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The European Central Bank, the Single Supervisory Mechanism and the COVID-19 related economic crisis: a neofunctionalist analysis

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ABSTRACT
The COVID-19 pandemic triggered a major economic crisis worldwide. The monetary policy response of the European Central Bank (ECB) was fast and massive. The ECB also intervened on the supervisory side because, after the establishment of Banking Union, the ECB was given responsibility for banking supervision in the euro area through the Single Supervisory Mechanism (SSM). This paper explains the response of the ECB-SSM to the COVID-19 related economic crisis during 2020 and 2021, up until February 2022. These ECB actions include the reduction of bank capital buffers, the redefinition of non-performing loans, and the limitations on dividends and bonuses paid by banks. We adopt a neofunctionalist approach, which suggests that policies are developed at the EU level in response to need, whereby supranational actors and spillovers are particularly important. We offer some concluding insights into whether the ECB-SSM's responses have led to a further deepening of integration.

KEYWORDS
COVID-19; pandemic; European Central Bank (ECB); single supervisory mechanism (SSM); banking supervision

1. Introduction

The coronavirus (COVID-19) pandemic, which began as a public health emergency in early 2020, had devastating economic and financial effects across the European Union (EU) and worldwide. It combined demand and supply shocks which, right away in 2020, led to the worst economic recession since World War II. The Gross Domestic Product (GDP) of the EU as a whole contracted by 6.2% and the euro area contracted by 6.6% (ECB 2021), whereas inflation in the euro area declined to 0.3% (it had been 1.2% in 2019) (ECB 2021). The economic repercussions of the pandemic posed significant risks to the stability of the financial system. The resilience of the banking system is of particular relevance in the EU, as banks provide most of the credit to businesses and households (Hardie et al. 2013). Moreover, banks have a unique role as deposit-takers from the general public. Thus, the pandemic not only placed a renewed strain on the economic governance of the EU, in particular, on Economic and Monetary Union (EMU), but it is was also a major challenge for Banking Union, which had been established in the euro area in various steps between 2010 and 2015 (for an overview see Donnelly 2018; Epstein and Rhodes 2016; Howarth and Quaglia 2016; Nielsen and Smeets 2018; Schimmelfennig 2016; Skuodis 2018).

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The European Central Bank (ECB) is the linchpin of EMU; it is also a crucial institution in shaping the EU's economic responses to crises. The central bank of the euro area looks after price stability via monetary policy. Since the sovereign debt crisis, it has also been given the role to be the banking supervisory authority of the euro area in the context of the Single Supervisory Mechanism (SSM). Hence, the ECB has been able to react to the pandemic crisis swiftly[1] with much of the action taking place in the first days and weeks after the Director-General of the World Health Organisation, Tedros Adhanom Ghebreysesus, pronounced in March 2020 that the coronavirus SARS-CoV-2 that produces COVID-19 had caused a pandemic (WHO 2020). The ECB responded to the crisis by using both of its two arms: the monetary policy arm and the banking supervision arm. Whereas the first aspect, i.e. the conventional and unconventional monetary policy measures of the ECB in reacting to the pandemic, has attracted much attention by practitioners, and has been examined by some academic works (e.g. Quaglia and Verdun 2022), much less is known about the ECB's response on the banking supervision side. As one of the most powerful banking supervisors in the world, and the cornerstone of Banking Union, it is important to get a better grasp on this response – not least because the EU has an important global banking sector (Kemplay 2022). Hence, the ECB's actions in this field have far-reaching repercussions across Europe and worldwide.

This paper asks how the ECB in its role as banking supervisor responded to the pandemic-related economic crisis and why it chose this particular course of action. In answering this central question, we also reflect on some broader questions that inform this special issue on Banking Union, namely, how have Banking Union and its pillars performed in the first decade after their establishment? What strengths and weaknesses concerning the institutional design of Banking Union have emerged over the last ten years and what could be done to address existing shortcomings? What theoretical lessons can we draw from these studies?

