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Should non-euro area countries join the SSM?

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1. Introduction

Following the summit of 29 June 2012, Europe is determined to move ahead with a banking union. The decision stemmed partly from the recognition of the discrepancy between the integrated European banking market and the largely national banking policies. But perhaps even more importantly, the decision was a response to the increasing market pressure on several interlinked banks and sovereigns of the euro area, and the increasing financial fragmentation, which risked having major negative impacts on the economy of the euro-area and beyond. It is worthwhile repeating the first sentence of the 29 June 2012 Euro Area Summit Statements: "We affirm that it is imperative to break the vicious circle between banks and sovereigns." The vicious circle had been previously highlighted by different researchers (e.g. Gerlach, Schulz and Wolff (2010), Véron (2011), Darvas (2011), Merler and Pisani-Ferry (2012), Angeloni and Wolff (2012)). The European Banking Union initiative aims to address this vicious circle, to improve the quality of banking oversight and thereby to reduce the probability of bank failures and the ensuing costs to taxpayers.

The following elements are generally seen as central to addressing the vicious circle and completing the banking union: a common banking supervision based on a single rulebook, a single resolution mechanism, agreement of fiscal burden sharing and some degree of common deposit insurance (Pisani-Ferry et al 2012). Better banking oversight would reduce the probability of bank failures and the ensuing cost to taxpayers while resolution equally aims at reducing costs to the tax payer. The element of fiscal burden sharing is the logical complement to fully overcome the doom-loop. Most of the discussion in the second half of 2012 was focused on the supervisory mechanism leading to a Council agreement on the legislative proposal for the Single Supervisory Mechanism (SSM) on 13 December 2012 (see Council, 2012) and an accompanying agreement on modifying the regulation of the European Banking Authority (EBA). The discussion on the single resolution mechanism, including its fiscal backstop, is currently undergoing and the European Commission has announced its intention to publish first proposals before the summer (see Véron and Wolff 2013 for more details). The most contentious part of the discussion certainly relates to the fiscal burden sharing arrangements (Pisani-Ferry and Wolff 2012).

The final design of the future banking union is still very much unclear. While euro-area members will be included in all element of the banking union, the December 2012 agreement allows non-euro area

[1] Thanks are due to Carlos de Sousa and Giuseppe Daluiso for excellent research assistance.

members of the EU to participate in the SSM. Presumably, further elements of the banking union will also allow the participation of non-euro area members in certain forms. For these countries, therefore, an important strategic question is whether and when to join parts or all elements of the emerging banking union. Currently, these non-euro countries have to decide about participation in the SSM once the December 2012 legislative proposal has entered into force, without knowing the design of the other elements. While the SSM as such is just a part of the banking union and as such cannot deliver the full benefits, a single supervision can bring a number of benefits. In particular the supervision of cross-border banks should be improved and supervisory practices should be made more consistent.

On September 12, 2012 the Commission had put forward its initial proposal for the single supervisory mechanism.[2] It was perceived by many non-euro area countries as not sufficiently catering for the interests of countries outside of the euro area. The core difficulty relates to the defined treaty base and the resulting decision making structure. Following the European Council conclusions of June 2012, the Regulation proposal employs as a Treaty base Article 127(6) TFEU. The Article puts the ECB at the centre of the mechanism. The ultimate decision making body of the ECB is the Governing Council (Art. 129(1) TFEU), in which the non-euro area countries do not have a vote. This Treaty base was seen by many non-euro area countries as essentially preventing them from participating in the mechanism.[3] . In the subsequent negotiations, significant modifications were undertaken also with the aim of addressing the concerns of non-euro area members (Council 2012).

In this note we assess the current legislative proposal from the perspective of EU member states outside the euro area and evaluate various arguments against, and in favour of, joining the SSM. The next section analyses the legal text, while section 3 discusses the arguments. The last section concludes.

2. The SSM regulation proposal: key aspects for non-euro area countries

In this section, we briefly discuss some the key aspects of the adopted regulation proposal (hereafter: Regulation), which are most relevant to non-euro area participating member states. We also review the safeguards for non-participating EU member states.

Legal Framework

Article 6 of the Regulation defines the terms of cooperation of participating member states whose currency is not the euro. The SSM is open to participation of EU countries that are not members of the euro area on the basis of "*close cooperation*" (Article 6). Close cooperation essentially requires that non-euro member states that wish to join the SSM, adopt the necessary legal framework and cooperate with the ECB along the lines codified in the Regulation. This means, in particular, that the national

[2] See the assessment of this proposal in Véron (2012).

