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The next SSM term: supervisory challenges ahead

Banking Union Scrutiny

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Abstract

We look at the challenges facing the Single Supervisory Mechanism in the coming years, and discuss vulnerabilities in the euro area's banking system, as well as possible improvements in the SSM's internal practices. Among the former are low profitability, the increased role of the shadow banking system and weak governance. The latter include an overly complex regulatory framework, limits on staffing that lead to excessive usage of consultants, the need for more transparency and accountability. The SSM should help banks achieve more sustainable returns by making supervisory requirements less complex. It should monitor shadow banks, ensuring that traditional lenders are isolated from possible shocks. As for governance, the SSM ought to engage in a multi-year action plan aimed at improving ethics, technical qualifications, checks and balances. Regulatory complexity must be reduced by further harmonising national rules. Constraints on the SSM's budget and human resources should be loosened, but the use of external consultants ought to be limited to special cases. Accountability and transparency can be enhanced, e.g., through greater disclosure on resources and objectives, SREP and other internal methodologies, and on decisions taken by the SSM's Administrative Board of Review. The European Court of Auditors should be entitled to assess the soundness of the SSM's processes, without interfering with individual supervisory decisions.

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EXECUTIVE SUMMARY

The challenges facing the Single Supervisory Mechanism consist of two broad categories: vulnerabilities in the euro area's banking system and possible improvements in the SSM's own institutional framework and operating practices.

As concerns the former, we focus on low profitability, the increased role of the shadow banking system and bad governance.

Low profitability can be seen as the worst danger facing the European banking sector, as unprofitable banks are bound to shrink, and so is the support they provide to the real economy. Bank profits have been negatively affected by low net operating income (down by 11.5% over the last three years), including poor net interest income, which was adversely affected by a prolonged period of low/negative rates. Operating costs lack flexibility as traditional banks are still struggling with overcapacity, legacy IT systems and outdated distribution networks. On the other hand, technology allows new competitors to lure away customers through cheaper price structures. Although profitability is a supervisory goal, the SSM can help banks achieve more sustainable returns on capital, e. g., through a more streamlined interaction with national authorities and the EBA, which would reduce complexity and overlapping requirements.

In 2017, the EU's shadow banking system ("SBS") accounted for roughly 40% of the assets held by the EU financial system. Although it does not raise deposits from the public, it is a source of systemic risk via its deep interconnections with banks and its significant investments in illiquid assets, which may trigger fire sales and downward spirals. The SSM must monitor the SBS (identifying and addressing vulnerabilities), advise legislators on how to amend relevant regulations and ensure that traditional banks are sufficiently isolated from SBS-originated shocks.

Poor governance remains a key issue for European banks, as new major cases of financial misconduct emerged in 2018. Although some improvement has occurred, especially at large banks, grey areas remain, as many lenders still lack diverse board members, equipped with an adequate technical background and the willingness to act independently and challenge top managers. A multi-year action plan aimed at enhancing ethics, technical qualifications, checks and balances would become a long-lasting legacy of the new Single Supervisory Board's ("SSB") chair.

The possible improvements in the SSM's own institutional and operating arrangements concern mainly three aspects: the complexity of the regulatory framework, limits on staffing that lead to excessive usage of external consultants, the need for greater transparency and accountability.

As regards regulatory complexity, some of the SSM's statutory activities are still governed by national regulations, e.g. in the areas of corporate governance and sanctions. Rules on the suitability of board members and key function holders ("fit and proper") stem from national transpositions of the CRD4, which often fall short of implementing the principles stated in the European guidelines. As for sanctions, the SSM Regulation grants the ECB with the power of imposing fines on legal persons (banks), while physical persons can only be disciplined by national competent authorities ("NCAs"). Furthermore, sanctions for similar breaches may differ significantly across Member States.

As far as staffing is concerned, it should be noticed that the SSB and its chair have only partial influence on the financial and human resources devoted to their mandate, which are controlled by the ECB's governing council. The SSB's ability to independently manage resources is further constrained by the fact that on-site inspections and joint supervisory teams rely heavily on staff supplied by NCAs, whose willingness to commit an adequate amount of resources has sometimes been questioned. Furthermore, the NCA personnel retains a hierarchical link with national authorities, which make them more open to national considerations. To overcome such constraints, the ECB has made significant use of external consultants, not only for stress tests but also for on-site inspections and special projects like the "targeted review of internal models". This raises several concerns, in terms of conflict of interest and distorted incentives. Banks may find it convenient to hire the same consulting firms used by the ECB, hoping to get "an insider's view" on the latter's methodologies. Consultants taking part in supervisory activities may be under psychological pressure to please prospective (or actual) customers, or may have access to sensitive information that might subsequently be used to the benefit of other banks. In an attempt to address these issues, the SSB has imposed confidentiality requirements and requested consultancy firms to introduce a "strict separation" of the teams supporting the ECB; still, the effectiveness of these measures remains unclear. In our opinion, as indicated by the European Commission in 2017, the use of consultants should take place on an occasional basis, when specific technical knowledge is required.

The last (and possibly largest) challenge facing the SSM involves accountability and transparency (including towards supervised entities), which may benefit from several improvements. E.g. the SSM's annual statements on "supervisory priorities" could provide an indication of the approximate amount of resources committed to each objective, and state the expected results in order to facilitate an ex post assessment. The ECB's annual report on banking supervision may provide greater detail on the costs of supervisory activities, as only a few macro items are currently being disclosed, making it impossible for outsiders to learn how resources are used. The SSM's Administrative Board of Review should make its decisions public through anonymised summaries that set a public precedent for future cases. Letters sent by MEPs to the SSB on specific issues may be organised by topic on the SSM's website, and an indicative time limit for replies may be agreed. The SSM's internal processes may also benefit from periodic reviews carried out by an experienced, authoritative and independently-staffed institution like the European Court of Auditors. Still, the latter's request for increased access to SSM documentation under its mandate to assess the "operational efficiency of the ECB's management" should not pave the way to an evaluation of the ECB's supervisory activities as such.

