 2012; 2015).

Only a few academic articles apply HI to the development of Banking Union or, more specifically, the SSM. Schimmelfennig (2016) uses this framework to explain the dynamics of differentiated integration in the EU, arguing that the original differentiation between euro- and non-Euro Area member states affected the successive integration process and the decision to participate or not to participate in Banking Union. The initial choice put euro opt-in and opt-out countries on different paths of policy and institutional development. McPhilemy (2014) uses HI to differentiate between transformative and incremental change. This distinction explains the process of incremental integration towards Banking Union through the endogenous changes made possible by well-integrated high politics and less-integrated low politics.

Glöckler et al. (2017) analyse the forces leading to the creation of the SSM by combining RCI and HI frameworks. Unlike McPhilemy (2014), these authors conclude that

contrary to previous reforms introducing incremental transformations, the creation of the SSM in 2012 corresponds to a punctual and sudden change. This swift institutional change was the consequence of a combination of three 'reproductive mechanisms' (Glöckler et al., 2017). First, the costs and benefits equilibrium related to the institutional arrangements was distorted. In 2012, the SSM emerged as a response to the collective action problem of recapitalising the Spanish banking sector (Glöckler et al., 2017). Second, the coalition's bargaining power in favour of change was increasing. With the need for direct bank recapitalisation, the position in favour of introducing the SSM became predominant, including not only creditor countries but also EU and international actors such as the vice president of IMF (Glöcker et al., 2017). And finally, from a HI perspective, the existing institutional setting could no longer accommodate pressure for change through incremental adjustments, with the EBA considered an unsuitable candidate for prudential supervision of the Euro Area (Glöcker et al., 2017).

HI has also been applied to analyse EU financial integration after the financial crisis. It was notably used to argue that the decision to create the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) during the critical juncture of the Euro Area sovereign debt crisis locked the integration process at the intergovernmental level to deal with any future crises (Gocaj and Meunier, 2013). HI has also been used to explain the limited politicisation of technocratic integration by way of isolation of policy-making at the EU level (Schimmelfennig, 2014). Verdun (2015) applies HI to explain the creation of new institutions during the crisis which built on or were inspired by existing institutions.

c. Limits of and refinements to HI

When using HI one should bear in mind some limits of this analytical framework. First, HI can be perceived as descriptive and inadequate in explaining the causal factors of change. Notably, it does not explain what influences the start of a new unstable phase which triggers

change (Immergut, 2006). For many HI scholars, major change is a consequence of an exogenous shock. If the change requires an exogenous action, there is no possibility of analysing how institutions could change on their own. By combining HI and Europeanisation in this dissertation, I cover this gap by incorporating EU-level endogenous shocks into my analysis.

If the change is driven by endogenous causes, in the case of path inefficiency, HI focuses only on how agents influence the change through their interactions. HI does not explain how the structure of institutions triggers those interactions (Capoccia, 2016). In addition, HI does not sufficiently shed light on the role of political actors/agents and their preferences. However, their preferences can modify the decisions taken at a certain point in time and could explain the preponderance of one decision over another during a critical juncture. The initial theory does not emphasise their role. While some recent revisions of HI (e.g., Mahoney and Thelen, 2009) incorporate the role of actors, this is limited to their position towards institutions and institutional change; these revisions do not mention their preferences in broader terms. To overcome this limitation, I incorporate into my HI analysis the actor preferences as analysed in the Europeanisation framework.

Critical junctures normally can be determined only *a posteriori*, which restrains the possibility to assess in advance the importance of decisions taken and their influence for future decisions. Even when a period is identified as a critical juncture, it is difficult to predict the resulting outcome. The decisions taken by political actors after a critical juncture in different countries can diverge, thus weakening HI's analytical purchase. In my analysis of the convergence of national prudential supervision within the SSM, I argue that the critical junctures that occurred at the European level – international financial crisis and public debt crisis - had a significant impact on the process of convergence.

Introducing Europeanisation and the role of national institutional configurations into my analysis allows me to overcome the limits of HI. The combination of HI with Europeanisation also assigns more importance to agents. As seen above, EU policy development provides differential empowerment of national actors, which will then encourage the adoption of their policy preferences (Risse et al., 2018). However, it does not explain what shapes the preferences of these actors. To explain why the national prudential supervisors are more likely to change their practices compared to national political authorities in the face of pressures to converge, I will also argue that national supervisors can be seen as part of an Epistemic Community or Transnational Policy Network.

2.2.3 Epistemic Community approach and Transnational Policy Network framework

a. Presentation of Epistemic Community approach and Transnational Policy Networks framework

The Epistemic Communities approach proposes to explain policy change in terms of the influence of a network of experts in a specific area (Adler and Haas, 1992; Haas, 1992; Verdun, 1999). Haas defines the Epistemic Community as 'a network of professionals with recognised expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue area' (Haas, 1992: 3). Members of the Epistemic Community could include national and international officials, but also academics and representatives from think tanks and even private sector. To be considered as an Epistemic Community, the network of experts shall share (1) common normative and principled beliefs, (2) common causal beliefs, (3) common notion of validity for the knowledge in their domain of expertise and eventually (4) a common policy enterprise with a corresponding practice (Haas 1992: 3). These common views are achieved through interactions among members of this network of professionals over time. The Epistemic Communities' influence often emerges on technical matters in situations of uncertainty, interpretation and institutionalisation, which are

very common in international coordination (Haas, 1992). An Epistemic Community can influence the outcome of national policies (i) by policy innovation in providing an interpretation of data according to their beliefs, which will, in turn, influence the interpretation of national interests by decision makers; (ii) by policy diffusion when communicating with other members of the Epistemic Community transnationally; (iii) by policy selection, which corresponds to the selection of an identified epistemic community which will legitimise their position; (iv) by policy persistence, with an influence over time and, (v) by policy evolution as a learning process (Adler and Haas, 1992; Verdun, 1999). The technicality of policy domains concerned by Epistemic Communities approach limits the influence of national governments. Their influence is even more critical when transnational Epistemic Communities are concerned since they can display their causal beliefs and policy preferences throughout different nations (Verdun, 1999). According to Haas (1992), an Epistemic Community does not need to meet regularly and formally; collaboration based on a common policy agenda is sufficient. However, a profession as such is not an Epistemic Community (Haas, 1992). To constitute an Epistemic Community, in addition to knowledge and causal beliefs, members of the same profession need to share common principled beliefs and interests to promote their shared beliefs (Haas, 1992; Verdun, 1999).

The Epistemic Communities approach is also close to the *Transnational Policy Networks* framework, which involves national experts and regulators, international authorities and other transnational policy professionals such as consultants or foundation officers working on a specific topic (Henriksen and Seabrooke, 2021; Slaughter, 2004; Stone, 2008). Professionals are defined as individuals with higher educational backgrounds and specific sets of skills, not limited to a formal profession (Seabrooke and Henriksen, 2017). They form networks with other like-minded professionals whom they identify as having the same training and complementary skills (Seabrooke and Henriksen, 2017). These Transnational Policy

Networks are not always official networks but often include unofficial communities with a shared identity around a common cause and constitute linked ecologies (Abbott, 1998; 2005; Henriksen and Seabrooke, 2021; Seabrooke and Tsingou, 2009). Seabrooke and Tsingou (2009) present how similar positions are socialised through linked ecologies where the logic of practice explains the transfer of ideas. Transnational professionals are often involved in the revolving doors mechanism, which consists of the movement of individuals among different institutions from the public to the private sector and vice versa (Seabrooke and Tsingou, 2021). The revolving doors phenomenon, between public bodies and private sector, explains how professionals reach a consensus via networks they build up in a specific policy area (Henriksen and Seabrooke, 2016; Seabrooke and Tsingou, 2021).

b. Banking supervisors as an Epistemic Community/ transnational policy network

According to some scholars, central bankers can be seen as members of an Epistemic Community (Marcussen, 2000; McNamara, 2019; Verdun, 1999). In order to be considered as part of an Epistemic Community the latter had to meet regularly in international fora and develop a common understanding (Verdun, 1999). This common understanding for central bankers in the EU might be the need to establish a monetary union in order to bolster the pursuit of low inflationary economic growth (Marcussen, 2000; McNamara, 2019: 68; Verdun, 1999). However, the position to treat central bankers as part of an Epistemic Community is not shared by some scholars. For instance, Kapstein (1992) argues that in order for central bankers to be part of the Epistemic Community three conditions must be fulfilled. First, they need to reach a consensus both on theoretical and empirical knowledge they share about international banking. Second, this knowledge has then to be used for regulatory purposes with no national ideological arbitrage. Eventually, bank supervisors shall be isolated from national governmental pressure in a supranational regulatory agency (Kapstein, 1992). Eichengreen (2013) defined the BCBS

as a typical example of an Epistemic Community, which meets in a regular manner to develop standards and agreements on capital adequacy and liquidity management. He argues that the technical nature of the matter gives experts the possibility to overcome national government pressures.

National supervisors can also be considered as part of an Epistemic Community, sharing the same expertise which nurtures the common goal of financial stability even if their specific material interests differ. Verdun (1999) considers that members of an Epistemic Community can use this same common goal to achieve diverging national interests. In addition, the fact that the ECB plays a dominant, leadership role in this community does not invalidate the use of this conceptual tool by competent authorities (see Verdun, 1999). The uncertainty that triggers the consultation of Epistemic Communities is important in such technical matters as prudential supervision and also triggers the transfer of policy-making responsibilities to supervisors. Moreover, the creation of the SSM can be perceived as an institutionalisation that, according to Haas (1992) is important for new Epistemic Communities to emerge. To be considered part of an Epistemic Community, supervisors must share a common vision in their area of expertise. The financial stability goal is the main purpose of prudential supervision and can be considered the common objective of the Epistemic Community consisting of prudential supervisors.

In addition, banking supervisors as non-elected experts on a specific topic – banking supervision - can be seen as members of the Transnational Policy Network. A socialisation process shapes supervisors' preferences through exchange opportunities and similar educational backgrounds and facilitates the creation of networks (Tsingou, 2004; 2012). This socialisation — promoted by cooperation in international fora — will facilitate the creation of common ideational approaches (Tsingou, 2012). The socialisation of supervisors is reinforced through cooperation institutionalised under the SSM. Before the creation of the SSM, national supervisors met primarily in colleges of supervisors. The development of colleges of

supervisors for cross-border banks was supported by the CEBS which issued guidelines[21], their establishment was further institutionalised by the EU legislation since 2006 (Alford, 2021).[22] These colleges of supervisors aimed to coordinate the prudential supervision among NCAs. Still, the frequency was often limited to once or twice a year (Ferrarini and Chiarella, 2013; Zeitlin, 2021: 22). The national supervisors also participated in CEBS/ EBA working groups. They were part of EBA's Board of Supervisors. Under the SSM, cooperation was significantly reinforced. The NCAs cooperated daily in joint supervisory teams, through expert networks, and ECB working groups and workshops brought together NCA members (EBA2, 2022; ECB, 2020b; ECB2, 2022; NCA2, 2019; Nouy, 2017; Zeitlin, 2021). Moreover, prudential supervisors also frequently change institutions. For instance, the ECB and EBA staffs are mainly composed of former national supervisors and seconded staff which also facilitates this socialisation and transfer of ideas (EBA, 2014c; ECB, 2016a). The socialisation is reinforced by the existence of guidelines and standards issued by the EBA and the ECB, which could exercise pressure to converge national prudential supervision, for instance in the Supervisory Manual and Joint Supervisory Standards for LSIs. In both cases – Epistemic Communities approach and Transnational Policy Network framework – the aim of using the approaches is to demonstrate how policy can be shaped by national supervisors which are non-elected officials and that have distinct preferences from governments.

[21] CEBS issued two papers on 27 December 2007: 'Range of Practices on Supervisory Colleges and Home-Host cooperation' and ' Template for a multilateral Cooperation Coordination Agreement on the Supervision of XY Group'

[22] Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions and Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions

To conclude, combining structure and agency dimension this section presented four complementary analytical approaches which are used to explain the convergence process in prudential supervision. First, on structural dynamics, Europeanisation is used to observe the change in national policies and practices. Then HI is presented to explain how the change of national prudential supervision happens. Finally, based on agency argument, I recommend treating national supervisors as part of an Epistemic Community/ Transnational Policy Network in order to explain the preferences of national authorities for convergence. Based on this four-part composite analytical framework, the following hypothesis will be tested in this dissertation: *the more discretion exercised by to the national supervisor in relation to its government the more likely the adoption of policies and practices that result in greater convergence with the rules and practices developed at the EU / Banking Union level*. The Europeanisation will explain the adaptation pressure exercised by the EU and Banking Union on national supervisors. HI will provide an insight on the discretion benefitting national supervisors as a consequence of the historical development of prudential supervision at the national level and eventually, Epistemic Communities approach/ Transnational Policy Network framework will explain why supervisors will use their discretion to converge to EU and Banking Union requirements. Before applying this composite analytical framework to banking supervision in Europe the next section presents an overview of alternative approaches and explains why they have not been selected.

2.3 Alternative approaches to study the convergence of prudential supervision

The objective of this section is to review complementary and alternative analytical approaches which were considered for this research project but rejected. I present the alternative frameworks, which also offer some merits but did not effectively answer the research question that I attempt to address. Principally, I seek to explain the change of domestic practice under

EU- / Banking Union-level pressure. Nonetheless, some other theories provide insight into institutional change under supranational pressures. I review Neofunctionalism (2.3.1), Rational-Choice Institutionalism (2.3.2) and Liberal Intergovernmentalism (2.3.3).

2.3.1 Neofunctionalism

Neofunctionalism was developed to understand regional integration. It accepts that the integration process is driven by decisions taken by rational actors which have the capacity to learn from their experience (Haas, 1958). However, these rational actors face incomplete information requiring incremental adaptation to unexpected consequences of their previous decisions (Haas, 1963; 2004). According to neofunctionalism, integration is a consequence of spill-over, shaping how national governments gradually change their initial position under regional pressure, accepting further economic and political integration. Neofunctionalism defines three types of spill overs: functional, political or cultivated (Tranholm-Mikkelsen, 1991). Functional spill over occurs when two different sectors are interdependent, and the correct functioning of the integration project in one sector implies the integration of another related area (Haas, 1958). Political spill over corresponds to a gradual shift of national elite's preferences from the national to the European level, leading to consensus formation and further integration (Haas, 1958). Eventually, cultivated spill over corresponds to the increasing role of supranational institutions and their preference for integration to increase their own power (Haas, 1958; 1963). As such, neofunctionalism describes a growing dynamic of integration reinforced by existing supranational institutions.

Some scholars describe the creation of Banking Union as an example of a functional spill over (Epstein and Rhodes, 2016; Niemann and Ioannou, 2015). First, according to Epstein and Rhodes (2016), the creation of Banking Union was supported by international institutions, some member states and a coalition of banks seeking a supranational response to the crisis

despite the opposition of Germany and its allies. The perception of a collective action problem shifted the preference towards the creation of Banking Union (Epstein and Rhodes, 2016). In the same vein, according to Niemann and Ioannou (2015), the initial response to the financial crisis consisting of the creation of the EBA was insufficient. After the 2010 public debt crisis, the prudential supervision to guarantee the financial stability of the European Monetary Union (EMU) was at risk (Niemann and Ioannou, 2015). While monetary and exchange rate policies were allocated to the EU, financial sector regulation was split between national and EU authorities, which created functional dissonances, with bank exposures spread across the EU whereas supervision was still national (Niemann and Ioannou, 2015). Banking Union appeared to be the solution to this created dissonance.

Neofunctionalism does not provide sufficient guidance as to different degrees of integration in the different provisions in the same policy areas in different member states, which is the objective of this research project. Thus, neofunctionalism focuses on the interdependencies of different policy areas but gives no explanation as to why in the same policy area various provisions are more or less complied with by national authorities. Neofunctionalism provides insight as to the integration of European bank supervision in general terms but does not explain why some specific policy area provisions do not follow the integration process. For these reasons, neofunctionalism is not further applied in this dissertation.

2.3.2 Rational Choice Institutionalism

Rational Choice Institutionalism (RCI) includes neither cultural nor ideational elements (Hall and Taylor, 1996) and is based on the assumptions that political actors are rational utility maximisers even if their preferences are related to the membership of a particular institution. Their behaviour is based on strategic interactions and the outcome depends on the expectation

of the likely behaviour of others. In this framework, the principal-agent relationship is a connexion 'between two (or more) parties when one of these designated agents acts on behalf of or as a representative for the other, the principal' (Ross, 1973: 134). These rational agents might try to obtain autonomy from their principal by using informational asymmetries.

The relation between a supranational institution and member states can be analysed through the principal-agent framework with member states being the collective principal delegating tasks to an agent, the supranational institution, to be carried out according to the member states' principals' preferences (Kiewiet and McCubbins, 1991; Pollack, 1997; Thatcher and Stone Sweet, 2002; Weingast and Moran, 1983). Following this reasoning, the ECB can be considered as an agent of the member states to manage the SSM. The principal-agent framework has been used quite often to analyse Banking Union. However, the application of the principal-agent framework for supranational entities such as the ECB requires specific peculiarities to be taken into consideration. First, member states are a collective principal composed of more than one actor. The delegation to the agent is based on preferences agreed upon by the collective principal. These preferences of the principal can shift. In the case of the collective principal, the shift of preferences and the observation of the compliance of the agent with these shifted preferences is much more difficult (Gren et al., 2015; Nielson and Tierney, 2003). Member states first need to agree collectively on the outcome of the delegation of supervisory power to the ECB. For example, during the negotiations on the SSM, countries such as France, the Netherlands, Italy and Spain were in favour of direct supervision of all banks from the Euro Area by the ECB, whereas Germany, Austria and Belgium, were in favour of a segregated model, limiting the direct supervisory power of the ECB (Howarth and Quaglia, 2016a). This, in turn might influence how these member state governments approach the margin of manoeuvre left to NCAs in the supervision of LSIs in the SSM. At the same time, the existence of multiple or collective principals also gives some additional power to the agent.

Most of the principal-agent literature focuses on the national supervisors as agents of their national governments. These works discuss the incentive problems in bank supervision (Schuler, 2003), analyse the determinants of the institutional regime of supervision (Masciandaro, 2004), the financing of bank supervision (Masciandaro et al., 2007) and the power consolidation in financial supervision (Masciandaro and Pellegrina, 2008). Another article has also analysed the contribution of accountability mechanisms to the behaviour of financial supervisors and thus to their adequate supervision (Dijkstra, 2010).

In another paper, Gren, Howarth and Quaglia (2015) introduce NCAs as the agents of the ECB. It considers a national independent authority as an agent of a supranational institution which is less common in applying the principal-agent framework (Gren et al., 2015). Indeed, NCAs and the ECB are non-majoritarian institutions in the sense that both entities are institutions which are neither elected nor managed directly by an elected entity (Gilardi 2001, Thatcher and Stone Sweet, 2002). The ECB wields principally soft law control mechanisms over NCAs. The latter are selected and appointed by their member states, which in turn risks contributing to NCA slippage in the supervision of LSIs (Gren et al., 2015).

In the SSM framework, one could consider in this dissertation that the NCAs' preferences are closer to those of the ECB than those of the member states and that, in their view, financial stability should prevail over banking stability. Indeed, both, NCAs and the ECB are supervisory agencies and their main objective can be seen in terms of the expansion of their resources and powers. The main objective of member state governments is to maintain their power and thus be re-elected. In this dissertation, RCI could have been applied as an alternative approach to explain the preferences of NCAs and national governments, assuming that NCAs are separate and autonomous entities from their home country governments. Moreover, the policy autonomy of NCAs is increased by their involvement in the European network of supervisors; thanks to the expertise developed within this network (Ruffing, 2015).

RCI describes the relations between different actors in a given institution based on the equilibrium which underpins the stability of the institution. A new institutional set occurs only if a new optimal equilibrium is found (Lesniak, 2013). It is difficult in these circumstances to explain change except through an exogenous shock which modifies the equilibrium with different actors adopting the best response to the new situation. However, in the case of banking supervision, different member states faced with the same exogenous shock do not have the same preferences when it comes to convergence. If NCAs and their national governments followed the logic of purely rational actors, one should have seen the same policies adopted in response to the same exogenous shock. National institutional frameworks matter in the analysis, and explain why RCI was not considered further for this study.

2.3.3 Liberal Intergovernmentalism

Another frequently used theoretical framework to explain European integration is Liberal Intergovernmentalism (LI). LI was developed by A. Moravcsik in 1990s and combines a liberal theory explaining national interest formation with intergovernmental institutionalism of international bargaining and institutions creation (Moravcsik, 1993). First, LI argues that European integration was driven by member states fully controlling the integration process and their economic preferences (Moravcsik, 1993). Based on liberal theory, LI considers that different domestic groups formulate national preferences, which are then aggregated by political groups considered as agents (Moravcsik, 1993). According to LI, international politics are decided domestically by rational groups or actors acting in their own interests. National interests influence member state positions. Then, based on Intergovernmentalism, LI argues that national governments use their preferences for international bargaining and negotiations. Governments represent their domestic preferences but can have an incentive to cooperate when the outcome of such cooperation reinforces their domestic position (Moravcsik, 1993).

Decisions taken at the EU level need to compromise with the position of less cooperative member states, which means that the outcome will always represent the 'lowest common denominator' (Moravcsik, 1993). All the main developments in EU integration were the consequence of issue-specific national preferences, which were bargained by member states at an intergovernmental level and led to the establishment of EU institutions securing the outcome of intergovernmental bargaining (Moravcsik, 2013). Institutions are therefore considered secondary tools created principally to facilitate intergovernmental agreements and ensure their implementation.

Schimmelfennig (2015) uses LI to analyse the Euro Area crisis, where the outcome represents the result of interstate bargaining. Different interdependences created by the Euro Area and the fiscal position of member states, influenced their position in favour of maintaining the Euro Area (Schimmelfennig, 2015). The LI framework has also been used to explain the bargaining process to build Banking Union (Donnelly, 2014; Howarth and Quaglia, 2016a; Schäfer, 2016) and the weaknesses in its design (Asimakopoulos and Howarth, 2022).

However, one can raise several problems with regard to the LI explanation of European integration in general and the move to Banking Union in particular. First, LI does not explain how domestic preferences are formed. For instance, in the case of the German government, its preferences for the SSM cannot be explained entirely through the preferences of domestic economic interests, including banks or producer groups (Schäfer, 2016). Moreover, LI considers that the outcome of Banking Union will reflect German preferences due to superior German bargaining power. LI does not explain the reasons for major German government concessions in the context of intergovernmental bargaining (Schäfer, 2016).

Unlike Europeanisation, LI considers that EU institutions have only a passive and facilitating role, whereas in this dissertation, I argue that institutions are intervening variables which can influence national preferences in creating adaptational pressures. Unlike HI, LI does

not consider the endogenous feedback that can influence institutional choices. It does not look at previous integration outcomes and their consequences in terms of the current integration process (Schimmelfennig, 2015) and analyses intergovernmental bargaining as an isolated process. My analysis, however, does not consider institutions as passive tools but rather as actors in themselves that influence convergence or lack thereof.

2.4 Dependent variable

The objective of this research project is to analyse the convergence of national practice in the framework of the SSM. Convergence is broadly defined as a process by which national supervisory practices or polices become more alike over time. Convergence is a broad term and as such, can be difficult to observe and compare across different policy areas and member states. This is why, I propose to approximate convergence with observed changes in prudential supervision. I define change as the dependent variable. 'Policy change' or absence thereof is often used in the political economy literature to explain the outcome of political decisions (Capano, 2009; Commain, 2022). However, the scope and typology of change vary from one study to another. It is, therefore, important to define the object of change more precisely. In this dissertation, change will correspond to the modification of national prudential supervisory practice between two given points in time. This change is expected to lead to greater convergence. As explained below, for the purpose of this research, I specified these points in time as the end of 2014 and the end of 2019. According to the HI framework presented above, the change observed could be incremental or radical, corresponding either to Hall's first or third order of change (Hall, 1993).

2.4.1 Change in prudential supervision – approximation of convergence by change

There are several closely related but still distinct concepts used in EU provisions to describe the process of convergence, such as 'harmonisation', 'convergence', 'approximation', 'unification' or 'Europeanisation'. According to Radaelli (2003), Europeanisation is a process which may lead to a convergence, which is a consequence. Moreover, the convergence does not always occur in a uniform way across member states but rather as a clustered convergence (Börzel, 2002; Radaelli, 2006). Convergence shall not be seen as a binary process but rather as a continuum.

Convergence can be driven by positive action, in case of which it is prescribed by regulatory provisions that require either a common provision 'unified' at the EU level or close but nationally distinct 'harmonised' legislation. 'Harmonisation' requires a standard to be defined and used to assess national provisions and practices (Lohse, 2011). The EU has also introduced the terms of 'minimum' and 'maximum harmonisation'. Minimum harmonisation means that minimum standards are approved at the EU level and member states are authorised to take stricter measures, whereas maximum harmonisation limits the ability of member states to adopt stricter requirements. The process of change towards similar practices can also be the result of interactions between different parties involved through the mechanism of 'convergence'. In the current research project, I will analyse how supervision is handled at the national level by member states and NCAs, which explains why I use the term convergence rather than harmonisation. However, one also need to bear in mind that the EU creates some standards, often through soft law provisions, such as guidelines or recommendations, and through the development of specific definitions for Significant Institutions supervised by the ECB.

The need for convergence implies that prudential supervision and regulation are not fully integrated. First, EU legal provisions are not fully harmonised, which results in *de jure* differentiation. EU prudential legislation is based on the Single Rulebook, and more specifically

on the banking package which is a set of harmonised rules. In addition, national authorities and member states can – in the implementation of these provisions – benefit from a margin of manoeuvre in their supervision thus creating *de facto* divergence. The analysis of formal *de jure* flexibility granted to the member states is the starting point of the analysis of reasons for convergence/ divergence of prudential supervision in member states. It allows assessing how member states supervise institutions under their responsibility and what influences the convergence of prudential supervision or lack thereof at the national level. The selection of cases should not lead to forget the importance of pressure for convergence in the EU and the global achievement of convergence at the EU level for prudential supervision. The creation of the Single Rulebook represents the efforts achieved towards complete convergence. However, to analyse the blocking points at the national level, I decided to focus on the less converged provisions facing reluctance from member states.

According to the Europeanisation framework, in this research project, I assume that EU pressure pushes towards change in national practice. This change could result either in convergence or divergence of national practice. Often scholars consider that change leads to convergence to create efficiency, compliance with best practices, or guarantee compatibility (Risse et al., 2018). Therefore, change is proposed as a dependent variable to be studied in this dissertation.

2.4.2 Change in national practice as a dependent variable seen in terms of *absorption* and *transformation*

The main dependent variable to be explained in this dissertation is the change in member state banking supervision leading to potential convergence. The change in the precise aspects of supervisory practice can vary from one national supervisory mechanism to another: this is why using a multiple dependent variable – change in specific areas of supervision – is proposed. The study of specific areas of supervision is also important to be able to analyse the actual

convergence or lack thereof. Moreover, empirically it remains difficult to assess whether the occurring change will lead to similar outcomes (Heichel et al.,2005; Holzinger and Knill, 2005). Complete convergence – achieved only when exactly the same rules are applied in the exact same manner across member states – is highly unlikely. It is therefore helpful to propose a continuum of convergence – running from the absence of any convergence to a unified legal framework and including intermediate levels of convergence – to analyse the convergence of banking supervision in a number of important areas.

In this dissertation, I did not use a specific scoring or index to measure convergence. The latter would require more quantitative study. I present the convergence as a process moving in time where the target (EU requirements) moves in parallel with national supervisors practice. To assess the degree of change in supervisory practice (and potential convergence), I will use the understandings of institutional change elaborated by Europeanisation scholars and developed earlier in this dissertation: *retrenchment*, *inertia*, *absorption* and *transformation* (Börzel, 1999; Cowles et al., 2001; Héritier, 2001; Héritier and Knill, 2001). These four understandings assist in the identification of change and potential convergence. As presented above, only Europeanisation as *absorption* and *transformation* leads to change and potential convergence and thus will be considered in this dissertation.

The next step is to analyse the actual supervisory practice of the supervisory bodies and how this has changed over the past decade. Using the HI framework to assess the stickiness of institutions, one needs to identify how this institutional change has occurred once the change has been observed. I will compare the situation in 2014 at the moment of the creation of the SSM and the introduction of the Asset Quality Review (AQR) and compare it to the situation at the end of 2019.

2.5 Antecedent variables

The EU-level policy entails formal and informal rules and procedures which vary from national provisions. It often creates pressure for the convergence of prudential supervision. The EU-level policy can challenge the national approach to prudential supervision and is thus the starting point of this study and operates as an antecedent variable. The objective of the banking package was to create an increased integration, which was expected to trigger change at the national level. As seen above in the section on Europeanisation, EU-level policy requires adaptive actions from the national institutional framework to be in compliance with EU requirements. However, as explained through the application of the Europeanisation framework outlined above, EU pressure is an essential condition but is not sufficient to trigger change (Börzel and Risse, 2003). The manner in which EU-level policy change impacts individual member states varies. Otherwise, one would observe the same reforms in all member states (Quaglia, 2008). This is also what is observable for prudential supervision. Even though European legislation may leave some margin of manoeuvre to member states especially when this concerns directives. Their objective is to provide a common set of rules applicable across member states. The discretion was also partially limited with the introduction of the Capital Requirement Regulation (CRR) under the banking package which imposes mainly identical rules to all member states.[23] The EU level adaptational pressure is also exercised through institutional misfits by the existence of different EU level regulatory actors involved in Banking Union — including the ECB and the EBA.

The European level adaptational pressure is pre-conditional for institutional change. Indeed, some post-financial crisis reforms in the field of prudential supervision have an objective to create more integrated and converged rules resulting in a major change to the

[23] Some discretion remained notably within Options and National Discretions allowed under CRR

institutional development of national supervision. The first important event was the move from 'minimum harmonisation' and 'mutual recognition' to 'maximum harmonisation' (Cappiello, 2015). This move was possible with the creation of the EBA in 2010 which was mandated to create the European Single Rulebook in banking. As such, the creation of the EBA did not require significant modifications to national practice straight off. However, the EBA was empowered to complement Level 1[24] legislative acts composed of Regulation and Directives through binding technical standards (Cappiello, 2015; Ferran, 2016). Moreover, the EBA had additional tools at its disposal — guidelines and recommendations as well as Questions and Answers providing an interpretation of EU legislation (Cappiello, 2015). With the creation of the EBA, national governments and supervisors faced additional convergence pressure, which went beyond the 'minimum harmonisation' that existed prior to the creation of the EBA.

The second event was the implementation of the SSM from November 2014. The SSM set up a two-level supervisory system to replace a member state-based system. After the transfer of power from national authorities, the ECB became the main supervisory authority of European banks. Applying the proportionality principle of EU law, the ECB is in charge of directly supervising the Significant institutions through the Joint Supervisory Teams (JSTs) and oversees the supervision by National Competent Authorities (NCAs) for the less significant institutions (LSIs). However, the ECB is not completely absent in the supervision of LSIs: it also oversees the NCAs' supervision of LSIs. The ECB can prescribe supervisory priorities or evaluation principles. Moreover, in specific circumstances, to ensure a consistent implementation of supervisory provisions, the ECB can assume the direct supervision of LSIs

[24] Level 2 measures comes to specify Level 1 legislation by the European Commission. It can take the form of, depending on the case, delegated and implementing acts drafted by the European Commission or technical standards drafted by the EBA (article 10 - 15 EBA Funding Regulation)

(Article 6(5)(b) of SSM Regulation). Therefore, I argue that establishing the SSM created subsequent convergence pressure on the supervision of LSIs.

2.6 Independent variables

As noted in the previous section above, the objective of this dissertation is to focus on national-level pressures on convergence and, therefore on bottom-up Europeanisation. I analyse the rule-making framework of supervision using both Europeanisation and HI to assess the impact of this framework on change in supervisory practice. Then I complement the outcome from the literature on Epistemic Communities and Transnational Policy Network, which considers national supervisors part of an Epistemic Community or a policy network that will facilitate the creation of a common perception and then influence the change in national practice. In the existing national legal setting, national supervisors enjoy more or less margin of manoeuvre (discretion). This discretion, however does not mean that the autonomy of the national supervisor is compromised. As presented in subsection 2.7.1 of this chapter both NCAs analysed in the empirical cases have were established as autonomous authorities.[25] Discretion is defined broadly as the margin of manoeuvre available to supervisors, allowing them to decide how to implement supervisory provisions. More precisely, I consider that the supervisor can exercise discretion every time there is no or limited intervention from the national government with legislative provisions constraining the supervisor's actions. The level of discretion available to NCAs varies depending on supervisory provisions. In their supervision, NCAs must implement Single Rulebook provisions, but the latter might offer some room for manoeuvre on implementation.

[25] The objective of this study is not to enter in the academic discussion on the independence and accountability of the regulatory agencies. For further developments on this topic, see Gren, 2018.

In some cases, for example, on options and national discretions (ONDs), the margin of manoeuvre is explicitly granted to supervisors by the EU law. The discretion can also be a consequence of the ambiguity due to contradictory legislative provisions at the EU and national levels but also solely at the EU level, with different EU institutions prescribing contradictory provisions. When legislative provisions describe how the supervisor shall act, the margin of manoeuvre of the supervisor is limited. However, when such legislation is absent or explicitly gives discretion to the supervisor, the latter can use this margin of manoeuvre in its supervision. The selected independent variable is, therefore, the discretion of the supervisor in prudential supervision.

The main hypothesis from these claims is that the national institutional setting prior to post-crisis institutional change — including legal frameworks and national practices — influences the outcome of national convergence towards EU standards. More specifically, I test the following hypothesis in this dissertation: *the more discretion exercised by the national supervisor in relation to its government, the more likely the adoption of policies and practices that result in greater convergence with the rules and practices developed at the EU / Banking Union level.*

Member states have distinct national rules on prudential supervision that are often difficult to change because they can apply not only to banks but also to other financial institutions. Where the supervisory practice is rooted in law that must be amended by the government, there can be less supervisory discretion and more involvement by national government. If the law does not change, supervision is less likely to change. Indeed, the amendment of hard law provisions necessarily involves legislative procedures. Where politicians are involved — in the design of legislation as opposed to administrative rules — there are bound to be greater political difficulties in modifying supervisory procedures. The national legal framework often involves provisions beyond banking supervision. For instance

commercial law, tax or corporate laws can have an influence on the prudential provisions (ECB1, 2022). National legislation represents the longstanding position of member states with *inertia* to change. Thus national governments will insist upon maintaining an ongoing margin of manoeuvre in the design of EU legislation and will seek to protect national legislative differences that this margin of manoeuvre allows (ECB1, 2022). This corresponds to the *path dependence* of national practice set by pre-existing legislation and legislative procedures. Political actors intervening in these processes, play the role of veto players and can limit or slow down the change of national practice and maintain the status quo.

First, according to the Europeanisation framework, the national governments will play the role of veto players and resist changes introduced at the EU level. This resistance can result in delays in the implementation of reforms by national governments. For example, there are cases where governments fail to move fast enough on legislative change to keep up with the EBA efforts to improve supervisory practice. In 2021, the EBA reported on between twenty and forty requests from national supervisors to prepare a letter for their national ministries to support a reform proposal (EBA2, 2022). Thus, the NCAs seek support from the EBA to push the national governments along in implementing necessary legislative change.

The reluctance of member states to change their national supervisory requirements can also be illustrated through the case of EU legislation which watered down Basel III guidelines to satisfy member states' expectations (Commain, 2022; Howarth and Quaglia, 2013). The lowest common denominator achieved at the EU level corresponds to the difficulties in achieving a common position among the national governments involved. Some scholars explain member states' preferences regarding national banking sector features. French banks, for example, had a greater reliance on short-term debt financing, which explains the reluctance of the French government to accept stringent capital requirements imposed by Basel III (Howarth and Quaglia, 2013; 2016b). Moreover, the change in national practice might also be resisted

because change can be costly (ECB1, 2022). Change can require additional staff and necessary training.

Where supervisory practice depends on non-legislative provisions, national supervisors' discretion is more likely to be higher. When discretion is given to the national supervisor, it is expected that they are more likely to agree to extensive convergence with the rules and practices developed at the EU level. This can, for instance, be illustrated by the common position expressed by a range of EU NCAs and central banks in a joint letter sent on 7 September 2021 to the European Commission requesting the full implementation of Basel III requirements at the EU level (Oesterreichische Nationalbank (OeNB) et al., 2021). Unlike national governments, which cover variety of national interest; national supervisors have the same preferences triggered by their common and main intended objective – financial stability.

As noted above, national supervisors can be seen as forming part of an Epistemic Community or a Transnational Policy Network which defends a common interest of financial stability. There are two main factors which explain the preferences of national supervisors for convergence. First, the creation of the SSM had implications for the power distribution at the national level and enabled, in some policy areas, the national supervisor to override the national executive (Cowles et al., 2001; Sandholtz, 1996). According to Europeanisation and its mediating factors, the creation of the SSM from the perspective of the NCAs can be seen as differential empowerment which gives them the possibility to bypass member state governments and their preferences. Thus, national supervisors become better able to defend their supervisory preferences and can therefore change national practice in areas where sufficient discretion is granted to the supervisor. Given the technicality of banking supervision and the expertise of national supervisors, the implementation of prudential supervision is transferred to these national authorities outside the political arena (Bach and Ruffing, 2013).

Once assigned to independent authorities it becomes difficult to remove the power from these actors, which gives national supervisors the ability to significantly shape if not control reforms (Capoccia, 2016). Where supervisors control the rules of supervision and benefit from discretion, change becomes possible. In this situation, the change could be the result of the national supervisor's preferences, with the supervisor making use of this discretion to achieve greater autonomy in relation to the national government.

Second, national supervisor preferences are expected to be closer to those developed at the EU level. Using the insight from the application of an Epistemic Community approach/ Transnational Policy Network framework, the convergence of preferences between national supervisors and the EU level can mainly be explained by socialisation pressures exercised by EU institutions and learning processes and exchange opportunities (see Verdun, 1999; Marcussen, 2000). The ECB in the SSM created an environment favourable to cooperation among NCAs. JSTs were for instance mixed teams composed of different NCA employees (EBA2, 2022; ECB2, 2022; NCA2, 2019; Zeitlin, 2021). The latter are sent on missions to the ECB and can intervene in other member states. NCA employees must also follow training programmes in Frankfurt and Florence. Moreover, the majority of ECB staff comes from national supervisors and central banks (ECB, 2016a). These different collaboration opportunities create a common culture among NCA employees and the ECB which in turn result in a convergence of supervisory approaches (NCA2, 2019; Eberlein and Grande, 2005). ECB supervision is seen as effective which facilitates the creation of an 'esprit de corps' among competent authorities and the use of the same language facilitates the convergence of ideas for instance in the Supervisory review and evaluation process (SREP) (ECB2, 2022). Moreover, prior to issuing EBA technical standards, different NCA preferences are discussed at the EU level. In doing so, the ECB and the EBA integrate the preferences of national supervisors into the final applicable text (EBA2, 2022). These two elements reinforce the cooperation of

supervisors and increase the likeliness of a change in those areas where supervisors have discretion.

