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European Harmonization of Banking Supervision: European Identity or International Context?

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Abstract

Currently, the world faces a tremendous issue: how to cope with the coronavirus pandemic through governmental responses. In terms of central banking strategies, that prudential policies are crucial to maintaining a stable and robust financial system seems unequivocal. Although monetary policy is the most indispensable application for central banking, micro- and macroprudential instruments are also recognized as essential crisis management toolkits. In this paper, we aim to clarify the dichotomy between European and international banking supervision methodologies. European identity, represented by the European Banking Union, is based on a jurisprudential approach, whereas the international approach that is implemented by the Basel Committee on Banking Supervision mirrors a soft-law methodology. This study explores prudential regulation issues in the relation between European internal harmonization and international cooperation. This analysis proposes future coordination of banking supervision through an effective mixture of hard- and soft-law implementation to prepare for crisis management.

Keywords: *European Banking Union (EBU), banking supervision, Basel Committee on Banking Supervision (BCBS)*

JEL Code: E58 (Central Banks and Their Policies), F36 (Financial Aspects of Economic Integration), G28 (Financial Institutions and Services: Government Policy and Regulation)

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[2] The paper was prepared to present at the EUSAAP (European Union Study Association Asia Pacific) Conference in Melbourne, Australia on 28-29 June 2021. I would like to appreciate the organizer and chairperson of the session for insightful comments.

1. Introduction

This paper aims to explore the experiences in Europe related to harmonizing banking legislative regulations and supervision. In today's world, offering a comprehensive convergence of banking supervision in diverse banking systems and regulatory regimes is no easy task. In fact, the regulatory systems in play in the European Union are differentiated with respect to each other; thus, strenuous effort should be made to harmonize the banking supervision method. In particular, the European Banking Union (EBU)[3] is the epitome of integrity in the harmonization of banking supervision in the Eurozone, in which the EBU has implemented two-thirds of its pillars.

After the inauguration of the 2012 Banking Union project[4], the Single Supervisory Mechanism (SSM) was established in November 2014[5] and has, since then, accumulated experience over 6 years. Currently, the SSM has developed credence in the European banking sector to avert fragmentation of the supervisory benchmark in the Eurozone. The SSM is based on the *ex-ante* approach in order to prepare countermeasures for financial crises in advance. The Supervisory Review and Evaluation Process (SREP)[6] is identified as an important method for the extent to which banking supervision needs to converge with 19 Eurozone countries' actual supervisory operations. The SSM is headquartered at the European Central Bank (ECB) in Frankfurt.

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[3] The first proposal on the EBU was unveiled by President of the European Council on 26 June 2012, getting along with the Genuine EMU (Economic and Monetary Union). European Council (The President). 2012. *Towards a Genuine Economic and Monetary Union, Reported by President of the European Council, Herman Van Rompuy*, Brussels 26 June 2012, EUCO 120/12, PRESSE 296, PR PCE 102.

[4] As it related to the more concrete elucidation of the EBU, the European Commission's communication on 12 September 2012 should be referred in terms of planning of the project from then onward. European Commission. 2012. *Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union*, Brussels, 12.9.2012, COM (2012) 510 final. Especially, the EBU has been put in place to assure the unity and integrity of European single market. *Ibid.*, p. 4.

[5] European Union. 2013. Council Regulation (EU) No 1024/2013 of 15 October 2013, conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, *Official Journal of the European Union*, L 287, 29.10.2013. As for relation between the ECB and the National Competent Authorities (NCAs), SSM Framework Regulation was stipulated in April 2014. European Union. 2014. Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014, establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation), ECB/2014/17, L 141, *Official Journal of the European Union*, 14.5.2014.

[6] Regarding the SREP, the recent publication in January 2021 should be informative. European Central Bank/Banking Supervision. 2021. "ECB asks banks to address credit risk and improve efficiency", *Press Release*, 28 January. In 2020, the ECB assessed four factors: (1) credit risk, (2) internal governance, (3) business model, and (4) capital adequacy. In terms for the 2021 priorities of the SREP are as follows: (1) credit risk, (2) capital strength, (3) business model sustainability, and (4) governance.

In contrast to the SSM, the Single Resolution Mechanism (SRM)[7] is on an *ex-post* approach coping with failing banks through efficient resolution during a crisis in an orderly manner. The SRM is determined as an effective trial to harmonize methodologies among member states for tackling plausible future financial crises. This *ex-post* approach represents efficacious *ex-ante* preparation in terms of how to implement an effective blueprint of recovery and resolution planning. The organization of the SRM has been expanded to comprise a substantial component of a single resolution regime. The SRM was launched in January 2015 and has been implemented as a full-fledged system since January 2016. The SRM is headquartered in Brussels, not Frankfurt.

Regarding the harmonization of deposit guarantee schemes (DGSs) in the Eurozone[8], the plausible convergence of the scheme—called the European Deposit Insurance Scheme (EDIS)[9]—has already been discussed[10]. However, the EDIS remains under discussion but is the last pillar of the EBU. A slight change in the headwind seems to have appeared recently, even though the EDIS faces strong opposition from the German perception, especially from Deutsche Bundesbank[11]. However, to complete the EBU, the EDIS would be deferred as originally scheduled, even though it requires time to be implemented. Obviously, this regime is necessary in order to strengthen the integrity of the holistic legislative framework of banking in Europe in the future.

In terms of international context, the Basel Committee on Banking Supervision (BCBS) has played a vital role in coordinating international banking activities. Since its establishment in December 1974, the BCBS has provided substantial regular meetings of the G10 plus Switzerland and the International Conference of Banking Supervisors (ICBS), which was opened to countries throughout the world.