Regarding transparency towards supervised entities, the abridged public versions of the SSM's supervisory manuals could be extended, providing more details on internal methodologies and making it easier for outsiders to monitor their correct implementation (or to identify areas for improvement). The motivations behind capital surcharges and other supervisory requests following the SSM's annual evaluation of individual banks ("SREP") should also be made accessible to the interested parties.

1. STRUCTURE OF THIS REPORT*

The challenges that the SSM must face in the coming years consist of two broad categories. The former is covered in §2 of this report, and includes vulnerabilities in the euro area's banking system, which need to be monitored and addressed by supervisors. The latter, to be discussed in §3, originate instead from the SSM's own institutional framework and operating practices, where some areas for improvement can still be found.

After reviewing those two groups of priorities, §4 concludes and §5 indicates some tentative questions that could be addressed to the Single Supervisory Board's new chairperson, Mr. Andrea Enria, during his hearing, scheduled for March 21, 2019.

2. CHALLENGES FOR THE EUROPEAN BANKING SECTOR

The list of potential weaknesses of European banks is virtually endless[1]. "Traditional" vulnerabilities, including credit and market risk, liquidity and leverage, continue to be a source of concern for bankers and supervisors. Next to them, several "new" threats have emerged – including e.g. cyber-risk, and cryptocurrencies – whose disruptive potential is still difficult to assess in full. In the interest of brevity, we focus on three specific areas: profitability, shadow banking and misconduct risk.

2.1 Low profitability

Low profitability can be seen as the worst danger facing the European banking sector. Unprofitable firms can hardly attract new capital from investors, and financial institutions are no exception to this rule. If their equity base suffers from poor retained earnings and investors' disaffection, banks can only be expected to shrink and provide weaker support to the real economy.

While it is true that profitability has been negatively affected by the need to provision for credit losses accumulated during the crisis[2], the most striking feature of the European banks' income statement is are low operating revenues: based on EBA data, the net operating income of large European banks was €313 bn in June 2018, down 11.5% over the last three years. While this poor performance is partly due to volatile trading profits, a key driver is net interest income, which has declined by 3% per year.

Interest-based revenues have been adversely affected by a prolonged period of low/negative rates; accordingly, they may rebound if economic activity picks up and monetary policy becomes tighter[3]. Bank profitability, however, also suffers from a number of more structural factors that are unlikely to change in the foreseeable future.

In fact, operating costs lack flexibility as traditional banks are still struggling with overcapacity, legacy IT systems and outdated distribution networks. On the other hand, technology allows new competitors

* Although the views expressed in this report are only mine, I gratefully acknowledge suggestions and advice from Nico Di Gabriele (ECB), Marcel Magnus (E-GOV, European Parliament) and Marco Onado (Bocconi University).

[1] Un updated picture of the main challenges facing the European banking sector can be found e.g. in (European Banking Authority 2018, 2019; European Central Bank 2018c).

[2] According to (Angeloni 2019), "[t]he profitability of European banks has been persistently weak for two main reasons: the need to provision for credit losses accumulated during the crisis and the low or even negative level of interest rates".

[3] Such a scenario has already materialised for US banks, which have benefited from a significant increase in short-term rates; as concerns Europe, however, expectations for a rise in money-market rates have recently weakened, due to a slowdown in macroeconomic indicators. Needless to say, interest rates do not fall under the remit of the SSM, which however may issue guidance to banks on how to deal with other, more structural issues (e.g., overcapacity, see below).

to lure away customers through cheaper – and simpler – price structures[4]. Also, capital-light, non-bank institutions may prove more effective in financing investments and consumption.

It may be argued that profitability is not, in itself, a supervisory goal. Indeed, some quick levers that banks could use to improve profitability in short term –stepping up leverage, softening competition, saving on internal controls – would clearly run counter the SSM's mandate and the interests of European citizens.

Nevertheless, the SSM can help banks achieve more sustainable returns on capital, e. g., through a more streamlined interaction with national authorities and the EBA, which would reduce complexity and overlapping requirements. Supervisory reporting provides an area where better forms of coordination could be explored, leading to less – and more predictable – information requests. More generally, predictability and transparency of the SSM's demands and decisions may play a key role in reducing supervisory costs.

Through its periodic analysis of business models, the single supervisor could warn banks against the risks of devoting an excessive share of resources to the maintenance of old production infrastructures (e.g., legacy IT systems), instead of experimenting with new technological solutions that may improve operating efficiency and commercial reach.

It may also be noticed that some policy choices made by the euro area's supervisors could have benefited from a more thorough analysis of their impact on bank profitability. This could be the case of the SSM's stance on non-performing loans ("NPLs")[5], where the objective of fostering a quick reduction in net impaired exposures – including through accelerated provisioning[6] and significant disposals - may not have been carefully weighed against the costs[7] that such policies would involve for bank shareholders[8]. Such wealth transfers may have lacked transparency for those NPL transactions where buyers were also significant shareholders of the selling bank, having potential access to internal information that was not available to other investors.

[4] Due to disruptive technologies (which, e.g., facilitate a quick comparison shopping across institutions offering different rates on deposits), part of the gross margins that banks used to enjoy in the past may in fact be lost forever, regardless of any future change in monetary policy.