[3] The alternative treaty base, Article 352, was not pursued and the Council had to find a compromise solution based on Article 127(6) which refers to the ECB.

authorities, as those authorities within the euro area, will be bound to abide by guidelines and requests issued by the ECB and be responsible to provide the adequate information.

Right to exit

The Regulation's Article 6 also allows for exit of non-euro area participating member states by three ways: (1) after three years without qualification (Article 6(6a)); (2) exclusion by the ECB in the event of a major non-compliance by the authorities of the non-euro area country (Article 6(6)); (3) expedited exit procedure on the request of the non-euro area country in case of a major disagreement with a supervisory decision impacting this country (Article 6(6aab)). Following an exit, re-entering the SSM is possible after three years.

Decision making

Supervisory draft-decisions of the SSM will be taken by a Supervisory Board that the new Regulation creates. These draft decisions will be deemed adopted unless the Governing Council of the ECB objects within a period to be defined but less than 10 days (Article 19(3)). The Supervisory Board will consist of the Chair, the Vice Chair, who is an ECB executive Board member, 4 representatives from the ECB and one representative from the supervisory authority of each member state participating in the SSM.[4] Decisions of the Supervisory Board shall be taken by simple majority of its members with every member having one vote (Article 19(2ab)), except for decisions on regulations adopted by the ECB (Article 4(3)).

This compromise considerably improves the influence of non-euro area countries on supervisory decisions and it probably reached the maximum which is possible under the adopted legal framework. Nevertheless, additional safeguards are provided for the non-euro area countries. First, the draft decision by the Supervisory Board is transmitted to the Member States concerned at the same time when it is transmitted to the Governing Council of the ECB. Whenever a non-euro area participating member states objects a draft decision prepared by the Supervisory Board, the Governing Council will invite the representatives of that member state to the meeting. Appeal to the European Court of Justice is possible. There is also the procedure (discussed above) allowing for an expedited exit of the member state (Article 6(6aab)), in which case the decision of the Governing Council will not apply to that member states.

Accountability

The accountability of the ECB in the exercise of its supervisory tasks is broad based. The ECB is accountable towards the European Parliament and the Council of Ministers for the implementation of the Regulation. There are regular reporting requirements and the chair of the Supervisory board needs

[4] When the national supervisor is not the central bank, then a representative of the central bank can also participate in the Supervisory Board. But for voting they will have only one vote (Article 19(1)).

to present the report to the European Parliament and the Eurogroup extended by those ministers of countries participating in the SSM. The chair may also be heard by the relevant committees on the execution of its tasks. Finally, the ECB is also required to answer in writing to any questions raised by national parliaments and national parliaments may invite the chair or any other member of the supervisory board for an exchange of views. Overall, in terms of accountability the Regulation therefore puts non-euro area countries on equal terms with euro area countries.

Supervisory convergence

One pre-requisite for the establishment of the SSM is the passing of the Capital Requirements Regulation (CRR) and its complement the fourth Capital Requirements Directive (CRD4). This is necessary so that the SSM can implement a harmonized supervisory rulebook based on the Basel III accord instead of the currently in place and different national regulations. To ensure consistence of standards throughout the EU, the regulation foresees that the EBA continues to ensure supervisory convergence and consistency of supervisory outcomes. From the point of view of the rules determining banking supervision, there should be no material difference between countries in the SSM and those outside of the SSM. Whether in practice there will be differences, remains to be seen. It appears, however, possible that the ECB will de facto become a standard setter in supervisory practices and most member states would eventually have to apply those standards.

Coverage

As a general rule, only "significant" financial institutions (and their subsidiaries and branches) will be directly supervised by the ECB, but the ECB will have the right to supervise any institution, if an institution is suspected to cause a significant risk for financial stability. In Box 1 we aim to quantify the share in total assets under direct ECB supervision in each non-euro country if it was to join the SSM. Our results indicate that participation would lead to a large coverage in terms of assets but relatively low number of banks (de Sousa and Wolff 2012 document a similar result for the euro area countries). For countries outside the SSM, only branches of large banks that are located in a participating member state will be falling under the ECB supervision while subsidiaries remain under the supervision of national supervisors.

Box1: SSM Coverage of non-euro area member states

We use the extensive but not comprehensive *The Banker Database* to estimate the percent of total banking assets covered by the Single Supervisory Mechanism (SSM) in non-euro area member states, should they decide to join. This database includes 1,032 bank holding companies and subsidiaries out of the 7,533 monetary and financial institutions standing in the EU at the end of 2011. Since the institutions not included are small, the database has a good coverage of the total banking assets in the EU (Table 1).