In this paper we take a neofunctionalist approach. We seek to draw some theoretical lessons from our analysis and embed them in the broader literature on this topic. We find that the ECB acted in a timely and substantive manner on the supervisory side, in response to a variety of spillovers and by deploying its institutional supranational entrepreneurship. It identified banking as an area where policies needed to be executed at the euro area level and took the lead. The ECB also jumped into the vacuum that emerged, as neither the member states nor the other EU institutions were able to act quickly because they needed time to come up with a major collective response. In this paper we do not examine the measures taken by other EU institutions, notably, the European Commission. The latter played an important role in the first six months of the pandemic and thereafter (see Kassim 2022; Donnelly, this issue). National governments also played an important role. They developed different strategies and in collaboration with the Commission worked on an EU response. However, this interaction between Commission and member state governments (through the Council, the Franco-German tandem, the Frugal Four, or through the European Council) took a fair bit of time. Eventually, these interactions did lead to important developments, such as the support via the Recovery and Resilience Facility and the Next-Generation EU budget (for further details see inter alia Buti and Fabbrini 2022; Howarth and Quaglia 2021; Genschel and Jachtenfuchs 2021; Jones 2022; Vanhercke and Verdun 2022; Verdun 2022a).

This paper is organised as follows. Section 2 discusses the state of the art on the ECB as a crisis manager, in particular its reactions to previous crises. It also outlines the analytical framework of the paper, examining the key concepts that inform the empirical analysis in the second part of the paper. Section 3 outlines the main economic challenges that ensued from the pandemic and examines the measures adopted by the ECB-SSM. Section 4 concludes and spells out the contributions of this paper to the broader literature on the economic governance of Banking Union.

2. State of the art and analytical framework

There is, by now, extensive literature in political science on the ECB's response to previous crises, namely the 2008 international financial crisis and the sovereign debt crisis in the euro area from 2010 to 2015.[2] These scholarly works in political science have mostly focused on one specific facet, be it the role of the ECB in the Troika (Henning 2017; Lutz et al. 2019), in the establishment of Banking Union (Epstein and Rhodes 2016; Glöckler, Lindner, and Salines 2017), as lender of last resort and 'saving the euro', namely, the ECB's 'whatever it takes' policy (Hodson 2013; Schoeller 2018; Verdun 2017), including its asset purchase programme. Some authors have examined the ECB's role from a neofunctionalist perspective (Vilpišauskas 2013; Niemann and Ioannou 2015). Others have pointed out the leadership of the ECB (Schoeller 2018; Verdun 2017); its self-empowerment (Heldt and Mueller 2021; Jones, E. 2020b) and its ideational and institutional power, especially in the so-called 'slow burning phase' of the crisis (Carstensen and Schmidt 2018; Schmidt 2016). More recently, some political scientists have considered the role of the ECB in dealing with the economic challenges posed by the pandemic, albeit mostly in a cursory fashion (see, inter alia, Dimitrakopoulos, Dionyssis and Lalis 2020; Jones 2020a, 2022; Schmidt 2020; Genschel and Jachtenfuchs 2021). The handful of works that have specifically focused on the ECB (Quaglia and Verdun 2022) have done so by examining its action as the central bank of the euro area with a focus on monetary matters – ignoring its role as banking supervisor and hence how the ECB has deployed its supervisory arm. This paper tries to fill that gap by focusing on the supervisory side, which has not been examined by the academic literature so far.

To explore the developments in this area of policy-making in the first two years of the pandemic crisis, this paper uses a neofunctionalist approach (Haas [1958] 2004; Lindberg and Scheingold 1970). Neofunctionalism focuses on the process of economic and political integration, paying particular attention to the role of supranational actors, notably, the European Commission, the European Parliament, and the Court of Justice of the European Union. In terms of the mechanism at work, it points to various types of spillover. *Functional spillover* means that once a particular policy area becomes integrated, there would be a need to integrate other connected policy areas. *Political spillover* unfolds when transnational and subnational actors, such as interest groups, mobilise at the EU level, shifting their loyalties from the domestic level to the EU level. *Cultivated spillover* occurs when supranational actors push for more economic and political cooperation, usually while member states are engaged in the process of negotiations (Tranholm-Mikkelsen 1991). According to neofunctionalism, European integration has a self-sustaining dynamic toward more integration (see also Van der Vleuten, 2018) although some scholars have examined the process of stop-and-go in integration and have further theorized that process to explain the timing of integration thereby accounting for more dialectical processes in neofunctionalism (Corbey 1995). This dialectical form of neofunctionalism deals with an important aspect of neofunctionalism, namely whether the process is automatic and should always move forward. A familiar metaphor is that the EU needs to move forward, much as a bicycle, or it would fall and crash (cf Emerson 1988). Others have questioned this need for always moving forward. They advocate for reassessment and reflection before moving forward (Trenz, Ruzza, and Guiraudon 2015; Rachman 2020). Recent studies suggest that the process may have these pressures, but that they are sometimes interrupted.