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[7] European Union. 2014. Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, *Official Journal of the European Union*, L 225, 30.7.2014.

[8] European Union. 2014. Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast), Text with EEA relevance, L 173, *Official Journal of the European Union*, 12.6.2014.

[9] European Commission. 2015. *Proposal for a Regulation of the European Parliament and of the Council, amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme*, Strasbourg, 24.11.2015, COM (2015) 586 final, 2015/0270 (COD).

[10] The European Commission published a review of the EDIS discourse, focusing on 22 national options and discretions (NODs). European Commission. 2019. *Options and national discretions under the Deposit Guarantee Scheme Directive and their treatment in the context of a European Deposit Insurance Scheme: Final Report*, A study prepared by CEPS in collaboration with Milieu Consulting SPRL for the European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union, November.

[11] With respect to the opposite standpoint, the Bundesbank insisted the prerequisites such as de-risking in banking sector and harmonization of individual solvency laws as well as the implementation of the BRRD (Bank Recovery and Resolution Directive). There should be, *inter alia*, risk of contagion of sovereign debt which is related to "communitised" in crisis periods under the EDIS. Deutsche Bundesbank. 2015. 'Deposit protection in Germany', *Monthly Report*, December.

After the global financial crisis (GFC) in 2008, the Financial Stability Board (FSB) was clearly strengthened by the Financial Stability Forum (FSF). The FSB has the privilege to deal with cross-cutting issues beyond the sector of finance, namely, banking, investments (securities), and insurance. Internationally recognized institutions, such as the BCBS and FSB, supply essential resources for authoritative and academic communication among the nations of the world to forge cross-border banking regulations and supervision.

2. Literature Survey

A number of publications cast light on the harmonization of banking supervision. First, Busch and Ferrarini (2015, 2020)[12] used a comprehensive approach to explore the legal aspect of the EBU. This distinguished book includes the insightful combination of "Single Supervision and Capital Requirements Directive (CRD) IV," "Single Resolution and the Bank Recovery and Resolution Directive," as well as "MREL (Minimum Requirement for own funds and Eligible Liabilities) and TLAC (Total Loss-Absorbing Capacity)" through the UK's perspective. Regarding the EMU (Economic and Monetary Union), Amtenbrink and Herrmann (2020)[13] assiduously compiled a number of articles through the EU law. Regarding the response to crises and financial stability, Delimatsis and Herger (2011)[14] provided a collection of papers that analyzed the magnitude of banking regulations using informative perspectives. In this publication, Hüpkes (2011)[15] elucidated the critical points through an international point of view as related to effective crisis management. Regarding individual financial systems, Krahnen and Schmidt (2004)[16] described the German financial structure, implying that the German financial system is still the crucial point to grasp the feasibility of the completion of European harmonization in the field of banking regulation and supervision, namely, the EBU. In an informative book, Fischer and Pfeil (2004)[17] focused on the features of German banking regulations, including the historical path of the deposit guarantee scheme. By necessity, this study sheds light on the German idiosyncratic attribute regarding reaching

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[12] Busch, D., and G. Ferrarini. eds. 2015, 2020. *European Banking Union: First Edition and Second Edition*, Oxford University Press.
[13] Amtenbrink, F., and C. Herrmann. eds. assisted by R. Repasi. 2020. *The EU Law of Economic and Monetary Union*, Oxford University Press.
[14] Delimatsis, P and N. Herger. eds. 2011. *Financial Regulation at the Crossroads: Implications for Supervision, Institutional Design and Trade*, Wolters Kluwer.
[15] Hüpkes, E. 2011. "How to Deal with Global Financial Institutions in Crisis', in Delimatsis, P., and N. Herger. eds. 2011. *Financial Regulation at the Crossroads: Implications for Supervision, Institutional Design and Trade*, Wolters Kluwer.
[16] Krahnen, J.P., and R.H. Schmidt. eds. 2004. *The German Financial System*, Oxford University Press.
[17] Fischer, K.-H., and C. Pfeil. 2004. "Regulation and Competition in German Banking: An Assessment", in Krahnen, J.P., and R.H. Schmidt. eds. 2004. *The German Financial System*, Oxford University Press.

agreement on the EDIS as composed by the three pillars of the EBU. In reference to international cooperation regarding banking supervision, Goodhart (2011)[18] excellently elaborated on the historical path of the BCBS by citing informative archival records from 1974 to 1997. Capie (2010)[19] magnificently delineated the trajectory of banking legislation as related to the Banking Act 1979 regarding UK banking supervision. In the context of European and international perspectives of prudential policies, an intertwined analysis for contextualizing European harmonization during the course of globally effective cooperation on banking supervision is necessary. Kapstein (1974, 2008)[20] provided a comprehensive overview of the international cooperation of central banks' supervision by exploring the magnitude of the global perspective on securing the financial stability referred to in the Basel process to enact a regulatory architecture. As a recent study on the historiological perspective, Schenk (2020) elucidated "the changes in regulation and the geographic pattern of international banking activity"[21] and focused on the period from 1975 to 1990.

This study features a mixture focused on the European and international perspectives on the harmonization of banking supervision, which are vital cornerstones for financial stability. As an exploration of the appropriate direction for prudential policy, this paper presents the relevant issues related to making the banking system sound and in tune with frequent fluctuations and unstable economic circumstances.