Table 1: coverage of The Banker Database of total assets in the national financial systems

Total assets (million euro, end of 2011)			
	ECB	The Banker	Coverage
Bulgaria	40,604	29,036	72%
Czech Republic	175,276	138,842	79%
Denmark	932,590	920,371	99%
UK	11,353,739	11,147,564	98%
Hungary	110,986	89,382	81%
Lithuania	22,855	22,421	98%
Latvia	27,019	23,499	87%
Poland	318,368	252,265	79%
Romania	84,094	65,313	78%
Sweden	1,647,740	1,515,659	92%

Sources: ECB and The Banker Database

A drawback of this dataset is that it does not include most of the branches and it misses some small subsidiaries as well. Given that we use the total assets reported by the ECB as denominator which includes all financial institutions, our estimates presented in Figure 1 (below) should be taken as the minimum share of total assets that would be under the SSM if a non-EA member state would decide to join.

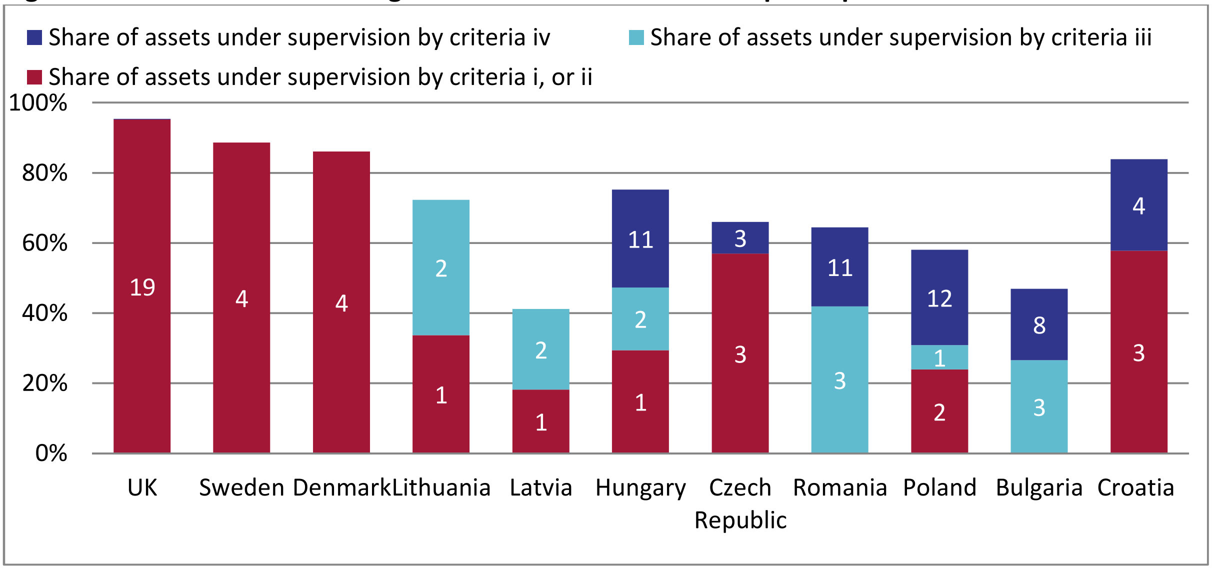
From the Regulation proposal, we used the following criteria to assess if a financial institution will fall under the supervision of the ECB

i. The total value of its assets exceeds 30 billion euro; or,
ii. The ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20%, unless the total value of its assets is below 5 billion euro; or,
iii. It is among the three most significant credit institutions in the participating Member state, unless justified by particular circumstances; or
iv. It is subsidiary or branch of a banking group which fall under the SSM.

Note that other institutions which are concluded to have a significant relevance with regard the domestic economy, and institutions, in which cross-border assets or liabilities represent a significant part of total assets, will also be covered by the SMM, but we did not incorporate these considerations. Also, all institutions for which public financial assistance has been requested or received directly from the EFSF or the ESM will be covered by the SSM, but such direct support has not yet been granted and, according to current legislation, non-euro area countries cannot benefit from the EFSF and ESM.

In Figure 1 we distinguish between financial institutions that would fall under supervision by complying one of the first two criteria, i.e. 'big enough', and those that fulfil only the third or the fourth one.