[5] In its 2017 Banking Union report, the European Parliament has stressed that "the mandatory disposal of NPLs in an illiquid and opaque market can result in unjustified balance-sheet losses for banks" (European Parliament 2018a).

[6] One may argue that accelerated provisioning does not, in itself, create an incentive towards selling NPLs, since banks may still choose to retain fully-provisioned exposures on their books in order to benefit from windfall profits due to future recoveries. Nevertheless, bank managers confronted with the alternative between taking the pain of a 100%-impairment and getting a few cents per dollar on the NPL market, are likely to choose the latter option to shore up short-term profits and provide today's shareholders with better financial results.

[7] It may be noticed that a different, and more cautious, stance has been adopted by the SSM towards other classes of illiquid, hard-to-value assets, such as those "Level 2" and "Level 3" securities that are still present, in a significant amount, in the balance sheet of some large lenders.

[8] This is not to say that credit institutions should not be asked to recognise latent losses on their NPL portfolio, or to have in place credible plans for NPL management. Still, a careful assessment should occur of the undue costs posed by an imbalance between sellers and buyers in the distressed loans' market, as well as by a provisioning regime that ends up treating expected recoveries as unexpected losses (to be entirely covered with equity capital). Additionally, the fact that low-NPL banks are often more profitable and efficient (Andersson et al. 2018) does not imply that greater profitability and efficiency can be achieved by just unloading non-performing exposures from the banking system's balance sheet (Resti 2017a).

2.2 Shadow banking system

One of the consequences of low bank profitability has been the growth of less regulated financial institutions, carrying out tasks that used to be performed by banks while generating higher returns.

As of end 2017, the EU's shadow banking system ("SBS", measured by financial sector assets net of banks, insurance companies, pension funds, and central counterparties) had reached €42 billion, accounting for roughly 40% of the assets held by the EU financial system (European Systemic Risk Board 2018). While not being subject to banking regulations, the SBS performs credit intermediation, maturity and liquidity transformation through investment funds, securitisation vehicles and other financial institutions. Although it does not raise deposits from the public, it is a source of systemic risk via its deep interconnections with banks[9]. The SBS also invests heavily in illiquid assets and has been reducing its holdings in financial securities – like short-term deposits and highly rated government bonds – that can be turned into cash in the event of a liquidity crisis. Large investors in funds specialising in private equity and non-investment grade debt have the right to recall their money at relatively short notice; this creates a risk that the SBS must sell assets at a discount, triggering a downward spiral that would boost market volatility and generate material second-order effects (e.g., through an increase in haircuts on securities financing transactions).

Against this backdrop, the SSM can play an important role by monitoring developments in the SBS, so that vulnerabilities can be timely identified and addressed. Additionally, it can issue advice to legislators and European supervisory agencies to suggest appropriate amendments to relevant regulations. Finally, it can verify that traditional deposit-taking institutions are sufficiently isolated from the SBS to withstand shocks that may originate from it in the future[10].

2.3 Conduct risk and poor governance

Misconduct and poor governance remain a key issue for European banks. Fines and litigation costs are unlikely to be, in themselves, a direct threat to the sector's stability; nevertheless, the sustained increase in misconduct episodes affecting consumers, borrowers and investors should ring an alarm bell to policy makers, as it may undermine trust and customer relationships.

Although some experts had foreseen a slowdown in misconduct fines and settlements[11], the trend remains strong, as indicated by some major cases that emerged in 2018 (see Figure 1[12]). Although some of them may be a legacy of the past, new allegations keep emerging, concerning more recent events.

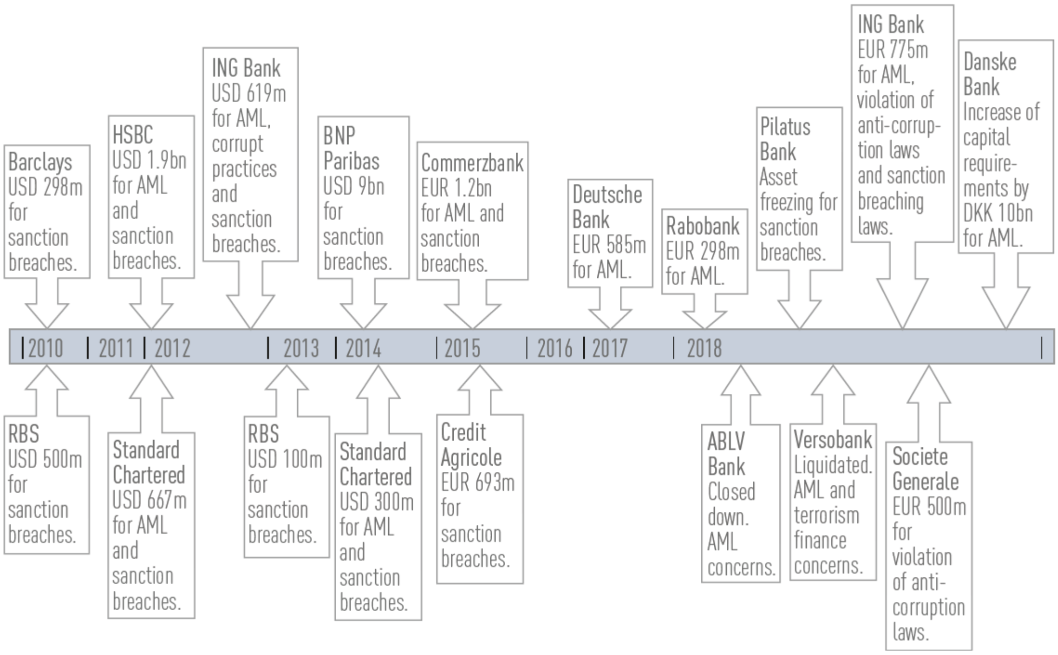
[9] Banks invest roughly 8% of their total assets in shadow financial institutions (mostly through loans and debt securities), which in turn, allocate about 5% of their assets to euro area banks, e.g. through the investment funds' holdings of bank bonds (European Systemic Risk Board 2018).

