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The European banking supervisory framework and its institutional arrangements since Austria's accession to the European Union[1]

The European banking supervisory framework has changed fundamentally over time with regard to the objectives pursued, the legislative approaches adopted and the institutional arrangements used, and last but not least also with regard to the scope of regulation and supervision. When Austria joined the EU, the goal of establishing a single market was paramount. Policymaking was focused on removing obstacles to the freedom to provide services and the freedom of establishment, and on ensuring a level playing field across all Member States. Specific amendments to EU legislation in this regard were laid down in a range of EU directives, usually without providing for supporting institutional arrangements. At the turn of the new millennium, the focus shifted toward facilitating faster and more flexible regulation processes by setting up European regulatory agencies. This change was motivated by the urge to address emerging developments in financial markets in a timely manner and to advance financial integration to be able to gain higher benefits from monetary union. In parallel, EU legislators made an effort to stop adding to what was perceived as a flood of overly detailed legislation by putting "better regulation" principles at the heart of policymaking processes. The 2007 financial crisis, finally, significantly altered the motivation for regulation and hence the scope of the supervisory framework. Without abandoning earlier goals, EU law-making has since been dominated by efforts to address the regulatory deficiencies uncovered by the crisis and to prevent such crisis scenarios from re-emerging. Relying on directly applicable regulations as the instrument of choice, measures have been taken to strengthen the crisis resilience of individual financial institutions and the financial sector as a whole, and to establish European supervisory and regulatory mechanisms with a view to creating and eventually completing the – as yet incomplete – European banking union.

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When Austria joined the European Union (EU) on January 1, 1995, EU-wide banking regulation was still very fragmented and based on a wide range of directives. As a result, there was little harmonization across the EU in this area, and little harmonization in the area of banking supervision. Things have changed fundamentally in the 25 years since then. The adoption of the Single Rulebook provided for a harmonized set of prudential rules, and the 2007 financial crisis caused the intensity of legislation to increase substantially. Moreover, the establishment of the banking union enhanced the convergence of supervisory practices within the euro area. Thanks to these regulatory developments and the resulting improvements to risk-bearing capacity and risk management in banks, the banking sector in the EU and thus also in Austria is more resilient to crises today than it was 25 years ago. At the same time, the playing field in the European banking sector has leveled out considerably. The financial crisis was one of the major drivers of this development – or at any rate acted as a catalyst for it. Responses to the crisis not only saw the regulatory framework tightened, but also led to supervisory practices being converged and the banking union being established in the euro area.

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The following paper consists of four sections. Section 1 describes the situation leading up to the financial crisis, a time which saw thoughts turn to harmonization in the form of a single market and trends toward deregulation. Section 2 looks at paradigm shifts in banking regulation based on lessons learned from the financial crisis, while section 3 addresses the establishment of the banking union in response to the crisis, including a discussion on the completion of the – as yet incomplete – banking union. The key conclusions are then summarized in section 4. The first three sections address the key issues of the regulatory debate that took place during the phase in question – including the events leading up to and following the phase – which means that there are overlaps in the timeline of the events described.

1 Harmonization and deregulation leading up to the financial crisis

After applying for membership of the European Community (EC) – as the EU then was – in July 1989, Austria subsequently had to transfer the *acquis communautaire*[2] of the European Union – which had been formed by this point – into national law.[3] While preparing to join the EU, Austria had to take into consideration around 4,000 directly applicable EU regulations and approximately 1,000 EU directives that needed to be written into national laws.[4] In the alignment process, the existing banking act (Kreditwesengesetz) was replaced with the Austrian Banking Act (Bankwesengesetz).[5]

At the European level, the idea of creating a single financial market was by no means new – the concept was first mentioned as far back as in 1966, when it appeared in a report on the development of a European capital market, which was drawn up by a group of experts appointed by the Commission of the European Economic Community (EEC) and chaired by Claudio Segré,[6] and which contained recommendations on resolving any obstacles to creating a level playing field.[7] This report came at a time when the arrangements in place in most member countries "*concerning the working and supervision of banks [continued to] date from measures taken to palliate the effects of the great economic crisis of the inter-war period.*"[8]

In 1973, the EC's efforts to achieve a single market for banking services were ramped up with the introduction of corresponding European legislative acts, with the European legislator adopting the first directives. Held up against the supervisory rules and regulations in force today, however, these

[2] *The acquis communautaire (Community legislation) is the entire body of EU law and obligations that are binding on all EU Member States. It consists of the primary legislation (the EU treaties), the secondary legislation (all EU legal acts such as regulations and directives) and the judgments of the European Court of Justice, as well as all international treaties in respect of EU matters. To become a member of the EU, candidate countries must accept the acquis communautaire, enact it into national law in advance and apply it after accession (see www.parlament.gv.at/PERK/GL/EU/).*

[3] *Owing to the obligations resulting from the Agreement on the European Economic Area, which entered into force on January 1, 1994, the Republic of Austria was actually required to implement the acquis communautaire a year prior to its accession to the EU (on January 1, 1995).*

[4] *Holzinger (1992), p. 177.*

[5] *Hlawati et al. (1994), p. 270.*

[6] *Segré Report (1966).*

[7] *In particular, it proposed harmonizing provisions on the management of assets and liabilities and provisions on participation rules.*

[8] *Segré Report (1966), p. 269.*

Chart 1

Acquis communautaire in the areas of banking regulation and banking supervision in 1995

Main elements of the banking supervisory framework[1]
Directive 73/183/EEC – Council Directive on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions
Directive 77/780/EEC – First Council Directive on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions
Directive 83/350/EEC – Council Directive on the supervision of credit institutions on a consolidated basis
Directive 89/299/EEC – Council Directive on the own funds of credit institutions
Directive 89/646/EEC – Second Council Directive on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC
Directive 89/647/EEC – Council Directive on a solvency ratio for credit institutions
Directive 92/30/EEC – Council Directive on the supervision of credit institutions on a consolidated basis
Directive 92/121/EEC – Council Directive on the monitoring and control of large exposures of credit institutions
Directive 93/6/EEC – Council Directive on the capital adequacy of investments firms and credit institutions (CAD)
Additional body of rules and regulations
Directive 86/635/EEC – Council Directive on the annual accounts and consolidated accounts of banks and other financial institutions
Directive 89/117/EEC – Council Directive on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents
Directive 94/19/EC – Directive on deposit-guarantee schemes

Source: Authors' compilation based on EU legislation.