Figure 1: Percent of assets falling under the SSM in the case of participation



Sources: The Banker Database, ECB and Bruegel calculations
Note: numbers over the bars indicate the number of banks that could be under ECB's supervision
In Central and Eastern Europe, where the banking systems are mostly dominated by subsidiaries and branches of euro-area parent banks, the inclusion in the SSM would mainly come from these subsidiaries and the criteria concerning the three biggest banks. In the case of Hungary, for example, the OTP Group is the only Hungarian banking group that has consolidated assets that exceed 20 percent of GDP.

In Lithuania, only three institutions could be under SSM: Swedbank (Swedish), SEB Group (Swedish) and Danske Bank (Danish). In Latvia, Swedbank, SEB Group and Aizkraukles Banka (third biggest Latvian bank) would be included.

In order to check the precision of our estimates from The Banker Database in the case of a particular country, we compared our results with the comprehensive dataset of the Hungarian Financial Supervisory Authority which includes all financial institutions, including branches (Table 2).

Table 2: Hungary: comparison of our estimates from The Banker Database with the official data

(Million euro; end-2011)	Hungarian Financial Supervisory Authority	The Banker Database	The Banker Database combined with ECB data on total assets
Total assets	118,297	89,382	110,986
Assets under SSM	91,690	83,427	83,427
Total number of institutions	435	20	20
Number of institutions under SSM	54	14	14
Share of assets under the SSM	78%	93%	75%

Source of the Hungarian Financial Supervisory Authority data:
https://www.pszaf.hu/bal_menu/jelentesek_statisztikak/statisztikak/aranykonyv (available only in Hungarian)
The two main reasons for the difference are that The Banker Database does not include (a) most of the branches and (b) smaller banks. As Table 2 shows, in the case of Hungary, the difference in assets under the SSM is not large and when we use total assets from the ECB and relate to it the assets to be covered from The Banker Database, the difference in the estimated share of assets to be covered by the SSM is small (78 percent versus 75 percent).

This box was prepared by Carlos de Sousa.

END OF BOX 1

Another interesting aspect in terms of coverage is the case of the subsidiaries established in the euro area of those banking groups that are headquartered in a non-participating member states. For example, in Box 2 we look at the composition of Danske Group and the Hungarian OTP Group. If Denmark stayed outside the SSM, then still, Danske's subsidiaries in euro-area countries would be directly supervised by the ECB because they would collectively be larger than the defined thresholds. This would not happen to the OTP group, because OTP's subsidiaries in euro-area countries are small. But OTP has significant exposure to Russia and Ukraine and some smaller subsidiaries in non-EU Balkan countries. Therefore, if Hungary was to join the SSM, 61 percent of OTP's activities would be covered for sure, but about one-fifth of the group's total activity would be surely outside the jurisdiction of the SSM (activities in non-EU countries) and another one-fifth would depend on the SSM participation of Bulgaria, Croatia and Romania.

Box 2: Danske and OTP: two major banking groups headquartered outside the euro-area

Unfortunately, we did not find a decomposition of all activities of Dankse Bank among the countries of its operation, but only a decomposition of lending activities, which account for 48 percent of total assets. Yet the banking activities in Finland and Ireland, two euro area countries, pass the €30 billion threshold and therefore these subsidiaries will be supervised by the ECB, irrespective of Denmark's participation in the SSM (Tables 3 and 4).

Table 3: Composition of the consolidated balance sheet of Danske Group

	€ billions	Share
Due from credit institutions and central banks	15.2	3%
Repo loans	41.2	9%
Loans and advances	224.4	48%
Trading portfolio assets	108.9	23%
Investment securities	14.4	3%
Assets under insurance contracts	32.3	7%
Other assets	30.6	7%
Total assets	**467.1**	**100%**

Source: The Danske Bank Group Annual Report 2012 (published on 7th February 2013) http://www.danskebank.com/en-uk/ir/Documents/2012/Q4/Annualreport-2012.pdf

Table 4: Geographical distribution of banking activities of the Danske Group

	€ billions	Share	Share in Total Assets
Retail Banking Denmark	127.8	57%	27%
Retail Banking Sweden	24.7	11%	5%
Retail Banking Finland	20.4	9%	4%
Retail Banking Norway	19.0	8%	4%
Retail Banking Ireland	13.3	6%	3%
Banking Activities Baltics	2.5	1%	1%
Other Banking Activities	2.3	1%	1%
Corporate & Institutional Banking	13.4	6%	3%
Total Banking Activities	**223.2**	**100%**	**48%**

Source: The Danske Bank Group Annual Report 2012 (published on 7th February 2013) http://www.danskebank.com/en-uk/ir/Documents/2012/Q4/Annualreport-2012.pdf

For the OTP Group, a decomposition of the consolidated balance sheet is available across countries of operations (Table 5).