The usage of neofunctionalism in scholarly analyses has tended to track the extent to which the range of EU competences has expanded. Therefore, whenever major steps were taken in integration that expanded the scope or depth of integration, neofunctionalism would see a revival. In this way, it has seen ebbs and flows in popularity. It was created in the 1960s and further expanded in the early 1970s; then abandoned in the mid-1970s by one of the lead thinkers himself (Haas 1975). With the renewed integration process, in the late 1980s and 1990s, it returned as an analytical framework that scholars thought useful as a tool for exploring the dynamics of European integration (Mutimer 1989; Burley and Mattli 1993; Sandholtz and Stone Sweet 1998). In the 2000s it lost some of its appeal, as did the clarity of the path of integration, even if we still saw a number of scholars work with the theory and fine-tune its usage (Börzel 2005; Risse 2005; Rosamond 2005; Schmitter 2005; Niemann and Schmitter 2009; Dyson and Marcussen 2009). In the 2010s we have seen it be used by some, to point to the deepening of integration and when supranational actors were in charge (Niemann and Ioannou 2015; Greer and Löblová 2017; Carstensen and Schmidt 2018; Nicoli 2020).

In this paper we adopt the neofunctionalist framework as we see three basic elements of neofunctionalism coming together: a strong entrepreneurial role by a supranational actor, spill-over and deepening of integration. Thus, we consider the deepening of integration as the explanandum and the role of supranational actors and spill-over as the explanans. We operationalise the notion of integration as the transfer of authority from member states to the EU level and the development of a policy response at that level. We consider the ECB in its role as banking supervisor (henceforth: 'ECB-SSM') as a supranational actor because it directly supervises 'significant' (i.e. large) euro area banks, and indirectly supervises 'less significant banks' in cooperation with the national competent authorities. Moreover, it issues 'soft law' to harmonise banking supervision in the euro area. Specifically, we seek to understand better the actions of the banking supervisory arm of the ECB; in particular, why and how it reacted to the COVID-19 related economic crisis.

We also investigate different types of spillovers. Drawing on Niemann and Ioannou (2015, 200) we operationalize functional spillovers by looking 'the existence of functional interdependence between issue A (original objective) and issue B (requiring further action)'. Political spillover is when relevant stakeholders accept that some policy competences have been transferred to the EU level and mobilise vis-à-vis EU bodies. We operationalize political spillover as occurring when we find evidence of calls for EU-level action by private financial actors. Cultivated spillover is observed when we find a supranational body pushing for more integration. We operationalize this type of spillover by examining the ECB-SSM's initiatives to promote further integration in response to the pandemic. Methodologically, we examine policy documents, speeches, public interviews, and a small set of interviews with key informants, whom we asked a set of semi-structured interview questions. Our interviewees work at the ECB, or are involved in EU monetary and banking supervision matters in other EU institutions and think tanks. These interviewees were selected as persons who have in-depth knowledge of economic and monetary integration and, given their long experience with EU institutions, are able to look at longer trends and developments.

3. The ECB supervisory response to the COVID-19 related economic crisis

When the pandemic began, it was a symmetric shock that hit all the member states of the euro area and the EU more generally. Its effects were of course not fully symmetric. To start with, public policy regarding health care varied among EU member states (Brooks et al. 2022). But more generally, EU and euro area economies differ greatly from one another, not in the least place because of the different structure of the economy, fiscal space, and state of the economy prior to the pandemic. During the sovereign debt crisis of 2010–5, it was generally felt that the member states who were most affected by it, were in part to blame, either because of poor economic policies or macroeconomic imbalances. In other words, there was some understanding that member states' policies or previous public debt or budgetary deficits were to blame for the size and impact of the crisis in those most affected by it. The COVID-19 crisis was different in this regard. Instead of being seen as avoidable, or impacted by previous choices, it was, regarded as a *force majeure* that hit member states at random; it was not their own fault (interviews 2,6).

The ECB as an institutional actor was a first mover in reacting to the crisis, although pundits were unsure at the outset whether it would deliver (C. Jones 2020). Although some measures were already taken on 12 March (ECB 2020a, 2020f), some other responses were triggered by the fact that the ECB president Christiane Lagarde made a misstep on 12 March in the meeting with the press that followed the Governing Council meeting on 12 March when responding to a journalist with a comment 'we are not here to close spreads' that sent the Italian bond yields sharply up (Financial Times 2020). Stock exchanges had been jittery for a month and these comments functioned as a spark to contribute to the already considerable inflammable financial markets, in Europe, the United States and across the globe (Ganie, Wani, and Yadav 2022). The most severe market turbulence was between 11 and 23 March (Financial Stability Board 2020; see also Financial Times 2022). The comments of Lagarde were interpreted as lacking support for the euro area countries, in particular to countries in the south, such as Italy. She corrected this situation that had emerged with press appearances soon after and by presiding over the Governing Council's next package on 18 March (ECB 2020b, 2020g; see also Verdun 2022b). These measures, including a new temporary asset purchase programme of private and public sector securities (pandemic emergence purchase program PEPP), were both monetary and oriented to banking supervision.

