

MBA-PART TIME
"Chinese walls within
the ecb after the
establishment of the
single supervisory
mechanism"

Alexis Kontogiannis (1418)
Supervisor Instructor : Professor
Dr.Christos V. Gortsos
Academic year : 2016





ECB'S MEETING

Table of contents

Abstract.....

Introduction.....

**Chapter 1: European Central Bank (ECB) – a general overview –
& the main features of Single Supervisory Mechanism(SSM)**

Chapter 2: Classification of the ECB’s tasks

**Chapter 3: Exploring the “nexus” between monetary policy & banking
supervision on the euro - area : Interaction between these 2 functions &
Conflicts of interest may arise**

**Chapter 4: The rationale for the separation of these 2 functions & the absolute
necessity for the creation of “ Chinese walls”**

**Chapter 5: The regulatory framework governing the “Chinese walls” within
the European Central Bank (ECB) – Solution and limits needed to be set –**

**5.1: General provisions assisted from the Single Supervisory
Mechanism (SSM) regulation**

**5.2: The provisions of the ECB’ s decision on the implementation of
this separation**



5.3: The Mediation Panel

Chapter 6: Case study, based on a different approach, relating to the supervision of credit institutions

– The United Kingdom (UK) Model –

Concluding remarks.....

Bibliography

Abstract

The object of this diplomatic is the "**Chinese walls within the ECB after the establishment of the single supervisory mechanism**". Initially there will be a presentation of the ECB and the SSM and then an observation to the nexus between monetary policy and banking supervision on the euro – area, as well as the interaction between these two functions and the conflicts of interests that may arise. Moreover, we will focus on the important issue of the rationale for the separation of the above functions and the absolute necessity for the creation of “Chinese walls”.

European Central Bank - ECB is the central bank responsible for the monetary system of the European Union (EU) and the euro currency. The bank was formed in Germany in June 1998 and works with the other national banks of each of the EU members to formulate monetary policy that helps maintain price stability in the European Union. The first step towards creating the ECB was the decision, taken in 1988, to build an Economic and Monetary Union: free capital movements within Europe, a common monetary authority and a single monetary policy across the euro area countries.

The Euro-system is responsible for: defining and implementing monetary policy, conducting foreign exchange operations, holding and managing the euro area's foreign currency reserves and promoting the smooth operation of payment systems. The ECB carries out specific tasks in the areas of banking supervision, banknotes, statistics, macro-prudential policy and financial stability as well as international and European cooperation.

The operational framework of the Euro-system consists of the following set of instruments: open market operations, standing facilities and minimum reserve requirements for credit institutions. In addition, since 2009 the ECB has implemented several non-standard monetary policy measures, i.e. asset purchase programs, to complement the regular operations of the Euro-system.

The **Single Supervisory Mechanism (SSM)** is the mechanism which has granted the European Central Bank (ECB) a supervisory role to monitor the financial stability of banks based in participating states, starting from 4 November 2014. Eurozone states are



obliged to participate, while Member states of the European Union outside the euro-zone can voluntarily participate. As of 3 November 2014, none of the non-euro-zone member states had opted to join, although the ECB reported that some of them had expressed an interest in joining, and that talks were being held with each of them to map which changes to national legislation need to be adopted in order to become a SSM member. The SSM is the first established part of the EU banking union, and will function in conjunction to the Single Resolution Mechanism. A first limit to the scope of the SSM is geographical: the SSM will only cover a part of the EU member states. It will hence contribute to what is known as multi-speed Europe. A second limit is the fact that the SSM only deals with bank supervision. Supervision of the rest of the financial sector (for example insurance firms) remains a national competence. In addition, some aspects of bank supervision (for example consumer protection) remain a task for national supervisors.

The 19 euro-zone member states participate automatically in the SSM. The last country to join was Lithuania, when it joined the euro-zone on 1 January 2015. Since the EU treaties only give the ECB jurisdiction over euro-zone states, legally it cannot enforce measures in non-euro-zone states. This would prevent the ECB from effectively carrying out its supervisory role in these states. Under the European Treaties, non-euro-zone countries do not have the right to vote in the ECB's Governing Council and in return are not bound by the ECB's decisions. Non-euro-zone countries cannot become full members of the SSM in the sense of having the same rights and obligations as euro-zone SSM members. However, non-euro-zone EU member states can enter into a "close cooperation agreement" with the ECB. The banks in that country are then supervised by the ECB and the country gains a seat in the ECB's Supervisory Board. It would allow banks in that country to be supervised by the ECB provided that they have mechanisms in place to make ECB measures binding upon national authorities. A "close cooperation" agreement can be ended by the ECB or by the participating non-euro-zone member state. Participating non-euro-zone states will also gain a seat on the ECB's Supervisory Board.

The procedure for non-euro-zone states to join SSM through "close cooperation", regulating the timing and content of applications and how the ECB shall assess such applications and the practicalities of admitting new members, was outlined by Decision ECB/2014/510. The decision entered into force on 27 February 2014. As of 3 November 2014, no requests to enter into "close cooperation" have been notified in line with the prescribed procedure. Nonetheless,



the ECB has received informal expressions of interest from some none-euro-zone Member States, and is currently organizing bilateral meetings with them with a view to their possible entry into close cooperation arrangements.

Introduction

The EC Treaty has established the ECB as a specialized, independent organization for conducting monetary policy and performing related functions. To this end, the ECB has been given a legal personality of its own, with its own decision-making bodies and powers. Its organization as a central bank responds to the specific nature of monetary policy, i.e. a public policy function that is implemented mainly by financial market operations. The ECB has legal personality under Article 107(2) of the EC Treaty and enjoys the most extensive legal capacity accorded to legal persons under the respective national law of each Member State under Article 9.1 of the Statute of the ESCB.

Separation between monetary policy and supervisory tasks was necessary. Supervisory tasks should be carried out in full separation from monetary policy, in order to avoid conflicts of interest and to ensure that each function is exercised in accordance with the applicable objectives. The separation principle covers, among other things, the separation of objectives, the separation of decision-making processes and tasks, including the organizational and procedural separation at the level of the Governing Council.

In early 2014 the ECB implemented a series of measures to achieve organizational and procedural separation, particularly regarding the separation of decision-making for the two policy functions. An independent Supervisory Board was established – separate from the ECB's Governing Council – to draft and implement decisions. Moreover, the ECB's Rules of Procedure were amended to regulate organizational and procedural aspects related to the Supervisory Board and its interaction with the Governing Council. This included the rule that the Governing Council's deliberations on supervisory matters would be kept strictly apart from those on other issues, with separate agendas and meetings.



The SSM Regulation furthermore requires the ECB to adopt and publish any necessary internal rules to ensure the separation between the supervisory function on the one hand and monetary policy functional areas and other tasks of the ECB on the other, including rules regarding professional secrecy and information exchanges. On 17 September 2014 the ECB adopted a Decision on the implementation of separation between the monetary policy and supervision functions of the ECB (Decision ECB/2014/39), which entered into force on 18 October 2014.

With regard to the **organizational separation**, the Decision provides that the ECB may establish shared services providing support to both the monetary policy and the supervisory function to ensure that these support functions are not duplicated, thus helping to guarantee the efficient and effective delivery of services, provided that such support will not lead to conflicts of interest.

Important efforts have been made in developing an SSM model of supervision, building on the experience acquired by the national supervisors. Joint Supervisory Teams (JSTs) were established, which clearly represent a cornerstone of the SSM supervisory organization. A Supervisory Manual, which describes to SSM staff the processes to be applied in the supervision of banks was drafted and has already been updated. A “Guide to banking supervision”, aimed at explaining the SSM supervisory model to supervised institutions and the general public, was published in September 2014. Finally, the operational framework for the supervisory oversight and indirect supervision of less significant institutions was developed.

In addition to the Bank of England since 1 April 2013, the ECB has now become another striking example of the trend of separation. Nevertheless, the creation of ‘Chinese walls’ within the central bank is an essential element to ensure the adequate separation of its monetary policy and other tasks from its (new) supervisory tasks.

At this point, i would like to personally thank my supervisor instructor, Professor Dr. Christos V. Gortsos, whose guidance and contribution was invaluable for carrying out this paper. Furthermore, I am deeply honored, having the unique experience of having close cooperation with such a reputable and well-respected person and professor, as Dr. Christos V. Gortsos.





Chapter 1: European Central Bank (ECB) – a general overview – & the main features of Single Supervisory Mechanism (SSM)

The ECB⁽¹⁾ is an official EU institution at the heart of the Euro-system and the Single Supervisory Mechanism. Over 2,500 staff from all over Europe work for the ECB in Frankfurt , Germany. They perform a range of tasks in close cooperation with the national central banks within the Euro-system and, especially for banking supervision, with the national supervisors within the Single Supervisory Mechanism. The European Central Bank and the national central banks together constitute the Euro-system, the central banking system of the euro area. The main objective of the Euro-system is to maintain price stability: safeguarding the value of the euro.

The European Central Bank² is responsible for the prudential supervision of credit institutions located in the euro area and participating non-euro area Member States, within the Single Supervisory Mechanism, which also comprises the national competent authorities. It therefore contributes to the safety and soundness of the banking system and the stability of the financial system within the EU and each participating Member State. The primary objective of the ECB's monetary policy is to maintain price stability. Monetary policy operates by steering short-term interest rates, thereby influencing economic developments, in order to maintain price stability for the euro area over the medium term.

The independence of the ECB is conducive to maintaining price stability. About institutional independence³ : “**Article 108**” is the key Treaty provision establishing the independence of the ECB. Its first sentence states explicitly that, “when exercising their powers and carrying out their tasks and duties, neither the ECB nor the NCB nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body”. The wording of Article 108 makes it illegal to accept or seek instructions from any body, be it public or private, national or international, with the emphasis on the term “instruction”. Article 108 does not preclude seeking

1The basics information about the organization of ECB are available at <http://www.ecb.europa.eu/ecb/orga/escb/html/index.en.html>

2 Klomp J., de Haan J. (2009), ‘Central Bank Independence and Financial Instability’, *Journal of Financial Stability*, pages 321-324.

3 SCHELLER HANSPETER (2006), THE EUROPEAN CENTRAL BANK HISTORY, ROLE AND FUNCTIONS, pages 123-127



relevant information or dialoguing with the aforementioned bodies. The prohibition on the acceptance of instructions is complemented by a *self-commitment* of the Community institutions and bodies and the governments of the Member States. The second sentence states that these bodies “have undertaken to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the NCBs in the performance of their tasks.” Thus, they are obliged to abstain from attempting to give instructions to the members of the decision-making bodies of the ECB and the NCBs and to abstain from influencing them.

About legal independence⁴ : The ECB and NCBs enjoy their own legal personality which is a prerequisite for the independence of the members of the Euro-system. For the ECB, legal independence includes the right to bring actions before the European Court of Justice (ECJ) in order to uphold its prerogatives if they are impaired by a Community institution or Member State. When the ECB was established in 1998, a system of staggered terms of office was applied for appointments to the Executive Board to ensure continuity.

About personal independence⁵ : To substantiate the institutional independence, the Statute protects the personal independence of the members of the ECB’s decision-making bodies. It stipulates, in particular, relatively long fixed terms of office:

- a minimum term of office of five years for the NCB governors, which is renewable;
- a non-renewable term of office of eight years for the members of the Executive Board

A member of the ECB’s decision-making bodies may not be dismissed in a discretionary manner on the grounds of past policy performance. Instead members may only be removed from office if they become unable to fulfil the conditions required for the performance of their duties or if they are found guilty of serious misconduct. In such cases, the Governing Council or the Executive Board may apply to the ECJ to have the member of the Executive Board compulsorily retired (Article 11.4 of the Statute of the ESCB). In the same circumstances, an NCB governor may be relieved from office by the competent national authority in line with the procedures

4 The basic information about the sorts of the independence of the ECB are available at <http://www.ecb.europa.eu/ecb/orga/independence/html/index.en.html>

5 SCHELLER HANSPETER (2006), THE EUROPEAN CENTRAL BANK HISTORY, ROLE AND FUNCTIONS, pages 123-127



specified in the statute of their respective NCB. However, the governor concerned or the Governing Council may refer the matter to the Court, which has jurisdiction in such cases (Article 14.2 of the Statute of the ESCB). The statutes of the NCBs (as amended in line with Article 109 of the EC Treaty) extend the protection against discretionary dismissals to the other members of the NCBs' decision-making bodies; however, the other members do not enjoy the right to refer the matter to the ECJ.

About financial and organizational independence⁶ : The ECB and the NCBs have their own financial resources and income and enjoy organizational autonomy. Their financial and organizational autonomy enable the Euro-system to perform its tasks as required. The capital of the ECB is subscribed and paid up by the NCBs. The ECB has its own budget, independent from that of the EU. The Statute also allows the ECB to adopt autonomously the conditions of employment for its staff and to organize its internal structure as it sees fit. In addition, as a supranational organization, the ECB enjoys in the territories of the Member States the privileges and immunities that are necessary for the performance of its tasks. Chapter 1 of the Protocol on the privileges and immunities of the European Communities of 8 April 1965 guarantees, among other things, that the premises and archives of the ECB are inviolable and that its property and assets are intangible. The Protocol states further that these must not be subject to any administrative or legal measure of constraint without the authorization of the ECJ. As regards the NCBs' financial and budgetary autonomy and the autonomy of their staff, the Member States have a certain influence over NCBs' budgets and the distribution of profits and staffing, be it as (sometimes sole) shareholder of their respective NCB or as national legislator. However, in line with the statutes of the NCBs, the Member States' rights are subject to the proviso that their exercise is not allowed to impede on the NCBs' capacity to perform their Euro-system-related functions.

The capital of the ECB comes from the national central banks (NCBs) of all EU Member States and amounts to €10,825,007,069.61. The NCBs' shares in this capital are calculated using a key which reflects the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting. The ECB adjusts the shares

⁶The basic information about the sorts of the independence of the ECB are available at <http://www.ecb.europa.eu/ecb/orga/independence/html/index.en.html>



every five years and whenever a new country joins the EU. The adjustment is made on the basis of data provided by the European Commission⁷.

The Governing Council ⁸ is the main decision-making body of the ECB. It consists of the six members of the Executive Board, plus the governors of the national central banks of the 19 euro area countries. Their responsibilities are : to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ECB and the Euro-system and to formulate monetary policy for the euro area. This includes decisions relating to monetary objectives, key interest rates, the supply of reserves in the Euro-system, and the establishment of guidelines for the implementation of those decisions. In the context of the ECB's new responsibilities related to banking supervision, to adopt decisions relating to the general framework under which supervisory decisions are taken, and to adopt the complete draft decisions proposed by the Supervisory Board under the non-objection procedure.