An intervention from political actors which limits the discretion of national supervisors is expected to lead to a change in the form of *absorption*. In such circumstances, national supervisors might induce change in national supervisory practice but will adapt the outcome to national preferences induced by the political authorities which can vary from the preferences of EU institutions (here the ECB). When there is no legislative intervention and the mediating factors include the learning and socialisation of national supervisors, the preferences of national actors will change, and the policy change will most likely be *transformative* to significantly change national supervisory practice to conform to EU institutional preferences.

The selected IV will be further specified for each specific supervisory provision. In this dissertation, I test the hypothesis with regard to provisions detailed by law and with regard to areas determined directly by the supervisor. I first give an overview of the main areas of supervisory practice with a broad overview of options and national discretions and then provide a more detailed analysis of two typical cases: NPLs (mainly covered by law) and SREP (providing supervisory discretion) to test the hypothesis. Figure 2.2 below summarises the analytical framework of this thesis.

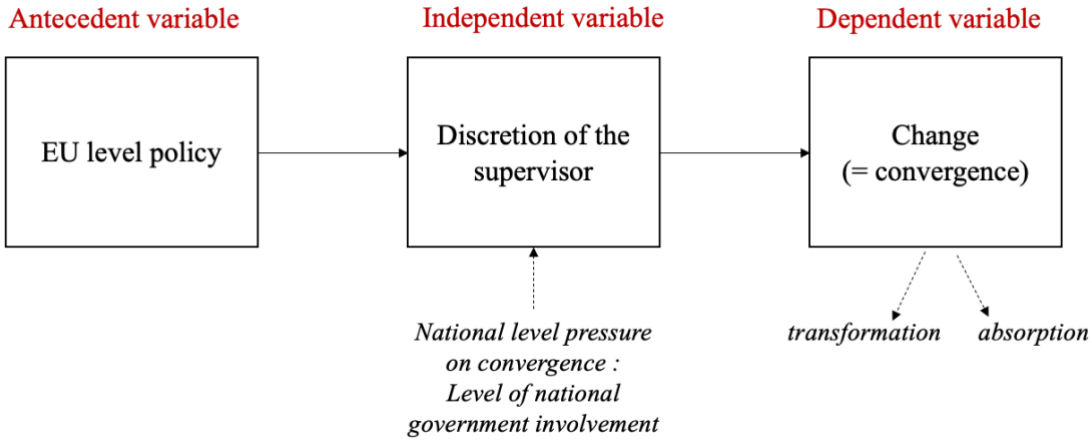


Figure 2-2 Analytical framework

An alternative institutional IV — that I have decided not to investigate further in my research — could have been the configuration of the national banking system and the extent to which this is dominated by Significant Institutions or LSIs. This IV could be analysed through the internationalisation and concentration of banking systems. Table 2.2 at the end of this chapter presents the configuration of national banking systems in France and Germany. The internationalisation of national banking systems contains two different indicators, the percentage of bank assets held internationally versus domestically and the percentage of domestic bank lending compared to the overall bank activities. According to their degree of internationalisation, banking systems can be categorised into three types of banking champions: international, national and local champions (Howarth and Quaglia, 2016c). International champions refer to well-capitalised and internationalised banks, whereas national champions correspond to institutions which are mainly present in and focused on their domestic market. Eventually, local champions ensure local funding to SMEs. The second element of categorisation is the level of concentration of banking system assets as measured by the

Herfindahl Index[26] and CR5 concentration ratio.[27] Banking systems dominated by Significant Institutions are those with more internationalised banks, whereas those with a larger presence of LSIs have a more domestic focus. It is expected that domestically-focused banks would be more likely to want to maintain national discretion to maintain their local specificities. Multinational banks are expected to prefer convergence to be able to apply the same provisions in different countries. A concentrated banking structure is also a sign of the relative importance of significant institutions, which are expected to be more in favour of converged supervision applicable to all banks and fewer specific provisions for LSI. For example, such provisions often reflect that LSIs issue less equity than Significant Institutions. Despite the interest in this IV, I decided not to proceed with its further analysis. The configuration of national banking systems offers a unique IV – LSIs/Significant Institutions dominant banking system — which cannot be stipulated for specific supervisory provisions. It is therefore more difficult to prove a causal relationship between the predominance of LSIs or Significant Institutions and the change in specific supervisory practices.

In this research project, I focus on the convergence of national practice. The convergence is directly implied if there is a unique harmonised provision which is applied by a single authority, which is not the case for the SSM. The existence of flexibilities allowed by the legislation, but also, reliance on a number of supervisors leave room to manoeuvre to national authorities. The convergence is expected when despite this discretion national authorities change their practice to comply with EU requirements/ standards. As mentioned above there is flexibility explicitly left by the EU legislation to national governments or supervisors, this is

[26] Herfindahl Index is obtained by the sum of the squares of all credit institutions in each market and is the concentration ratio showing the share of businesses of a given number of largest banks published by the ECB

[27] CR5 concentration ratio is calculated as the share of total assets of five largest credit institutions

the case of Options and National Discretions. In other cases, flexibility is a consequence of national practice, when national authorities are in charge of the implementation of EU provisions. To examine more in detail the consequences of the flexibility exercised by national authorities, I selected a case study which requires intervention from the national government (NPLs) and a case which leaves discretion to national supervisors (SREP).

In my research, I have decided to analyse some specific Options and National Discretions and their application by member states and their NCAs. To be able to assess the specificities of the member states, and to explain the factors resulting in resistance to convergence pressure, the specific pieces of legislation that I analyse in my dissertation must present difficulties in terms of their convergence. At the time I started this research project end of 2016, the OND provisions concerned by convergence, through the ECB Regulation[28], Guide[29], Guideline[30] and Recommendation[31] as presented in Chapter 4, had just begun and the analysis of these provisions risked lacking substantive elements through which to analyse national positions on their convergence. This is why this dissertation does not focus on ONDs harmonised in the framework of the ECB's Guideline and Recommendation. I also set aside temporary national provisions or provisions allowed to member states, which potentially contributed to divergence but were expected to be converged for the most part by 2019-2020. However, the documents issued by the ECB do not converge all the flexible provisions in the banking package composed of CRD IV/V and CRR as for instance the ONDs addressed to the member states. The convergence of remaining provisions was expected at a later stage with the

[28]Regulation 2016/445 of the European Central Bank on the exercise of options and discretions available in Union law

[29] ECB Guide on options and discretions available in Union law (ECB, 2016d)

[30] Guideline on the exercise of options and discretions available in Union law by national competent authorities in relation to less significant institutions (ECB, 2017a)

[31] Recommendation of the ECB on common specifications for the exercise of some options and discretions available in Union law by national competent authorities in relation to less significant institutions. (ECB, 2017b)

intervention of the European Commission (ECB, 2016a). The next section explains the selection of case studies analysed in greater detail in this dissertation and discusses another possible case, the analysis of which I considered but then dropped.

2.7 Selection of case studies

2.7.1 Selection of country cases

My dissertation focuses on the preferences of Euro Area member states participating in Banking Union. All these countries are under the oversight of the SSM and are required, by EU law, to have supervisors that are independent of government. I exclude non-Banking Union participants because the Single Rulebook foresees the possibility for persisting divergence through options and national discretions which are not expected to converge. I decided to use a paired comparison because it offers a sufficient balance between theory testing and an in-depth description of specific cases, which is difficult to achieve in a single-case analysis and more extensive comparative studies (Slater and Ziblatt, 2013; Tarrow, 2010). The objective of this dissertation is to examine the main potential explanatory variables for the divergence in supervisory practice. The comparative methods used are specifically suited to small *n* analyses: they give the opportunity to understand a bigger picture and an inside analysis of selected cases (Nissan, 1998). A comparison of national provisions and practices for different cases allows for a better understanding of this divergence. The selection of country cases is based on the method of concomitant variation (Lijphart, 1971; Nissan, 1998; Pzeworski and Teune, 1970; Tarrow, 2010). I selected this method, which appears to be most suitable for studying country cases at different degrees of convergence. My main argument developed in this dissertation is that the national pre-existing legal setting in which, national supervisor exercise more or less discretion, will influence the change in national prudential supervision. The method of concomitant variation is helpful in establishing a correlation between the IV and DV with 'parallel variation'

(Nissan, 1998). To validate the causal relationship between the IV and DV, I selected cases with very similar general characteristics presented below to eliminate as many as possible other explanatory causes of variation in convergence (Nissan, 1998; Pzeworski and Teune, 1970; Tarrow, 2010). This dissertation will focus on the two Banking Union countries with the most significant banking systems: France and Germany. The main characteristics of the banking structure of France and Germany are presented in table 2.2 at the end of this chapter. Banking and financial sector size matters because it is assumed that these countries will likely have more influence in EU banking policy-making and specifically more influence in the context of SSM policy-making. Size might also better enable these member states to resist convergence pressures. Indeed, one would expect countries with smaller banking sectors to be more Europeanised and thus adapt their legislation to EU provisions more quickly because of their greater sensitivity to potential reputation gains (a point made by several interviewees: e.g., NCA1, 2017; NCA2, 2019). However, one could also surmise that the preferences of countries with significant banking sectors are already included in the EU provisions, given that it is more likely that they have been able to upload these preferences to the EU level and thus, it could be easier for them to adapt their legislation. However, the existence of countries with strong and large banking sectors with longstanding and/or distinct supervisory practices should argue against this supposition.

In addition to the similarities in selected member states, two sets of criteria directed the selection of country cases: variation in independent (a) and dependent variables (b). The observed differences in France and Germany on these variables justify the selection of these countries for further assessment.

a. Variation of IV in selected member states

As outlined above, the selected IV is the discretion left to the national supervisor. I mainly focus on two sets of actors who play an essential role in national banking supervision: the government (majoritarian institution) and the supervisor. There are also banks and potentially other actors which can exercise influence on prudential legislation, but these are set aside. Governments (through parliaments) adopt hard law provisions, whereas unelected supervisory officials produce more technical provisions often in the form of soft law. Variation of IV corresponds to the selection of cases where the government maintains regulatory power and where the supervisor exercise its discretion.

The first variation of the IV corresponds to the provisions mainly depending on national governments, leaving lower room for discretion to the national supervisor. National governments may also issue prudential regulation, either because there are no provisions foreseen at the EU level or because of the transposition of EU directives at the national level which leaves some flexibility for national provisions. Both countries have a history of strong prudential regulation, which was replaced by the banking package with the establishment of the Single Rulebook (CRD IV/V and CRR I/II). As presented above, the Single Rulebook left some room for regulatory flexibility for the national governments. This is the case when it comes to ONDs addressed to member state governments. In both member states, Germany and France, national governments used these flexibilities to maintain their national specificities. Another example of prudential regulation is the case of NPLs. NPLs were expected to be regulated by the national regulator before the creation of the SSM. In France, the definition of NPLs was issued by the national government whereas, in Germany, no specific provision was foreseen by the national government but only by the regulation from *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin). The treatment of NPLs in both member states mainly depended on the national governments.

When it comes to supervisory discretion, it implies the possibility for the supervisor to adapt the implementation to the specific case and sometimes to issue more a permissive treatment on a case-by-case basis. The second variation of the IV is the presence of an autonomous supervisor who can exercise discretion with no restriction from national government. The legal and de facto autonomy of the supervisor from government matters. Article 19.1 of the SSM Regulation[32] formally requires that NCAs act independently when carrying out prudential supervision under the SSM. However, despite this requirement, the de facto autonomy of national supervisors in Banking Union varies massively. Indeed, a non-autonomous supervisory body does not benefit from discretion in its implementation of prudential supervision and is less likely to introduce change. In addition, the role of supervisors can be analysed according to an existing typology of the institutional setting for banking supervision, which also provides some indicators of supervisory discretion. Using the typology developed by Kremers et al. (2003), there are three main types of prudential supervisory bodies: sectoral, integrated and partially integrated (Calvo et al., 2018; Kremers et al., 2003; Schoenmaker and Véron, 2018). The sectoral model refers to the system where a specific and separate authority is responsible for banking, insurance and securities supervision. In the integrated model, a single agency is responsible for the supervision of all three sectors. The partially integrated model groups supervisory authority either by objective or sector (Calvo et al., 2018; Schoenmaker and Véron, 2018). In this latter case — referred to as the Twin-peaks model — a single agency is responsible for the supervision of banks and a second body is responsible for protecting investors and consumers of financial services (Restoy, 2016; Schoenmaker and Véron, 2018). It is expected that a sectoral authority will benefit from more

[32] Council, 2013

considerable discretion because there is no pressure from the supervisory regulation of other sectors. The two selected country cases have very different types of prudential supervision as presented below; however, in both cases the supervisors have significant discretion in their supervisory activities.

Regarding France, from an historical perspective, the first banking supervision appeared in France during the Vichy regime. The Bill of 16 August 1940 and its implementing decree of 30 September 1940 created two complementary authorities for banking supervision – the Permanent Committee for Professional Organisation of Banks composed of bank and government representatives and the Banking Control Commission under the remit of the *Banque de France* (Bank of France). As a consequence, the first supervisory authorities in France did not have autonomy from the government and this did not change with the reform of 1945 that replaced the Permanent Committee with the National Credit Council. In the meantime, French Treasury supervised directly mutualist and cooperative banks as well as financial institutions with a specific legal status (Lacoue-Labarthe, 2003).

Banking Act of 1984 created three authorities in charge of control of the banking sector: the Banking Regulation Committee, the Credit Organisation Committee and the Banking Commission. It introduced liquidity and solvability constraints for credit institutions. The Banking Commission was composed of members of the government (Treasury) and chaired by the governor of the *Banque de France*. It was officially under the control of the *Banque de France,* which also provided for the staff members of the secretariat (Westrup, 2007), and no provisions were foreseen on the autonomy of the Banking Commission, which was only introduced in 1994 (Howarth, 2009).

After the financial crisis of 2008, the reform of 2010 created the ACP (*Autorité de contrôle prudentiel*) by merging the former banking and insurance authorities and giving an additional mandate on consumer protection. The French government adopted a twin-peaks

model, with a distinct authority in charge of securities and the financial market.[33] The French monetary and financial code expressly qualified the ACP as an independent administrative body for the first time. As presented below, ACP gradually gained its autonomy. The Government did not exercise any hierarchical power on the ACP. However, the French parliament had the power to nominate the members of the ACP and control its activity. As for the Banking Commission, ACP leaned back on the *Banque de France,* which provided the ACP with its financial and economic expertise but with a distinct separation at the staff level (IMF, 2013a). Such a combination helped coordination, but the cooperation at the decision level (e.g. governor *of Banque de France* chairing the ACP) risked creating a conflicting interest between monetary policy and banking supervision. In parallel, the Bank of France itself gained autonomy from the Treasury and, as such, ensured the autonomy of the ACP from the government. The reform of 2010 also created the COREFRIS (*Conseil de Régulation Financière et du Risque Systémique*) a systemic risk board that produced a framework for coordination without decision-making power. French reforms of the banking sector adopted in July 2013 and fully implemented by July 2015 introduced a separation of risky speculative trading activities from retail activities. It was substantially different from Liikanen proposal (European Commission 2012) which did not prescribe the separation of speculative activities from market-making. Under the new regulation, banks, above a specific threshold, were required to create a separate trading entity which was not allowed to collect deposits and offer payment services to retail customers. The regulation introduced a balanced reform (Fernandez-Bollo, 2013) which preserved the universal bank system in France and some market activities (e.g. customer-driven investment services, liquidity management activities) were authorised within the entity in charge of collecting deposits. The reform of 2013 strengthened the supervisory framework by

[33] *Commission des opérations de bourse* (COB) replaced in 2003 by *Autorité des marchés financiers* (AMF) was in charge of securities and financial market supervision.

giving new powers to the supervisory authority and asserting its autonomy in relation to government. The role of the ACP was reinforced with additional *ex ante* intervention tools (e.g., fit and proper assessment). In 2013, the ACP was also granted resolution powers and became the ACPR (*Autorité de contrôle prudentiel et de resolution*). Supervisory activities were mainly handled by the latter. The ACPR benefited from the supervisory autonomy but was still leaning back on the *Banque de France*. The ACPR was responsible for the supervision, SREP and the assessment of NPLs management. It contributed to and was a member of the HCSF (*Haut Conseil pour la Sécurité Financière*), the authority in charge of macro-prudential supervision. In addition, the national government could issue macro-prudential measures to be applied by banks. Therefore, I consider that the French supervisor gradually increased its supervisory autonomy over time.

As for Germany, German banking supervision was established in 1934 in order to supervise the overall banking sector which submitted all three pillars – composed of private sector banks, public saving banks and cooperative banks – to the same regulatory basis (Behr and Schmidt, 2015). Before, supervision was ensured only for certain types of institutions (Detzer et al., 2017). It was decentralised after the Second World War and centralised again by the Banking Act of 1962 in the Federal Supervisory Office for Banking (*Bundesaufsichtsamt für das Kreditwesen (BAKred*)) in charge of determining regulatory policy but also gave a large power to the Bundesbank which was in charge of the day-to-day supervision and reporting (Westrup, 2007). The Bundesbank considered itself the most independent central bank in Europe and gave much less importance to supervision, which – it considered – could create a conflict of interests (Dyson, 2009).[34] The Bundesbank, therefore, worked in close cooperation with BaKred to whom it delegated some of its key activities (Dyson, 2009).

[34] On the separation of monetary policy from prudential supervision See Goodhart, 1999; Goodhart and Eric, 2000

Germany represented the model of integrated supervision with a single supervisory authority and a role given to the central bank (Schoenmaker and Véron, 2018). Before 2002, Germany had specialised supervisors for insurance, security trading and banking. Unlike France, since 2002 and the creation of BaFin (the German Federal Financial Supervisory Authority), under the remit of the Federal Finance Ministry, German banking supervision merged with insurance and securities regulation and supervision, with cross-sectoral departments in charge of common issues for all three sectors (Dyson, 2009; IMF, 2016; Schüler, 2005). The power of the Federal Finance Ministry grew with the creation of the Euro Area, which consequently diminished the involvement of the Bundesbank in prudential supervision (Dyson, 2009). According to the Supervisory Guideline[35] issued by BaFin, which regulated the division of tasks between the two bodies, BaFin was put in charge of administrative acts and operational tasks such as the licensing and planning of banking supervision. In contrast, the Bundesbank retained control over day-to-day supervision (Steffen, 2016) and was therefore in a subordinated position to BaFin on supervision (Dyson, 2009; Lombardi and Moschella, 2016). BaFin assessed the information collected by the Bundesbank as part of its supervisory activity and issued guidelines and binding prudential regulations. The latter required a specific mandate from the Bank Act (Kreditwesengesetz KWG). From a legal stand point, the autonomy of BaFin was limited; it took the final decisions, which needed governmental approval (BaFin, 2013; IMF, 2016). However, BaFin could act independently and no proof of governmental influence could be noticed (IMF, 2016; Fraccaroli et al., 2020).[36] Unlike BaFin, the Bundesbank was not subject to any ministerial or governmental control but benefited from functional and organisational autonomy (Dyson, 2009; IMF, 2016; Westrup, 2007). Thanks to

[35] Guideline on carrying out and ensuring the quality of the ongoing monitoring of credit and financial services institutions by the Deutsche Bundesbank of 19 December 2016

[36] However the Federal Ministry of Finance approved and could modify BaFin decisions on security market (see Kaufhold et al., 2021).

the pressure from the Bundesbank, it regained some power post-2008 and the new structure assigned the same responsibilities for banking supervision to the Deutsche Bundesbank as before the reform (Dyson, 2009; Werstrup, 2007).

As a consequence, the organisation of the NCAs varied significantly in France and Germany, but in both cases, the level of autonomy of the national supervisor can be judged as sufficient to exercise their discretion in banking supervision activities, notably the Supervisory Review and Evaluation Process. In both cases, German and French NCAs exercised discretion to conduct SREPs – the second thematic case studied in this dissertation. To sum up, the selection of France and Germany allows us to present a variation in the IV with a case mainly dependent on prudential regulation with national government intervention (NPLs) and a case granting discretion to the supervisor (SREP).

b. Variation in the dependent variable

Observing differences in national supervision and thus divergence in the treatment of the cases mentioned above — NPLs and SREP— by selected countries allows a comparative analysis of convergence. On NPLs, the main quantitative criterion of the EBA definition of NPEs based on ninety days past due is applicable in both member states, but there are differences when it comes to additional elements of the definition. A qualitative criterion of the EBA definition – unlikeliness to pay – was used in both member states, but the exact provision was developed at the national level. France has introduced specific guidelines and legislative measures to handle NPLs, whereas Germany used only EBA definition as well as *MaRisk* principle-based guidelines (ECB, 2016b). As a consequence, under the EU requirements, France introduced some adjustments to EU definition, which corresponds to *absorption* category of convergence, whereas Germany profoundly changed its national practice according to *transformation* category of convergence. When it comes to management of NPLs in both

member states this mainly depended on national governments which exercised resistance to convergence in order to maintain national specificities. As a consequence, NPLs management represents a case of *inertia*.

Regarding SREP for LSIs, each member state developed its own methodology. The risk assessment system used in France was mainly based on quantitative criteria, which then could be complemented by 'expert judgement', whereas, in Germany, the assessment was mainly qualitative. The supervision of consolidated entities varied. Supervisors in both countries were assessed at the consolidated level, while only the French supervised at the level of the individual bank entities (Germany in principle did not do so). NCAs in both member states significantly changed their national SREP in order to comply with ECB requirements, according to *transformation* degree of convergence. Table 2.1 below shows the variation of the type of change experienced by Germany and France for two thematic cases selected for this dissertation.

Table 2.1 Comparison of dependent variable variation

	NPL	**SREP**
France	The main quantitative and qualitative elements of the definition remained the same but some adjustments were introduced to the EU definition of NPLs. This corresponds to the *absorption* category of convergence Management of NPLs relies mainly on the national government's intervention which led to *inertia*.	Initially French NCA developed its own methodology based on quantitative risk assessment and expert judgement. The ECB requirements introduced changes to national practice which correspond to the *transformation* category of convergence.

Germany	German NCA introduced EBA definition in MaRisk principle-based guidelines and therefore *transformed* the national definition of NPLs. Management of NPLs relied on the national government's intervention which led to *inertia*.	Initially, Germany relied on qualitative assessment, under its own methodology. The ECB requirement introduced the *transformation* of national practice.

Source: own assessment

Both member states present sufficient variation in the independent and dependent variables of this dissertation. To confirm the analysis a shadow case of additional small countries will also be presented briefly. For this purpose, I selected the case of Luxembourg and Estonia. Unlike in France and Germany, in 2022, Luxembourg's domestic banks represent only approximately seven per cent of total national banking assets and banks operating in the country lend mainly to non-domestic non-financial corporations, in other words to companies outside Luxembourg (European Banking Federation (EBF) data). My second shadow case is Estonia, which has a highly concentrated banking system with comparatively few assets and is also mainly composed of foreign subsidiaries and branches, representing approximately 85 per cent of bank assets in 2022 (EBF data). Observing covariation of the IV and DV for shadow cases, using the method of concomitant variation, will a fortiori confirm the hypothesis developed by this research project.

2.7.2 Selection of thematic cases

The aim of this dissertation is to test the applicability of the initial hypothesis to different areas of supervision. To be able to assess different national specificities and to explain the

factors leading to resistance to convergence, the specific areas of supervision that I analyse in my dissertation must present difficulties in terms of convergence. All the measures examined are part of the flexibility allowed in the banking package. My choice of case studies was also motivated by the importance of these provisions to EU financial stability. For the selection of cases, I have also considered the importance of existing divergence between different member states. I propose to start with an overview of the main areas of supervision with cases where there were differences in national practice prior to the creation of the SSM and which provided discretion to national authorities.

For that reason, I start the analysis with Options and National Discretions (ONDs) which represent a typical provisions providing supervisory discretion to member states and their NCAs. ONDs allow me to test if there is a correlation between the rule-making framework and the degree of change. I set aside those temporary national provisions that were to be phased out gradually, which could also create ongoing divergence but were, for the most part, converged by 2019-2020. The convergence of the remaining provisions was expected at a later stage to include the EBA's and European Commission's recommendations (ECB, 2016). Therefore, I test my hypothesis on the main ONDs left to national authorities – national governments and supervisors. According to the hypothesis, it is expected that ONDs granted to member state governments were used to maintain the initial supervisory practice, whereas ONDs granted specifically to NCAs created the opportunity for change in national practice. This first overview will help to demonstrate the validity of the main hypothesis, showing a greater degree of change in the cases where the supervisor enjoyed full discretion with no intervention from national governments. Once applied to ONDs, I analyse the cases providing the variation in the dependent variable. Therefore, I select a typical case granting discretion to NCAs and a typical case with government intervention limiting supervisory discretion as applied to France and Germany. These two typical cases will be used to test the main hypothesis.

The case of a prudential provision granting discretion to national governments is the convergence in the national treatment of bank non-performing loans (NPLs). A NPL is a loan which is ninety days or more overdue. Large discrepancies can be observed in the way that NPLs are supervised across Banking Union. The biggest differences are observed in the recognition, classification and measurement of bad loans and the calculation of their provisioning. The high level of NPLs hampers the effective activity of the banking sector, and a common EU response to NPLs is expected to mitigate the risks. To give investors and supervisors sufficient information about the quality of assets, the EU has encouraged transparency on NPLs. The EU member states have the obligation 'to disclose information on loans and debt securities exposures and their credit quality pursuant to Regulation (EC) No 1606/2002 and in Council Directive 86/635/EEC' (EBA, 2013a). However, this obligation was not followed by a common definition of NPLs at the EU level. Even within a single country, there could be different co-existing terms that designated non-performing assets (d'Huelster et al., 2014). Various EU interventions promoting convergence of the treatment of NPLs did not manage to completely change national practice. At the national level, the definition and treatment of NPLs mainly depended on the government. This case would therefore represent a typical case under the government control – which is the reason why I selected NPLs for my case studies. Government control was expected to limit the change in the national treatment of NPLs.

The second thematic case is the convergence of national Supervisory Review and Evaluation Processes (SREPs). SREP represents a typical case that grants significant discretion to the supervisor. SREP allows a supervisory review of the capital and liquidity situation of the bank in a more continuous way than the evaluation of Pillar I risk limits and considers the internal governance and risk management practices of banks (Baglioni, 2016; Dragomir, 2010). I have also chosen SREP as a case study given the importance of this process for the supervision

of banks. The introduction of SREP in the Capital Requirements Directive adopted on 30 June 2006 (CRD I)[37] reinforced the autonomy of NCAs which could use different types of evaluation processes with more focus on qualitative and/or quantitative elements in their assessment (McPhilemy, 2014). According to the initial hypothesis, this essential power benefitting to NCAs was expected to create a more favourable environment to change national practice.

2.7.3 Other considered case - Macro-prudential instruments

The convergence of macro-prudential supervision was the third thematic case study to be considered for my dissertation. Unlike the other two thematic cases, macro-prudential instruments have a system-wide focus. According to the ECB, systemic risk is the risk that financial instability can cause significant damage to the real economy (ECB, 2009). Systemic risk can be caused by significant macroeconomic shocks, excessive leverage or contagion risk from interdependent institutions (Constancio, 2016). Macro-prudential supervision aims to diminish excessive risk-taking by banks and reduce the spill-over effect. Macro-prudential supervision is a preventive approach which has as its primary objective to limit credit expansion and increase the shock absorption capacities of banks (Borio, 2003; 2006; Cartapanis, 2011). National authorities continue to enjoy significant discretion about macro-prudential supervision, resulting in considerable and persistent divergence among Banking Union member states. In addition, there are differences in the activation mechanisms for some instruments, which can influence the use of specific macro-prudential instruments (such as a higher real estate risk weight or Pillar 2) to the detriment of others (e.g., higher capital requirements).

Moreover, national authorities can use additional national measures regarding which they have a considerable margin of manoeuvre. Despite the lack of convergence, the EU does not prescribe the convergence of macro-prudential measures. For that reason, with very limited

[37] Capital Requirements Directive 2006/48/EC

pressure for convergence on these measures coming from the European Systemic Risk Board (ESRB) and the ECB, I decided not to pursue this third case.

2.8 Research design

My analysis of convergence in national practices is based mainly on qualitative analysis of various primary sources. I proceeded through documentary analysis of primary and secondary materials in my research. The primary material is composed of EU and national legislation. EU level legislation entails the Single Rulebook provisions and technical standards and recommendations. Despite the main focus of this dissertation on national-level explanatory variables, EU-level provisions matter because they provide the convergence reference and the agreed expectations of the EU institutions involved. I next analyse the evolution of national-level legislation and compare this evolution to EU standards. This analysis is supplemented by examining additional primary material composed of public documentation issued by EU and national authorities, such as implementation reports, public statements, disclosures, Questions and Answers (Q&As), internal European Commission and NCA documents, and other publicly available primary material. In particular, I focus on the internal preparatory documents from national authorities. Transparency is not fully guaranteed given the commercial sensitivity of banking supervision, and thus access to some relevant documents was challenging to obtain. This project also requires the analysis of political debates at the EU and national levels, notably the analysis of negotiations on a European Commission proposal on ONDs. This additional documentation allowed me to analyse national practice in prudential supervision and legislation.

I also examined secondary academic material. Most of the secondary material available on prudential supervision is not political science but is rather from legal scholars or economists. Some of these scholars focus on the role of the supervisor and its effect on performance in the

banking sector (Barth et al., 2013; Chortareas et al., 2012; Eichengreen and Dincer, 2011). Other economists examine factors that influence national supervisory settings for instance by consolidating supervision outside the central banks (Masciandaro et al., 2007; Masciandaro and Quintyn, 2009). As presented earlier in this chapter, some economists also focus their studies on the different typologies of prudential supervisors and its consequence on the supervisory outcome (Calvo et al., 2018; Kremers et al., 2003; Schoenmaker and Véron, 2018). Scholars also examine the prudential regulation and its Europeanisation at international and EU levels from a legal perspective (see Dragomir 2010). There are also political science and legal studies on the role of the EBA (Capiello, 2015; Ferran and Babis, 2013; Ferran, 2016; Gren et al., 2015; Gren 2017; 2018; Howarth and Quaglia, 2013, 2016a; b; Salter, 2015, 2019; Wymeersch, 2014). Only a limited number of political economy studies on the convergence of prudential supervision (e.g. Gandrud, 2013). Spendzharova (2014) analyses the main political and economic factors explaining the supervisory approach that Central and Eastern European countries took. Masciandaro and Quintyn (2016) represent supervisory governance as a principal-agent problem combining political economy and economics approaches. No political science studies on convergence factors in prudential supervision in the Banking Union involve a combined framework of Europeanisation, HI, the Epistemic Communities approach and the Transnational Policy Network framework.

To reinforce my findings, I also undertook eleven exploratory discussions and semi-structured interviews with SSM national supervisory authority staff, ECB supervisory staff and supervised bank risk officers and experts. The output from these interviews is analysed empirically to demonstrate converging/ diverging trends and to explain or comment on my findings from the documentary analysis. Given the secrecy of many elements of bank supervision, the interviewees requested anonymity. I summarise the main outcomes from these semi-structured interviews in the Appendix and reference only the type of institution and the

position of the interviewees and in some cases only a general job description. The interviews were semi-structured, based on questions related to the interviewee's position and job description. The interviewees statements can be influenced by the image they have of their institution and the image they want to give to the interviewer. In order to validate the findings and reduce potential biases, I interviewed experts from different member states and triangulated with other publicly available documents and official positions reported in the press.

2.9 Chapter Conclusion

To summarise, in this chapter, I presented the main objective of this dissertation: to explain the process of convergence of prudential supervision under the SSM. Convergence can be analysed through the combination of Europeanisation and Historical Institutionalism, complemented by insights from the Epistemic Communities approach and the Transnational Policy Network framework. Europeanisation will reply to the question 'Does convergence occur?'. HI will clarify how the convergence occurs, while the Epistemic Communities approach/ Transnational Policy Network framework will provide vital insight into what explains national actors' preferences. I also reviewed alternative analytical frameworks that were considered but did not bring sufficient explanatory power to address my main research question. Neofunctionalism provides an overview of the integration process but does not explain why one observes different levels of convergence in other areas of supervision. RCI explains the change in terms of the response of rational actors but does not explain the different preferences of national actors with similar objectives. Further, LI focuses principally on treaty change and does not consider institutions as independent actors involved in the change process.

Then I presented how the selected analytical framework will apply to the analysis of the convergence of national prudential supervision under the SSM. I define the dependent variable as the change of national prudential supervision and the independent variable as the discretion

of national supervisory authorities. According to the hypothesis presented above, it is expected that the intervention of national governments will limit change. On the contrary, where discretion is exercised by the national supervisor, with no legal intervention, this will allow change towards EU requirements and thus supervisory convergence. The difference results in the socialisation and learning process experienced by national supervisors when national government intervention is limited.

Then, I explained the selection of country cases – France and Germany – based on the method of concomitant variation, which is the most suitable method for cases with a concomitant variation in the IV and the DV. I also presented ONDs, which allows a large spectrum analysis to test the hypothesis and the main factors that led to select the case studies – NPLs, which provides with a case where the national government is largely involved, and SREP a typical case where the supervisor exercises discretion. Finally, I introduced the research design of the study.

Table 2.2 Comparison of main characteristics of the banking structure of France and Germany

Characteristics		**France**	**Germany**
The scope of banking sector in national economy (2015) **Ratio of assets to GDP**		€ 6.9 trillion c.6%	€ 6.9 trillion c.4%
Percentage of bank assets held by LSIs (2015)		10%	43%
Structure of the banking system	**Concentration** **Shares of assets of largest 5 banks**	Moderate (47%)	Low (32%)
	Importance of alternative banks, their resistance to the financial crisis	High Good resistance	High (public banks 27%) and cooperative banks (13.5%). Good resistance for cooperative banks Less resilient Landesbanken
	Internationalisation **1. International assets hold by national banks (EU & Rest of the world (RoW))**	Low 24%	High c.29%

	2. Foreign banks penetration (EU&RoW)	c.10.5%	c. 12%
	Universal bank	Yes, but banks above specific threshold required to create a separate trading entity	Yes, soft separation of trading and deposit activities, prohibiting speculative transactions exceeding specific thresholds
National supervisory model		Two Agency	Integrated model
NCA		ACPR And specific authority responsible for consumer protection	BaFin and Bundesbank BaFin oversees administrative acts and operational tasks, Bundesbank is in charge of the supervision itself
Macro-prudential authority		HCSF (High Council for Financial Stability)	BaFin and Financial Stability Committee

Source: own assessment based on the ECB data, 2017 (report on financial structure October 2017)

Chapter 3 Development of EU supervision in favour of convergence and national supervisory institutions' adaptation

The creation of the EBA and the establishment of the SSM triggered the formation of convergent prudential supervision in the EU and, more specifically, in the Euro Area. The establishment of the EBA contributed to the creation of common standards for prudential regulation to be applicable throughout the EU. The centralisation of banking supervision in the ECB within the SSM also represented a significant shift in European prudential supervision, which had only changed incrementally prior to 2014, building on national policy legacies and coordination (see also De Rynck, 2016; Glöckler et al., 2017; Röseler, 2015). As a reminder, the SSM, is composed of all Euro Area member states and other member states which could opt to join Banking Union though a close cooperation agreement. Once close cooperation was established, member states could participate in the SSM with the same rights as the Euro Area member states, i.e. transfer the supervision of Significant Institutions to the ECB and participate in Joint Supervisory Teams (JSTs) and the SSM's Supervisory Board.[38] On 1 October 2020, Bulgaria and Croatia joined the SSM under a close cooperation agreement as part of their Euro Area accession process.

In the following sections, I will present how the creation of the EBA (section 3.1) and the SSM (section 3.2) encouraged the convergence of prudential supervision in the EU (section 3.3). Then I will illustrate which changes were introduced to national supervisors to adapt to the creation of the EBA and the SSM (Section 3.4).

[38] However, member state from close cooperation does not participate to Governing Council of the ECB and the latter cannot address binding acts to banks in these member states

3.1 The EBA as a forum to facilitate the convergence of prudential regulation

The EBA tools to facilitate convergence

At the request of the Commission in October 2008, a high-level working group chaired by J. de Larosière prepared a report with recommendations on the reforms to undertake on financial regulation and supervision in the EU. The report recommended the creation of three European Authorities, a European Banking Authority (EBA), a European Insurance Authority and a European Securities Authority. Following this report, the EBA was established in 2010 as an EU agency[39] to facilitate the integration of prudential regulation and its uniform application in the EU. It replaced the Committee of European Banking Supervisors (CEBS) – a committee created in 2004 to coordinate national supervisors and advise the European Commission on prudential aspects. The CEBS, composed of senior representatives of national supervisory authorities and central banks of the EU, was the initial forum to facilitate discussions and exchange of information among national supervisors, enabling the creation of a common culture among them. It issued non-binding soft law provisions in the form of guidelines, recommendations and standards, limiting the convergence pressure on national prudential requirements. The EBA could also issue recommendations and guidelines. However, under the EBA Regulation,[40] national supervisors had to comply with these provisions. They were subject to the 'comply or explain' principle to ensure convergence in prudential supervision among member states. To that end, once the guidelines and recommendations were formally issued, the NCAs had to inform the EBA whether they complied or intended to comply with the provision.[41] In case of non-compliance, the NCAs had to explain the reasons for non-

[39] On the agencification of banking supervision, please see Levi-Faur, 2013, Beroš, 2018
[40] Article 16(3) EBA regulation
[41] The compliance status monitoring table is published on the EBA website and updated regularly

compliance. The pressure exercised on NCAs by this ‘comply or explain’ mechanism was sufficient to ensure substantial compliance with the EBA guidelines and recommendations. For example, as of mid-2022, out of more than 3300 notifications received since 2011, only about 180 notifications concerned a non-compliance, representing roughly five per cent of all notifications. However, the degree of compliance depended on the areas concerned. Some areas, such as SREP, were fully compliant, whereas for some others areas the compliance was less important, such as 'notional discount rate for variable remuneration', where eight NCAs out of twenty-seven notified non-compliance.[42]

Moreover, national authorities exercised discretion in transposing these measures into national legislation, with some taking the form of legislation adopted by the national government. In contrast, NCAs adopted other measures via lower-level regulations such as circulars by NCAs (Enria, 2015). These differences could create confusion among banks and, therefore, divergence in their application. In addition to non-binding requirements, the EBA could issue constraining rules.