[1] Excluding provisions on ancillary matters (consumer borrowing, anti-money laundering prevention, etc.).

legislative acts were comparatively minimalist, their main focus being to remove identified obstacles to banks' freedom of establishment and freedom to provide services and, subsequently, to implement the provisions laid down in the 1988 Basel Capital Accord of the Basel Committee on Banking Supervision (BCBS; Basel I).[9] Subsequent regulatory discussions were driven by the EC's landmark decision to implement the Basel provisions for all banks operating in the EC, regardless of their size or complexity, with a view to creating a level playing field.

Austria joined the EU at a time when the EU was pursuing a selective, gradual approach to harmonizing banking regulation, issuing directive after directive to cover specific aspects of banking regulation (chart 1), with which the Austrian Banking Act had to be aligned.

In May 1999, several months after the introduction of the euro, the European Commission adopted the Financial Services Action Plan (FSAP)[10] to achieve the goal of realizing a single market for financial services. The plan contained 42 action points, including 25 specific proposals for directives, designed to "*reap the full benefits of the euro and ensure continued stability and competitiveness of EU financial markets.*"

According to the FSAP, the European legal framework in place at that time had already established a sufficient "*bulwark against institutional failure and systemic risk*" and was providing adequate protection to depositors and insurance policy holders against the risk of payment

[9] *The Basel I Capital Accord was the first global initiative to establish minimum own funds requirements for banks on the basis of risk-weighted assets and (depending on the risk of the assets concerned) graded risk weights. See BCBS (1988).*

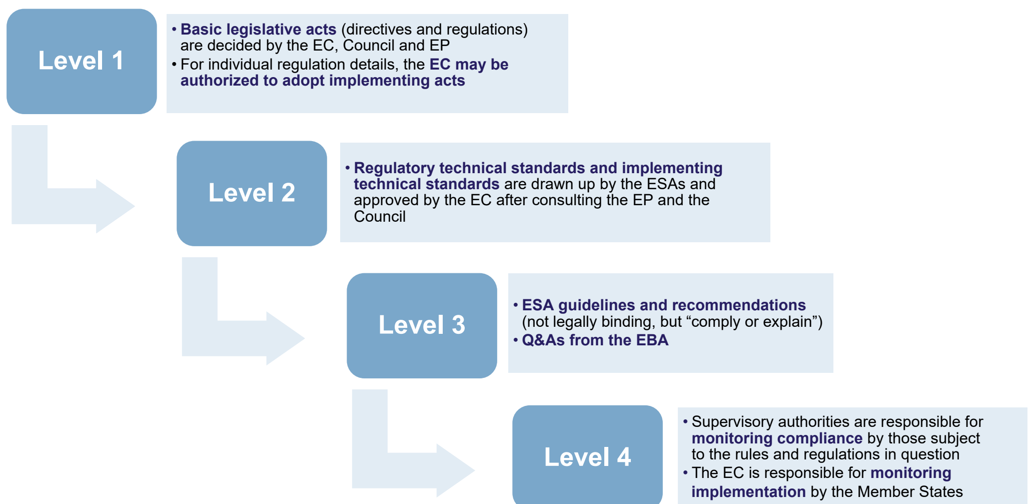
[10] *European Commission (1999). Following quotations from ibid.*

default. As relevant measures to be taken in the areas of banking regulation and supervision, the FSAP pointed in particular to implementing the changes made to own funds requirements in the Basel framework (Basel II)[11] and adopting the directive on the winding-up and liquidation of banks, also known as the Bank Insolvency Directive (BID).[12]

According to the FSAP, the introduction of the euro opened up the opportunity to equip the EU with a "*modern financial apparatus in which the cost of capital and financial intermediation are kept to a minimum*," but also heralded new challenges for financial regulators and supervisors which called for swift action. The focus was on ensuring the balanced regional distribution of the benefits of competitive and integrated financial services markets. Considering that the "*adaptation of EU prudential rules to cope with new sources of instability or to align it on state-of-the-art regulatory/supervisory practice [was] painstakingly slow,*" the European Council established a committee in July 2000, led by Alexandre Lamfalussy, which was tasked in essence with reviewing the regulation of European securities markets. The committee examined how to best address current developments in the securities markets using EU regulations and how to make sure the markets were working efficiently and dynamically.[13] One of the main proposals in the "*Lamfalussy Report*"[14] was introducing a four-level regulatory approach (chart 2) and creating representative "comitology committees" to be consulted in the four-level process of legislation, starting with a committee for securities markets in 2001 followed

Chart 2

Lamfalussy process: the comitology procedure in EU financial market law



Source: Authors' compilation on the basis of EU legislation, legal situation since January 1, 2011.

Note: EC= European Commission, EP = European Parliament, ESAs = European Supervisory Authorities, EBA = European Banking Authority. Based on the legislation in force since 2011 with the successors of CEBS, CEIOPS and CESR, i.e. the ESAs (EBA, EIOPA and ESMA); see also section 2.

