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# The next SSM term: Supervisory challenges ahead

Banking Union Scrutiny

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# The next SSM term: Supervisory challenges ahead

**Abstract**

This paper focuses on two ways in which overall bank supervision and oversight can be improved in the next SSM term: (i) by more effective market discipline of banks by investors in banks' securities, and (ii) by more effective oversight of bank risk taking by bank boards. To improve market discipline, the ECB should consider facilitating the publication of additional bank-specific supervisory information. In addition, the ECB can cooperate with the EBA to increase the coverage of SSM banks in the EU-wide transparency and stress test exercises. The ECB could also review the quality of banks' Pillar 3 reports as part of its supervisory process, and it could potentially use market information on banks' valuation and cost of funding to inform its supervisory work. Furthermore, the ECB should revise its current guidance regarding bank boards that has the effect of increasing shareholder influence, as bank shareholders tend to benefit more from excessive bank risk taking than other stakeholders, including the bank's management.

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# EXECUTIVE SUMMARY

By now, more than five years have passed since the ECB assumed its supervisory tasks. This makes the current moment an appropriate time to assess how the ECB/SSM has performed over the past years against the main goals it was supposed to accomplish, and to look ahead by highlighting some areas that may merit modified supervisory practices.

The ECB's main task is to maintain financial stability, and thus a somewhat crude measure of ECB effectiveness is to see how many significant institutions have failed since 2014. By this measure, the ECB has done well as only a few significant institutions have failed in recent years. However, to achieve financial stability, the ECB has had to provide extremely cheap and unlimited funding to the banking sector.

This paper focuses on two ways in which overall bank supervision and oversight can be improved in the next SSM term: (i) by bringing about more effective market discipline of banks by investors in banks' securities, and (ii) by revising the current SSM guidance on the corporate governance of banks to make boards more inclined to control bank risk taking.

To improve market discipline, the ECB should consider facilitating the publication of additional bank-specific supervisory information. The extant legal framework provides some scope for broader disclosure of supervisory information in the future. The CRD IV (European Parliament and EU Council, 2013a) prevents the supervisor from disclosing bank-specific supervisory information that it receives in the course of its duties. However, the CRR IV (European Parliament and EU Council, 2013b) authorises the supervisor to require institutions to disclose information where such disclosure is necessary to provide market participants with accurate and comprehensive information regarding their risk profiles. This suggests that the ECB could require banks to disclose, for instance, their Pillar 2 guidance capital requirement that banks currently often do not reveal.

To further promote market discipline, the ECB can also cooperate with the EBA to increase the coverage of SSM banks in the EU-wide transparency and stress test exercises that are conducted under the auspices of the EBA. In addition, the ECB should assess the quality of banks' Pillar 3 reports as part of its supervisory review, and it could potentially use market information on banks' valuation and cost of funding to inform its supervisory work.

In the area of corporate governance, the ECB's current guidance and the implied supervisory approach are inadequate. In 2016, the ECB published guidance with the effect of increasing shareholder influence in bank boards, for instance by indicating that the chair of the board should not be the bank's senior manager. Guidance along these lines is inappropriate in the case of banks, as bank shareholders tend to benefit more from increased bank risk taking than other stakeholders, including the bank's management. By promoting shareholder-friendly boards, at present, the ECB is inadvertently promoting additional bank risk taking.

# 1. INTRODUCTION

On November 4, 2014, the European Central Bank (ECB) assumed bank supervisory responsibilities in euro area countries as part of the Single Supervisory Mechanism (SSM). A main task of the ECB has been to oversee the implementation of new bank regulations that were adopted after the financial crisis. Banks are now subject to requirements to hold more and better capital, a new leverage ratio requirement, and new liquidity requirements. Other major changes include the implementation of the International Financial Reporting Standard (IFRS) 9 on January 1, 2018 calling for an expected loss model of loan loss provisioning, and more recently, the guidance that the ECB has formulated itself to reduce banks' Nonperforming Loans (NPL) stocks.

By now, more than five years have passed since the ECB commenced its supervisory tasks. This makes the current moment an appropriate time to assess how the ECB/SSM has performed over the past years against the main goals it was supposed to accomplish, and to look ahead by highlighting some areas that may merit modified supervisory practices.