3. Current Status on European Banking Supervision

A discourse on the difference between supervision and regulation

Regarding the field of prudential policies, the difference between banking supervision and regulation provides an informative standpoint for characterizing each function. Capie (2016) suggested a thought-provoking perception as follows: "There is a difference between supervision and regulation. The first implies some overseeing and possibly some suggestion of appropriate behaviour. The second carries the clear implication of policing and disciplining and would have to carry the threat of penalty to be effective."[22]The European banking prudential field can be divided into two bodies:

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[18] Goodhart, C. 2011. *The Basel Committee on Banking Supervision: A History of the Early Years 1974 -1997*, Cambridge University Press.
[19] Capie, F. 2010. *The Bank of England: 1950s to 1979*, Cambridge University Press.
[20] Kapstein, E.B. 1994. *Governing the Global Economy: International Finance and the State*, Harvard University Press, Kapstein, E. B. 2008. "Architects of Stability? International Cooperation among Financial Supervisors", in Borio, C., Toniolo, G., and P. Clement. eds. *Past and Future of Central Bank Cooperation*, Cambridge University Press.
[21] Schenk, C. R. 2020. "Regulatory foundations of financialization: May Day, Big Bang and international banking, 1975-1990", *Financial History Review*, 27. 3, Cambridge University Press on behalf of the European Association for Banking and Financial History.
[22] Capie, F. 2016. "Central Banking", in Cassis, Y., Grossman, R.S., and C.R. Schenk. eds. *The Oxford Handbook of Banking and Financial History*, Oxford University Press, p. 356.

the ECB's SSM as banking supervisor and the European Banking Authority (EBA) as banking regulator. **Figure 1** shows these two bodies' differentiation in their respective roles and targets. The ECB has been identified to play a pivotal role in directly supervising significant institutions (SIs) in the Eurozone, Bulgaria, and Croatia in tandem with the national competent authorities. As of January 1, 2021, the ECB has reportedly supervised 115 SIs (ECB 2021).[23] The EBA is an important regulatory institution and one of the European Supervisory Authorities (ESAs) established through the proposal of the *de Larosière Report*, as is subsequently discussed. The essential responsibility of the EBA is to establish a single rulebook and set up numerous regulatory technical standards for banking supervision, resolutions, and DGSs. The EBU's foundation is the single rulebook in which all of its pillars are stipulated.

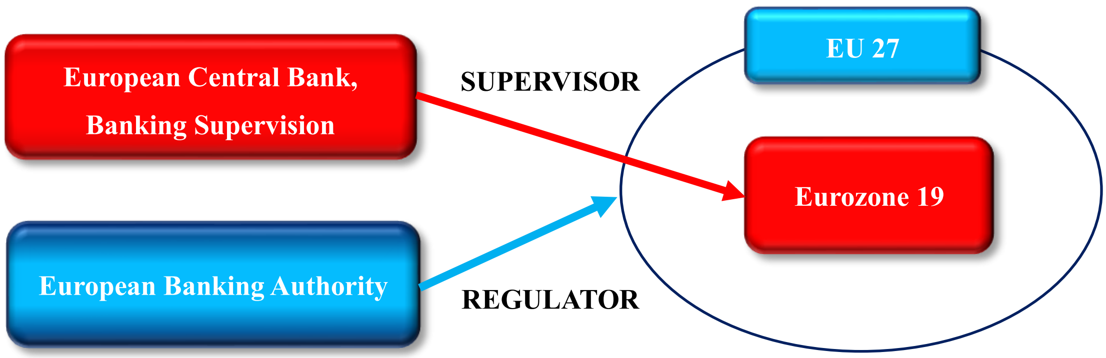

Figure 1: Supervisor vs. regulator: EU's classification and targets

Source: Author.

Antecedent Condition of the EBU: De Larosière Report for All EU Member States

After the GFC, European experts promptly published a report in response to the crisis. In February 2009, *de Larosière Report* proposed the trans-European supervisory mechanism of banking, securities, and insurance.[24] The ESAs consist of the EBA, the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). These three bodies conform to the European System of Financial Supervision (ESFS) from the perspective of microprudence. The ESFS embraces the European Systemic Risk Board (ESRB), which mandates macroprudence across the European Union. These supervisory bodies are different from the EBU's SSM and SRM because of the EU member states' target. The EBA's headquarters was moved from London to Paris because the UK left the EU in 2020. However, the EBA represents the single rulebook

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[23] European Central Bank. 2021. *List of supervised entities*, Cut-off date for changes in group structures, 1 January 2021.

[24] The High-Level Group on Financial Supervision in the EU (The de Larosière Group). 2009. *Report*, Brussels, 25 February.

for professionality, which is the foundation of supervision, resolution, and deposit insurance, as previously mentioned. **Figure 2** delineates the holistic picture of the ESFS, and the essence is recapitulated: ESFS = ESRB +ESAs.

Regarding the interconnection of deposit-taking and investment banks (securities), cooperation between the EBA and ESMA should be a vital cornerstone in terms of formulating the Capital Markets Union (CMU) and the EBU. On the basis of the comprehensive design of blueprints for a genuine, completing, and deepening EMU, the Financial Union (FU) is prominently placed in the EMU's progress in the 2020s. Succinctly, the FU is considered as follows: FU = EBU + CMU.

