The current issue of M & M can be found at: www.managementmarketing.ro

The U.S. bank insurance and resolution experience and lessons for the European Union

Emmanuel N. ROUSSAKIS
Florida International University, Miami, Unites States of America

Abstract: The viewpoint presents the bank insurance and resolution experience of the United States and the European Union in addressing the financial stability of their respective markets. It first describes the development of the U.S. Federal Deposit Insurance Corporation and its functions as shaped by law, technological advances and market forces. Then it describes the European Union experience through an overview of the major enactments that have shaped the corresponding framework. The recent establishment of Eurozone's Single Supervisory Mechanism although short of a pan-European insurance fund offers the prospect of a complement structure to its counterpart across the Atlantic.

Keywords: Federal Deposit Insurance Corporation (FDIC), insured and uninsured depositors, bridge bank, recovery and resolution, bail-in, subprime mortgage crisis, sovereign debt, tier 1 capital, stress test.

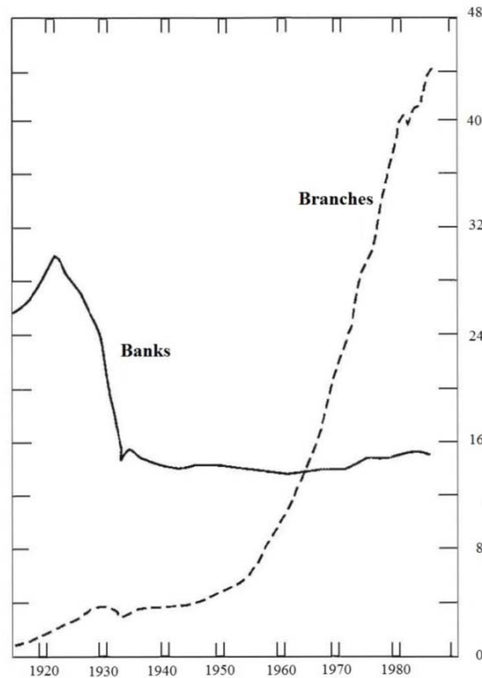
Please cite this article as following: Roussakis, E.N. (2014), "The U.S. Bank Insurance and Resolution Experience and Lessons for the European Union", *Management & Marketing. Challenges for the Knowledge Society*, Vol. 9, No. 4, pp. 501-516.

Formative years of the U.S. banking industry

From the latter part of the nineteenth century on through the outbreak of World War I, the U.S. economy underwent important changes. It entered World War I as a debtor nation, and emerged as a creditor. This war turned the tide in the country's economic development. The growing needs of the Allies and neutral nations generated the necessary momentum for the growth of exports. Rising productivity in agriculture, increased efficiency in industry, and the influx of flight capital from Europe combined to transform the United States into an industrial and financial power. The country's economic momentum resulted in an unprecedented increase in the number of banking facilities which reached by 1920 into 30,000 banks operating 1,300 branches.

Correspondence:
Emmanuel N. Roussakis
emmanuel.roussakis@fiu.edu

Figure 1. *Number of banks and branches 1911-1988*



Source: *Board of Governors of the Federal Reserves, 1988, p. 82.*

This momentum reversed in the course of that decade. As depicted in Figure 1, commercial banks suffered important setbacks during the 1920s and early 1930s resulting in significant consolidation of the industry. Mergers and, most important, failures during the 1921-33 period were responsible for the disappearance of about 15,000 banks and losses to depositors in excess of $2 billion. Sizable losses were also sustained by the owners of bank stock, who in addition to the loss of their investment often paid voluntary assessments to meet the claims of bank creditors, in an effort to avert the closing of their bank.

Many of the banks which failed during this period were small banks in the agricultural and rural regions of the country. The sharp postwar deflation of 1920-22 and the recession of 1923-24 caused a general retrenchment in economic activity that hit the agricultural sector especially hard. The renewed collapse of agricultural prices in 1929-30, accentuated by severe drought, accelerated the pace of bank failures in farming areas. These failures undermined further the depressed state of economic activity precipitating a general distrust in the banking system, widespread panics and run on banks.

With the U.S. financial system in the verge of collapse, legislators became convinced of the need to subject the activities of commercial banks to comprehensive controls. It was under these circumstances that Congress passed the Banking Act of 1933 (Glass-Steagall Act), which was complemented two years later by an equally comprehensive piece of legislation, the Banking

Act of 1935. Some of the key provisions of the former included the introduction of a temporary federal deposit insurance plan for the country's 13,201 banks, in the amount of $2,500; prohibition of interest payment on demand deposits and the setting of maximum interest rates on time and savings deposits (Regulation Q); and the strengthening of controls over the use of bank funds for speculative and investment uses.