[11] *Negotiations to revise the Basel I framework pursuant to the BCBS (1988) were initiated in 1999, ultimately resulting in the publication of the Basel II framework from 2004 onward (see BCBS, 2004 and 2006). See section 2 for further details of the key changes introduced by Basel II.*

[12] *Subsequently adopted on April 4, 2001. See BID (2001).*

[13] *Karpf et al. (2007), p. 6.*

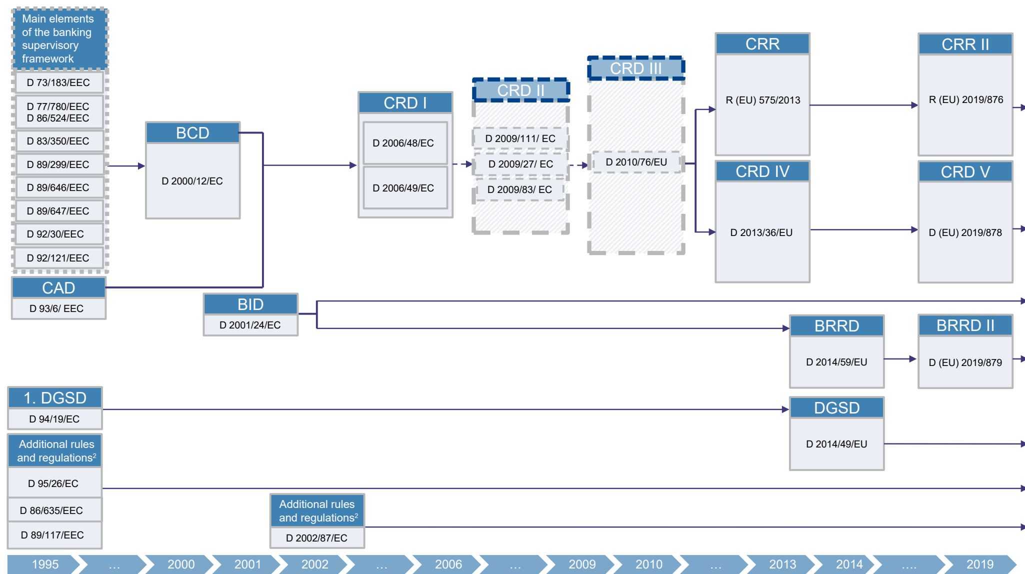
[14] *Lamfalussy et al. (2001).*

by additional committees for banking and insurance in 2004.[15]

The introduction of the comitology procedure laid the foundations for the European legislative model that is in use today, which seeks to provide for the timely and flexible adjustment of supervisory legislation to current developments. Since the European Supervisory Authorities (ESAs)[16] became operational on January 1, 2011, a wide range of binding technical standards to be determined have been developed by the ESAs rather than being laid down in primary law.[17] In parallel, the supervisory framework started to increase in scope and complexity because of the emergence of a new practice to delegate to the ESAs not only numerous technical specifications, but also points of disagreement, for which the ESAs were tasked with finding a compromise. Moreover, the ESAs – as the committees before them – were mandated to establish coherent, efficient and effective supervisory practices through the adoption of binding technical standards, guidelines and recommendations, as well as Q&As. For example, the legislative packages adopted in 2013 and 2014 to implement the global lessons learned from the financial crisis[18] in the EU

Chart 3

Introduction of the Single European Rulebook



Source: Authors' compilation based on EU legislation.

[1] *Excluding provisions on ancillary matters (consumer borrowing, anti money laundering prevention, etc.).*

[15] *Namely the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR). See Karpf et al. (2007) for a detailed description.*

[16] *Consisting of the succeeding organizations of the committees mentioned in footnote 14, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). These were set up as independent authorities with their own legal personality and granted more extensive powers than their predecessors. See also chapter 2. See, for example, Ladler (2014), pp. 185 et seq. for a more detailed description.*

[17] *As the ESAs themselves do not have any legislative powers here, these standards are simply developed as drafts of technical standards that are subsequently adopted by the European Commission. See, for example, Article 10 et seq. of ESAR (2010).*

[18] *See section 2.*

contained a mandate for the European Banking Authority (EBA) to create a collection of technical standards and guidelines stretching into the triple digits.

2000 brought with it another significant development with the adoption of the Banking Consolidation Directive (BCD) relating to the taking up and pursuit of the business of credit institutions. Providing for the first ever partial codification of the European regulatory framework, the BCD replaced the fragmented framework of directives that had been in force up until that point (chart 3). In terms of substance, however, the changes introduced by this directive were relatively insignificant.

To implement the Basel II framework published between 2004 and 2006, the European legislator subsequently amended and recast the BCD and the Capital Adequacy Directive (CAD), which together became known as the *CRD I package*.[19] Basel II brought about comprehensive changes in the field of banking regulation. This naturally resulted in challenges for the banking sector, which were not received without criticism.[20]

Ultimately, Basel II was the regulatory response to financial sector requests to align supervisory practices with progress made in quantifying and managing risks since the late 1980s. Thus, Basel II enabled banks to determine their minimum own funds requirements on the basis of internal models to be approved by the supervisor. Basel II also complemented the mandatory minimum own funds requirements (pillar 1) set out under Basel I with a supervisory review process to take into account institution-specific risks (pillar 2)[21] and enhanced disclosure requirements (pillar 3). The underlying idea is that if the supervisory authority does not deem certain risks to be (adequately) covered by pillar 1, it can require banks to hold own funds under pillar 2 beyond the minimum requirements laid down by pillar 1.[22] This Basel II principle formed the basis of the additional pillar 2 own funds requirements introduced in EU legislation as part of the CRD I package.[23]

Achieving an integrated European financial services market – and removing the obstacles standing in the way of this goal – remained the main driving force behind the CRD I package.[24]

As the EU's regulatory activities increased, so too did its critics, with many people perceiving the regulatory framework – still fragmented by today's standards – as excessive. Critics claimed that European and U.S. credit institutions considered the relentless increase in supervisory requirements to pose a far greater banking risk than all market risks.[25] Furthermore, critics called upon supervisory committees to stop overregulating, arguing that Europe was holding itself hostage to its own

[19] *CRD I (2006a) and CRD I (2006b).*

[20] *For a more comprehensive description, see, for example, Putz (2006); Jansen (2002); or Bärenfänger et al. (2006).*

[21] *Consisting of the internal capital adequacy assessment process (ICAAP) and the supervisory review and evaluation process (SREP).*