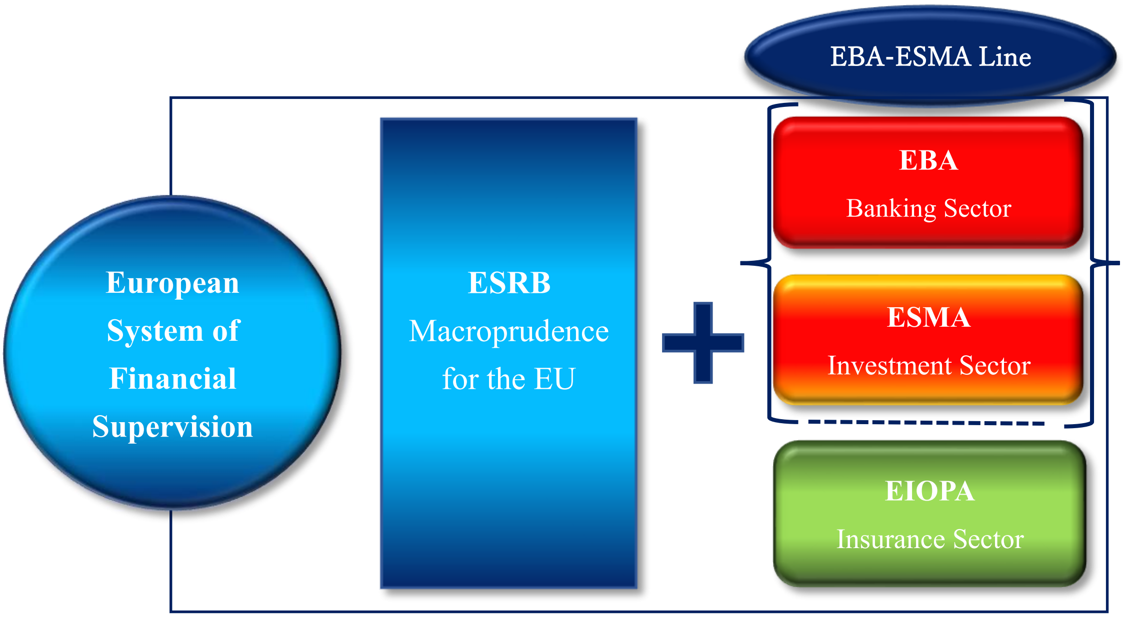

Figure 2: Macro- and microprudential EU policies: *Risk Reduction and Risk Sharing*

Source: Author.

In the field of banking supervision, striking a right balance between risk reduction and risk sharing is necessary.[25] This relation could be reflected through the three pillars of the EBU—the SSM, SRM, and EDIS. In terms of risk reduction, the SSM functions can primarily be combined because this mechanism in the ECB's banking supervision plays a crucial role in checking significant individual institutions and managing a reduction in non-profit loans (NPLs).

In contrast, the SRM is focused on risk sharing related to the magnitude of bank resolutions. A resolution policy could be viewed as an *ex-post* approach even though respective banks' recovery and

[25] I greatly appreciate the informative discussion on the dichotomy of risk reduction and risk sharing with M. Denis Beau, First Deputy Governor of the Banque de France, in October 2018. Regarding historical and current aspects of European integration and supervisory issues, I am grateful for precious and continuous meetings with M. Didier Brunnel, Honorary Director General of the Banque de France, since 2013.

resolution plans are hammered out in advance. How to resolve failed and failing banks in an orderly manner has become more important than before the GFC. Currently, the role of the Single Resolution Board (SRB), whose headquarters is located in Brussels, is to be increasingly indispensable in both bank resolution and deposit insurance after its establishment as the EDIS.

The EDIS is under construction, which the EBU needs to complete and launch to integrate the member states' DGSs. The integrity of the DGS is diversified among the member states, especially in terms of the German deposit protection scheme.[26] The DGS is *per se* an essential instrument—an essential safety net—to cover consumer deposits, reflecting the risk sharing with respect to integrity in the Eurozone. However, the EDIS is designed to contribute to risk reduction as its common coverage (it currently covers at most 100,000 EUR) is integrated and provides a single yardstick with depositors (**Figure 3**). Micossi (2017) informatively elucidated the EBU proposal toward completion, including capital-strengthening measures.[27] The progress of elaborating the capital requirements, such as the Capital Requirements Regulation II and CRD V, is currently observed. These capital requirements actually contribute to risk reduction by strengthening the capital soundness through the lens of microprudence.

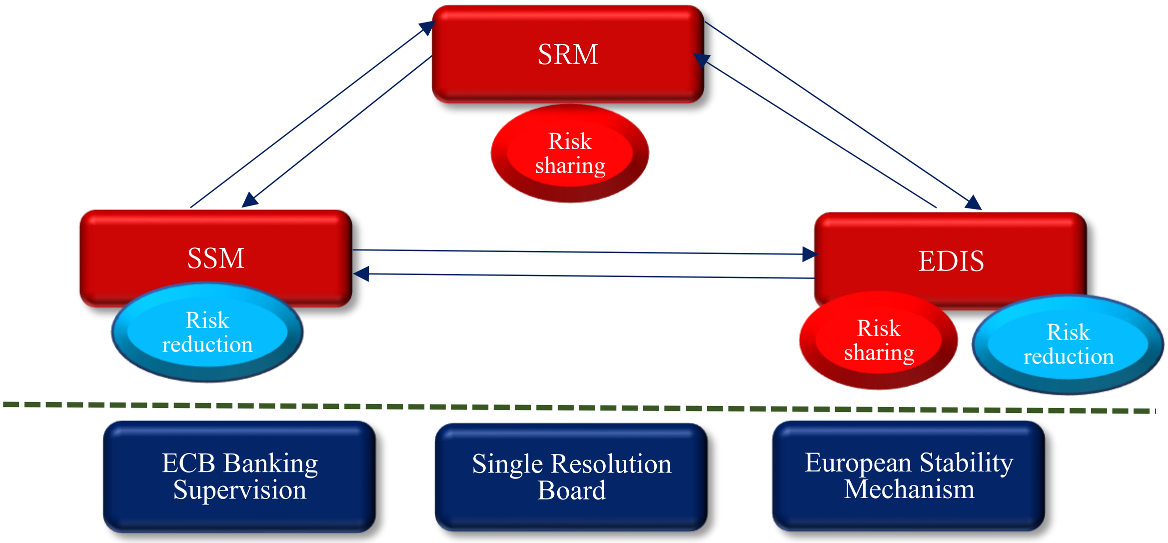

Figure 3: Risk reduction and risk sharing:

Three pillars of the EBU and key relevant European bodies on supervision

Source: Author.