[10] In its 2018 Banking Union report (provisional text), the European Parliament has encouraged EU authorities to continue monitoring the risks posed by the SBS and to address them as quickly as possible in order to ensure fair competition, transparency and financial stability, while calling on the European Commission to urgently identify and repair any regulatory gaps (European Parliament 2019).

[11] (Grasshoff et al. 2018; Standard & Poor's 2016).

[12] This chart does not include a USD 4.9 billion settlement that was reached in August 2018 by Royal Bank of Scotland with the US Department of Justice ("DoJ"), following allegations that RBS misled investors in the underwriting and issuing of residential mortgage-backed securities between 2005 and 2008. This was the largest penalty imposed by the DoJ for financial crisis-era misconduct at a single entity (US Department of Justice 2018).

Figure 1: Some recent misconduct-related losses for European banks



Source: (European Banking Authority 2018)

Governance plays a key role in minimising a bank's vulnerability to misconduct-related events. Diverse board members, equipped with an adequate technical background and the willingness to act independently and challenge top managers, remain crucial in ensuring that weak spots are promptly recognised, escalated and mended.

Many large institutions headquartered in the euro area have made significant progress towards a more robust governance architecture[13]; still, grey areas remain, especially – but not exclusively – for less significant banks.

Sound governance does not lend itself to strictly quantitative targets and may prove hard to enforce in short term. Nevertheless, it remains crucial to the viability of the European banking system. A multi-year action plan aimed at improving ethics, technical qualifications, checks and balances would become a long-lasting legacy of the new SSB chair[14].

[13] (Andersson et al. 2018).

[14] Such a plan could, e.g., include public opinions released by the ECB on the technical and personal qualifications of the top managers appointed by the euro area's largest lenders; while such opinions would not be binding, the ECB may exert pressure on choices that it sees as unfit by publicly announcing that it is not willing to issue a full endorsement. Additionally, the ECB may want to promote a certification programme for board members (focusing on a minimum set of required professional skills) which, while not being compulsory, would be recommended to banks as a best practice option.

3. CHALLENGES FOR THE SINGLE SUPERVISORY MECHANISM

3.1 Complexity of the regulatory framework

As noted by the SSB Chair (Enria 2019a), the smooth operation of the SSM also requires greater regulatory harmonisation, as the application of different national rules complicates supervisory activities and jeopardises the level playing field.

In fact, while the ECB's mandate encompasses a large number of supervisory issues, some of them are still governed by national regulations. This makes bank oversight more complex and supervisory actions less predictable. Corporate governance, enforcement and sanctions provide examples of areas where the ECB operates under heterogeneous national rules[15].

As concerns corporate governance, one may mention the suitability of board members and key function holders ("fit and proper"). The ECB, under Article 4.1 of the SSM Regulation[16], has a mandate to ensure compliance with the relevant rules, which however stem from national transpositions of the criteria set out in CRD4[17]. In principle, the European Central Bank has access to the powers that Member States assign to their local authorities, but these powers can only be used within the limits of its specific supervisory tasks. As a result, legal uncertainties arise, and litigation risks may lead the ECB to refrain from fully enforcing fit and proper rules, including the principles stated in the ESMA/EBA guidelines on suitability[18]. Indeed, even individuals sent to trial for misbehaviour regarding their office, or convicted by final judgement to significant administrative penalties may choose to ignore any suggestion to step down coming from the SSB.

Regarding sanctions, Article 18 of the SSM Regulation states that the ECB may impose fines on supervised entities (legal persons) in case they breach "a directly applicable act of Union law". For physical persons, breaches of national laws and non-pecuniary sanctions, it can only require NCAs to open proceedings, with a view to imposing appropriate penalties. Also, it may prove impossible to enforce compliance with rules for which national laws do not foresee any sanction[19].

This may give rise to situations where the ECB is responsible for a supervisory activity (e.g., fit and proper requirements) but has no direct sanctioning powers and can only require NCAs to initiate a

[15] Further areas are banking licences, M&As and other strategic decisions, the amendment of credit institutions' statutes and shareholders' agreements on voting rights, loans issued to related parties, outsourced activities and external auditors (European Central Bank 2017). Coordination issues also arise for anti-money laundering ("AML") activities, where the ABLV case has shown how European lenders can be hit by disruptive sanctions issued by non-EU authorities. Although the ECB is responsible for withdrawing banking licences within the euro area, it cannot freely access information concerning breaches of the AML regulations; this makes its decisions slower and harder to defend if challenged in court. Finally, the existence of national liquidation regimes that may apply when the SSB assesses that a bank is "failing or likely to fail" makes it harder to promote a smooth and uniform implementation of the Bank Recovery and Resolution Directive.

[16] Council Regulation (EU) No 1024/2013.

[17] Directive 2013/36/EU of the European Parliament and of the Council. As noted by (European Commission 2017a), the detailed criteria, procedural rules, deadlines and supervisory procedures applicable (e.g. ex ante approval or ex post notification of an appointment) are laid down in national laws. The ECB is therefore confronted with rules and procedures stemming from 19 different legal systems.