Table 5: Distribution of the consolidated balance sheet of the OTP Group among countries of operations, 2012Q3

	€ billion	share
(a) Hungary	**21.3**	**57%**
(b) Euro-area countries	**1.3**	**4%**
Slovakia	1.3	4%
(c) Other EU countries	**8.0**	**21%**
Bulgaria	4.6	12%
Croatia	1.8	5%
Romania	1.6	4%
(d) Non-EU countries	**6.8**	**18%**
Montenegro	0.8	2%
Serbia	0.4	1%
Russia	3.4	9%
Ukraine	2.3	6%
Consolidated	**37.5**	**100%**

Source: Interim Management Report, First nine months of 2012 results (English translation of the original report submitted to the Budapest Stock Exchange), 15 November 2012, OTP Bank Plc.
https://www.otpbank.hu/static/portal/sw/file/121114_OTP_20123Q_e_final.pdf

END OF BOX 2

Non-participating member states

As regards countries outside the SSM, the regulation foresees that they would conclude a Memorandum of Understanding describing how they will cooperate with the ECB. This would involve regular consultations as well as an agreement of how to manage emergency situations. The change in EBA decision making by the accompanying EBA regulation, whereby double majority (majority of both SSM participating member states and also the majority of the non-participating member states) is needed, strongly improves the position of the non-participating member states in EBA decisions.[5]

[5] Also, the Preamble of the Proposal states that: "*EBA is entrusted with developing draft technical standards and guidelines and recommendations ensuring supervisory convergence and consistency of supervisory outcomes within the Union. The ECB should not replace the exercise of these tasks by the EBA*", but to adopt regulations based on the guidelines and recommendations of the EBA.

3. Pros and cons of joining the SSM

A number of arguments need to be carefully weighed when considering whether to join or not join the SSM.

First, let's consider the major earlier worries[6] regarding the first proposal of the European Commission and assess the extent to which the compromise Regulation addresses these issues. Here, we do not discuss the multiple questions related to the single bank resolution mechanism, whose shape remains still largely unexplored.

1) Inadequate inclusion of non-euro participating member states in decision making

It was feared that the SSM only caters for the interest of euro area countries, while countries outside the euro would either not be able to participate in the system, or if they would, they will not have a sufficient voice in the decisions. The Treaty's Article 127(6) provides a relatively weak basis for the involvement of non-euro area member states as the article puts the ECB in the centre of decision making. Indeed, the final decision making body of the ECB is the Governing Council, consisting of the ECB executive board and the central bank governors of the countries belonging to the euro. As a consequence, final supervisory decisions will have to be passed in the Governing Council. As argued above, within these limits, the compromise text has arguably achieved the maximum decision making power and involvement for non-euro area members possible.

Also, whenever a non-euro area participating member state disagrees with a draft proposal of the Supervisory Board and this proposal is passed by the Governing Council, or when such a member states agrees with the draft proposal, but that proposal is overturned by the Governing Council,[7] then the special opt-out clause for non-euro participating member states can apply, so that the member state is not bound by the decision. This is, of course, a radical decision and the regulation therefore foresees that it is impossible to re-enter the SSM within a three year delay. The opt-out clause caters for concerns but comes at a significant price. In particular, it introduces a significant uncertainty as to the permanency of the geographical coverage of the SSM.[8]

Furthermore, the Preamble of the regulation keeps the option open of adjusting the treaty base of the SSM so as to enshrine a full participation of non-euro area countries.[9] Overall, we would argue that non-

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[6] The source of some of these earlier worries is Zettelmeyer, Berglöf and de Haas (2012), while others emerged during our interviews with various stakeholders.

[7] It is, however, quite unlikely that the majority on any major supervisory decision is so thin in the Supervisory Board that there would be a different majority in the Governing Council.

[8] This option provides the non-euro area countries with a very special status in which purely national interests under certain conditions can be put ahead of the common interest.

[9] Wolff (2012) called for a sunset clause in the regulation so as to force the reconsideration of the treaty base. The regulation's preamble now reiterates the Commission proposal (which was put forward in its Blueprint for a deep

euro area participating member states will have sufficient voice in decision making in the steady state.