Information on what the ECB does can easily be gleaned from yearly SSM annual reports and announcements of supervisory priorities. Table 1 summarizes the SSM supervisory priorities for 2018 and 2019. Some priorities are maintained from one year to the next. Non-performing loans, a targeted review of internal models, the internal capital adequacy assessment process (ICAAP), and the internal liquidity adequacy assessment process (ILAAP) are supervisory priorities in both 2018 and 2019. These stated supervisory priorities are in some instances efforts to determine whether banks appropriately implement regulatory reforms. For instance, in 2018, checking banks' preparedness for IFRS 9 was a supervisory priority. Overall, these various supervisory priorities seem appropriate.

**Table 1:** SSM supervisory priorities in 2018 and in 2019

| Category | 2018 | 2019 |
|---|---|---|
| Business models | Interest rate risk implications for business models and profitability | |
| Credit risk | Non-performing loans<br><br>Exposure concentration & collateral management and valuation | Follow-up NPL guidance<br><br>Credit-underwriting and exposure quality |
| Risk management | Targeted review of internal models<br><br>ICAAP and ILAAP<br><br>Preparedness for IFRS 9 and other regulatory changes | Targeted review of internal models<br><br>ICAAP and ILAAP<br><br>IT and cyber risk<br><br>Liquidity stress test |
| Multiple risk dimensions | Brexit preparedness<br><br>Stress testing | Brexit preparedness<br><br>Trading risk and asset valuations |

Sources: ECB (2018a) and ECB (2019a)

It is more difficult to establish how well the ECB performs its supervisory tasks. The ECB's main task is to maintain financial stability, and thus a somewhat crude measure of ECB effectiveness is to see how many significant institutions have failed since 2014. By this measure, the ECB has done well as only few significant institutions have failed in recent years.[1] However, to achieve financial stability the ECB has had to provide extremely cheap and unlimited funding to the banking sector.[2]

Some additional information on ECB effectiveness can be learned from the European Court of Auditors' (2016) report on the functioning of the SSM. The Court's mandate was limited to examining the operational efficiency of the ECB, and hence does not concern supervisory outcomes. The Court concluded that the ECB's efforts to ensure transparency for the SSM and accountability towards the European Parliament and the general public are potentially weakened by the lack of a proper mechanism for assessing, and then reporting on, supervisory effectiveness. In the area of accountability, the Court indicates that the ECB should make available all documents requested by the Court to exercise its audit mandate, and that it should develop and make public a formal performance framework to demonstrate the effectiveness of its supervisory activities.[3] More information along these lines, if it were to become available, would certainly help to assess the effectiveness of the ECB.

The next five years will no doubt be difficult for European banks, as at present they continue to experience low profitability despite a relatively benign macroeconomic environment, and as they are likely to be confronted with new fintech entrants that will challenge their current business models. This implies that the ECB faces the supervisory tasks of seeing whether the weaker banks can adopt to these difficult circumstances, and, if not, to ensure that these banks exit the banking market in a timely fashion.

Taking these supervisory challenges as given, this paper instead focuses on two ways in which overall bank supervision and oversight can be structurally improved in the next SSM term: (i) by bringing about more effective market discipline of banks by investors in banks' securities, and (ii) by revising the current SSM guidance on the corporate governance of banks to make boards more inclined to control bank risk taking. These two areas of potential action in the next SSM term have in common that they both aim to enable and incentivise important bank stakeholder, i.e. financial markets participants and bank boards, to do part of the heavy lifting of overseeing and curbing bank risk taking. Making the most of financial markets and bank boards as overseers of banks is important, as the ECB by itself can only supervise banks imperfectly.

To improve market discipline, the ECB should consider facilitating the publication of additional bank-specific supervisory information. The extant legal framework provides some scope for broader disclosure of supervisory information in the future. The CRD IV (European Parliament and EU Council, 2013a) prevents the supervisor from disclosing bank-specific supervisory information that it receives in the course of its duties, but the CRR IV (European Parliament and EU Council, 2013b) authorises the supervisor to require institutions to disclose information where such disclosure is necessary to provide market participants with accurate and comprehensive information regarding their risk profiles. This suggests that the ECB could require banks to disclose, for instance, their Pillar 2 guidance capital requirement that banks currently often do not reveal.

The traditional argument against revealing additional supervisory information is that any negative information could cause a sharp and potentially fatal withdrawal of a bank's market funding. This

[1] On June 6, 2017, the ECB declared Spain's Banco Popular to be failing or likely to fail. This bank was subsequently taken over by Banco Santander. On June 23, 2017, Banca Popolare di Vicenza and Veneto Banca were determined as failing or likely to fail. These banks were liquidated under Italian insolvency law. On February 23, 2018, Latvia's ABLV Bank was announced to be failing or likely to fail. This bank was wound down.