The Governing Council usually meets twice a month at the ECB's premises in Frankfurt , Germany. The Governing Council assesses economic and monetary developments and takes its monetary policy decisions every six weeks. At the other meetings, the Council discusses mainly issues related to other tasks and responsibilities of the ECB and the Euro-system. To ensure the separation of the ECB's monetary policy and other tasks from its supervisory responsibilities, separate meetings of the Governing Council are held. The monetary policy decision is explained in detail at a press conference held every six weeks. The President, assisted by the Vice-President, chairs the press conference. In addition, the ECB publishes regular accounts of the Governing Council's monetary policy meetings before the date of the next one⁹.

The main principles¹⁰ of the ECB's members, which are common to SSM's members are¹¹:

7Gianviti F. (2010), The Objectives of Central Banks, in Giovanoli, M. and D. Devos (2010, editors): *International Monetary and Financial Law: The Global Crisis*, Oxford University Press, Oxford - New York, Chapter 22, pages 449-451

8 Information about the organization of ECB are available at https://en.wikipedia.org/wiki/European_Central_Bank

9 Klomp J., de Haan J. (2009), 'Central Bank Independence and Financial Instability', *Journal of Financial Stability*, pages 325-328

10 The main principles of the ECB are available at http://ec.europa.eu/finance/generalpolicy/docs/committees/reform/20120912-com-2012-511_en.pdf



- a. participation : all members of the Euro-system and the Single Supervisory Mechanism (SSM) will contribute strategically and operationally to their goals.
- b. cooperation : all members of the Euro-system and the SSM will perform all their functions in a spirit of cooperation and teamwork.
- c. transparency and accountability :all members of the Euro-system and the SSM will have to act transparently and be fully responsible and accountable for the effectiveness of all their functions.
- d. distinguishing European and national activities : the European activities performed by national central banks and national competent authorities will be clearly identified and distinguished from those pertaining to national responsibilities.
- e. cohesion and unity : while respecting the legal status of their members, the Euro-system will act as cohesive and unified entity and the SSM as a cohesive and coordinated entity. They will each work as a team and speak with one voice, aiming to be close to the citizens of Europe.
- f. exchange of resources :the members of the Euro-system and the SSM will promote the exchange of personnel, know-how and experience.
- g. effectiveness and efficiency in decision-making : all decision-making and deliberative processes of both the Euro-system and the SSM will pursue effectiveness and efficiency. Decision-making will focus on analysis and arguments as well as the expression of a variety of views.
- h. cost efficiency, measurement and methodology : the members of the Euro-system and the SSM will manage all resources prudently and will promote effective and cost-efficient solutions in all their activities. The Euro-system and the SSM will develop control systems and performance indicators to measure the fulfilment of their functions and alignment with their objectives. Comparable cost evaluation and cost-reporting methods will be further elaborated and utilized.
- i. exploit synergies and avoid duplications : within both the Euro-system and the SSM, while fully respecting the separation between monetary policy and supervisory tasks, potential synergies and economies of scale will be identified and exploited to the extent feasible.

11 Gianviti F. (2010), The Objectives of Central Banks, in Giovanoli, M. and D. Devos (2010, editors): *International Monetary and Financial Law: The Global Crisis*, Oxford University Press, Oxford - New York, Chapter 22, pages 450-452



Unnecessary duplication of work and resources and excessive and inefficient coordination will be avoided. To this end, organizational options that ensure effectiveness, efficiency and prompt action, taking advantage of the experience available through intensified use of existing resources will be energetically pursued. The outsourcing of Euro-system support functions and activities will be considered against the same criteria and will take security aspects into account.

In order to best serve its objective¹² of maintaining price stability, the ECB, like any other central bank, needs to thoroughly analyze economic developments. The ECB's approach to organizing, evaluating and cross-checking the information relevant for assessing the risks to price stability is based on two analytical perspectives, referred to as the "two pillars": *economic analysis and monetary analysis*. They form the basis for the Governing Council's overall assessment of the risks to price stability and its monetary policy decisions. The two pillar approach ensures the appropriate attention is paid to different perspectives to be able to make an overall judgement of the risks to price stability. The diversified approach to the interpretation of economic conditions reduces the risk of policy error caused by over-reliance on a single indicator, forecast or model.

At this part of is important to refer to the main framework⁽¹³⁾ of ECB :

- Headquarters Agreement between the Government of the Federal Republic of Germany and the ECB concerning the seat of the ECB 29.12.1998.
- Decision of the ECB of 12 October 1999 concerning the Rules of Procedure of the Executive Board of the ECB (ECB/1999/7), OJ L 314, 8.12.1999, p. 34.
- Decision of the ECB of 19 February 2004 adopting the Rules of Procedure of the ECB (ECB/2004/2), OJ L 80, 18.3.2004, p. 33.
- Decision of the ECB of 18 December 2008 to postpone the start of the rotation system in the Governing Council of the ECB (ECB/2008/29), OJ L 3, 7.1.2009, p. 4.

¹²Gianviti F. (2010), The Objectives of Central Banks, in Giovanoli, M. and D. Devos (2010, editors): *International Monetary and Financial Law: The Global Crisis*, Oxford University Press, Oxford - New York, Chapter 22, pages 455-458

¹³ About legal framework of ECB see at <http://www.ecb.europa.eu/ecb/legal/html/index.en.html>



- Decision of the ECB of 19 March 2009 amending Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the ECB (ECB/2009/5), OJ L 100, 18.4.2009, p. 10.
 - Decision ECB/2004/2. Unofficial consolidated text [3a) and c)]. Produced by the Publications Office of the European Union 18.4.2009.
 - Decision of the ECB of 22 January 2014 amending Decision ECB/2004/2 of 19 February 2004 adopting the Rules of Procedure of the ECB (ECB/2014/1), OJ L 95, 29.3.2014, p. 56.
 - Decision ECB/2004/2. Unofficial consolidated text produced by the Publications Office of the European Union 24.1.2014.
 - Decision (EU) 2015/716 of the ECB of 12 February 2015 amending Decision ECB/2004/2 adopting the Rules of Procedure of the ECB (ECB/2015/8), OJ L 114, 5.5.2015, p. 11.
 - Decision of the ECB of 14 April 2014 concerning the establishment of an Administrative Board of Review and its Operating Rules (ECB/2014/16), OJ L 175, 14.6.2014, p. 47.
-
- Decision of the ECB of 17 June 2004 adopting the Rules of Procedure of the General Council of the ECB (ECB/2004/12), OJ L 230, 30.6.2004, p. 61.
 - Decision of the ECB of 6 February 2014 on the appointment of representatives of the ECB to the Supervisory Board (ECB/2014/4), OJ L 196, 3.7.2014, p. 38.
 - Rules of Procedure of the Supervisory Board of the ECB, OJ L 182, 21.6.2014, p. 56.
 - Amendment 1/2014 of 15 December 2014 to the Rules of Procedure of the Supervisory Board of the ECB, OJ L 68, 13.3.2015, p. 88.
 - Rules of Procedure of the Supervisory Board of the ECB - Unofficial consolidated text produced by the ECB, 15.12.2014.
 - Decision (EU) 2015/433 of the ECB of 17 December 2014 concerning the establishment of an Ethics Committee and its Rules of Procedure (ECB/2014/59), OJ L 70, 14.3.2015, p. 58.



Addressing systemic risk involved in traditional mediatory activity of banks, especially in the current period, takes place through action from the ECB at European level, as summarized in the **SSM** - Single Supervisory Mechanism financial institutions. The European Central Bank (ECB) has published the SSM Framework Regulation for the Single Supervisory Mechanism (SSM). The SSM Framework Regulation lays the basis for the work of the SSM when it takes over as supervisor of euro area banks in November 2014. This is an important milestone in the set-up of the SSM. The identification of significant banks, which will be subject to direct supervision by the ECB, will take place according to criteria set out in the SSM Council Regulation and further developed in the SSM Framework Regulation. The participating States will be covered in the euro-zone and those outside the euro who want their cooperation with the SSM. With the help of the SSM, the ECB will directly supervise the "important" banks (around 130) and work closely with national regulators for the supervision and other credit institutions. The ECB may, at any time, to take the same supervision and for "non-significant" credit institutions¹⁴.

The categorization of the "significance" of a credit institution is based on: the total value of its assets, its importance for the country's economy is based on the entire EU, the importance of cross-border trading, and whether he has received financial assistance from the Common European Support Mechanism.

The main target of the SSM is to ensure the safety and soundness of the European banking system, but also to promote financial integration and stability in Europe. The ECB will be responsible for the effectiveness and consistent operation of the SSM. Within this context, the ECB may exclusively grant or abolish credit institutions operating permits and even check and acquisitions belonging to the account credit. In addition, the ECB will be able to provide general guidance to the national regulatory authorities relating to the supervision of the "insignificant" supervised credit institutions and generally to hold direct supervisory powers for each institution. These include consultation, conduct audits, field inspections, even taking direct supervision "non-significant" institutions when necessary.

14 SSM QUARTERLY REPORT 2014/1 pages 3-10 and 2014/3 pages 6-12



As provided by the SSM's founding Regulation (1024/2013), and the (under consultation) operating context, the mechanism of supervision of credit institutions starts with the following steps: supervisory management of risk (risk assessment), through selected portfolios, review and complete overview of the quality of their assets (Asset Quality Review), and the stress test scenarios (tests stress).

Essentially through the methodologies that the SSM is used, it can be made, a series of actions and measures¹⁵:

- 1) exercise control over the overall level of lending by financial institutions, whose size allows them to influence, through the multiplier credit, the overall level of liquidity in the financial system,
- 2) exercise regulatory control over the risk involved in excessive lending,
- 3) the requirement of increase of assets or equity and / or reduction of sight deposits on the liabilities of financial institutions,
- 4) activation as a last resort liquidity sponsor, in conjunction with the activation of the state as guarantor of deposits,
- 5) The administration of last resort credits directly to individual financial institutions experiencing short term liquidity problem, and
- 6) exercise decisive persuasion on financial institutions to consistency in a team effort to boost liquidity in the market, which will have more overall benefits for each of them individually.

The main legal source of the SSM¹⁶, is the Council Regulation (EU) No 1024/2013 “conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions” (the ‘SSMR’), one of the three main pillars of the European Banking Union (the ‘EBU’). Taking into account that the political decision was to make use of the existing EU Treaties, the legal basis of the SSMR is **Article 127(6)** of the Treaty on the Functioning of the European Union (the ‘TFEU’) (repeated in Article 25.2 of the Statute of the European System of Central Banks and of the ECB (the ‘Statute’), which contains an

15 SSM QUARTERLY REPORT 2014/1 pages 3-10 and 2014/3 pages 6-12

16 See REGULATION (EU) No 468/2014 OF THE EUROPEAN CENTRAL BANK of 16 April 2014 at https://www.ecb.europa.eu/ecb/legal/pdf/celex_32014r0468_en_txt.pdf



enabling clause (known as the ‘sleeping beauty clause’). The SSMR confers on the ECB specific tasks “*concerning policies relating to the prudential supervision of credit institutions*” (a phrase taken over *verbatim* from **Article 127(6) TFEU**) with a view to: contributing to the safety and soundness of credit institutions and the stability of the financial system within the EU and each Member State, which is the main objective of the ECB under the SSMR, and preventing regulatory arbitrage, fully taking into account and caring for the unity and integrity of the internal market (a duty with which it was assigned) based on equal treatment of credit institutions.

The legal framework for the language policy of the SSM is primarily determined by Council Regulation No 1 of 1958 on the languages to be used by the institutions of the EU. The SSM Framework Regulation lays down the language regime to be adopted for communication between the ECB and the NCAs, and between the SSM and the supervised entities. As far as communications within the SSM are concerned, English will be used as part of the arrangements between the ECB and the NCAs laid down in Article 23 of the SSM Framework Regulation. With regard to communication with the supervised entities, as provided for under Article 24 of the SSM Framework Regulation, any document sent to the ECB by a supervised entity may be drafted in any one of the official languages of the EU, and the supervised entity will have the right to receive a response in that same language. The ECB and the supervised entities may agree to exclusively use one official language of the EU in their written communication, including with regard to ECB supervisory decisions. Supervised entities may decide at any given time to revoke this agreement and the change will only affect the parts of the ECB supervisory procedure that have not yet been carried out. In addition, where participants in an oral hearing request to be heard in an official language of the EU other than the language of the ECB supervisory procedure, sufficient advance notice must be given to the ECB so that the necessary arrangements can be made¹⁷.

The main governing body is : the Supervisory Board, the Steering Committee, the Administrative Board and the Mediation Panel¹⁸ . In line with the SSM Regulation, the planning

17 Eijffinger, S. and R. Nijskens (2012): *Monetary Policy and Banking Supervision*, European Parliament, Directorate General for Internal Policies, available at: <http://www.europarl.europa.eu/studies>

18 SSM QUARTERLY REPORT 2014/1 pages 8-10 and 2014/3 pages 9-12



and execution of the tasks conferred on the ECB are fully undertaken by the **Supervisory Board** as an internal body of the ECB. The Supervisory Board takes draft decisions, which are adopted by the Governing Council under the non-objection procedure. Decisions are deemed to be adopted unless the Governing Council objects within a defined period of time, not exceeding ten days. Apart from that, decisions on the general framework (e.g. the SSM Framework Regulation) are taken by the Governing Council outside the non-objection procedure. In accordance with the Rules of Procedure of the Supervisory Board, representatives of the European Commission and the European Banking Authority (EBA) were invited to some of the Supervisory Board meetings in order to ensure an optimal interplay with the Single Market on a number of issues

The establishment of the Supervisory Board, including the appointment of the Chair, Vice-Chair and three ECB representatives between late December 2013 and early 2014, was thus a key step in setting up the SSM. **Ms Danièle Nouy** was appointed by the EU Council on 16 December 2013 as Chair of the Supervisory Board. The appointment was made, based on a proposal by the ECB's Governing Council on 20 November 2013, following an open selection procedure, and approval by the European Parliament on 11 December. While following the steps set out in the SSM Regulation and agreed with the European Parliament and the EU Council, the appointment was made under a fast-track procedure. **Ms Sabine Lautenschläger** was appointed by the EU Council as Vice-Chair of the Supervisory Board with effect from 12 February 2014, following the approval of the European Parliament. As stipulated under the SSM Regulation, the Vice-Chair was chosen from among the members of the ECB's Executive Board. On 6 March 2014 the ECB's Governing Council appointed three ECB representatives to the Supervisory Board: **Mr Ignazio Angeloni**, **Ms Julie Dickson** and **Ms Sirkka Härmäläinen**. The fourth representative, **Mr Luc Coene**, was appointed on 18 February 2015¹⁹.