The Banking Act of 1935 addressed issues that covered virtually every aspect of banking. For example, it introduced a new revised insurance plan by providing for the establishment of the Federal Deposit Insurance Corporation (FDIC) with authority over all insured banks that were not in any way supervised by a federal agency. Other provisions amended the structure and functions of the Federal Reserve System, increased its control over the commercial banking activity, and strengthened the influence of the government over the Federal Reserve System.

As the effects of the depression started to fade and economic recovery set in, the banking industry began to undergo important structural changes. As seen in Figure 1, the following decades were characterized by a gradual decline in the number of banks and a fast rise in the number of branches. The former was due to a wave of bank mergers while the latter to population mobility and industry shifts out of central cities. The consequent growth of branch banking, initially confined within state boundaries and later expanded to contiguous states, prompted renewed consolidation of the banking industry and growth of interstate branching. By year-end 2013, these trends accounted for the presence of 5,876 FDIC-insured commercial banks in the United States operating 83,394 branch offices.

Two forces defining the current size and scope of activities of U.S. commercial banks have been technology and globalization. Both of these forces are credited for breaking down geographical and functional barriers among banks and between banks and nonbank financial institutions, contributing to increased competition and convergence of the financial service industry. As these trends have been transforming the market for financial services they have contributed to the increased efficiency of bank regulation in its efforts to protect the depositor and ensure the soundness of the financial system. The FDIC has been an important catalyst in this effort.

FDIC Functions

Since its inception, the Federal Deposit Insurance Corporation (FDIC) has boosted public confidence in banks by functioning as a key deterrent to panics and bank runs. Established as a United States government corporation, the FDIC operates as an independent agency performing the following functions:

(i) Guarantees the safety of accounts at member institutions (6,589 commercial banks and savings institutions as of the third quarter 2014) by providing deposit insurance up to $250,000 per depositor, for each deposit ownership category, in each insured bank.

(ii) Examines and supervises certain financial institutions for safety and soundness.

(iii) Manages banks in receiverships (failed banks).

In protecting depositors' funds, and hence in fulfilling one of the most important objectives for its establishment, the FDIC charges banks and thrifts a deposit insurance premium. Initially a uniform amount for all institutions, these assessments provided funds for operating costs as well as the maintenance of an insurance fund. The concept of a uniform assessment was abandoned in 1991 through enactment of legislation that directed the FDIC to relate deposit insurance rates to institutional risk-taking, so that low-risk institutions do not subsidize high-risk institutions. Focus on risk-based assessments was furthered with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), enacted following the real estate crisis. This act empowered the FDIC to redefine the assessment base for insured banks (average consolidated total assets minus average tangible equity), and restructure the schedule of assessment rates (including discretionary adjustments) for alternate categories of institutional risk (based on supervisory CAMELS composite ratings). Special provisions address institutions that are small and newly insured (less than 5 years) or very large and highly complex (assets in excess of $10 billion).

Regulatory examination is intended to assure the bank's health by providing an accurate picture of its activities and performance at all times. Thus, problems can be spotted at their inception and corrective steps taken before the problems grow large or serious enough to threaten the bank. To monitor the health of individual banks, and the industry as a whole, the FDIC and other bank regulators make use of a number of tools. One tool is the on-site examination which, conducted every 12 to 18 months, assesses each bank and assigns it a CAMELS rating. Although this rating provides the most complete and reliable information on the financial health of an institution, changes in the interim period may undermine its accuracy. Thus, the FDIC and other regulators have developed electronic surveillance systems to monitor institutional performance between examinations. FDIC's major electronic surveillance tool is the Statistical CAMELS Off-site Rating (SCOR) system which helps identify institutions that have experienced noticeable financial deterioration.

If an insured bank or thrift is determined to be in danger of failing, the FDIC as insurer may forestall its failure through use of an open bank assistance (OBA) transaction. Under this venue, the FDIC can make loans to, purchase the assets of, or place deposits in a troubled institution. The supported institution is expected to repay its assistance loan in whole or in part. However, as the nation grappled with a large number of failing institutions in the 1980s, legislative enactments imposed restrictions on the use of the OBA approach. As a result, OBA is no longer a commonly used resolution method.

The FDIC does not close banks. A bank's chartering authority (the individual state banking agency for state chartered institutions, or the Office of the Comptroller of the Currency for national banks) closes a bank and appoints the

FDIC as receiver. Receivership procedure requires the FDIC to choose among all possible resolution alternatives the option that is the least costly to the deposit insurance fund. FDIC options include:

(i) Merger of the failed institution with an insured depository institution.

(ii) Formation of a new institution (e.g., a bridge bank) to take over the assets and liabilities of the failed institution.

(iii) Purchase and Assumption (P&A), whereby healthy banks submit bids for the purchase of assets and the assumption of deposit liabilities of the failing institution. With interested buyers requesting advancement of cash equal to the amount by which liabilities exceed the value of the failed bank's assets, the FDIC accepts the lowest-cost bid, absorbing part, or all, of the acquiring bank's losses from the transaction. Any bank assets that revert to the FDIC as receiver are sold and auctioned through various methods (e.g., online, and using contractors).