[2] Since 2014 the Eurosystem provides financing to credit institutions for periods of up to four years in the form of targeted longer-term refinancing operations (TLTROs).

[3] See ECA (2016, p. 12).

argument, however, now carries less weight than in the past, as recent bank regulatory reform towards bail-in, rather than bailout, is designed to reduce the public and private costs of bank failure, making a bank failure caused by a run on the bank by its creditors less damaging.[4]

To further promote market discipline, the ECB can also cooperate with the European Banking Authority (EBA) to increase the coverage of SSM banks in the EU-wide transparency and stress test exercises that are conducted under the auspices of the EBA. In addition, the ECB could assess the quality of banks' Pillar 3 reports as part of its supervisory process, and it could potentially use market information on banks' valuation and cost of funding to inform its supervisory work.

Regarding corporate governance, the ECB's current guidance and the implied supervisory approach to the structure of bank boards are inadequate. In 2016, the ECB (2016b) published guidance with the effect of increasing shareholder influence in bank boards, for instance by indicating that the chair of the board should not be the bank's senior manager. Guidance along these lines is inappropriate in the case of banks, as bank shareholders tend to benefit more from increased bank risk taking than other stakeholders including the bank's management. By promoting shareholder-friendly boards, at present the ECB is inadvertently promoting additional bank risk taking.

In the remainder of this paper, section 2 discusses possible approaches to making more supervisory information available to market participants with a view to improving market discipline. Section 3 discusses the need for revised ECB guidance on corporate governance in the area of bank boards. Section 4 concludes.

[4] Bail-in can also cause a bank to fail if its creditors withdraw funding for ill-founded reasons.

# 2. HOW TO IMPROVE MARKET DISCIPLINE WITHIN THE SSM

Market discipline is the notion that investors in a bank's shares and debts monitor a bank's financial strength and risk profile, with potential implications for the pricing of its equity and liabilities.[5] Monitoring by market participants could, for instance, result in higher yields on bonds issued by riskier banks, which discourages bank risk taking.[6] If effective, market discipline can be a useful complement to bank supervision as a way to control bank risk taking.

Investors can only exercise market discipline if they have sufficient information on banks to be able to assess the implications of bank actions for the valuation of bank equities and liabilities.[7] In practice, investors obtain detailed information on banks' financial positions from their financial reporting, from the Pillar 3 reports that banks are required to publish, and from occasional press releases. In addition, bank supervisors are a potential source of bank-level information that is relevant to investors in bank securities.

This section discusses the potential for the SSM to disclose additional supervisory information on the banks that it supervises with a view to improving market discipline in the euro area. Section 2.1 reviews how the recent financial crisis, and the policy response to it, have shaped investor incentives to exercise market discipline. Section 2.2 discusses the legal framework regarding the publication of supervisory information by the ECB. Section 2.3 examines the ECB's current practice of disclosing supervisory information. Finally, section 2.4 provides some suggestions on what the ECB could do to improve the operation of market discipline in the euro area, including the publication of additional supervisory information.

## 2.1 The experience of the financial crisis and market discipline

Market participants only have incentives to exercise market discipline on banks if the valuation of their holdings of bank securities is materially affected by a bank's risk taking behaviour. The recent financial crisis and subsequent regulatory reforms have provided investors with new information regarding the likely effect of bank distress on the valuation of their bank securities, and hence it has shaped the incentives for market participants to engage in market discipline.

The experience of the crisis itself taught investors in banks' securities that European governments were prepared to bail out distressed banks on a very large scale: Gerhardt and Vander Vennet (2017) report that 114 European banks benefited from some form of government support during the financial crisis. Government bailouts on such a big scale potentially weakened market discipline to the extent that investors in bank liability expect distressed banks to obtain government support again in the future.

An immediate policy response to the crisis was to increase the minimum deposit insurance coverage in the EU from initially Euro 20,000 to Euro 100,000 in 2010 to reduce incentives for depositors to participate in a run on their banks. This policy intervention reduced incentives for depositors with larger deposit amounts to monitor their banks, which weakened market discipline. More recently, the Bank Recovery and Resolution Directive (BRRD) adopted in 2014 limited the public moneys that can be used to bail out banks, and instead provided for the bail-in of bank creditors to recapitalise a distressed bank. European banks currently have to satisfy minimum requirements for own funds and eligible liabilities (MREL), with certain bail-in-able debts counting as eligible liabilities. Holders of some debts that are included in MREL are first in line to suffer losses in case of bank distress, possibly before any large

[5] See Bliss (2015) for a survey of the literature on market discipline in financial markets.