2) Inattention to small countries

Some feared that the ECB might devote insufficient attention to the supervision of a small country's financial system. However, this is not a concern that is in any way specific to non-euro area countries. Moreover, the Regulation defines the clear goal of safeguarding financial stability both at the EU level as well as in each individual participating member states. The ECB will supervise credit institutions at a consolidated basis with regard to the group, but also on an individual bases with regard to subsidiaries and branches in participating member states. While the primary focus of the SSM will be on large banks, whenever there is a risk that a small bank poses a threat to financial stability, the ECB can exercise supervisory tasks to this credit institution, even if it is a branch from a parent bank outside the SSM. We do not see the risk therefore that the ECB would miss important supervisory tasks in countries with few and small banks.

3) Macroprudential tools

Some non-euro area member states were concerned that the centralisation of macro-prudential tools at the ECB would prevent them from taking appropriate macroprudential regulatory action in response to the issues specific to countries outside the euro, especially with regards to capital buffers. The compromise regulation grants the right to adopt national macro-prudential regulations (Article 4a). While the ECB can express objections to the proposed measures, the concerned national authority only has to "*duly consider the ECB's reasons prior to proceeding with the decision*", but the ECB cannot block such measures unless they violate a relevant EU law. On the other hand, the ECB can apply higher requirements for capital buffers and more stringent measures aimed at addressing systemic or macroprudential risks.

4) Supervisory coordination failures with respect to banks with cross-border activities

As argued by Zettelmeyer, Berglöf and De Haas (2012), a major drawback of the September 2012 proposal of the Commission was not addressing the supervisory coordinator failures with respect to multinational banks, for which either the parent or the subsidiary is located outside the SSM countries. These failures arise from direct conflict of interest over how to share the burden of bank resolution, and the anticipation of such a situation during good times. National authorities' main concern is the eventual burden to their domestic taxpayers and they pay much less attention to cross-border

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and genuine economic and monetary union) to amend Article 127(6) of the TFU to eliminate some legal constraints, such as "*to enshrine a direct and irrevocable opt-in by non-euro area Member States to the SSM, beyond the model of "close cooperation", grant non-euro area Member States participating in the SSM fully equal rights in the ECB's decision-making, and go even further in the internal separation of decision-making on monetary policy and on supervision.*". A re-consideration of the legal framework is thus not fully of the table.

externalities of their actions.

Despite the establishment of the EBA, which aims to coordinate between home and host supervisors in the EU, several unilateral actions were adopted by national supervisors to ring-fence banking activities. While Article 1 of the Regulation states the importance of the unity and integrity of the single market, there is not much in the Regulation that could help to resolve such cross-border supervisory conflicts. There will be cooperation between the ECB and authorities of both EU countries not in the SSM and with countries outside the EU. It needs to been if such cooperation will improve the aforementioned supervisory coordinator failures. However, since most banks and subsidiaries established in non-euro countries are headquartered in euro-area member states, if non-euro countries would join the SSM, this problem would have a lesser relevance thereafter, because the ECB will be the supervisor of both the parents and the subsidiaries in participating member states.

Still, as discussed above, national supervisory authorities in the SSM could apply various macroprudential measures which may also serve ring-fencing and the ECB will not be able to block such measures.

But arguably, addressing cross-border supervisory coordination issues should be easier if both the parent and the subsidiary will belong to the SSM, which calls for entering the SSM by those non-euro area member states in which subsidiaries of euro-area parent banks have a large role.

Beyond these earlier worries, a number of additional factors have to be considered.

5) Effect on the activities of major banking groups in non-participating countries

Some observers speculate that large banking groups headquartered in euro-area countries may re-consider the geographical scope of their business and may reduce the activities of their subsidiaries established in countries that will not participate in the SSM. This may in particular be a concern, when one sees the decision to join the SSM as a clear decision to also join the forthcoming Single Resolution Mechanism. If that was to happen, it may bring economic costs to these countries and may prove to be difficult to re-establish the currently strong cross-border financial integration, once a country has joined the SSM later.

A number of arguments need to be considered carefully in this regard. First, delaying a decision on joining the SSM increases the uncertainty for the concerned banks. Banks do not know whether they will eventually fall under the joint supervision, whether they will be supervised as a group or whether subsidiaries will remain under national supervision only. This represents an important uncertainty which will justify delaying decisions on bank operations as well as investments. When bank regulation and the scrutiny of bank supervision will be very much different under the SSM than under the national supervisors, then this uncertainty is compounded.