The **Steering Committee** supports the activities of the Supervisory Board and prepares its meetings. The ECB's revised Rules of Procedure include rules for the selection of its members, which include the Chair and Vice-Chair of the Supervisory Board, one of the ECB representatives, and five NCA members appointed for one-year terms. To ensure a fair balance and rotation among NCAs, the NCAs have been allocated to four groups, according to a ranking based on the total consolidated banking assets in the relevant country. There must always be at

¹⁹ Ibid



least one member from each group on the Steering Committee. The first meeting of the Steering Committee took place on 27 March 2014. A total of nine meetings were held during 2014²⁰.

The members of the **Administrative Board**²¹ act independently and in the public interest and are not subject to instructions by the ECB. The role of the Administrative Board is to carry out an internal administrative review of the ECB's supervisory decisions adopted by the ECB's Governing Council under the non-objection procedure, if such a review is requested by a natural or legal person to whom the decision is addressed or to whom the decision is of direct and individual concern. The Administrative Board must adopt an opinion on the review no later than two months from the date of receipt of the request for review. The opinion of the Administrative Board, which is not binding on the Supervisory Board or the Governing Council, will propose whether the contested decision is to be abrogated, replaced with a decision of identical content or with a new decision. The Administrative Board began its activities in September immediately after the appointment of its members. It is assisted by the Secretariat of the Supervisory Board and other ECB departments, as appropriate. The Secretary to the Supervisory Board also acts as Secretary to the Administrative Board.

The **SSM Mediation Panel**²² was established by virtue of Regulation ECB/2014/26 of 2 June 2014 (the Mediation Panel Regulation) with a view to ensuring the separation between monetary policy and supervisory tasks, as required under Article 25(5) of the SSM Regulation. The Mediation Panel must comprise one member per participating Member State, chosen from among the members of the Governing Council and the Supervisory Board. The procedure for appointing the members of the Mediation Panel must comply with the requirement laid down in the aforementioned Mediation Panel Regulation, in accordance with which the Chair of the Mediation Panel – who is the Vice-Chair of the Supervisory Board and not a member of the panel – “shall facilitate the achievement of a balance between Governing Council and Supervisory Board members”. To establish the Mediation Panel, in August 2014 the ECB proposed to the President of the EU Council an annual rotation procedure for the appointment of members. This proposal was discussed with the other ECOFIN ministers and subsequently

20 SSM QUARTERLY REPORT 2014/1 pages 8-10 and 2014/3 pages 9-12

21 Ibid

22 Ibid



agreed upon. The **rotation arrangement** involves forming two groups of countries of as close to even size as possible, based on the protocol order of the countries in their national languages. In the first year: group one countries appoint their Governing Council member and group two countries appoint their Supervisory Board member. In the following year, the two groups swap around (i.e. a Supervisory Board member would replace a Governing Council member and vice versa). If a non-euro area Member State chooses to participate in the SSM in close cooperation, its government would be invited to appoint its Supervisory Board member to the Mediation Panel. Lithuania, which joined the euro area on 1 January 2015, is also represented on the Mediation Panel.

Setting up the Single Supervisory Mechanism (SSM) required some changes to the ECB's existing organizational structure. The new micro-prudential function has been organized into five new business areas within the ECB: four directorates general (DGs) and a Secretariat to the Supervisory Board²³. DGs Micro-Prudential Supervision I and II (DGs MS I and II) deal with the direct supervision of significant banks. Both DGs are organized according to a risk based approach to supervision and are thus specialized by risk exposure, complexity and business models.

- DG MS I covers the supervision of the approximately 30 most systemic banking groups and is organized into seven divisions with about 200 full-time equivalent positions (FTEs).

- DG MS II covers the supervision of approximately 90 banking groups and is organised into eight divisions, also with about 200 FTEs.

Supervision of the significant banks is carried out in close cooperation with NCAs. A **Joint Supervisory Team** (JST) has been established for each entity or significant banking group supervised directly by the ECB. Each team operates under the coordination of a JST coordinator from DGs MS I and II of the ECB, supported by one or more local sub-coordinators from the NCAs and comprising a number of supervisors from both the ECB and the NCAs of the participating countries. Each of the 14 most complex banking groups has one dedicated JST coordinator for all the other banking groups. JST coordinators are as a rule responsible for two or three banking groups. In order to foster and emphasize neutrality, the JST coordinator is generally not from the home country of the bank under his or her supervision. In the same vein, a

²³ ECB Annual Report 2014, pages 23-25



rotation principle will be applied, whereby, as a rule, JST coordinators must change banks every three to five years to prevent the establishment of overly close relationships with the supervised banks.

DG Micro-Prudential Supervision III ²⁴(DG MS III) is responsible for the oversight function of the ECB regarding the direct supervision of less significant institutions by NCAs. At any time, the ECB, after consulting the relevant NCA or at the request of the NCA, may take over the responsibility for the direct supervision of less significant institutions to ensure the consistent application of high supervisory standards and the consistency of supervisory outcomes. DG MS III is organized into three divisions, with around 80 FTEs working on tasks pertaining to: (i) oversight of NCAs' supervisory practices for less significant institutions as well as relations with NCAs, (ii) institution-specific and sectoral oversight of less significant institutions, (iii) provision of analysis and methodological support.

DG Micro-Prudential Supervision IV²⁵ (DG MS IV) hosts all horizontal and specialized expertise services of supervision. It supports JSTs and NCAs in the conduct of supervision of both significant and less significant credit institutions. About 250 FTEs are allocated to DG MS IV, which is organized into the following ten divisions:

- Planning and Coordination of Supervisory Examination Programs
- Authorization
- Enforcement and Sanctions
- Supervisory Quality Assurance
- Supervisory Policies
- Methodology and Standards Development
- Crisis Management
- Centralized On-Site Inspections
- SSM Risk Analysis
- Internal Models

24 Beck, Th. and D. Gros (2013): *Monetary Policy and Banking Supervision: Coordination Instead of Separation*, CEPS Policy Brief No. 286, available at: <http://ssrn.com/abstract=2189364>

25 Ibid



Given the wide diversity hitherto in national supervisory frameworks (including policy, methodology, standards, processes) and practices, a critical objective of DG MS IV is to promote the development and implementation of a single, consistent and state-of-the-art supervisory approach, with a view to establishing a level playing field and delivering more effective supervision across Europe. For all DGs, close cooperation and coordination between ECB Banking Supervision and the NCAs is key to achieving the SSM's objectives and, in particular, to truly working and acting as a single European supervisor. Mirroring to some extent the concept of the JSTs, networks pooling together ECB and NCA staff have been established by DG MS III as well as for all horizontal and specialized expertise services.

Chapter 2: Classification of the ECB's tasks

In light of the above, as of 4 November 2014 the scope of the ECB's tasks ⁽²⁶⁾ has been significantly broadened, since its tasks consist of the following⁽²⁷⁾ :

1. The first group comprises the ECB's '**basic tasks**'²⁸ set out in Article 127(2) TFEU , i.e. the definition and implementation of the euro area monetary policy, the conduct of foreign-exchange operations consistent with the provisions of Article 219 TFEU, the holding and management of Member States' official foreign reserves, and the promotion of the smooth operation of payment systems. Especially Article 127 (1 and 2) points out : **(1)**. The primary objective of the European System of Central Banks (hereinafter referred to as "the ESCB") shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on

26 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», pages 3-4

Gortsos is Professor of International Economic Law at the Panteion University of Athens. He is also Visiting Professor and has teaching assignments at Europa Institut of the Zurich University, the Europa Institut of the Saarland University, the Law Faculty of the National and Kapodistrian University of Athens and the Law Faculty of the Izmir University of Economics. The cut-off date for the information used in this study is 6 December 2015

27 The basic tasks of ECB are available at <http://www.ecb.europa.eu/ecb/tasks/html/index.en.html>

28 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», pages 3-4



European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources, and in compliance with the principles set out in Article 119. (2). The basic tasks to be carried out through the ESCB shall be:

- to define and implement the monetary policy of the Union,
- to conduct foreign-exchange operations consistent with the provisions of Article 219,
- to hold and manage the official foreign reserves of the Member States,
- to promote the smooth operation of payment systems.
-

Moreover Article 219 points out²⁹:

(1). By way of derogation from Article 218, the Council, either on a recommendation from the European Central Bank or on a recommendation from the Commission and after consulting the European Central Bank, in an endeavor to reach a consensus consistent with the objective of price stability, may conclude formal agreements on an exchange-rate system for the euro in relation to the currencies of third States. The Council shall act unanimously after consulting the European Parliament and in accordance with the procedure provided for in paragraph 3. The Council may, either on a recommendation from the European Central Bank or on a recommendation from the Commission, and after consulting the European Central Bank, in an endeavor to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the euro within the exchange-rate system. The President of the Council shall inform the European Parliament of the adoption, adjustment or abandonment of the euro central rates.

(2). In the absence of an exchange-rate system in relation to one or more currencies of third States as referred to in paragraph 1, the Council, either on a recommendation from the Commission and after consulting the European Central Bank or on a recommendation from the European Central Bank, may formulate general orientations for exchange-rate policy in

29 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», pages 3-4



relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.

(3). By way of derogation from Article 218, where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the Union with one or more third States or international organizations, the Council, on a recommendation from the Commission and after consulting the European Central Bank, shall decide the arrangements for the negotiation and for the conclusion of such agreements. These arrangements shall ensure that the Union expresses a single position. The Commission shall be fully associated with the negotiations.

(4). Without prejudice to Union competence and Union agreements as regards economic and monetary union, Member States may negotiate in international bodies and conclude international agreements.

2. The second group contains the other (**non-basic**) ECB tasks set out in the TFEU, such as³⁰:

- the exclusive right to authorize the issue of banknotes denominated in euro according to Article 128(1) TFEU, and the approval of the volume of euro coins issued by Member States (Article 128(2) TFEU), these paragraphs on this Article point out :
- (1). The European Central Bank shall have the exclusive right to authorize the issue of euro banknotes within the Union. The European Central Bank and the national central banks may issue such notes. The banknotes issued by the European Central Bank and the national central banks shall be the only such notes to have the status of legal tender within the Union.
- (2). Member States may issue euro coins subject to approval by the European Central Bank of the volume of the issue. The Council, on a proposal from the Commission and after consulting the European Parliament and the European Central Bank, may adopt measures to harmonize the denominations and technical specifications of all

30 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», pages 3-4



- coins intended for circulation to the extent necessary to permit their smooth circulation within the Union.
- the contribution to the smooth conduct of policies pursued by the (national) competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system according to Article 127(5) TFEU, and the collection of statistical information according to Article 5 of the Statute, which points out :
 - (1). The Member States shall coordinate their economic policies within the Union. To this end, the Council shall adopt measures, in particular broad guidelines for these policies. Specific provisions shall apply to those Member States whose currency is the euro.
 - (2) The Union shall take measures to ensure coordination of the employment policies of the Member States, in particular by defining guidelines for these policies.
 - (3). The Union may take initiatives to ensure coordination of Member States' social policies.
3. The third group consists of the specific tasks conferred on the ECB under Article 2 of Council Regulation (EU) No 1096/2010 (based on Article 127(6) TFEU as well). These tasks concern **the macro-prudential**³¹ oversight of the EU financial system in the context of the functioning of the European Systemic Risk Board (the 'ESRB') established by Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010, which is one of the components of the European System of Financial Supervision (the 'ESFS').
4. Finally, the fourth group comprises the specific tasks conferred on the ECB under the SSMR concerning the **micro-prudential**³² supervision, within the SSM, of certain types of financial firms and predominantly credit institutions.

31 The tasks of ECB are available at <http://www.ecb.europa.eu/ecb/tasks/html/index.en.html>

32 The tasks of ECB are available at <http://www.ecb.europa.eu/ecb/tasks/html/index.en.html>



Chapter 3: Exploring the “nexus” between monetary policy & banking supervision on the euro - area : Interaction between these 2 functions & Conflicts of interest may arise

Supervision and monetary policy are completely different functions in many respects, e.g. the nature of the decisions that are taken, the background information needed to take them, their implementation, the qualifications of the staff that is needed, etc.

Monetary policy³³, at least in normal times, required only relatively infrequent decisions about one variable, namely the interest rate that the ECB sets on its main refinancing operations. This decision was then implemented uniformly throughout the system by the National Central Banks (NCBs), which all just changed essentially one element in their computer code. The NCBs thus had no discretion in how to implement monetary policy decisions. Moreover, central banks do not change their interest rate daily, but at most with a monthly frequency. Monetary policy could thus be decided by a body that does not need to manage ‘*hands on*’, but that meets only every second week and has essentially then one big decision to take (whether to change rates).

The staff of the ECB had naturally a key role in preparing the material for taking monetary policy decisions (inflation and general economic outlook), but the staff of the ECB did not have to manage on a daily basis the actual implementation, which could be left to the NCBs. The latter had no leeway in this matter in any event. With the crisis, the nature of monetary policy has of course changed somewhat. For example, collateral requirements had to be changed frequently and the use of new collateral has to be monitored. But even here there is little need to take frequent decisions on specific cases as the collateral rules are set in such a way (mainly ratings requirements) that the staff of the ECB only has to check the fulfilment of the formal requirements.

The ECB **monetary strategy** aims at firmly anchoring inflation expectations, based on a “consistent and systematic method for conducting monetary policy” with a medium-term reference time horizon, and clear and open communication to the public of its goals and the underlying analysis. However, while the inflation forecast is central in the policy analysis and

33 Daniel Gros (2012), The Single European Market in banking in decline – ECB to the rescue? , available at <http://voxeu.org/article/single-european-market-banking-decline-ecb-rescue>



discussions, both within the ECB governing bodies and public presentations, the ECB does not adhere to a formal inflation targeting strategy – entailing quasi-automatic reactions to deviations of forecast inflation from the target over a predetermined time horizon. Rather, it bases its actions on a more flexible strategy both as regards the economic variables taken into consideration and the relevant time horizon for responding to shocks in the economy. Thus, in assessing the appropriate response to a price shock or an emerging threat to price stability, the sources and the nature of the shock may entail different responses. In this context, the ECB has always included financial stability among the factors to be taken into consideration, owing to the potential impact of financial imbalances on output and price developments. Therefore, while there is no formal targeting of monetary aggregates, a monetary pillar in its strategy allows it to ‘lean against the wind’ of building imbalances, such as an excessive money and credit creation or asset price increases³⁴.