As a reminder, in the financial services sector, which also includes banking, regulation is adopted according to the four-level Lamfalussy Process. First, Level 1 is composed of legislation adopted by the European Parliament and the Council and provides for a general basis. It is composed of regulations or directives. On the delegation of Level 1 legislation, the Commission can pass Level 2 provisions (non-legislative measures). The latter is composed of delegated or implementing acts drafted by the European Commission or in the form of RTS or ITS drafted by the EBA, which the European Commission then endorse in the form of regulations. According to the EBA funding regulation, these technical standards specify the content of legislative acts and do not have to imply any strategic decisions. However, one could

[42] For additional information, refer to the compliance status monitoring table on the EBA website

observe the very detailed provisions of some Level 1 regulations, while delegating to the EBA some political and strategic aspects (Cappiello, 2015; Ferran, 2016). Such delegation was used to ensure the uniform application of some provisions across the EU and to overcome political disagreements and bottlenecks among EU legislators in the legislation process (Cappiello, 2015).

Eventually, the EBA developed a Q&A tool to help national authorities implement and interpret the Single Rulebook, which also influenced convergence by ensuring a more consistent implementation of the EU prudential provisions (EBA1, 2019; Enria, 2015; Cappiello, 2015). However, when the question required the interpretation of Union law, the Commission, and more specifically its Directorate General Financial Stability, Financial Services and Capital Markets Union (DG FISMA) provided the answer, which the EBA then publishes in its own name (EBA, 2022; Ferran, 2016). These Q&A were not legally binding. However, the Q&A process entailed interaction with the European Commission and the NCAs, ensuring a high degree of implementation of these positions.

Governance of the EBA facilitating NCA socialisation

The main decision-making body of the EBA was the Board of Supervisors which adopted EBA's decisions on policy-oriented topics. According to article 43 of the Regulation establishing the EBA,[43] the Board of Supervisors was in charge of taking policy-oriented decisions and adopting opinions, recommendations, decisions and issuing advice. It also adopted the EBA's budget. The Board of Supervisors was composed of representatives of EU member state supervisors. Regulatory matters had to be adopted by a qualified majority vote requiring at least 55 per cent of all votes in favour, representing at least fifteen members and coming from national supervisors from member states comprising at least 65 per cent of the EU

[43] Regulation (EU) No 1093/2010

population (EBA, 2020). It was complemented by an additional 'double simple majority' consisting of a simple majority of national authorities from the member states participating in Banking Union and a simple majority of non-participating member states' national authorities.[44] This double majority vote — demanded by the British government — ensured that the position of the non-Banking Union member states was also taken into consideration on bank supervisory matters. Despite the requirement made to NCAs to act 'independently and objectively in the sole interest of the Union',[45] concerns were raised that the decisions taken by the Board of Supervisors reflect NCA preferences (European Commission, 2014; European Parliament, 2013; IMF, 2013c). As a consequence, the participation of NCAs to the Board of Supervisors allowed them to upload their preferences to the EU level. At the same time, the participation of NCAs in the decision-making at the EU level also favoured their socialisation (Beroš, 2018; EBA1, 2019; EBA2, 2022). NCAs used the Board of Supervisors to find common ground on regulatory provisions by developing new standards based on national best practices.

In addition to the Board of Supervisors, the Management Board ensured that the EBA's activities complied with the founding acts. The Management Board was composed of a chairperson and six representatives of member states appointed by the Board of Supervisors. The composition of the Management Board also reflected the importance of the NCAs in the decision-making procedure of the EBA.

3.2 The ECB, centralisation of prudential supervision

[44] According to article 2 of Council Regulation (EU) No 1024/2013, participating member states 'means a member state whose currency is the euro or a member state whose currency is not the euro which has established a close cooperation in accordance with article 7'
[45] Article 42, EBA funding regulation

Prior to the creation of Banking Union, banking supervision remained almost entirely a national competence and the powers of EU bodies were very limited. From 2004, national supervisors coordinated their supervision within the CEBS. EU-level involvement in prudential supervision was based entirely on cooperation without centralisation. The coordination concerned mainly the supervision of cross-border groups, which could establish branches in other member states supervised by the home country supervisor or subsidiaries (independent legal entities) supervised by the host country supervisor. In this second case, the concerned banking groups were subject to several national supervisory frameworks and rules, which could allow them to avoid adequate supervision (see Howarth and Quaglia, 2016c: 445). In the absence of harmonised supervision, cross-border banks preferred using branches rather than subsidiaries, whereas national supervisors encouraged the establishment of subsidiaries (Gros, 2012). Moreover, the financial crisis began in 2007-2008; cross-border cooperation was significantly undermined by the prevalence of national measures (Enria, 2015).

Eventually, colleges of supervisors under the CEBS fostered supervisory coordination for cross-border banks within the EU. After the financial crisis in 2009, the De Larosière report recommended that the supervision of cross-border institutions should rely on colleges of supervisors and the CRD II required the cross-border banks in the European Economic Area to set up supervisory colleges. In January 2009 the CEBS also provided a more structured framework with guidance on the organisation and cooperation within the colleges of supervisors (CEBS, 2009; Posner, 2015). The role of these colleges was the cooperation and coordination of national supervisors involved in the supervision of cross-border banking groups. They did not focus on the possible convergence of prudential supervision. However, through discussion on specific cases, cooperation and exchange also reinforced socialisation and contributed to the convergence of supervisory practice (Posner, 2015).

On 29 June 2012, in the aftermath of the debt crisis, the Euro Area Heads of State or Government announced the need to create the SSM. In the aftermath, the European Commission issued a Roadmap for a Banking Union on 12 September 2012, which proposed conferring supervisory power to the ECB. The SSM installed centralised prudential supervision. Before granting the ECB this new competence, the EU institutions and member states also explored alternatives (Chang, 2015). For instance, the European Commission favoured assigning greater powers to the EBA (Chang, 2015; Gortsos, 2016). The de Larosière report noted reluctance to assign the ECB powers over supervision, which in the view of the report's authors, would conflict with the ECB's monetary policy objectives. However, the ECB designation was considered by member states as quicker and easier to install and did not require a Treaty change (see, for instance, Chang, 2015; Véron, 2014).[46]

According to the new mechanism, the ECB became the direct supervisor of Significant Institutions, whereas the direct supervision of LSIs continued to be controlled by NCA. This two-level supervision resulted from divergent preferences of member states. Some, such as France and the Netherlands, preferred the full delegation of supervisory competencies to the ECB. Others, led by Germany, opposed a large delegation of competence to the ECB (Howarth and Quaglia, 2016c; Lombardi and Moschella, 2016; Schäuble, 2012).

The supervision of Significant Institutions became the responsibility of Joint Supervisory Teams (JSTs). JSTs were composite units comprising ECB and NCA staff coordinated by an ECB official. They were established for each Significant Institution, and their composition varied depending on the specificities of the supervised bank. A JST coordinator from the ECB allowed a convergent decision based on the same standards regardless of the

[46] The ECB's competence for banking supervision was granted on the basis of Article 127(6) of the Treaty on the Functioning of the EU

bank's country. JST coordinators were supported in their tasks by JST sub-coordinators from relevant NCAs.

Since the establishment of the Single Rulebook and the creation of the SSM, the difference between the treatment of branches and subsidiaries also lost its relevance for Significant Institutions. As a consequence the number of subsidiaries of Banking Union member states banks significantly fell from 256 subsidiaries in 2014 to 193 subsidiaries in 2019, while the number of branches remained largely stable dropping only marginally from 555 branches to 545 branches (ECB Data warehouse). The trend was confirmed in 2021, with 496 branches and 149 subsidiaries. Indeed in the case of significant banking groups, the ECB took over the direct supervision of branches and subsidiaries which removed the importance of relying on subsidiaries to benefit from host member state supervision.

LSIs were supervised indirectly by the ECB, NCAs carried out the day-to-day supervision, and the ECB exercised an oversight function through its Directorate General Microprudential Supervision III (DG MS III).[47] The latter hosted the senior management network, which gathered ECB and NCA experts to discuss central issues related to the supervision of LSIs (ECB, 2015c).

In its initial proposal to transfer the prudential supervision to the ECB, the Council attributed the competence for ensuring convergence of prudential supervision only to the EBA and not to the ECB (Council, 2012; Gren, 2017). However, in practice, the ECB also promoted the convergence of prudential supervision. The ECB ensured the convergence of banking supervision of LSIs by replicating the supervisory approach applicable to Significant Institutions proportionally by developing standards for LSIs and performing thematic reviews. The ECB also established country desks to ensure its oversight mission and to facilitate the

[47] DG Microprudential Supervision III was in charge of overseeing the supervision of LSIs by NCAs. In July 2020, the ECB announced changes to its internal organisation, the DG responsible for LSIs supervision became DG Specialized Institutions and LSIs (DG/SPL)

discussion with the NCAs. The ECB also stimulated the creation of a common culture among NCAs by promoting staff exchange with the ECB or among NCAs, through training programmes, roadshows and workshops (ECB, 2018b; NCA2, 2019). The number of such initiatives increased from 23 in 2006 to 32 in 2017 and 34 in 2018 (ECB, 2019a). In 2017, these initiatives involved the participation of a quarter of all staff related to LSI supervision under the SSM (ECB, 2019a). More directly, to promote convergence, the ECB was empowered to address instructions to NCAs and could move to assume the direct supervision of LSIs if the ECB considered it necessary to ensure convergence. However, the latter remained more as an incentive to influence consistent supervision by NCAs and as of the end of 2022, the ECB had yet to assume the direct supervision of LSIs for convergence purposes.[48]

In order to promote convergence, the ECB could also issue recommendations, guidelines and decisions. Recommendations were non-binding, whereas the guidelines and decisions were binding legal provisions. The ECB could therefore use these latter instruments to impose convergence on prudential supervision by NCAs. At the same time the ECB instruments had to comply with EU legislation and EBA technical standards. Moreover, the ECB did not have any regulatory power except the possibility to issue regulations for the organisation of its activities (for a more detailed overview of legal aspects, see Brescia Morra 2014). There were also some additional limits to the convergence pressure that the SSM could exercise. According to article 4(3) of the SSM Regulation, the ECB had to apply not only EU law but also 19 national legislative frameworks where applicable. This applicable legislation concerned, for instance, national legislation transposing EU law and where the EU law granted options and national discretions to national governments.

[48] Since the creation of the SSM and as of the first quarter 2020, the ECB took over the supervision of eleven LSIs, ten of which were expected to meet significance criteria. The last LSI in Latvia, where the supervision was taken over by the ECB on 4 April 2019 at the request of the Financial Capital and Market Commission and withdrew its authorisation in February 2020 (ECB, 2021a)

Governance of the SSM – room for NCAs

The governance of the SSM also incorporated an important role for the NCAs. First, Directorate General Microprudential Supervision I and II[49] originated draft decisions for Significant Institutions and to a lesser extent by DG MS III for common procedures for LSIs or general instructions to NCAs on the supervision of LSIs. Draft decisions were submitted to the Supervisory Board, which adopted decisions under the SSM by a simple majority. The Supervisory Board comprised the Chair, the Vice Chair, four ECB representatives and NCA representatives from each participating member state. If the NCA was not a central bank, a representative of the national central bank could accompany the NCA. However, in this case, the member state had only a single voting right. Such composition of the Supervisory Board favoured the relative influence of the NCAs, which could exercise a large majority of votes (19 out of 25). The decisions taken by the Supervisory Board drew on the experience and position of 19 national supervisors (Enria, 2019). As a result, the composition of the Supervisory Board influenced the cooperation among NCAs involved in the decision-making procedure. Compared to the EBA's Board of Supervisors, the discussions were more on day-to-day supervision rather than political topics (cf., for instance, Zeitlin, 2022). Consequently, the preferences of NCAs were already embedded in the decisions made by the SSM, which can explain why the NCAs were expected to comply largely with these decisions. Moreover, NCAs senior management participated in high-level networks and conferences which supported their cooperation and socialisation. The objective of these initiatives was to assist the Supervisory Board in its mission connected to the supervision of LSIs (ECB, 2019a). When it comes to

[49] Directorate General Macroprudential Supervision I and II (DG MS I and II) were in charge of coordinating the supervision of Significant Institution. In July 2020, ECB announced the change to its internal organisation with new directorates replacing DG MS I and II, namely Directorate General Systemic and International Banks (DG/SIB) and Directorate General Universal and Diversified Institutions (DG/UDI)

expert levels, NCAs staff participated in workshops and working groups on specific topics (ECB, 2019a).

Then the decisions had to be sent for final approval to the ECB's Governing Council. The Governing Council comprised six members of the ECB's Executive Board and the Euro Area's member states' central bank governors. The Governing Council adopted the draft decisions of the Supervisory Board through 'tacit consent' unless it explicitly objected within ten working days. This procedure was called the 'non-objection procedure', and the Governing Council could only accept or object and could not change the Supervisory Board's proposed draft. If the Governing Council would object, a mediation panel would be requested to solve the difference of views among NCAs. In practice, however, since the creation of the SSM, the Governing Council never challenged the decision of the Single Rulebook and no mediation intervened between 2014 and 2022 (ECB, 2022a; Enria, 2019; Zeitlin, 2022).

3.3 The transition from minimum to maximum harmonisation – the establishment of the Single Rulebook

Convergence efforts started in 1977 with the First Banking Coordination Directive.[50] At that time, prudential supervision was based on the principles of minimum harmonisation and the mutual recognition of national laws. These principles relied on the 'single passport', which authorised banks in one member state to provide financial services across the EU without requesting additional authorisation in each member state. Minimum harmonisation imposed common minimum standards on banks from participating member states; the latter could, however, deviate from these standards with stricter measures. Moreover, minimum harmonisation undermined the convergence of prudential supervision by allowing regulatory

[50] First Council Directive 77/780/EEC

arbitrage, lack of comparability in prudential provisions and creating obstacles to an effective risk-management of cross-border groups (Cappiello, 2015). Such a possibility to impose more stringent provisions created opportunities for gold-plating, in other words, the possibility to impose more stringent national provisions. For instance, André Sapir (2016) describes the case of gold-plating in Belgium. Moreover, minimum harmonisation made mutual recognition inefficient. It allowed 'policy shopping' for banks to seek more favourable banking regulation and for national authorities to use prudential supervision to favour domestic banks (Lehmann, 2017; Montanaro, 2016; Quaglia, 2010; Story and Walter, 1997).

The shift from minimum to maximum harmonisation corresponds to the move to the Single Rulebook. T. Padoa-Schioppa initially promoted the concept of the Single Rulebook at the beginning of the 2000s. The de Larosière Report then took this up. The objective of the Single Rulebook was to establish a common set of EU rules applicable to the whole banking sector. Banking Union relied entirely on the Single Rulebook even though the latter addressed not only Banking Union participants but all EU member states. As stated by Sabine Lautenchläger (2016) — Vice Chair of the Supervisory Board of the ECB — 'banking supervision can only be as harmonised as the rules and regulations that govern it.'

Establishing the Single Rulebook required replacing the existing framework composed of directives and their national transposition with directly applicable regulations achieving maximum harmonisation across the EU (Teixeira, 2014). In these circumstances, in 2013, the Capital Requirement Directive III was replaced by two pieces of legislation, a directive and a regulation. The latter introduced maximum harmonisation. The introduction of maximum harmonisation limited the possibility of deviating from EU standards and imposing more stringent requirements but did not remove it completely. Indeed the banking package of 2014 was composed of a regulation (CRR) which required common rules but also a directive (CRD IV) which had to be transposed by member states. Moreover, even the CRR left room for

Options and National Discretions (ONDs) which could also be used by national authorities to take more stringent provisions (Lehmann, 2017). In certain circumstances, the ECB had to apply these national provisions, for instance, ONDs exercised by national governments.[51] An example of such a provision is the German rule in Kreditwesengesetz (KWG, German Banking Act) which goes beyond EU provisions on large exposures and requires a unanimous vote of all other directors of a bank and approval by its supervisory board to approve a loan to one of its directors (Lehmann, 2017).

The combination of the CRR with the CRD IV - in other words, with a directive transposed into national legislation - and the survival of Options and National Discretions indicated that the Single Rulebook was not fully achieved (Lehmann, 2017; Wissink, 2017). The combination of the Single Rulebook and the centralised supervision within the SSM was still insufficient to create fully harmonised prudential supervision. It relied on NCAs and their cooperation. For instance, the ECB relied on NCAs' national expertise to implement applicable national legislation (Wissink, 2017).

3.4 Changes in national supervisory institutional frameworks favouring convergence

The creation of the EBA and the SSM also introduced changes into the national supervisory frameworks of Banking Union member states. National governments established NCAs, which could be the central bank or another independent authority — as was the case for eight participating member states. In some member states, the national central bank played a role in prudential supervision without being the NCA. Even though the national supervisors

[51] From a legal perspective, which will not be assessed in this dissertation, gold-plating raised the issue of the obligation for the ECB to apply such national transposing rules going beyond EU requirements. On this topic, see Lehmann, 2017; Budinská, 2022.

remained, their competence changed to adapt to the transfer of competence over Significant Institutions to the ECB. One could expect the workload of NCAs to diminish since the creation of the SSM. However, in practice, their assignments increased. For instance, in Luxembourg, the *Commission de Surveillance du Secteur Financier* (CSSF – Luxembourgish NCA) massively increased in size from 2013-2014 just as it was losing direct supervision of the country's biggest banks (CSSF, 2015). First of all, some tasks remained national competence, such as consumer protection, supervision of entities which do not enter the definition of banks under the CRR, and prevention of money laundering and terrorist financing. Despite the EBA and the ECB requirements that NCAs act in the sole interest of the EU, the NCAs also used EBA and ECB forums to defend their positions. For instance, NCAs created units to coordinate their activities with the Supervisory Board at the ECB (NCA2, 2019). The establishment of such internal organisations within national authorities shows that NCAs also played an active role in the SSM and its decision-making process. Some NCAs had also established special units to monitor the banking sector outside their home market (Zeitlin, 2022). Supervision required more resources even at the national level and NCA officials were needed to take part in the supervision of banks from other member states as part of the JSTs (Götz et al., 2019; Röseler, 2015; Cacciatore, 2019). The ECB relied on the resources of NCAs to exploit their information advantage resulting from their market proximity, knowledge of national specificities, national banking legislation and language skills (BSE, 2022; Götz et al., 2019; Röseler, 2015; Wissink, 2017). Moreover, NCAs were requested by the ECB to prepare draft decisions on Significant Institutions located in their member state — and NCAs could prepare draft decisions on their own initiative. In addition, when prudential regulation originated from national laws, there remained an NCA competence. Such active participation of the NCAs, allowed them to upload their preferences at the EU level.

An overview of the operation of French and German supervisors within the SSM confirms the findings. In both member states, the management of supervisors encouraged exchanges with the ECB and other NCAs (NCA2, 2019, BaFin, 2015), which helped to create a common culture among supervisors. The French banking sector was predominantly composed of Significant Institutions, on which the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR) focused most of its resources. Consequently, LSIs represented only one of the ACPR's eight units in charge of banking supervision (NCA3, 2019). In France, the ACPR also indirectly played a role in the transposition of directives and implementation of regulations developed at the EU level by bringing its expertise to the national government. To prepare its positions for Supervisory Boards or working groups, the ACPR created a specific unit — an ad hoc coordination unit within its international affairs directorate (ACPR, 2015). The ACPR also initiated bilateral exchanges with other national authorities (ACPR, 2015).

The introduction of the SSM also introduced changes to the German Supervisory framework, involving joint operations by the Federal Financial Supervisory Authority (BaFin) and the Bundesbank. Both supervisory bodies participated in the JSTs for Significant Institutions, and BaFin was assigned as the voting member in the Supervisory Board of the SSM. Unlike France, LSIs represented a large majority of banks in Germany. The supervision of approximately 1600 LSIs was still decentralised in nine Regional Offices of the Bundesbank, which then addressed the reports to BaFin for assessment. In contrast, its Central Office was in charge of coordination and policy issues (BaFin, 2015; Deutsche Bundesbank, 2016; NCA4, 2021).

In an interview, one year after the introduction of the SSM, the Executive Director of BaFin, Raimund Rösler (2015), also pushed for the convergence of standards. He recognised that the SSM adopted many German rules at the EU level. The NCAs participated in different working groups at the ECB in both member states. They aimed to raise awareness and influence

decisions on specific national features of their home country. For instance, BaFin introduced topics on cross-guarantee schemes, and both the ACPR and BaFin raised awareness of the governance of cooperative banks (BaFin, 2015; NCA3, 2019). NCAs considered it essential to raise these specific issues at the EU level because, according to the NCAs, the SSM represented a competition of national supervisors to upload their standards at the EU level, which could then be used as standards for all member states (Gren, 2018: 294; NCA3, 2019; Zeitlin, 2022). See, for instance, the position of Andreas Dombret (2014), a member of the executive board of the Deutsche Bundesbank:

> But, for all the benefits it offers, European supervision also means more competition for us as national supervisors — as I mentioned earlier, the SSM supervisory standards will be developed by cherry-picking best practices from national approaches to banking supervision. And this is precisely where we are challenged to deliver our best practices and strategies in the prudential field.

3.5 Chapter Conclusion

This chapter presents the EU and national institutional frameworks which have influenced the convergence of prudential supervision of those member states participating in Banking Union. In the context of the sovereign debt crisis in the EU, two new institutions were created at the EU level — the EBA and the SSM — which shaped the national practice of prudential supervision. First, the creation of the EBA in 2010 promoted the convergence of regulation on prudential supervision. To that end, the EBA could issue non-binding regulations and guidelines. These legal acts were subject to ‘comply or explain’ mechanisms which influenced the compliance of national supervisors. The EBA could also issue binding technical

standards. However, the EBA's main decision-making body — the Board of Supervisors — mainly relied on NCAs.

The convergence efforts were reinforced by developing the Single Rulebook, based on the maximum harmonisation principle, which partially replaced the CRD with CRR. However, the persistent use of directives which could be transposed in different ways at the national level and the absence of centralised supervision rendered the convergence pressure insufficient. This changed when the ECB became a supervisory authority within the SSM. The ECB gained control over the direct supervision of Significant Institutions and the indirect supervision of LSIs. The activities of the ECB within the SSM also promoted the convergence of banking supervision, either directly by issuing binding legal acts or indirectly by facilitating exchanges among NCAs and issuing non-binding recommendations. As for the EBA, the decision-making bodies of the ECB as a single supervisor relied on the NCAs which could therefore upload their preferences to the EU level. As a consequence, ECB decisions already included NCA preferences, which facilitated their implementation, as will be examined further in the following chapters.

Eventually, the NCAs also favoured the convergence process by facilitating cooperation and participating in exchanges. The NCAs changed their institutional framework to adapt to the EBA and the SSM creation. They developed coordination units and, like the ECB, fostered active cooperation among NCAs and with the ECB. Such forums of exchange helped create a common position among NCAs, facilitating convergence in prudential supervision.

Chapter 4 Overview of main areas providing margin of manoeuvre to national authorities – the case of Options and National Discretions

4.1 Introduction to Options and National Discretions in the EU framework

In this chapter, I provide an overview of large number of prudential provisions to test my general hypothesis and investigate whether the national legal setting in place prior to the crisis, providing the supervisor with a narrower or wider margin of manoeuvre, will influence the change of national supervision and whether intervention from a national government will limit such change. The objective is to test whether a change is more likely in cases where national supervisors exercise policy-making margin of manoeuvre vis-a-vis the national governments. It is expected that when the prudential provision is set by law, it is less likely to change. In contrast, the change is more likely when the national supervisor exercises discretion. To test this hypothesis, I focus on the provisions that offer room to manoeuvre to national authorities – national majoritarian institutions (governments) and supervisors – to implement prudential supervision. One way to analyse these discretionary provisions is to focus on Options and National Discretions (ONDs) authorised under the banking package. An alternative way would have been to focus on provisions which are not regulated by the banking package (e.g., tax legislation). The latter would include national rules on supervision that are difficult to change because they cover a range of commercial operations beyond banking. Consequently, analysing ONDs is deemed more appropriate for obtaining a broad overview of the application of prudential supervision in member states.

The banking package did not define the concepts of 'Option' and 'National Discretion'. They referred to different types of flexibilities granted either i) to member states (in other words, to national governments) through legislative intervention or ii) to supervisors. An 'Option'

designated the situation in which the national government or the competent authority was given a choice on how to implement the provision. 'National Discretion' was the situation in which the majoritarian institution or the NCA could choose whether or not to apply the provision (EBA, 2013d; ECB, 2016a). The ONDs were addressed directly to the NCAs or the member state majoritarian institution, thus requiring legal intervention.

In the case of member state ONDs, the legislative provision could be issued by the national parliament but could also be the consequence of an executive law-making. In principle, law-making is a parliament prerogative. While parliaments could delegate law-making power to the executive (e.g. article 80 of German *Grundgesetz* and article 21 of the French Constitution), such cases were limited[52] and required specific delegation (Haibach, 1997). In the French case, however, article 37 of the French Constitution gave the executive the power to legislate on all matters which were not explicitly listed as the domain of the parliament and even in these latter cases, a decree (*ordonnance*) could delegate the legislative power to the executive (Haibach, 1997). As a consequence, a member state OND could be issued by the national parliament or the executive through national provisions transposing or implementing EU provisions (Kudrna and Puntscher Riekmann, 2018).

ONDs were the outcome of the 'minimum harmonisation' principle that national authorities often used before CRD IV. Removing them from European prudential regulation was the main objective of the banking package. Despite their number having diminished compared to the previous version of CRD, according to the ECB, over 150 ONDs were present in the Single Rulebook in 2014 (ECB, 2015a). Approximately thirty ONDs were available to the member states, in other words, to national government. The remaining ONDs were granted to competent authorities — whether at the supranational (the ECB) or at the national levels

[52] As for instance in Germany, the theory of essentialness (*Wesentlichkeitstheorie* forbids the delegation of essential questions from Parliament to the executive

(NCAs). The ECB, qualified as a competent authority for Significant Institutions, could use a number of these provisions.

Some of these ONDs were enshrined in the regulation (CRR) and thus were easier to remove by changing the EU law because they were directly applicable to member states. They referred to the most important ONDs on capital adequacy and liquidity requirements. Their convergence required the modification of the regulation, which has partially been achieved with CRR II of 2019. Thus the introduction of CRR II removed some of ONDs as for instance, the waiver from prudential requirements foreseen under article 7 of the CRR or the exposures to covered bonds under article 129 of the CRR. However, CRR II also introduced some additional ONDs. For example, the banking package created the concept of 'small and non-complex institutions'[53] which were subject to less stringent prudential requirements. One of the criteria for qualifying as 'small and non-complex institution' was that the average level of assets over a four years period shall be below five billion euros. CRR II introduced a new Option allowing member states to lower this threshold.

Others ONDs were part of the Directive itself and their convergence required the modification of national rules transposing the Directive (ECB, 2015a; b). ONDs could also be temporary or permanent measures. Temporary measures had a lower impact since they were progressively phased-out. Most were eliminated by 2018-2020 — for instance, the inclusion of goodwill and unrealized losses in Common Equity Tier 1 (CET 1) — but others had a longer application (e.g. – Deduction of deferred tax assets from CET 1).

ONDs represent a large spectrum of provisions offering room to manoeuvre to national authorities specifically granted to them by the Single Rulebook. It gives an opportunity to test on large range of provisions how the enforcement at the national level varies when national

[53] Article 4(145) of Regulation 575/2013

authorities exercise discretion. Another possibility would have been to test the hypothesis presented in Chapter 2 on provisions not covered by ONDs. Still, the existence of room to manoeuvre specifically granted by the EU legislation provides ground to test the main hypothesis of this dissertation with the variation in the independent variable – with some ONDs granting discretion specifically to the NCAs and others authorising NCAs discretion only at the intervention of the national government.

In the next section, I start by presenting the EU level legislation which provided room to manoeuvre for national authorities, with no sufficient pressure to remove ONDs (section 4.2). Then, I test the hypothesis with regard to ONDs specified by national legislation. It is expected that legal intervention is used at the discretion of national governments to maintain the status quo (section 4.3). Finally, I will test the hypothesis on areas determined directly by the supervisor, where, despite the NCAs' discretion, the latter should most likely change their practice to converge to ECB's expectations if there is no national legislative intervention (section 4.4).

4.2 An asymmetric EU pressure to remove ONDs available to national authorities

In this section, I present an overview of the origins of ONDs and the EU's actions to remove the existing ONDs. I will show that EU/ Banking Union institutions adopted different measures to converge the treatment of ONDs. However, despite their objective of supervisory convergence, in practice, different initiatives led to increasing divergence, which left the discretion to national authorities. Once the ambiguity at the EU/ Banking Union level is demonstrated, I will assess to what extent the initial hypothesis is confirmed by examining the implementation of ONDs at national level.

The existence of various ONDs was related to the fact that the Single Rulebook was adopted before the creation of the SSM and addressed all EU member states. The Single Rulebook reflected national preferences on prudential supervision. Allowing ONDs was the response to national specificities and national supervisory approaches while using ONDs could be seen as a tool to maintain existing national legislation and to limit change. Despite this possibility, the ECB and the EBA put pressure towards their convergence.

In 2016, the ECB started the convergence process on ONDs available to Banking Union participants. This convergence process was initiated under the SSM's mandate of the ECB to ensure the consistent functioning of the supervisory system.[54] A High-Level Group composed of the ECB and NCAs members identified 122 ONDs, which could be harmonised (ECB, 2016a). On 24 March 2016, the ECB issued a Regulation[55] and a Guide[56] harmonising these ONDs (ECB, 2016a). The Guide was a non-binding document for joint supervisory teams (JSTs) which provided guidance on how to exercise 82 case-by-case ONDs for Significant Institutions. The non-binding nature of the Guide was, however alleviated since its publication could be considered as self-commitment by the ECB (ECB2, 2022; Witte, 2021, Budinská, 2022). The Guide was complemented by additional ONDs after two additional consultations on recognition of institutional protection schemes from 19/02/2016 to 15/04/2016 and eight additional ONDs from 18/05/2016 to 21/06/2016. Despite this convergence effort, the non-binding nature of the Guide was to ensure the discretionary power of the supervisor when exercising the case-by-case ONDs (ECB, 2016b). The Regulation was a legally binding act which was directly applicable with the objective to converge the exercise of 35 general ONDs for Significant Institutions from the banking package and the LCR delegated act. It entered into

[54] Article 6 of SSM Regulation
[55] Regulation 2016/445 of the European Central Bank on the exercise of options and discretions available in Union law
[56] ECB Guide on options and discretions available in Union law (ECB, 2016d)

force on 1st November 2016 and was amended to introduce changes from CRR II[57] and CRD V[58]. Since 2019, the OND framework being updated and CRD V introduced new ONDs, e.g. new liquidity requirements under the Net Stable Funding Ratio (NSFR). On 28 March 2022, the ECB published the amended version of the ECB Guide on ONDs (ECB, 2021b; ECB, 2022b). As presented in the First Chapter of this dissertation, the assessment goes from the end of 2014 to the end of 2019. These new amendments are therefore out of scope and will not be examined any further.

After the implementation of the Guide and the Regulation, further divergence could arise between the rules applied by the ECB to Significant Institutions and the rules used by NCAs to LSIs, which were still subject to national provisions applying ONDs. To ensure a level playing field, the ECB exercised a solid push to ensure conformity in the treatment of Significant Institutions and LSIs in its capacity of oversight authority for NCAs (ECB2, 2022; ECB, 2016a). In April 2017, the ECB published a Guideline and a Recommendation on the exercise of ONDs by NCAs (ECB, 2017a; b). These documents respectively replicated the Regulation and the Guide issued for Significant Institutions. However, they considered the proportionality principle and the legitimate expectations of the supervised institutions to accommodate the peculiarities of LSIs. For this purpose, the ONDs were divided into three different categories. The first category contained ONDs for which the same approach as for Significant Institutions has been taken. This was the case, for instance, for the definition of 'default' and 'own funds'. The second category was composed of ONDs with differentiated approaches from the Significant Institutions. And finally, some ONDs were not affected in any direct way by the ECB convergence efforts (ECB, 2017a; b).

[57] Regulation (EU) 2019/876
[58] Directive (EU) 2019/878

As a consequence, a divergent treatment remained enshrined in the Banking Union-level provisions between LSIs and Significant Institutions. As per their nature, the Guideline, according to article 10(2), was binding upon the NCAs, whereas the Recommendation was a non-binding instrument and thus subject to NCAs' implementation (ECB2, 2022). Therefore, the discretion of the NCAs was ensured, so that one can test the hypothesis regarding ONDs as presented in this dissertation.

Despite this margin of manoeuvre, the ECB, following the implementation of ONDs specified in the Guideline, concluded that the NCAs complied with the latter (ECB2, 2022). There was only one NCA which did not fully comply but was in the process of implementing Guideline provisions (ECB2, 2022). Regarding the Recommendation, there was no comprehensive assessment of the implementation of the Recommendation of the ECB. However, no specific shortcomings were deferred to the ECB at this stage (ECB2, 2022).

What explains the compliance of NCAs with ECB requirements on Options and National Discretion? First of all, as mentioned above, the NCAs were involved in preparing the Guide, the Regulation, the Guideline and the Recommendation as part of the High-Level Group mandated by the Supervisory Board (ECB, 2016a; Wissink, 2017). The NCA could therefore upload their preferences to the EU level. Such close cooperation required collaboration with the ECB and other NCAs to define an acceptable framework to implement ONDs (ECB2, 2022; Wissink, 2017), which can be seen as a creation of an Epistemic Community/ Transnational Policy Network. As a result, the outcome of these four ECB provisions incorporated the preferences of NCAs and was sometimes considered as a common lower denominator (ECB2, 2022; Wissink, 2017). Similarly, the Guide and Regulation were addressed to JST members, who were also composed of NCAs' members. Those NCA members were not exclusively dedicated to the supervision of Significant Institutions but could also be in charge of the supervision of national LSIs (NCA2, 2019). In other words, they have downloaded EU

provisions applicable to Significant Institutions to the national practice. As a consequence, they had integrated the ECB requirements in their assessments of LSIs. In addition, the '*comply or explain mechanism'* also swayed the NCAs' decision to comply (ECB2, 2022), demonstrating that ECB socialisation pressure was certainly present. Under this ECB pressure, the preferences and priorities of NCAs and the ECB were aligned and defended the financial stability, as I will show it in the next section of this chapter.

With regard to member state ONDs, they addressed national governments and required a national legal provision to be exercised. They represented fewer but really important ONDs. The creation of the SSM pushed towards an integrated and more convergent supervisory regime. On the basis of the SSM mandate to the ECB 'to ensure the consistent functioning of the supervisory system',[59] the ECB was entrusted to promote the convergence of the ONDs in the banking package. However, the SSM Regulation in its article 4 paragraph 3 excluded from ECB competence the convergence of ONDs requiring legal intervention stating that:

> 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 was composed of Regulations and where those Regulations explicitly granted Options for member states, the ECB shall apply also the national legislation exercising those Options (SSM Regulation). [60]

As a consequence, there was no EU pressure to converge ONDs available to member states. Besides, such position of the SSM imposed on the ECB to apply national provisions, including the gold-plated provision, further limiting the possible convergence of prudential supervisions in the areas concerned by the ONDs covered by national legislation (ECB, 2016a; b; ECB,

[59] Article 6 of SSM Regulation
[60] Article 4.3 of SSM Regulation

2017a; IMF, 2018; Kudrna and Puntscher Riekmann, 2018; Zeitlin, 2021). The requirement for the ECB to implement national legislation was considered non-conventional as usually, the higher-level entities only implement higher-level legislation. In other words, the EU body shall only apply the EU-level regulatory/ legislative provisions (Lehmann, 2017; Witte, 2021). These ONDs requiring regulatory intervention were thus more likely to resist convergence. As Danièle Nouy's foreword in the 2015 ECB annual report indicated, these ONDs were often the result of difficult negotiations to maintain national traditions and interests (ECB, 2016a) and would require new EU regulatory measures. The lack of convergence of member state ONDs was the outcome of national governments' pressure to maintain their national differences (ECB1, 2022; ECB2, 2022). National governments insisted on an ongoing margin of manoeuvre in the design of EU/ Banking Union legislation. This resistance took two main forms. First, in the context of the transposition of Basel III rules into EU legislation, national governments pressured to the implementation of a lighter version of Basel III requirements into EU legislation[61] by lobbying the European Commission (Commain, 2022; Lautenschläger, 2018; Howarth and Quaglia, 2013; 2016b). Once included in directives, the national governments could also present resistance to transposing into national legislation. In both cases, national governments are constrained in terms of how they seek to shape EU legislation and transpose that legislation by existing commercial and corporate legislation (ECB1, 2022; ECB2, 2022). Such position of member state majoritarian institutions shows that they would defend their national specificities, which I will present in the next sections of this chapter.

The most important ONDs in the remit of national governments were on macro-prudential measures, allowing an additional countercyclical capital buffer and systemic risk buffer. As opposed to micro-prudential instruments, a large degree of discretion was guaranteed

[61] This complements the resistance of member states to integrate significant capital increases into Basel III, see the Hangzhou declaration of G20 members (Commain, 2022).

in the framework of macro-prudential policies (European Commission, 2016a; c). Macro-prudential ONDs were not affected by the convergence effort mentioned above. Regarding those ONDs available to national majoritarian institutions it was expected that they will be used by national authorities with no convergence. One explanation given for this difference was that Banking Union was not an optimum monetary area in which member states were hit by exogenous economic shocks in a similar manner. As a consequence, it was important to give them some room to manoeuvre to address systemic risk at the national level when the risk occurred (Schüler et al., 2015). However, the coordination of macro-prudential measures was supposed to ensure the smooth functioning of the internal market. The coordination of macro-prudential policy could also prevent the cross-border spill-over of macro-prudential measures or their absence. For example, a macro-prudential capital buffer in a specific member state could reduce cross-border lending (European Commission, 2016a). That was the factor explaining why the convergence of macro-prudential ONDs was not completely abandoned. Indeed, all member states agreed that ONDs should be discussed in the context of a regular review of macro-prudential policy (European Commission, 2016b).

As presented above, the differentiated integration and the room for manoeuvre granted to national authorities, through the ONDs, were likely to allow continued divergence instead of convergence in prudential supervision in the EU. The convergence pressure exercised by the ECB left room for national discretion on the implementation of the ONDs. In the next section of this chapter, I will present an overview of ONDs addressed to member states' national governments that required national legislation to be exercised. These ONDs limited the discretion of NCAs in their supervision. According to the initial hypothesis, it is expected that the legal intervention will be used to maintain the status quo and limit the NCA discretion and therefore the change in national supervision in the concerned areas.