[22] *See BCBS (2006), p. 239, principle 3 of the supervisory review and evaluation process.*

[23] *See Article 136 of CRD I (2006a).*

[24] *See, for example, recital 2 of CRD I (2006a).*

[25] *See Pichler (2005), citing from an unspecified PriceWaterhouseCoopers study: "Der unerbittliche Anstieg der Aufsichtsvorschriften stellt nach Ansicht europäischer und amerikanischer Kreditinstitute das größte bankgeschäftliche Risiko vor allen Marktrisiken dar."*

harmonization dogma.[26] This was partly due to the fact that Basel II had been implemented quite differently in the individual jurisdictions – both in terms of the number of banks affected[27] and in terms of the specific supervisory practices.[28] In addition, the broad consultations and impact assessment studies that are used to gauge the costs and benefits of regulations in today's regulatory landscape were not yet common practice at that time.

Having gained significantly in number and intensity by the mid-2000s, these critical views also became increasingly reflected in corresponding legislative initiatives. The European Commission embraced the concept of "better regulation" and acknowledged both gold-plating and excessive regulation as issues impeding the creation of the single market for financial services.[29] The CRD I package adopted in 2004 was, in fact, among the first attempts to live up to the spirit of "better regulation."[30]

In its "*White Paper – Finance Services Policy 2005–2010,*"[31] the Commission also highlights the topic of "better regulation" as its main focus, the keywords being open and transparent consultations, impact assessments with a focus on costs and benefits, close monitoring of the implementation and enforcement of the EU regulatory framework by the Member States and their authorities, ex-post evaluation of the FSAP as a whole and simplification and codification of the rules and regulations.

To support these aims, the paper emphasizes the need to adapt the regulatory and supervisory structures in place, taking into account the Lamfalussy process, and reduce regulatory costs where possible.[32] In addition to clarifying the roles of home and host supervisors and minimizing duplicative reporting requirements, developing a real pan-European supervisory culture was also listed high up on the Commission's agenda.

2 Paradigm shifts in banking regulation triggered by the financial crisis

The outbreak of the global financial crisis in 2007 marked a fundamental turning point in regulatory discourse. The principle of "better regulation" was pushed into the background, overshadowed by questions of how such a crisis could happen given the regulatory framework in place, and of how to considerably

[26] *Schackmann-Fallis (2007), p. 9.: "Ich bin davon überzeugt, daß sich Europa in den letzten Jahren zur Geisel seines eigenen Harmonisierungsdogmas gemacht hat."*

[27] *While in the EU the Basel regulations were implemented for all banks to ensure a level playing field, they were only applied to major banks in the U.S.A – partly because additional own funds requirements (leverage ratio, capital buffer) outside the Basel framework were already mandatory for all U.S. credit institutions prior to the introduction of Basel II.*

[28] *The U.S.A. and Japan, for example, have not implemented any of the pillar 2 own funds requirements for banks that are standard practice in the EU.*

[29] *See, for example, the speech by Charlie McCreevy, European Commissioner for Internal Market and Services, McCreevy (2005).*

[30] *In addition to the wide range of implementing powers granted to the Commission to be developed as part of the comitology procedure together with CEBS, the Commission is required to prepare reports on the application of certain provisions at certain stages of the process. For certain areas of regulation, the Commission is obliged to propose modifications on the basis of the Member States' progress reports, as well as to report on the application of the body of rules and regulations as a whole and their impact on the economic cycle. See, for example, Article 150 of CRD I (2006a), Article 41 of CRD I (2006b), Article 119 of CRD I (2006a), Article 28 of CRD I (2006b), Article 62 of CRD I (2006a), Article 12 of CRD I (2006b), Article 51 of CRD I (2006b) and Article 156 of CRD I (2006a).*

[31] *European Commission (2005b).*

[32] *European Commission (2005b), p. 9.*

reduce the likelihood of another crisis. While in the past the directives adopted contained recitals focused on "*making it easier to take up and pursue the business of credit institutions,*" on "*eliminating the most obstructive differences between the laws of the Member States*" and on "*the achievement of the internal market,*"[33] legislation adopted in the aftermath of the crisis prioritized taking "*step[s] to address shortcomings revealed by the financial crisis.*"[34]

In November 2008, the European Commission appointed an expert group chaired by Jacques de Larosière to make recommendations on navigating the course out of the crisis and on avoiding crises in the future. The final report submitted in February 2009, named the "*de Larosière Report,*"[35] analyzed the causes of the crisis and offered a total of 31 recommendations for addressing shortcomings in the European regulatory and supervisory framework, underlined by two strategic objectives. The first was to make banks more resilient and therefore reduce the likelihood of crises in the banking sector, and the second was to contain the systemic damage caused by banking crises as far as possible, thus minimizing the costs to the public purse. This was to be achieved by strengthening regulations on capital and (for the first time also) liquidity[36] – harmonized at the EU level and on a global scale under the Basel framework – and establishing a regulatory framework for crisis intervention and resolution for banks and other financial intermediaries. At the institutional level, the de Larosière Report recommended gradually developing a decentralized network of competent supervisory authorities ("European System of Financial Supervision"), which should rely on a common set of core harmonized rules and supervisory tools, and supported an extended role for the European Central Bank (ECB) in the identification of macroprudential risks.[37]

In September 2009, the CRD II package[38] was adopted, containing – in addition to measures planned prior to and independently of the de Larosière Report[39] – the initial responses to the crisis.[40]

In November 2010, the European legislator adopted the Capital Requirements Directive, known as CRD III,[41] as a further partial response to the crisis,[42] as well as the legislative acts which provided for the creation of the

[33] *Recital 2 of CRD I (2006b) and recital 4 of the BCD (2000).*

[34] *See the first recital of CRD II (2009a).*

[35] *The de Larosière Group (2009).*

[36] *See the implementation of these measures as well as other recommendations on strengthened supervisory regulations in footnotes 47 and 48.*