[18] (European Banking Authority and European Securities and Markets Authority 2017). According to the IMF (International Monetary Fund 2018), dependence on national law makes the process for fit and proper determination "very complex, time consuming and not fully harmonised".

[19] E.g., in some southern Europe jurisdictions, no sanctions exist for banks refusing to sell real estate property acquired from defaulted borrowers a long time before.

penalty procedure (with no clear powers to follow up on such requests). Furthermore, sanctions based on national laws they may differ significantly across Member States.

3.2 Budget, staffing and reliance on external service providers

In order to discharge their institutional obligations, the ECB's supervisory functions must have access to an adequate amount of resources and have the power to allocate them in the most efficient way. An analysis of the available information suggests that this is not always the case.

The budget allocated to banking supervision is made public through the ECB's annual report on supervisory activities[20]: §6 reports the total supervisory fee received by banks (€465 million[21]) and a high-level breakdown of expenses (see Figure 2).

Figure 2 - Breakdown of expenses related to banking supervision tasks

	2017 €	2016 €	Change €
Salaries and benefits	215,017,183	180,655,666	34,361,517
Rent and building maintenance	52,959,161	58,103,644	(5,144,483)
Other operating expenditure	168,769,875	143,392,045	25,377,830
Expenses related to banking supervision tasks relevant for supervisory fees	**436,746,219**	**382,151,355**	**54,594,864**
Allowance for doubtful administrative penalties	11,200,000	0	11,200,000
Total expenses related to banking supervision tasks	**447,946,219**	**382,151,355**	**65,794,864**

Source: (European Central Bank 2018a)

Salaries and benefits – growing by about 23% per annum in the last two years – account for almost half of the total costs[22]; rent and building maintenance (up by 44% per annum since end-2015) absorbs another 12%; the remaining 39% goes to "other operating expenditure", a miscellaneous item (including consultancy, IT and statistical services[23], depreciation for fixed assets other than buildings, business travel and training) for which no further detail is provided.

The SSB and its chair have only partial influence on the financial and human resources devoted to their mandate. On one hand, the ECB's budget for supervisory activities is controlled by the Bank's governing

[20] (European Central Bank 2018a, §6). Similar data can be found in the ECB annual report (European Central Bank 2018b, Chart 17).

[21] Supervisory fees applied to individual banking groups are based on their size (total assets) and risk profile (risk-weighted assets). The use year-end figures, however, may provide some scope for regulatory arbitrage (especially for large banks that use short-term transactions to reduce end-of-quarter leverage ratios); the use of daily averages and/or income-related variables may be considered, in order to limit the impact of such window-dressing practices.

[22] According to (European Central Bank 2018a), the "core ECB Banking Supervision business areas" accounted for 1,028.5 full-time equivalents FTEs.

[23] IT and statistical services may include the cost of "shared" services provided by ECB departments working for both supervisory and non-supervisory (e.g., monetary policy-related) functions. It is unclear, however, whether such costs (if present) are quantified on the basis of the expenses incurred by the "internal" providers or rather through a system of "shadow prices" that accounts for the fair value of the purchased services (e.g., by means of benchmarks based on market best practices).

council, as are decisions on senior positions. On the other hand, day to day supervision still relies, to a significant extent, on staff contributed by national competent authorities ("NCAs").

As concerns the role of the governing council, one must recall that the SSB was not part of the original institutional architecture of the ECB: in fact, supervisory activities were conferred to the latter by the SSM Regulation, which could not change the competences dictated by its statute[24]. Accordingly, Article 15.2 of the ECB's Rules of Procedure states that the governing council, following a proposal by the executive board, adopts the budget of the ECB, including expenditure items related to supervisory activities; regarding these items, the governing council has a duty to "consult" with the chair and the vice chair of the SSB. Similarly, Article 13 of the Rules of Procedure states that the powers of the executive board with regard to ECB personnel also apply to the staff involved in supervisory tasks; again, the board "shall consult" the chair and vice chair of the SSB on such decisions[25].

The SSB's ability to independently manage resources devoted to supervisory tasks is further constrained by the fact that on-site inspections, as well as the joint supervisory teams conducting day-to-day activities on significant institutions, still rely heavily on staff supplied by NCAs[26]. The latters' willingness to provide an adequate amount of resources has sometimes been questioned; e.g. (European Court of Auditors 2016) has noted that the mix between national and ECB staff has remained below the "75/25" ratio that was set (as a "widely shared" benchmark) when the SSM was established. Heavy reliance on NCA staff – while reducing travel costs and enhancing the SSM's understanding of local banking practices – may also negatively affect the effectiveness of supervisory action. Experts provided by NCAs are often shared between the SSM and other "horizontal" tasks carried out for national authorities; hence, NCAs may choose to prioritise internal work and constrain the amount of time that can be devoted to SSM-related activities. Furthermore, NCA personnel retains a hierarchical link with national authorities (which are responsible for their salaries and career paths); this may make them more open to national considerations and less committed to ECB-led objectives. Finally, NCA staff may have access to pay levels that are considerably below those of their ECB peers[27], with adverse effects on motivation[28].

To overcome such constraints and meet tight deadlines that were essential to its statutory objectives, the ECB has made significant use of external consultants. Although no full disclosure has been

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[24] According to Article 26.2 of the ESCB statute, the annual accounts of the ECB are drawn up by the executive Board and must be approved by the governing council. According to Article 36.1, the governing council, based on a proposal from the executive board, "lays down the conditions of employment" of the staff of the ECB.

[25] While the vice-chair of the SSB is also a member of the executive board (and may therefore raise issues concerning budget and career advances during the board's meetings), the SSM chair is not. Accordingly, he/she cannot follow through on his/her requests when the "consultation" phase is over.