4.3 Member state ONDs – the mechanism to maintain national specificities

In order to provide a consistent overview of supervisory provisions detailed by law, I will focus on the main ONDs for banking supervision available to member states' majoritarian institutions. The ECB has identified about thirty of such member state ONDs to be adopted through national legislation (ECB, 2016a). Following the hypothesis developed in the Analytical Chapter, it is expected that member state ONDs addressed to national governments were to lower extent subject to EU/ Banking Union pressure to converge and therefore less subject to change. Moreover, the ECB as a competent authority was required to apply national legal provisions transposing ONDs addressed to national governments. As such member state ONDs compromised not only on the convergence of prudential regulation but also on their enforcement in practice (Binder, 2017).

Table 4.1 at the end of this chapter lists the main member state ONDs. The table excludes temporary measures and the Options under article 493(3) of the CRR, which are presented in more detail below. It can be observed that France and Germany adopted national legislative measures to introduce the flexibility offered by ONDs in all cases where pre-existing national legislation allowed the possibility. In other words, national governments used all the flexibilities they had negotiated and obtained when the banking package was adopted. National governments did not change their practice to comply with ECB recommendations but used the ONDs to maintain the previous national practice and protect national specificities. According to HI, this shows the *path dependence* in the practice of national governments. ONDs were therefore used by national governments to maintain the pre-existing national practice and to create *inertia*.

These Options were then implemented by hard law provisions such as laws, decrees or ordinances, thus also limiting the discretion of the NCAs and as a consequence limiting the

change in these specific areas of supervision. According to the main hypothesis of this thesis, these results indicate that the intervention of national majoritarian institutions is most likely to defend the status-quo and limit the change.

Below I outline the most important provisions regulated by law. Eleven member state ONDs allowed exemptions on large exposure limits. This category represented by itself, the large majority of ONDs available to national governments.

Exemptions on large exposures limits

As defined in article 392 of the CRR, a large exposure is the exposure of an institution greater than ten per cent of its eligible capital to a client or a group of connected clients. Large exposure provisions are essential to avoid the concentration of bank exposures to single counterparties. In case of a default, a concentrated portfolio lacking granularity will threaten the bank's stability. EU member states have, for a long time, set limits on large exposures. However, differences were maintained in the practical measures on the scope of application across banks, supervisory practice and exemptions resulting from the intervention of national governments (CEBS, 2006a).

Article 395 of the CRR set the limits to large exposures to 25 per cent of eligible capital. Article 493(3) CRR[62] contained eleven temporary ONDs addressed to national governments until 31 December 2028. These provisions offered the Option to exempt fully or partially different categories of exposures from the large exposure limits. In the case where national governments decided to exercise these Options, the NCAs for LSIs and the JST for Significant Institutions had to apply national exemptions.

[62] Article 493(3) of the CRR needs to be read in parallel with article 400(2) CRR which grants the same options to NCAs in the cases where the member state did not use its own option under article 493(3) CRR

National governments implemented large exposure limits exemptions in a variety of ways, using different national legal frameworks, from laws to government orders and circulars (Deutsche Börse Group, 2017). More specifically, eleven national majoritarian institutions opted to exercise the Option in a different way than the ECB Recommendation (ECB, 2017c). The exercise of the Option by these member states could be explained by the presence of a bank under their scope which exceeded the exposure limit of 25 per cent of its eligible capital (EBA, 2018). This created the potential for divergent application of provisions because even in the case of Significant Institutions, the ECB was required to apply different provisions depending on the member state where the Significant Institution had its headquarters (Bassani, 2019). At the same time it shows that this Option was requested by member states and granted by the European authorities to protect the domestic banking sector and national specificities (EBA, 2016c; ECB2, 2022). Indeed, all national governments could have used this Option, but some of them did not do so, because they did not have anything to protect (EBA, 2016c; ECB2, 2002). Table 4.2 at the end of the chapter, shows the use of Options under article 493(3) CRR in France and Germany.

The German and French governments were part of these eleven member states which had decided to exercise the ONDs and issued legal provisions to implement their ONDs available under article 493(3) of the CRR. In the case of France, the Options under article 493(3) CRR were applied for all provisions except the Options under the paragraphs a, h, and j. France issued the decree (*arrêté*) of 23 December 2013 to apply article 493(3) of the CRR.[63] This legal provision partially transposed national regulation 95-05 dating from 1993.[64] All the Options that France decided to implement by granting the exemptions on large exposure provisions were

[63] Decree of 23 December 2013 on the application of article 493(3) of the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms. Last amended by the decree of 27 July 2015

[64] Regulation 95-05 dating from 21 December 1993 as last amended on 23 November 2011

replications of the pre-existing national legislation. The Options which were not activated were not present under the regulation 95-05. In this case, the national government decided to activate those ONDs which allowed them to maintain the existing national prudential regulation and therefore to limit the change.

In the same vein, in Germany, large exposure provisions were referred to in section 13 and 13b of the Banking Act (*Kreditwesengesetz KWG*) and were specified in the delegated regulation - *Grosscredit- und Millionen- Kreditverordnung* (GroMiKV) (IMF, 2011; Deutsche Börse Group, 2017). Prior to 31 December 2010, and the amendment of GroMiKV, there were numerous exemptions to large exposure provisions. With the implementation of the CRR, GroMiKV was amended and since 1 January 2014 the regulatory scope has been limited to the Options allowed by article 493(3) of CRR. Except for 493(3) c) and d), all provisions implementing the Options under article 493(3) CRR were already in a previous version of the GroMiKV. The use of Options by Germany thus represents the replication of positions which were already used in the country before the SSM.

For example, Article 493(3)(c) provided an Option to exclude exposures to entities that are part of the same group. Germany exercised this Option restrictively in its Section 2 GroMiKV. Germany used to have quantitative limits to the amount which could be transferred within a subgroup (ECB2, 2022). As a consequence, it used this Option and introduced the quantitative thresholds presented below:

Full exemption of participations, unless the participation exceeds 25 per cent of eligible capital;

Full exemption of comfort letters issued;

75 per cent exemption for other intragroup exposures;

Up to 93.75 per cent exemption possible on request (Die Deutsche Kreditwirtschaft, 2016).

Those quantitative limits were a historical legacy of the previous German prudential regulation, which also shows that ONDs in Germany was used to maintain a pre-existing national setting.

In both the German and the French case, pre-existing national legislation influenced the use of ONDs on the exemption of large exposure limits. National majoritarian institutions used the ONDs to maintain the status quo. The national government seemed more in favour of maintaining pre-existing legislation rather than changing it whenever it was given the possibility to do so, which corresponds to their willingness to maintain and protect the specificities of the national banking system. This finding aligns with the hypothesis that whenever there was room for member states, with necessary legal action to change prudential supervision, the change was less likely to happen. This is even more obvious when it comes to these particular ONDs on large exposures because they can be used by national majoritarian institutions (article 394(3) CRR) but also NCAs, every time the former did not use its discretion (Article 400(2) CRR).

This can be illustrated by article 394(3)(d) of the CRR, which gave the exemption to 'exposures to regional or central credit institutions with which the bank [was] associated in a network'. This provision was mainly affecting the French and German banking sectors with an important presence of cooperative and saving banks (EBA, 2016c). In France, mutual and cooperative banks represented in 2018, 48 per cent of banking assets and 50 per cent of loans (Coelho et al., 2019) which justified the existence of this exemption even before the implementation of the banking package and was taken up in the decree of 23 December 2013. In Germany, the banking sector was also mainly organised in networks which would exceed the large exposure limit if this OND was not applied (Die Deutsche Kreditwirtschaft, 2016). The German government introduced this Option under article 2(5) of the GroMiKV. As a consequence, the Option was used by German and French governments to protect their saving and cooperative banks.

Another example is the partial exemption for loans under article 493(3)(e), of the CRR which authorised member states to exempt exposures from credit institutions that operate on a non-cooperative basis in specific sectors. The majority of member states did not exercise this Option, whereas France and Germany were highly affected and did so (EBA, 2016c). Many German bank business models involved only lending. In contrast, regional or national promotional/development banks, such as *Thüringer Aufbaubank, Wirtschafts-und Infrastructurbank* or *KfW*, could provide promotional loans to customers via commercial banks (Die Deutsche Kreditwirtschaft, 2016). This specific German business model could explain the logic behind the pre-existing German legislation. Moreover, the way the exemption was transposed into national legislation and was applicable only to promotional loans explains why the guarantees were excluded (Section 1 of GroMiKV). This corresponds to the adaptation of the OND to the business model of German promotional banks providing promotional loans via commercial banks (Die Deutsche Kreditwirtschaft, 2016). It can therefore be considered that the German government used the exemption under article 493(3)(e) to maintain its practice and to limit the change in prudential supervision in Germany.

In France, the decree of the Ministry for Economy and Finance of 23 December 2013 also exempted loans and guarantees from these promotional institutions — such as the *Caisse de refinancement de l'habitat* which was an institution in charge of refinancing real estate loans for banks and used the legislation to limit change to its existing business model. Yet again, the OND given to the national government with the possibility of legal intervention, rather than the supervisor led to maintaining the pre-existing legislation in order to protect the national promotional banks sector.

Eventually, the exemption from article 493(3)(h) of the CRR illustrates the use of ONDs by national governments to maintain the pre-existing legislation while supporting national banks. This provision granted an Option to national governments to exempt the exposure to

assets held to meet statutory liquidity requirements. France did not exercise the OND as opposed to Germany. The different approach of national governments is explained by the national pre-existing specificities. In France, the exemption was not foreseen under the previous regulation (Regulation 93-05) whereas the German GroMiKV already exempted sovereign assets for statutory liquidity requirements (Section 1 no 5 GroMiKV). The initial stance of national majoritarian institutions relates to the greater or lesser importance of sovereign exposures in national banking assets. German banks had a large exposure to sovereign debt from a range of countries (Pozzolo et al., 2016). In 2015, the sovereign bonds exposure represented sixteen per cent of the overall exposures of German banks participating to the EBA 2016 stress test, whereas the figure was nine per cent in France (Matthes and Rocholl, 2017). This is why the German federal government chose to exercise this Option to maintain its initial position, whereas the French government decided not to do so. All these examples support the hypothesis that the French and German governments used the ONDs at their disposal to maintain their pre-existing national legislation in the area of large exposure risk exemptions in order to maintain the national specificities of the banking sector.

In the case of ONDs addressed to national governments the discretion was directly set out in the EU legislation and was therefore accepted as such by the EU authorities. It was also outside the competence of the ECB. There was no specific pressure to remove the potential diverging rules (ECB1, 2022). But what explains the persistence of differences from a national perspective? First of all, national governments had negotiated and could use these ONDs to maintain their national legal framework, which goes beyond banking supervision and can include commercial or corporate laws that they want to maintain (ECB1, 2022). Moreover, the change of national provisions could involve costs, such as training prudential supervisors to new methodologies, to hire new staff (ECB1, 2022; ECB2, 2022; NCA2, 2019). Eventually,

majoritarian institutions use these ONDs to protect the specificities of the national banking sector (NCA2, 2019).

In the next section, I will present the cases on ONDs offering discretion to NCAs. It is expected that, whenever the NCAs can exercise discretion with no legal intervention, change will most likely happen. Whereas the change will probably be limited if the OND requires first a transposition by the majoritarian institution before the NCA can use the provision.

4.4 NCA Options and National Discretions – discretions used to comply with SSM standards

In order to test the hypothesis further, I will analyse ONDs which were subject in full or in part to the discretion of national competent authorities. Two types of competent authority ONDs existed. Some of these ONDs based on the directive (CRD IV) required national governments to transpose the Option or National Discretion into national legislation and then allow the competent authority to use the Option or National Discretion on a specific case. These case by case ONDs available to NCAs are listed in Table 4.3 (at the end of the chapter). This table presents the ONDs from the banking package applicable to banks, excluding transitional provisions which have already expired. For these ONDs, according to the initial hypothesis, it is expected that change is more limited. Other competent authority ONDs were in the regulation (CRR) and could be directly exercised by NCAs. Competent authorities had full discretion without requiring national legislation to authorise their actions. NCAs could, for instance, issue soft law provisions, such as recommendations or administrative notes explaining the way they intend to apply ONDs. These ONDs are listed in Table 4.4 (at the end of the chapter). It is expected that NCAs will use their discretion to change national practice to comply with ECB requirements.

The ONDs granted to competent authorities, which were first transposed into national legislation show that the national governments adopted the ONDs into national law except for one OND under article 21(1) of CRD IV on the 'waiver for credit institutions permanently affiliated to a central body', which Germany did not use. This demonstrates that the majoritarian institutions largely used ONDs to allow NCAs margin of manoeuvre in these specific areas of supervision. However, despite the discretion, the German supervisor decided not to exercise these three Options, whereas the French supervisor only exercised one out of three Options. As a consequence, this corresponds more to the *absorption* degree of change with national authorities introducing some adjustments to accommodate national legislation first. This indicates that when the national government intervenes and despite the discretion granted to the supervisor, the latter was more likely to maintain the existing provisions and not use the Option, which potentially could lead to change. In such a case, the pressure from the national government to maintain the pre-existing position and avoid change was greater than the EU institutions' pressure to change. This also corresponds to the cases where the NCAs participated less in the working group with other NCAs and the ECB and were, therefore, less subject to a learning process and socialisation pressure, which could influence their preference to change national supervision.

Regarding the ONDs fully granted to national competent authorities, some of them were exercised, while others were not. In order to assess whether there was a change in national practice towards Banking Union standards, I compare the national supervisory practice to the ECB recommendations on these specific ONDs. Of the 31 ONDs presented below, Germany and France followed policy recommendations on 25 ONDs. Both member states did not follow policy recommendations for two ONDs (Article 84(5) CRR and 124(3) CRR), while one of the two member states did not follow recommendations on the last four ONDs (please see the summary in table 4.4 below). Overall, national supervisors generally followed Banking Union

recommendations presented in section 4.2 of this chapter on the application of ONDs. This illustrates the higher likelihood of change when supervisors have discretion with no intervention from the national government. National supervisors showed their preferences to reduce the number of ONDs. For instance, in a conference dedicated to the ONDs, Andreas Dombret, a member of the Bundesbank Executive Board, also stated that ONDs can 'be seen as an obstacle to creating a regulatory level playing field' (SURFI 2016). National supervisors seemed more open to allowing Europeanisation than national governments. The latter used the ONDs to maintain the status quo while the national supervisor used their discretion and therefore changed national practice when the ECB recommended this. The national supervisor was more subject to socialisation pressure from the ECB, through the interactions between NCAs and the ECB (NCA2, 2019; NCA4, 2021). There was porosity in supervisors, with national supervisors participating in JSTs or missions at the ECB, which created a common culture (NCA2, 2019; ECB2, 2022).

Bellow I present in detail several cases of ONDs applicable to NCAs. I selected the most important ONDs, which require additional explanation and detail on their application to assess whether change in national practice occurred in respect of these two cases. The first is the possibility of waiving the obligation to apply prudential requirements on an individual basis; the second is related to the possibility of consolidating the qualifying holdings outside the financial sector.

Waiver from compliance with prudential requirements on an individual basis

The ONDs for waiver from compliance with prudential requirements on an individual basis reflect a basic principle of prudential supervision. According to article 6 of the CRR, prudential requirements on 'Own funds, Capital requirements, Large exposures, Exposures to Transferred Risk, Liquidity, Leverage and Disclosure' are applicable on an individual basis.

This means that every bank had to comply with them at a company level, bank subsidiary by bank subsidiary. The NCAs could waive the prudential requirement of article 6 of the CRR on 'Own funds, Capital requirements, Large exposures, Transferred credit risk' and Disclosure to comply with prudential requirements at an individual level for parent banks (article 7(3) of the CRR) and subsidiaries (article 7(1)(2) of the CRR). The ECB Recommendation on the exercise of ONDs for LSIs prescribed that NCAs follow the ECB Guide to Significant Institutions. The Guide authorised the use of the waiver on a case by case basis as long as the conditions laid down in article 7 of the CRR are fulfilled.

In France, the ACPR applied the Options on a case-by-case basis with specific criteria and according to ECB requirements. To apply the waiver under article 7(1)(2) of the CRR, the ACPR required parent companies to provide the documentation specified in the ECB Guide (Chapter 1, point 3). The ACPR established a list of criteria characterising obstacles to the transfer of capital to the parent company and to exercise the Option under article 7(3) (ACPR, 2019):

- Exchange risk and risk of political instability which could create significant obstacles to the transfer of capital from subsidiaries located in third countries to the European Economic Area;
- Legislation of countries in which foreign subsidiaries are located which do not provide the parent company with a sufficient level of protection at least equivalent to that offered by the French law on capital transfer mechanisms;
- Statutory or contractual clauses preventing the transfer of capital from subsidiaries to parent company (e.g. in the case of subsidiaries under joint control, the procedures for exercising this joint control must not prevent the raising of capital);
- Non-compliance by a subsidiary with the capital requirements of the country where it is established.

Historically, France used to have a consolidated supervision at the group level with the possibility to waive capital requirements (ECB2, 2022). A similar waiver for parent companies applied in France before the implementation of the banking package and could be found in regulation 2000-03 (ACP, 2013). However, under the previous legislation only the criteria on exchange risk and statutory and contractual clauses were considered as obstacles to the transfer of capital to the parent company. As a consequence, the French NCA used its discretion to change national practice in order to comply with ECB recommendations. It can therefore be considered as a confirmation of the hypothesis regarding the national supervisor transforming national practice to comply with EU recommendations when there is no intervention from the national government.

In the same vein, in Germany, the NCA applied the Options which were transposed in Section 2a KWG – the German banking act – which made reference to article 7 of the CRR to waive the obligation of article 6 of the CRR to apply prudential requirements at an individual level. In order to be able to apply requirements at a parent bank level the following conditions were to be met:

- Parent and subsidiary companies are licensed in the same member state;
- No material, practical or legal obstacles to the transfer of own funds or the repayment of liabilities;
- The parent company guarantees the commitments of the subsidiary;
- The subsidiary applies the risk evaluation, measurement and control procedures of its parent company;
- The parent company holds the majority of voting rights or can appoint or remove the majority of members of the management body. (KWG, Section 2a)

As a consequence, the German supervisor allowed the waiver and therefore *transformed* its national practice according to ECB recommendations. The German case thus also confirms the hypothesis according to which change is likely to occur when the supervisor has discretion.

Qualifying holdings outside the financial sector

The second example of OND applicable to NCAs corresponds to the Option of qualifying holdings. The CRR in its part I described subsidiaries which could be consolidated for the purposes of prudential supervision. Only financial institutions, ancillary services and portfolio management companies as described in article 4(1) of the CRR could be consolidated. According to article 89(3) of the CRR, the NCAs could authorise the consolidations of qualifying holdings outside the financial sector. In case of authorisation, the institution had to apply a risk weight of 1250 per cent to the amounts above the specified limits.

In Germany, the Option was exercised by BaFin, which could authorise qualifying holdings under its general administrative acts on the condition that it applied a risk weight of 1250 per cent of the specified limits[65] or deducted the excess from Common Equity Tier 1 as foreseen under article 90 of the CRR (BaFin, 2014). Before 31 December 2013, section 12 of the KWG also permitted such a process but required the consent of BaFin on a case by case basis (BaFin, 2014). Such legal constraint was removed by the implementation of the CRR. The discretion exercised by the competent authority, without national legal constraint, allowed the change in German national practice according to the ECB recommendation. This means that the German NCA introduced a *transformation* of BaFin rules to converge its practice to the ECB recommendation.

[65] 'a risk weight of 1,250 percent to the greater of either the amount of such significant ownerships in excess of 15 percent of the eligible capital of the institution or the total amount of such significant ownerships that combined exceed 60 percent of the eligible capital of the institution' (IMF, 2016)

In France, the decision 2017-C-79 of ACPR, introduced the Option on qualifying holdings with the risk weight of 1250 per cent for the higher of either the exposures exceeding fifteen per cent of own funds or the total participations exceeding sixty per cent of own funds as specified in article 89(1) and (2) of the CRR. Therefore, the French NCA was able to *transform* its national supervision given that no legal provision was needed.

To summarise, this section presented that NCAs have mainly used their discretion to change their national practice and to comply with ECB requirements, despite the margin of manoeuvre to maintain their national practice. But what explains the changes that occurred in the supervisory practice of national supervisors? First of all, as presented in the first section of this chapter, the members of national supervisory authorities participated in the discussions on the establishment of ECB positions on ONDs, for instance, as members of the High-Level Group. There was a collective decision-making process, and as such, NCAs integrated their preferences into the final versions of the Guide, the Regulation, the Guideline and the Recommendation (ACPR, 2019; ECB, 2021b; ECB2, 2022). As a reminder, these documents were developed in close cooperation with NCAs and needed to be approved by the Supervisory Board and the Governing Council, composed of the members of the NCAs (ECB, 2021b). The ECB documents constitute a consensus, with the provisions sometimes defined as the lowest common denominator. Compliance could therefore be explained as a consensual decision (ECB2, 2022; Wissink, 2017). An example of such a consensual decision is the Options under article 428(h) of the CRR which concerns the net stable funding ratio (NSFR). NSFR set up an additional liquidity requirement – on top of the liquidity coverage requirement (LCR) – based on a one-year time horizon. The transposition of NSFR from Basel III into CRR introduced some alleviation with regard to the calibration and scope of eligible products and services.

Initially, an Option was available for LCR[66] but under the pressure of one of the NCAs, it was also extended to the NSFR (ECB2, 2022). The new option introduced in 2021 gave the possibility to apply higher or lower required stable funding factor on a case by case basis and represents as such a consensus achieved among NCAs and the ECB.

4.5 Conclusion on Options and National Discretions applicable to national governments and NCAs

As explained in this chapter, member state Options and National Discretions addressed national governments and were implemented by national legislation. These ONDs were initially created to allow majoritarian institutions to delay significantly change and continue existing practices despite the creation of Banking Union and the transfer of supervisory responsibilities to the ECB. National governments first negotiated the introduction of these ONDs in the banking package and then used the ONDs in order to defend the status quo and to avoid change and thus protect national banking sector specificities. For instance, in this vein, the German and the French government used the ONDs on large exposure limits to maintain the pre-existing national legislation on this matter.

When it comes to the NCAs, the implementation of ONDs was based either on technical provisions and recommendations issued by the NCAs themselves or first required legislative intervention. In both cases detailed above, following the creation of Banking Union, German and French NCAs applied ECB recommendations and *transformed* their national pre-existing practice on the provisions for which they had the discretion to do so. On the contrary, when the Option or National Discretion requested an initial legislative intervention, the national

[66] Commission Delegated Regulation (EU) 2015/61 for the purpose of the LCR

government maintained the status quo. As a consequence, the supervisor had less margin of manoeuvre to change its practice, it did so mostly by *absorption* of its practice while complying with national legislation. In the first case, the NCA participated to the creation of EU standards, as for instance by participating to the working groups created by the ECB and were under the direct socialisation pressure from the ECB. The NCA had therefore developed the same preferences as the ECB, which facilitated the change of supervisory practice. Whereas in the second case, the ECB socialisation pressure was alleviated by the national government and its intervention and the change was therefore limited.

In order to validate further this hypothesis, the next step is to test two additional thematic cases, one where initial prudential provision depended largely on national majoritarian institutions and the second where provisions were mainly under the control of NCAs. These two cases — Non-performing loans and Supervisory Review and Evaluation Process— are examined in the following two chapters.

Table 4.1 List of main member state Options and National Discretions

Article	**Provision**	**Description of the option or discretion (CRD IV or CRR)**	**Germany**	**France**
Article 9(2) CRD IV	Exception to the prohibition against persons or undertakings other than credit institutions from taking deposits or other repayable funds from the public	'The prohibition against persons or undertakings other than credit institutions from carrying out the business of taking deposits or other repayable funds from the public shall not apply to a member state, a member state's regional or local authorities, a public international bodies of which one or more member states are members, or to cases expressly covered by national or Union law, provided that those activities are subject to regulations and controls intended to protect depositors and investors.'	Option exercised, Section 2 (1) - (4) of the German Banking Act (KWG)	Option exercised, Monetary and Financial Code article L518-1

Article 12(3) CRD IV	Initial capital	'Member states may decide that credit institutions which do not fulfil the requirements to hold separate own funds and which were in existence on 15 December 1979 may continue to carry out their business.'	Not exercised	Not exercised
Article 12(3) CRD IV	Initial capital	'Credit Institutions for which member states have decided that they can continue to carry out their business according to Article 12(3) of Directive 2013/36/EU may be exempted by member state from complying with the requirements contained in the first subparagraph of Article 13(1) of Directive 2013/36/EU.'	No data available	Not exercised

Article 12(4) CRD IV	Initial capital	'Member states may grant authorisation to particular categories of credit institutions the initial capital of which is less that EUR 5 million, provided that the initial capital is not less than EUR 1 million and the member state concerned notifies the Commission and the EBA of its reasons for exercising that option.'	Not exercised	Not exercised
Article 133(18) CRD IV	Requirement to maintain a systemic risk buffer	'Member states may apply a systemic risk buffer to all exposures.'	Option exercised, Section 10e(1) sentence 2, KWG	Option exercised, Ministerial order on Capital Buffers, article 50
Article 134(1) CRD IV	Recognition of a systemic risk buffer rate	'Other member states may recognise the systemic risk buffer rate set according to Article 133 and may apply that buffer rate to domestically authorised institutions for the	Option exercised, Section 10e(8) sentence 2, KWG	Option exercised, Ministerial order on Capital Buffers, chapter 2

		exposures located in the member state setting that buffer rate.'		
Article 152 first paragraph CRD IV	Reporting requirements to host competent authorities	'The competent authorities of host member states may, for statistical purposes, require that all credit institutions having branches within their territories shall report to them periodically on their activities in those host member states.'	Not exercised	Option exercised, Monetary and Financial Code, article L613-33
Article 152 second paragraph CRD IV	Reporting requirements to host competent authorities	'Host member states may require that branches of credit institutions from other member states provide the same information as they require from national credit institutions for that purpose.'	Not exercised	Option exercised, Monetary and Financial Code, article L613-33

Article 4(2)CRR	Treatment of indirect holdings in real estate	'Member states or their competent authorities may allow shares constituting an equivalent indirect holding of immovable property to be treated as a direct holding of immovable property provided that such indirect holding is specifically regulated in the national law of the member state and, when pledged as collateral, provides equivalent protection to creditors.'	Not exercised	Not exercised

Source: Own compilation based on data available in CRD IV, CRR as well as in German and French legislation

Table 4.2 French and German use of Options and National Discretions under articles 493(3) and 400(2) of the CRR

Article (CRR)	**Option to exempt from large exposure requirements for:**	**ECB recommendation**	**EBA (2016) recommendation to keep or to remove the Option**	**France**	**Germany**
493(3)(a) 400(2)(a)	exposures to covered bonds	Exercise partially: i.e., taking 20 per cent of the nominal value	Not applicable	Option not exercised by the national government: 100 per cent applicable RWA (risk weighted average)	Partial exemption of 20 per cent Section 1 no 1 of GroMiKV. Such exemption existed under the initial version of the legislation

493(3)(b) **400(2)(b)**	exposures to regional governments or local authorities	Partial exercise in line with risk weighted treatment	Not applicable	Partial exemption for exposures on EU member states' regional or local authorities under the decree of 23 December 2013: 80 per cent instead of 20 per cent under the standard approach. Such exemption already existed under national regulation 93-05	Partial exemption: 80 per cent under Section 1 no 2 of GroMiKV. Such exemption existed under the initial version of the legislation

493(3)(c) **400(2)(c)**	intragroup exposures	Full exercise	Not applicable	Full exemption, under decree of 23 December 2013. Such exemption existed under national regulation 93-05	Section 2(1-4) of GroMiKV introduced a full exemption of participations, except if it exceeded 25 per cent of eligible capital and of comfort letters issued. 75 per cent exemption for other intragroup exposures and up to 93.75 per cent on demand. No similar exemption was foreseen before CRR.

493(3)(d) **400(2)(d)**	exposures to regional or central credit institutions with which the credit institution is associated in a network	Full exercise	Recommendation to keep the option	Full exemption, decree of 23 December 2013 => Already existed under national regulation 93-05	Partial exemption, 50% of participations and other kind of holdings are exempted. Section 2 (5) GroMiKV => new exemption
493(3)(e) **400(2)(e)**	Interbank exposures to institutions which operate on a non-competitive basis under government oversight	Full exercise	Recommendation to keep the option	Full exemption under decree of 23 December 2013. Already existed under national regulation 93-05	Partial exemption under Section 1 no 10 of GroMiKV restricted to a situation where the credit institution operating on a non-competitive basis provides a loan (no

					guarantees) to another credit institution. Such possibility existed under the initial version of the legislation
493(3)(f) **400(2)(f)**	exposures to overnight interbank	Full exercise	Recommendation to remove the option	Full exemption under decree of 23 December 2023. Such exemption existed under national regulation 93-05	Full exemption under Section 1 no 3 of GroMiKV. Such exemption existed under the initial version of the legislation
493(3)(g) **400(2)(g)**	exposures to central banks	Full exercise	Not applicable	Full exemption under Decree of 23 December 2023.	Full exemption under Section 1 no 4 GroMiKV. Such

				Such exemption existed under national regulation 93-05	exemption existed under the initial version of the legislation
493(3)(h) **400(2)(h)**	exposures to sovereign assets held for statutory liquidity requirements	Full exercise	Not applicable	Not exercised. Not foreseen under 93-05	Full exemption of Section 1 no 5 of GroMiKV. Such exemption existed under the initial version of the legislation
493(3)(i) **400(2)(i)**	exposures to off-balance commitments	Full exercise	Not applicable	Full exemption under Decree of 23 December 2023.	Partial exemption only for low/medium credit risk commitments (50 per cent) under Section 1 no 6 GroMiKV.

				Such exemption existed under national regulation 93-05	Such exemption existed under the initial version of the legislation
493(3)(j) **400(2)(j)**	exposures to legally required guarantees for mortgage loans financed by issuing mortgage bonds	Full exercise	remove	Not exercised. Not foreseen under 93-05	Full exemption under Section 1 no 8 of GroMiKV. Such exemption existed under the initial version of the legislation
493(3)(k) **400(2)(k)**	exposures to recognized exchanges	Full exercise	remove	Full exemption under Decree of 23 December 2023. Such exemption existed	Full exemption under Section 1 no 9 GroMiKV. Such exemption existed under the initial

				under national regulation 93-05	version of the legislation

Sources: own aggregation of information from the annexes II of national Overviews of OND set out in Directive 2013/36/EU and Regulation (EU) No 575/2013 as updated in July 2019; ECB Recommendation; EBA, 2016c

Table 4.3 Options and National Discretions for NCAs implemented by national legislation

	Provision	**Description and ECB recommendation**	**Implementation in France**	**Implementation in Germany**
CRD IV art. 21(1)	Waiver for credit institutions permanently affiliated to a central body	Based on Article 21(1) of CRD IV, NCAs may waive certain authorisation requirements with regard to 'credit institutions permanently affiliated to a central body' in accordance with the conditions set out in article 10 of the CRR. Requirements that may be waived are: • 'Need for a programme of operations and structural organisation • Minimum initial capital • Management board of at least two persons The applicable conditions according to Art. 10 CRR are: • Central body and affiliates share commitments jointly	Option transposed into national law in the Monetary and Financial Code; Decree of 4 December 2017 Articles R511-3, R512-40, R 515-1 (Option exercised in practice)	Option not transposed into national law

		and certain commitments of the affiliates are guaranteed by the central body • Solvency and liquidity of central body and affiliates are monitored on a consolidated basis • Central body management is empowered to give instructions to the management of the affiliates.' The policy recommendation is to exercise the OND.		
CRD IV art. 103(1)	Application of Pillar II measures to institutions with similar risk profiles (Horizontal Pillar 2)	Flexibility to apply supervisory measures on the basis of Article 103 of CRD IV and Article 16 of SSM regulation. The policy recommendation is to exercise on a case by case basis.	Option transposed into national law (Option not exercised in practice)	Option transposed into national law (Option not exercised in practice)

CRD IV art. 142 **(1) à (4)**	Capital Conservation Plan - 4 ONDs	Defines the supervisory discretions of competent authorities in the context of capital conservation plans: • with regard to the timeline for banks to submit the capital conservation plan (article 142(1)). The policy recommendation is to not exercise the option. • the possibility for competent authorities to ask for additional information (article 142(2)). The policy recommendation is to exercise on a case by case basis. • the period in which the institution needs to restore its capital position (article 142(3)). The policy recommendation is to exercise on a case by case basis. • the use of supervisory measures in case the competent authority does not approve the capital	Option transposed into national law (Option not exercised in practice)	Option transposed into national law (Option not exercised in practice)

		conservation plan (article 142(4)). The policy recommendation is to exercise on a case by case basis.		

Source: 2020, own aggregation of data available from the ECB, and from annexes II of national Overviews of ONDs set out in Directive 2013/36/EU and Regulation (EU) No 575/2013 as updated in July 2019

Table 4.4 Options and National Discretion for National Competent Authorities implemented by French and German NCA decisions with no legislative intervention

Article	**Provision**	**ECB policy recommendation (source: ECB Guide)**	**Implementation in France**	**Implementation in Germany**
CRR art. 7(3)	waiver from compliance with prudential requirements at solo level for subsidiaries	Competent authorities may waive the application of the prudential requirements to subsidiaries if all CRR conditions are met. The policy recommendation is to exercise (i.e. grant the waiver), on the basis of the proposed specifications.	Case by case option, with specific criteria	Case by case option, with specific criteria under Section 2a KWG
CRR art. 7(1)(2)	waiver from compliance with prudential requirements at solo level for parents	Competent authorities may waive the application of the prudential requirements to subsidiaries if all CRR conditions are met. The policy recommendation is to exercise (i.e. grant the waiver), on the basis of the proposed specifications.	Case by case option, with specific criteria	Case by case option, with specific criteria under Section 2a KWG
CRR art. 8(1) and 8(2) and	Liquidity requirements waiver at solo level	The competent authorities may decide to waive fully or partially the application of liquidity requirements to an institution and to all or some of its subsidiaries in the	Case by case option, with specific criteria	no available data

LCR DA art. 2(4)		same member state and supervise them as a single liquidity sub-group if they fulfil CRR conditions. The policy recommendation is to exercise (i.e. grant the waiver), on the basis of the proposed specifications.		
CRR Art. 8(4) and LCR DA Art. 2(4)	liquidity requirements waiver for institutional protection scheme	Competent authorities may apply Article 8 (1) 8(2) and 8 (3) of the CRR to institutions which are members of the same 'institutional protection scheme' referred to in Article 113(7)(b) of the CRR and to 'other institutions linked by a relationship' referred to in Article 113(6) of the CRR. The policy recommendation is to exercise (i.e. grant the waiver), on the basis of the proposed specifications.	Not applied, no institutional protection schemes in France	Not applicable
CRR art 18(2)	Methods of consolidation (proportional consolidation)	This is an option to apply proportional consolidation of subsidiaries instead of full consolidation, under the condition that the parent undertaking's liability is limited	Exercised on a case by case decision (few cases)	Case by case option not exercised yet

		to its shares of capital of this subsidiary and that other shareholders also meet their liabilities. The policy recommendation is to not exercise the option.		
CRR art 18(5)	Methods for consolidation (other participations or capital ties)	Competent authorities may decide whether and how consolidation shall be carried out for cases not specified by articles 18(1) to 18(4) of the CRR, including whether the equity method - which solely reflects the subsidiaries' situation by adjusting the accounting value of the investment- shall be used. The policy recommendation is to exercise the option.	Exercised on case by case	Not applicable
CRR art 49(1)	Non-deduction of insurance holdings in case of conglomerate	In the case of financial conglomerates, competent authorities may authorise banks not to deduct the holdings of own funds instruments of an insurance in which the parent institution has a significant investment, provided that some specific conditions are met. The policy recommendation is to exercise the option.	Discretion exercised and authorisations granted	Discretion exercised and authorisations granted

CRR art 49(2)	Deduction where consolidation is applied	Banks shall not deduct 'holdings of own funds instruments issued by financial sector entities included in the scope of consolidated supervision', unless the competent authorities considers that those deductions are required for some specific purposes. The policy recommendation is to exercise the option.	Discretion exercised and discretion in practice relevant	No available data
CRR art 49(3)	Deduction where institutional protection schemes are applied	Competent authorities may decide not to deduct 'holdings of own funds instruments in other institutions falling within the same protection scheme', following CRR conditions. The policy recommendation is to exercise the option.	A member state without any institutional protection scheme in place	A member state without any institutional protection scheme in place
CRR art 83(1)	AT1 and T2 instruments issued by a Special Purpose Entity	Special Purpose Entities may be included in the qualifying AT1 or T2 capital only when certain conditions are met. One of those conditions is that the only asset of the Special Purpose Entity is 'its investment in the own funds of the parent or a subsidiary thereof'.	Not applicable	Not exercised

		Competent Authorities may waive this condition if the other assets held by the vehicle are minimal and insignificant. The policy recommendation is to exercise the option.		
CRR art 84(5)	Minority interest waiver for certain parent financial holdings	Competent authorities may waive the limited recognition of minority interest foreseen by Article 84(1) of the CRR for those parent financial holding companies or parent mixed financial holding companies that require conditions. It is recommended not to exercise this OND.	Case by case with low probability to grant it	Case by case
CRR art 89(3)	Qualifying holdings outside the financial sector (holdings exceeding the thresholds)	Competent Authorities can select between either prohibiting, or applying a 1250 per cent risk weight to holdings outside the financial sector beyond individual or aggregate regulatory limits. The policy recommendation is to apply a risk weight of 1250 per cent	Option exercised according to Decision 2017-C-79	Option exercised by the general decree for LSIs, alternatively to apply 1250 per cent, institutions may

				deduct those excess amounts from CET1 pursuant to Art 90 of the CRR
CRR art 116(4)	Credit risk SA (Exposures to public-sector entities)	Exposures to Public sector Entities may be treated by competent authorities 'as exposures to the central government, regional government or local authority in whose jurisdiction they are established where in the opinion of the competent authorities of this jurisdiction there is no difference in risk between such exposures because of the existence of an appropriate guarantee by the central government, regional government or local authority.' The policy recommendation is to exercise the OND.	Exercised	Exercised