The objectives of the ECB's response to the pandemic were manifold: to provide access to funding to banks at favourable rates; to keep under control the spread on the bond yields of the euro area member states; to buy time and provide some breathing space for other EU institutions and the member states to act (interviews 1, 3, 4, 5; ECB 2020g; European Parliament 2020). In order to respond to the COVID-19 related economic crisis, the ECB deployed instruments of its monetary policy arm as well as banking supervision arm. Thus, for the first time, the ECB had the opportunity to use instruments both on the monetary policy side and the supervisory side, which could pull in the same direction because both were allocated at the same level, the euro area level (interviews 1 and 5). Indeed, these two policies were complementary and were clear examples of *functional spillover*, that bring to the fore interdependence between two policies. In fact, some monetary policy measures of the ECB, notably, the Targeted Long-Term refinancing Operation[3] were consequential for banks, as they helped banks to cope with the crisis. At the same time, the ECB deployed its banking supervisory powers as a monetary policy tool by enhancing funding available to banks for lending purposes.

The very allocation of supervisory competences to the ECB as part of Banking Union had been a notable example of *functional spillover* – once monetary policy had become supranationalised (meaning that it was conducted in a centralised way at the euro area level), there was a need to supranationalise also banking supervision in the euro area. In other words, monetary policy competences and supervisory competences should be located at the same level of (euro area) governance because these two policies are intricately connected. Moreover, Banking Union was a way to solve the 'financial trilemma' (see, for instance, Buti and Fabbrini 2022), which consisted of the interplay of financial stability, international banking, and national financial policies, whereby not all three objectives can be achieved at the same time: one has to give. This trilemma was made particularly acute for those member states that had the single currency as their currency. On the one hand, EMU reinforced financial (banking) integration in the euro area. On the other hand, monetary union undermined national financial policies not least because the function of lender of last resort could no longer be performed at the national level. Since the safeguard of financial stability could best be achieved at the supranational level, euro area member states agreed to Banking Union, which replaced the third element of Schoenmaker's trilemma, namely 'national financial policies', by partially transferring banking supervision and resolution at the euro area level. In fact, some supervisory competences (i.e. those for less significant institutions) stayed in the hands of national competent authorities (Howarth and Quaglia 2016).

Once the ECB took over the competences for banking supervision in the SSM, it set in motion a process toward loosening the ties between sovereigns (specifically, national supervisors) and domestic banks (see Introduction), adopting rather stringent measures that helped to build-up bank capital buffers and forced banks to deal with non-performing loans (NPLs) (Bozina Beros, this issue; Pierret et Howarth, this issue).[4] This is another example of *functional spillover*. After all, prior to the pandemic, the ECB-SSM improved the resilience of the banking system in the euro area (Zeitlin, this issue) and created the space for relaxing capital buffers and introducing some flexibility concerning NPLs in response to the COVID-19 related economic crisis. The fear was that without a coordinated response there could be a series of bank failures. Thus, whereas in the global financial crisis and the euro crisis, the banks were part of the problem, during the COVID-19 pandemic there was an enormous effort made by the ECB to make sure that banks were part of the solution (interview 1, Enria 2020a, EP 2020: 5). Enria stated in a hearing with the European Parliament Economic and Monetary Committee on 5 May 2020: 'As supervisors, we have adjusted our supervisory work to the crisis and focused on ensuring that banks can continue to support the real economy in the future – and that they will also be able to support a recovery' (EP 2020: 2).

In contrast to previous crises, euro area banks ended up remaining resilient and capable to support the economy (Af Jochnick 2021). Whereas the policy measures taken during the 2008 global financial crisis primarily aimed at stabilising the euro area banking sector itself, those enacted in response to the pandemic sought to mitigate the broader impact of the pandemic on the real economy. In this respect, the banking sector was a key conduit, given its critical role in lending to firms and households. Moreover, once the ECB became the banking supervisor of the euro area, it also had to take on responsibility for crisis management in the banking sector, even when crises originated outside the financial sector, as in the case of a health-related crisis, which was likely going to have an impact in the economic domain. The impact of a health crisis on the economy is also an example *of functional spillover* – the need to take action in policy areas other than the one which originally triggered the crisis. The pandemic could have triggered further fragmentation in Banking Union, as had happened during the previous crises, but this did not happen, because *functional spillover* concerning crisis management kicked in. Unlike during the previous crisis, the ECB as the banking supervisor of the euro area, had considerable legal competences and technical tools to deploy to this end.