The second pillar, the operational framework, is the set of instruments and procedures to achieve the desired interest rate. The ESCB Statute (Article 18) provides that, in order to carry out the tasks of the ESCB, the ECB and NCBs may: (i) buy and sell outright (spot and forward) or under repurchase agreements and lend or borrow any type of marketable instruments (therefore including sovereigns) in any currency as well as precious metals; and (ii) conduct credit operations with credit institutions and other market participants, with lending based on adequate collateral³⁵.

The credit institutions of the euro area are also required to maintain minimum reserves on their current accounts at the Euro-system – currently, 1% of deposits and debt securities with maturity up to two years – with the twin purpose of stabilizing money market interest rates and maintaining a ‘structural’ liquidity scarcity in the banks so as to strengthen the ECB’s ability to steer rates with open market operations.

The Governing Council may also decide, by a two-thirds majority of the votes cast, to use other operational methods of monetary policy “as it sees fit” (Article 20 ESCB Statute), while always respecting its primary goal of price stability. The decisions of the Governing Council on

34 Daniel Gros (2012), The Single European Market in banking in decline – ECB to the rescue? , available at <http://voxeu.org/article/single-european-market-banking-decline-ecb-rescue>

35 Ibid



monetary policy instruments and procedures are formalized in the Guideline of the ECB, which is published in the Official Journal of the European Union.

In the Continental tradition of bank-based financial systems, the Euro-system operations mainly consist of bank refinancing facilities, mostly in the form of *reverse* transactions granted against *eligible* collateral: up until the financial crisis, they comprised the short-term (MROs, one week) and the long-term refinancing operations (LTROs, three months), fine tuning operations (non-standard duration, also including collection of fixed-term deposits and foreign exchange swaps), issuance of ECB debt certificates (to drain liquidity), and standing facilities at the disposal of banks to draw or deposit funds overnight to smooth liquidity (the marginal lending and deposit facility). Reverse transactions minimize the market and credit risks taken by the ECB. Once the financial crisis struck, special instruments and facilities were introduced, both for refinancing banks under stress for longer periods and for purchasing private and sovereign securities outright.

The MROs are the main **monetary policy instruments**, and the interest rate charged on these operations is the key official reference rate. The rate charged on marginal lending – available overnight for unlimited amounts (against adequate collateral) for eligible counterparties on their own initiative – and the rate paid on banks’ deposits in the standing deposit facility effectively set a ceiling and a floor, respectively, for the overnight money market rate, and hence the corridor within which this rate may fluctuate. The reference overnight market interest rate is the EONIA, or euro overnight index average of overnight rates in euro-zone money markets, leaving room for other money market rates to adjust in response³⁶.

Eligible collateral is defined in a *single list* of assets, covering marketable and non-marketable instruments that fulfil uniform euro-wide criteria specified by the ECB (non-marketable instruments cannot be used for overnight operations). Eligible counterparties in the Euro-system monetary operations are credit institutions subject to the system’s minimum reserve requirements and to supervision ‘of high quality’ by at least one national authority of a participating country.

36 Di Noia, C. and G. Di Giorgio (1999): *Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?*, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>

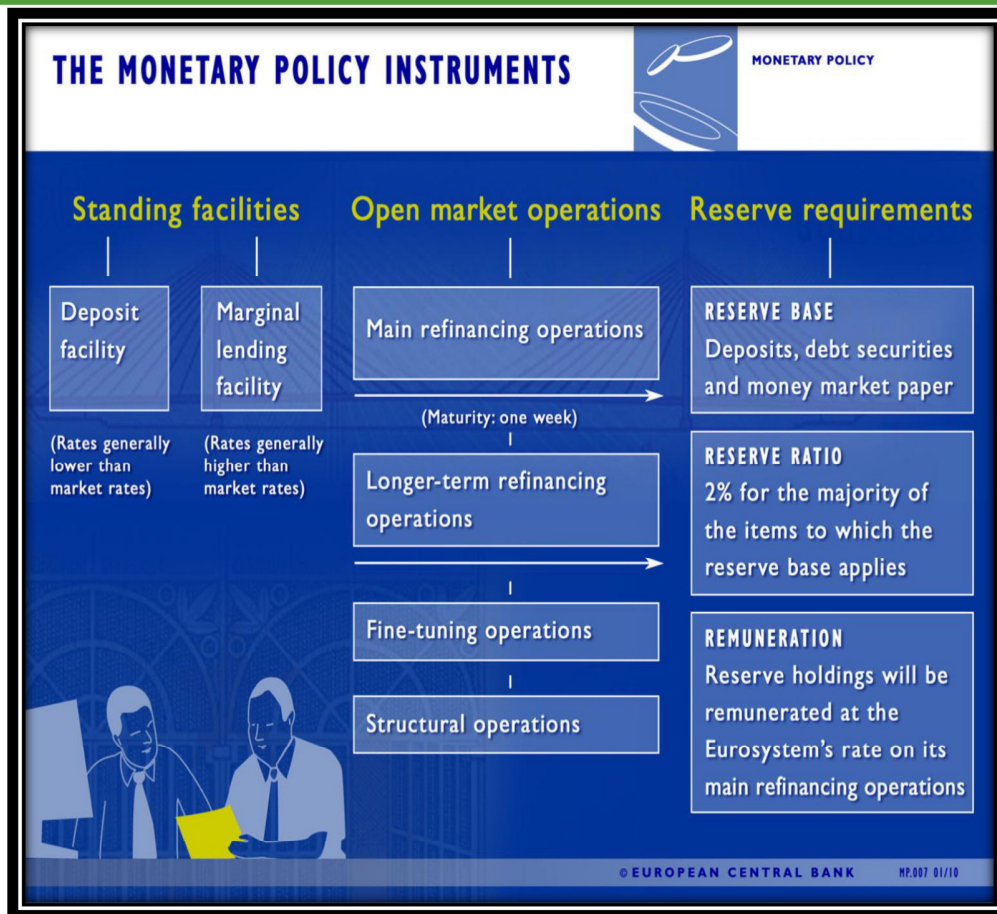


The panoply of instruments is completed by the lines of Emergency Liquidity Assistance (ELA) established with the NCBs to assist individual banks facing temporary liquidity problems; therefore, these lines are in principle not available to insolvent banks – although distinguishing between illiquidity and insolvency may not be easy in the presence of a systemic shock to the banking system. Up until the inception of the SSM, the decision to intervene was left to the NCBs, except when there was a Troika assistance program – in which case the ECB would also come in to assess the state of the banks. The collateral requirements were set by the NCBs, normally with less demanding standards than the ECB's. These lending-of-last-resort functions were functionally related to the NCBs' supervisory responsibilities, and as such not part of the single monetary policy. However, the ECB was to be fully and timely informed of their beneficiaries, size and timing; and the Governing Council could restrict these operations if it considered that they interfered with the monetary policy tasks of the Euro-system (acting by a two-thirds majority of the votes cast).³⁷

As may be seen, the Euro-system possesses all the policy tools normally available to a central bank, with ample room for "manoeuvre" on how to deploy them. However, their actual use is subject to political constraints, reflecting the goals assigned to the Euro-system by the Treaty. As we shall see, this became a source of serious difficulty when the Euro-system had to confront the need to intervene as lender of last resort in the government bonds markets.

37 Di Noia, C. and G. Di Giorgio (1999): Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>





Supervision is totally different from monetary policy in these practical aspects. Supervision is by nature an activity that requires hands-on management with thousands of detailed information to be collected. During normal times, when the financial system is stable, few decisions have to be taken as supervisors try not to interfere with the daily business of their banks. But during a crisis major decisions on individual banks have to be taken almost daily. This requires more than broad rules and guidelines. Interpretation of the rules and the way they are applied then become crucial. It follows that the SB will have little influence if it meets with the same frequency as the Governing Council (once every second week). Supervision can be said

to be exercised by the ECB only if it is done directly by ECB personnel. Very little will change if the SB simply elaborates general guidelines for national supervisors³⁸.

Finally it usually argued that supervision can have immediate fiscal implications. Bini-Smaghi (2012a and 2012b) argues that this is also the case for monetary policy in general. This is true and in terms of the size of the fiscal consequences of potential mistakes there might be little difference, as an increase in interest rates can cost a government much more than a bank rescue operation.

But the **important difference between monetary policy and supervision** is that the fiscal implications of monetary policy are much more diffuse and arise throughout the euro area as a by-product of standard monetary policy operations, whereas the fiscal implications of supervision are much more direct and concentrated in perhaps only one Member State (e.g. the decision to close down a bank or the failure to detect excessive lending). Moreover, supervision affects the interests of a wide variety of interests much more directly than monetary policy operations, whose impact is in general rather diffuse³⁹.

Linkages between the traditional central banking functions (in particular, monetary policy) and banking supervision have been deeply analyzed over many decades. More recently, financial stability considerations have gained importance, especially as a consequence of the major financial and economic crisis that has affected the industrialized world since 2007. In this regard, macro-prudential policies have emerged as a crucial item in the policy-makers' toolkit.

It is well documented that keeping monetary policy and banking supervision decision-making processes apart is highly beneficial as this minimizes conflicts of interest. Countries have approached this *separation principle* in a variety of ways, designing different institutional structures. Even when banking supervision has been assigned to the central bank, it has been well understood that supervision and central banking functions belong to very different realms, each requiring its own particular analytical approaches and decision-making processes. All these caveats have been duly taken into account in the design of the SSM which the ECB is set to perform as from November 2014.

38Di Noia, C. and G. Di Giorgio (1999): Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>

39Ibid



However, the question of the best reporting framework to support monetary policy and banking supervision has not, until recently, received enough attention in this long-standing debate. This is striking since a large part of the data used for both these functions stem from the same reporting entities (the banks) and are grounded in the same raw material (mainly financial instruments). In spite of this coincidence in the reporting sources and their content, the reporting models in those fields have often been largely disconnected, although some work has been done in the last few years to reduce the differences. As a result, banks have been asked to deliver information in accordance with certain rules, templates and schedules for monetary policy uses while, at the same time, somewhat similar data have been required for banking supervision, although with different definitions for similar concepts (for instance, short positions are deducted directly from debt securities held, for monetary purposes, while they are reported separately for supervisory purposes), different measurement criteria (e.g. loans and deposits are measured at nominal value for monetary purposes and by their carrying amount for prudential purposes) and different levels of detail (e.g. the breakdown of the institutional sector)⁴⁰.

This situation notably increases the burden on banks to comply with such reporting requirements, as well as the resources devoted by central banks and supervisors to the collection, checking and analysis of the incoming data. Moreover, it has become increasingly clear that the (mainly) macro perspective of monetary policy data is useful for supervisors and that the typically more granular supervisory data can be helpful for assessing the macroeconomic situation and the monetary policy transmission mechanism. Again, both worlds are intertwined.

Accordingly, it seems clear that the different perspectives of central banking and supervisory functions should not prevent policy-makers from exploiting all the information synergies we can find. In particular, we should ensure that an efficient system to collect financial information is in place, as this will allow us to minimize costs, better allocate the available resources and facilitate the circulation of information to the interested stakeholders, thus enhancing the decision-making processes in both policy areas.

40 Di Noia, C. and G. Di Giorgio (1999): Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>



The most commonly cited argument against central banks being bank supervisors, an argument apparently accepted by the European Commission (2012) is that there is a potential **conflict of interest between the goals of monetary policy and banking supervision**. Banks tend to benefit from low short-term interest rates and an upward-sloping yield curve as it allows them to pay low short-term rates on liabilities and earn higher long-term rates on their assets. Thus, as documented by Goodhart, the claim is often made that monetary policy decisions can be distorted by a central bank having close involvement with the banking sector because it sometimes leads to central banks setting low interest to assist weak banks.

A number of points are worth making about this as a potential conflict of interest⁴¹. First, the fact that central banks have been observed keeping policy rates low when banking sectors are weak does not mean there has been a conflict of interest. As noted above, a weak banking sector tends to increase the cost of credit to the private sector and to reduce the supply of such credit. A central bank focused on reaching a medium-term inflation target will have to take such weakness into account when setting monetary policy. Even if a central bank has no explicit supervisory role, it may react to banking weakness by adopting looser policy as well as specific measures aimed at combating weakness in the banking sector. So removing bank supervision from the central bank is unlikely to end the linkage between monetary policy and financial sector health that apparently bothers those who wish to see a separation. Conversely, access to the information obtained in the supervisory process can only help with calibrating monetary policy during periods of banking weakness.

Second, one can point to arguments against the common presumption that the involvement of central banks means a less stringent approach to banking supervision (and thus an increased risk of moral hazard). As Andrew Crockett outlined in his description of macro-prudential policy, a central bank that is monitoring the financial system during a lending boom should be able to detect weaknesses that may not be obvious to individual supervisors. When asset prices are high and default rates are low, standard supervisory diagnostics can suggest that all the institutions in the financial system are well capitalized. Indeed, as pointed out by

41 Di Noia, C. and G. Di Giorgio (1999): Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>



Danielsson (2001), the reliance of the Basle capital adequacy regulations on credit agency ratings and on Value-at-Risk calculations that use short samples introduces a pro-cyclicality into risk-weighted capital ratios that can leave banks surprisingly short of capital when a boom turns into a recession⁴².

An examination of the risks at a macroeconomic level can reveal fragilities not picked up by measuring the capital position of individual banks. While macro-prudential policies have not featured heavily in central bank thinking in the past, there are good reasons to hope that the involvement in banking supervision of central banks that have a wider view of the economy and the financial system will, in future, result in tighter supervision of banks during booms.

Recently, Bundesbank president, Jens Weidmann has discussed a slightly different version of the '*conflicts of interest*' idea. In a recent article in Handelsblatt, Weidmann (2012) asserts that supervision needs to be separated from monetary policy because otherwise a central bank could not '*stand the heat*' associated with debt crisis. Implicitly, it appears that Weidmann believes that an ECB tasked with supervising banks would be an ECB that fails to meet its inflation target.

The ECB has the maintenance of price stability as its primary objective. Despite its involvement in many other activities and despite the legal requirement to '*support the general economic policies*' of the EU (without prejudicing price stability) there has been no reason to question the ECB's commitment to price stability. It is hard to see why the addition of bank supervisory tasks would undermine this commitment.