CRR art 124(2)	Credit risk SA/IRB (real estate exposures)	Competent authorities may require higher risk weight or stricter eligibility criteria for real estate exposures, if they consider it appropriate, based on financial stability considerations, and if risk weight determined by the CRR appears no longer appropriate with regards to historical data. The policy recommendation is to exercise the OND.	Not exercised to date	Not exercised to date
CRR art 162(1)	Credit risk IRB (Maturity)	Banks that have not received permission to use internal models based on 'Foundation IRB', shall use the maturity definition from article 162(1) of the CRR, i.e. shall assign a maturity of '0,5 years to exposures arising from repurchase transactions or securities or commodities lending or borrowing transactions' and a maturity of '2,5 years to all other exposures'. The competent authorities have the option to allow these	Not applicable	Not exercised

		banks to calculate the maturity according to 'Advanced IRB'. It is recommended not to exercise the OND.		
CRR art 178(1)(b)	Credit risk IRBA (Default definition)	In determining the occurrence of a default of an obligor, whereby a condition is that 'the obligor is past due more than 90 days, competent authorities may replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposures class, as well as exposures to public sector entities.' It is recommended not to exercise the OND.	Option exercised under Decision 2013-C-110, but changed to align with ECB position on Significant Institutions (regulation 2016/445 from 14 March 2016 setting	Not exercised

			up a unique 90 days past due)	
CRR art 178(2)(d)	Credit risk IRBA (Default definition)	In determining the occurrence of a default on an obligor, 'the materiality of a credit obligation past due shall be assessed against a threshold, defined by the competent authorities. This threshold shall reflect a level of risk that the competent authority considers to be reasonable.' The policy recommendation is to exercise the OND.	Exercised under decision 2013-C-110, replicated under decision 2017-C-79, the materiality of a credit obligation was considered if the threshold of EUR 1 except exceptional circumstances	Exercised. Past due definition corresponds to the sum of the amounts past due more than 90 days (or 180 days if applicable) Structure of the threshold is constructed as the c combination of absolute and

			which demonstrated that it was not caused by debtors' situation Decision 2018-C-84, ACPR amends the default definition according to Commission delegated regulation which shall be applied by credit institutions at the latest on 1 January 2021	relative threshold; and there is a differentiation of the threshold for retail and non-retail exposures

CRR art 179(1)	Credit risk IRBA (Data quality)	Competent authority may allow institutions some 'flexibility in the application of required standards for data.' It is recommended to exercise the OND.	No information available	OND not exercised
CRR art 225(2)(e)	Credit risk SA&IRB (Volatility adjustments)	For institutions that use the Own Estimates Approach, 'competent authorities may require an institution to calculate its volatility adjustment using a shorter (than one year) observation period, where in the competent authority's judgement this is justified by a significant upsurge in price volatility'. The policy recommendation is to maintain the exercise of the OND where such requirements are already in place.	OND not exercised	OND not exercised
CRR art 284(4) and (9)	Counterparty credit risk (exposure value), two ONDs	1) Regarding the option to require a higher α than 1.4, the exercise of the option on a case-by-case basis is recommended since α is currently the only supervisory means in Counterparty credit risk to compensate for	Option under (4) exercised Order of 20	Option under (4) exercised on a case by case basis

		exposure model shortcomings. The policy recommendation is to exercise on a case by case basis. 2) Regarding the option to allow the use of own estimates of α, it is recommended to not exercise this OND because of concerns about whether these estimates can be empirically supported; not permitting an α below 1.4 is also the more prudent approach.	February 2007 article 280	
CRR art 311(2)	Counterparty credit risk (Central Counterparties)	'Alternative calculation of Own funds requirements for exposures to a central counterparty if the competent authority considers that the reasons why the central counterparty has stopped capital of central counterparty are valid, it may permit institutions in its member state to apply the treatment set out in Article 310 of the CRR to their trade exposures and default fund contributions to that Central Counterparty.' The policy recommendation is to exercise the OND.	Case by case decision: option not yet exercised	Case by case decision: option not yet exercised

CRR art 311(3)	Counterparty credit risk (Central Counterparties)	Competent authority may not to shorten the three months period given to institutions to change the treatment of exposures to a Central Counterparty when it becomes known that such Central Counterparty will no longer comply with the conditions for authorisation and recognition. It is recommended not to exercise the OND.	Case by case decision: option not yet exercised	Case by case decision: option not yet exercised
CRR art 315(3)	2 ONDs Operational risk Basic Indicators Approach (Own funds requirement)	Under the Basic Indicator Approach, under certain circumstances (merger, acquisitions or disposal of entities or activities), the competent authorities may permit institutions to amend the calculation of the relevant indicator, which is used to calculate the own funds requirements for operational risk. If deemed necessary, the competent authorities may also require the institutions to do so.	Exercised (few cases)	Exercised

		The policy recommendation is to exercise both ONDs on a case by case basis.		
CRR art. 317(4)	2 ONDs Operational risk Standardised Approach (Own funds requirements)	Under the Standardised Approach, under certain circumstances, the supervisor may permit institutions to amend the calculation of the relevant indicator, which is used to calculate the own funds requirements for operational risk. If deemed necessary, the competent authorities may also require the institutions to do so. The policy recommendation is to exercise both ONDs on a case by case basis.	Exercised (few cases)	Exercised
CRR art 327(2)	Market risk (Netting)	The option is 'to allow netting between a convertible and an offsetting position in the instrument underlying it.' The policy recommendation is to exercise the OND.	OND exercised following decision 2017-C-79	OND not exercised
CRR art. 366(4)	Market risk - Internal Models (Back	Competent authority may not to limit the addend to the multiplication factor to that resulting from overshooting	Option not exercised	Option exercised

	testing and multiplication factors)	under hypothetical changes. The policy recommendation is to exercise the OND.		
CRR art. 395(1)	Large Exposures	Option to set a lower nominal limit than 150m for large exposures to institutions. It is recommended not to exercise the OND.	Option not exercised	Option not exercised
CRR art. 396(1)	Large Exposures (permission to temporarily continue with exceeded large exposure limit)	Where, in an exceptional case, exposures exceed the large exposures limit, the Competent Authority may allow a limited period of time until the institution meets again the LE limit. The policy recommendation is to exercise the OND.	Exercised	Not applicable
CRR art 396(1) 2nd subparagraph	Large Exposures (permission to exceed the limit of 100% eligible capital)	Competent authorities may allow, on a case-by-case basis, to exceed the limit of 100% of the institution's eligible capital (the maximum of EUR 150million still applies). The policy recommendation is to exercise the OND.	Exercised	Not applicable

CRR art. 420(2) and LCR DA art 23(2)	Liquidity (Liquidity Coverage Ratio (LCR), outflow rate of off-balance sheet items)	The applicable outflow rates will be calibrated following the L-SREP (Short Term Exercise – STE). The policy recommendation is to exercise the OND.	Not applicable	Option exercised
CRR art. 422(4)	liquidity (LCR, identification of operational deposits)	Competent authority may provide additional guidance on the identification of operational deposits. It is recommended not to exercise this OND.	Option not exercised	One of the only two Competent Authorities which has decided to exercise the option exercise is planned by circular letter

Source: 2020, aggregation of data available from CRR, ECB Guide, and from annexes II of national Overviews of Options and Discretions set out in Directive 2013/36/EU and Regulation (EU) No 575/2013 as updated in July 2019

Chapter 5 Convergence of NPLs – a typical case regulated by the national government

In this chapter, I will test the hypothesis regarding the definition and management of non-performing loans (NPLs) by EU member states. To that end, I will start by presenting the degree of legislative intervention and room for discretion left to NCAs. The definition and treatment of NPLs represent a typical case where national governments are expected to be very active. It is therefore expected that convergence in the management of NPLs to a European standard will be limited because of national government intervention, which will try to implement provisions to defend national interests. For the sake of the analysis, I will separate the definition of NPLs and their management. The definition of NPLs varies across member states: for some, it is regulated by law, while for others, by the NCAs. According to the hypothesis tested in this analysis, one expects to observe a change in the national practice of member states with NCA intervention and no or limited change in member states where the definition of NPLs is provided by law. The management of NPLs greatly depends on national insolvency, and fiscal and property laws, which are still highly divergent across member states (European Commission, 2018a; Platsa, 2019). It offers a good example of a case with national government intervention. It is expected that national practice with regard to the management of NPLs will not change or only change marginally due to the limited discretion of national supervisors and the intervention of national governments.

I will start by introducing the terminology of NPLs and the logic of convergence in both the definition and the management of NPLs in the SSM (Section 5.1). Then I will examine the level of legal intervention and the margin of manoeuvre left to NCAs to use their own definition of NPLs and the changes that have occurred since the introduction of the SSM. First, I give an

overview of the NPLs definition and provisions regulating NPLs developed by EU institutions and the margin of manoeuvre left to national authorities (Section 5.2), and then I consider the margin of manoeuvre left to Germany and France and its implications (Section 5.3). In conclusion (5.4), I assess whether the hypothesis developed in the Analytical Chapter according to which prudential supervision is more likely to change when NCAs have discretion is verified with regard to the provisions regulating NPLs in Germany and France.

5.1. Introduction – Importance of a common ground for the definition of NPLs

Following the financial crisis, the number of NPLs in the EU member states increased significantly. The NPL ratio — calculated as the total NPLs over the total loan portfolio — in Europe represented 6.5 per cent in December 2014, which was much higher than the level of NPLs in the United States (below two per cent) and Japan (1.7 per cent) (EBA and World Bank data). This situation has been explained mainly by the worsening macroeconomic situation and loan quality following the financial crisis (Athanasoglou et al., 2008; Beck et al., 2013; Gambera, 2000) and/ or the inappropriate management of assets (IMF, 2015). Despite the improvement in the economic situation, the NPL ratio was still too high in Europe, with the NPL ratio across the EU amounting to 5.1 per cent in December 2017. The situation improved in 2019 with a ratio of 3.1 per cent for the EU, which was still higher than in the United States (1.4 per cent) and Japan (1.7 per cent) (ECB and World bank data). Moreover, the distribution of NPLs has been highly unequal among member states. In 2019, Greece reported more than 41 per cent of NPLs in its bank balance sheets, whereas a number of member states have had a very low level of NPLs, such as Latvia, with 1.1 per cent (EBA, 2019a).

The high level of NPLs is an issue for banks, which as a result face increased difficulties to lend because of provisioning constraints that lower profitability, higher capital requirements and increased funding costs. It is also a macroeconomic issue with limited available capital and

a decrease in credit growth (EBA, 2016a; EIB, 2014; IMF, 2015). In order to provide both investors and supervisors with improved information about the quality of assets, the EU institutions were encouraging transparency on NPLs.[67] The EU member states had the obligation to 'disclose information on loans and debt securities exposures and their credit quality pursuant to Regulation (EC) No 1606/2002 and in Council Directive 86/635/EEC' (EBA, 2013a). However, this obligation was not accompanied by a unified definition of NPLs at the EU level. Even at the national level, different terms designating non-performing assets coexisted in a number of member states (d'Huelster et al., 2014). As of 2016, there was no common global definition of NPLs which varied across countries and banks (BIS, 2016). In the international context, according to Barisitz (2013b), NPL referred to a loan which was 'principal or interest ninety days or more overdue', presented 'well-defined weaknesses' and was qualified as 'substandard – doubtful – loss/write-off'.

A common definition is important in order to obtain comparable data across banks and member states. The management of NPLs at the national level had to be based on the identification of NPLs thanks to a common definition, the management of NPLs by banks thanks to provisioning rules and recovery procedures and eventually on the elimination of NPLs from banks' portfolios either by selling it on the secondary markets sometimes with the backing of Assets Management Companies and resolution of bad loans in bad banks or Asset Management Companies. In addition, the level of NPLs depended on the national legal settings influencing the storage of NPLs. This national legal setting consisted of the fiscal system, the existence of a secondary market and the bankruptcy law applicable. In this chapter, I will mainly focus on the supervisory issues of NPLs. With the creation of the EBA and then of the SSM,

[67] See for instance ECB Guidance to banks on non-performing loans (ECB 2017h); European Commission 2018a

the EU set up actions to bring about the convergence of the definition and the management of NPLs in member states.

5.2 Margin of manoeuvre left by EU interventions to develop a NPLs definition

The EU institutions have largely regulated the NPLs topic. In order to evaluate the margin of manoeuvre left to the national authorities by the EU regulation and therefore the adaptational pressure on national authorities, I assess the level of coordination in the EU intervention on NPLs (sub-section 5.2.1). A coordinated intervention of EU institutions will reinforce their influence on national authorities and leave less room for national discretion. Whereas the lack of coordination would reflect different preferences of member states on the topic and would be expected to leave a larger discretion to the national authorities – government and supervisor – to select the path in line with national definition and practice and therefore limit change. I will then assess whether national authorities have discretion with regard to the EU NPL provisions and to what extent it influences the change in national practice (sub-section 5.2.2).

5.2.1 Parallel and independent interventions of EU institutions to regulate NPLs

In this subsection, I present whether the EU institutions have created a common definition and coordinated legislation on the treatment of NPLs. The creation of a coordinated action plan and regulation would be expected to create more important adaptational pressure on national authorities by limiting their discretion as is assessed under the general hypothesis tested in this dissertation, whereas non-coordinated actions would leave room for manoeuvre to the national authorities.

When the economic crisis in 2008 occurred and before the creation of the SSM, the amount of NPLs in Europe started to increase, no common definition of NPLs existed in the

EU. The only common definition to qualify impaired exposures referred to defaults. The definition of 'default' in the CRR article 178, took into account both the 'unlikeliness to pay' and more than ninety days past due (dpd)[68] criteria on the credit obligation. However, as presented in Chapter 4, article 178 introduced additional flexibility for the quantitative criterion and allowed discretion for the national authorities to replace the ninety dpd with 180 dpd, 'for exposures secured by residential or SME commercial real estate in the retail exposure class as well as exposures to public sector entities' (Article 178(1)(b) of CRR). Moreover, the NCA had the discretion to define the materiality threshold of a credit obligation past due. As a consequence, national supervisors could exercise a large discretion in their definition of NPLs before the creation of the SSM.

This room for manoeuvre from the CRR remained, and the EBA introduced two new terms with their own definitions in 2013 in an implementing technical standard (ITS). The EBA published a common EU definition of 'forbearance' and 'non-performing exposure' (NPE) with the objective of ensuring the comparability of asset quality in Europe. The EBA developed these definitions based on existing international and national practices and the existing definitions of default and impairment but with a broader scope.

Under the EBA definition, the asset is considered as a NPE if at least one of the following criteria is satisfied:

> (a) material exposures which are more than 90 days past due;
>
> (b) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past due amount or of the number of days past due (EBA, 2014d).

These criteria were very close to the default criteria from Article 178 CRR, which also used the criteria of ninety dpd and the unlikeliness to pay (see the comparative table 5.3. at the

[68] Past due is a payment which is unpaid as of its due date

end of this chapter). However, there were some differences in the definition of default and NPE. First, the ninety dpd criterion was stricter for the NPE definition and could not benefit from the discretion to use 180 dpd for specific asset classes. The existence of these similar definitions of 'default' and 'NPE' was likely to confuse national authorities. Besides, when this new term of NPE was introduced, the financial intermediaries, notably the Banking Stakeholder Group,[69] considered the timeframe too conservative and asked for more flexibility for 'exposures secured by residential and small and medium-sized enterprises (SMEs), commercial real estate in the retail exposure class, as well as exposures to public sector entities' (EBA, 2013b). Such a request from the Banking Stakeholder Group – to align with 'default' definition and flexibility – confirmed the confusion faced by banks on the extent of the NPE definition.

On the contrary, the EBA members were in favour of a stricter condition and considering NPE exposures below ninety days past due. Some Board of Supervisors members supported even a tighter thirty days past due criterion (EBA, 2013a). As a reminder, the EBA Board of Supervisors comprises NCAs representatives and the EBA chairperson, which illustrates that the preference of national supervisors was similar to the one defended by the EU institutions and favoured a stricter delimitation. The position of Board members emphasised the willingness of the EBA and participating NCAs to create a new terminology different from the definition of default. Therefore, resulting from this new definition, a loan could be considered as a NPE without being defaulted or impaired because the quantitative criterion was sufficient and did not require the realisation of the collateral. Moreover, if one of the criteria was fulfilled, all exposures to the same debtor had to be qualified as non-performing if the NPE reached twenty per cent of the outstanding amount of total exposure to the same debtor (pulling effect). And finally, unlike the defaulted or impaired loan, a forborne loan could not exit from the NPE

[69] The Banking Stakeholder Group (BGS) is a consultative body of the EBA representing credit and investment institutions operating in the Union

classification before one year period over which the debtor had demonstrated its ability to fulfil the restructured conditions (cure period) (EBA, 2016a).

The EBA definition was elaborated in the framework of the technical standards and was thus applicable to all member states for reporting purposes. As a result, the national supervisors, were facing at least three different definitions of impaired assets at a national level – definition of default, national definition of impaired assets and the EBA definition of NPE. In these circumstances, the national authorities maintained their margin of manoeuvre to define their impaired loans. The EBA definition following to the EBA ITS on forbearance and NPE was only mandatory for the reporting purposes to all International Financial Reporting Standards (IFRS) banks, which were submitted to the Financial Reporting (FINREP) in September 2014 (EBA, 2016d).

In December 2016, the EBA issued guidelines on disclosure requirements under Part Eight of the CRR, which provided a template to be filled by banks. However, this template was initially only applicable to Global Systemically Important Institutions (G-SIIs) and Other Systemically Important Institutions (O-SIIs); it became mandatory for all institutions at the end of 2018. The EBA definition applied only for prudential reporting purposes; flexibility was maintained for the management reporting activities. This meant that the national definitions coexisted and that some financial intermediaries had to face a double reporting activity, which increased their costs (EBA, 2013a). As a consequence, the introduction of the NPE definition did not remove the margin of manoeuvre of the national authorities which could use such margin to implement a definition which was most suitable to national standards.

In addition, when issuing NPL legislative provisions, other EU institutions did not use the terminology of NPE but referred to NPLs. When it comes to the European Commission, it stated that NPE was a more extensive term, including ‘NPLs, non-performing debt securities and non-performing off-balance-sheet items’ (European Commission, 2018c). The European

Commission defined NPLs as loans in which 'payments are more than 90 days past due or the loan is assessed as unlikely to be repaid by the borrowers' (European Commission, 2018c). This definition de facto corresponded to the definition of NPE issued by the EBA. When it comes to the ECB, even though the ECB used the terminology of NPLs, it referred, in fact, to NPE as defined in the EBA technical standards. The ECB specified that it addressed all the NPE composed of non-performing loans and debt securities as referred to in the EBA ITS along with foreclosed assets and performing assets with the risk of turning into non-performing (*i.e.* Watch list exposures). As a consequence, in 2017, the ECB, in its NPL Guidance, despite its name, addressed a more extensive and more granular categorisation of distressed assets that went beyond the EBA requirements (Montanaro, 2019). Such a variation in terminologies illustrates the lack of coordination among the EU institutions and created uncertainty for national authorities. Eventually, in its Addendum to the NPL Guidance issued in March 2018, the ECB referred to NPE and aligned its denomination with that of the EBA.

In parallel to the EBA technical standards, several EU institutions launched their own initiatives to tackle NPLs.[70] These parallel actions confirm an increasing and insufficient coordination on the part of the EU institutions in tackling NPLs. At the EU level, the convergence of NPL treatment was supported by the Structural Reform Support Service of the European Commission, which was established in July 2015.

In May 2017, the European Commission published a European Strategy for NPLs. The same year, on 11 July, the (Economic and Financial Affairs) ECOFIN Council issued its Action Plan to tackle Non-Preforming Loans in Europe. The Action Plan included comprehensive coverage of the NPLs issue with policy actions in the field of 'banking supervision', 'reform of restructuring, insolvency and debt recovery frameworks', 'development of secondary markets

[70] Unlike EBA, other EU institutions refer to NPLs; both terminologies will therefore be used as interchangeable

for distressed assets' and 'fostering restructuring of the banking system' (Council, 2017; European Commission, 2018a; b).

The action plan also included a number of several measures for the member states to follow:

- General guidelines on NPLs management to all EU banks;
- Detailed guidelines on banks' loan origination, monitoring and internal governance;
- Macro-prudential measures to prevent NPLs problem at a systemic level; and
- Disclosure requirements with regard to banks' asset quality and NPLs (Council, 2017).

On 14 March 2018, the European Commission made public its complementary policy actions to reduce the level of NPLs. The package contained:

- a proposal for a directive to prevent any future accumulation of NPLs by more secured collateral enforcement or by developing secondary markets;
- a proposal for a regulation to set a minimum loan loss coverage for NPLs; and
- a technical blueprint to set up Asset Management Companies.

Regulation[71] amending the CRR was adopted in April 2019 and had been applicable since May 2019.

From these initiatives, it results that the main elements governing the management of NPLs and identified by the European Commission and the Council were composed of prudential supervision, NPLs' provisioning rules and the development of secondary market and Assets Management Companies. The directive on the creation of the secondary market aimed at facilitating the transfer of NPLs from banks to non-credit institutions. This goes beyond supervisory provisions and will therefore be set aside. The Assets Management Companies corresponding to the resolution process subject to the Bank Recovery and Resolution Directive

[71] Regulation (EU) 2019/630

and to the Single Resolution Mechanism it will not be assessed in this research project. Below, I will assess whether a coordinated position was elaborated by the EU institutions to tackle the NPLs on these main elements.

First, when it comes to prudential supervision, at the Banking Union level, in addition to EU requirements, the ECB High-Level Group published on 20 March 2017 the guidance to banks on non-performing loans (NPL Guidance). The NPL Guidance was addressed to banks, which had to explain any deviation from the Guidance and JSTs in charge of their supervision could take measures if the banks did not respect the Guidance provisions. The High-Level Group was composed of representatives of the NCAs and the ECB, it also included the EBA acting as an observer. It was chaired by Sharon Donnery, a high-level representative of the Central Bank of Ireland, which was acknowledged for its expertise in dealing with NPLs (Gren, 2018). The NPL Guidance can therefore be considered as illustrating the position of the NCAs which participated in its elaboration. An Addendum complemented it in March 2018. The NPL Guidance was based on the best practices of participating member states and to create a mechanism for convergence in the treatment of NPLs for Significant Institutions. The Guidance required the banks with a high level of NPLs to develop their NPL strategy in line with the business plan and the risk management framework of the bank, which had to be implemented through the NPL Operational Plan. Before this, banks had to perform an evaluation of their NPLs and present a Self-Assessment Report. It was the banks' responsibility to set up quantitative targets. Still, in order to ensure consistent treatment across banks, the SSM's JST examined and potentially challenged the target during its supervisory activity (ECB, 2016f). Targets had to be set up for one and three years by portfolio to decrease their NPLs. This meant that the obligations were implemented progressively. Further, I will assess whether this NPL Guidance complies with other EU initiatives to tackle NPLs.

The NPL Guidance addressed Significant Institutions directly supervised by the ECB. As for LSIs, the latter should comply with Single Rulebook provisions and, therefore the EBA definition and EU Regulations. Such a situation was likely to create discrepancies in the application of the NPLs provisions at a single member state level applicable to Significant Institutions or LSIs. In addition, the lack of coordination among EU institutions was likely to entitle national authorities with additional discretion, which in turn could influence the level of change in prudential supervision at the national level.

Another example of non-coordination was linked to the ECOFIN Council recommendation in 2017. The ECOFIN Council requested the ECB to issue guidance on NPL management for LSIs by the end of 2018 and requested the EBA to issue general guidelines applicable to all EU banks by the summer 2018. Despite this recommendation, no provisions were published on the management of NPLs by LSIs at the Banking Union level. This illustrates the divergence of position between the ECB and member states represented by the ECOFIN Council gathering the economic and finance ministers from member states. One can consider that national governments were in favour of specific provisions for LSIs with proportionate constraints, whereas the ECB – in line with national supervisors - was more in favour of a more inclusive position. Therefore the divergence observed in the provisions issued by EU bodies was due to divergence between national governments and supervisors and between supervisors from Banking Union participants and non-participants.

The ECB considered that NPL Guidance could also be used in terms of good practice for LSIs, whereas the EBA issued its guidelines (EBA Guidelines) applicable to all banks, including LSIs within Banking Union, in October 2018 (EBA, 2018c). A specific task force composed of national supervisors and the ECB prepared the EBA Guidelines on NPLs. According to the Council mandate, the EBA Guidelines were drafted to be consistent with ECB NPL Guidance addressing Significant Institutions (European Commission, 2018a). The

requirement for consistency with ECB documentation and close coordination with ECB, favoured the creation of a convergent position between these two levels of regulation. However one could note that from a legal perspective, the ECB, as a competent authority, should have followed the EBA requirements when establishing its NPL Guidance and not the opposite. Despite the similarities, differences remain between these two documents.

According to the EBA (2018c), it was expected that the ECB NPL Guidance would comply with the EBA Guidelines, and the NCAs were expected to comply with the ECB NPL Guidance. But both ECB NPL Guidance and EBA Guidelines were non-binding; therefore, the NCAs faced two distinct sources of NPL management guidelines at the EU level. The non-binding nature of the EBA Guidelines could be limited by the 'comply or explain' principle. This ambiguity and lack of clarity in the coordination between these two pieces of legislation was also raised in the comments received by the EBA during its consultation (see the Summary of responses to the consultation and the EBA's analysis in EBA, 2018c). As a consequence and due to the non-binding nature of the Guidance and Guidelines the national authorities had the discretion to implement ECB NPL Guidance or EBA Guidelines. The consequences of such discretion could lead to divergence if the NPL Guidance and the EBA Guidelines provisions were different.

EBA Guidelines had also incorporated some of the same definitions (NPE and forborne exposures) as the ECB, but there remained some discrepancies in the management of NPLs. For instance, the ECB took only immovable collateral valuation into account, whereas the EBA also included movable collaterals. The definition of high-level NPL banks was also different. The ECB had a moving target of high NPL banks with a considerably higher level of NPLs than the EU average, whereas the EBA set a fixed threshold of five per cent of NPLs to establish a NPL strategy. If I go more into detail, the NPL Guidance was applicable to all Significant Institutions in a proportional way. It was specifically addressed to 'high NPLs banks', which

was expressed in the Guidance as the 'banks with an NPL level that is considerably higher than the EU average*'* (ECB, 2016f). However, ECB seemed to expand the application of the NPL Guidance entirely to a large part of Significant Institutions. The term 'considerably higher' was not defined in the document and left room for interpretation, while the 'average' level was still a constantly changing target (Allen and Overy, 2016; ECB, 2016f). Such vagueness of the definition could be considered deliberate and was explained by the ECB's willingness to create an extendable definition. This position emerged from the NPL Guidance itself, when it stated that 'banks not falling under its terms might still benefit from applying the full content' (ECB, 2017h). In this way, ECB was controlling its definition, with no clarity given to the banks which should apply the whole NPL Guidance if there was a doubt on their qualification as 'high NPLs banks'. As a consequence, the applicability of ECB NPL Guidance and EBA Guidelines differed in substance, with the ECB targeting a larger number of banks. Such divergence gave the discretion to national authorities to decide whether the NPL requirements should be applied as recommended by the ECB to banks with considerably higher than the EU average level of NPLs beyond the five per cent threshold required by the EBA. In order to create consistency between ECB NPL Guidance and EBA Guidelines, the ECB issued a communication explaining the interaction between the two documents (ECB 2019b). It stated that the ECB NPL Guidance complemented the EBA Guidelines, which did not go into detail sufficiently. As for the obligation to establish a NPL strategy, the threshold of a five per cent ratio of NPLs to be considered as a high-level NPL bank must also be applied by the ECB. The ECB could overcome the threshold in order to apply its supervisory discretion. Therefore such discretion could also be used by national authorities as a good practice when implementing an NPL strategy for LSIs.

Second, on the provisioning rules proposed, the ECB in its Addendum and the European Commission in its Regulation indicated minimum coverage of loans becoming non-performing.

In the draft version of the regulation and the ECB Addendum, both institutions indicated a hundred per cent provisioning starting from the second year of non-performance of unsecured exposures. The final Regulation changed the provisioning calendar, and full provision was only foreseen for the third year of withholding an unsecured NPE. Regarding secured exposures, the calendar of the proposed provisioning was more stringent for the ECB than for the European Commission (Antonin et al., 2018). As an example, the ECB requested full provisioning after seven years, whereas the European Commission required a hundred per cent provision only after eight years and only for securities other than the immovable securities. Table 5.1 below shows the differences between the ECB expectations and the EU Regulation requirement for provisioning NPEs. The final Regulation, with the reviewed calendar and the level of provisioning, corresponds to the common denominator reached between the Council of the EU and the European Parliament, which favoured less stringent requirements (Council, 2018; European Parliament, 2018b). Consequently, the divergent position of EU institutions is again the illustration of the divergent position of national governments.

Table 5.1 Prudential provisioning for non-performing secured exposure

	Unsecured exposures		Secured exposures	
Years of NPE vintage	**ECB expectations**	**EU Regulation**	**ECB expectations**	**EU Regulation**
1	n.a.	n.a.	n.a.	n.a.
2	100%	35%	n.a.	n.a.
3	100%	100%	40%	25%
4	100%	100%	55%	35%
5	100%	100%	70%	55%

6	100%	100%	85%	Secured by immovable collateral: 70% / secured by movable collateral: 80%
7	100%	100%	100%	Secured by immovable collateral: 80% / secured by movable collateral:100%
8	100%	100%	100%	Secured by immovable collateral: 85% / secured by movable collateral:100%
9	100%	100%	100%	100%

Source: ECB, 2018b; European Commission, 2018

The distinction between immovable and movable securities was not present in the Addendum nor the draft Regulation presented by the European Commission. It was only added in the final version of the Regulation. The discrepancies between the two documents, therefore, increased after the enforcement of the ECB Addendum and showed a growing lack of

coordination between the two institutional positions but also the differences in preferences of Banking Union supervisor and national governments.

Moreover, the Addendum was already applicable since April 2018 to all exposures (new and existing) which became non-performing. Whereas the Regulation package of 14 March 2018 became applicable only from 26 April 2019 and was to be used only for new credit lines. The Addendum was still applicable only to Significant Institutions under the SSM, while the Regulation applied to all banking institutions including LSIs under the SSM. The ECB initially indicated that it was using its right to impose more stringent provisions as part of its Pillar 2 requirements (del Barrio Arleo, 2020: 311-23; Zeitlin, 2022). This ECB statement meant that the enforcement of the Regulation would not void the Addendum, which again stated the divergence in the NPLs management by the EU institutions (Antonin et al., 2018).

It is only in its communication from August 2019 that the ECB came to reduce the overlap between the Regulation and its supervisory requirements (ECB, 2019b). In this communication, the ECB introduced a change to its supervisory requirements to comply with Pillar 1 requirements. The ECB Addendum was still applicable to the loans that originated before 26 April 2019 but changed the timeframe from 2/7 NPL vintage years to the same timeframe as the one foreseen by the Regulation - 3/7/9 years – and introduced the distinction between unsecured and secured NPLs with movable and immovable collaterals. As for the stock of NPLs, as of 31 March 2018, the requirements stayed unchanged. This evolution in the ECB position shows the pressure, which the European Parliament and national governments exercised through the Council, which forced the ECB to change its practice and to comply with the Regulation.

Another difference between the NPL Guidance and Addendum and the Regulation is the legal nature of documents. The NPL Guidance, as its denomination implies, was a legally non-binding document, whereas the Regulation was a hard law provision. To that end, the ECB

changed the wording of the final version of the Guidance in order to render it less prescriptive (del Barrio Arleo, 2020: 315). However, NPL Guidance could also be expected to constitute an effective set of rules. Indeed, the NPL banks were subject to a 'comply or explain' mechanism and could be subject to a 'supervisory trigger for non-compliance' and could also face additional supervisory actions with add-ons under Pilar 2 (Allen and Overy, 2016; ECB, 2018a; *Financial Times*, 13 September 2016; Montanaro, 2019). Moreover, as the NPL Guidance had to be applied by the supervisor, the ECB declared that the banks under its direct supervision should 'apply the guidance, in line with the scale and severity of the NPL challenges they face' (ECB, 2016g). Despite the hierarchy of norms governing the Regulation and the NPL Guidance, the 'complain and explain' mechanism governing the regulation could also create confusion at the national level on the implementation of EU NPL provisions. Such confusion also maintained the discretion that could be exercised by the national authorities and influenced the degree of change in the NPL provisions applied at the national level in line with the initial hypothesis.

The Addendum in its first version played a role in maintaining the confusion of the national authorities. The Addendum issued in 2018, supplementing the NPL Guidance, should have had the same characteristics as the latter. However, in its first version, published on 20 March 2017, the non-binding nature of the requirements was questionable. The draft Addendum indicated that it provided 'quantitative supervisory expectations concerning the minimum level of prudential provisions for NPEs' (ECB, 2017e). This character of provisions applicable at a minimum level to new NPEs and the mention that 'measures should be seen as a prudential provisioning backstop' could have suggested that the ECB introduced legal requirements — which was questioned by the European Parliament on 9 October 2017 (Antonin et al., 2018; European Parliament, 2018a). In her letter addressed to the European Parliament on 13 October 2017, Danièle Nouy – head of the Supervisory Board of the ECB – affirmed that the ECB action was a Pillar 2 measure and not a binding regulation (ECB, 2017f). The final version of the

Addendum indicated that it was not binding, but any divergence needed to be explained by the bank under the 'complain or explain' mechanism.

The growing number of provisions on NPLs by three EU institutions over a short period of time with diverging requirements demonstrated a lack of coordination but also the diverging preferences of member states represented by the Council and the national supervisor which were active through the ECB. The EU institutions created intercurrences on NPL treatments, with different authorities producing non-cooperated contradictory policy outcomes. Despite a common definition, the differences introduced by the three institutions created a growing divergence in the management of NPLs at the EU level. This created room to manoeuvre for the NCAs and member states to apply the NPL management strategy at the national level. It gave the discretion to national authorities to apply the most suitable provision, which was less different from national pre-existing regulations. The Banking Union NCAs were expected to follow ECB Guidance, as the ECB recommended the proportionate application of NPL Guidance to LSIs. The EU Regulation was, in the meantime, directly applicable to NCAs and their banking sector. At the same time, the NCAs were also expected to apply EBA Guidelines to their national practice. ECB NPL Guidance and EBA Guidelines being non-binding, the national authorities maintained their margin of manoeuvre in the management of NPLs. The next section will analyse how national authorities have applied the NPL definition at a national level.

5.2.2 The NPL Framework creating a margin of manoeuvre for member states

As it was presented in the previous subsection, the EU developed a harmonised definition of NPLs whereas the management of such NPLs was increasingly divergent. This increasing divergence left a margin of manoeuvre for the national authorities in the implementation of NPLs supervision at the national level. In this section, I will assess whether

member states used this situation to regulate NPLs through national legislation to maintain the status quo and whether NCAs could exercise discretion to change their practice. In this section, I will introduce a general overview of the definition and management of NPLs at the national level and analyse whether national authorities developed the definitions according to the EBA requirements and if the national management of NPLs follows EU and/ or Banking Union requirements. I will start first by assessing the state of play in 2014 prior to the implementation of the NPLs requirements at the Banking Union level and then examine the situation by the end of 2019 after the introduction of the EBA Guidelines.

The ECB preparatory analysis for the AQR identified significant differences in the way bad loans were recognised and classified. Prior to 2013, EU member states had developed their own definitions of NPLs, and the scope of these definitions was different from one country to another. Large discrepancies could be observed in how the NPLs were supervised across Banking Union. For instance, in one of the interviews I conducted, a bank risk manager pointed out significant differences between their previous impaired loan management requirements under national supervision and the changes required by the ECB (Bank, 2019). Before the introduction of the SSM, banks were not required to create a dedicated risk directorate (Bank 2019). The biggest differences were observed in the recognition, classification and measurement of bad loans and the calculation of their provisioning (EBA, 2016a). Indeed, banks in order to avoid loss recognition, could postpone the process of debt restructuring or deleverage and hold the NPLs in their balance sheet for longer than warranted. This was, for instance, the case in Italy under its previous tax regime (NCA2, 2019). The AQR in October 2014 revealed much higher NPLs than the banks had previously disclosed (IMF, 2015). On average, the level of NPLs increased from 9.2 per cent to 12.4 per cent (IMF, 2015). It shows that the national definitions were much more restrictive than the EBA definition of NPE.

Following the introduction of the EBA definition and despite the discretion not to implement the NPE definition beyond mandatory cases, national authorities vastly changed their national definitions of NPLs (See table 5.4 at the end of this chapter). Overall, as of 2018, the majority of EU member states (23 out of 27) had already applied the EBA definition, beyond the mandatory cases, to all their financial intermediaries. Only four countries – Belgium, France, Croatia and Ireland – had maintained their national definition of NPLs (EBA, 2016d). The widespread application of the EBA definition could be mainly explained by the fact that the EBA definition was used by all EU institutions themselves, as described in the previous subsection, which left little discretion to national authorities. Moreover, the NPE definition was elaborated by the task force under the Standing Committee on Accounting, Reporting and Audit (SCARA) in collaboration with the NCAs (EBA, 2012). The NCAs were involved in the decision-making process which could have helped to elaborate a converging definition. Such collaboration created socialisation pressure from EU institutions which influenced the change in national practice.

However, in addition to the EBA definition, some NCAs had also introduced additional subcategories based on days past due (dpd) and the quality of the loan and other measures including principle-based guidance to recognise and classify NPLs, which showed that national practice did not ultimately evolve (ECB, 2016e). These sub-categories could include different kinds of performing loans, distinguishing between those which were previously classified as non-performing and the others such as cured loans or loans in forbearance in a probation period. It could also include different subcategories of NPLs depending on their situation triggering the qualification — for example, insolvency, negative equity and persistent losses. Such divergence could be explained by the persistent divergence existing at the EU institutions level which left some room for national legislative intervention, which in turn limits the discretion of national supervisors.

The ninety dpd criterion was usually applied by national authorities, but the additional qualitative criteria of well-defined weaknesses of the borrower or the loan had not been applied in all national definitions. This was the case for instance in Finland and in the United Kingdom (Barisitz, 2013a). Moreover, the definition of 'days past due' also varied across member states. Often it included the principal and the interest, but some countries have also included fees and commissions in the calculation (Barisitz, 2013a; BIS, 2016). In some cases, the definition only consisted of the full outstanding value of the loan, whereas in others, it was only the net value after deducting the provisioning. The second criterion was even vaguer (Barisitz, 2013a). It was difficult to say to what extent the interpretation of the 'objective impairment of loans' in France and the 'the payment of interest or principal appears partly or fully jeopardised' in Austria, for instance, would qualify the same loan as a NPL (Barisitz, 2013a; BIS, 2016). The qualitative criteria used did not change across member states, suggesting a lack of convergence which can be explained by the lack of a coordinated position on the NPLs at the EU level which left a margin for national legislative intervention. In such circumstances, the national government preferred to maintain its existing legislation according to *path dependence* described in the Analytical Chapter.

When it comes to the management of NPLs, I will review the application of the elements defined in the previous subsection – banking supervision, NPL provisioning rules and secondary market for NPLs – at the national level. It is expected that the lack of coordination at the EU level will provide room for national intervention in the supervision of NPLs management. The NPLs management was mainly dependent on the national governments. When the national governments intervened, less discretion was exercised by NCAs and according to the initial hypothesis, the change was less likely. In cases where the NCAs benefited from that discretion, it was expected that the prudential provisions will change. With regards to the prudential supervision of NPLs, NCAs implemented EBA Guidelines at a

national level. Only six member states out of 27 did not yet comply as of mid 2022,[72] but are intended to comply after the implementation period (see compliance status monitoring table on the EBA website).[73] However, some member states brought some national specifications. For instance, on the cure period, EBA required probation of one year for NPLs only in the cases of forbearance. However, in France, Ireland and Latvia one-year probation applied even without forbearance (EBA, 2016d). This confirms that national governments used the lack of coordination at the EU level to maintain their pre-existing prudential provisions and therefore to limit change.