The ECB's measures aimed 'to allow banks to keep providing financial support to viable households, small businesses and corporates' hit by the economic fallout (Enria 2020a). Specifically, the ECB deployed three sets of measures on the supervisory side. First, in March 2020, the ECB Banking Supervision provided *temporary relief of capital and liquidity buffers*. These buffers were designed with a view to allowing banks to withstand economic stress and the European banking sector had built up a significant amount of these buffers. The ECB allowed banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance, the capital conservation buffer and the liquidity coverage ratio (ECB 2020e). Banks were allowed to use partially capital instruments that did not qualify as Common Equity Tier 1 capital, for example, Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 requirements. Banks were expected to use the extra capital ensuing from these measures to support the economy and not to increase dividend distributions. The ECB estimated that the capital relief provided by the possibility to operate below the Pillar 2 Guidance of Pillar 2 and the frontloading of the new rules on the Pillar 2 Requirement composition amounted to €120 billion of CET1 capital. This relief was available for banks to absorb losses without triggering any supervisory actions or to potentially finance up to €1.8 trillion of loans to households and corporates (ECB 2020a). In April 2020, the ECB reduced temporarily bank capital requirements for market risk. It extended additional credit claims frameworks so as to include loans to small and medium-sized enterprises and to the self-employed (ECB 2020c). In September 2020, the ECB announced temporary relief on banks' leverage ratio. The main purpose of these measures was to free up some capital that banks could use to lend to businesses and households.

Second, in late March 2020, the ECB introduced *supervisory flexibility regarding the treatment of non-performing loans* (NPLs), in particular, to allow banks to benefit from guarantees and moratoriums put in place by public authorities to tackle the economic distress. Supervisors would exercise flexibility regarding the classification of debtors as 'unlikely to pay' when banks called on public guarantees granted in the context of coronavirus. The supervisor would also exercise flexibility regarding loans under COVID-

19 related public moratoriums. Furthermore, loans that became non-performing, and were under public guarantees, would benefit from preferential prudential treatment in terms of supervisory expectations about loss provisioning. The ECB also allowed the use of transitional arrangements in accounting standards IFRS 9, so as to increase flexibility in accounting for NPLs. The main purpose of these measures was to reduce the losses deriving from NPLs so as not to create holes in the balance sheets of banks, which would then need to raise new capital to deal with these losses.

Third, in late March 2020, the ECB issued *recommendations to banks not to pay dividends* or buy back shares during the pandemic. The ECB expected banks' shareholders to join the collective effort to support the economy. These ECB's recommendations were renewed in July 2020 and December 2020, when, however, the ECB revised (softened) its recommendations, acknowledging the reduced uncertainty in macroeconomic projections. The ECB expected dividends and share buy-backs to remain below 15% of the cumulated profit for 2019–20 and not higher than 20 basis points of the Common Equity Tier 1 ratio, whichever was lower (ECB 2020d). Banks that intended to pay dividends or buy back shares needed to be profitable and have robust capital trajectories. The ECB's recommendations on dividend distribution restrictions were 'intended to keep precious capital resources within the banking system . . . to enhance its capacity to lend to the real economy and to support other segments of the financial sector as they come under stress' (Enria 2020a).

The measures that the ECB took on the supervisory side were unprecedented in two ways. To begin with, it was the first time that the ECB-SSM deployed its supervisory tools in order to ease the COVID-19 related economic recession – the ECB did not have bank supervisory responsibilities prior to the creation of Banking Union, so it was obviously unable to deploy its supervisory arm in responding to the 2008 international financial crisis as well as the sovereign debt crisis. Furthermore, it is true that banking supervisors in other jurisdictions also adopted similar measures, but the scope and magnitude of ECB's actions were extraordinary. The Chair of the SSM estimated that the ECB's supervisory measures created a space of approximately €160 billion, which represented additional capital that could be used by banks during the crisis. Moreover, banks had €400 billion of capital available as a buffer that could be used on top of the capital conservation buffer. To give an idea of the order of magnitude, €400 billion was an amount that would have been sufficient to withstand an increase in non-performing loans similar to the one that took place during the sovereign debt crisis. By adding the capital conservation buffer, which is the additional buffer on top of minimum requirements, that amounted to a total buffer of €610 billion of capital resources that could be used by banks (Enria 2020c). In the US, the Federal Reserve and other banking supervisors, adopted, although to a more limited extent, measures similar to those adopted by the ECB-SSM. Thus, US banking regulators provided temporary capital relief to banks, encouraging banks to dip into their regulatory capital and liquidity buffers to increase lending during the pandemic. They also imposed limitations on capital distributions and allowed banks to mitigate the impact of the expected credit losses, following changes in US accounting standards (Clarida, Duygan-Bump, and Scotti 2021). In comparison, the ECB-SSM's action was more extensive than US's action with reference to NPLs, leaving more leeway to banks (FSB 2021).