(iv) Payoff the full amount of insured deposits. Uninsured deposits (accounts that exceed the federally insured limit) and general liabilities of the institution are issued receivership certificates which entitle them on a pro rata basis to the sales/collections on the failed institution's assets. Subordinated debt is allowed claim on the receivership assets only after all entitlements with a higher priority have been satisfied.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 assigned to the FDIC resolution powers for large banks in addition to those in existence for smaller banks.

European Union (EU) deposit guarantee schemes and resolution initiatives

Deposit guarantee schemes (DGS)

One of the early objectives that EU set out to accomplish upon its establishment was the introduction of an effective regulatory framework on deposit insurance - formally referred to as Deposit Guarantee Schemes - for the institutions of member states. This move was deemed essential for the protection of consumers and the stability of financial markets.

To this end, legislation enacted in 1994 (*Directive 94/19/EC*) sought to enhance the integration of retail banking within EU by requiring member states to introduce basic standards of deposit protection. Provisions of this enactment included the requirement for a minimum deposit protection of €20,000 for all accounts denominated in EU currencies and held by private individuals and enterprises (deposits of public authorities and financial institutions were excluded from any protection). In spite of its aspiration, this legislative attempt fell short of expectations as it tried to minimize interference in national sovereignty by maintaining the existing diversity in national deposit insurance systems. Essentially, the level of introduced standards was too low to ensure an effective harmonization policy throughout the union. It upheld the multiplicity of deposit insurance schemes with significant variation between member countries on such aspects as the level of coverage, deposit/depositor eligibility, payout procedures and funding mechanisms. This variation proved disruptive,

and undermined the financial stability of the internal market during the 2008 crisis (many depositors shifted money out of British banks to branches of Irish banks in the UK, because Ireland had unilaterally introduced unlimited deposit guarantees. This move caused severe and abrupt draining of liquidity from the British banks and increased their vulnerability).

Addressing the limitations of the preceding legislation in the light of the financial crisis, a Union law (*Directive 2009/14/EC*) implemented in 2009 focused on financial stability in times of economic stress and promoted convergence of DGS throughout the union. To strengthen public confidence in the banking system the law increased depositor protection to avert panic withdrawals, such as experienced by Northern Rock in UK (2007) and Landsbanki in Iceland (2008). To this end it revised the €20,000 minimum coverage provision by requiring member states to raise depositor protection - first, to at least €50,000, and then to a uniform EU-wide level of €100,000 by the end of 2010. Further, it extended this coverage to eligible deposit accounts (held by private individuals and non-financial businesses) regardless of their currency of denomination. Another feature of this directive was the shortening of depositors' reimbursement period to expedite payout.

A more recent enactment (*Directive 2014/49/EU*) in 2014, reaffirmed the amended level of protection coverage (€100,000 per depositor per bank), provided for improved information on insurance coverage, called for faster repayment deadlines (target payout of seven working days), and decreed the compulsory membership of deposit-taking institutions in DGS.

A key objective of this Directive was the harmonization of funding mechanisms by requiring member states to ensure that insurance schemes have enough funds in place to meet depositor claims in case of bank failure. Deposit insurance premiums, *ex-ante* contributions, are to be assessed on the basis of the covered deposits and the risk profile of institutional participants. Extraordinary, *ex-post* contributions, and in exceptional circumstances higher assessments, may be levied if available financial means are insufficient to reimburse depositors. This source of financing does not prevent pursuit of additional funding options, such as borrowing from other DGS within the Union on a voluntary basis. Although primarily used to repay depositors, available financial resources may be used, subject to authorization, to prevent the failure, or finance the resolution, of a credit institution.

Other provisions of this enactment address the cross-border cooperation of DGS, financial responsibility of home/host country GDS over the respective cross-border activities of branches/subsidiaries of banks from other member states, and the compatibility of deposit protection schemes of foreign branches operating within a member state but headquartered outside the Union.

Recovery and resolution of credit institutions

The financial crisis of 2008 made apparent the need for a complementary regulatory framework to DGS to provide uniform guidelines on bank failure prevention and, if necessary, bank liquidation with the aim to minimizing their

impact on the economy and the financial system. A series of Union laws address this objective, the most recent of which was enacted in 2014 (*Directive 2014/59/EU*). Amending earlier legislative initiatives, this directive fosters common minimum harmonization rules to remedy procedural differences between the laws, regulations and administrative provisions that govern the insolvency of institutions in member states. To ensure consistency in the regulatory framework, it requires member states to have in place recovery and resolution mechanisms and to designate and empower public administrative authorities to handle situations involving both systemic crises and failures of individual institutions. The Directive attends to three main issues: prevention and preparation for financial adversity, early intervention, and resolution and financing.