[6] Sironi (2003) shows evidence that the spreads on European banks' subordinated notes and debentures reflect bank riskiness as evidence of market discipline by investors.

[7] Market discipline could make it more difficult for banks to fund opaque activities about which it cannot reveal clear information to investors in banks' securities.

depositors will be bailed in.[8] Hence, holders of MERL liabilities generally face larger incentives to monitor bank risk taking than depositors, in the current setting. Bail-in, which has so far not been applied to one of Europe's largest banks, will have to function well for effective market discipline by investors in MERL instruments to be applied to banks in the future.[9]

## 2.2 The legal framework regarding the publication of supervisory information

Under the Capital Requirements Directive (CRD) IV of 2013 (European Parliament and EU Council, 2013a), competent authorities including the ECB cannot provide information about banks to third parties. According to Paragraph 1 of Article 53 of this directive (see the Appendix), all persons working for competent authorities shall be bound by the obligation of professional secrecy. This entails that confidential information that such persons receive in the course of their duties may be disclosed only in summary form, such that individual credit institutions cannot be identified. Paragraph 2, however, stipulates that this shall not prevent competent authorities from transmitting information to the EBA as well as several other European institutions. In addition, paragraph 3 says competent authorities are authorised to publish the outcomes of stress tests.

Paragraph 3 of Article 431 the CRR IV (European Parliament and EU Council, 2013a), however, enables the supervisor to require institutions to disclose information where such disclosure is necessary to provide market participants with accurate and comprehensive information regarding their risk profiles (see the Appendix).

Taken together, these legal provisions limit the conditions under which the ECB can disclose bank-specific information itself, but they provide it with the authority to require the banks to disclose information, if this is necessary for market participants to assess their risk profiles.

## 2.3 The publication of supervisory information by the ECB

At present, the ECB publishes aggregated data on supervisory outcomes for significant banks, it facilitates the publication of bank-level data through transparency and stress test exercises administered by the EBA, and it re-publishes a small part of the bank-level information that banks disclose themselves in their Pillar 3 reports.

### Aggregated SREP data and banking statistics

The ECB subjects significant institutions to an annual Supervisory Review and Evaluation Process (SREP). This yields bank-level supervisory risk scores in the areas of i) business model sustainability, ii) internal risk governance, iii) capital risk, and iv) liquidity risk. In addition, banks receive an overall SREP score that reflects the supervisor's view of a bank's general viability. On the basis of these SREP scores, the ECB sets bank-level capital requirements. A Pillar 1 capital requirement of 4.5% applies to all banks. Additionally, there are the Capital conservation, Countercyclical and Systemic buffers that are subject to no or little discretion by the ECB. The Pillar 2 capital requirement, which is meant to reflect bank risks that are not adequately covered by the Pillar 1 requirement and the buffers, is instead more discretionary, depending on the supervisor's assessment of bank riskiness. The Pillar 2 Common Equity

[8] Large depositors may be *pari passu* with senior unsecured debt holders depending on the creditors' hierarchy.
[9] Bail-in has been applied to several relatively small EU banks complying with State-aid rules requiring the bail-in of subordinated creditors before the BRRD became effective on January 1, 2016. See http://www.europarl.europa.eu/RegData/etudes/ATAG/2016/574386/IPOL_ATA%282016%29574386_EN.pdf

Tier (CET) 1, specifically, consists of a general Pillar 2 requirement, and an additional Pillar 2 guidance requirement that represents the additional capital that the bank is expected to hold to be able to continue operations under stressed conditions.[10] At present, the ECB only publishes aggregated data on SREP risk scores and capital demands for significant institutions (see ECB, 2017, for the SREP capital demands that applied in 2018).

In addition, the ECB (2019b) publishes aggregated supervisory banking statistics for significant institutions on a quarterly basis, covering balance sheet composition and profitability, capital adequacy and leverage, asset quality, funding and liquidity. This publication provides information on developments for SSM banks over time, and it gives data breakdowns by country and by different bank classifications reflecting the location of activities (geographical diversification), scale of operations (size), and risk (overall risk and vulnerabilities based on SREP scores). While providing general information, these data are too aggregated to contribute to market discipline at the individual bank level.