There were however some criticisms concerning the ECB-SSM's supervisory measures in response to the pandemic. To begin with, the possibility to reduce the capital buffer –

the extra capital space to lend to businesses – was not taken up by many banks. Banks worried about having to increase capital buffer again after the crisis, thus, they did not reduce these buffers in the first place (Abad and Garcia Pascual 2022). At the same time, the fact that banks did not use capital should not be a criticism of ECB's action, it means that banks were sound and did not need to do so. Moreover, the bank-sovereign nexus that Banking Union was designed to tackle was reinforced during the pandemic crisis, even though this was not due to ECB-SSM's supervisory actions. The extension of government guarantees to banks and the payment moratoria for bank customers reinforced the linkages between domestic banking systems and their respective sovereigns (national governments). The ECB-SSM called for close monitoring of the exit from the payment moratoria and loan guarantees that had been extended to banks across Europe, paying attention to banks' exposures to local or central governments in an environment of rising public debts (Af Jochnick 2020). Last but not least, it is worth noting that while the total amount of state guarantees announced by euro area governments during the pandemic was comparable to that during the great financial crisis, during the pandemic such guarantees targeted non-financial corporations rather than banks themselves (Af Jochnick 2021). Unlike during the great financial crisis, governments did not have to intervene to directly support euro area banks as a result of the pandemic itself. It is however true that many national member state governments provided some COVID-19 funding to businesses during the lockdowns, thus reducing the risk of non-performing loans that would have badly hit the banking sector. Thus, if that risk (which, at the time of writing, is still present) did not materialise, it was also thanks to governments' actions.

There were also *political spillovers*, which occur when relevant stakeholders accept that some policy competences have been transferred to the EU/euro area level and mobilise vis-à-vis EU bodies, calling for EU/euro area-level action. Indeed, during the pandemic, banks and other private financial actors mobilised at the euro area level – i.e. vis-à-vis the ECB – to urge it to take action on the supervisory side. For instance, the main transnational banking association in the EU, the European Banking Federation (EBF), which brings together national banking associations, sent numerous letters[5] to the ECB during the pandemic concerning banking supervision in particular. The EBF maintained that it was the 'the joint responsibility of European authorities, regulators, supervisors and banks, to quickly adopt a series of measures needed to neutralize the effects of the COVID-19 on the economy'. In particular, the EBF called for more flexibility in the definition of NPLs, the use of capital buffers and the extension of LTROs'.[6] Along similar lines, the Association of German Banks[7] called for the ECB to take actions to reduce capital add-ons, re-define NPLs and adopt a more flexible approach to accounting rules on risk provisioning. It subsequently noted that 'The measures taken by the ECB and EBA show the scale of the challenges facing banks and their customers. . . .These fast-acting measures will enable banks to help customers who are short of liquidity. The supervisory authorities have demonstrated the flexibility needed in times of crisis'.[8]

Finally, in line with neofunctionalist expectations, the ECB's supervisory response to the crisis generated *cultivated spillovers*, which occur when supranational actors push for more economic and political integration, usually while member states are engaged in the process of negotiations. During the pandemic, a supranational actor, the ECB, repeatedly pointed out the need to complete Banking Union by establishing a European deposit insurance scheme in order to complement the existing pillars of Banking Union (namely, banking supervision and resolution) (Enria 2020, see also Quaglia 2019). Moreover, the Chair of the Supervisory Board of the ECB, Andrea Enria, pointed out the 'need to improve and harmonise the toolbox for dealing with crises in small and medium-sized banks and . . . . Overall, our goal should be to complete the banking union within the current institutional cycle, by 2024' (Enria 2020b; cf. Af Jochnick 2020). He also noted that 'Banking union has worked well in the current crisis. European banking supervision was able to react very fast and in a fully unified manner. Compared with 2008, this is a huge improvement! So, if anything, the current crisis is a wake-up call: it shows that we need *European solutions* for *European problems*' (Enria 2020b, *emphasis added*).