Prevention and preparation: institution and group recovery plans

Pertinent provisions call upon credit institutions to develop recovery plans comprising measures that would enable them to promptly restore their financial health in the event of material deterioration of their financial condition. For group entities operating across the Union, the requirement for a recovery plan extends both to the group as a whole and to each institutional participant to the group. If a plan is deemed inadequate, the resolution authority is empowered to require the management of an institution, or a group, to redress the material deficiencies of such plan.

Contrary to the national law of some member countries, this directive upholds the extension of intra group financial support subject to appropriate safeguards. Specifically, for institutions that operate within a group structure, a recovery plan may include financial support from another entity in that structure. Given the interdependence of these entities, intra-group support may take such form as a direct loan, a guarantee, or a provision of an asset as collateral to a transaction. However, such support may be prohibited or restricted by the competent authority if it undermines the liquidity or solvency of the transferor, or the financial stability of the market.

Early intervention

The Directive authorizes the early intervention of competent authorities to preserve the financial health or solvency of an institution. Depending on individual circumstances, early intervention may entail the request on the management of the institution to pursue any of the following courses of action: implement one or more of the arrangements or measures set out in the recovery plan; draw up an action program and a timetable for its implementation; convene, or convene directly, a meeting of shareholders, set the agenda and recommend adoption on certain proposals; restructure and negotiate debt with creditors; remove, or replace, one or more members of the management, or senior management, if unfit to perform their duties.

Competent authorities are also empowered to appoint a temporary administrator either to replace or work with the management of an institution.

The role and functions of the temporary administrator shall be specified at the time of appointment and may include ascertaining the financial position of the institution with a view to preserving or restoring the sound and prudent management of its business. The appointment will specify the special administrator's powers which may include some or all of the powers of the management of the institution without prejudice to the rights of shareholders in accordance with Union and national company law.

Resolution and financing

When an institution is failing or likely to fail, and there is no prospect to restore it to financial health within a reasonable timeframe, the resolution authority is empowered to pursue resolution action. Additionally, such action must be deemed appropriate by reasons of public interest.

Resulting losses may be allocated in accordance with the principles established by this Directive, irrespective of the pronouncements of national insolvency regimes. According to these principles, losses must first be allocated in full to the shareholders of the institution, and then to creditors consistent with their order of priority of claims under normal insolvency proceedings. The Directive lists additional resolution measures, which may be applied individually or in any combination as the case may be. These include:

(i) sale of the institution, or part of its business, in an open, transparent process, without the consent of shareholders;

(ii) transfer all or part of the assets to a bridge institution to ensure that essential financial services continue to be provided to the clients of the failing bank. Government owned or controlled, the bridge institution should operate as a viable going concern with the intention to be put back on the market when conditions permit;

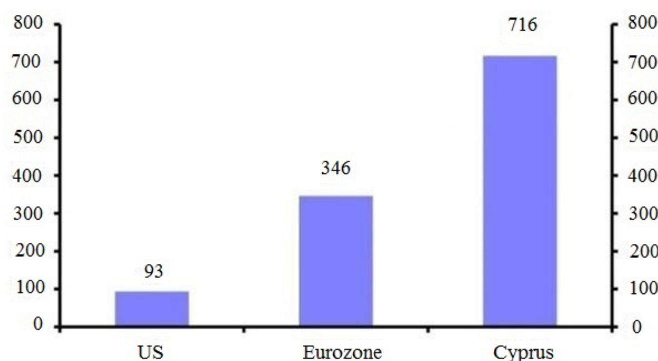
(iii) separation and transfer of problematic assets to a special-purpose vehicle on commercial terms, so that these can be managed with a view to maximizing liquidation proceeds through eventual sale or orderly wind down. Unlike the other resolution measures, asset separation may take place only in conjunction with one or more of the other measures;

(iv) bail-in refers to the write down of the claims of unsecured creditors of a failing institution if such action will restore its financial viability and enable it to continue to operate as a going concern. The resolution authority is empowered to pursue such action, and if so warranted in individual cases, convert debt claims into equity. The write down or conversion does not apply on such liabilities as covered deposits, employee salary and pension amounts owed, and secured claims (e.g., liabilities arising from repurchase transactions). In principle, shareholders' claims would be written off first before the bail in process takes effect - subordinated creditors' claims would take precedence over those of unsubordinated creditors. If the institution under consideration has some residual capital, the resolution authority may convert the claims of the subordinated and unsubordinated creditors into equity. The conversion shall be conducted at a rate that significantly dilutes existing holdings of shares.

To pursue an effective deposit insurance and resolution framework, the Directive gives member states the option to either use a combined fund to address both the compensation of depositors in bank failure and resolutions, or establish two separate funds for the corresponding functions. In either case, the designated structure will be funded by institutions themselves (through ex ante contributions to attain the target level, and ex post extraordinary contributions as needed).