But more importantly, some of the cross border banks are already now affected by regulatory practices as regards cross-border liquidity and capital operations. There is a risk that the home supervisor of the parent bank adopts measures discriminating against non-participating member states. Indeed, a number of home supervisors tried to ring-fence banking activities inside the home country during the crisis and even recently, the European Commission had to issue a statement on 4 February 2013 trying to limit such activities.[10] While this risk will remain, one of the goals of the proposal regulation on the SSM is to preserve the integrity of the single market. Yet it remains to be seen to what extent the ECB will be able and willing to change the currently reported ring-fencing of banking activities.

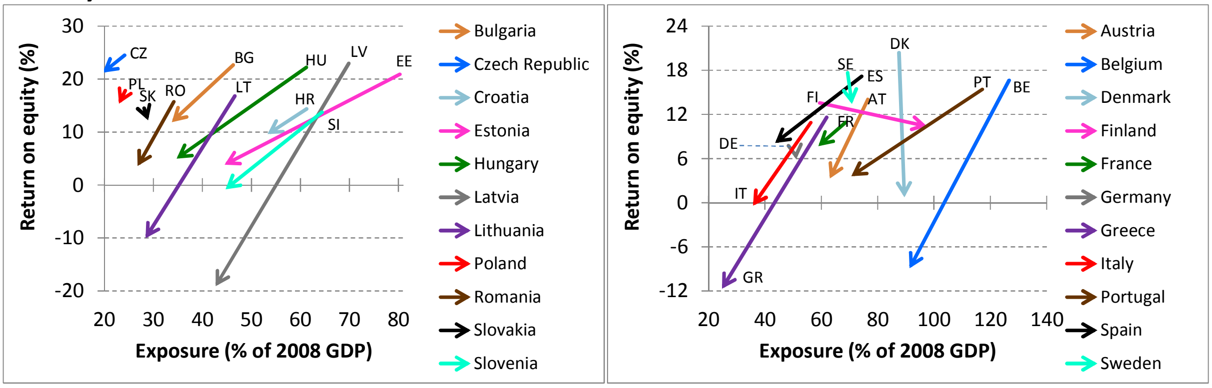
At the same time, there are also factors suggesting that the participation in the SSM, or the lack of it, may not be a key factor for cross-border investment decision of major banking groups. Banking groups engaged in activities outside the country of their headquarters based on strategic decisions. Regarding non-euro are member states in central and eastern Europe (CEE), banking business was much more profitable than in EU15 countries before the crisis, and also during the crisis.[11] While the growth rates of CEE will likely be smaller compared to the pre-crisis growth rates, these countries continue to have a brighter economic outlook than euro-area countries according to medium term forecasts. Therefore, banking in these countries will likely remain more profitable than banking in euro-area countries. Clearly, major euro-area banking groups have started to decrease their exposure to region, but most likely because either their exposure have grown too high or because they faced serious capital and liquidity needs in their home countries or regulatory pressure with similar effects. These later considerations may remain and therefore their exposure to the region may be reduced further.

Figure 2 confirms that the change in exposure to CEE countries from 2008Q3 to 2011Q3 was larger when (a) the exposure was larger in 2008Q3 and (b) where bank profitability declined significantly during 2008-2011. Foreign banks may be more selective in cross-border investments, but we see little incentives to reduce the exposure to eg the Czech Republic and Poland, two countries in which banking business remained highly profitable during the crisis and the exposure of foreign banks is not too high.

[10] Some quotes from the 4 February 2013 statement of the EC: "*The Commission took this action because it had been made aware that, on several occasions, national bank supervisors acted independently to impose allegedly disproportionate prudential measures on national banking subsidiaries of cross-border EU banking groups. The alleged measures in question include capital controls, restrictions on intra-group transfers and lending, limiting activities of branches or prohibiting expatriation of profits. These would have the effect of 'ring-fencing' assets, which could, in practice, restrict cross-border transfers of banks' capital and potentially constrain the free flow of capital throughout the EU.*"

[11] During the crisis, return on equity was highly negative in the three Baltic counties that went through unsustainable credit booms before the crisis and an extreme bust and economic hardship. Bank profitability also turned negative in Hungary by 2011 due unusually high bank taxes and other measures.