[26] The Bundesbank's clear opposition to the integration of the DGSs was shown as a prudent perception to implement a European convergence of GDSs. Deutsche Bundesbank (Speech by Mr. Andreas Dombret, Member of the Executive Board). 2016. *Common supervision, common resolution, common deposit insurance scheme?* at the Bundesbank symposium "Banking supervision in dialogue", 1 June.

[27] Micossi, S. 2017. "A Blueprint for Completing the Banking Union", *CEPS Policy Insights*, No 2017/42, November.

Fundamental Necessity of Harmonization of Supervision

The EBU, whose two pillars (SSM and SRM) were already implemented, was established on the basis of the magnitude of recognition: how to reduce the interconnectedness between the sovereign and banking crises. Gual (2013) has delineated the detailed design of these two impactful phenomena.[28] Regarding the recognition of the nexus between the two crises that are intertwined with each other, **Figure 4** indicates a feasible design of a desirable scheme in the Eurozone solution.

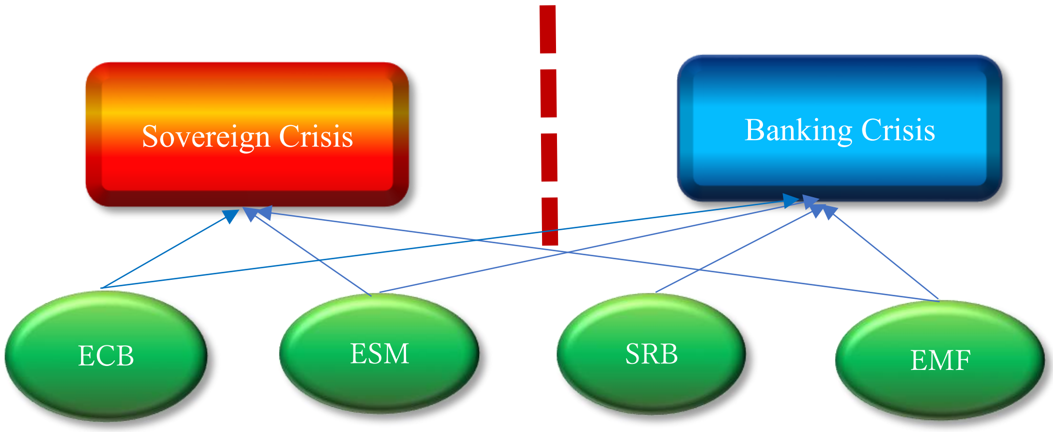

Figure 4: Nexus of sovereign and banking crises in the Eurozone

Note: The EMF has been proposed to establish, however, it is under discussion.

Source: Author.

EBA and ESMA Line

In terms of the coordination among the ESAs, the EBA and ESMA cooperate with each other because the European banking system is based on a "universal banking system." The significant components discern a profitable banking structure that causes difficulty of "separation" of deposit-taking institutions and extremely risky investments. The UK's Vickers Report and the USA's Dodd–Frank Act are stringent about separating these two domains; however, the so-called *Liikanen Report*[29] has failed to clarify this separation. On the other hand, cooperation of each European supervisory authority needs to be implemented when it comes to facing cross-cutting issues. The EBA has to cooperate with the ESMA in the field of the Investment Firms Directive (IFD) related to the governance for class 2 investment firms[30].

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[28] Gual, J. 2013. "Banking Union: made of concrete or straw?", *"la Caixa" economic papers*, No. 09, July. "la Caixa" Research Department.

[29] High-level Expert Group on reforming the structure of the EU banking sector, Chaired by Erkki Liikanen. 2012. *Final Report*, Brussels, 2 October.

[30] European Banking Authority. 2021. *Annual Report 2020*, p. 44.

4. International Harmonization of Banking Supervision

The BCBS in the Bank for International Settlements (BIS) has been determined to play an essential role in harmonizing the methodologies and has provided occasions for commonalities among the member states. Goodhart (2011) clearly delineated the initiated period as antecedents of the BCBS, especially the *Groupe de Contact*.[31] During the early period of the BCBS, considering a European Economic Community (EEC) approach to banking legislation was necessary. The parallel between the EEC and the BCBS should be maintained in order to grasp the quintessence of the harmonization of banking supervision. Recognizing the European jurisdiction and the UK's approach based on a discretional perspective is necessary to contextualize the process of the UK's Banking Act 1979 and its mutual relation with the EEC Banking Directive in 1977. During the international financial regime, Kapstein (1994) has attractively exposed his perception to clarify the path of the Basel Accords, especially regarding UK–US cooperation in the middle of the 1980s.[32] Walker (2001)[33] used a holistic approach and adopted an international perspective to international banking regulations to extensively explore the effect of the trajectory of the legal, political, and practical aspects on the progress of banking regulatory issues.

BCBS' Core Principles of Banking Supervision

The magnitude of the international aspect from several significant perspectives needs to be recognized regarding the harmonization of banking supervision in European countries.

First, the BCBS published the "Core Principles for Effective Banking Supervision (The Basel Core Principles),"[34] which was indispensable to forging common recognition. This publication consists of 29 key principles that provide the essence of harmonization, as shown in **Table 1**. From Principles 1 to 13, the publication proposes "supervisory powers, responsibilities, and function." In contrast, Principles 14 to 29 clarify "prudential regulations and requirements." The BCBS has many member states[35] that have not only advanced economies but also emerging markets.

The BCBS was set up in December 1974. Its launch was a crucial phenomenon that enacted the

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31 Goodhart. 2011. *op. cit.*, Chapter 2.