An argument discussed by Goodhart⁴³ and, more recently, by Eijffinger and Nijskens (2012) is that taking on banking supervisory tasks could damage the central bank's reputation for achieving its inflation goals. As Goodhart puts it '*A supervisor is only noticed when either he/she angers the regulated by some restrictive or intrusive action, or when supervision 'fails' in the sense that a financial institution collapses or a customer gets ripped-off ... If an independent*

42 Di Noia, C. and G. Di Giorgio (1999): Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>

43 Goodhart, C.A.E. and D. Schoenmaker (1993): Institutional Separation between Supervisory and Monetary Agencies, in Goodhart, C.A.E. (1993, editor): The Central Bank and the Financial System, Macmillan Press, London



*Central Bank feels the need to achieve credibility and a good reputation, then being yoked with simultaneous responsibility for banking supervision may not be advisable.*⁴⁴

An argument that has been expressed in recent months for why the ECB should not be involved in banking supervision is that supervisors need to be accountable to politicians. This argument suggests that because bank failures can lead to losses for taxpayers via deposit insurance or recapitalization requirements, there is a need for political oversight. In contrast, the ECB's monetary policy is legally independent of politicians. Taken together, these points could suggest that the ECB is not an appropriate body for taking on the task of bank supervision.

There are a number of problems with this argument. First, the fact that public money is at risk does not actually distinguish banking supervision from monetary policy. Money created by the Euro-system in monetary policy operations could be used for other purposes, such as direct acquisition of securities and profits made by central banks are generally passed back to national treasuries. For this reason, one can just as easily argue that the ECB's monetary policy operations place large amounts of public money at risk and yet it is widely agreed that these operations should be free from political control. Second, as former ECB Executive Board member Lorenzo Bini Smaghi (2012) discusses in a recent Financial Times article, political control over the bank supervisors can have negative consequences. As he puts it: *'Bank supervisory authorities that are not sufficiently independent, and are too closely associated with the political authorities, are generally under pressure to delay the identification of insolvent banks, for the fear that taxpayers would get upset. The problem thus tends to be postponed, and the cost to the taxpayer rises. The experience of the recent crisis has shown that taxpayers have paid most in countries where supervision was less independent and where the political authorities are most closely associated with the banking system.'* For these reasons, it is best to have limits placed on the involvement of politicians in overseeing bank supervisors⁴⁵.

Third, the type of oversight that is perhaps most desirable—the requirement that the heads of the supervisory authority are asked to appear in public and explain their performance to publicly-elected representatives—already exists for the ECB. Political independence is not the

44 Ibid

45 Daniel Gros (2012), The Single European Market in banking in decline – ECB to the rescue? , available at <http://voxeu.org/article/single-european-market-banking-decline-ecb-rescue>



same thing as never having to explain your actions and Mario Draghi's press conferences and appearances at the ECON committee provide a clear model for how an ECB-centered banking supervisor could communicate its decisions to the public.

Another theme in this debate is the idea that the combination of banking supervision and monetary policy leads to an organization that is simply too large to function effectively, i.e. that economies of scope dictate the need for separation. This aspect of the debate about the appropriate structure for supervision goes back to regulatory changes that took place in the 1980s and 1990s. Deregulation around the world changed the nature of the leading financial institutions. Instead of clearly-defined separate industries dedicated to banking, insurance, asset management, equity issuance and so on unitary financial institutions emerged that undertook all of these activities under one roof. This meant there would be multiple regulators examining different parts of a single institution's business, perhaps without any of them being able to step back and assess the institution's soundness as a whole or its impact on the financial system⁴⁶.

As Goodhart ⁴⁷discusses in detail, these considerations lead to proposals for the introduction of supervisory organizations tasked with overseeing the whole financial system. Because many of the activities overseen by unified financial supervisors would lie outside the scope of traditional central bank activities, some argued that this provided a case for removing supervision from central banks. A unitary organization that attempted to implement monetary policy, banking supervision, non-bank financial supervision and consumer protection and regulation could possibly be too large to function efficiently.

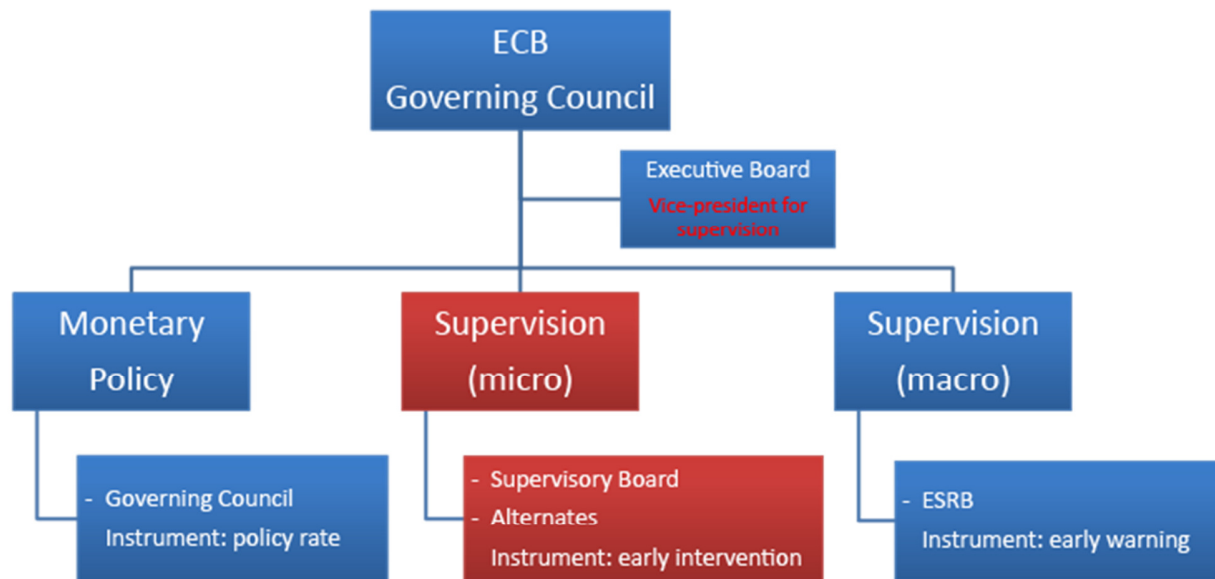
For a number of years, this argument gained traction around the world. As documented by Masciandaro and Quintyn (2009) the introduction of unified financial supervisors located outside central banks accelerated in the period prior to 2007. A number of Scandinavian countries lead the way in introducing these agencies in the 1980s but the UK's creation of the Financial Services Authority (FSA) in 1997 appears to have been particularly influential in triggering reform in supervisory structures around the world.

46 Daniel Gros (2012), The Single European Market in banking in decline – ECB to the rescue? , available at <http://voxeu.org/article/single-european-market-banking-decline-ecb-rescue>

47 Goodhart, C.A.E. and D. Schoenmaker (1993): Institutional Separation between Supervisory and Monetary Agencies, in Goodhart, C.A.E. (1993, editor): The Central Bank and the Financial System, Macmillan Press, London



Chapter 4: The rationale for the separation of these 2 functions & the absolute necessity for the creation of “Chinese walls”



The Euro Area Summit Statement issued in the context of the European Council meeting for 29 June 2012 declared: 'We affirm that it is imperative to break the vicious circle between banks and sovereigns. The Commission will present Proposals on the basis of Article 127(6) for a single supervisory mechanism shortly. We ask the Council to consider these Proposals as a matter of urgency by the end of 2012.'

In response, the Commission published in September 2012, a legislative proposal on the Single Supervisory Mechanism (SSM). In this proposal it is foreseen that the responsibility for supervision should come under a new 'Supervisory Board', to be created within the ECB. This new board would have six members from the ECB: a President and a Vice-President plus four other members. In addition, the other members of the Supervisory Board should represent national supervisors.

The proposal by the Commission says that a 'representative of each national central bank or other national competent authority' will sit on the Supervisory Board (SB) to be created within the ECB: '[T]he Chair of the supervisory board will be selected from the Members of the

Executive Board [...].The supervisory board will be led by a Chair and Vice Chair elected by the ECB Governing Council and composed in addition to them of four representatives of the ECB and of one representative of each national central banks or other national competent authority'.

In more than one-half (11 out of 17) of all euro area Member States, the central bank is also the supervisor, that is, the 'national competent authority' as defined under EU rules. The SB will thus be composed largely of representatives of the same institutions which also numerically dominate the Governing Council (GC), namely the National Central Banks (NCBs). This domination of both boards by representatives of NCBs might be slightly decreased if there were the full participation of the non-euro area group of countries. Five out of nine would delegate a member of their national financial supervisory authority (FSA)⁴⁸.

However, the individuals who sit on the two boards might still be different because only the governors of NCBs sit on the Governing Council while the existing legislative proposals suggest that somebody else might represent the NCBs on the SB. The key practical question that arises is whether many central banks will have two different representatives within the ECB: one for the GC (the governor) and somebody else for the SB (e.g. the vice governor or whoever is responsible for supervision). The two individuals will work most of their time in the same institution (probably also in the same building) and one (the governor) is hierarchically superior to the other (the head of supervision). It is difficult to imagine that these two individuals will not be in constant contact, thus rendering any **Chinese walls** between the GC and the SB somewhat permeable⁴⁹.

The presence of representatives of other institutions on the SB raises a delicate problem of independence. For example in Germany supervision of banks and insurance companies is the responsibility of the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). In reality supervision is executed together with the Bundesbank, whose staff participates in most on-site inspections and which prepares many of the reports. The Bundesbank has thus automatically an intimate knowledge of the state of the financial system and de facto has access to all necessary detailed information which is often highly confidential.

48 Beck, Th. and D. Gros (2013): Monetary Policy and Banking Supervision: Coordination Instead of Separation, CEPS Policy Brief No. 286, available at: <http://ssrn.com/abstract=2189364>

49 Beck, Th. and D. Gros (2013): Monetary Policy and Banking Supervision: Coordination Instead of Separation, CEPS Policy Brief No. 286, available at: <http://ssrn.com/abstract=2189364>



One problem this raises is that BaFin (like other supervisors) is not independent from the German Finance Ministry (in German BaFin is 'weisungsgebunden'). This means that some members of the Supervisory Board will not be independent. Another problem is that in the countries where supervision does not reside in the central bank, the supervisors have other tasks, such as supervising insurance institutions or consumer protection.

Gros (2012) has shown how national supervisors have a natural incentive to '*ring fence*' the banks under their watch, i.e. national supervisors actively encourage '*their*' banks to reduce their cross-border exposure. This segmentation of the euro area's financial markets is one key cause of the crisis because it means that the savings surpluses of countries like Germany or the Netherlands can no longer be recycled to those countries with a current account deficit and even the existing stocks of cross-border liabilities cannot be rolled over in the market. In some cases supervisors in savings surplus countries have even de facto prevented the local subsidiaries of cross-border banks to fund their headquarters located in countries under financial stress⁵⁰.

As long as resolution (and deposit insurance) remains totally national, the incentives of the national supervisory agencies (mostly central banks, except in Germany, whose savings surplus is a lynchpin of the euro area economy) will continue to be to ring fence because any losses abroad might lead to costs for them (or rather their own governments). Delegating supervision to the supra-national level but without a concomitant move of resolution powers will thus not help address the current crisis or change anything fundamentally in the set-up of the currency union. Some observers have even argued that this partial banking union might make things worse (Wyplosz, 2012).

The limited access to information is the most important problem whose solution would be hampered by Chinese walls. At present, the ECB can only observe that a number of banks have become dependent on its funding. Moreover, some have even needed Emergency Liquidity Assistance (ELA). Both developments are in general a sign of weakness, but the ECB has no way of knowing how weak or strong these institutions are in reality. Only the national central bank of the home country of these institutions has all the required information in its possession.

50 Lastra, R.M. (2013): Banking Union and Single Market: Conflict or Companionship?, Fordham International Law Journal, Volume 36, pages. 1189-1223



But this information is not shared. National central banks have an obvious interest in championing the interests of their banks and thus are not unbiased judges of the health of their banking system or of the quality of the collateral that their banks use for ELA. ECB staff has no access to any confidential supervisory information and cannot thus form its own independent view of the health of the euro area's banking system. The other members of the Governing Council (i.e. the governors of the NCBs) also do not have access to any information about the state of the health of banks in other countries and they naturally mistrust the judgment of their colleagues. This makes it of course very difficult for the Governing Council to form an unbiased opinion of the degree of financial market stress (and the measures needed to stem the crisis)⁵¹.

Separation between monetary policy and supervisory tasks was necessary. Supervisory tasks should be carried out in full separation from monetary policy, in order to avoid conflicts of interest and to ensure that each function is exercised in accordance with the applicable objectives. The separation principle covers, among other things, the separation of objectives, the separation of decision-making processes and tasks, including the organizational and procedural separation at the level of the Governing Council.

In early 2014 the ECB implemented a series of measures to achieve organizational and procedural separation, particularly regarding the separation of decision-making for the two policy functions. An independent Supervisory Board was established – separate from the ECB's Governing Council – to draft and implement decisions. Moreover, the ECB's Rules of Procedure were amended to regulate organizational and procedural aspects related to the Supervisory Board and its interaction with the Governing Council. This included the rule that the Governing Council's deliberations on supervisory matters would be kept strictly apart from those on other issues, with separate agendas and meetings.

Separation at the staff level has also been ensured by the establishment of four directorates general and a Secretariat to the Supervisory Board, which report functionally to the Chair and Vice-Chair of the Supervisory Board. ECB Decision on separation between the monetary policy and supervision functions The SSM Regulation furthermore requires the ECB to

51 Lastra, R.M. (2013): Banking Union and Single Market: Conflict or Companionship?, Fordham International Law Journal, Volume 36, pages. 1189-1223



adopt and publish any necessary internal rules to ensure the separation between the supervisory function on the one hand and monetary policy functional areas and other tasks of the ECB on the other, including rules regarding professional secrecy and information exchanges. On 17 September 2014 the ECB adopted a Decision on the implementation of separation between the monetary policy and supervision functions of the ECB (Decision ECB/2014/39), which entered into force on 18 October 2014.

The Decision focuses on general principles, allowing for further specific arrangements with regard to internal procedures. It contains, in particular, provisions relating to organizational aspects and the exchange of information between the two policy areas. With regard to the organizational separation, the Decision provides that the ECB may establish shared services providing support to both the monetary policy and the supervisory function to ensure that these support functions are not duplicated, thus helping to guarantee the efficient and effective delivery of services, provided that such support will not lead to conflicts of interest.