The prudential coverage was also different from one country to another before the implementation of the ECB NPL Guidance and the EU regulation on prudential provisioning. In June 2019, coverage ratio ranged from 26 per cent in Malta and Ireland to 66 per cent in Romania (EBA, 2019b). This confirms that with no coordinated actions from EU institutions and the room left for legislative intervention, national governments did not change their prudential coverage requirements for banks. Besides, tax rules could influence the provisioning rules and therefore impact the management of NPLs (see for instance the case of Italy mentioned by NCA2, 2019 and presented above). Indeed, tax-deductibility of losses varied across member states and influenced the identification and provisioning of losses by banks (EBA, 2019b). For instance, the losses were not deductible in Malta, whereas they were partially deductible in Greece and in Italy, the government allowed for a full tax deduction. Here again, national legislative intervention explained the conservation of national practice in provisioning rules.

Table 5.4 at the end of this chapter compares the definition of NPLs across member states. As it can be seen from this sub-section and table 5.4, despite a general change and

[72] This member states are Bulgaria, Czech Republic, Ireland, Hungary, Malta and Portugal
[73] https://www.eba.europa.eu/about-us/legal-framework/compliance-with-eba-regulatory-products, accessed on 10/08/2022

introduction of NPL terminology in the member states, national practices remained and changes were limited. The lack of coordination among EU institutions created room for national government to implement a NPL definition that better suited their national legal setting. Some member states have also introduced out-of-court or hybrid mechanisms to tackle NPLs, according to the 2014 European Commission recommendation. However no common judicial or extra-judicial framework was installed in the EU member states and the competence remains in hand of national governments.

It appears from what has been presented above that France has largely used its own definition of NPLs and management of NPLs occurred also be different from the EU requirements, whereas Germany has largely complied with EU definition and NPL Guidance. It leads us to use a paired comparison of the definition and management of NPLs in these two member states. This is even more relevant regarding the similar characteristics of these two countries in terms of size of their banking sector, their influence in Banking Union and a stable level of NPLs. Therefore it gives us the opportunity for a concomitant variation analysis. In the next section, I will see how the definition is applied to the cases of France and Germany.

5.3 Application of NPL definition to Germany and France

In this section, I will apply the hypothesis presented in the Analytical Chapter to the cases of France and Germany. I will see to what extent national provisions on NPLs depends on the legislative intervention and to what extent it leaves discretion to the NCAs in both member states. It is expected that in the member states where the NCA has its say, the national provisions on NPLs will change.

As of third quarter of 2018, the NPL ratio in France represented 3.5 per cent.[74] This is a relatively limited number compared to other EU member states such as Spain (5.1 per cent) or Italy (12.4 per cent), but slightly higher than Germany (2.6 per cent). In fourth quarter 2019, the ratio in Germany was 1.2 per cent, whereas it was 2.5 per cent for France for the same period.[75] The slightly higher degree of NPLs in France compared to Germany can be explained by the domestic recovery legal framework as described below which does not encourage the sale of NPLs. In other member states, NPLs were quickly transferred to specialised actors which removed them from banks' balance sheets (*Les Echos*, 2018). As seen above two main elements will need to be analysed. I will first present the use of the NPL definition in France and in Germany (5.3.1) and then focus on the management of NPLs (5.3.2).

5.3.1 Definition of NPLs

In this subsection, I will present the French and German definitions of NPLs. At the creation of the SSM, both member states had very different legal setting on the NPLs and therefore different adaptational pressure exercised on national authorities to change their practice. In France, the government regulated the terminology, whereas, in Germany, there was no legislation limiting supervisory practice. In such circumstances, it is expected that Germany was more likely to change its national definition of NPLs.

Historically speaking, the concept of NPLs did not exist in France until the creation of the SSM (NCA2, 2019)[76] and no specific French rules or guidelines were foreseen to manage NPLs by banks, which explains why French banks used to have different types of organisation structures for the management of impaired loans (Bank, 2019). Despite the absence of the

[74] ECB, 2019b
[75] ECB, data warehouse
[76] See for instance Regulation 97-02, Regulation from Banking and Financial Regulation Committee issued on 21 February 1997 which do not refer to NPLs

concept of non-performing loans (‘*prêts non performants’*), the essential models of credit risk assessment were not new in France and Regulation 97-02 provided principles of monitoring and control of distressed assets. This regulation issued by the Banking and Financial Regulation Committee – a government-nominated body – was a principle-based regulation with no specific definition of NPLs. As a consequence, France experienced substantial adaptational pressure from the EU on the NPLs definition with a very different national framework significantly diverging from EBA provisions.

To determine the performance of exposures, French NCA relied on the credit risk assessment based on the Texas ratio, calculated by dividing impaired loans by the common equity of the bank. Until 2012, the ACP (*Autorité de contrôle prudentiel*) used the terminology of failure (‘*défaillance’*) in its enterprises’ notation activity (Schirmer, 2014). Failure occurred only when the debtor was facing a collective proceeding for legal redress or liquidation. Therefore, *Banque de France* used a more restrictive definition as the one used for NPLs. Since 2012, the ACP – and since 2013 its successor the ACPR – used the definition of default under Basel II (‘*défaut bâlois*’)[77] as requested by the ECB. ‘*Défaut bâlois*’ occurred when one of the following conditions was met: unlikeliness to pay, ninety days past due or suspension of payment procedure. The definition of ‘*défault bâlois*’ used at that time was close to those of the NPLs. As observed from Table 5.2 below, the main quantitative and qualitative elements of the definition of NPLs remained the same in France and the EU level. As for the qualitative condition, the one used in France was more restrictive. There were also differences on the secondary elements of NPLs definition.

In the same way, there was no single legal definition of NPLs in Germany before the creation of the SSM. Unlike in France, there was neither a specific domestic terminology to identify risky exposures. Each bank used to have its own categorisation of credit quality

[77] See Basel Committee on Banking Supervision 2004 paragraph 452

classification. The only provision which indicated what should be identified as non-performing was an internal comment to section 25 of the Audit Report Regulation (*PrüfbV*) (IMF, 2016). As with the EU definition, this definition of NPLs was composed of two elements: unlikeliness to pay without the activation of recovery processes such as realisation of the collateral or ninety days past due for the parent company or any of its subsidiary (IMF, 2016). Table 5.2 provides the German definition and compares it to the EBA and French definitions. The German definition was much broader than the EBA ITS definition of NPE. Generally speaking, the Deutsche Bundesbank identified as non-performing loans requiring loss provision and loans with no value adjustments but which full recovery was uncertain according to the Auditor Report Regulation[78] (Deutsche Bundesbank website; IMF, 2016). It shows that the initial definition of NPLs depended upon the German supervisor, which decided not to impose a single definition of non-performing assets and the position was very different from the one required in the AQR in 2014.

[78] Deutsche Bundesbank website: https://www.bundesbank.de/en/statistics/sets-of-indicators/financial-soundness-indicators/methodological-notes-795772, consulted on 27/01/2021

Table 5.2 Comparison of NPL definitions in France and Germany and EBA definition

	2013 EBA definition of NPE	**France**	**Germany**
quantitative condition: Principal or Interest 90 days past due	Yes	Yes	Yes
qualitative condition: well defined weaknesses of either the loan or the borrower	Yes	Yes (Objective evidence of impairment of loan)	Yes (the bank considers that debtor will not fulfil its credit obligation without the realisation of the collateral)
Consideration of collateral or guarantee when measuring loan quality	No	No	No
total loan recorded as non-performing	Yes	Yes	Yes

pulling effect: existence of downgrade requirements for multiple loans	all exposures to the same debtor have to be qualified as non-performing when the part of the outstanding amount which is more than 90 days past due reaches 20 per cent of the total on-balance sheet exposure to that debtor	No	No
consequence of the forbearance	Forborne exposures cannot exit the NPE classification before one year over which the debtor has to prove its ability to meet the restructured condition	Usually classification as impaired (yet each bank was responsible for its own credit risk assessment)	Depends on the bank practice

Source: Barisitz, 2013a; EBA and own assessment

The creation of the SSM in 2014 played a significant role in the creation of the definition of NPLs in France. The concept of NPLs was first discovered by many French supervisors in 2014 during the AQR (NCA3, 2019). The new Internal Control Regulation[79] issued by the French Ministry of Finance in 2014 replaced Regulation 97-02 by transposing the EU directive (CRD IV). As a consequence, NPLs in France were mainly regulated by the national government which acted as a veto player. It was therefore expected that the ACPR would have

[79] Decree of 3 November 2014 on the internal control of companies in the banking sector, payment services and investment services subject to the authority of the ACPR

less discretion and that the NPL provisions were less likely to change. This new French regulation was more detailed than article 79 of CRD IV and provided some specific principles for loans and credit risk identification, with a review of the credit files and monitoring of credit quality (ECB, 2017g). On 5 February 2019, ACPR addressed a notification to the EBA informing that it is compliant with EBA Guidance (EBA, 2021). However, to some extent, the French NCA went beyond EBA requirements.

First of all, according to this national legal provision, the ACPR could request information on NPLs beyond what could be requested by the EBA, including an ad hoc report, monitoring, and on-site and off-site inspections. Second, the ACPR imposed some early warning procedures and identification of risky exposures such as 'watch lists' (Bank, 2019; ECB, 2017g). Those classifications could differ from those required by the ECB in its supervision of Significant Institutions. The majority of cases for risk classification of exposures — performing exposures (PE), Watch list and NPE— were foreseen by ECB Guidance for Significant Institutions (Bank, 2019). Watch list exposures tagged exposures which required additional monitoring without being impaired, while NPE tagged impaired loans. For instance, forbearance, past due, and unlikely to pay exposures without taking into account the collateral were classified as non - performing by the ECB. Each bank could also introduce some additional explanations which were specific to the bank's activity. For example, for co-financing activities, the exposure could be tagged watch list if another bank had declared as a NPE, or for a precarious situation of the counterparty and by independent judgement, the bank was considering that the exposure must be provisioned. The national supervisor allowed banks margin of manoeuvre, whereas the ECB as a supervisor required the changes of watch list exposures to NPE. Consequently, a divergence could emerge between the definition of NPLs for Significant Institutions directly supervised by the ECB and LSIs. For instance, in a specific case, a bank revealed that the ECB requested to tag an amicable settlement procedure as a NPE,

whereas under national supervision banks used to tag it as a watch list (Bank, 2019). In the same vein, the ECB required that banks classify as watch list exposure to an enterprise with no overdue on its loan but whose balance sheet was deteriorated. Unlike the EBA and SSM requirements, banks in France could decide to exit those exposures from NPE before the one-year holding period. Even if banks started to comply with EU requirements, some of those requirements were too cumbersome or different from their existing practice. Therefore, the French NCA did not wholly follow ECB Guidance and national actors introduced some adjustments. This was, for instance, the case for the classification of a loan as a NPE. In some cases, banks did not have the specific subcategories of NPE as requested by the ECB for Significant Institutions. Therefore they would place it in a generic one (Bank, 2019). If, for a retail portfolio, more than twenty per cent of the exposure was classified as NPE, the EBA and the ECB required the classification of all exposures of the same counterparty as NPE ('pulling effect'). In France, there was no pulling effect of impaired exposure. This meant that, unlike what was requested by the ECB for Significant Institutions, a French LSIs could record some exposures as non-performing without spill-over to the exposures to the same debtor. In this way, the ECB operated with counterparty risk to classify an exposure as non-performing, whereas French LSIs used transaction risk (Bank, 2019). As a consequence, the French NCA changed its action but this change was limited by the legal intervention. The overall action of French LSIs is compliant to the EBA Guidelines, but some adjustments were introduced by the French government and implemented to LSIs. According to the Europeanisation framework, the current application of NPL rules in France corresponded to the *absorption* category of convergence, with change introduced to comply with EU requirements but this change was limited by the national legislative intervention.

With the enforcement of the EBA ITS, and unlike in France, no legal provisions were used and Germany did not issue any additional guidelines for the recognition and classification

of NPLs (ECB, 2016e). NPLs definition in Germany fully reported to German NCAs. Germany had a principle-based approach to the management of NPLs giving flexibility to banks that relied on the BaFin circular 'Minimum Requirements for Risk Management' (*MaRisk,* M*indestanforderungen an das Risikomanagement*) (GBIC, 2016; 2018). *MaRisk* created some principles in its sections BTO 1.2.4 and 1.2.5 to request banks to identify and deal with their problem assets ('intensified loan management') according to their internal procedures. The introduction of the ECB Guidance was, therefore, mainly in contradiction with the German principle-based approach to dealing with NPLs (GBIC, 2016). The ECB Guidance was more procedural, requiring specific supervisory control of the NPL strategy of banks and creating minimum coverage requirements whereas the German provisions left more room for manoeuvre for banking institutions themselves to decide and elaborate their strategy. Therefore, on 27 October 2017, BaFin issued a circular to amend the *MaRisk* in line with ECB Guidance. Section 1.2.5. BTO developed the procedure for the management of NPLs by German banks, which was previously in the banks' hands. The new provision required banks to set criteria to identify 'problem loans' which had to be managed outside the front office. In 2020, BaFin published consultation 14/2020 on a new amendment of *MaRisk* to adapt the sections AT 4.2 and BTO 1.2.4 and 1.2.5 to the EBA Guidance on NPL. The objective of this amendment was to introduce the EBA NPL Guidelines in the *MaRisk*. According to the EBA, it required monitoring of NPLs, the compliance with resolution measures and an annual valuation of the collateral. Such amendments significantly changed the German approach to banks NPLs, with principle based *MaRisk* imposing more constraining rules to banks. *MaRisk* also introduced the five per cent threshold to comply with sections 4 and 5 of the NPL Guidelines therefore constraining the high NPL banks to provide with NPL strategy. Such modification in German provisions corresponds to the significant change in the NPL definition and identification in Germany. BaFin being the author of *MaRisk*, the German NCA exercised discretion to change its practice

with no legal intervention. BaFin, therefore, used its margin of manoeuvre for the *transformation* of its supervisory practice to comply with ECB Guidance on NPLs.

The difference between the French and German changes in the NPL definition can be explained by the fact that the two member states relied on different types of mediating factors. In Germany, the NPL definition was subject to the NCA. It was a principle-based soft law provision, whereas, in France, the definition was subject to a legally binding regulation issued by the national government. The existence of these national legal provisions in France created inertia to the adaptational pressure from the EU level. Thus, the French definition remained more distinctive from the ECB's definition, while the German definition changed largely to converge with that of the ECB. The case of NPL definition in Germany illustrates a case where the national supervisor could exercise its discretion and used its new empowerment since the creation of the SSM to change the national definition. This finding supports the central hypothesis of this dissertation that changes to supervisory practice are most likely when the supervisors exercise its discretion rather than rely on legislative intervention.

5.3.2 Management of NPLs

The French and German legislative settings can explain the different levels of storage of NPLs in both countries. Indeed, member states developed legislative tools which can directly or indirectly influence the management of NPLs by banks. Despite the European Commission interventions and Council Actions Plans to reduce the stock of NPLs, their management remained mainly at national level. As per the hypothesis presented in the Analytical Chapter, it is expected that the change will be limited in this case largely in hand of national governments. In this sub-section, I will assess whether the management of NPLs in France and Germany depends largely on the government and to what extent the intervention of the government limited the convergence of NPLs management by national authorities. I will review the main

national settings influencing the management of NPLs and the changes introduced since the creation of the SSM.

French supervisor supported the SSM requirements on the management of NPLs, as illustrates the speech of the governor of Banque de France and chairman of the ACPR François Villeroy de Galhau:

> We must give our unequivocal support to these authorities in the performance of their duties: when the SSM, chaired by Danièle Nouy, and the ECB propose standards for the provisioning of new non-performing loans, they are operating fully within their remit to prevent future crises and ensure the convergence within the Euro Area that is at the heart of the Banking Union. (ACPR, 2017).

However, the legislative intervention limited the discretion of NCAs and change in national practice. First, when it comes to the stocks of NPLs, unlike in some other member states — including Italy where the tax system allowed the immediate deduction of NPL losses — French banks had to hold on to their NPLs during long periods. In France, tax deduction was only possible for loan write-offs – a hundred per cent for the first one million euro profits to be offset and fifty per cent thereafter. The sales of collateral were excluded. In the same vein, in Germany, the provision for tax purposes was limited to one million euro and sixty per cent of average loan losses. The dependence on legal provisions outside prudential requirements with no discretion left to the supervisor, made it difficult to change the fiscal treatment of NPLs in both member states.

Then, regarding the secondary market, the adaptational pressure on French NPLs provisions was also very strong and national government through its legislation acted as veto player limiting change. Under French bankruptcy law, the restructuring of loans required a judicial procedure. For a large part of debts, the regulation did not require the consent of the borrower to sell the loan, even when it was written off (ECB, 2017g). However, some loans

could have a non-transferability clause, which was still valid even when the exposure became non-performing. Moreover, the banks were incentivised to keep NPLs on their balance sheet in order to ease judicial recovery (ECB, 2017g). In addition, during the extra-judicial procedure (*e.g.* '*conciliation'* or '*mandat ad hoc'*), banks had to abide by legal confidentiality provisions and bank secrecy rules. The predictability of the outcome of the procedure was relatively low, as there were some uncertainties on the order of repayments (FBF, 2017). This made it very difficult to transfer NPLs to an external counterpart. The bankruptcy law was still applied in 2019 and would continue to apply even with the adoption, transposition and implementation of the new European Directive on Insolvency that was under discussion. Moreover, in France, until 2014, banks had a monopoly on secondary NPLs markets. The Decree of 12 March 2014, sought to facilitate the transfer of NPLs to non-bank partners. This new procedure was inspired by common law provisions and introduced a change in prudential requirements. The Decree of 12 March 2014 introduced the 'pre-established sale' and 'pre-pack procedure'. The latter was a procedure under which the court approved a restructuring plan agreed consensually between the borrower and its creditor before the insolvency procedure (ECB, 2017g). Despite the fact that these new procedures represented a change in French debt management, it was still far from the requirements of creation of a transparent secondary NPL market as prescribed by the European Commission in its directive proposal. Indeed, the new procedures were not transparent and did not create the competition expected for a secondary market.

There were also some legal provisions protecting the debtor which came also limiting the NPLs transfers on a secondary NPL market. Article 1699 of the French Civil Code allowed debt reduction when the legal validity of the claim could be contested ('*retrait litigieux'*). This represented a risk to the buyer of the NPLs. Article 1343-5 of the Civil Code foresaw the possibility for the debtor to obtain a payment stay from the court for a period of up to two years. Those provisions also limited the possibility or the advantage of selling NPLs.

As for Germany, national government also intervened as a veto player. Germany benefitted from its insolvency framework which favoured a quick resolution of NPLs (BSE, 2022). This was especially the case with regard to its foreclosure procedure. Indeed, the latter on average took one year in Germany, whereas the process took for instance on average of five years in Italy (Aiyar et al., 2015). In Germany, the secondary market for NPLs was not used a great deal, notably given the low level of NPLs. The requirements for a collateral transfer could also limit the transfers. Moreover, at times, the change of lender might have required the agreement of the borrower. Here again, the existence of national legislation limited the change in national practice, which supported the hypothesis that change was less likely when new legislation had to be adopted to bring about change in supervisory practice.

There were also specificities for real estate loans in France. Indeed, unlike in other EU member states, French banks did not often use mortgage loans. Eighty per cent of real estate loans were guaranteed by the *Crédit Logement*, which contributed to the recovery of NPLs (FBF 2017). Moreover, riskier borrowers, with low income could benefit from a State-guaranteed scheme (FGAS) which guaranteed a real estate loan (FBF, 2018). The existence of *Crédit Logement* and FGAS, allowed the LSIs in their recovery processes and at the same time changed the NPE loss allowance requirements for French banks (FBF, 2017; 2018). Those mechanisms limited the losses of housing loans, which recovery rate was not limited to the collateral value as for mortgage loans.

All the above-mentioned cases present a real resistance from the national governments to modify their practice to introduce change in the management of NPLs. This case can correspond to the *inertia* of national government to introduce change. Thus, despite the preferences of the national supervisor to comply with EU requirements, the legislative intervention limited change. In this area, mainly governed by the national majoritarian institutions, the French NCA also showed a resistance to change. During their on-site

inspections when controlling NPL, the French supervisor tended to select the most important files, and specifically those that contained abnormalities, less provisioning than usual, new activities less mastered by the institution, etc. (NCA3, 2019). The ECB, however, encouraged inspections based on statistical sampling which were more systematised but also required additional resources. According to the internal control regulation, the French ACPR considered this technique less efficient and was reluctant to change. It shows that, when the national government has its say the NCA is less likely to use its discretion to change its practice to converge to EU standards.

5.4 Conclusion on the convergence of NPLs

This chapter provides with an overview of NPLs definitions and provisions regulating NPLs at the EU level. As presented above, no common definition of NPLs existed in the EU before 2013. The EBA issued the NPE definition in 2013 and for reporting purposes only. When it comes to the European Commission and the ECB, they used the terminology of NPLs even if they referred to NPEs as defined by the EBA. Consequently, the national definition of NPLs coexisted with the definition at the EU level with no coordinated action from the EU institutions. This situation left room for national intervention to implement the NPL definition. In the same vein, the EU institutions did not achieve coordinated action on the treatment of NPLs. Parallel action provided with NPL Guidance from the ECB to manage NPLs for Significant Institutions in Banking Union, NPE Guidance from the EBA and EU Regulation initiated by the European Commission. As shown in this chapter, this divergence at the EU level also reflects the different preferences of national governments on the definition of NPLs. The lack of coordination could for instance be observed between ECB Guidance and EBA Guidelines which defined the high NPL banks differently. In the same way, the EU Regulation and ECB Guidance both foresaw prudential provisioning rules for NPE with different

thresholds. The lack of coordination on the NPL definition and its management shows a growing divergence in the management of NPLs at the EU level. This divergence was used by the national governments to limit the changes in their national practice. When it comes to the NPL definition, even if only four countries did not change their national definition of NPLs, a majority of member states introduced additional subcategories based on other criteria such as days past due, or quality of loans. As a consequence, divergence persisted in EU member states. When it comes to the management of NPLs, NCAs have implemented EBA Guidelines but also introduced a number of national specifications, taking advantage of the lack of coordination at the EU level. This is the case, for instance, with the prudential coverage requirements, regarding which ongoing divergence can mainly be explained by government intervention on NPLs.

In the last section of this chapter, I examined the application of NPLs provisions in Germany and France. In Germany, the government provided no definition of NPLs. The NPLs were only regulated by a principle-based *MaRisk* regulation issued by BaFin. With the introduction of the EBA Guidance, BaFin introduced amendments to the *MaRisk* to comply with EU provisions. Such change corresponds to the *transformation* of German prudential requirements on the definition of NPLs. It comes to reinforce the initial hypothesis that when an NCA – such as *BaFin*, exercise the discretion, change (and convergence to the EU standard) becomes possible. In France, no definition of NPLs existed prior to 2013, the ACPR using the terminology of *'créances douteuses'*. The French government regulated the identification of NPLs, and government intervention resulted in very limited change to the definition of NPLs.

When it comes to the management of NPLs, both in Germany and France, national settings influencing the management of NPLs were mainly controlled by the government and the changes to this legislation were very limited. For instance, in both cases, the sell-on of NPLs on secondary markets was not promoted by the national legal provisions on insolvency proceedings. This also confirms the initial hypothesis that change (and convergence) in bank

supervision is limited in areas where the government intervenes. As a conclusion, then, this chapter reinforces the initial hypothesis applied to the case of NPLs. It can be observed that the change in national practice regarding NPLs was limited by the large degree of government intervention in an environment with growing divergence at the EU level — which also in large part resulted from ongoing divergence in member state government preferences on bank supervision.

Table 5.3 Comparison of non-performing/defaulted exposures definitions under different international frameworks

		IMF Financial soundness Indicators Compilation Guide	**Default definition provided by article 178 of CRR since 2006**	**EBA definition 2013 of NPE**	**BIS 2016 April, Consultative Document**
main criteria	quantitative condition: Principal or Interest ninety days past due	Yes, Principal and/ or Interest	yes. 'NCAs may replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities.'	yes	yes

	qualitative condition: well defined weaknesses of either the loan or the borrower	Yes	'obligor is unlikely to pay its credit obligations in full, without recourse by the institution to actions such as realizing security'	yes	yes
secondary criteria	Consideration of collateral or guarantee when measuring loan quality	No	yes	no	no
	total loan recorded as non-performing	Yes	no	yes	yes
	pull effect: existence of downgrade requirements for multiple loans		no	'all exposures to a debtor have to be considered non-performing when its on-balance sheet 90 days past	yes

				due reaches 20% of the outstanding amount of total on-balance sheet exposure to that debtor'	
	consequence of the forbearance	Can lead to exit	Can lead to exit from default	'cure period' NPE that are 'forborne cannot exit the NPE classification before one year over which the debtor has to prove its ability to meet the restructured condition'	Forborne exposures should remain non-performing if the exposures have been categorized as non-performing prior to the forbearance measure or if they meet the criteria to be categorized as nonperforming.

Source: own assessment

Table 5.4 Comparison of non-performing exposure definitions in the Banking Union Member States at 2014

		Austria	**Belgium**	**Cyprus**	**Estonia**	**Finland**	**France**	**Germany**
Main criteria	**Quantitative condition: Principal or Interest 90 days past due**	Yes	No	Yes	Yes	Yes	Yes	Yes
	Qualitative condition: well defined weaknesses of either the loan or the borrower	Yes, repayment of interest or principal appears partly or fully jeopardized	Yes, impaired or doubtful exposures and uncertainty on the repayment of the loan	Yes, objective evidence of impairment of assets or group of assets	Yes	-	Yes, objective evidence of impairment of loan	Yes, the bank considers that debtor will not fulfil its credit obligation without the

								realization of the collateral
	Consideration of collateral or guarantee when measuring loan quality	No	No	Yes, assessment of macroeconomic triggers that might affect collateral value	Yes	-	No	No
Secondary criteria	**Total loan recorded as non-performing**	Outstanding net value of loan (after deducting of cumulative value adjustments)	Yes	Yes	-	Yes	Yes	Yes

	Pulling effect: existence of downgrade requirements for multiple loans	No	-	Follows EBA rules	-	Yes	No	No
	Consequence of the forbearance, classified as NP	Yes	Yes	Yes	Yes	Yes	Usually classification as impaired (yet each bank is responsible for its own credit risk assessment)	Depends on the bank practice

		Greece	Ireland	Italy	Latvia	Lithuania	Luxembourg	Malta
main criteria	**quantitative condition: Principal or Interest 90 days past due**	Yes	Yes	Yes	Yes	Yes, more than 61 days past due	Yes	Yes
	qualitative condition: well defined weaknesses of either the loan or the borrower	Yes, Bank of Greece requires the classification into the following sub-categories: (i) loans in pre-arrears; (ii)	Yes, payment in full of principal or interest is not expected even if less than 90 days overdue	Yes, borrower insolvent, even when insolvency is not ascertained by court; or borrower in temporary	-	Yes	Yes	Yes

		loans in early arrears (1-89 dpd); (iii) NPLs; and (iv) "denounced" loans		difficulties that can be expected to be cleared up in a reasonable time				
Secondary criteria	**Consideration of collateral or guarantee when measuring loan quality**	No	No	-	-	-	-	-
	Total loan recorded as non-performing	Yes	Full outstanding, value of loan as well as net	Yes	-	-	-	-

			value of loan (after deduction of value adjustments recorded as nonperforming					
	Pulling effect: existence of downgrade requirements for multiple loans	Yes	No	Yes	-	-	-	-
	Consequence of the	Yes	Yes	Yes	Yes	Yes	Yes	Yes

	forbearance, classification as NP							

		The Netherlands	Portugal	Slovakia	Slovenia	Spain
main criteria	**Quantitative condition: Principal or Interest 90 days past due**	Yes	Yes	Yes	Yes, defaulted exposures are classified in national categories D (91 to 360 dpd) and E (over 360 dpd)	Yes
	Qualitative condition: well defined weaknesses of either the	Yes	Yes, partly (bankruptcy or liquidation of the debtor)	Yes, significant perceived decline in credit quality or obligor files for bankruptcy or	Yes	Yes, reasonable doubts about full repayment of loan; or loans classified

	loan or the borrower			seeks restructuring proceedings		as doubtful due to country risk)
Secondary criteria	**Consideration of collateral or guarantee when measuring loan quality**	-	No prescriptive classification categories	-	Yes	-
	Total loan recorded as non-performing	Yes	Yes	Yes	Yes	Yes
	Pulling effect: existence of downgrade		Yes, but only if NPE represents 25 per cent of	Yes	-	Yes, but only if the NPE exceed 25 per cent of

	requirements for multiple loans		the overall outstanding			the overall outstanding
	Consequence of the forbearance	-	-	-	Classification as NPL	-

Source: Barisitz, 2013a;b; Bykova and Pindyuk, 2019 and own assessment

Chapter 6 Convergence of Supervisory Review and Evaluation Process – an example of supervisory discretion

6.1Introduction - Historical development of SREP in the EU

In this chapter, I will test the dissertation's main hypothesis through a case where the supervisor can exercise discretion with no or limited intervention from national government. To this end, I selected the case of the Supervisory Review and Evaluation Process (SREP) because it provides variation in the independent variable. Competent authorities have full control over SREP, and they can use the discretion left to them by the EBA and the SSM. It is expected that the NCAs will use their discretion to change national practices towards EU requirements.

From a historical perspective, SREP was introduced by Basel II in 2006 to consider the risk profile of banks. This was part of the second pillar of Basel II, complementing and reinforcing the regulatory capital requirements of the first pillar according to the risk profile, risk management, and risk mitigation systems of banks. SREP was a holistic approach that allowed a supervisory review of a bank's capital and liquidity situation more continuously and considered banks' internal governance and risk management practices (Baglioni, 2016; Bevilacqua et al., 2019; Dragomir, 2010). It was based on the cooperation between supervisory authorities and supervised entities. Banks had to set up two processes: the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP), to evaluate the level of economic capital and liquidity adequate to the banks' risk profile, respectively. The analysis should cover quantitative risks, such as credit and concentration risks and more qualitative aspects, such as reputational and strategic risks. These

ICAAP and ILAAP had to be reviewed by the supervisory authority during SREP. The supervisor reviewed the risk profile of the supervised entities in line with their ICAAP/ ILAAP and, if deemed necessary, could take prudential measures such as additional capital or liquidity requirements or qualitative measures to reduce risk requirements. The objective of SREP was to review and evaluate the risk profile of supervised institutions continuously, considering all types of risk and the specificities of each bank.

Before CRD I, in the EU, the assessment of banks by national supervisors was not harmonised. No common definition was foreseen, and the Codified Banking Directive 2000/12/EC contained only general provisions (Dragomir, 2010). CRD I introduced a *minimum harmonisation* principle for implementing SREP by NCAs, established the obligation for early intervention and enumerated the minimum level of measures for the banks to adopt. In 2004, the Committee of European Banking Supervisors (CEBS) drafted a consultation paper to minimise heterogeneities in SREP methodologies. In January 2006, the CEBS issued the Guidelines on the application of the supervisory review under Pillar 2. These Guidelines provided the parameters to evaluate banks' ICAAP and tools to implement SREP convergently (Dragomir, 2010). CEBS Guidelines were not binding but were subject to a *comply or explain mechanism*. However, these first Guidelines only set minimum standards and recognised the possibility for differentiation in applying SREP by NCAs (CEBS, 2006b).

In order to test the main hypothesis of this dissertation, I will first present the state of play and the discretion provided by the EU to NCAs (Section 6.2). A convergence process on SREP was launched by the EBA and Banking Union that imposed a common SREP methodology for NCAs in all participating member states. It is therefore necessary to assess the level of discretion left to the NCAs under this common SREP methodology. Then, I will assess, whether according to the main hypothesis, the NCAs will use this discretion to change their

practice. In the second part of this chapter, I will test the application of this hypothesis to the cases of France and Germany and the implementation of SREP by the ACPR and BaFin/ the Bundesbank (Section 6.3). At the creation of the SSM, the supervisory review in these two member states varied significantly. In this area that is largely controlled by national supervisors, despite the differences in the pre-existing SREP practice in Germany and France, it is expected that the supervisors will use their discretion to significantly change their practice to comply with EBA and ECB Requirements.

6.2EU adaptational pressure and room for discretion left to NCAs

6.2.1 The development of common rules on SREP at the EU/ Banking Union levels leaving room for manoeuvre for the NCAs

I will start by evaluating the level of convergence imposed by the EU institutions. First, CRD IV foresaw the implementation of SREP in its article 97, which mentioned broadly that 'the competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the institutions' (CRD IV article 97). Such general provisions left room for interpretation (Bevilacqua, 2019). The detailed process was then described in the EBA's SREP Guidelines,[80] applicable from 1 January 2016, addressed to NCAs and specifying the application of SREP. These Guidelines went beyond CEBS's requirements, detailed the methodology for SREP and indicated measures that the supervisor could take. According to the Guidelines, the supervisory authority should evaluate banks under its supervision on the following four elements:

- their business model analysis,
- the assessment of internal governance and control arrangements,

[80] EBA, 2014a

- the analysis of capital adequacy, and
- the analysis of liquidity risk (EBA 2014).

All four elements contained a qualitative dimension, internal governance being based only on supervisory judgement. This qualitative dimension gave room for appreciation and therefore was a source of discretion for the NCAs responsible for implementing SREP Guidelines. In addition, these four elements had a quantitative dimension which was less discretionary. The Guidelines presented two types of scores: risk scores, which applied to a specific risk assessed, and viability scores, applicable to all four SREP elements. For each component, a score from one to four was provided. All four elements were then summarised in a final score with positive scores ranging from one to four and a negative grade of 'F' for institutions identified as 'failing or likely to fail' (EBA, 2014a; 2018a). Depending on the total score obtained by the supervised entity and on the supervisory judgement, the supervisor could issue requirements to the bank on capital, liquidity or other matters including the reorganisation of risk management or the restriction in the products portfolio (EBA, 2014a).

The objective of the EBA's SREP Guidelines was to adopt a consistent treatment of banks with comparable risk profiles, business models and similar exposures to geographic areas in all EU member states (EBA, 2014a; Ferran, 2016). However, one should bear in mind that the EBA issued Guidelines and not Regulatory Technical Standards (RTS) — and therefore aimed to leave more margin of manoeuvre. As with the CEBS Guidelines of 2006, the EBA set a 'minimum supervisory engagement model' (EBA, 2014a). The measures foreseen by the EBA's SREP Guidelines were not constraining in the sense that national supervisors were able to introduce other supervisory measures to respect the preferences of member states while considering the principle of proportionality and under the condition that they informed the EBA about their process (EBA, 2014a; 2018a; Ferran, 2016). As a result, the EBA's SREP

Guidelines explicitly left some discretion to the supervisor in the implementation of its SREP. At several points, the EBA's SREP Guidelines allowed for stricter rules and conditions to be applied by NCAs, for instance, the possibility to have more granular scoring for the overall assessment of SREPs, or the possibility to apply stricter requirements to cover certain types of risks if the NCA considered it appropriate. For instance, competent authorities could go beyond and apply national law and early intervention measures (Bevilacqua, 2019).

In July 2018, the EBA issued revised SREP Guidelines, which entered into force in January 2019.[81] These Guidelines objective was to introduce provisions to improve the convergence of national practice on SREP identified in the EBA's convergence reports (EBA, 2019c). In addition, the revised Guidelines introduced Pillar 2 Guidelines (P2G), which were non-binding capital requirements that the supervisor could set in addition to the overall capital requirement (OCR).[82] It also indicated that the EBA provided minimum requirements which could be exceeded by NCAs wanting to impose stricter measures. However, for the first time, the revised Guidelines explicitly prohibited the application of less strict requirements, thus limiting the discretion granted to national supervisors. However, more stringent measures were still allowed. The EBA did not expect a common method to be used by the NCAs but only focussed on the convergent outcome of supervision (EBA2, 2022). Consequently, the EBA granted the NCAs significant discretion to implement their SREP even if this discretion gradually diminished over time. Such soft law provisions were expected to give an additional margin of manoeuvre to national supervisors at the EU level.

[81] EBA Final report, Guidelines on the revised common procedures and methodologies for the Supervisory Review and Evaluation Process (SREP) and supervisory stress testing – 19 July 2018 – EBA/GL/2018/03

[82] OCR was a sum of Total SREP capital requirements (TSCR) and additional capital buffers i.e., capital conservation buffer, counter-cyclical buffer, and systemic buffers. TSCR was composed of Pillar 2 Requirements and Pillar 1 Requirements (See Resti, 2018)

As for the Banking Union participating countries — as will be explained further below — the SSM also gradually reinforced its requirements on SREP to promote convergence. First, the ECB issued a common SREP Methodology that was applicable to Significant Institutions. The ECB, through its JSTs, oversaw the centralized supervisory review of Significant Institutions. In 2015, for the first time, the ECB applied a common SSM SREP Methodology to Significant Institutions. This Methodology followed the EBA's SREP Guidelines but went further and combined quantitative and qualitative criteria from national best practices, and focused more on the sustainability of bank business models with the aim of treating all banks consistently (Bonomo et al., 2016; ECB, 2016a). This Methodology introduced a detailed process for the assessment composed of three detailed steps: data gathering, an automated preliminary score of the risk level, and supervisory risk assessment based on supervisory judgement. Unlike the EBA, the ECB retained a 'holistic approach' assembling different risk factors into an overall risk profile which was considered as a whole (Resti, 2018).

The ECB through the SSM retained discretion to adjust the decision in the assessment of qualitative elements (Schoenmaker et al., 2016). However, one could expect that consistency was ensured by the 'constrained' nature of the judgement which meant that the reasoned judgement of the JSTs could influence qualitative data to a certain extent by improving the overall score by one notch or worsen it by two notches (ECB, 2014; Lautenschläger, 2015). The importance of this discretionary power was highlighted by the EBA. The latter stated that less automated nature of the EBA Guidelines compared to the ECB Methodology was to guarantee the supervisory judgement of competent authorities when exercising their SREP assessment. The EBA asked the ECB to avoid creating an automated evaluation of banks without supervisory judgement (EBA2, 2022). In the meantime, the ECB also declared its support to maintain the supervisory judgement. Chair of the Supervisory Board, D. Nouy (2017) stated:

> Being able to use supervisors' judgement is crucial to ensuring flexible and effective supervision. In that context, I am concerned about some changes to the rules that have been proposed by the European Commission. In my view, these changes would restrict supervisory actions too much in core aspects. An adequate degree of judgement should be maintained to allow for risk-based and bank-specific supervision.