32 Kapstein, E.B. 1994. *Governing the Global Economy: International Finance and the State*, Harvard University Press.

33 Walker, G.A. 2001. *International Banking Regulation: Law, Policy and Practice*, Kluwer Law International.

34 Basel Committee on Banking Supervision. 2012. *Core Principles for Effective Banking Supervision*, September.

35 The BCBS member states are as follows: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxemburg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

international cooperative response to the Herstatt crisis in 1974.[36] The original member states were Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Switzerland, the UK, and the USA. Obviously and unequivocally, the membership structure is comprised of European countries; the outsiders were solely Canada, Japan, and the USA. Regarding the advent of the harmonization of banking supervision, Blunden—an actual icon for the supervisory issues represented by the UK—stressed the EEC's prowess for initiating motivation as the *Groupe de Contact*, namely, the Dondelinger Committee (Blunden, 1977).[37] The Dutch initiative during the early period of the trial—intended to harmonize various banking supervision systems—was actually conducive to attracting keen attention to current supervisory issues by the Netherlands' authorities.

By and large, these G10 countries plus Switzerland have led the international cooperation on banking supervision, especially through the UK's initiative. Sato (2018)[38] focused on the UK's Banking Act 1979 by exploring the British approach to banking supervision. For further research, Sato (2019)[39] explored the Bank of England's leadership during the Basel process through the lens of historical implications for the harmonization of international banking supervision in the early era of the BCBS. Regarding the comprehensive collections of analyses, Gardener (1986)[40] provided informative standpoints of the UK's banking supervision in terms of progressive path, practice, and related issues, including capital adequacy and deposit insurance.

Table 1: 29 Core Principles of international effective commonalities on banking supervision

Supervisory powers, responsibilities, and functions	
Principle 1	Responsibilities, objectives, and powers
Principle 2	Independence, accountability, resourcing, and legal protection for supervisors
Principle 3	Cooperation and collaboration
Principle 4	Permissible activities

[36] As related to the Herstatt Crisis in July 1974, Mourlon-Druol (2015) elucidated in detail the development of the crisis. Mourlon-Druol, E. 2015. "Bank Crisis and its Implications for International Regulatory Reform", *Business History*, Vol. 57, No. 2, 311-334, Routledge.
[37] Blunden, G. 1977. "Control and Supervision of the Foreign Operations of Banks", in Wadsworth, J.E., Wilson, J.S.G., and H. Fournier. eds. *The Development of Financial Institutions in Europe, 1956-1976*, A.W. Sijthoff – Leyden, p. 194.
[38] Sato, H. 2018. "UK Banking Supervision and Regulation through a Historical Approach: Implications for the European Banking Union", *Discussion Paper Series*, Faculty of Economics and Management, Institute of Human and Social Sciences, Kanazawa University, No. 46, pp.1-30.
[39] Sato, H. 2019. "The UK's Initiative on International Banking Supervision in the 1980s: Basel Process and International Cooperation on Prudential Policies", *Discussion Paper Series*, Faculty of Economics and Management, Institute of Human and Social Sciences, Kanazawa University, No. 50, pp. 1-21.
[40] Gardener, E.P.M. ed. 1986. *UK Banking Supervision: Evolution, Practice and Issues*, Allen & Unwin.

Principle 5	Licensing criteria
Principle 6	Transfer of significant ownership
Principle 7	Major acquisitions
Principle 8	**Supervisory approach**
Principle 9	**Supervisory techniques and tools**
Principle 10	**Supervisory reporting**
Principle 11	Corrective and sanctioning powers of supervisors
Principle 12	Consolidated supervision
Principle 13	**Home-host relationships**
Prudential regulations and requirements	
Principle 14	Corporate governance
Principle 15	Risk management process
Principle 16	**Capital adequacy**
Principle 17	Credit risk
Principle 18	Problem assets, provisions, and reserves
Principle 19	Concentration risk and large exposure limits
Principle 20	Transactions with related parties
Principle 21	Country and transfer risks
Principle 22	Market risk
Principle 23	Interest rate risk in the banking book
Principle 24	**Liquidity risk**
Principle 25	Operational risk
Principle 26	Internal control and audit
Principle 27	Financial reporting and external audit
Principle 28	Disclosure and transparency
Principle 29	Abuse of financial services

Source: The Basel Committee on Banking Supervision. 2012. *Core Principles for Effective Banking Supervision*, September (the author highlighted in bold the significant principles).

Concrete Points of the Core Principles

The latest version of the Core Principles was published in September 2012, and the following points need to be emphasized. The document states that "the importance of applying a system wide, macro perspective to the microprudential supervision of banks to assist in identifying, analysing and taking pre-emptive action to address systemic risk"[41] needs to be recognized. As of September 2012,

[41] Basel Committee on Banking Supervision. 2012. *op. cit.*, p. 2.

4 years after the GFC, a macroprudential viewpoint for addressing microprudential issues needed to be used. In the field of prudential policies, the origin of the prudence was a micro-based prudence[42] focused on the individual financial institution's crisis. This emerging phenomenon, however, clearly mirrored the magnitude of transition from microprudence to macroprudence.

The Core Principles include the recognition of an effective resolution. In terms of resolution, the FSB published, in 2014, the Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs).[43] However, before the publication of the FSB's KAs, the BCBS's Core Principles stated that the paper reflected "the increase focus on effective crisis management, recovery and resolution measures in reducing both the probability and impact of a bank failure."[44] The latest version pointed out the magnitude of the audit to secure public disclosure and transparency through financial reporting and an external audit.[45]

FSB: Transnational Governance Coping with Cross-Cutting Issues

The FSB was launched in April 2009, in a nutshell strengthening the former institution, that is, the FSF. The FSB's headquarters is also located in Basel, underpinned by the BIS. However, different from the BCBS, the FSB plays a key role in maintaining a level playing field over banking, securities (investment banking), and insurance. After the GFC, the mandate of the FSB has been to focus on cross-cutting issues, which has been indispensable to global financial stability. For example, the rise of shadow banking should be covered by international standard-setting bodies because it could cause a financial crisis and lacks stringent regulations.