The Cyprus banking crisis and enforcement of the EU resolution provisions
Following its independence from the United Kingdom in 1960, Cyprus pursued an open, free-market, service-oriented policy that resulted in strong economic growth. The development of Cyprus into a maritime, financial and commercial center contributed to a booming economy that enjoyed one of the highest GNP per capita in the Mediterranean. This is all the more remarkable considering that a Turkish invasion (1974) partitioned the country into separate Greek and Turkish communities. Since then the Greek-dominated Republic of Cyprus emerged as a significant financial center, much the way Ireland and Iceland did before it. A 10 percent corporate tax rate, the lowest in EU, together with treaties on double taxation with more than 30 countries helped propel the country into a dominant offshore banking center (OBC) for capital flows into Russia and Eastern Europe. Further, its location, seven hours ahead of New York and seven hours behind Tokyo, offered portfolio managers a desirable trading window for transactions in these centers. Its banks extended Internet accounts to foreigners, were renowned for their service, and provided substantial privacy to clients.

Figure 2. *Bank assets as a percentage of respective GDPs*



Source: *Zhang (2013).*

Accession to the EU (2004) and the Eurozone (2008) realigned Cyprus' regulatory framework and enhanced its competitive positioning. Although still small compared to other well established international financial markets, its thriving financial services industry grew by leaps and bounds. By early 2013 there were more than €68 billion on deposit in Cypriot banks with foreigners

holding about 40 percent of these deposits - Russian savers and locally registered Russian businesses accounted for the overwhelming majority.[1] The sizeable volume of deposits inflated bank balance sheets. At the height of the boom, Cyprus banks' assets ballooned to more than seven times the country's gross domestic product. As seen in Figure 2, unlike the U.S. and the Eurozone bank assets that accounted for 93 percent and 346 percent of their corresponding gross domestic products, Cypriot bank assets accounted for as much as 716 percent of the country's GDP.

The global recession that followed the U.S. subprime mortgage crisis and spread in world markets undermined Cyprus' economic momentum by causing a general slowdown in economic activity, rising unemployment, and a consequent surge in nonperforming loans. Although a key adversity for the Cypriot banking sector, of critical importance was its exposure to the Greek financial crisis.

Greek sovereign debt and the Cyprus's banking crisis

A strong increase in Greece's government debt, fueled by high and unsustainable budget deficits especially during the global recession, led in late 2009 to a crisis of confidence among investors concerning the country's ability to meet its debt obligations. Downgrade of Greek government debt to junk bond status (April 2010) alarmed the financial markets, and prompted a €110 billion bailout loan from the Eurozone countries and the International Monetary Fund (May 2010), conditional upon the implementation of austerity measures and structural reforms when a second (€130 billion) bailout loan for Greece became essential, it was conditioned upon the restructure of all Greek public debt held by private creditors. Many private creditors, including banks, hedge funds and insurance companies, were thus forced to forego about €107 billion (April 2012) to contribute in debt relief through a more sustainable debt to GDP ratio. Among the private creditors that suffered significant losses from the restructuring ("haircut") of Greek government debt were Cyprus's commercial banks which had amassed sizable amounts of such debt in their investment portfolios. At a time when bankers elsewhere in Europe were seeking to contain their own exposures to Greece, Cyprus's largest banks were willing (from 2009 onwards) to invest in risky, high-yielding Greek debt in an effort to counter the erosion of their balance sheets from rising non-performing loans.[2]

When banks turned to their own cash-strapped government for financial assistance, the country's economy, too, was in dire need of an international rescue. The downgrade of Cypriot government bonds by credit rating agencies to junk status undermined the country's ability to tap international markets to address its financial needs. Further, with the banking system so large, the government would not have been able to bail it out even if the economy was in a healthy condition. Initial negotiations with the EU on a bailout deal (March 16, 2013), required Cyprus to impose a one-time levy of 6.75 percent on deposits of less than €100,000 euro - the ceiling for EU account insurance - and 9.9 percent on funds above that.

Rejection of this plan resulted in a revised package that protected all insured deposits of €100,000 or less but imposed a significant levy on larger, uninsured, deposits, held mostly by wealthy Russians and Russian corporations that used Cyprus as a tax haven. Another feature of this package was the direct closure of the troubled second largest bank, the Popular Bank (also known as Laiki Bank). Its viable assets and insured deposits up to €100,000 were to be transferred to the country's largest bank, the Bank of Cyprus, while shareholder capital was to be written off, and the uninsured deposits above €100,000 - along with other creditor claims - were to absorb resulting losses from the liquidation of the remaining bad assets (bad bank). As an additional precaution, the revised package required uninsured deposits at the Bank of Cyprus to also remain frozen until enforcement of a recapitalization plan (with a possible use of a haircut if deemed essential to satisfy the requirement for a 9 percent tier 1 capital ratio). The bank's bondholders were to exchange their claims for equity through a debt-for-equity swap.