This shows that the EBA and the ECB were in favour of maintaining the discretion granted to the supervisors when promoting convergence, even if the ECB went beyond the EBA Guidelines. This speech also revealed ECB's disagreement with the European Commission's legislative proposal issued in November 2016 to amend SREP, removing the flexibility granted (Nouy, 2017; see also ECB, 2017d). Consequently, without being diverging, the EBA and the ECB provisions for SREP showed a slight difference in the perception of how SREP should be implemented while accepting the discretion to be granted to the competent authorities.

When it comes to the LSIs, the convergence of SREP was made more complicated by the fact that there was no common methodology for LSIs until 2018. The NCAs were only covered by the EBA's SREP Guidelines, which created an asymmetric effect given the harmonised and more stringent evaluation of Significant Institutions and the continuation of distinct national methodologies for LSIs (Navaretti et al., 2015). Since 2015, the ECB had been developing a common methodology for the LSI Risk Assessment Systems (RAS), to be used by the NCAs to carry out SREPs. In a staggered approach, the Methodology for LSIs was applied from 2018 to high-priority LSIs – defined as LSIs with medium or high intrinsic risk with medium or high impact – rolled out to all LSIs as of 2020. The SREP Methodology for LSIs was non-binding by nature and left room for judgment to NCAs, which could lead to different outcomes (NCA3, 2019; Zeitlin, 2021).

The convergence of SREP for LSIs happened gradually. As presented by the JST member at the ECB, to build a common SREP, the first step was to build a common supervisory culture by creating a common ground and then involve horizontal teams to assess what works and what does not (NCA5, 2021). Before the creation of the SSM, there were two predominant schools for national SREPs; some of them relied on ICAAP – as in Germany, whereas some others relied on stress tests – like in France. Over time these two approaches converged thanks to increasing cooperation even if they were still not completely aligned (Deutsche Bundesbank, 2016; NCA3, 2019; NCA4, 2021). For instance, stress tests which were initially considered internal risk management tools for banks became the input into SREP (Bevilacqua, 2019; Enria, 2018). This cooperation led to the creation of a converging SREP Methodology composed of best practices across the Banking Union member states (NCA5, 2021; Nouy, 2017). The ECB then organised training activities and events to help NCAs to appropriate the Methodology (ECB, 2019a). Eventually, the second step, once the common culture was acquired, was to go on more demanding and constraining requirements (NCA5, 2021). This is exactly what happened for SREP; gradually, ECB developed its ICAAP methodology with an explicit risk-by-risk approach and incorporated the ICAAP into SREP. Moreover, the new Methodology focused more on quantitative elements with a score assigned to each of the four elements assessed under SREP. The quantitative nature of the scoring limited the discretion of the NCAs. The automatic rating allowed the standardisation of NCA activity and decreased the differences between national authorities. However, the room to manoeuvre available to the NCAs was maintained thanks to the qualitative elements. Indeed, in addition to the quantitative elements, the NCAs had to provide a qualitative evaluation of the supervised entities. The Methodology was expected to set the minimum requirement for the NCAs when performing a SREP (Deutsche Bundesbank, 2016). Therefore, the Methodology left some discretion to the NCAs. There was also some flexibility compared to the Methodology for Significant Institutions. For

instance, the NCA had the choice to apply EBA Guidelines on the composition of Pillar 2 requirements (P2R) that required 56 per cent of Common Equity Tier 1 (CET1) and 75 per cent of Tier 1 capital. In contrast, the ECB had to apply more restrictive requirements for Significant Institutions with P2R composed of CET1 only (NCA3, 2019).

In addition, and as for Significant Institutions, the NCAs were bound by the 'constrained judgment' from which they could exceptionally depart, for instance, regarding the quality of data. However, the NCAs had more margin of manoeuvre and could use the proportionality principle to adapt their evaluation. For example, the full SREP was organised yearly for high-priority LSIs but could be less frequent for other LSIs. The NCAs could also use discretion to consider bank specificities particularly to assess the internal governance and risk management element. For the third element 'risk to capital', the NCAs could benefit from the discretion to use national methodologies to assess the need for additional capital requirements for the bank risk profile. The NCAs also had the discretion to use top-down and/or bottom-up stress tests and to translate scenarios into shocks. For the fourth element 'Risk to liquidity', the NCAs could use national approaches for assessing bank liquidity needs.

As seen from the EU and Banking Union requirements, the EBA and the ECB launched the move toward the convergence of SREP. However, the existence of two different EU actors issuing non-binding guidelines as well as the minimum requirements qualification of the Guidelines and the Methodology left the NCAs some discretion in implementation. SREP was mainly at the hands of the NCAs, with little or no intervention from national governments. In the next subsection, I will test the hypothesis according to which, when more discretion is exercised by the NCAs, the latter will be more likely to follow EU requirements and align their position/ supervision with the ECB.

6.2.2 Application of SREP by Banking Union member states

SREP was a Pillar 2 requirement that was fully in the hands of the supervisor with no intervention from the national majoritarian institution. SREP was fully transferred outside political intervention to national supervisors because of the technicality of the matter (Bach and Ruffing, 2013). As a consequence, national supervisors benefited from discretion with no intervention from national governments. However, according to the initial hypothesis, it is expected that the NCAs will use this margin of manoeuvre to change their national practice to converge to European supervisory standards. The change is only expected if the existing practice of national authorities across member states varies from EU/ Banking Union requirements; in other words, when there is an adaptational pressure. To test the hypothesis, I will evaluate the state of play of national SREPs in 2014 and compare these to EBA requirements. Subsequently, I will assess the change in the national practice of LSI SREPs by evaluating the compliance with the EBA's SREP Guidelines and the ECB's SREP Methodology for LSIs.

First, when the SSM began operating in November 2014, prudential supervisory review varied significantly across member states. At the time, the NCAs followed national methodologies to assess banks (Draper, 2014; ECB1, 2022).[83] It was observable notably in comparison to prudential requirements imposed by the ECB and by the NCAs on Significant Institutions. After the launch of the SSM, the ECB applied tougher reviews to banks under its direct supervision and Pillar 2 Requirements were increased on average by thirty basis points compared to the previous year. This meant that the ECB applied higher standards to banks under its direct supervision (Angeloni, 2015; Schoenmaker et al., 2016). It confirms that national-

[83] The comparison of national methodologies can be found in the EBA's supervisory disclosure document. The full document is available at: http://www.supervisory-disclosure.de/supervisory_disclosure/Navigation/EN/Supervisory_review/supervisory_review.html

level SREP before the SSM's launch was less strict and varied significantly from one member state to another. In the same vein, in its convergence reports, the EBA noted that despite the use of common principles, the notable differences in the application of SREP remained across EU member states (EBA, 2015; 2017; 2019).

Adaptational pressure varied across member states with the implementation of the new Methodology requiring a complete change in some NCA practices. The main differences were related to the scoring of SREP elements which differed from one supervisor to another – especially on the viability score, the role of the ICAAP in the calculation of the Pillar 2 Requirements, the reliance on stress tests, the determination of the total SREP Capital Requirements and the business model analysis. The differences in the supervisory review process across member states could mainly be explained by the structural differences in the banking sector, as well as the maturity of the ICAAP and ILAAP processes (De Prince and Sebbag 2017). For instance, Germany and Italy were very attached to ICAAP with strong capital requirements, whereas Spain was very soft on ICAAP with capital requirements coming just like add-ons (NCA5, 2021). France had a similar culture that relied mainly on stress tests but not on the ICAAP (NCA5, 2021). Moreover, in the case of Germany for instance – with its more legalistic approach – the pre-existing methodology was mainly based on a qualitative assessment and was expected by the ECB to be revised to introduce quantitative scoring elements (Röseler, 2015; Schoenmaker et al., 2016). Whereas other member states, applied a more quantitative approach, as for instance France and Spain.

Having observed the national differences at the creation of the SSM, this chapter will now present how national practice evolved since the introduction of the SSM and the adoption of a common Methodology by the ECB to check whether the NCAs changed their practice despite the discretion from which they benefited. According to the ECB, in 2019, fifteen NCAs

applied the ECB recommendations to all LSIs beyond the mandatory application to high-priority LSIs (ECB, 2020a). Such a general observation runs in the direction of the hypothesis that the NCAs are most likely to change their practice to converge toward EU/ Banking Union standards.

A summary table (6.1) at the end of this chapter, presents a comparison of national practices in Banking Union with the EBA Guidelines. As of the end 2019, according to the data available in Annexes III[84] of their supervisory disclosure, all the NCAs notified to the EBA the compliance with the EBA Guidelines in their SREP according to *comply or explain mechanism*.[85] In Annex III, all but three competent authorities[86] referred to the EBA Guidelines. This reference to the EBA Guidelines in their supervisory disclosure did not necessarily mean that the NCAs were compliant with the Guidelines but at least, it showed that the NCAs officially committed to complying. For three NCAs which did not mention EBA Guidelines in their Annex III, the EBA Guidelines were referred to in the national SREP documentation. In its convergence reports, the EBA also marked the changes in national SREPs (EBA, 2019c). The EBA considered that, overall, the NCAs followed the EBA's SREP Guidelines. On each round of convergence report, the EBA noted the changes that occurred in the national supervisory review procedures (EBA, 2019c). The latter concerned mainly the categorisation of institutions and the definition of the engagement models of NCAs in 2017 and the refinement of the scoring of risks to capital in 2018 (EBA, 2019c). Despite these changes, the EBA was of the view that the convergence was not complete with some areas still presenting differences —

[84] Annex III corresponds to the form set up by the European Commission implementing regulation (EU) no 650/2014, article 3, pursuant to Article 143(1)(c) of the CRD IV, which requires NCAs to publish information on their SREP methodology

[85] See Compliance status monitoring table on the EBA website, available at https://www.eba.europa.eu/about-us/legal-framework/compliance-with-eba-regulatory-products, consulted on 10/08/2022

[86] These NCAs are Italy, Hungary, and Lithuania

for example, in the application of the risk score to smaller and non-complex institutions (EBA, 2019c). Regarding the business model analysis – one of the main SREP elements – despite improvements between 2015 and 2019 – differences remained in the adopted approaches (EBA, 2019c). The lack of convergence on this matter can be explained by the mainly qualitative nature of the assessment of the business model with limited guidance provided by the EBA.

On overall, a significant change of national SREPs and convergence to the EU/ Banking Union requirements can be observed. The faster implementation beyond ECB requirements was explained by the NCAs and the ECB by the fact that supervisors were also concerned with having strong and safe banks and therefore had the same priorities as the ECB (BaFin, 2020; ECB2, 2022; NCA3, 2019). Consequently, the NCAs, the ECB and the EBA shared a common belief and objectives to promote a sound banking sector and were part of an Epistemic Community/ transnational policy network. The common preferences were also shaped by socialisation pressure exercised by the ECB and the EBA on NCAs to change their national practice. First, the EBA and the ECB organised training on SREP and monitored compliance with EBA/ ECB requirements to check the supervisory convergence and organised visits and reports. They could also issue recommendations if there were any non-compliance observed (EBA1, 2019; ECB, 2020b). As seen for ONDs in Chapter 4, the ECB also designated a High-Level Group for SREP (ECB, 2016a). Therefore, the design of a common Methodology for LSIs was developed in cooperation with the NCAs and was in line with the EBA's SREP Guidelines and the SSM's SREP Methodology for Significant Institutions (Nouy, 2017). The NCAs participated at the SSM level in the development of the methodologies on SREP as well as the ICAAP and the ILAAP; they transferred their comments to the ECB Directorate General Micro-Prudential Supervision III (DG MS III) of the ECB, which was responsible for LSIs supervision and then validated by the Supervisory Board (ECB, 2020b; NCA3, 2019).

Consequently, the participation of the NCAs in the development of this new Methodology played a role in the socialisation and learning process of national supervisors to take ownership of the tool. Moreover, the SREP Methodology was updated every year, and the NCAs could also submit their input to the ECB. The socialisation pressure was not limited to the supervision of Significant Institutions and took place on SREP for LSIs. On the one hand, JSTs participated in the shaping of the SREP Methodology and in the adjustment of it from one year to another. The JSTs were composed of two-thirds of the NCAs staff, contributing to creating a shared culture through socialisation (ECB, 2020b; Zeitlin, 2016). On the other hand, the NCAs members participating in JSTs did not only focus on Significant Institutions but could also oversee LSIs at the national level. As such, they could download the ECB supervisory culture to the national practice of SREP. Using an integrated information technology (IT) system also pushed toward the convergence of national practice (NCA3, 2019). The negotiations with NCAs, the participation of a High-Level Group composed of NCAs in methodology development, and the creation of working groups allowed the creation of a common supervisory culture among NCA members and the ECB (ECB1, 2022; NCA1, 2017; NCA2, 2019; NCA5, 2021).

In addition, NCA members participated in developing EBA SREP Guidelines as part of the Standing Committee on Oversight and Practices (SCOP) – a lower-level governance structure of the EBA (Beroš, 2021; EBA1, 2019). The Board of Supervisors often delegated to these kinds of Standing Committees, which provided opportunities for interaction and reaching consensus among NCAs (Beroš, 2021; EBA1, 2019). Consequently, EBA also created a socialisation environment for NCAs, making it easier for NCAs to comply with the EBA Guidelines.

The starting points of national SREP can explain the remaining divergence observed by the EBA. For instance, the integration of ICAAP and ILAAP into the national practice of member states. ICAAPs and ILAAPs were still very divergent across member states and even across banks. For instance, France, which did not use these possesses before the SSM was launched and required additional time for integration (EBA2, 2022; NCA3, 2019). The EBA issued guidelines[87] on the collection of information for ICAAP and ILAAP in 2016, followed in 2017 by the ECB Guides[88] addressed to banks in Banking Union. By way of conclusion, a real change can be observed in SREP implemented by NCAs since the launch of the SSM. This observation confirms the initial hypothesis according to which change is more likely when the supervisors have discretion. In the next section, I will apply the hypothesis to the cases of France and Germany.

6.3 Case Studies – Germany and France

The objective of this section is to assess whether their initial ICAAP and SREP in 2014 in France and Germany differed from the EBA Guidelines. Differences in national prudential practice are expected to reinforce the adaptational pressure on the national supervisors. First, in both member states, the NCAs developed their own SREP methodology before the creation of the SSM with no legal intervention from their national government. With regards to France, the adaptational pressure was strong since, at the moment of the creation of the SSM, the French NCA did not use the SREP terminology (NCA3, 2019). Rather the ACPR followed the 'ORAP' (*Organisation et Renforcement de l'Action Préventive*) methodology. ORAP is a Risk Assessment System developed in 1998 and modified in December 2006. It was designed to

[87] EBA, 2017b
[88] ECB Guide to the internal capital adequacy assessment process (ICAAP) and ECB Guide to the internal liquidity adequacy assessment process (ILAAP)

consider different categories of risks to which banks were exposed as specified in the directive 2006/48/CE and to comply with recommendations of CEBS to adapt the supervision to the volume and typology of risks (*Commission Bancaire*, 2007). ORAP was based on the analysis of the *SURFI* report (*Système unifié de reporting financiers*) implemented by the General Secretariat of the ACPR.[89] It was updated in September 2013 before the transposition of CRD IV. At that time, the French supervisor had already applied a holistic approach combining scoring and expert judgment (EBA, 2014) and used its internal Risk Assessment System,[90] which was a CAMELS-type[91] assessment. The ACPR mainly considered the following elements in its assessment:

- The level, structure, and permanence of regulatory capital;
- Credit risk, including concentration risk, market risk, operational risk, interest rate risk in the non-trading book and liquidity risk and the level of transformation;
- Earnings and profitability generated by day-to-day business;
- The organisation of the institution, including corporate governance and internal control;
- Anti-money laundering and anti-terrorist financing measures, and more generally, measures for combating financial delinquency and reputation risk;
- The level and distribution of internal capital are judged appropriate by institutions. (EBA supervisory disclosure as published in 2014).

French supervisors had a centralised approach with the supervisory review mainly at the consolidated level and used a lot of stress testing but did not rely on the ICAAP and ILAAP of banks (EBA2, 2022; NCA5, 2021).

[89] It was first implemented by the General Secretariat of Commission bancaire under: '*Mise en œuvre du processus de surveillance prudentielle et d'évaluation des risques (pilier 2) – Critères et méthodologie utilisés par la Commission bancaire'*, December 2006

[90] *Organisation et Renforcement de l'Action Préventive* 2 (ORAP2)

[91] CAMELS stands for: Capital adequacy, Asset quality, Management quality, Earnings, Liquidity, Sensitivity to the market

In the same way, Germany also experienced strong adaptational pressure. Before the SSM's launch, BaFin and the Bundesbank used their model and relied partially on external auditors to assess compliance with supervisory requirements. While the Bundesbank regional offices assessed each bank's detailed profiles on at least an annual basis, BaFin oversaw the overall process, finalised their risk profiles and took final decisions (Draper, 2014). The German NCAs first proceeded with a bank-by-bank analysis to place the bank into a risk matrix composed of four risk categories and three levels of systemic relevance (IMF, 2011). The German NCAs mainly focused on assessing the business model and governance and identifying the impact of the bank risk management and profile relying on external auditors (Draper, 2014; Eurosai, 2017; IMF, 2016). All these elements implied a qualitative analysis. Quantitative analysis, with the assessment of the risks to capital, liquidity, or funding, was not prioritised by German NCAs. The German SREP process was a qualitative process based on the onsite meetings with Management Board and was very attached to the analysis of ICAAP as well as the risk profile (IMF, 2016; NCA5, 2021). The German SREP mainly focused on regional group-level data with little assessment of the bank's organizational structure. As part of SREP, the Bundesbank organized on-site inspections and reviewed financial information from regulatory reporting and other financial statements, to assess the business model of the banks, and different categories of risks. In line with their assessment, the decision imposed by the German supervisor represented mainly qualitative decisions, as for instance the improvement of the business model (Eurosai, 2017).

Therefore, in both cases, the NCAs developed their own supervisory review process, quite different from the one prescribed by the EBA. As can be seen from the above, the national governments left discretion to the NCAs to develop their own SREP. In both cases the adaptational pressure was therefore important, with a national process largely different from EBA Guidelines/ ECB Methodology. The SSM SREP Methodology mainly relied on ICAAP

provided by the banks. For this reason, below, I also present the ICAAP procedure in place used by the NCAs.

ICAAP did not play a role in the supervisory review by the French NCA, it was purely an informative element (EBA2, 2022). France had largely relied on the regulatory measures, considering that regulatory requirements were more reliable than the banks' self-assessment (EBA2, 2022). The application of the ICAAP in France was based on quantitative and qualitative elements coming from the internal control report which needed to be submitted by institution on an annual basis. LSIs benefitted from discretion granted by the French regulation 97-02[92] on internal control. At the time of the SSM's launch, French banks paid little attention to Pillar 2 and most banks did not prepare the ICAAP (de Prince et Sebbag, 2017). The correlation between the risk assessment framework and the ICAAP was also very limited. This neglect of Pillar 2 requirements was mainly explained by the financial crisis which erupted just after the issuance of the SREP Methodology at the international level (Basel III) and the resulting reinforcement of Pillar 1 capital requirements under CRD IV. The new Pillar 1 capital requirements were sufficiently higher than economic capital requirements under Pillar 2, which explained that French NCA did not implement it (de Prince et Sebbag, 2017). Consequently, the introduction of ICAAP and ILAAP in the SREP assessment was a real change of paradigms for French banks and their NCA (EBA2, 2022; de Prince et Sebbag, 2017).

Unlike France, Germany used its ICAAP as part of its SREP evaluation even before the launch of the SSM. German NCAs largely relied on banks' internal models, and unlike France, it considered that a model developed by the bank itself is the best reference to assess its risk. The implementation of ICAAP was explained in a national guideline issued by the supervisory authorities (*Leitfaden zur Erstellung von Risikoprofilen für systemrelevante und nicht-systemrelevante Institute*) which was used as a basis for assessment. These internal guidelines

[92] Regulation of CRBF 97-02 from 21 February 1997

provided guidance regarding 'the risk identification process, risk quantification and aggregation methodologies, risk bearing capacity definition, data integrity and timeliness and involvement of management in the ICAAP development, design of the reporting system and relevance to decision-making' (EBA, 2018b). Therefore, German banks were already in compliance with ECB requirements before the launch of the SSM.

Therefore, by the end 2014, France and Germany also had very divergent application of their ICAAP and its use for SREP by NCAs. The implementation of SREP and ICAAP was mainly governed by the NCAs themselves with no involvement of national governments through legislation — and was very different at the moment of the creation of the SSM. Therefore, this is a good case to test the hypothesis. To that end, I will assess, to what extent SREP in Germany and France changed between the end of 2014 and the end of 2019. Table 6.2 at the end of this chapter compares the main criteria of SREP in France and Germany in 2014 and in 2019. A significant change in national practice would reinforce the initial hypothesis that despite the discretion the NCAs exercise, they are more likely to change their practice.

When it comes to the changes in SREP in France, the terminology used had changed and this change also corresponded to the changes in national practice. Thus, the NCA *transformed* the ORAP significantly to converge to the SREP Methodology implemented by the ECB for Significant Institutions even before the issuance of the specific methodology for LSIs (IMF, 2019; NCA3, 2019). The ACRP explained such a quick shift by the relative importance and dominant market share of Significant Institutions in France and the socialisation of the French supervisor with ECB and other NCAs (NCA3, 2019). To comply with ECB requirements, in 2018, the ACPR changed the organisation of its LSIs supervision assigning all but three of them to the same division and aligning with more procedural SREP provisions (IMF, 2019; NCA3, 2019). The other seven divisions of the ACPR in charge of banking

supervisions focussed mainly on Significant Institutions, which explains why the ACRP did not want to introduce supervisory specificities for LSIs (NCA3, 2019).

The importance of Significant Institutions implied the participation of French supervisor members in the JSTs and implementation of the SSM Methodology for Significant Institutions which was then used as a reference for LSIs. In such circumstances, the NCA was less likely to create a specific supervisory methodology to apply to LSIs. At the moment of the assessment – at the end of 2019 - the methodology applied by the ACPR for SREP was based on the EBA's SREP Guidelines on common procedures and the Methodology issued by the ECB for LSIs. The documentation published by the General Secretariat of the ACPR regarding SREP, as communicated to the EBA, was 'based on the EBA's SREP Guidelines and referred directly to different orientations and guidelines to address every step of the assessment' (EBA, 2018b). Consequently, in the framework of its SREP assessment, the supervisor complied with EU requirements and applied the four-pillar assessment and analysed the business model, the governance and risk management, the risk to capital, and the risk to liquidity and funding (EBA, 2018b). The implementation of these four pillars was different from what was assessed previously by the French NCA. Indeed, there were similarities in the assessment elements as described by the 97-02 regulation, for example, governance-related questions and different types of risk. However, the business model was a new item that required new skills and additional studies and know-how for banks (NCA3, 2019; PWC, 2017). As required by CRD IV, the supervisor reviewed institutions covered by the supervisory examination programme, on at least an annual basis. Since the implementation of CRD IV, the General Secretariat of the ACPR also fully changed its procedure and applied the methodology recommended by the EBA's SREP Guidelines for ICAAP and ILAAP. The implementation of SREP required a cultural change within the ACPR in limiting the supervisory discretion which was allowed by the ORAP (IMF, 2019; NCA3, 2019). Several LSIs (nine in 2017 and ten in 2018) took part in

a test LSI SREP (IMF, 2019). The test was conclusive for LSIs, and the LSIs SREP had become mandatory to high-priority LSIs since 2018. The ECB methodology was step by step extended to all LSIs by 2020 (IMF, 2019).

By the end 2019, the main changes introduced in its supervisory process by the ACPR concerned the more frequent use of quantitative elements (ACPR, 2019). Under SREP, the ACPR started to examine COmmon solvency ratio REPorting (COREP) and FINancial REPorting (FINREP) instead of SURFI used previously. As mentioned earlier, the ICAAP and ILAAP processes were not used by the ORAP, therefore the compliance of LSI in France took longer than in countries accustomed to using these processes (NCA3, 2019). It was only with the ECB requirements that banking practice in terms of the ICAAP and ILAAP started to change. However, room for improvement remained: for example, the risk identification exercise was often only perceived as a mapping exercise, whereas it should have been the opportunity to analyse the materiality of all risks (de Prince and Sebbag, 2017). In addition, and even if the content of control remained very similar, SREP required a more formalised assessment of credit risk (IMF, 2019). The ACPR also introduced a more procedural approach as requested by the ECB. As for instance under the ORAP, the French NCA could have granted an authorisation provided that the bank produced expected documents within a limited timeframe, whereas the ECB requested all the documents to be given before granting any authorisation (IMF, 2019). When it comes to the assessment of liquidity risk, the introduction of SREP did not constitute a significant change (IMF, 2019). Indeed, ORAP previously included its own liquidity metrics, while with SREP these were replaced by the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

It can be concluded that the French NCA has significantly changed its prudential supervision to comply with EBA and ECB requirements. As described above and summarised in table 6.2, the main changes concerned the methodology used and the items to be analysed

under SREP, notably with the introduction of the business model assessment. The new French SREP process also changed its rating from thirteen elements assessment to a four-range assessment as requested by the EU institutions. Eventually, metrics of credit and liquidity risks changed as well as the type of assessment and basis for reporting. The rare cases of non-compliance concerning on-site inspections under SREP. According to the ECB, one-tenth of establishments were to be visited annually by the NCAs (ACPR, 2019). However, organizational issues — and more specifically the existence of other prioritised institutions and the lack of personnel — did not allow compliance with these provisions (ACPR, 2019; IMF, 2019). The change that occurred in French SREP illustrates a Europeanisation process. As presented in the Analytical Chapter, the analysis in this dissertation considers two types of degrees of change according to the Europeanisation framework – *absorption* and *transformation*. In the case of *absorption*, the national actors change their practice but introduce some adjustments to EU requirements. Whereas in the case of a *transformation*, the national authorities significantly change their national practice to conform to Europeanisation pressure as can be seen in table 6.2 at the end of this chapter. When it comes to the implementation of SREP, it can be considered that the French NCAs significantly changed their practice and that the introduction of SREP in the ACPR supervision corresponds to a *transformative* type of change. Moreover, the change in French SREP occurred even before the introduction of the SSM SREP Methodology for LSIs. This can be explained by the preference of the ACPR to align with Significant Institutions' methodology developed by the ECB and represents the consequences of learning and socialisation pressure exercised by the ECB when NCAs participated in the development of the LSIs SREP methodology (NCA3, 2019). As explained in the Analytical Chapter this learning and socialisation of national supervisors is more likely to lead to *transformative* change which can also be observed here. Therefore, the French case

reinforces the initial hypothesis by illustrating the case of a change in national practice in an area where the supervisor benefitted from discretion.

When it comes to SREP in Germany, BaFin had significantly changed its practice since the launch of the SSM. For an overview of the main elements of SREP in 2014 and in 2019 in Germany please see table 6.2 below. SREP changed from a qualitative approach based on the dialogue between the supervisor and the bank to a more quantitative one (IMF, 2016). Since 2015, the German NCAs introduced more quantitative assessments with a focus on capital and liquidity risks as requested by the EBA in its SREP Guidelines (Eurosai, 2017). BaFin implemented the EBA's SREP Guidelines into the national *Leitfaden Risikoprofile* (German SREP Guidelines) in 2016. And since 2018, the German Supervisor implemented directly the SSM SREP Methodology for LSIs, complemented with national comments. The supervisor provided a Risk profile assessment subdivided into four parts with each of them following a four-grade classification as prescribed by the EBA's SREP Guidelines. As a result, the German supervisor shifted from mainly qualitative analysis to introducing quantitative measures.

In 2017, BaFin amended its Minimum Requirements for Risk Management (*MaRisk*) to align its SREP process with the EBA's SREP Guidelines. For instance, BaFin amended AT module 4.1 on internal capital and requested that internal capital adequacy levels corresponded to the levels required to ensure the business continuity and impact of economic losses. In the same vein, BaFin introduced a new AT Module 4.3.4 on Data management, data quality, and risk data and BT Module 3 on risk reporting. BaFin also changed its practice on the recommendations it could issue, by introducing additional capital requirements as foreseen in the EBA's SREP Guidelines (Eurosai, 2017). As a result, the German supervisor set individual capital requirements for some 303 LSIs in 2016 (BaFin, 2017). On 23 December 2016, BaFin also issued a general order on capital requirements for interest rate risk in the banking book applicable to all LSIs which did not benefit from the individual measures (BaFin, 2017).

In 2017, the German NCAs introduced an additional change – overall capital requirements for individual institutions using the Pillar 1 plus approach (BaFin, 2017). This approach added to Pillar 1 risks other risks quantified by their ICAAP. ICAAP itself also changed to comply with the SSM Methodology for LSIs. In 2020, BaFin amended the German Financial and Risk-bearing-capacity information Ordinance (*FinaRisikoV*) to implement the EBA Guidelines on ICAAP and ILAAP by introducing additional reporting information.

As can be seen from the above and as summarised in table 6.2 below, Germany also significantly changed its SREP mechanism. German supervisor shifted from its own model to SSM SREP Methodology for LSIs and introduced a quantitative assessment, especially the assessment of capital adequacy and liquidity risks that were set aside in the previous version of SREP. To conclude, confirming the expectations from the hypothesis as with the French case, the German NCAs completely *transformed* their national practice in implementing the German SREP to LSIs while benefitting from discretion. This significant change can also be explained by the socialisation of German NCAs. In this vein, the previous President of BaFin, Felix Hufeld stated when presenting the harmonisation of the SREP review that the performance of SREP was linked to 'the impressive sense of collegiality and togetherness that has developed between the ECB and representatives of the national supervisors when tackling a common task' (BaFin, 2020). By this statement, BaFin illustrated the socialisation of German NCA members and the creation of a common culture among NCAs and the ECB, which could explain the convergence of prudential supervision in Germany. In the same vein, according to the EBA, the convergence was explained because of the involvement of national supervisors in the negotiation and appropriation of EU preferences by the NCA (EBA2, 2022).

6.4 Conclusion on the convergence of national SREPs

SREP is a process that is controlled principally by the national supervisor with no intervention of the national government. Since the creation of the SSM and as of the end of 2019, the EU institutions have regulated this area with soft law provisions. First, in 2014, the EBA issued SREP Guidelines indicating a methodology consisting of four elements to elaborate on SREP and the measures that NCAs could take. The EBA's SREP Guidelines left some margin of manoeuvre to the NCAs, notably to adopt stricter requirements. For specifically Banking Union member states, prior 2018 there was no orientation, nor guidelines issued by the ECB applicable to SREP for LSIs. The ECB issued a SREP Methodology for LSIs only in 2018. The latter was based on the EBA Guidelines but went further. The ECB Methodology was initially only applicable to high-priority LSIs but was, in 2020, widened to cover all LSIs. NCAs maintained their discretion thanks to the 'constrained judgement' principle applicable by the ECB. As was expected from the hypothesis developed in the Analytical Chapter, despite the discretion exercised by them, the NCAs applied the ECB Methodology beyond the mandatory cases even before 2020, thus changing their national practice.

The third section of this chapter applied the hypothesis to two national cases. At the moment of the creation of the SSM, both French and German authorities had very different existing national SREP methodologies. In France, the supervisory review was based on the ORAP methodology, and the banks did not systematically provide the ICAAP to the supervisor. In Germany, SREP followed a more procedural and qualitative approach, very different from the one designed by the EBA and the ECB. Unlike in France, the ICAAP was well developed and integrated into SREP.

With the implementation of the EBA's SREP Guidelines and then of the SSM Methodology for LSIs and, despite the NCAs' margin of manoeuvre, both supervisors significantly changed their supervisory review practice. In France, the NCA changed its SREP to LSIs even before the introduction of the SSM Methodology for LSIs, basing its new approach

on the ECB's Significant Institutions SREP Methodology. The ACPR changed its internal regulation to introduce some qualitative elements as requested by the EBA and developed on-site inspections. In Germany, the supervisory review also changed significantly. First, BaFin integrated the EBA's SREP Guidelines into the internal guidelines and then transposed the SSM LSI Methodology directly with national comments. With the implementation of EU requirements, the German SREP introduced more quantitative assessments based on the 4 x 4 scoring matrix as provided by the EBA's SREP Guidelines. This significant change observed in both member states can mainly be explained by the learning and socialisation process preceding the development of the SSM LSI SREP Methodology favouring cooperation and co-development with NCAs.

In conclusion, SREP illustrates a typical case where the NCAs exercised discretion to change their national supervisory practice. And despite this discretion, the NCAs changed their practice to be more in line with EU/ Banking Union requirements. It illustrates a case of national supervisors' socialisation and changes in preferences to comply with EU-level requirements. As such, this confirms the initial hypothesis on the greater likeliness of change in the cases governed by national supervisors.

Table 6.1 Comparison of SREP across Euro Area NCAs as of end of 2019

EBA requirements	Austria	Belgium	Cyprus	Estonia	Finland	France	Germany	Greece	Ireland	Italy
Assessment of business model	yes	yes	yes	yes	yes	Yes	yes	yes	yes	yes
Assessment of Internal governance and risk management	yes	yes	yes	yes	yes	Yes	yes	yes	yes	yes
Assessment of Capital risks	yes	yes	yes	yes	yes	Yes	yes	yes	yes	yes
Assessment of liquidity risks	yes	yes	yes	yes	yes	Yes	yes	yes	yes	yes
Quantitative assessment	yes	yes	yes	yes	yes	Yes	less important	yes	yes	yes

Qualitative process	yes	yes	yes	yes	yes	Yes	yes, categorization in 4x4 matrix according to their quality and impact	yes	yes	yes
Continuous process	In line with EBA Guidelines, annual updates and, full	In line with EBA Guidelines, variable depending on the	The frequency depending on the size, scale, and		Assessments are conducted on an on-going basis	At least annually, transposed into national legislation	Updates once a year, on-site review every one	In line with EBA Guidelines	Annually, can be more often for larger banks	annually

	assessment frequency depending on the categorization of the institution	size and riskiness of the bank	complexity of the institutions		throughout the year.		to three years depending on minimum engagement levels once a year for larger banks			

EBA requirements	Latvia	Lithuania	Luxembourg	Malta	The Netherlands	Portugal	Slovakia	Slovenia	Spain
Assessment of Business Model	yes	yes	yes	yes	Yes	yes	yes	yes	yes
Assessment of Internal governance and risk management	yes	yes	yes	yes	Yes	yes	yes	yes	yes
Assessment of Capital risks	yes	yes	yes	yes	Yes	yes	yes	Yes, using its own	yes

								RAS methodology	
Assessment of liquidity risks	yes	yes	yes	yes	yes	yes	yes	Yes, using its own RAS methodology	yes
Quantitative assessment	yes	yes	yes	yes, according to the Risk Assessment tool (RAT)	Yes	yes	yes	yes	yes
Qualitative process	yes	yes	yes	yes, according to the Risk	Yes	yes	yes	yes	yes

				assessment tool (RAT)					
Continuous process	According to the EBA Guidelines	NA	at least once a year	In line with EBA Guidelines	At least every two years	Frequency depends on the potential impact each institution may have	Depending on the bank risk profile, on -site inspection from 6 to 24 months or continuous monitoring	at least once a year	Annually

Source: own compilation in 2021 with information available in the EBA supervisory disclosure

Table 6.2 Evolution of SREP in Germany and France

	Germany in 2014	**Germany in 2019**	**France in 2014**	**France in 2019**
General overview of SREP	Own model, partial reliance on external auditors, assessment based on a four-risk categories matrix but with descriptive criteria	German supervisor implemented the SSM-LSI-SREP methodology 4 grade classification according to the LSI-SREP methodology	ORAP analysis of SURFI Report, the French supervisor already applied a holistic approach combining scoring and expert judgement and used the internal Risk Assessment System (RAS) based on thirteen items. Each item is analysed either as one of the thirteen individual indicators or as an integral	Converged to SREP methodology for SIs even before the issuance of the methodology for LSIs: Four-pillar assessment and analyses the business model, the governance and risk management, the risk to capital and the risk to liquidity and funding

			part of these thirteen criteria	
Business Model	Yes, main focus	Yes	No	New assessment introduced
internal governance and control arrangements	Yes, main focus (very strong ICAAP under MaRisk)	Yes	Yes, stress test model	Yes
Capital adequacy	Not prioritised	Yes	The level, structure and permanence of regulatory capital	Yes

Liquidity risk	Not prioritised	Yes	Yes, based on internal metrics	Yes, based on Liquidity Coverage Ratio and the Net Stable Funding Ratio
Frequency	At least annual	Annual	At least annually or more frequently for more risky institutions	Annual
Type of assessment qualitative/quantitative	Qualitative mainly	Shift for quantitative analysis	Examination of SURFI reporting, with quantitative elements, but less extended	Examining COREP and FINREP, with more quantitative elements
Level	Group level data only	Individual bank and group level requirements	Individual and group level	Generally at group level but SREP is also conducted at solo level
Use of ICAAP	Yes, based on internal guidelines	Yes	No ICAAP and ILAAP examination	Introduction of ICAAP and ILAAP

On-site inspections	Yes	Yes	Yes	Yes but did not achieve the level of 1/10

Source: BaFin (Germany); Banque de France

Chapter 7 Conclusion

This dissertation began with the observation that the creation of the EBA and then of the SSM, which had the objective to ensure consistent supervision in the EU or Euro Area, did not completely eliminate the divergence in national supervisory practice. While the ECB assumed control over the direct supervision of Significant Institutions, LSIs remained the responsibility of national supervisors. This distinction created the potential for divergence in the supervision of LSIs across Banking Union member states. This divergence could result either as a consequence of EU legal provisions, which left some margin of manoeuvre to national authorities or as a result of the national implementation of prudential supervision. The objective of this dissertation was to assess how existing domestic institutional settings impact the convergence of national systems. To that end, I defined the following main overarching question to guide my research:

Under what conditions do pre-existing national institutional configurations continue to determine the trajectory of national supervisory practice in the context of European-level convergence pressures (the creation of the EBA and the SSM)?

In this conclusion, I will first summarise the main findings presented in this dissertation to answer the research question (7.1). I will apply these findings to the two shadow cases – Luxembourg and Estonia (7.2) and will then present the main implications of the study and policy recommendations (7.3).