[37] *The changes to the European regulatory and supervisory framework described in the rest of this section are all based on recommendations made in de Larosière Report, the vast majority of which have been implemented.*

[38] *CRD II (2009a), CRD II (2009b) and CRD II (2009c).*

[39] *Such as on large exposures or hybrid financing instruments; see Lembeck (2009).*

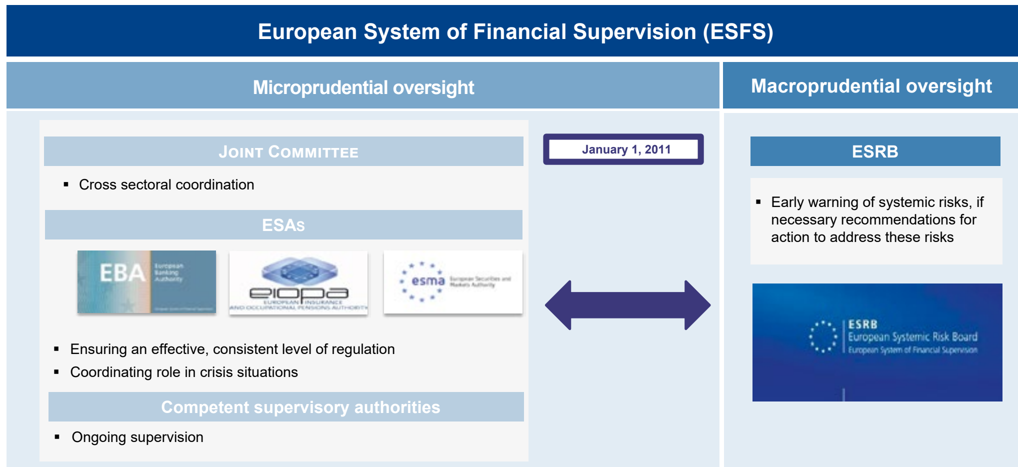
[40] *CRD II focused in particular on revising the large exposure regime, strengthening cross-border supervision, establishing stricter requirements for using securitized products and establishing uniform criteria for recognizing hybrid financing instruments as own funds.*

[41] *CRD III (2010) focused on introducing rules governing remuneration practices, increasing own funds requirements for securitized exposures in the trading book, increasing risk weights for re-securitizations, enhancing disclosure requirements and ensuring that authorities have effective, proportionate and dissuasive financial and non-financial sanctions and measures at their disposal.*

[42] *"Excessive and imprudent risk-taking in the banking sector has led to the failure of individual financial institutions and systemic problems in Member States and globally," recital 1, sentence 1, CRD III (2010).*

Chart 4

ESFS: Better links between microprudential and macroprudential oversight



Source: Authors' compilation on the basis of EU legislation.

ESAs (EBA, EIOPA and ESMA, as successors to the former "level 3 committees")[43] and for the establishment of the European Systemic Risk Board (ESRB). Together with the competent supervisory authorities, the ESRB, the ESAs and their Joint Committee form the European System of Financial Supervision (ESFS, chart 4).[44] These measures also reflected the lessons learned from the crisis and recommendations made in the de Larosière Report.[45] In June 2013, the Capital Requirements Regulation (CRR, 2013) and CRD IV (2013) were adopted, marking the pan-European implementation of the new Basel framework (Basel III),[46] which had been fundamentally overhauled in response to the crisis. In this respect, even the type of legislation reflects the paradigm shift triggered by the financial crisis. The CRR is the first ever regulation to have been issued by the EU in the area of banking supervision, based on the consideration that regulations are directly applicable, allowing for greater uniformity in the legislative framework, in line with the principle of maximum harmonization, and therefore a more level playing field for banks' business activities. In addition to the decision to issue both a directly applicable regulation[47] and a directive to be written into national law by the Member States,[48] the abundance of mandates for the EBA – some of which with ambitious deadlines imposed – is particularly remarkable. By harmonizing basic rules as

[43] *See pages 4 and 5, in particular footnotes 14 and 15.*

[44] *For details about the tasks and objectives of the ESFS, the ESRB and the ESAs, see Weismann (2011).*

[45] *"Financial stability is a precondition for the real economy to provide jobs, credit and growth. The financial crisis has revealed important shortcomings in financial supervision, which has failed to anticipate adverse macro-prudential developments and to prevent the accumulation of excessive risks within the financial system." See recital 1 of ESRBR (2010).*

[46] *BCBS (2011).*

[47] *CRR I (2013) lays down enhanced regulations on the quality of own funds, minimum own funds requirements, liquidity requirements, the leverage ratio, disclosure and the large exposures regime.*

[48] *CRD IV (2013) sets out, in particular, rules on licensing, cross-border activities, supervisory measures, macroprudential tools, corporate governance and pillar 2.*

much as possible and entrusting the EBA with additional tasks in this respect, CRD IV aimed to bring the Commission closer to realizing its vision of a Single European Rulebook, a term coined in 2009 in order to refer to the aim of a unified regulatory framework for institutions throughout the EU.[49] Key innovations triggered by the CRR/CRD IV package included the introduction of macroprudential supervisory instruments and specific liquidity requirements, as well as a leverage ratio (initially only applicable as a reporting requirement). Existing prudential rules, meanwhile, were developed further, with the main aim of ensuring that credit institutions hold an adequate level of own funds in terms of their total loss-absorbing capacity and risk adequacy.

In April 2014, further recommendations from the de Larosière Report were implemented with the adoption of the Deposit Guarantee Schemes Directive (DGSD).[50] This directive requires EU countries to introduce an ex ante deposit guarantee fund financed by the banking sector, while the funds held in these schemes may also be used to prevent the failure of a credit institution.