As part of the rescue plan, Cyprus was expected to take measures to control government budget deficits, introduce structural reforms and privatize some state assets. Formal agreement on the rescue plan (April 30, 2013) led to a €10 billion aid which made Cyprus the fifth country - after Greece, Ireland, Portugal and Spain - to receive financial assistance from the EU-IMF. In spite of its effectiveness in the rescue of a member state, this plan's significance lies on its imposition, for the first time, of the bail-in concept to an EMU crisis state.

The bail-in concept, a key component of the EU Resolution framework, provides a model to absorb losses and finance the recapitalization of an insolvent institution. It requires existing shareholders and bondholders, and then uninsured depositors, to bear the brunt of failure of a crisis-hit institution. The European authorities had floated the bail-in concept earlier but no detailed rules were released until its application on the Cypriot banks, and even then its implementation was unique in that it called for realized losses to be overwhelmingly funded by depositors, not bondholders. At the EU policy level, it bore the hallmark of a new approach aimed at taming financial services and getting bloated banking sectors under tight control.

Cyprus banking crisis: EU precedents and concerns

Although the levy on Cyprus's large depositors was presented as a one-off deal, European countries have taxed bank deposits before. In the 1990s, Italy levied a tax on every bank account to stave off the collapse of its (lire) currency. The rate, however, was miniscule (0.06 percent) compared to Cyprus's haircuts which at the end amounted to 47 percent of deposits above €100,000. This is an alarming precedent for future crises as it may trigger, to the dismay of the European Central Bank, a capital flight from any country experiencing financial adversity.

Iceland, another island with an outsized financial sector, also relied on depositors to prop up its banks. When the crisis hit there in 2008, the government protected domestic deposits but reneged on deposit insurance for overseas, Internet-based accounts held by British and Dutch. The respective

governments stepped in to help these account holders with a $5 billion package and sued Iceland unsuccessfully in a European court. Nevertheless Iceland has started to repay some of this money.

Cyprus could have used Iceland's approach and go after non-EU depositors, but it would have been hard to distinguish between Cypriot and Russian depositors because many Russians have dual citizenship and several of their businesses are locally registered.

In the immediate period following the Cyprus crisis, there were concerns for other countries with huge banking systems relative to their economies - notably Malta, at about eight times gross domestic product, and Luxembourg at more than 22 times GDP. Yet a major consideration that weighted in favor of these countries was that they were less exposed than pre-bailout Cyprus to peripheral euro zone debt. Cypriot banks' exposure to Greek government bonds and to the sagging Cypriot and Greek private sectors was so sizeable that it delivered a blow to the banks' asset quality and undermined their financial viability. Additionally, Cypriot banks had much lower levels of equity to cushion against failing assets.

Another key consideration in favor of Malta and Luxembourg was that the national financial markets of these countries included subsidiaries and branches of large European and US banking parents that were prepared to extend their support in the event of a crisis. In the case of Luxembourg, domestic banks held just eight percent of local banking assets compared to the 71 percent share of Cypriot banks.

EU headway toward a Banking Union

As the financial crisis of individual EU member states evolved and turned into a Eurozone debt crisis, it became clear that, for those countries which shared the euro and were even more interdependent, the most immediate priority was further economic and monetary integration through establishment of a Banking Union. EU policymakers took a major step in this direction by reaching agreement on a Single Supervisory Mechanism (SSM). Enacted legislation amended earlier directives and tasked the SSM to implement stronger prudential requirements, improved depositor protection, and efficient rules for managing failing banks - a single rulebook for all financial institutions in the Eurozone. With its establishment formally approved (October 2013), the SSM has become operational (November 2014) under the oversight of the European Central Bank. All current Eurozone member states (18), accounting for approximately 4,900 banks, automatically participate in the SSM. Other EU member states may choose to participate in the SSM by opting in through the regime of "close cooperation." Several other member states have indicated that they are likely to become "participants," while the UK, Sweden and the Czech Republic have opted to remain outside.

Enacted legislation empowers the ECB to:

(i) Supervise 120 "significant banking groups" (approximately 1200 entities), representing 82 percent of the total banking assets of the euro area at year-end 2014. The group is made of institutions that meet any of the following criteria - total assets in excess of €30 billion, or over 20% of the national GDP, or being one of the three largest credit institutions in its member state.

(ii) Cooperate closely with national regulators in the supervision of "less significant banks" (approximately 3,400 institutions) under the broad oversight powers of the SSM. For example, national regulators will have to act in accordance with ECB guidelines, specific rules and manuals of supervisory practices, as the success of the SSM will depend on supervision across the SSM being harmonized and of equally high-quality. The ECB will also have the power at any time to decide to exercise direct supervision over a credit institution in particular should it have concerns over the quality of supervision. As a result, the ECB will be responsible for the carrying out of prudential supervisory tasks for all banks in member states participating in the SSM. However, national regulators will remain in charge, and will continue to play a pivotal role in the banking supervision of member states, on all tasks falling outside the scope of the SSM (e.g., consumer protection, money laundering prevention, and payment services).