7.1 Main findings – preference of national supervisors in favour of convergence of prudential supervision in the EU

To answer the research question, in Chapter 2, I defined a composite analytical framework and tested an hypothesis based on combination of Europeanisation, Historical Institutionalism, Epistemic Communities and Transnational Policy Networks. I used the mechanisms of *absorption* and *transformation* from the Europeanisation framework to define the changes in national supervisory practice. When national authorities changed their prudential supervision, it was expected that national practice would converge with EU requirements. However, according to Historical Institutionalism, I argued that national legislation represented the well-entrenched position of member states and was less likely to change due to institutional and political difficulties in bringing about change. Yet national supervisors, operating as part of an Epistemic Community/ Transnational Policy Network, could make use of their discretion to trigger the change in national supervisory practice. This positioning and change were explained by the fact that national supervisors' preferences were expected to be closer to those developed at the EU level due to socialisation pressures and the learning process. In Chapter 3, I provided an overview of how the EBA and the ECB promoted convergence of prudential supervision in the EU through binding and non-binding provisions but also through the cooperation possibilities they offered. However, in both cases, the decision-making framework granted a prominent position to NCAs, which both helped the latter to upload their preferences to the EU level and facilitated the adaptation of their practices to EU requirements.

The explanatory causal mechanism derived from the four above-mentioned analytical approaches tested in the case studies selected for their importance for the effective functioning of prudential supervision within Banking Union. I provided a comparative analysis of the supervisory frameworks of two national cases, German and French, on the grounds of their relative importance to the agreement on and successful operation of the SSM. First, I specified the main areas of supervision that granted discretion through the examination of ONDs. Then I tested two additional thematic cases chosen to provide variation on the independent variable:

first, a case where national governments were expected to intervene — NPLs; and, second, a case which gave discretion to the national supervisors with no intervention of the national government — SREP. Here I summarise the outcome of the analysis starting with ONDs, and then proceeding to NPLs and SREP.

Options and national discretions

As presented in Chapter 4, ONDs are provisions that give choice to national governments or the NCAs on how and whether to apply a prudential provision. ONDs can be addressed to national governments or NCAs. Regarding ONDs addressed to national governments, the latter made use of the discretion granted to them to maintain the status quo. Moreover, the ECB did not have the competence to exercise pressure for the convergence of member states' ONDs which left full discretion to national governments. This is mainly explained by the fact that these ONDs were granted to national governments to limit change and to keep national specificities.

For NCAs' ONDs, despite the fact that national supervisors were also granted these ONDs to maintain the pre-existing national setting, they followed ECB recommendations. They significantly changed their national practice by *transforming* their supervisory practice whenever they benefitted from the discretion granted to them by national governments. Whenever the supervisor had less margin of manoeuvre, with its discretion subject to an initial legal intervention, the change was less significant and corresponded to the *absorption* category of change. In the cases where national supervisors could exercise discretion with no intervention from the national government, the change in their practice was explained principally by the fact that NCAs participated in the ECB working groups on the convergence of ONDs. This collective work facilitated a common understanding of the topic and the convergence of preferences with those of the ECB, which in turn led to a convergence in national practice.

However, where the NCA's discretion was subject to national government intervention, and less subject to EU-level socialisation pressure, change was more limited or did not take place.

Non-performing loans

The first thematic case analysed in this dissertation was the definition and management of NPLs. NPLs were chosen as a typical case requiring national legal intervention. The definition of non-performing exposures was provided by the EBA in 2013. However, regarding the management of NPLs at the EU level, several parallel interventions from the ECB, the EBA and the Commission, with divergent provisions, illustrate the lack of cooperation — let alone coordination — on the part of the main EU institutions involved. This divergence left discretion to national authorities and was mainly explained by different national government preferences regarding the definition of NPLs. Regarding their implementation, this thesis has shown that member states introduced the EU definition of NPLs but added additional national criteria, thus maintaining divergence. In the same vein, regarding the management of NPLs, national supervisors also introduced national specificities, thus limiting convergence.

According to the expectation derived from the adopted analytical framework, national governments used their intervening power to limit change in national practice. Through comparative analysis, this dissertation argues that a transformation in the national definition of NPLs in Germany can mainly be explained by the fact that no definition of NPLs was provided by the German government, thus allowing more discretion to the national supervisor, whereas in France the change was more limited by the active intervention of the French government. When it comes to the management of NPLs in both cases, change was limited by national government intervention.

Supervisory Review and Evaluation Process

The second thematic case analysed in the thesis concerned the Supervisory Review and Evaluation Process. This is a process which gives discretion to national supervisors with no or limited intervention from national governments. The EBA and the ECB issued soft law provisions to guide national supervisors in their implementation of SREP. Thus, the ECB issued a SREP Methodology for LSIs in 2018, but national supervisors maintained some discretion in the implementation of SREP. Despite the differences existing before the creation of the SSM, the NCAs radically changed their national practice and applied SSM requirements even, for some of them, beyond mandatory cases — i.e., beyond high-priority LSIs. The observation was also confirmed in the cases of French and German NCAs which both radically changed their national practice and complied with the ECB Methodology. This Methodology was developed in cooperation with NCAs based on their best practices, which explains the compliance of national supervisors with these new requirements.

My analysis has shown that convergence of banking supervision in member states is more likely when national supervisors can exercise discretion with regard to their national governments. Given the observation of change in the cases where national supervisors benefitted from discretion as predicted in Chapter 2, the tested hypothesis was confirmed. There is a real dichotomy observed between the position of national governments and national supervisory authorities. As a consequence, this thesis challenged the expectation that national authorities, be they elected or non-elected, would have the same preferences on prudential supervision within the SSM. Indeed, national governments were expected to support supervisory convergence with the aim of better insuring financial stability. Moreover, EU institutions, notably the ECB and the EBA, also placed significant pressure on national governments to converge. However, in practice, national government preferences were shaped by factors in addition to issues surrounding effective banking supervision which explains why they were more in favour of the preservation of divergent national practices. As presented

throughout this thesis, national governments defended national specificities and limited change in those areas that remained subject to their legislative intervention. In some cases, divergent national competences also resulted in different outcomes at the level of EU institutions, as can be illustrated with the case of NPLs where the ECB and the European Commission initially issued contradictory provisions.

In contrast, despite their longstanding nationally distinct supervisory practices, which might have created resistance to change from national supervisors, the latter used their discretion to converge their supervision of LSIs to ECB practice on Significant Institutions whenever there was no national government legislative intervention limiting their actions. This NCA positioning is principally explained by the socialisation of NCA officials through their participation in different working groups, cooperation within decision-making bodies and both formal and informal exchanges.

7.2 Shadow cases – the convergence of prudential supervision in Luxembourg and Estonia

In this thesis, I focused upon the two case study member states with the EU's largest banking sectors — Germany and France. However, these member states are expected to have already uploaded their preferences at the EU level, thus facilitating their implementation of EU provisions and therefore convergence. The case studies presented in this thesis also show that EU/ Banking Union provisions were based on national best practices. One can expect that these best practices correspond to the capacity of a given member state to upload its preferences to the EU level, which is more likely for the largest and more longstanding EU member states, and notably France and Germany. This capacity of national authorities to upload their preferences also facilitates their compliance with EU requirements and therefore convergence

to EU standards. For instance, SREP adopted at the EU level was also a combination of best practices from these two member states. Moreover, France and Germany had banking systems largely dominated by national banks, resulting in government efforts to upload their preferences to the EU level in order to create a supervisory framework sufficiently adapted to their domestic banks. The generalisability of the analytical framework adopted in this thesis can be further established by testing the main hypothesis with regard to other member states and notably those with very different — specifically, more internationalised and smaller — banking systems.

In order to validate the main hypothesis of this thesis, I will thus briefly test it with regard to two other EU/ Banking Union member states with lower levels of banking assets. Estonia is a member state with one of the lowest levels of banking assets (after Latvia) in the Euro Area. The second shadow case is Luxembourg, which also represents a relatively low level of banking assets in absolute terms. However, the Grand Duchy also has the highest level of banking assets in the EU in relation to national GDP. In absolute terms, total banking assets in Estonia represented €22 billion and €811 billion in Luxembourg by the end of 2014, and €34.4 billion and €1.2 trillion, respectively by the end of 2020 (EBF data). These figures are to be compared to €7 trillion and €8.9 trillion in Germany, and €7.2 trillion and €10.5 trillion in France by the end of 2014 and by the end of 2020 respectively (EBF data). Both member states also have a low relative presence of domestic banks. Estonia and Luxembourg are dominated by foreign banks: 80 per cent of bank assets in Estonia and 94 per cent in Luxembourg were held by foreign banks in 2022 (EBF data). In Germany and France, national government resistance might have been expected with the aim of defending national banks. In the cases of Estonia and Luxembourg, there was less potential government interest in defending national banks. Still, there was greater interest in diminishing the causes of banking system instability through the stringent application of prudential supervision. In 2022, three institutions in Estonia and five in Luxembourg were considered Significant Institutions and were directly supervised

by the ECB. The remaining institutions — eight in Estonia and circa sixty in the case of Luxembourg — were LSIs and thus supervised by national competent authorities.[93]

During its EU accession negotiations, Estonia followed EU provisions closely and transposed EU bank regulation into national legislation with no deviation (Juuse, 2015). However, the transposition of legal provisions was not followed by implementation in practice, a divergence that can largely be explained by overregulation, with the national transposition of regulatory provisions which did not have any relevance in the national banking system (Juuse, 2015, Juuse et al., 2019). According to the chairman of the Estonian supervision and resolution authority, Finantsinspektsioon (FSA) — Kilvar Kessler (2022) — the creation of the SSM had a catalytic effect in fostering a common culture among national supervisors, cross-fertilisation, and best practice sharing and adoption. Kessler (2022) also points to the impact of the national supervisor's staff's involvement in the SSM supervisory activities, including Estonia's three Significant Institutions. This involvement triggered a cultural change in national supervision, from a more legalistic approach prior to the creation of the SSM, shifting to a more dialogue-oriented supervision. The exchanges with other NCAs were of great importance in the development of Estonian supervision. The Estonian NCA combined its efforts with other Baltic States with staff participating in different JSTs on the basis of specialisation on specific topics rather than on the national origin of the bank (Kessler 2022). For instance, Estonian supervisors were responsible for credit risk for banks in the Baltic States, whereas Latvian supervisors were responsible for market risks in the same banks.

Luxembourgish authorities were also in favour of the creation of centralised supervision within Banking Union (Howarth and Quaglia, 2016a; *L'Essentiel*, 2012). The Luxembourgish supervisor is the CSSF (*La Commission de Surveillance du Secteur Financier*) in cooperation

[93] ECB website, list of all supervised entities as of July 2022, available at: https://www.bankingsupervision.europa.eu/banking/list/html/index.en.html, consulted on 05/11/2022

with the Central Bank of Luxembourg (BCL). The BCL is in charge of the supervision of liquidity and macro-prudential supervision, whereas the CSSF is in charge of day-to-day supervision. Both authorities are represented in the Supervisory Board of the SSM and receive the same information. The sharing of responsibilities between the BCL and the CSSF and their cooperation is governed by a Memorandum of Understanding (NCA1, 2017). Since the creation of Banking Union, the CSSF and the BCL have also provided their expertise to the ECB and encouraged their staff to collaborate with the ECB in order to foster a common culture among national supervisors (CSSF, 2015; NCA1, 2017).

When it comes to the thematic case studies analysed in this dissertation, Estonia and Luxembourg have declared compliance with EBA guidelines on SREP methodology as can be seen in Chapter 6. The Finantsinspektsioon in Estonia applied SREP to LSIs under its jurisdiction. The FSA also established national guidelines[94] to explain the EBA Guidelines on the Supervisory Review. In the same vein, in Luxembourg, SREP was implemented through CSSF regulation[95] which applied EBA Guidelines in the national framework. In 2018, the CSSF applied the Common Methodology to high-priority LSIs (CSSF, 2019). The CSSF also confirmed that the Common Methodology issued is a result of a collaboration between NCAs and the ECB (CSSF, 2020). In both national cases, NCAs have implemented EU requirements on SREP into national practice which, as a consequence, confirms the main hypothesis of this thesis regarding the convergence of prudential supervision.

With regard to NPLs, in Estonia, the main guidelines for NPLs used by the national authorities are the EBA's ITS and there were no specific national provisions related to NPL management. According to the national Credit Institution Act, Estonian supervision has the legal right to request a write-down of assets (ECB, 2017g). Estonian authorities recognised that

[94] Issued on 13/03/2015

[95] CSSF regulation 15-02 relating to the supervisory review and evaluation process that applies to CRR institutions (Article 21)

the treatment of NPLs was not harmonised in the EU. For instance, the former Estonian finance minister, Tomas Toniste, stated:

> 'Non-performing loans are a problem for the banking industry for which solutions have until now been mainly defined at the national level. We need to free up these resources, make our financial system more resilient and prevent the re-emergence of NPL issues in the future' (Finantsinspektsioon, 2017).

At the same time, the Estonian NCA encouraged a convergent response from supervisors. In November 2017, Kilvar Kessler gave an introductory presentation at the international conference 'Reflections on the cooperation between ECB/ SRB and NCA/ National Resolution Authorities in the SSM/ SRM' during which he stated that the attention of supervisors on the NPL issue must be consistent and strong and that it is important to require banks to have sufficient buffers (Finantsinspektsioon, 2017). According to the Estonian NCA, one of the key elements for dealing with NPLs is constructive cooperation with banks, central banks and partner supervisory authorities (Finantsinspektsioon, 2017). Estonia tackles NPLs principally through the imposition of strong coverage ratios on banks.

In Luxembourg, due to a low level of NPLs, national authorities did not issue any specific guidance on NPLs or the definition of NPLs. The CSSF applied in a proportionate manner the ECB Guidance to LSIs under its supervision (ECB, 2017g). As a consequence, the Luxembourg NCA transposed the ECB Guidance which was foreseen for Significant Institutions to Luxembourgish LSIs with no binding requirement asking them to do so. The CSSF also adopted EBA Guidelines on the management of non-performing and forborne exposures and the Guidelines on disclosure of these exposures (see circular 20/751). As a consequence, the case of NPLs also confirms the initial hypothesis tested in this thesis. In the case of Estonia, a strong national legislative framework maintained national specificities in the treatment of NPLs, whereas in Luxembourg, in the absence of national government

intervention, the national supervisor implemented the EU provisions for banks under its supervision.

7.3 The main implication of the study and policy recommendations

The SSM introduced centralised supervision in the EU by transferring the supervision of Significant Euro Area banks to the ECB. However, this centralisation was not complete and relied on NCAs, notably with regard to the supervision of LSIs. Moreover, the development of new procedures and rules also involved the SSM's NCA members. Despite this incomplete centralisation, the main implication of this study is that providing national supervisors with discretion is favourable for the convergence of prudential supervision in Banking Union and the EU. The combined Europeanisation – Historical Institutionalism analytical framework applied in this thesis offers insight into the reasons for different speeds and, in some cases, even *inertia* in the convergence of prudential supervision in the EU. The Epistemic Community approach and Transnational Policy Network framework provide an explanation of the development of the preferences of national supervisors, which converge their practice towards ECB requirements. This study complements the Europeanisation literature on banking supervision and introduces domestic-level factors that influence change and apply it to Banking Union (Howell, 2004a; b; Quaglia, 2008). This study also adds to the Historical Institutionalist literature on the SSM (Glöcker et al., 2017; Schimmelfennig, 2016). Combining four analytical frameworks, it complements the range of studies on prudential supervisory convergence in the EU. It goes further by providing an in-depth analysis of specific prudential provisions and their implementation by member states. This dissertation also spells out an additional explanatory mechanism to account for the differences in the convergence of supervision within the same member states. In terms of future research that could build on my analysis, larger quantitative studies could be conducted on all Banking Union NCAs, or even on non-Banking Union NCAs,

to assess how they interact with EU institutions and implement EU supervisory requirements at the national level.

To conclude, a certain number of policy recommendations can be derived from the analysis developed in this thesis. First, the findings imply that in order to reinforce supervisory convergence within Banking Union, efforts should be undertaken to further strengthen the socialisation mechanisms involving the SSM's NCA members and the ECB. As noted in this dissertation, national supervisors are favourable to such a development and encourage exchange opportunities with other NCAs and the ECB. At the same time, this dissertation showed that national governments often have national biases and, as a consequence, use ONDs to defend pre-existing national settings. A deeper development of Banking Union and its other pillars would limit biases, for instance, reducing the differences in the treatment of failing banks. Further harmonisation of the Single Rulebook, relying on regulations instead of directives and eliminating member states' ONDs could also further restrict diverging national supervision.

Furthermore, if discretion is to be granted within EU legislation and within the SSM, it is better to give it to non-political institutions such as NCAs. National supervisors are part of an Epistemic Community/ Transnational Policy Network and are, therefore, more likely to have similar preferences, which will facilitate convergence with ECB standards. Eventually, granting the ECB with a more important role in the supervision of LSIs — at least for high-priority LSIs — could also facilitate exchanges with NCAs and trigger convergence.

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Annex

Annex - Executive summaries of informal interviews

Summary table

Date	Code	Type of institution
28/11/2017	NCA1 2017	NCA
23/05/2019	Bank 2019	Bank
22/08/2019	NCA2 2019	NCA
09/09/2019	NCA 3 2019	NCA
15/09/2019	EBA1 2019	EBA
22/04/2021	NCA4 2021	NCA
21/05/2021	NCA5 2021	NCA
05/04/2022	EBA2 2022	EBA
19/04/2022	ECB 1 2022	ECB
13/05/2022	ECB2 2022	ECB
21/06/2022	BSE 2022	Industry association

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	NCA 1 2017
Institution/type of institution	NCA
The function of the interviewees	Legal councils
Date and place of interview	28/11/2017 in Luxembourg
Duration	c. 1:30
Topic	Competence sharing between the SSM and national competent authorities

The interviewees presented the distribution of competence between the SSM and NCAs. National organic law, which governs the internal functioning of the NCA, goes back to 2008. These changes were the consequences of the financial crisis when some foreign banks had liquidity issues. The financial crisis led to the de facto cooperation between the CSSF (*Commission de Surveillance du Secteur Financier*) and the BCL (*Banque centrale du Luxembourg*), with the latter being responsible for liquidity monitoring for all operators and not only banks. The distribution of competence between the CSSF and the BCL was based on a flexible internal separation system which is not regulated by law. The reforms at the EU level and the introduction of the SSM did not lead to the modification of the organic law. Changes in national organisations derived directly from the EU law.

Both institutions – the CSSF and the BCL – have representatives on the Supervisory Board and Governing Council and receive the same documentation. So theoretically, no strict division of roles was foreseen. However, the interviewees highlighted that the BCL was independent, whereas the CSSF depended on the minister.

The interviewees also stated their position in favour of deregulation at the national level and regulation at the EU level. When an EU measure was available, interviewees claimed that national supervisors always applied EU rules instead of pre-existing national rules but sometimes with some delay.

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	Bank 2019
Institution/type of institution	Financial Institution
The function of the interviewee	Prudential regulation expert
Date and place of interview	23/05/2019 in Paris
Duration	c. 1hour
Topic	Implementation of prudential requirements by financial institutions

The interviewee worked for the Risk Management directorate of the bank. This directorate defines the risk limits by business lines and by significant types of risks in cooperation with operational departments.

During phase 2 of the Asset Quality Review (AQR), the ECB audited the bank's collective provisioning model. The ECB introduced significant changes in banks' classification of loans compared to the ACPR requirements, which prevailed before the SSM. Consequently, loans had to be classified as PP for fully performing, WL for watch list and NP for non-performing. The ECB also required changes in the bank classification of some loans from the watch list to non-performing. For instance, the interviewee indicated that the bank used transaction risk to tag non-performing loans. In contrast, the JST required the bank to use counterparty risk, which extended the qualification of non-performing to all loans of the same counterparty, even if the latter did not experience any payment default on a specific loan. The creation of the SSM also implied organisational changes within the bank. For instance, the bank did not have any risk directorate before 2016 and only relied on a commitment committee.

The interviewee indicated that such changes required from the new supervisor implied additional human and IT costs. The interviewee also stated that a specific department was created within the bank to implement changes required by the new SSM supervisor. However, the interviewee considered that despite the human and financial investments to comply with

ECB requirements, the bank could only implement some changes required by the ECB in the given time lap.

Annex

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	NCA2 2019
Institution/type of institution	NCA
The function of the interviewee	Supervisor
Date and place of interview	22/08/2019 online
Duration	c. 45 minutes
Topic	Convergence of prudential supervision with a specific focus on NPLs

The interviewee worked for the SSM coordination unit of a NCA and dealt with the Guidance on NPLs for LSIs. The interviewee considered that with the introduction of the CRD V package, many provisions were transferred from the directive to the regulation and therefore became directly applicable. However, according to the interviewee, a reverse movement was also observable as a consequence of national negotiations and preferences (e.g. the principle of proportionality).

Some national specificity influenced the outcome of SSM provisions on NPLs. For instance, the management of NPLs stocks was initiated by France and was then taken over by the European Commission. Another example is the tax law which influences the management of NPLs, e.g. in Italy; there was an incentive to hold NPEs; in other countries, there were incentives to write them off. Member states' preferences could also be influenced by their national insolvency laws (e.g. France).

The interviewee gave a few elements which, in his view, influence the preferences of member states:

- First national tradition can play a role. For instance, Cyprus practices recovery by seizure of assets. France does not use mortgage loans like other member states but requires real estate deposits.
- National banking system structure, for instance, the three-pillar banking system in Germany. Similarly, home countries and host countries will have different preferences.

From a general perspective, the interviewee considers that national banking supervision had specificities, but it tends to fade. For example, the number of cross-border mergers of LSIs is increasing, which shows the ability of banks to integrate structures from other member states.

According to the interviewee, the national supervisory authorities tend to converge, as illustrated by on-site inspection models. There was a porosity of on-site inspections; the JSTs were mixed teams and involved a large number of NCAs staff. In addition, NCAs' agents carried out missions at the ECB and could intervene in other countries. The Interviewee considers that the ECB established a sort of 'Erasmus' for creating a common culture and exchanging good practices and information among supervisors. This was also promoted at the political level by the executive management of the NCAs. The interviewee also mentioned the impact of training courses in Frankfurt and Florence, the objective of which was to harmonise prudential supervision across EU member states. In conclusion, the interviewee considers that there is little difference in prudential supervision of NCAs but lots of common.

Annex

Interviewer	Farida Valieva, PhD student University of Luxembourg
Code	NCA3 2019
Institution/type of institution	NCA
The function of the interviewee	Supervisor
Date and place of interview	09/09/2019 online
Duration	c. 1 hour
Topic	Convergence of prudential supervision

As a preliminary point, the interviewee mentioned that LSIs are historically less important in France than in other countries such as Germany, given the concentration of the sector - this tends to reduce the specificities of prudential supervision of LSIs in France because the supervision of Significant Institutions focuses attention and serves as a reference. For instance, the Less Significant Institutions Supervision Department was only one of the NCA's eight banking supervision departments.

Convergence of SREP

The interviewee considers that significant changes for SREP are related to EU regulatory development and soft law provisions. The EBA SREP Guidelines and the ECB SREP LSI methodology triggered harmonisation at the national level. NCAs benefitted from 'comply or explain' mechanism, which in most cases resulted in compliance rather than explanation. According to the interviewee, the compliance was explained by the development of the LSI SREP Methodology, which involved networks of ECB and NCA experts. DG MS III of the ECB also used NCAs feedback and then validated by the Supervisory Board.

However, the interviewee also stated that in the national supervisors' view, the new SREP was based much more than before on standardised data and filling in templates. The terminology of 'SREP' was also new in France at the time. The broad outlines of the risk assessment under SREP and the previous French ORAP methodology remained the same. Moreover, the SREP methodology also took into account some French national specificities

(e.g. the use of real estate guarantees instead of a mortgage loan, the waiver for 'Livret A' – a saving account managed by *Caisse des Dépôts et des Consignations*, and governance of mutual banks concerning the degree of independence granted to local bodies and the ownership of central entities by local bodies.

The interviewee considers national practices increasingly integrated, which can also be illustrated by the same IT systems used by the NCAs and the ECB. Some practices evolve more or less quickly – e.g. the so-called ICAAP and ILAAP processes were not part of French national methodological habits, bringing institutions into compliance with the requirements in this area logically took longer than in countries that used these techniques; conversely, France was more rehearsed in terms of controlling internal models, and this gap is narrowing.

Harmonisation of NPLs

Regarding NPLs, the interviewee considers the change to be significant since the concept of non-performing loans appeared with the SSM. Many French supervisors discovered the terminology of NPLs during the AQR of 2014. Previously French NCAs used the "Basel default" (unpaid to 90 days), with accounting concepts for the provisioning of doubtful customers, which responded to similar concerns. There was still divergence regarding the provisioning of old NPL stocks, even within the EU authorities. Legal, institutional, prudential and circumstantial viewpoints could lead to different conclusions.

The interviewee gave an example of slight national resistance in France, which is the control of NPLs that was formerly done according to an expert opinion by looking first and foremost at the most interesting files that presented irregularities or were less provisioned than other loans, etc. The ECB encouraged the deployment of inspection techniques based on statistical sampling, which was more systematic but required more resources, which the NCA sometimes considered inefficient development.

Annex

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	EBA1 2019
Institution/type of institution	EBA
The function of the interviewee	Policy expert
Date and place of interview	15/09/2019 online
Duration	c. 30 minutes
Topic	the EBA's role in convergence

The Interviewee is a policy expert at the EBA. The interviewee pointed out the Reports on the convergence of Supervisory practices that the EBA issues each year. These reports listed the tools at the EBA's disposal to promote convergence. In the Interviewee's view, the convergence was facilitated by the fact that NCAs staff was involved in the EU-level decision-making processes. For Banking Union member states, it was reinforced by JSTs composed of NCAs members. Within the EBA, the interviewee mentioned exchange forums for national supervisors, which facilitated their cooperation and exchange of information on a day-to-day basis.

One of the main tools to promote convergence is regulatory and policy products. The EBA governance also implied national supervisors. The main governing body is the Board of Supervisors which is composed of national supervisors from all EU member states and the EBA Chairperson. Decisions are taken by a majority vote, and the type of majority depends on the decision to be taken. The second decision-making body is the Management Board which is composed of six national supervisors and the EBA Chairperson. The Management Board takes decisions by simple majority. National supervisors' members are also present in Standing Committees. The interviewee considers that the EBA has more of an objective view. The EBA drafts a proposal and asks for views. If there is a strong view, it goes to a Standing Committee to present opposition. If there is strong opposition, the Board of Supervisors decides (at a majority voting).

‘Comply and explain’ procedure is also used to facilitate convergence. In addition, the EBA organises training online (e.g. training on SREP in March 2019). EBA also monitors compliance with products to check supervisory convergence and organises visits and reports. Eventually, the interviewee mentioned the Q&A tool, which facilitates a consistent application.

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	NCA4 2021
Institution/type of institution	NCA
The function of the interviewee	Supervisor
Date and place of interview	22/04/2021 online
Duration	c. 1 hour
Topic	Convergence of prudential supervision

The interviewee works for a NCA and was a member of JST for a German National Promotional Bank between 2016 and 2017. The interviewee indicated that he is not familiar with NPL issues because he worked with German Significant Institutions with low levels of NPLs. However, the interviewee pointed out that BaFin did not regulate NPLs.

Supervision in Germany is shared between BaFin and the Bundesbank. Germany has a legalistic approach with more lawyers within the supervisor. A Gentlemen's agreement between BaFin and the Bundesbank foresees a dialogue between the two institutions, and some specific topics are dealt with in a specific institution. For instance, BaFin focuses more on compliance with internal models and regulatory terms, whereas Bundesbank supervision focuses on the overall financial situation of supervised banks. With the establishment of the SSM, the ECB merged these two perspectives; national supervisors were invited to this dialogue with the ECB in a continuation of existing national supervisory practice.

The interviewee found the cooperation with BaFin more cumbersome than with the Bundesbank. He explained the differences in the cooperation by the fact that BaFin was understaffed and had smaller teams for the amount of work, by the recent change of the chairman, the legal framework, and personal affinities. On Bundesbank's side, there were also some difficulties in cooperation with the ECB. For instance, Bundesbank had branches in different Länder, and sometimes the supervision was split between subsidiaries from different locations with some staff not familiar with JSTs.

According to the interviewee, the main triggers of convergence are determined by try-and-error and compromise and constant negotiation between the NCA and the ECB. However, according to him, national legal intervention could limit convergence. For instance, CRD V foresees a change to the list of exceptions of financial institutions under ECB supervision. The National promotional banks (NPBs) were included in that list. After that, Germany decided to change the national legislation and transferred the supervision of NPBs from ECB to BaFin and the Bundesbank. It directly stopped the EU-level supervision for all NPBs in Germany (including KfW with c. EUR 100 billion of assets) with an immediate effect. According to the EU legislation, the transfer of supervision should have been done only after three years. It was not a NCA decision but came from the national government. As a consequence, it decreased the harmonisation. This legislation also excluded the NPBs from the CRR framework and national provisions cherry-picking the applicable provisions. This legislative measure also challenged the definition of a bank.

Moreover, according to the interviewee, the lack of legal clarity undermines the convergence. The nature of legislation implementing CRD IV is completely different from one member state to another. For instance, in Germany, MaRisk is a Guidance, whereas, in other countries, the provisions are prescribed by law. BaFin is very independent, and MaRisk allows for more flexibility, which often goes beyond ECB Guidance. And for the cases where it overlaps ECB Guidance, it is less normative and uses less constraining formulations. This changes the burden of the proof, and the ECB, when supervising German banks, is also bound by that drafting.

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	NCA5 2021
Institution/type of institution	NCA
The function of the interviewee	Supervisor
Date and place of interview	21/05/2021 online
Duration	c. 50 minutes
Topic	Convergence of prudential supervision, focus SREP

The interviewee is a NCA supervisor who worked on the convergence of the SREP. The interviewee pointed out that at the beginning of the SSM; there were two schools for SREP. The first one is the German supervisory approach, which mainly relied on the ICAAP. For instance, there is a very strong ICAAP in German MaRisk. Second is the French approach, which is a stress test-based culture. Over time these two approaches converged thanks to increasing cooperation, but they still are not completely aligned. Spanish approach was very soft on ICAAP, with capital requirements coming just like add-ons. Gradually the ECB developed its ICAAP with a straightforward risk-by-risk approach and incorporated the ICAAP into SREP.

The alignment was possible thanks to the negotiations with national supervisors, methodology development and the creation of working groups which needed to come up with common guidelines. All these activities involved national supervisors. The SSM's first step in the convergence process was to build a common supervisory culture and develop a common ground. The SSM also initiated horizontal teams to determine what works and what does not. According to the Interviewee, more people working horizontally together led to alignment. The second step went with more demanding requirements (see, for instance, ICAAP evolution over time under ECB supervision).

This gradual convergence was necessary because the supervisors first needed an agreement on basic elements; then, when a common understanding was achieved, the requirements could go further. According to the interviewee, it corresponds to a learning curve for national supervisors.

Annex

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	EBA2 2022
Institution/type of institution	EBA
The function of the interviewee	Policy
Date and place of interview	05/04/2022 online
Duration	c. 45 minutes
Topic	EBA's role in convergence

The interviewee oversees the implementation of EU standards to ensure the convergence of prudential supervision across the EU. The interviewee noted that the EBA focuses only on banks and that the EU integration for banks is the most advanced. The EBA will look at the correct application of the rule at the national level to ensure a level playing field; the method to achieve this level playing field does not matter.

According to the interviewee, there is no divergence between the SSM and the EBA, the ECB may seek to specify certain points of the methodology for its teams, but in the interviewee's view, this is not a divergence. For instance, on the 'benchmark', the EBA did not specify on purpose because it wanted to leave room for supervisory judgement. However, the EBA also warned the ECB not to create automated assessments with a predominant place given to benchmark.

From the EBA perspective, the EU needed to achieve more convergence for SREP. For instance, for France and Germany, the ICAAP remained divergent. Both member states started from two different assumptions. France has a more regulatory approach, and the ICAAP was considered purely informative, whereas, in Germany, internal models and internal capital allocation mechanisms were considered the best reference. There was an important legal debate in the initial CRD on the ICAAP, which evolved over time. The divergence has been identified thanks to the creation of the SSM and the resulting debate.

The interviewee does not see any resistance from national supervisors and noted that 95% of guidelines are always applied. The resistance exists only for the drafting of the guidelines. The resistance is internalised and discussed before the final document. According

to the interviewee, the lack of convergence would mean that the EBA could not detect a problem ahead. The EBA monitors the convergence and the satisfactory application of its policy products.

The EBA internalises the negotiations among national supervisors and requires the latter to clarify their needs and the underlying structural difficulties in implementing a provision. The main resistance is linked to the national legislative structure. Often changing national legislation requires time. From a member state perspective, a conflict can emerge when they forget that European legislation is immediately applicable, but from the European point of view, there is no conflict.

The EBA can facilitate the change of national legislation. Often national supervisors request a letter from the EBA that they will send to their ministry. The EBA received between twenty and forty requests of this kind last year. How to explain it? European law represents ninety per cent of banking law and few things remain purely national (e.g. consumer law is still purely national).

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	ECB1 2022
Institution/type of institution	ECB
The function of the interviewee	Supervision
Date and place of interview	19/04/2022 online
Duration	c. 45 minutes
Topic	Convergence of prudential supervision

The interviewee is a supervision analyst at the ECB. Regarding SREP, the interviewee reminded that at the beginning of the SSM, SREP was applied by member states in different ways. The ECB issued supervisory standards to be applied by the NCAs. The interviewee also pointed out the differences between the EBA and the ECB approaches. The former providing a general framework for conducting SREP, the latter issued a very specific provision (manual) to facilitate NCA's work.

The interviewee noted what, in his views, drives the compliance of NCAs with ECB requirements. The first element is the 'esprit de corps' with the ECB supervision considered as effective. Then the language and the use of the same concepts facilitate the understanding. Eventually, socialisation may also be a driver with shared ownership thanks to working groups and cooperation possibilities.

When it comes to options for national governments, in the Interviewee's view, there is no resistance because when there is an option in CRD IV/V, national governments are free to transpose them as they want. And the ECB needs to apply these provisions and national laws transposing them. The more appropriate question on ONDs is why they have these options. The divergence may be explained by the existence of national pressure to maintain specific legislation (e.g. commercial law, corporate laws). Moreover, the convergence implies costs. If the legislation does not change, there is no need to hire new staff or train the existing ones.

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	ECB2 2022
Institution/type of institution	ECB
The function of the interviewee	Policy expert
Date and place of interview	13/05/2022 in Luxembourg
Duration	c. 1 hour and a half
Topic	Convergence of prudential supervision, with a main focus on ONDs

The interviewee is a former ECB supervisory expert. Since 2019, he has been in charge of updating the ONDs framework.

In 2016 ECB published a Guide which explains how the supervisory teams shall supervise the application of ONDs and the Regulation binding on banks. Both documents apply to Significant Institutions. It was extended to LSIs with the Guideline that replicates the Regulation but addresses the NCAs, and the Recommendation that replicates the Guide for LSIs. CRD V introduced new ONDs (e.g. new liquidity requirements – NSFR).

There are different types of ONDs.

1. Some addresses competent authorities. For these competent authorities ONDs, even for LSIs, The ECB recommends how NCAs shall apply. There is a strong push from the ECB to conform to the treatment of LSIs to those of Significant Institutions. First, the Guideline is legally binding. The ECB followed the exercise of these ONDs and observed that NCAs complied with these ONDs, except one NCA was in the process of implementation. The NCAs comply with these provisions because of the pressure from the network of LSIs and 'comply or explain mechanism' that forces NCAs to comply. The ECB also issued a Recommendation that is not binding. The content of the Recommendation was discussed with NCAs before its publication. The interviewee has not seen any comprehensive evaluation of its implementation.

2. Some other ONDs apply to member states (i.e. national governments). These are fewer but important ones on which the ECB cannot intervene.

On NCA's ONDs, there is a collective decision-making process, and all the authorities must agree or disagree on the Supervisory Board. National supervisors do not sign up if they disagree. There is a long debate about what shall be the standard. Eventually, the decision is taken when a consensus is achieved, with sometimes a common lowest denominator. Mainly compliance with ONDs can be explained because it is a result of a consensual decision.

Regarding member states' ONDs, the ECB has to apply national law. For instance, Article 493 on large exposures. National governments use these ONDs to protect their domestic banking sector because of the incompleteness of Banking Union. In CRR II, there are few new member states' ONDs. For instance, the option on small and non-complex institutions under Article 4(145) (b) of CRR II, these institutions will be subject to simpler and less conservative prudential standards. According to the OND, member states can lower the asset threshold. In practice, NCAs are not willing to use it because they prefer to have stricter requirements to guarantee financial stability. According to the interviewee, this shows that NCAs have the same objectives as the ECB.

The main factor explaining the use of waivers by the member states is historical. Banks are subject to national legislation outside the prudential sphere, which did not change. For instance, France used the OND under article 7 of the CRR because national authorities used to have consolidated supervision. ECB's Guide and Recommendation allow the use of this waiver. The interviewee also pointed out cases of accommodation and considered that each member state wanted to continue doing the way it has been doing it. He gave the example of the OND on NSFR under article 428h of CRR, which is a result of a compromise between NCAs and the ECB.

Eventually, the interviewee gave his views on SREP. The ECB created the SREP process from scratch. Faster implementation of SREP by NCAs can be explained by the fact that supervisors are concerned about having solid and safe banks, illustrating that they have the same objectives as the ECB.

Interviewer	Farida Valieva, PhD student, University of Luxembourg
Code	BSE 2022
Institution/type of institution	Industry association
The function of the interviewee	Banking supervision expert
Date and place of interview	21/06/2022 online
Duration	c. 30 minutes
Topic	Convergence of prudential supervision

The interviewee is a banking supervisory expert. The interviewee noted that the ECB has direct supervisory powers for significant institutions (i.e., sizeable balance sheets and/ or significant cross-border activities) and can assume direct supervision for less-significant institutions on a case-by-case basis. From the interviewee's perspective, there should be a stronger focus on direct ECB supervisory responsibility for large and highly cross-border institutions.

A direct responsibility of NCAs for LSIs is warranted, as these predominantly operate regionally or nationally, and NCAs can thus utilise their informational advantage from their market proximity. This division of direct supervisory responsibility also follows from the subsidiarity principle as a fundamental legal principle laid down in Article 5 of the Treaty on the European Union. According to the interviewee, another not entirely neglectable argument for local supervision arises from the environmental impact of long-distance travel resulting from on-site inspections by a single competent authority.

ONDs

The notion of national options and discretions and, in particular, the use of directives versus regulations directly follows the recognition of national characteristics in the EU. It is reflected in the European leitmotif "United in Diversity". Moreover, the principle of national options and discretions is to be upheld because the EU is not a federal state.

NPLs

NPL ratios in the Federal Republic of Germany are traditionally low. One reason for this is the principle of creditor protection in German insolvency law and what appears to be an efficient judicial insolvency procedure as compared to other member states. Other explaining factors are the rather conservative lending standards of German credit institutions and a moderate level of corporate debt in general.

The interviewee said that he is not competent in SREP and could not provide any information on that matter.