[26] According to (European Central Bank 2018a), in 2017, 90% of the inspections had been led by NCAs, with only 10% of the inspections being led by the ECB's Centralised On-site Inspections Division (COI). 18.5% of the planned inspection teams were "cross-border" (as the team leader and at least another member did not come from the relevant NCA) or "mixed" (at least two team members did not come from the relevant NCA). According to (European Court of Auditors 2016), the ECB provided on average 11.3 out of 42.6 team members for the largest JSTs, and 1.8 out of 4.8 team members for the smallest ones.

[27] Only recently the ECB has started to hire NCA staff for onsite inspections via fixed-term contracts. This has led to a higher number of cross-border missions (see Footnote 26), although their development is still constrained by linguistic and "cultural" barriers (due e.g. to a lack of knowledge of the relevant national regulation, especially for areas like corporate governance where country-specific rules continue to play a key role).

[28] Echoing these concerns, the European Parliament, in its 2017 Banking Union report (European Parliament 2018a, §17) has noted that "the involvement of more ECB staff in on-site inspections could contribute to further enhancing the independence of banking supervision from national considerations". The Commission, in its 2017 report on the SSM, has stated that improvements in the staffing of on-site inspection teams could be achieved by increasing the proportion of ECB personnel (European Commission 2017b).

provided, the SSM chair has declared that €24,2 million were paid in 2014 to Oliver Wyman for its participation in the so-called "comprehensive assessment" of the euro area's significant institutions, and another €8,2 million went to Blackrock and McKinsey for the support provided to the 2016 stress tests (Nouy 2018). Stress tests and related assessments are not, however, the only area where the ECB has been hiring external experts; another example is the so-called "targeted review of internal models" ("TRIM"), a multi-year project aimed at assessing the banks' internal rating systems. In 2017, the ECB claims to have paid €45.1 million (more than 10% of its total budget for supervisory activities) for "external support" related to TRIM (European Central Bank 2018a, 104).

As indicated in the ECB's manual, external contractors also assist the SSM personnel with on-site inspections. During the consultation that lead to the final draft of the manual, French banks requested that consultants may not represent more than 50% of an inspection team[29], but this proposal was not included in the final text.

The use of external consultants raises several concerns, in terms of conflict of interest and distorted incentives. Banks may find it convenient to hire the same consulting firms used by the ECB, hoping to get "an insider's view" on the latter's methodologies. Conversely, consultants taking part in supervisory activities may be under psychological pressure to please large institutions that may have been, be, or become significant customers for their company. On the other hand, contractors working with supervisory teams may also prove detrimental to a bank, as they may have access to sensitive information (on business data and processes) that might be used by their firms for projects commissioned by the bank's competitors[30]. Further perplexities emerge when consultants are part of financial groups that also invest in bank shares.

Such concerns have to an extent been addressed by the SSB. Besides imposing confidentiality requirements on individual experts, it has requested consultancy firms to introduce a "strict separation" (subject to a "cooling off" period) between teams supporting the ECB and other teams advising large financial institutions or investors. However, the details of these mechanisms (e.g., the length of the cooling off period) have not been disclosed; additionally, it unclear whether the SSM has put in place tools to verify how such requirements are complied with, and to escalate signs of unethical behaviour. Since previous attempts to use "Chinese walls" in financial regulation have produced mixed results (Buiter 2007), greater attention should be given to how these requirements are actually enacted.

As noted by (European Commission 2017b), "[i]t is acceptable for the ECB to occasionally rely on external consultants, especially where specific technical knowledge is required […]. However, the use of external experts in on-site inspections should be limited and accompanied by appropriate safeguards". One can hardly disagree with these remarks, including the fact that the involvement of external consultants should mainly focus on special areas of expertise which cannot be covered by the SSM itself. In fact, jumbo contracts may include a large number of junior resources which, while being comparatively expensive, receive an on-the-job training to develop skills that will be used to the benefit of other customers.

3.3 Accountability and transparency

The SSM's decisions take place at arm's length from political influences. In fact, most members of the supervisory board are indicated by NCAs (based on local procedures that involve some independence from governments), while another four members are chosen by the ECB's governing council.

[29] (French Banking Federation 2018).

[30] Furthermore, as noted by (Huertas 2018), "some financial institutions are concerned that the use of external consultants may affect their remediation efforts in light of the SSM expectations, as well as other work streams in the wider Banking Union sense. This concern stems from the fact that certain inspection teams include at times members of external consultants that also act on behalf of that said financial institution."

It is crucial that such independence be not perceived as a lack of legitimacy, especially at a time when the Union's technical bodies are sometimes accused of being disconnected from voters. Additionally, while monetary policy must pursue price stability without bending to political pressures, bank supervision may not require such a strong degree of separation[31] and may need to remain aware of the social consequences of its decisions.

It essential that the SSB – while operating independently - makes full use of all the accountability tools that connect it to EU institutions and citizens. These include hearings and exchanges of views that the European Parliament and the Eurogroup, annual reports and statements on supervisory priorities for the following 12 months.

The SSM's work is also subject to scrutiny by two oversight bodies:

- an internal Administrative Board of Review ("ABoR") may be called by any affected party to review the ECB's supervisory decisions, in order to ensure that they comply with the relevant rules and procedures. In 2017, five requests for review were filed with the ABoR, leading to the board issuing four opinions; this compares with 8 requests per year in 2015-2016;
- the European Court of Auditors (ECA) has a mandate to examine the operational efficiency of the ECB's management, including supervisory tasks[32]. Since 2016, when the ECA carried out its first special report on the SSM (European Court of Auditors 2016), some areas of disagreement with the ECB have emerged, regarding the auditors' mandate. The ECA maintains that any assessment of the SSM's operational efficiency must include the "significant risks to the public purse" that may be triggered by ineffective supervision[33]. The ECB has refused to provide the ECA with documents (such as the minutes of the Supervisory Board, or individual supervisory decisions) that it considers unrelated to operational efficiency[34].