As regards the exchange of information, the rules on information sharing between the functions set out in the Decision allow the ECB to fulfil its multiple tasks in an effective and efficient manner while at the same time avoiding undue interference from one function to another and sufficiently protecting confidential information. In particular, the Decision states that the ECB's confidentiality regime constitutes the main framework for classifying and sharing information within the ECB. The sharing of confidential information must always be conducted on a need-to-know basis and must ensure that the policy objectives of the two policy areas are not compromised. In the event of a conflict of interest, the Executive Board should decide on access rights to confidential information. In respect of the exchange of confidential information between the monetary policy and supervisory functions, the Decision stipulates that anonymized FINREP and COREP data, as well as confidential aggregated information (containing neither individual bank information nor policy-sensitive information), may be shared in accordance with the confidentiality regime. In respect of raw data, such as individual supervisory banking data and assessments (particularly with regard to individual institutions or policy-sensitive information), access will be more restricted and subject to approval by the Executive Board. The ECB is implementing the internal framework for the exchange of information. All in all, the



ECB now has a very solid framework for preventing conflicts of interest between its monetary policy and micro-prudential tasks.

In the author's (Dr. Christos V. Gortsos) view⁵², the creation of 'Chinese walls' within the ECB is an essential element in order to ensure the effective separation of its monetary and other tasks from its (future) supervisory tasks.

Here, it is worth noting that although micro-prudential supervision over credit institutions has historically been the main competence of central banks in many countries (with the exception of a few central European states), in the course of the last twenty years, an ever increasing number of countries across the world have assigned this supervision to independent authorities other than the central bank. This was based on the thought that the exercise of supervisory powers by the central bank may give rise to conflicts of interest as far as the achievement of its monetary objectives is concerned (not least in terms of maintaining price stability). In any event, this trend tends to be reversed in the aftermath of the recent international financial crisis as a result of the relevant failures attributed to independent supervisory authorities in many states⁵³.

In conclusion, for the above purposes, the ECB will have to adopt and make public any necessary internal rules, including rules regarding professional secrecy and information exchanges between the two functional areas. There must be quite an efficient planning of the institutional, organizational and operational framework governing the ECB's exercise of supervisory tasks over euro area credit institutions, including mainly 'Chinese walls' in order to ensure that the ECB's stature as an institutional body is fully safeguarded. At the end of the day, the onus of the successful performance of these tasks will be on the ECB itself.

Chapter 5: The regulatory framework governing the "Chinese walls" within the European Central Bank (ECB) – Solution and limits needed to be set

52 Christos V. Gortsos (2015a) : The 'single supervisory mechanism': a major building-block towards a European Banking Union (the full europeanization of the 'bank safety net'), Athens

53 Ibid



5.1: General provisions assisted from the *Single Supervisory Mechanism* (SSM) regulation

The principle of separation of monetary policy and micro-prudential supervisory tasks of the ECB (due to the difference of their objectives as already mentioned), by creating ‘Chinese walls’ within it, is established in **recital 65 SSMR**. It reads as follows: *“The ECB is responsible for carrying out monetary policy functions with a view to maintaining price stability in accordance with Article 127(1) TFEU. The exercise of supervisory tasks has the objective to protect the safety and soundness of credit institutions and the stability of the financial system. They should therefore be carried out in full separation, in order to avoid conflicts of interests and to ensure that each function is exercised in accordance with the applicable objectives. The ECB should be able to ensure that the Governing Council operates in a completely differentiated manner as regards monetary and supervisory functions. Such differentiation should at least include strictly separated meetings and agendas⁵⁴.”*

In this respect, **Article 25 SSMR** lays down the following two rules⁵⁵:

1) When carrying out the specific supervisory tasks conferred upon it by the SSM Regulation, the ECB must *“pursue exclusively the objectives set therein”* in accordance with Article 1 (first sub-paragraph)⁵⁶.

2) The ECB must also carry out these tasks ‘separately’ from both its tasks relating to the definition and implementation of the single monetary policy (in accordance with Article 127(2), first indent TFEU) and its other tasks⁵⁷. In particular : The specific supervisory tasks should neither interfere with, nor be determined by, its tasks relating to monetary policy. They should also not interfere with its tasks in relation to the ESRB or any other tasks. For the sake of accountability, the ECB must report to the European Parliament and to the Council with regard to its compliance with this provision. Moreover the tasks should not alter the ongoing monitoring

54 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», pages 6-7

55 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», pages

56 SSMR , Article 25 (1)

57 SSMR, Article 25 (2)



of the solvency of its monetary policy counterparties⁵⁸. Finally, the staff involved in carrying out these tasks must be organisationally separated from, and subject to, separate reporting lines from the staff involved in carrying out other tasks conferred on the ECB. **Recital 66** states on this: *“Organisational separation of staff should concern all services needed for independent monetary policy purposes and should ensure that the exercise of the tasks conferred by this Regulation is fully subject to democratic accountability and oversight as provided for by this Regulation. The staff involved in carrying out the tasks conferred on the ECB by this Regulation should report to the Chair of the Supervisory Board.”*

It is also worth mentioning that Article 3 of the Code of Conduct for the members of the Supervisory Board on ‘separation from the monetary policy function’ provides that members of the Supervisory Board and other participants in its meetings must respect the separation of the ECB’s specific tasks concerning policies relating to micro-prudential supervision from its tasks relating to monetary policy, as well as other tasks, and comply with internal ECB rules on this separation adopted pursuant to Article 25(3) SSMR. In the performance of their tasks, these persons must take into account the objectives set by the SSMR and not interfere with other ECB tasks.

In order to comply with these two rules, the ECB was required to adopt and make public any necessary internal rules, including rules regarding professional secrecy and information exchanges between the two functional areas. The relevant rules are set out in the ECB Decision 2014/723/EU of 17 September 2014 “on the implementation of separation between the monetary and supervision functions of the European Central Bank” (ECB/2014/39).

In addition, it should establish a ‘Mediation Panel’⁵⁹. The ECB should also ensure that the operation of the Governing Council is completely differentiated as regards monetary and supervisory functions (including strictly separated meetings and agendas). In this respect, Article 131 of the ECB Rules of Procedure provides for the following: the Governing Council meetings regarding the supervisory tasks must take place separately from the regular Governing Council meetings and have separate agendas. On a proposal from the Supervisory Board, the Executive

58 European Central Bank (2011): Monetary Policy of the ECB, European Central Bank, third edition, May, pages 96-97

59 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», page 13



Board must draw up a provisional agenda and send it, together with the relevant documents prepared by the Supervisory Board, to the members of the Governing Council and other authorised participants at least eight (8) days before the relevant meeting. In cases of emergency the Executive Board must act appropriately having regard to the circumstances. The Governing Council must consult with the Governors of the national central banks of the non-area participating Member States before objecting to any draft Decision prepared by the Supervisory Board that is addressed to the national competent authorities in respect of credit institutions established in such Member States. The same applies where the concerned national competent authorities inform the Governing Council of their reasoned disagreement with such a draft decision of the Supervisory Board. Finally, in principle, the general provisions pertaining to Governing Council meetings laid down in Articles 2-5a of the ECB Rules of Procedure apply also to Governing Council meetings as far as ECB's supervisory tasks are concerned.

5.2: The provisions of the ECB's decision on the implementation of this separation

Regulation (EU) No. 1024/2013 (hereinafter "SSM Regulation") establishes the (SSM) single supervisory mechanism, which comprises the European Central Bank (ECB) and the national competent authorities (NCAs) of participants Member States. In accordance with Article 25 paragraph 2 of SSM regulation, the ECB should exercise its supervisory functions subject and regardless of its tasks relating to monetary policy and any other duties. The ECB supervisory tasks should not interfere with the duties of those concerning monetary policy, nor be defined by them. Moreover, they should not interfere in the duties of those concerning the European Systemic Risk Board (ESRB), or any other tasks. The ECB is required be accountable to the European Parliament and the Council regarding their compliance with the terms of this provision. The performance of the ECB supervisory duties may affect ongoing monitoring the creditworthiness of the counterparties in monetary policy operations. Furthermore, the personnel involved the performance of the ECB supervisory functions should be separated organizationally from the staff participates in the execution of other tasks of the same, and be subject to different requirements for accountability.



In accordance with Article 25 paragraph 3 of SSM Regulation for the purposes of paragraphs 1 and 2 of that Article the ECB shall adopt and publish the necessary internal rules, including rules for the professional secrecy and the exchange of information between the two functional domains. In accordance with Article 25 paragraph 4 of Regulation SSM, the ECB ensures that a fully differentiated operation of the board in relation, first, to the monetary policy tasks and, second, supervisory tasks. Diversification involves strict separation in terms relevant meetings and agendas.

To ensure separation between monetary policy tasks and supervisory functions, the Article 25 paragraph 5 of SSM Regulation requires the establishment of the ECB mediation committee compromise different views that may be expressed by the competent authorities of the participating Member States in case of objection of the board on a draft decision of the supervisory board. The committee will be composed of one member per participating Member State, chosen by each Member State between members of the board and the supervisory board. The decisions are to be taken by simple majority, each member having one vote. The ECB shall adopt and publish Regulation setting up the mediation committee and the rules of this Regulation.

About organizational separation: The ECB has autonomous decision-making procedures for its supervisory functions and the monetary policy. All work units of the ECB must be placed under the managing direction of the Executive Board, whose competence in respect of the ECB's internal structure and the staff of the ECB must encompass the supervisory tasks. Moreover the ECB staff involved in carrying out supervisory tasks must be organizationally separated from staff participating in other tasks conferred on the ECB. This staff is accountable to the Executive Board regarding organizational, administrative issues and human resource issues, but must be subject to functional reporting to the Chair and the Vice Chair of the Supervisory Board. Exceptionally the ECB may establish shared services providing support to the monetary policy and supervisory function in order to ensure that the exercise of these support functions is not duplicated.

About professional secrecy: The members of the Supervisory Board, the Steering Committee and any substructures set up by the Supervisory Board , ECB staff and seconded staff by participating Member States carrying out supervisory duties are required not to disclose any



information covered by the obligation of professional secrecy, even after cessation of their duties. Persons having access to data covered by EU legislation imposing an obligation of secrecy must also be subject to such legislation. The ECB must subject individuals providing, (directly or indirectly, permanently or occasionally), any service related to the discharge of supervisory duties to equivalent professional secrecy requirements by means of contractual arrangements. Moreover, the rules of professional secrecy laid down in Directive 2013/36 / EU are applicable to the above - mentioned persons. In particular, any confidential information received in the course of their duties may be disclosed only in summary or aggregate form in such a way that individual credit institutions cannot be identified, without prejudice to cases covered by criminal law. However, if a credit institution has been declared insolvent or is being compulsorily wound up, it is acceptable to disclose confidential information, not concerning third parties participation in rescue efforts, but only in civil or commercial proceedings.

About general principles governing the access to information between policy functions and classification: information may be exchanged between the policy functions only if permitted under relevant EU law and notwithstanding Article 4 on professional secrecy. The information, except “ raw data”, which must be classified separately, must be classified according to the ECB’s confidentiality regime, by the ECB policy function owing the information. The exchange of confidential information between the two policy functions must be subject to the governance and procedural rules set out for this purpose, and a “need to know” requirement to be demonstrated by the requesting ECB policy function. Moreover, unless otherwise stated in the ECB Decision 2014\723\EU, access to confidential information by the supervisory or monetary policy function from the respective other policy function must be determined by the ECB policy function owing the information in accordance with the ECB’s Confidentiality Regime. In case of conflict between the two ECB policy functions , this access is decided by the Executive Board in compliance with the principle of separation. Consistency of decisions on access rights and adequate recording of such decisions must be ensured.

About the exchange of confidential information : The ECB's policy functions must disclose confidential information in the form of non-anonymized common reporting (COREP) and financial reporting (FINREP) data, as well as other raw data to the respective other ECB policy function upon request on a “need to know basis “after approval of the Executive Board.



The ECB's supervisory function must disclose confidential information in the form of anonymized common and financial data to the monetary policy function upon request on a need to know basis under reservation of other EU law institutions. Also the ECB's policy function must not disclose confidential information containing assessments or policy recommendations to the respective other policy function, except upon request on a need know basis, and ensuring that each policy function is exercised in accordance with the applicable objectives and the disclosure is expressly authorized by the Executive Board. On the other hand, they may disclose confidential aggregated information containing neither individual banking information nor policy – sensitive information related to the preparation of decisions to the respective other policy function upon a request on a need to know basis and ensuring that each policy function is exercised under the applicable objectives. It is highly important that the analysis of any received confidential information must be conducted autonomously by the receiving policy function in accordance with its objective, and any subsequent decision must be taken solely on this basis. According to Article 7 the exchange of information involving personal data must be subject to applicable EU law on the protection of individuals with the regard to the processing of personal data and on the free movement of such data. Finally Article 8 provides that, notwithstanding Article 6, in an emergency situation as defined in **Article 114 CRD IV** { Article 114(1) CRD IV classifies a situation as an emergency, if it has the potential to jeopardize market liquidity and the stability of the financial system } , an ECB policy function must communicate , without delay, confidential information to the respective other policy function, if that information is relevant for the exercise of its tasks in respect of the particular emergency at hand.

5.3: The Mediation Panel

The rationale for the creation of the Mediation Panel as one of the new bodies set up within the ECB is laid down in recital 73 SSMR: “With a view to ensuring separation between monetary policy and supervisory tasks, the ECB should be required to create a mediation panel. The setting up of the panel, and in particular its composition, should ensure that it resolves differences of views in a balanced way, in the interest of the Union as a whole.” According to Article 25(5) SSMR, the task of this panel is the resolution of differences of views on the part of



national competent authorities of interested participating Member States regarding an objection of the Governing Council to a draft Decision by the Supervisory Board. The ECB should adopt and make public a Regulation setting up the Mediation Panel and its Rules of Procedure. The relevant ECB Regulation (EU) No 673/2014 was adopted on 2 June 2014, entered into force on 20 June 2014, supplements the ECB Rules of Procedure⁶⁰.

Especially: the Mediation Panel is composed of one member per participating Member State. Its Chair is the Vice-Chair of the Supervisory Board, which is not a member in its own right. The members are appointed by each participating Member State from among the members of the Governing Council and the Supervisory Board, the Chair having to facilitate the achievement of an adequate balance. Their mandate expires when they cease to be members of the body from which they were appointed and they must act in the interest of the EU as a whole. Specific rules govern meeting attendance, organization and voting arrangements⁶¹.

A mediation is kick-started when the national competent authority of a participating Member State is concerned by and has different views regarding an objection by the Governing Council to a draft Decision of the Supervisory Board. Such an objection may be subject to mediation only once. In such a case, the following procedure applies⁶²:

- (i) The national competent authority concerned must submit to the Supervisory Board's Secretariat a notice requesting mediation in order to resolve differences, with a view to ensuring separation between monetary policy and supervisory tasks. This notice must be submitted within five (5) working days from receipt of the reasoned objection by the Governing Council, identify that objection, and include a statement on the reasons for requesting mediation. The Secretariat must notify the notice to the Supervisory Board members.
- (ii) Any other national competent authority of a participating Member State concerned by and having different views regarding the same objection may give a separate notice requesting mediation or join an

60 Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism», page 13

61 SSM QUARTERLY REPORT 2014/3 pages 6-8

62 SSM QUARTERLY REPORT 2014/3 pages 6-8



existing request for mediation, within five (5) working days of the notification of the first request for mediation, and state that it has a different view.