Prior to assuming its new function, and in line with the creation of the SSM for Eurozone banks, the ECB undertook a comprehensive assessment of the financial health of its directly supervised banking group. Made up of three parts, this assessment sought to gauge supervisory risk, review asset quality and conduct a stress test. ECB's intention was to detect weaknesses, identify appropriate measures (e.g., raise loss provisions, or capital levels), promote balance sheet transparency and financial soundness, and build investor confidence.

EU financial supervisory structure

The SSM is an integral part of the EU financial supervisory structure which began operating in 2011 in response to the financial crisis. The SSM was conceived as a component of the still new European System of Financial Supervision ("ESFS"), which includes the European Systemic Risk Board ("ESRB"), three European Supervisory Authorities ("ESAs") - the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) - and the national regulators. As might be expected, SSM's establishment has led to some overlap of supervisory responsibilities and duplication of bank-imposed requirements.

With ESRB the overlap lays in the extent and nature of supervisory authority - ECB has direct power over credit institutions at member states, while ESRB's macro-prudential oversight - including systemic risk detection - extends to the entire EU and consequently it covers the financial system as a whole. The ESRB can only issue warnings and recommendations directed to any supervisory authority, such as the Union, one or more of the member states, the ESAs, national regulators, and the ECB by virtue of its supervisory status.

In the case of the three ESAs, and more specifically the EBA, the overlap laid with its Board of Supervisors, which is made up of the 28 EU national regulators. Concern that SSM supervisors from member states may dominate

this body prompted a change in voting guidelines to provide for a double majority from authorities of both participating and non-participating member states. The ECB, on its part, implements its own rules concerning the coordination of bank regulators of participating member states.

Empowered to develop a single set of harmonized prudential supervisory rules EU-wide, EBA has sought to fulfill this task through issue of a European supervisory handbook of technical standards and guidance. The intended objective has been to enhance the development of a common supervisory philosophy and the use of best supervisory practices. ECB, on its part, addresses the same objective through its own internal supervisory manual - Guide to Banking Supervision - which is adapted to the SSM requisites. A major challenge to both the EBA and the ECB will be to ensure the consistency of both of these key documents.

Stress tests are another common task to both the EBA and ECB. While the former carries its own stress tests EU-wide, the latter conducts them within the SSM. Following ECB's initial stress test associated with the launching of the SSM, subsequent tests are to be conducted in close cooperation with EBA in terms of design and timing.

With respect to the other two ESAs, the ECB may have some interaction with ESMA and the EIOPA. Although their area responsibility is distinct from that of the SSM, supervision of financial conglomerates (encompassing both banking and insurance businesses) would provide a common ground for ECB interaction and oversight cooperation.

While the ECB fulfills its supervisory role to monitor the financial stability of banks, the effectiveness of day-to-day oversight in participating member states will largely depend on the support of the home state regulator. For supervisory tasks falling outside the purview of the SSM, national regulators will continue to be in charge and therefore play a decisive role. The ECB will have to make use of the local knowledge and expertise of national regulators, and this also applies to national legislation that goes beyond minimum European standards. It will be challenging for ECB to understand, interpret and implement national law concepts across multiple jurisdictions. The same may be said also for jurisdictions where the regulatory process has been generally established by precedent.

Conclusions

Since its inception (1935) the Federal Deposit Insurance Corporation (FDIC) has boosted public confidence in banks, and stability of the U.S. financial market, by functioning as a key deterrent to panics and bank runs. Established as a United States government corporation, it operates as an independent agency guaranteeing the safety of member bank deposits up to a stipulated amount; supervising and examining certain financial institutions to ensure their safety and soundness; and managing banks in receivership (failed banks).

Efforts at enacting a counterpart institution within EU were initially of limited scope and effectiveness. Early EU initiatives sought to promote the stability of the internal financial market by endorsing the existing diversity in national deposit insurance systems. Concerned about interference in national

sovereignty, EU legislation thus upheld the multiplicity of deposit insurance schemes. This stance proved disruptive, and undermined the financial stability of the internal market during the 2008 crisis. Subsequent enactments addressed shortcomings of earlier legislation by dealing with such specific issues as raising the amount of depositor protection, shortening depositor reimbursement period, harmonizing state funding mechanisms, and providing for bank failure prevention and liquidation. However, a turning point in EU legislation promoting the financial stability of the internal market came after the global recession - which followed the U.S. subprime mortgage crisis - hit individual member states. When the financial crisis of Greece, Ireland, Portugal, Spain, and Cyprus evolved into a Eurozone debt, further economic and monetary integration, through establishment of a Banking Union, became the most immediate priority. EU policymakers took a major step by reaching agreement on a Single Supervisory Mechanism (SSM) which, under the oversight of the European Central, would implement stronger prudential requirements, improved depositor protection, and efficient rules for managing failing banks - a single rulebook for all financial institutions in the Eurozone.