Another point that requires keen attention is the FSB's assiduous regulatory prowess as an industrious proposer to the G20. As is known, the politics reflected by the G20 is at the level of the finance ministers and central bank governors. However, the FSB continuously proposes relevant regulatory schemes to be agreed on by G20 member states. This powerful institution is certainly dedicated to nurturing desirable frameworks of international commonalities. Although the proposal frequently agrees with the "*communiqué*" form, this approach is easily recognized by member states as *soft pressure* to abide by the *de facto* regulations. Since its transition from forum to body, the FSB has become an essential body for managing financial crises and preventing potential crises.

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[42] I am grateful for the great discussion with Mr. Claudio Borio, Head of the Monetary and Economic Department of the BIS, in December 2019. It was an informative discourse on the essence of microprudential policy as an origin of prudential policy.

[43] Financial Stability Board. 2014. *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 15 October.

[44] Basel Committee on Banking Supervision. 2012. *op. cit.*, p. 2.

[45] *Ibid.* An effective external audit becomes more essential and pertinent to effective banking supervision through the lens of impartial inspections.

5. Comparative Discussion

Figure 5 shows that the dichotomy on prudential issues through a comparison of the methodologies between European and international institutions is necessary. Two discussion points on prudential perspectives are in focus.

First, the focus is on "integrity" versus "diversity." Obviously, the magnitude of European integration mirrors the identification of "integrity." Since the Treaty of Rome in 1958, European integration has progressed with the *hard law*, which is based on a legislative foundation. Numerous stringent regulations, directions, and communications buttressed the robustness of the European system. Since the introduction of the Euro as a single currency, the EU—especially the Eurozone—strengthened its integrity even through several financial crises. By and large, the European jurisprudential approach, as represented by the European Commission, provides impartial and unambiguous rules in the fields of banking supervision, regulation, and resolution.

In contrast, the harmonization approach in the international arena has presented a "diversity." It is rational for international standard-setting bodies, such as the BCBS, FSB, and International Monetary Fund, to develop a number of systems through relatively discretionary yardsticks. The methodology focuses on the *de facto* standard implemented through *soft law* rather than legislation that is called *hard law*. The BCBS applies the prowess of peer pressure to forging a "common recognition," including capital adequacy stipulated by the Basel III (BCBS 2011, BCBS 2021).[46] The FSB also supplies the substantial standards of absorption, namely, the TLAC (FSB 2015),[47] which is in line with the KAs as previously mentioned (FSB 2011, 2014).[48] Although configuring the effective regulatory scheme in the international arena was robustly prepared for, it has also been kept flexible to comply with the diversity of member states' individual regulatory structures.

Second, the focus is on the discernment between legislative and principal-based approaches. As was previously mentioned, a reasonable postulate exists for the EU, especially for the Eurozone 19 countries, and the EBU is an essential legal framework for developing individual prudential polices as much as possible. Clarity and transparency should be indispensable to the orderly arrangement of the diversified system of banking supervision. As was referred to in the *de Larosière Report,* the urgent response to the GFC actually imposed stringent pressure on the European Commission to set up a single rulebook to engage in a robust prevention effort from the tremendous crisis. Since 2020, the need has existed to react to the pandemic crisis as quickly as possible through emergent monetary

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[46] Basel Committee on Banking Supervision. 2011. *Basel III: A global regulatory framework for more resilient banks and banking systems*, June (the original version was published in December 2010). The documents on the Basel III were integrated for updating. See the integrated version: Basel Committee on Banking Supervision. 2021. *The Basel Framework*, 22 January.

[47] Financial Stability Board. 2015. *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet*, 9 November.

[48] Financial Stability Board. 2011, 2014. *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October.

policy toolkits, such as the Pandemic Emergency Purchase Programme (PEPP), which was initially implemented at the scale of €750 billion in March 2020 (ECB 2020)[49] and expanded powerfully during 2020 to €1,850 billion in total (Lagarde 2021).[50] In May 2020, the European Commission published a proposal for establishing the Recovery and Resilience Facility (European Commission 2020).[51] The Recovery and Resilience Facility is currently a cornerstone on the scale of €672.5 billion, which consists of €360 billion in loans and €312.5 billion in grants in the NextGenerationEU framework (European Commission 2021).[52] This phenomenon allows for the Eurobond to be issued, which had, thus far, been deemed an impossible solution to implement. These initiatives started by the European Commission should be developed on a jurisprudential approach using a number of regulations, directions, and recommendations after a discussion of the Commission's proposal papers.

Meanwhile, international standard-setting bodies, such as the BCBS and FSB, have adopted a principal-based methodology. Harmonizing diverse supervisory and regulatory systems among the nation states throughout the world necessitates strenuous efforts and continuous perseverance. For instance, the BCBS has implemented various regulatory directions and standards using a discretional methodology that aptly applies to the harmonization of banking supervision. Because banking regulatory and supervisory issues are *per se* intricate issues, their convergence should be considered impossible. However, since the establishment of the BCBS in December 1974, it has played a crucial role in implementing informative discussions among not only advanced economies but also emerging markets. As mentioned in the introduction, the conference was called the ICBS. The first ICBS was held in London in July 1979, initiated by the Bank of England whose chairperson was Peter Cooke. Cooke had magnificent leadership skills and harmonized member states' different supervisory schemes through a non-binding approach. The Bank of England and the BCBS shared a common standpoint to effectively cooperate with other authorities using a gradual methodology. To summarize, the soft-law, non-binding, discretional, and gradual methodologies were quintessential features for the actual convergence of prudential policies from an international perspective.