In May 2014, the Banking Restructuring and Resolution Directive (BRRD)[51] was adopted, marking the start of another new chapter in European banking regulation. The BRRD equipped supervisory authorities with new tools for preventing crises, granting them the possibility to redress the situation by taking early intervention measures – i.e. allowing them to act before an acute crisis situation takes hold. Furthermore, the BRRD grants the resolution authority, a public administrative body to be established in each Member State as part of the directive, the power – under certain circumstances[52] – to resolve failed credit institutions in a way that has the least impact on the system as possible. Specifically, the "bail-in" resolution tool was introduced, involving creditors in absorbing losses to be covered in the course of bank resolution. In addition, banks have to contribute to newly set up national resolution funds. The measures and instruments under the BRRD are aimed at ensuring that, as far as possible, taxpayers no longer have to foot the bill for bailing out institutions that have run into difficulties. This principle of replacing bail-out with bail-in in the future is intended to eliminate the implicit state guarantee in place, in particular for very large banks ("too big to fail") and to address the issue of moral hazard associated with this. In other words, as evidenced by the BRRD's recitals, these rules are clearly intended to implement lessons learned from the crisis and safeguard financial market stability.[53]

The most recent relevant act of legislation was adopted in May 2019 in the form of the European banking package, which consists of amendments to the current body of rules and regulations, resulting in CRR II (2019), CRD V (2019), and BRRD II (2019). This was

[49] *See www.eba.europa.eu/regulation-and-policy/single-rulebook.*

[50] *DGSD (2014).*

[51] *BRRD I (2014).*

[52] *Particularly if it is in the public interest to do so.*

[53] *See the first three recitals of BRRD I (2014).*

accompanied by a range of reforms,[54] with the recitals again highlighting the implementation of lessons learned from the crisis.[55] Other recitals acknowledge the need to enhance financial stability, address the current uncertainties in the economic outlook, implement internationally agreed standards and take targeted deregulation measures by applying proportionate supervisory requirements.[56]

Over the last few years, the scope and complexity of regulations adopted since the financial crisis, in the form of both primary legislation and accompanying binding technical standards, has prompted discussions about the necessity of having a proportional supervisory approach.[57] The banking package adopted in 2019 was an essential step toward achieving such an approach. It was the first piece of legislation to introduce a category of small, less complex banks for which certain regulations, such as in the areas of remuneration and disclosure, will not be applicable, or apply only to some extent.

Box 1

Impact of EU regulations on banking regulation in Austria

To meet its obligation to transfer the acquis communautaire into national law, Austria replaced the existing banking act (Kreditwesengesetz – KWG) with the Austrian Banking Act (Bankwesengesetz – BWG) on January 1, 1994. In addition to adopting the European acquis communautaire, the national legislator also consolidated a range of domestic laws, resulting in a fundamental reform of Austrian banking supervision law. Subsequent additions or amendments to EU legislation were written into domestic law first and foremost by making corresponding amendments to the BWG or to regulations adopted on the basis of corresponding powers of authorization in the BWG (for example, before the CRR came into force around 20 regulations based on powers of authorization in the BWG were in force).

When implementing the BRRD, the Austrian legislator decided to adopt a dedicated piece of legislation – the Federal Law on the Recovery and Resolution of Banks (Sanierungs- und Abwicklungsgesetz – BaSAG).

The DGSD was enacted as Austria's Deposit Guarantee Schemes and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz – ESAEG), and new regulatory frameworks were created for deposit guarantee and investor compensation at credit institutions, areas previously governed by the Austrian Banking Act (chart 5).

[54] *These measures include binding obligations regarding the leverage ratio (LR) and the net stable funding ratio (NSFR), introducing targeted simplifications for small and non-complex institutions (proportionality), tightening regulations on own funds eligibility, establishing the pillar 2 guidance, reviewing the interaction between pillar 2 and macroprudential instruments, tightening the requirements related to the trading book, and revising the basis for calculating the minimum requirement of own funds and eligible liabilities (MREL).*

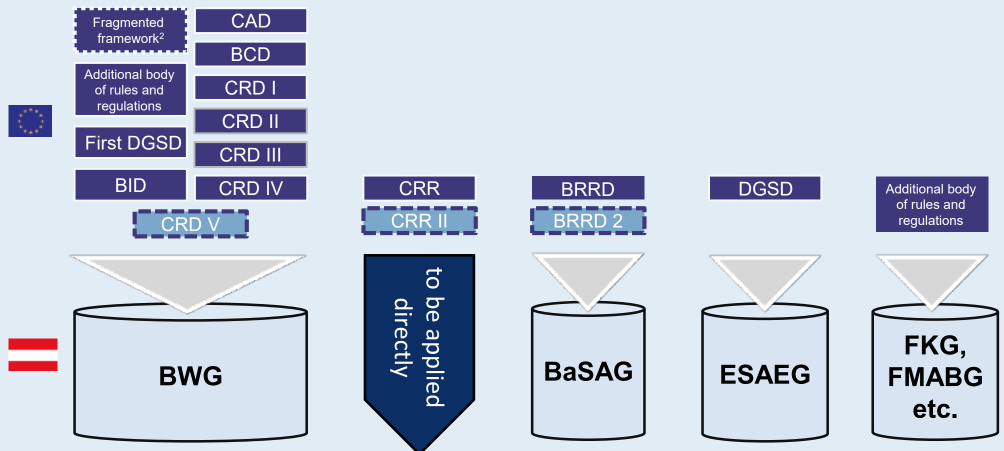
[55] *"(1) In the aftermath of the financial crisis that unfolded in 2007-2008, the Union implemented a substantial reform of the financial services regulatory framework to enhance the resilience of its financial institutions… (2) While the reform has rendered the financial system more stable and resilient against many types of possible future shocks and crises, it did not address all identified problems… (3) In its communication of 24 November 2015 entitled "Towards the completion of the Banking Union", the Commission recognised the need for further risk reduction and committed bringing forward a legislative proposal that would build on internationally agreed standards...", recitals 1–3 of CRR II (2019).*

[56] *See recitals 4–8 of CRR II (2019).*

[57] *See Angeloni (2018), Boss et al. (2018), and Castro Carvalho et al. (2017).*

Chart 5

Implementation of the European framework in Austria at a glance[1]



Source: Authors' compilation based on EU legislation.