### Bank-level data from transparency and stress test exercises

On a regular basis, the EBA publishes supervisory reporting data on a bank-by-bank basis as part of an EU-wide transparency exercise. In the case of SSM banks, the ECB has provided supervisory data to the EBA. The sample of the 2018 EBA transparency exercise consisted of 130 banks from 25 European countries including a set of SSM banks (see EBA, 2018b, pp. 59-63, for a list of covered banks). On average, about 7000 data points are furnished for each bank, providing market participants with detailed data on banks' capital positions, risk exposure amounts and asset quality.[11] Granular data of this kind facilitates market discipline.

The EBA also publishes the outcomes of EU-wide stress tests that have been administered by competent authorities including the ECB following a common analytical framework. The aim of stress tests is to assess the reaction of key bank variables such as capitalisation to adverse market developments and shocks.[12] The 2018 EU-wide stress test covered 48 banks from 15 countries, including 33 SSM banks. The outcomes of the 2018 EU-wide stress test were published by the EBA (2018a) on November 2, 2018. Before that, on May 5, 2018, the ECB itself had already published the stress test outcomes for the four Greek significant banks included in the EBA sample to make these data available in a timely fashion, as allowed by Paragraph 3 of Article 53 of the CRD IV.[13]

### Collection and re-publication of some bank-level information from Pillar 3 reports

On its website, the ECB provides an excel file where it collects some information on the regulatory capital ratios and risk-weighted assets of significant institutions that these banks are required to publish following Pillar 3 disclosure requirements.[14] Specifically, the EBC re-publishes information on solvency and leverage ratios that banks are required to publish under the Capital Requirements Regulation (CRR) (European Parliament and EU Council, 2013b), as well as an overview of risk-weighted

[10] The Pillar 2 guidance is not legally binding, but the ECB expect banks to comply with it.

[11] For a description of the transparency exercise data set on the EBA website, see https://eba.europa.eu/documents/10180/2518657/CSV_guide_Transparency_2018.pdf

[12] Petrella and Resti (2013) find evidence that the publication of the results of the 2011 European stress test exercise affected bank stock prices consistent with the notion that this disclosure reduced bank opaqueness.

[13] For a press release on the stress test results for Greek banks as published by the ECB, see https://www.bankingsupervision.europa.eu/press/pr/date/2018/html/ssm.pr180505.en.html

[14] The excel sheet on the ECB website can be found at: https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html. See Basel Committee on Banking Supervision (2018) for an updated framework for Pillar 3 disclosure requirements.

assets as published by significant institutions that are global systemically important institutions (G-SIIs), or other systemically important institutions, pursuant to EBA Guidelines 2016/11 on disclosure requirements. In some instances, the ECB has required the reporting banks to amend this information before re-publication. The collection and checking of these data by the ECB potentially improves market discipline.

## 2.4 Possible ways to improve market discipline within the SSM

The ECB can facilitate market discipline further by disclosing additional information on SREP outcomes, by ensuring that transparency and stress test exercises include more SSM institutions, by subjecting banks' entire Pillar 3 reports to regular supervisory review, and by investigating whether market information can be a useful input into standard supervisory activities.

### Additional disclosure of SREP outcomes

As discussed, currently, the ECB publishes only aggregate information on SREP capital demands. In practice, many banks issue a press release after being informed by the ECB about their capital demands for the next year, which brings some information about SREP capital demands into the public domain in a timely fashion. In a sample of 28 press releases about the 2018 SREP capital demands, 22 banks provided full disclosure of the composition of their CET1 capital demand net of the Pillar 2 guidance, while only two banks disclosed their Pillar 2 guidance (Huizinga, 2018).[15] A priori, one expects a bank to be less willing to disclose SREP capital demands if this entails negative information to bank shareholders. If so, the failure to publish information on regulatory capital demands constitutes a negative, but imprecise signal about a bank's financial position and vulnerability to stressed scenarios.

Paragraph 3 of Article 431 of CRR IV appears to imply that the ECB has the authority to require banks to disclose their Pillar 2 guidance, as such disclosure would convey important information about a bank's risk profile to market participants.[16] The publication of a very large Pillar 2 guidance could cause the market to withdraw funding from a bank, as market discipline is applied. This could engender the failure of the affected bank. While this possibility can be used as an argument against any disclosure of SREP capital demands, it is not clear that it can be used to rationalise the current situation in which many banks publish their SREP capital demands with the exception of their Pillar 2 guidance.