- (iii) (iii) The Secretariat of the Supervisory Board must then file the notice requesting mediation with the Secretariat of the Governing Council, within ten (10) working days from receipt of the objection by the Governing Council, annexing to the notice both the relevant draft Decision of the Supervisory Board and the relevant objection by the Governing Council. The notice must also be communicated to the Governing Council and Supervisory Board members.

The above provisions are without prejudice to the procedure according to which a non-euro area participating Member State (which is not represented in the Supervisory Board) notifies the ECB of its reasoned disagreement with an objection of the Governing Council to a draft Decision of the Supervisory Board under Article 7(7) SSMR. In particular, if the competent authority of such a Member State notifies the ECB of its reasoned disagreement pursuant to Article 7(7) it may not request mediation on the same objection. Vice versa, if such a competent authority has requested a mediation regarding an objection by the Governing Council and then notifies the ECB of its reasoned disagreement with the same objection according to Article 7(7) the request for mediation is deemed withdrawn. Accordingly, the procedure under Article 7(7) prevails as “lex specialis”.

Once a notice requesting mediation is filed with the Secretariat of the Governing Council, the Chair of the Mediation Panel must immediately forward it to its members. For each duly filed notice requesting mediation, the panel must set up a Case Committee within five (5) working days of the filing, and inform the Mediation Panel members of its composition.

The *Case Committee* is composed of the Chair of the Mediation Panel acting as its Chair and four (4) other members appointed by the Mediation Panel from among its members. The Mediation Panel must aim to achieve a balance between Governing Council and Supervisory Board members. The Case Committee may not include the member appointed by the participating Member State whose competent authority has expressed different views pursuant to Article 8(1) of the ECB Regulation (EU) No 673/2014 or the member appointed by the



participating Member State whose competent authority has joined an existing request for mediation under Article 8(2) thereof⁶³.

Within fifteen (15) working days from receipt by the Mediation Panel of the notice requesting mediation, the Case Committee must submit to the Chair of the Mediation Panel a draft opinion, which will contain an analysis of whether the request for mediation is admissible and legally founded. The Chair must immediately submit this draft opinion to the Mediation Panel and call a meeting⁶⁴.

After considering the draft opinion of the Case Committee, the Mediation Panel must submit its own opinion to the Supervisory Board and the Governing Council, in principle within twenty (20) working days from receipt of the notice requesting mediation. This opinion, which must be in writing and be reasoned, is not binding either on the Supervisory Board or on the Governing Council⁶⁵.

Upon submission of the Mediation Panel's opinion, it is at the discretion of the Supervisory Board to submit a new draft Decision to the Governing Council, in principle within ten (10) working days from the submission (in urgent cases, the Chair of the Supervisory Board may decide to shorten this period). A request for mediation concerning an objection by the Governing Council to a new draft Decision is not admissible.

Even though the Mediation Panel's proceedings are confidential, the Governing Council may authorize the ECB President to make their outcome public. Documents drawn up or held by the Mediation Panel are ECB documents and must be classified and handled in accordance with Article 23.3 of the ECB Rules of Procedure, i.e. in accordance with the organizational rules regarding professional secrecy, as well as management and confidentiality of information.

Chapter 6: Case study, based on a different approach, relating to the supervision of credit institutions – The United Kingdom (UK) Model –

63 SSM QUARTERLY REPORT 2014/3 pages 6-8

64 Ibid

65 Ibid



The Bank of England⁶⁶ is the UK's central bank is owned by the Government but set monetary policy independently. Its mission is to deliver monetary and financial stability for the British people. Its main responsibilities are: **1) Issuing banknotes** and managing the UK's currency. **2) Monetary stability** : Its monetary stability objective is to deliver stable prices and confidence in the UK's currency. Its Monetary Policy Committee (MPC) aims to achieve this by setting interest rates with the goal of reaching the Government's 2% inflation target. **3) Financial stability**:

The Bank of England has the responsibility for UK financial stability – in other words, making sure that the system runs smoothly and that people can trust financial institutions. **Its Financial Policy Committee (FPC)** looks out for and works to remove or reduce risks and weaknesses in the UK financial system. The **Bank's Prudential Regulation Authority (PRA)** regulates and supervises roughly 1,700 banks, building societies, credit unions, insurers and investment firms to ensure that they are run safely.

They also have the following financial stability responsibilities⁶⁷ :

- They regulate and oversee key payment systems, such as CHAPS and Bacs, which transfer money between banks.
- They act as lender of last resort, meaning that we can offer loans to financial institutions which are in serious difficulty or near collapse.
- They act as market maker of last resort at times of financial stress, meaning that we may buy and sell assets to provide liquidity to the markets.
- They can intervene to manage failing financial firms, to make sure that the effect on the economy is minimized.

In March 2014, the bank of England launched its three-year Strategic Plan to transform the way it work. The plan established a renewed mission for the Bank: 'promoting

66 The most basics information about the Bank of England are available at <http://www.bankofengland.co.uk/about/Pages/default.aspx>

67 Bank of England (2014): Financial Stability Report, June, available at: <http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr35.aspx>



the good of the people of the United Kingdom by maintaining monetary and financial stability'. The aim of this Strategic Plan is a commitment to build One Bank, which recognizes the importance of having responsibility for micro-prudential supervision, macro-prudential policy and monetary policy within the same organization. It means that the Bank is better placed to deliver key economic benefits: stable inflation, economic growth, and the continuous provision of financial services. One Bank means a strong common culture, built from the best of all parts of the Bank, which brings together the whole of the organization to better support each.

The Prudential Regulation Authority (PRA)⁶⁸ was created as a part of the Bank of England by the Financial Services Act (2012) and is responsible for the prudential regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms. The PRA's objectives are set out in the Financial Services and Markets Act 2000 (FSMA). The PRA has three statutory objectives: a **general objective** to promote the safety and soundness of the firms it regulates, **an objective specific** to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders, and a **third objective** to facilitate effective competition.

The PRA⁶⁹ advances its objectives using two key tools. First through regulation, it sets standards or policies that it expects firms to meet. Second, through supervision, it assesses the risks that firms pose to the PRA's objectives and, where necessary, takes action to reduce them. The PRA's approach to using regulation and supervision has three characteristics – it is: Judgement based: the PRA uses judgement in determining whether financial firms are safe and sound, whether insurers provide appropriate protection for policyholders and whether firms continue to meet the Threshold Conditions. Forward looking: the PRA assesses firms not just against current risks, but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it generally aims to do so at an early stage. Focused: the PRA focuses on those issues and those

68 The most basics information about the Bank of England are available at <http://www.bankofengland.co.uk/pru/Pages/default.aspx>

69The most basics information about the Bank of England are available at <http://www.bankofengland.co.uk/pru/Documents/publications/ss/2016/ss216.pdf>



firms that pose the greatest risk to the stability of the UK financial system and policyholders. A stable financial system is one in which firms continue to provide critical financial services – a precondition for a healthy and successful economy. The PRA does not seek to operate a “zero-failure” regime. Rather, it seeks to ensure that a financial firm which fails does so in a way that avoids significant disruption to the supply of critical financial services. The Prudential Regulation Authority is a subsidiary of the Bank of England and is a UK public regulatory body.

International headquartered banks can either operate in the United Kingdom as subsidiaries or branches. A subsidiary is a separate legal entity from its parent, and as such requires its own governance and risk management, as well as meeting capital and liquidity requirements in the United Kingdom. A branch forms part of the same legal entity as its head office, and therefore will not have its own capital base or board as this is covered in the head office, though local governance is required. This structure is also mirrored in relation to supervisory powers. For subsidiaries the PRA has the same legal powers and follows broadly the same supervisory framework as for UK headquartered firms. However, the responsibilities for prudential supervision of branches are split between the supervisor where the bank is headquartered (the HSS) and the PRA. This CP is therefore primarily focused on the PRA’s approach to branches. In terms of establishing a branch in the United Kingdom, non-EEA deposit-taking branches need to be authorized by the PRA (ie the whole firm is required to meet the Threshold Conditions) whereas EEA firms have EU treaty rights to passport into other Member States.

In promoting its statutory objective of safety and soundness, the PRA⁷⁰ focuses primarily on the harm that firms can cause to the stability of the UK financial system. A stable financial system is one in which firms continue to provide CEFs— a precondition for a healthy and successful economy. The PRA’s view is that the ability for financial services

70 Under the UK Financial Services Act 2012, the Prudential Regulation Authority (‘PRA’) was established as a subsidiary of the Bank of England, responsible for the micro-prudential supervision of banks, building societies and credit unions, insurers and major investment firms. In addition, the above Act established the Financial Conduct Authority as a conduct of business regulator. Finally, an independent Financial Policy Committee (‘FPC’) was also established, entrusted with the objective of financial stability and macro-prudential financial oversight. On the most recent work of the PRA, see Bank of England (2014). Its publications are available at: <http://www.bankofengland.co.uk/pr/Pages/publications/default.aspx>.



firms to branch into other countries is, if done safely, an important component of an open world Economy which in turn benefits the UK economy. For non-EEA subsidiaries and branches, both new and existing, the FCA's Threshold Conditions and conduct of business rules apply, including in areas such as anti money laundering (AML). For new applicants, authorization can be granted only where both the FCA and the PRA are satisfied with their respective requirements have been met. The FCA will independently assess applicants from a conduct perspective against its own requirements (FCA Threshold Conditions) and FCA objectives. Applicants should therefore discuss their proposals with the FCA at an early stage⁷¹.

For a subsidiary of an international bank, the PRA has the same legal powers and follows broadly the same supervisory framework as for a UK headquartered firm. This model focuses on three key elements: 1) the potential impact that a firm could have on financial stability, both by the way it carries on its business and in the event of failure 2) how the external context in which a firm operates and the business risks it faces (together, its risk context) might affect the viability of the firm and 3) mitigating factors including: a firm's management and governance and its risk management and control (operational mitigation), its financial strength, specifically capital and liquidity (financial mitigation), and its resolvability (structural mitigation).

The PRA will work closely with the HSS to assess the linkages between the UK subsidiary and the wider consolidated group as well as the group's recovery and resolution plan. Consistent with its objective, where necessary the PRA will limit these linkages between the UK subsidiary and the group. Where the subsidiary is of a significant size, the PRA will be part of the supervisory college and attend the Crisis Management Group (CMG) for the consolidated group. Where firms operate in the United Kingdom with both a subsidiary and a branch, the PRA expects appropriate governance to oversee and manage the links between the two entities. In supervising these firms the PRA will clearly delineate its

71 Bank of England (2014): Financial Stability Report, June, available at: <http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr35.aspx>



supervision between the entities and expect the firm to have a clear booking model in place setting out what it will book in each entity and how they will verify its application⁷².

Another important object which contributes to the economic stability of the British economy is the Financial Policy Committee (FPC)⁷³. Financial Services Act 2012 brought major reforms to create a UK regulatory framework which is focused on the issues that matter and better equipped to deliver financial stability. On 1 April 2013 the new legislation established an independent Financial Policy Committee (FPC) at the Bank. The Committee is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the Government.

Previously, in February 2011, the Bank's Court of Directors created an interim FPC to undertake, as far as possible, the future statutory role of FPC. The interim FPC held its first policy meeting in June 2011, and met on a quarterly basis thereafter. The Committee publishes a record of its formal policy meetings, and is responsible for the Bank's bi-annual Financial Stability Report. The FPC members are the Governor, the four Deputy Governors, the Chief Executive of the Financial Conduct Authority (FCA), the Bank's Executive Director for Financial Stability Strategy and Risk, four external members appointed by the Chancellor, and a non-voting representation of the Treasury.

The Bank of England's Financial Policy Committee (FPC) has decided to exclude central bank reserves from the exposure measure in the current UK leverage ratio framework, with immediate effect. In doing so, the FPC's aim is to ensure that the leverage ratio does not act as a barrier to the effective implementation of policy measures that might lead to an increase in central bank reserves. These measures include actions taken to maintain monetary and financial stability since the referendum on the United Kingdom's membership of the European Union: the package of actions being announced today by the Monetary Policy

72 Bank of England (2014): Financial Stability Report, June, available at: <http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr35.aspx>

73 The most basics information about the Bank of England are available at <http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx>



Committee and the precautionary step announced by the Bank on 30 June to provide additional flexibility in the Bank's provision of liquidity insurance by continuing to offer indexed long-term repo operations on a weekly basis until end-September 2016⁷⁴.

The FPC judges that this change to the exposure measure is appropriate because an increase in central bank reserves does not typically expose a firm to additional risks, if matched by liabilities in the same currency: as the ultimate settlement asset, central bank reserves are a unique asset class. The FPC highlighted in its Financial Stability Report in July that there was a risk of unintended effects from leverage ratio standards on the ability of the banking system to cushion shocks and draw on central bank liquidity facilities as necessary⁷⁵.

As a result, it encouraged the Basel Committee on Banking Supervision to review carefully any possible unintended effects of forthcoming leverage ratio standards. The FPC is making this improvement to the design of the leverage ratio in the United Kingdom now, given the policy measures being put in place. It recognizes that, absent offsetting the impact of this change, excluding current central bank reserves from the exposure measure – the denominator of the leverage ratio – mechanically reduces the nominal amount of capital required to meet the leverage ratio standard, other things equal. This is not the FPC's intention. It therefore intends to recalibrate the UK leverage ratio standard to offset this impact. It will consult and decide on the appropriate form of this recalibration as part of its planned review of the leverage ratio framework in 2017, in the light of the finalized international standard. In the intervening period, the Prudential Regulation Authority (PRA) will monitor firms' behavior.

Benefits of the involving the central bank in bank regulation and supervision are⁷⁶ :

Access to better information: The central bank needs accurate and timely information about banking sector performance in order to effectively exercise its monetary policy functions (Goodhart, 2000; Peek, Rosengren and Tootell, 1999). It might also help better assess the risk-

74 The most basics information about the Bank of England are available at <http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx>

75 Ibid

76 Refers from DIRECTORATE GENERAL FOR INTERNAL POLICIES POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY «Monetary Policy and Banking Supervision: Coordination instead of Separation»



taking consequences of loose MONETARY policy (Jiménez et al., 2012). In the context of the current crisis, this will give a better assessment of the current bottlenecks in the transmission channels of easing monetary policy. It will also help the ECB better execute its new task in macro-prudential regulation

Crisis resolution: If the central bank has supervisory powers, it may be able to act more effectively via the banking system in times of crisis (Goodhart and Schoenmaker, 1995). Critically, the ECB has de-facto taken over the lender-of-last resort function, without being able to judge the credit-worthiness of banks. This does not only exacerbate the tragedy of shared problems from the crisis (see below), but also increases risks on the ECB's balance sheet, i.e. the risk that weak banks will not be intervened in time (Wyplosz, 2102).