[1] This figure is intended to provide a rough overview of the national laws into which the most relevant provisions of the banking supervisory directives have been transferred – but does not constitute an exhaustive list. The laws mentioned are to be understood independently of any national regulations that were adopted owing to a power of authorization contained in the law in question.

[2] Excluding provisions on ancillary matters (consumer borrowing, anti money laundering prevention, etc.).

Note: FKG = Finanzkonglomerategesetz (Financial Conglomerates Act); FMABG = Finanzmarktaufsichtsbehördengesetz (Financial Market Authority Act). All other abbreviations explained in the text.

3 Establishing the European banking union in response to the sovereign debt crisis

There have long been discussions about whether having an integrated financial market raises the need for a competent cross-border supervisor. The introduction of the euro in particular had people asking whether, to reach its full potential, a monetary union needed to be accompanied by a banking union with a view to creating a system of uniform banking supervision. Back in 1998, for example, the International Monetary Fund (IMF) highlighted challenges that could be encountered in managing a banking crisis under the institutional framework in place in the euro area at that time, with the ECB also joining calls for a common approach to banking supervision in the euro area.[58] Proposals to more closely coordinate the national supervisory authorities of cross-border banks were also advocated beyond the euro area, for the EU as a whole. The concepts discussed ranged from having a lead supervisor responsible for a cross-border group[59] to having a competent one-stop supervisor,[60] while the challenge of supervising cross-border institutions based on limited national jurisdictions was generally acknowledged.[61] For instance, an IMF recommendation issued prior to the outbreak of the financial crisis concerning banking supervision in Europe aimed to resolve two

[58] *See IMF (1998, p. 106), Padoa-Shioppa (1999) and de Rynck (2016) for a more comprehensive overview of this discussion.*

[59] *See, for example, Christl (2005).*

[60] *See, for example, Čihák et al. (2007).*

[61] *See, for example, Pisani-Ferry et al. (2012).*

problems that had been identified: the lack of uniform requirements for business activities and issues relating to cross-border financial stability.[62] With the benefit of hindsight, the colleges of supervisors[63] created by CRD II no doubt have come to play a crucial role and can be considered one of the initial lessons learned from the crisis.

Nevertheless, the European sovereign debt crisis was the last nudge needed to set up the *banking union*. During the EU summit in June 2012, the Union's heads of state and government decided to establish a Single Supervisory Mechanism (SSM) involving the ECB as a precondition for the direct recapitalization of banks by the European Stability Mechanism (ESM). They mandated the Commission to present proposals for a suitable supervisory mechanism. In March 2013, the European Commission, the European Parliament and the European Council finally reached an agreement on the creation of the SSM,[64] and in March 2014 decided on the creation of the Single Resolution Mechanism (SRM).[65] In November 2015, the Commission presented a proposal for completing the banking union, including a legislative proposal for establishing a single deposit guarantee scheme (European Deposit Insurance Scheme – EDIS).[66] EDIS continues to be under discussion, however, as the Member States have not been able to agree on a compromise so far. Together, SSM, SRM and EDIS constitute the three pillars of the euro area banking union. With a view to ensuring uniform business conditions across the EU, any non-euro area EU Member State can join the banking union through an arrangement known as "close cooperation." While the idea of close cooperation failed to gain traction in the early years of the SSM, recent times have seen both Bulgaria (2018) and Croatia (2019) apply for membership. In Sweden, the Ministry of Finance released a publication in 2019 analyzing the effects of Sweden potentially joining the banking union,[67] and Denmark has also been considering the idea.[68]

Even before the SSM was established, the ECB was in regular contact with the national supervisory authorities of the euro area countries via the Banking Supervision Committee (BSC).[69] The BSC provided advice in areas that were in the common interest of both the ECB and the national supervisory authorities, and conducted studies on the national financial systems. However, it was not until the SSM was established that the ECB took on an operational role in banking supervision. Under the SSM, the ECB has been responsible for the operational supervision of the approximately 120 "significant credit institutions"[70] in the euro area, in cooperation with

[62] *Čihák et al. (2007).*

[63] *A college of supervisors is essentially a permanent committee consisting of a cross-border bank's "home" and "host" supervisors. Supervisory colleges facilitate a better understanding of a cross-border bank's risk profile and vulnerabilities and provide the authorities tasked with supervising this bank with a framework for addressing key issues that are relevant from a supervisory perspective. See www.bankingsupervision.europa.eu/about/ssmexplained/html/supervisory_colleges.en.html.*

[64] *See SRMR I (2014).*

[65] *See SRMR I (2014), which has already been amended as part of the banking package described above to form SRMR II (2019).*

[66] *See European Commission (2015a) and European Commission (2015b).*

[67] *Government Offices of Sweden (2019).*

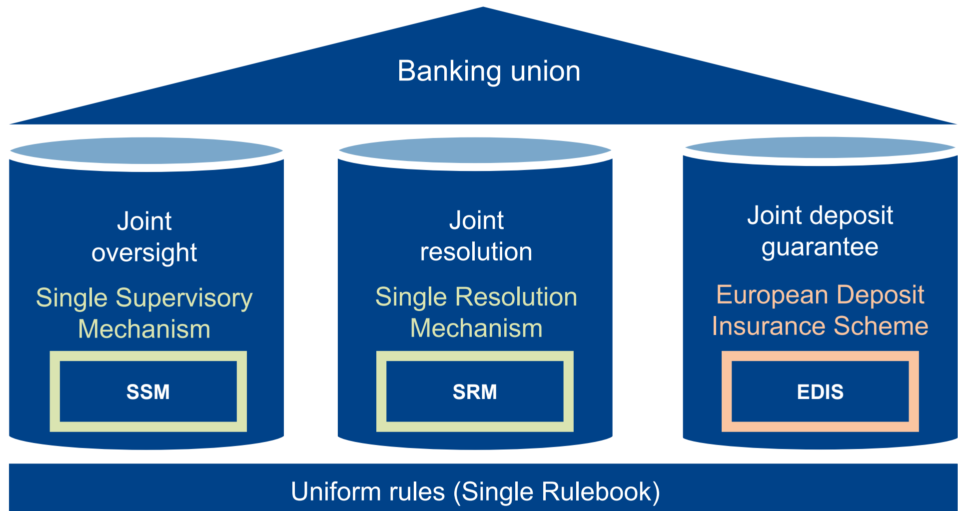
[68] *Danish Ministry for Industry, Business and Financial Affairs (2019).*