Recent developments in bank regulation towards bail-in weaken the argument in favour of withholding critical bank supervisory information in order to protect the bank against harsh, potentially terminal market discipline. Bank resolution involving bail-in, as foreseen by the BRRD, generally reduces the public and private costs of bank failures, even if the failure is triggered by the publication of supervisory information. Thus, recent regulatory reform may tip the balance or the argument over disclosing SREP capital demands towards favouring full disclosure in the near future.[17] Beyond

[15] No bank disclosed information on SREP risk scores through their press release.

[16] Such a disclosure requirement, however, would be contrary to current EBA guidance. Specifically, the EBA (2017, p. 5) states: "… considering the supervisory objectives of P2G, which is to act as a type of monitoring metric not automatically linked to any further supervisory measures, competent authorities would not require institutions to disclose capital guidance publicly. It should be noted, however, that competent authorities under the CRD do not have the legal powers to actively prevent institutions from disclosing P2G. Institutions are generally expected not to disclose P2G but they are expected to evaluate whether or not that information meets the criteria of insider information and, if so, ensure compliance with provisions of the Market Abuse Regulations."

[17] In a speech delivered on November 15, 2018, Mr Enria, the current Chair of the SSM, advocated publishing the overall SREP decision in a transparent way along with the outcome of the stress test results. See p. 13 of the speech found at https://eba.europa.eu/documents/10180/2453936/2018+11+15+-+What+we+have+learnt+from+EU-wide+Stress+Tests+%28AE+NBR+seminar%29.pdf

furthering market discipline, more comprehensive publication of bank-level supervisory information also provides more insight into the performance of the ECB as a supervisor, which could introduce additional discipline on the supervisor to perform well.

### Broader transparency and stress test exercises including additional significant institutions

It is advisable to extend the coverage of current transparency and stress test exercises to include additional significant institutions to promote market discipline. In the case of the transparency exercise, this needs to be done in cooperation with the EBA. In case of the stress tests, the ECB could do this in collaboration with the EBA or by itself. An argument against such extensions is, of course, that it would require additional supervisory resources.

### Regular supervisory review of banks' Pillar 3 reports

In addition to solvency and leverage information, the CRR (European Parliament and EU Council, 2013b ) requires banks to disclose extensive bank-specific data on, for instance, market risk and remuneration by way of their Pillar 3 reports. The disclosure of this information is a regulatory requirement, which in principle is subject to supervisory review. As part of its regular supervisory activities, the ECB should ascertain the accuracy and completeness of bank-specific information disclosed through Pillar 3 reports. As a matter of accountability, it would be good for the ECB to indicate to what extent it actually reviews Pillar 3 reports, and what its findings are in general from such reviews.[18]

### The use of market information in supervisory work

Market information could lead to 'indirect' market discipline, if it causes the supervisor to modify its supervisory stance towards a bank. In case a bank has a low market-to-book value, the ECB could, for instance, subject the bank to a more intense review of its capitalisation, business model and long-run viability, with possible implications for current supervisory decisions. Similarly, the interest rates that a bank needs to pay to attract bail-in-able debt potentially inform the ECB about a bank's riskiness beyond the standard supervisory information that it receives from the bank itself. The ECB could test for the usefulness of market data in supervisory decision making by seeing whether current market data can predict changes in supervisory outcomes (in terms of SREP risk scores and capital demands). If this were the case, this would provide an additional argument for the ECB to consider market information in its regular supervisory process.

[18] The EBA (2015) provides an evaluation of EU banks' transparency in their 2014 Pillar 3 reports at an aggregated level.

# 3. A NEED FOR REVISED ECB GUIDANCE ON CORPORATE GOVERNANCE

A bank's internal governance ideally provides checks and balances within the banking organisation to control excessive risk taking. In 2015, one of the key supervisory activities of the SSM was to examine banks' governance and risk appetite (ECB, 2016a, p. 5). In that year, the ECB conducted an in-depth assessment of the corporate governance of all significant institutions through a thematic review. As an outcome of this review, the ECB (2016b) published a supervisory statement on governance and risk appetite. In this report, the ECB describes its perception of good corporate governance in the financial sector, and in particular, it sets out its supervisory expectations regarding a bank's board.