As mentioned above, the neofunctionalist approach expects that the COVID-19 shock will lead to a revival of the plans to complete European integration in the domain of Economic and Monetary Union. Enria's advocacy to complete the Banking Union fits in that framework. Full EMU includes delivering on the remaining steps in completing the Banking Union, and possibly renewed momentum to complete EMU as, for instance, had been envisaged in documents such as the four and five presidents report but also the 2017 reports on completing EMU (European Commission 2017). It anticipates that supranational actors will take the lead in promoting these changes to the governance structure. Finally, it assumes that spillovers between different policy-making areas (here: monetary policy integration and the need for deeper banking supervision) will drive deeper integration.

Some would argue that deeper integration by definition requires treaty change. Although it is true that when increased legal competences are confirmed via treaty change, it would be the ultimate affirmation that integration has further deepened, and thus has been cemented. However, the process of treaty change requires member states' representatives to bargain. That process typically contains intergovernmentalist pressures – given who the actors are in the room. What we argue here is that the ECB-SSM plays a role in agenda setting, pointing out to member states the importance of the 'right' macro-economic policy mix, and drawing attention to the plans that are available and need to be acted upon. Furthermore, a process we have also seen, is that action is taken *without treaty change* and after a realisation of the importance of collaboration in that area, formal recognition of this need is incorporated in treaty change at a later stage (think of how the Schengen Acquis got into the treaty (Schimmelfennig, 2018) or how differentiated integration can also move the process of integration gradually forward (Schimmelfennig 2016; Leruth, Gänzle, and Trondal 2022)).

Our neofunctionalist approach also encourages a reflection on the role of supranational actors more generally with regard to deeper integration. With reference to the last crisis, there was a lively debate as to whether supranational actors, in particular the Commission, was able to be the engine of integration. Various scholars argued that the Commission did indeed perform that role (see inter alia, Bauer and Becker 2014; Becker et al. 2016; Savage and Verdun 2016). Others were not so sure (see inter alia, Hodson 2013; Menz and Smith 2013; Copeland and James 2014). The present paper invites students of integration to consider once again what supranational actorship looks like, and which institution may be best placed to be in the pole position to take action at any given point in time.

4. Conclusion

This paper started off by asking the question of how the ECB in its role as banking supervisor has responded to the COVID-19 pandemic-related economic crisis and why it chose this particular course of action. We argued that the ECB's supervisory response was quick and effective; it was also unprecedented, because during previous economic crises the ECB did not yet have these supervisory responsibilities, but also because of the size of the financial amounts involved. In this paper we consider the ECB in its role as banking supervisor as a supranational actor in the way that neofunctionalists consider such an actor: a primary driver for integration. It was also an actor that jumped in when other institutions were still grappling with the onset of the pandemic. It was clear that the EU needed a coordinated response to offset the economic crisis that would ensue as the result of lockdowns and the ECB acted in that fashion. By and large, there were three broad areas in which the ECB as a banking supervisor has sought to offset the worst impact of the crisis on the banking sector: temporary relief of capital and liquidity buffers; supervisory flexibility regarding the treatment of non-performing loans (NPLs), recommendations to banks not to pay dividends or buy back shares during the pandemic.

On the one hand, the ECB's supervisory actions in the run-up to and during the COVID-19 related economic contributed to ensuring that banks coped with the shock and remained in business. On the other hand, the national measures taken by governments, notably, state guarantees and financial support to business and households were also important in coping with the crisis. There were also fiscal measures at the EU level, notably, the Next-Generation EU. Thus, there is no counterfactual of what would have happened to banks and the broader economy without the actions taken by the national governments and the supervisory arm of the ECB. Yet, the ECB was able to act quickly and decisively, whilst the European Commission and member state governments were sorting out an EU-level public expenditure plan.