The ECB has sometimes been criticised for not making its supervisory processes adequately transparent to the public and the supervised entities. E.g. the IMF has recommended "that ECB banking be more transparent about its supervisory approach and techniques" (International Monetary Fund 2018). The ECA has noted that "the information disclosed to supervised entities is not sufficient in all respects for a proper understanding of SSM methodology" (European Court of Auditors 2016). Furthermore, it has reported that banks have requested more clarity on the supervisory review and evaluation process ("SREP") carried out annually by the SSM[35] and are concerned that limited transparency might increase

[31] The Basel Committee's core principles for effective supervision (Basel Committee on Banking Supervision 2012) require that supervisors possess "operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources", but are also accountable for the discharge of their duties and use of their resources.

[32] See Article 287 of the Treaty on the Functioning of the European Union, Article 27.2 of the Statute of the European System of Central Banks, Article 20.7 of the SSM Regulation.

[33] (European Court of Auditors 2019).

[34] In November 2017, the European Commission has called on the ECB and the ECA to conclude an inter-institutional agreement to specify the procedures for information exchange. In April 2018, the European Parliament has found it "unacceptable, from a point of view of accountability, that the auditee, i.e. the ECB, wants to decide single-handedly to which documents the external auditors may have access" and has called on the ECB to fully cooperate with the ECA (European Parliament 2018b).

[35] As mentioned by (Resti 2017b), in carrying out the SREP the ECB currently adopts a "holistic" approach to the determination of a bank's "pillar 2" capital requirement ("P2R"), rather than relying on a risk-by-risk quantification, as suggested by the EBA SREP guidelines (European Banking Authority 2014). While a flexible approach to P2R is certainly welcome, banks find it hard to understand the drivers (e.g., credit or market risk exposure) of their overall P2R. Although the ECB may be evolving towards a more "risk-by-risk" attitude, such a change is likely to take time and "holistic" valuations can be expected to remain the cornerstone of the next round of SREP decisions.

"the risk of supervisory arbitrariness"[36]. The European Parliament, in its 2015 annual report on the Banking Union, has also called for more transparency on SREP decisions and the underlying motivations[37]. The "need to ensure higher transparency on the full set of supervisory practices" has been reiterated in the following report, while the 2017 edition has requested more clarity on solvency assessments for credit institutions, resolution decisions and stress test results for banks that fall outside the EBA sample (European Parliament 2016, 2017, 2018a). The advent of a new SSB chairperson may provide an opportunity for addressing these concerns[38].

Indeed, several actions could be taken in order to improve the accountability and transparency of the SSM's supervisory activities:

- the SSM's annual statements on "supervisory priorities" could provide an indication of the approximate amount of resources that will be committed to each key item and state the expected results (including one or more quantitative objectives when appropriate). Such plans could then be reassessed in the ECB's annual report on banking supervision, explaining gaps between expected and actual outcomes;
- the annual report on banking supervision may also be used to provide European citizens with greater detail on the costs of supervisory activities. As seen above in §3.2, only a few macro items are currently disclosed, making it impossible for outsiders to learn how resources are used to serve different objectives;
- as noted by (European Commission 2017b), increased transparency on the decisions taken by the ABoR may also prove beneficial. In fact, if such decisions were made public (e.g. through summaries reported on the ECB's website after removing any confidential details) this may set a public precedent for future cases, making the SSB's decisions more predictable and consistent. Additionally, a full picture of the ABoR's past evaluations might help supervised entities to better assess the expected costs and benefits of challenging the SSM's decisions;
- the relationship between the SSB chair and the European Parliament may possibly benefit from more structured forms of interaction. E.g., letters sent by MEPs to seek clarifications on specific issues – if relevant to the ECB's mandate – may be organised by topic on the SSM's website, with questions and replies on which MEPs could follow up with further inquiries. An indicative time limit for replies may also be agreed, to encourage timely responses when possible.

As concerns the European Court of Auditors' request for increased access to SSM documentation, one may note that its mandate to assess the "operational efficiency of the ECB's management" cannot be turned into an evaluation of the ECB's supervisory activities as such. Still, the SSM's internal processes may greatly benefit from periodic reviews carried out by an experienced, authoritative and independently-staffed institution like the ECA[39]. Accordingly, it would be helpful if the ECA's powers

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[36] A survey of 69 supervised entities (European Court of Auditors 2016) shows that almost 40% of the interviewees find the feedback arrangements established by the ECB insufficient to meet their needs. Similarly, when requested to assess the information received on the SREP process and results, half of the respondents reply "4" or "5" on a scale ranging from 1 ("very comprehensive") to 5 ("poor").

[37] The European Parliament has regretted "the limited transparency of information for the supervised entities as the result of the approach adopted by the ECB with regard to disclosure, which had the result that supervised entities were not able to fully understand the outcome of the review process and prudential assessment".

[38] In a speech given at the at the SSM/EBF Boardroom dialogue, the chairman of the SSB noted the following: "I have heard some calls for more clarity and predictability with regard to our assessments. I think we should listen to such requests and check whether some things could be improved. Why not specify which risk drivers guide our overall decision, for instance?" (Enria 2019b).