Although short of a single pan-European insurance and resolution mechanism, establishment of the SSM is of pivotal importance as it centralizes prudential supervision of credit institutions in the Eurozone. ECB's powers (e.g., regulations, manuals of supervisory practices and guidelines to national regulators) are assurances that the supervision across the SSM will be harmonized, and of equally high quality. This alleviates concerns about differences in supervisory regimes for credit institutions and it marks the beginning of a consistent and more resilient oversight. A common and consistent oversight across all members of the SSM is the key to the Banking Union. It will support full confidence in the quality and impartiality of banking supervision across European countries; it will increase transparency and therefore help to embed best practice across the region. For the ECB, the SSM presents a unique opportunity to raise the overall standards expected of credit institutions irrespective of their "significance" and location (whether based in the Eurozone or a non-Eurozone SSM participant state).

The challenge for the credit institutions would entail issues relating to compliance to ECB guidelines and standards, operational decisions (e.g., data collection templates, asset quality reviews, and information follow up requests), and strategic questions on supervisory relationship management (dealing with supervisors).

The ECB challenge would range from the hiring of the diverse talent and expertise needed to staff the SSM center in Frankfurt to the strategy for rolling out its new framework with the different stakeholders (e.g., national regulators and credit institutions). No less important will be the needed refinement in overlaps with other EU financial authorities in the supervisory structure.

With the foundations for the Banking Union set in, strides in Eurozone's integration hold the promise of contributing to the transformation of the current SSM structure into a single pan-European FDIC counterpart.

Notes

[1] Nicholas Comfort and Annette Weisbach, "Cyprus Banks Like Iceland's Dwarf Economy as Clients Pay," *Bloomberg*, Mar 19, 2013, available at http://www.bloomberg.com/news/2013-03-18/cyprus-bank-assets-dwarfing-economy-to-make-aid-exception.html (accessed on November 24, 2014).

[2] Michele Kambas, Stephen Grey and Stelios Orphanides, "Insight: Why did Cypriot banks keep buying Greek bonds?" *Reuters*, April 30, 2013, available at http://www.reuters.com/article/2013/04/30/us-cyprus-banks-investigation-insight-idUSBRE93T05820130430 (accessed on November 23, 2014).

References

Barnato, Katy (2013), "Malta's banks are safe… for now: Fitch", *CNBC,* available at: http://www.cnbc.com/id/100646028 (accessed on February 11, 2014).

Dilorenzo, Sarah (2013), "A Look at Cyprus' move to seize bank deposits", *Yahoo News,* available at: http://news.yahoo.com/look-cyprus-move-seize-bank-051236050.html (accessed on October 22, 2013).

Gerhardt, Maria and Karel, Lannoo (2011), *Options for Reforming Deposit Protection Schemes in the EU,* available at: http://aei.pitt.edu/30828/1/ECRI_Policy_Brief_4.pdf (accessed on November 26, 2014).

Kanterman, Matthew (2013), "Largest depositors in Cypriot banks to lose 8.3 billion euros in bail-in", *Benzinga,* available at: http://www.benzinga.com/markets/bonds/13/04/3497583/largest-depositors-in-cypriot-banks-to-lose-8-3-billion-euros-in-bail-in (accessed on November 24, 2014).

Pritchard, Ambrose Evans (2014), "Stoic Cyprus back from the dead after banking collapse", *The Telegraph*, available at: http://www.telegraph.co.uk/finance/ financial crisis/10655816/Stoic-Cyprus-back-from-the-dead-after-banking-collapse.html (accessed on November 24, 2014).

Traynor, Ian (2013), "Cyprus's banks have been tamed – are Malta and Luxembourg next?", *The Guardian,* available at: http://www.theguardian.com/business/2013/mar/25/ cyprus-banks-malta-luxembourg (accessed on November 25, 2014).

EU Banking Union, available at: http://ec.europa.eu/finance/general-policy/banking-union/index_en.htm (accessed on November 26, 2014).

EU Deposit Guarantee Schemes, available at: http://ec.europa.eu/internal_market/bank/guarantee/#maincontentSec2 (accessed on October 20, 2013).

EU Directive 2014/59/EU of the European Parliament and of the Council, *Official Journal of the European Union,* available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32014L0059 (accessed on December 2, 2014).

European Central Bank, *Guide to Banking Supervision*, 2014, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf (accessed on January 12, 2015).

European Central Bank, *The List of Significant Supervised Entities and the List of Less Significant Institutions*, 2014, available at https://www.ecb.europa.eu/pub/pdf/other/ssm-listofsupervisedentities1409en.pdf (accessed on January 12, 2015).

FDIC, *Managing the Crisis: The FDIC and RTC Experience*, available at: http:// www.fdic.gov/bank/historical/managing/Chron/pre-fdic/(accessed on October 20, 2013).

FDIC, *The First Fifty Years,* available at: www.fdic.gov/bank/analytical/firstfifty/ (accessed on October 20, 2013).