Independence. Central banks are known for their independence, which is important for successful supervision (Abrams and Taylor, 2000). The ECB has achieved a reputation as being a truly European institution, well above national interests and being independent from political influence. In the context of constructing a banking union, it is therefore easiest to build on this already acquired reputation. The strong reputation of ECB might also help attract more skilled staff.

Disadvantages of involving the central bank in bank regulation and supervision

Conflicts of objectives: Combining prudential supervision and monetary policy could result in an excessively loose monetary policy, since the central bank might want to avoid adverse effects on bank earnings and credit quality (Goodhart and Schoenmaker, 1995 and Ioannidou, 2012). In the current crisis, one could argue that the ECB might not necessarily be a tougher supervisor than national authorities. It might actually be more lenient, as it is concerned about contagion across the euro area and because it has more resources available since it is also the lender of last resort (Allen, Carletti and Gimber, 2012). On the other hand, it is not clear whether monetary and financial stability policies conflict with each other with the rise of macro-prudential regulation as an additional policy tool.

Reputational risk: If the credibility of the central bank as a prudential supervisor is undermined, this could also negatively affect its credibility in the area of monetary policy (Goodhart, 2000). This risk is especially great in the area of bank stability as only the absence of such can be properly observed, while monetary stability is a more transparent target.



Loss of independence or too much power: The central bank could become more prone to political capture when its role increases, thereby undermining its independence (Goodhart, 2000). In the context of the envisaged SSM within the ECB, this danger is especially grave, as representatives of national supervisory authorities do not enjoy the same degree of political independence as NCBs. Furthermore, supervisory decisions involving taxpayer-financed recapitalization of banks might make the ECB vulnerable to more political pressure. On the other extreme, there is the fear that a central bank with banking supervisory power will become too powerful, with limited accountability to elected legislatures and governments. This concern might be especially pertinent in Europe, where the European Parliament still enjoys limited legitimacy.

Scope diseconomies: An institution with several objectives might tend to misallocate resources and neglect one of its tasks (Abrams and Taylor, 2000). A related argument is that the boundaries of financial intermediation have moved far beyond banking and that a bank regulatory authority tasked with systemic financial stability has to expand significantly beyond banking. This is also reflected in the euro area where bank supervisory authorities often have additional responsibilities for other segments of the financial sector.

It seems that while in general, there are arguments both pro and contra establishing bank regulation and supervision at the ECB, the current situation in the euro area – both being in the crisis and thus the need for relatively fast action but also given its current governance structure – provides a strong argument for establishing the responsibility for bank supervision and regulation at the ECB. Or, expressed differently, some of the conflicts mentioned above will always exist, even if bank regulation and monetary policy are located in different institutions, but the ECB might be in a better position to internalize these conflicts.

There are strong arguments to include bank regulation and supervision in the ECB's brief rather than locate the tasks with a different institution. The most convincing argument, however, refers to the tragedy of the common problems caused by the crisis in the euro area as each member tries to shift the burden to the ECB. Only an institution that is free of direct national



interference can overcome this problem and internalize the externalities stemming from national banking fragility for the overall currency union⁷⁷.

While the current situation might not be an appropriate one to distribute responsibilities across several institutions, there is a strong case to not bundle responsibility for bank resolution together with supervisory responsibilities at the ECB (Schoenmaker, 2012). The Commission is planning to come forward with proposals next year for a separate institution (which would need also funding) to deal with bank resolution. Such a separate institution could also counter the moral-hazard risk mentioned above, i.e. the risk that the ECB is reluctant to intervene in a bank to which it has high exposure as lender of last resort.

The above analysis of the advantages and disadvantages did a brief comparison between the two models, understanding the pros and cons of these models and judging everyone which system is better and guarantees more benefits.

Concluding remarks

The banking and financial landscape is changing rapidly in the euro area. Private banks and public authorities have been working hard in recent months to catch up with the ambitious initiatives launched as a consequence of the financial crisis, in particular, with the setting up of the SSM and further moves to achieve a banking union at the EU level. Measures are being taken simultaneously in several fields, but we run the risk of focusing too much on every single measure needed to progress towards those targets while missing the overall picture which is emerging. This is particularly true in the case of banking statistics. It is reasonable and feasible for much more efficient use to be made of banking data by monetary authorities and bank supervisors than has been made up till now.

77 The most basics information about the Bank of England are available at <http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx>



In this regard, all efforts made by the ECB with a view to moving towards an integrated approach are welcome, because we are convinced, due to our experience, that the use of multi-purpose statistics affords many synergies between the central banking and supervisory functions, reduces the reporting burden and increases the quality of data. Along with the tasks to progress on that front, it is also important to disseminate the best practices followed at present by some European countries. In fact, some experience shows that a much better exploitation of banking information is feasible and less costly.

It is also very important for all relevant stakeholders in international organizations to be fully aware of the broad landscape of financial statistics, in particular, when they are setting new requirements or new standards. New requests by those institutions (such as the ECB, SSM, FSB, ESMA or EBA) should be coordinated in order to reduce the reporting burden and maximize the usefulness of the information already available.

Deeper reflection is also needed on the new possibilities entailed by the use of information across domains (for example, exploring the potential benefits of an integrated approach for economic research). The trade-off between confidentiality and the use of information should be addressed with appropriate rules. IT advances facilitate making those two targets compatible since it may help to set up an appropriate access rights management regime.

At the SSM level, challenges are more urgent and do not relate as much to the lack of harmonization across domains (monetary policy vs. banking supervision) as to that across countries. The current approach is mainly based on the FINREP-COREP schemes required by the EU implementing technical standard on reporting (ITS), although it is expected that the ECB will enrich it by extending the requirements of FINREP data to non-IFRS groups and some banks on a solo basis, because they are outside of the scope of the ITS.

Setting a minimum level of harmonization can be considered an appropriate target, but only as a starting point. In this regard, the existence of jurisdictions with more demanding solo basis requirements means that different reporting burdens are imposed on euro area banks and, as a result, the ability of the ECB to supervise them depends on the country in which they are established. Despite this, the additional information available in some countries should not be overlooked, since in the long term a more ambitious harmonization should be aimed at. Indeed, a

level playing field must be ensured, without compromising the need to have an ever deeper knowledge of banking data.

In the short term, an enhancement of the current scheme for institutions should be foreseen and further work on harmonizing definitions and concepts to make data fully comparable would be very welcome. Apart from the harmonization of some crucial definitions, such as those of *non-performing loans* and *forbearance*, progress is also needed on harmonizing accounting practices, with full respect for international accounting rules. In this respect, the lessons drawn from the AQR are very relevant: e.g. it has been ascertained that a crucial item such as *provisions* does not actually mean the same thing throughout the euro zone.

These harmonization issues are complex and may require long periods of preparatory work but it is important to be clear about the target, while being pragmatic about the timeframe for achieving it. An ambitious approach to the compilation of banking information, along the lines of a more integrated model, will definitely allow both central banks and banking supervisors to be better equipped to take sound policy decisions.

The supervisory priorities for 2016 of the Single Supervisory Mechanism (SSM) set out focus areas for supervision in 2016. They build on an assessment of the key risks faced by banks under ECB supervision and take into account relevant developments in the economic, regulatory and supervisory environment.

The key risks SSM banks are confronted with have been identified in cooperation with the national competent authorities, leveraging on the input from the Joint Supervisory Teams, ECB macro-prudential and micro-prudential analyses as well as reports by external bodies. Among the key risks identified, business model and profitability risk is ranked the highest, followed by other key risks, the importance of which varies across SSM countries: credit risk and heightened levels of non-performing loans; reversal of the search for yield; conduct and governance risk; sovereign risk; geopolitical risk and growing vulnerabilities in emerging economies; IT and cybercrime risk; and banks' ability to meet upcoming regulatory capital requirements.

To ensure that banks address these key risks effectively, the SSM has adopted five high-level priorities to guide its supervision throughout 2016. These are (i) business model and profitability risk, (ii) credit risk, (iii) capital adequacy, (iv) risk governance and data quality, and



(v) liquidity. For each of these priorities, a number of supervisory initiatives will be carried out. In some cases, their full implementation spans more than one year.

The aforementioned risks, as well as the supervisory priorities, should not be seen as an exhaustive list. Differing supervisory activities may be required at bank level, taking into account credit institutions' specific risk profiles. Nonetheless, the priorities are an essential tool to coordinate supervisory actions across banks in an appropriately harmonized, proportionate and efficient way, thereby contributing to a level playing field and a stronger supervisory impact.

The key risk that stands out relates to banks' business models and profitability. Both are being challenged by the high level of asset impairments and the protracted period of low interest rates. In 2016, building on previous work around banks' elevated levels of non-performing loans (NPLs) deserve heightened supervisory attention. The deterioration in the credit quality of loans to corporates and/or households as well as in credit standards is a source of concern in a number of SSM countries, particularly in ones hit hard by the crisis. A task force on NPLs is reviewing the situation of institutions with high levels of NPLs and will propose follow-up actions. In addition, exposure concentrations in areas such as real estate will be subject to greater supervisory scrutiny. Another credit-related topic is the implementation of "IFRS 9 – Financial Instruments" (International Financial Reporting Standards). A thematic review will assess the potential impact of IFRS on banks' provisioning practices and how banks are preparing for its introduction.

Capital adequacy remains a high priority for the SSM in 2016. Focal points are the quality and consistency of banks' Internal Capital Adequacy Assessment Processes (ICAAP), including banks' internal stress-testing capacities, and the conduct of supervisory stress tests such as the EU-wide stress test coordinated by the European Banking Authority. Further pivotal elements of supervision in 2016 are the follow-up on the quality and composition of banks' capital (also in relation to the ongoing efforts to harmonize options and national discretions) as well as the examination of banks' preparedness for new regulatory standards such as total loss-absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL), the application of which will result in minimum requirements for "bail-in able" capital instruments. In addition, a targeted review of banks' internal models will be carried out over several years.



The 2015 Supervisory Review and Evaluation Process revealed that a number of banks do not yet fully meet supervisory expectations regarding the sound management of liquidity risks. The SSM will therefore focus on the reliability of banks' Internal Liquidity Adequacy Assessment Processes (ILAAP). Banks' progress in implementing and maintaining sound frameworks for managing liquidity and funding risk, both in a going concern situation and under stressed circumstances, will be scrutinized

Bibliography

- Bank of England (2014): Financial Stability Report, June, available at: <http://www.bankofengland.co.uk/publications/Pages/fsr/2014/fsr35.aspx>
- Beck, Th. and D. Gros (2013): Monetary Policy and Banking Supervision: Coordination Instead of Separation, CEPS Policy Brief No. 286, available at: <http://ssrn.com/abstract=2189364>



- Christos V. Gortsos (2015a) : The ‘single supervisory mechanism’: a major building-block towards a European Banking Union (the full europeanization of the ‘bank safety net’), Athens
- Christos V. Gortsos (2015) «Chinese Walls within the European Central Bank after the establishment of the Single Supervisory Mechanism»,
- Di Noia, C. and G. Di Giorgio (1999): Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?, Universitat Pompeu Fabra, Economic Working Paper No. 411, available at: <http://ssrn.com/abstract=193730>
- ECB Annual Report 2014, pages 23-25
- Eijffinger, S. and R. Nijskens (2012): Monetary Policy and Banking Supervision, European Parliament, Directorate General for Internal Policies, available at: <http://www.europarl.europa.eu/studies>
- European Central Bank (2011): Monetary Policy of the ECB, European Central Bank, third edition, May, pages 96-97
- Gianviti F. (2010), The Objectives of Central Banks, in Giovanoli, M. and D. Devos (2010, editors): International Monetary and Financial Law: The Global Crisis, Oxford University Press, Oxford - New York, Chapter 22, pages 450-452
- Goodhart, C.A.E. and D. Schoenmaker (1993): Institutional Separation between Supervisory and Monetary Agencies, in Goodhart, C.A.E. (1993, editor): The Central Bank and the Financial System, Macmillan Press, London
- Klomp J., de Haan J. (2009), ‘Central Bank Independence and Financial Instability’, *Journal of Financial Stability*



- Lastra, R.M. (2013): Banking Union and Single Market: Conflict or Companionship?, Fordham International Law Journal, Volume 36, pages. 1189-1223
- Refers from DIRECTORATE GENERAL FOR INTERNAL POLICIES POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY «Monetary Policy and Banking Supervision: Coordination instead of Separation»
- REGULATION (EU) No 468/2014 OF THE EUROPEAN CENTRAL BANK of 16 April 2014 at https://www.ecb.europa.eu/ecb/legal/pdf/celex_32014r0468_en_txt.pdf
- SCHELLER HANSPETER (2006), THE EUROPEAN CENTRAL BANK HISTORY, ROLE AND FUNCTIONS,
- SSM QUARTERLY REPORT 2014/1
- SSM QUARTERLY REPORT 2014/3
- SSM QUARTERLY REPORT 2014/4
- About legal framework of ECB see at <http://www.ecb.europa.eu/ecb/legal/html/index.en.html>
- Information about the organization of ECB are available at https://en.wikipedia.org/wiki/European_Central_Bank
- The basics information about the organization of ECB are available at <http://www.ecb.europa.eu/ecb/orga/escb/html/index.en.html>
- The basics information about the sorts of the independence of the ECB are available at <http://www.ecb.europa.eu/ecb/orga/independence/html/index.en.html>
- The basics tasks of ECB are available at <http://www.ecb.europa.eu/ecb/tasks/html/index.en.html>



- The main principles of the ECB are available at
http://ec.europa.eu/finance/generalpolicy/docs/committees/reform/20120912-com-2012-511_en.pdf
- The most basics information about the Bank of England are available at
<http://www.bankofengland.co.uk/about/Pages/default.aspx>
- The most basics information about the Bank of England are available at
<http://www.bankofengland.co.uk/prs/Documents/publications/ss/2016/ss216.pdf>
- The most basics information about the Bank of England are available at
<http://www.bankofengland.co.uk/financialstability/Pages/fpc/default.aspx>
- The tasks of ECB are available at <http://www.ecb.europa.eu/ecb/tasks/html/index.en.html>