Figure 2: Return on equity of banks and the change in foreign banks' exposure to the domestic economy from 2008Q3 to 2012Q3



Note: the starting coordinate of an arrow is the exposure of BIS reporting banks (ie all banks of the world, not just euro-area banks) in 2008Q3 as a percent of 2008 GDP of the host country on the horizontal axis and the average return on equity during 2003-2007 on the vertical axis. The end coordinate of an arrow is the exposure in 2012Q3 (on an exchange rate adjusted basis so that exchange rate changes do not influence the reported magnitude of the change in exposure) on the horizontal axis and the average return on equity during 2008-2011 on the vertical axis. Data for six EU countries are not reported due to very high values. In these countries, the exposure declined from 2008Q3 to 2011Q3: in Cyprus from 271 percent to 242 percent; in Ireland from 486 percent to 299 percent; in Luxembourg from 1778 percent to 1748 percent; in Malta from 546 percent to 450 percent; in the Netherland from 177 percent to 143 percent; and in the United Kingdom from 202 percent to 179 percent (all are expressed as a percent of 2008 GDP and are based on exchange-rate adjusted changes).
Source: Bruegel calculations using IMF Financial Soundness Indicators tables and BIS data.

Also, supervisory differences may not be a major concern. Major banking groups have developed their central European subsidiaries under the supervision of national authorities and hence the absence of change in the supervisor should not immediately imply a change in their strategic engagements. It can be assumed that the headquarters anyway have strong controls over their subsidiaries and therefore even if the remaining local supervisor may be viewed less careful than the ECB, it may not matter much. Too-stringent national macro-prudential tools limiting business opportunities may be implemented under the SSM as well as outside of it.

Overall, the immediate risk related to reducing the activities of subsidiaries established in non-participating countries of major banking groups may not be very high, but uncertainty, including about discriminatory measures against non-participating member states by the home supervisor of the parent bank could limit the activities of large financial groups in non-participating member states (and also in non-EU countries).

6) Competitive disadvantage of banks not owned by a parent bank headquartered in an SSM country

When a country stays outside of the SSM, then domestically owned banks and those banks that do not have a parent bank in a SSM participating member state may face a competitive disadvantage. If supervision by the ECB will be regarded as an important safeguard in the assessment of the soundness of banks, then staying out may imply higher financing costs: both the cost of wholesale funding may be relatively higher and the depositors may also require a higher interest rate. While it is difficult to assess the risk and the magnitude of such competitive disadvantages, they call for a membership in the SSM.

7) Implicit obligation to join other elements of the banking union after SSM membership

Clearly, there is uncertainty about the next steps of the banking union and belonging to the SSM may at least implicitly imply an obligation to join other elements of the banking union when they are adopted. However, the experience with the negotiations for the SSM showed that the interests of non-euro area member states were considered to perhaps the greatest possible extent allowed by the TFEU. As in the case of the SSM, the next steps of the banking union, the SRM, will be agreed upon by the co-legislators to which the non-SSM members are full party. We do not see how non-SSM countries would have a smaller impact on policy choices than SSM members. At the same time, non-euro area countries are already excluded from important debates, in particular when they relate to the European Stability Mechanism, but SSM membership would not make a material difference in these debates.

8) Contribution to the shaping of the practical operation of the SSM

The governing council as well as the supervisory board will have to set the rules of the practical operation of the SSM. This will be done at an early phase and will likely shape in a fundamental way the effectiveness and inclusiveness of the new mechanism. While according to the regulation, non-euro member states will be members only if this decision is published in the Official Journal of the European Union (Article 6(4) of the Regulation) and therefore most likely they can join formally only after the system has been set up, a clear and early signal to join the SSM is likely to increase the voice of non-euro member states in shaping the modalities. At the same time, however, the modalities have to be in line with the draft technical standards and guidelines and recommendations prepared by the EBA. This argument therefore calls for an early indication of the intention to join.

9) Access to supervisory information

Non-participating EU member states will sign a memorandum of understanding of the ECB with regards to cooperation during good times (ie consultations relating to decisions of the ECB having effect on subsidiaries and branches established in the Member State) and cooperation in emergency situations. While this may improve the flow of information related to supervisory matters from the SSM towards non-participating countries, but undoubtedly, participating member states will have full access to supervisory information. This would be especially valuable for countries in which several subsidiaries and branches of euro-area banking groups are established. Therefore, access to supervisory information calls for participation in the SSM.

4. Conclusions

This paper has reviewed the new legislation for the establishment of a Single Supervisory Mechanism from the point of view of non-euro area countries. The Treaty base provides a relatively narrow basis for the involvement of non-euro area countries. Yet, the achieved compromise provides strong safeguards to protect the interests of non-euro area countries.

The paper has outlined a number of arguments speaking in favour and against an early entry into the SSM. While it is too early to come to an overall conclusion, on balance, in our assessment an early decision to join may bring more benefits than drawbacks.

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