The ECB is seen to favor a set of board features that, as it turns out, all promote the effectiveness and power of the board in its relation to senior management. The main precepts of the ECB (2016b, pp. 7-9) on board structure can be summarised as follows:

- Regarding the size of the board, the ECB states that a large board can hamper interactive discussions, while small boards sometimes face issues of diversity in the composition of their members. Thus, the ECB favors boards of intermediate size, rather than very small or very large boards.
- Regarding board independence, the ECB states that having independent members on the board contributes to enhancing its capacity to independently challenge senior management. Conversely, insufficient independence of the board is seen to limit its oversight capacity. Hence, the ECB favors board independence vis-à-vis management.
- In order to promote checks and balances, the chair of the board should be an independent or non-executive board member according to the ECB.

Boards of intermediate size can more effectively challenge management decisions than, say, a very small board. Similarly, boards with more independent members and with a chair that is not a senior manager can more easily oppose management. Boards with these features are more likely to promote shareholder interests rather than the interests of managers. Perhaps the ECB favors shareholder-friendly boards as a useful mechanism to control bank risk taking, as managers could be seen to promote bank risk taking. While such a view would have some intuitive appeal, it is not obvious that managers are in fact more interested in bank risk taking than shareholders. Rather, shareholders may benefit from additional bank risk taking, as they are protected by limited liability on the downside and stand to benefit from implicit and explicit public guarantees that pay out in case of bank distress. Compared to shareholders, senior management may well be less interested in bank risk taking, as their jobs, reputations and a large share of their personal wealth tend to be linked to the performance of their bank.

Recent empirical research finds evidence that more power to shareholders in bank boards increases, rather than reduces, bank riskiness. In particular, Anginer, Demirguc-Kunt, Huizinga and Ma (2016) find that more shareholder-friendly governance, in the form of intermediate board size and a separation of the roles of chair of the board and chief executive officer, are associated with lower bank capitalisation, which implies more bank risk. In addition, banks with shareholder-friendly corporate governance are more likely to continue payments to shareholders in the form of dividends and share repurchases after experiencing a major negative income shock, which further contributes to lower bank capitalisation and higher bank risk. In a further study, Anginer, Demirguc-Kunt, Huizinga and Ma (2018) find that more shareholder-friendly corporate governance, for instance in the form of more independent boards, is

associated with greater bank-level risk, and also greater contributions of a bank to banking sector systemic risk.[19]

These research findings have two important policy implications. First, as long as shareholders can benefit materially from increased bank risk, bank boards should not be structured to increase the power of shareholders in the board relative to other stakeholders, and in particular senior management. Thus, the ECB's current guidance on bank boards towards boards of intermediate size, boards with more independent members, and boards where the chair is not a senior manager, appears to be misguided, as this guidance implies that boards will be more likely to favor shareholder interests, and hence to tolerate excessive bank risk taking. Hence, the current SSM practice of guiding banks towards adopting more shareholder-friendly boards should be reconsidered. Instead, the ECB should promote board structures where shareholder interests are represented, but balanced by other interests, in part expressed by managers.[20]

A second important policy implication is that implicit and explicit government guarantees should be eliminated to take away one of the main reasons why bank risk is in the shareholders' interest. This is the approach of recent regulatory reform through the BRRD, which aims to replace bailout by bail-in, thereby limiting public support in bank resolutions. However, doubts remain whether bail-in will be credible, especially in the case of very large banks. To make it more credible, bail-in preparedness should be a key supervisory priority.

[19] These findings are consistent with Laeven and Levine (2009) who find that increased shareholder power in the form of the presence of large owners with substantial cash-flow rights is associated with higher bank risk. See De Haan and Vlahu (2016) for a survey of the literature on the corporate governance of banks.

[20] The ECB can in principle use its 'fit and proper' assessments of board members as an instrument to ensure that boards do not become too shareholder-friendly. The ECB (2018b) provides a guide on how it conducts fit and proper assessments. When assessing individual board members, the ECB considers how an appointee will fit into the collective suitability, but the overall shareholder-friendliness of the board is not mentioned as an issue.

# 4. CONCLUSIONS

This paper focuses on two ways in which overall bank supervision and oversight can be structurally improved in the next SSM term: (i) by bringing about more effective market discipline of banks by investors in banks' securities, and (ii) by revising the current SSM guidance on the corporate governance of banks to make boards more inclined to control bank risk taking.

To improve market discipline, the ECB should consider facilitating the publication of bank-specific supervisory information about SREP outcomes. In addition, the ECB can cooperate with the EBA to increase the coverage of SSM banks in the EU-wide transparency and stress test exercises that are conducted under the auspices of the EBA. The ECB should also assess the quality of banks' Pillar 3 reports as part of its supervisory review, and it could potentially use market information on banks' valuation and cost of funding to inform its supervisory work.