[69] *The BSC was subsequently replaced by the Financial Stability Committee (FSC); see Ladler (2014), p. 162.*

[70] *See Article 6 of the SSMR (2013).*

Chart 6

Establishing the banking union in the euro area as a second response to the financial crisis



Source: Authors' compilation on the basis of EU legislation.

the competent authorities of the Member States, since November 2014. "Less significant credit institutions" continue to be supervised by the relevant competent national supervisory authorities, though the ECB bears the primary responsibility for ensuring the effective and uniform functioning of the SSM. In the Member States, too, the lessons learned from the financial crisis have resulted in central banks becoming more strongly involved in banking supervision. In Belgium, Ireland and the United Kingdom, for example, banking supervision was transferred back to the central banks, while in Luxembourg the central bank was entrusted with the supervision of bank liquidity. Thus, 16 out of the 19 euro area central banks also played a role in banking supervision within the national division of responsibilities in 2020.[71]

The second pillar of the banking union, the SRM, started its operations on January 1, 2015. Similarly to the SSM, the SRM is a system of collaboration between a central resolution authority – the newly established Single Resolution Board (SRB) located in Brussels – and the national resolution authorities, supported by a single resolution fund. The division of powers between the SRB and the national resolution authorities, in particular in terms of the banks placed directly under the SRB's responsibility, largely corresponds to the division of powers under the SSM.

In its legislative proposal, the Commission proposed that the third pillar of the banking union, the EDIS, be developed over three stages. In the first stage of its implementation, the re-insurance phase, risks would remain largely at the national level and mutualized funds would only be distributed – to a limited extent – after national funds available had been fully depleted. In the second stage (co-insurance), coverage of deposits would be shared between the EDIS and the national participating deposit

[71] *See Nowotny (2019).*

guarantee scheme, with the share of funding provided by the EDIS in the event of a pay-out increasing gradually each year. In the third stage, losses would be fully mutualized.[72]

Since the Commission published its legislative proposal, progress in the negotiations on the concrete terms of the EDIS – particularly the extent to which losses should be mutualized – has been sluggish. A range of different models, targeted at the first two stages in particular, and the prerequisites for the transition to the next respective stage have been considered and discussed. At the euro summit on December 13, 2019, the Eurogroup was mandated to continue working on strengthening the banking union in all areas[73] – however, the concrete terms of the EDIS and a concrete timeline for its implementation are yet to be determined.

4 Conclusions

Looking at the developments in banking regulation and supervision over the past 25 years, changing levels of importance attached to the motivations and objectives behind law-making in this area over this time are clear to see. When the Segré Report was prepared in 1966, the frameworks of most European Economic Community member countries for regulating banking and banking supervision continued to reflect the measures taken to address the great economic crisis of the inter-war period. From 1970 to the mid-2000s, the central aim of the prevailing regulatory practice was harmonization, with efforts focused on creating uniform conditions for banks' business activities and completing a single market for financial services, as well as the implementation of internationally established supervisory standards. In the 2000s in particular, more attention was paid to finding the right balance of regulatory intensity, guided by the "better regulation" principle.

The outbreak of the financial crisis in 2007 significantly shifted the emphasis of targets once again, albeit this did not result in earlier goals being abandoned. Policymakers made dedicated efforts to strengthen financial market stability, minimize risks and lower the burden on the public purse in crisis situations. At the same time, they continued to pursue the objectives of creating a level playing field (harmonizing regulatory and supervisory conditions for banks' business activities in the different Member States) and continued to adhere to the "better regulation" approach. Testament to the latter are the discussions surrounding the application of the principle of proportionality to the Single Rulebook over the last few years, a subject also taken on board in the banking package in 2019.

It is not just the objectives that have been changing, however – the legislative approach to banking regulation has also undergone a transformation. While the process started with what tended to be fragmented European standards in individual areas, the Banking Consolidation Directive (BCD) in 2000 and the subsequent Capital Adequacy Directive (known as the CRD I package) laid down the framework for a more all-embracing approach. This was subsequently accompanied by a large number of mandates for technical work to be carried out by the EBA. In 2013, supervisory norms aimed at strengthening the single market were for the first time implemented through a regulation directly applicable in all Member States.

[72] *For further information, see European Commission (2015b).*

[73] *Eurogroup (2012).*

At the institutional level, too, the European supervisory framework continued to develop, with key changes induced in part by the crisis. This is reflected in the creation of the European System of Financial Supervision (ESFS) and the foundation of the first two pillars of the banking union, namely the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). On top of this, the increased focus on macroprudential aspects of supervision and crisis management led to central banks assuming a stronger role in banking supervision, as seen in the transfer of responsibility for supervising credit institutions in the euro area to the ECB.

In terms of substance, both the scope and complexity of the regulatory framework in place have increased significantly. This is partly the result of closing the gaps in supervisory rules following the financial crisis – a necessary step – and partly due to extensions to these rules and regulations to take into account, among other things, national exemptions when transferring international standards into European law. In light of lessons learned from the financial crisis, efforts to reduce complexity must therefore not involve rolling back important, stability-enhancing regulations, but rather focus on applying more proportionality and reducing the number of historical, predominantly national derogations with a view to creating a uniform, consistent regulatory framework for the entire EU: the Single European Rulebook.

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