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[49] European Central Bank. 2020. "ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)", *Press Release*, 18 March.

[50] Lagarde, C. 2021. "European Parliament plenary debate on the ECB Annual Report: Introductory statement", at the plenary session of the European Parliament, Brussels, 8 February.

[51] European Commission. 2020. *Proposal for a Regulation of the European Parliament and of the Council establishing a Recovery and Resilience Facility*, COM (2020) 408 final, Brussels, 28.5.2020 with Annexes 1 to 3 to the Proposal on the same date.

[52] European Commission. *Recovery and Resilience Facility*, Accessed on 22 February 2021.

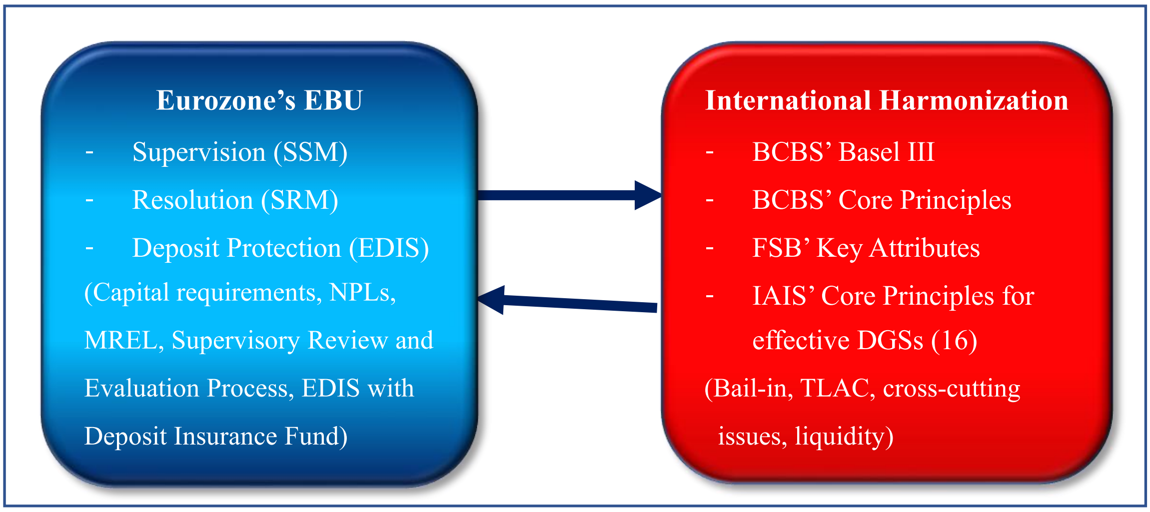

Figure 5: Interactive relation between the EBU and international harmonization

Source: Author.

6. Concluding Remarks

The search for an efficient solution to harmonizing European regulations and supervision, given critical financial stability issues, has truly been an indispensable activity during both peaceful and crises periods. This section summarizes the three points of focus of this study as follows.

First, this study focused on the implications of the current status of the harmonization of banking supervision in the EU, especially in the Eurozone. Different from the GFC, the COVID-19 pandemic has placed much of the world under confinement, reducing free mobility. Tourism and airline industries have been significantly affected by this pandemic. However, stock markets, such as the US New York Stock Exchange, reached high prices during 2020 and at the beginning of 2021, with some expectations for the USA's new president. The global financial sentiment seems to have positive momentum in general. The current crisis's phenomenon of not having a tremendous negative impact on the financial sector differentiates its circumstances from that of the GFC that stemmed from the collapse of subprime loans in 2007 and affected a number of significant financial institutions, including deposit-taking institutions, investment banks, and insurance companies, among US and European credit institutions. A striking issue on the matter was generated from the reregulation and stringent supervision of banks, such as the *de facto* regulation on capital adequacy generally implemented by the BCBS, even though the Basel III was postponed because of the pandemic. The European Commission has been attempting to take advantage of the situation and proactively incorporated the BCBS's international direction.

Second, striking the right balance between risk reduction and risk sharing is critical. As was discussed in the previous section, the three pillars of the EBU—the SSM, SRM, and EDIS (under construction)—have embodied the desirable distribution of single, effective supervision, resolution, and deposit insurance in the Eurozone. As can be exemplified, a reduction in NPLs should contribute to the soundness of the banking system; therefore, the risk reduction mandate needs to be prioritized. In contrast, risk sharing also necessitates the integrity of the financial system to share the negative aspects and to seek effective methodologies for the resolution. The SRB must be the key foundation to developing a single, efficacious resolution and enacting a single, credible deposit insurance framework. With respect to this issue, the US Federal Deposit Insurance Corporation should be referred to for developing an efficient, intertwined relation between resolution and deposit protection.

Third, international harmonization of banking supervision is pertinent. As was discussed in the fifth section, the legislative and arbitrary approaches to the EU's foundation and international philosophy clearly contrast one another. In the EU, especially in the Eurozone, unambiguous jurisprudence should be implemented because the European Commission has to adopt a tremendous amount of legislation to harmonize the diverse banking regulatory and supervisory systems of the member states. In contrast, the BCBS and FSB should introduce a more discretional methodology for harmonizing member states' individual regulations and supervision. Since 2016, the world has faced significant global issues, such as Brexit, and the circumstances are uncertain. However, forming harmonization to convergence based on a down-to-earth approach is a crucial and substantial component in the field of transnational cooperation of banking regulation and supervision.

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