[39] Alternative solutions, like entrusting the ABoR with the power to conduct periodic reviews of the SSB's internal processes and procedures, may not prove entirely effective. In the case of the Board of Review, for instance, it is

and responsibilities *vis à vis* the ECB were defined more clearly; in case this cannot be achieved through inter-institutional dialogue between the interested parties, Council and Parliament may want to take the lead.

Indeed, a possible watershed between an overly narrow definition of the ECA's tasks and an unduly extensive mandate could be the following: while the Court of Auditors should refrain from looking into individual decisions, it could be asked to assess whether the SSM's policies and procedures are such to make its internal processes predictable, consistent and unbiased process. As concerns, e.g., the additional capital requirements imposed on banks following the SREP and the stress test results, the ECA could verify that the criteria used to impose capital add-ons are defined before the SSB learns about individual outcomes, and then uniformly applied with a reasonable amount of flexibility.

Concerning transparency towards supervised entities, it should be noted that the SSM only publishes "abridged" versions of its internal manuals, while other supervisors (e.g., in the United States) tend to make full texts available to credit institutions and the public. As noted by (International Monetary Fund 2018), the SSM may want to disclose more details on its internal methodologies, making it easier for outsiders to monitor their correct implementation and to identify areas for improvement. SREP results are another key area where more could be done to disclose the motivations leading to additional capital (or liquidity) requirements (Resti 2017b)[40].

worth recalling that it is an internal body of the ECB which, inter alia, nominates its members and can renew their mandate.

[40] In an attempt to increase transparency, the SSM has sometimes announced its "expectations" on how banks should deal with specific issues. This was the case, e.g., with non-performing exposures and "calendar provisioning" (a scheme that requires banks to step up provisions against impaired loans, reaching a 100% coverage within a predefined time window). While such announcements may have overlapped with concurrent initiatives by the co-legislators, it is unclear whether they could play a positive role in enhancing transparency and predictability of supervisory actions. In fact, as the SSM reserves the right to apply its "expectations" on a case by case basis, these announcements may actually increase uncertainty, as new criteria are disclosed without specifying how (and towards what institutions) they will be enforced.

4. FINAL REMARKS

In order to meet the challenges facing European banks (including low profitability, shadow banking system and misconduct), the Single Supervisory Mechanism must continue to evolve and address some areas were results may not have been fully satisfactory.

This includes the promotion of sound governance practices where the SSB, although its action is constrained by a fragmented regulatory framework relying mostly on national rules, may want to launch a multi-year action plan aimed at improving ethics, technical qualifications, checks and balances.

The SSB should also be given more leeway in defining its own budget and career paths. Although the competences of the governing council and executive board are carved in stone by EU treaties, suitable legal arrangements can be found (like the "non-objection" mechanism that is used of supervisory decisions) to grant an adequate level of autonomy to the ECB's supervisory functions when it comes to financial and human resources. A more independent SSB should focus on developing an adequate amount of internal skills, so that reliance on consultants can be significantly reduced, while carefully addressing the risk that external contractors pose to the SSM and to supervised entities. While the contribution of national experts is bound to remain crucial for the single supervisor, coordination with the ECB staff should be strengthened, and cross-country barrier further torn down.

Much remains to be done in terms of accountability and transparency. Supervisory priorities should be spelt out more clearly, setting targets and indicating a clear – if flexible – allocation of resources. The ECB's annual report on banking supervision may become more informative on the cost structures underlying the SSM's various activities, including special projects. The SSM's Administrative Board of Review may increase its role by making decisions public through anonymised summaries. Written dialogue with the Members of the European Parliament may become more structured, deeper and faster. The ECA's request for greater access to the SSM's documents and internal processes should not fall on deaf ears. Still, it cannot pave the way to an evaluation of the ECB's supervisory outcomes.

The abridged supervisory manuals currently released by the SSM could be extended, providing more details on internal methodologies, and making it easier for outsiders to monitor their correct implementation. The motivations behind supervisory requests following the SSM's annual evaluation of individual banks ("SREP") should also be made accessible to supervised entities. Stress test results for banks not falling in the EBA sample may also be made public, to the benefit of investors and the public at large.

In return for greater transparency and accountability, however, the single supervisor should be given a clearer mandate and a more homogeneous set of rules. Provisions on governance, sanctions or money laundering – where national legislation still plays a major role – should be (further) harmonised by amending and enhancing the Capital Requirements Regulation.

5. QUESTIONS THAT COULD BE RAISED DURING MR. ENRIA'S HEARING

Financial misconduct continues to undermine public trust towards financial institutions. Do you think that the SSB should engage in a multi-year action plan aimed at improving ethics, technical qualifications, checks and balances? As part of such a plan, would you consider it useful if the SSB were to issue public, non-binding opinions on the technical and personal qualifications of the top managers appointed by the euro area's largest lenders? Similarly, do you think that the ECB could take steps to promote a certification programme aimed at board members, focusing on a minimum set of required professional skills?

Do you believe that the ECB and the Council could seek ways to increase the SSB's Chair control of the financial and human resources devoted to supervisory activities?

Would you commit to reducing the SSM's usage of external consultants, while strengthening requirements on confidentiality and conflict of interest and the mechanisms put in place to identify, escalate and sanction possible breaches?

What could be, in your opinion, the key elements of an inter-institutional agreement between the European Court of Auditors and the European Central Bank concerning the former's access to relevant documentation? Would you object to an agreement whereby the ECA would be given access to documents required to assess that the ECB's supervisory processes are sound and uniformly implemented, while committing to refrain from any interference with decisions affecting individual institutions?

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