In the area of corporate governance, the ECB's current guidance and the implied supervisory approach are inadequate. In 2016, the ECB published guidance with the effect of increasing shareholder influence in bank boards, for instance, by indicating that the chair of the board should not be the bank's senior manager. Guidance along these lines is inappropriate in the case of banks, as bank shareholders tend to benefit more from increased bank risk taking than other stakeholders, including the bank's management. By promoting shareholder-friendly boards, at present, the ECB is inadvertently promoting additional bank risk taking.

Two examples of questions about the next SSM term:

Q1. Market discipline of banks can be a complement to bank supervision as a means to check excessive bank risk taking. In what ways do you think the ECB can contribute to improving the operation of market discipline in the next SSM term? [This paper makes several suggestions to improve market discipline, and there can be a discussion on the feasibility and desirability of these suggestions.]

Q2. The ECB's current guidance on the corporate governance of banks appears to favor bank boards that imply large power of shareholders vis-à-vis a bank's management. Do you think this guidance is appropriate given that bank shareholders rather than a bank's managers stand to benefit most from excessive bank risk taking? [This question relates to the issue that the ECB's current preference for boards that imply large shareholder power could lead to more rather than less bank risk taking.]

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# ANNEX A. EXCERPTS FROM CRD-CRR IV ON DISCLOSURE

*Article 53 from the CRD IV (European Parliament and EU Council, 2013a):*

Professional secrecy

1. Member States shall provide that all persons working for or who have worked for the competent authorities and auditors or experts acting on behalf of the competent authorities shall be bound by the obligation of professional secrecy.

Confidential information which such persons, auditors or experts receive in the course of their duties may be disclosed only in summary or aggregate form, such that individual credit institutions cannot be identified, without prejudice to cases covered by criminal law.

Nevertheless, where a credit institution has been declared bankrupt or is being compulsorily wound up, confidential information which does not concern third parties involved in attempts to rescue that credit institution may be disclosed in civil or commercial proceedings.

2. Paragraph 1 shall not prevent the competent authorities from exchanging information with each other or transmitting information to the ESRB, EBA, or the European Supervisory Authority (European Securities and Markets Authority) ("ESMA") established by Regulation (EU) No 1095/2010 of the European Parliament and of the Council ( 1 ) in accordance with this Directive, with Regulation (EU) No 575/2013, with other Directives applicable to credit institutions, with Article 15 of Regulation (EU) No 1092/2010, with Articles 31, 35 and 36 of Regulation (EU) No 1093/2010 and with Articles 31 and 36 of Regulation (EU) No 1095/2010. That information shall be subject to paragraph 1.

3. Paragraph 1 shall not prevent the competent authorities from publishing the outcome of stress tests carried out in accordance with Article 100 of this Directive or Article 32 of Regulation (EU) No 1093/2010 or from transmitting the outcome of stress tests to EBA for the purpose of the publication by EBA of the results of Union-wide stress tests.

*Article 431, Paragraph 3 of CRR IV (European Parliament and EU Council, 2013b):*

Institutions shall adopt a formal policy to comply with the disclosure requirements laid down in this Part, and have policies for assessing the appropriateness of their disclosures, including their verification and frequency. Institutions shall also have policies for assessing whether their disclosures convey their risk profile comprehensively to market participants.

Where those disclosures do not convey the risk profile comprehensively to market participants, institutions shall publicly disclose the information necessary in addition to that required in accordance with paragraph 1. However, they shall only be required to disclose information which is material and not proprietary or confidential in accordance with Article 432.

This paper focuses on two ways in which overall bank supervision and oversight can be improved in the next SSM term: (i) by more effective market discipline of banks by investors in banks' securities, and (ii) by more effective oversight of bank risk taking by bank boards. To improve market discipline, the ECB should consider facilitating the publication of additional bank-specific supervisory information. In addition, the ECB can cooperate with the EBA to increase the coverage of SSM banks in the EU-wide transparency and stress test exercises. The ECB could also review the quality of banks' Pillar 3 reports as part of its supervisory process, and it could potentially use market information on banks' valuation and cost of funding to inform its supervisory work. Furthermore, the ECB should revise its current guidance regarding bank boards that has the effect of increasing shareholder influence, as bank shareholders tend to benefit more from excessive bank risk taking than other stakeholders, including the bank's management. This document was provided by the Economic Governance Support Unit at the request of the ECON Committee.

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