The paper also explored a related question, namely, how Banking Union and its pillars have responded to the COVID-19 related economic crisis. Overall, Banking Union and the ECB-SSM within it, withstood well the test of the pandemic crisis (Af Jochnick 2020). It was the first time that there was a 'completely unified European supervisory response' – a 'single banking supervisor rolled out a relief package for banks across the euro area' – supervisory decisions were taken quickly, in close coordination with monetary policy measures (Enria 2021b). These findings also contribute to the broader literature on Banking Union and EU economic governance more generally by pointing out that Banking Union performed well in the first decade after its establishment and responded swiftly and effectively to the pandemic-related economic crisis. The experience could be built on in the second decade and now going into the third decade. Yet, as elaborated by other papers in this Special Issue (e.g. Zeitlin, this issue), the ECB-SSM is the strongest (that is, fully fledged) pillar of Banking Union, with a fully independent and well-resourced institution, the ECB, at its centre. By contrast, the weakest link of Banking Union is the missing common European deposit guarantee scheme, whereas banking resolution and to be precise the SRM is half-baked (Petit, this issue), as lamented, for example, by ECB's officials (Enria 2021a). Hence, the institutional design of Banking Union is incomplete (see the Introduction to this Special Issue, see also Quaglia 2019).

What theoretical lessons may we draw from this study? In terms of the contribution of this study to neofunctionalist theory of integration, the paper shows that supranational actorship can occur in different institutions. Although many studies concentrate on the role of the European Commission in this regard, the paper demonstrates that the ECB-SSM, an understudied supranational institution, is also able to make a considerable mark on policy development. Another observation is that the ECB-SSM jumped into the vacuum left by other EU-level institutions and was able to act quickly. It took on supranational leadership, it was entrepreneurial in responding to the crisis that required a response at the EU level, that it recognised EU national leaders could not do right away. Similarly, on the monetary front, which is not discussed in this paper but is relevant for an overall assessment of the ECB's actions in responding to the COVID-19 related economic crisis, the ECB deployed in a timely and effective manner the instruments at its disposal (Quaglia and Verdun 2022). Several reasons account for that: the fact that the ECB is a 'robust' institution with treaty-guarantee independence, it has the financial and economic tools to intervene in a timely manner, and overall, there was a certain degree of consensus within the ECB concerning what needed to the done to respond to the COVID-19 related economic crisis and what the ECB could and should do. The ECB has also pushed the member states to act decisively on the fiscal side, emphasizing that a central bank cannot act alone. Further research may want to explore whether these initiatives during this crisis period will provide sufficient impulse to complete the Banking Union as neofunctionalist theory would suggest. Furthermore, the EU and, more generally, the world, seem to be moving from crisis to crisis. The war in Ukraine, its dire economic repercussions and the adoption of financial sanctions against Russia, pose major new challenges to the EU and its institutions, including the ECB-SSM. It remains to be seen how they will cope with this new crisis and whether the neofunctionalist dynamics (which underpin the metaphor of the bicycle) that we have singled out in this paper will continue, or perhaps will stand still and then require further check-ups before continuing along.

Notes

1. This paper considers the COVID-19 pandemic crisis and the response to the economic fallout from 2020 until February 2022 – that is the effects of the war in Ukraine are left outside the scope of this paper.
2. See, inter alia, Dyson and Marcussen (2009); Howarth and Loedel (2005); Quaglia (2008); Mabbett and Schelkle (2019); Macchiarelli, Monti, Wiesner and Diessner (2020); Tortola (2020); Moschella and Diodati (2020) and Schulz and Verdun (2022).
3. TLTROs are ECB measures that offer banks long-term funding at attractive conditions. They were adopted on 16 March 2020 and then subsequently revised on 30 April 2020, 29 January 2021, 30 April 2021.
4. At the start of 2020, approximately 117 banks were subject to direct ECB supervision (the so-called 'significant banks') (ECB 2019), which accounted for approximately 82% of the assets of euro area banks (Institut Montaigne 2021). Bulgaria and Croatia joined the SSM in October 2020. Their entry meant that more significant banks were added (five Bulgarian banks and eight Croatian banks) (ECB 2021, 58).
5. These letters can be found here https://www.ebf.eu/covid-19/
6. https://www.ebf.eu/ebf-media-centre/ebf-calls-for-european-measures-to-face-covid-19-outbreak/

7. https://en.bankenverband.de/newsroom/press-release/German-banks-calls-further-measures-stabilise-economy/
8. https://en.bankenverband.de/newsroom/press-release/peters-takes-positive-view-package-measures/

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Appendix: list of interviews

The seven interviews conducted by both authors and experts explicitly for this project (all conducted via Zoom) were held with these individuals on the following dates.

Interview 1, ECB official, 28 July 2021

Interview 2, ECB official, 29 July 2021

Interview 3, ECB official, 17 August 2021

Interview 4, European Council official, 15 September 2021

Interview 5, Economist at Bruegel, 22 September 2021

Interview 6, ECB official, 9 November 2021

Interview 7, European Commission official, 3 December 2021

The interviews lasted about one hour. This research design was approved by the Human Ethics Board of University of Victoria.