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Constraints on settling a holistic regulatory framework under the European Banking Union

The importance of conduct supervision

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Abstract

The proper balance between conduct and prudential supervision is considered to be the main feature for establishing a sound banking regulatory and supervisory framework. This working paper examines the architecture designed after the outbreak of the financial crisis in 2008. It highlights the rationale behind the need for a strong structure and better coordination at a supranational level that resulted in years later in the creation of the European Banking Union. Under this scheme, the European Central Bank (ECB) has been given supervisory powers with the purpose of maintaining the stability of the financial system in the Eurozone. However, the core function of the ECB is focused on the performance of prudential supervision, while the conduct supervision has been excluded from its scope. This approach suggests a lack of balance that allows a wider and integrated assessment of the risks to which an institution is exposed. In this sense, the working paper centre the discussion on the current powers of the ECB, specifically on whether it should also supervise the relationship between banks and customers beyond its current limitations, with the aim of having a full perspective of the bank operations and early identification of potential high-risk exposure. Further, some lessons learned from large banks are presented, making clear the importance for a more effective and systematic articulation between both types of supervision with a view to making a real contribution to the long-run stability in the financial sector.

Key Words: Conduct supervision, Prudential Supervision, Single Supervisory Mechanism (SSM), ECB's tasks and powers, regulation.

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i. Introduction

The effectiveness of banking supervision has become a crucial topic after many financial crises that have occurred worldwide. The application of «Laissez faire et laissez passer» in the financial market has not demonstrated to be the best decision, especially because this market operates in a very peculiar and distinctive manner. Indeed, negative externalities in this market can lead not only to the financial crisis, but also to cross border contagion. Therefore, one of the main lessons learned is that banking supervision must be strengthened following a holistic and active approach in order to effectively guarantee financial stability.

After a series of banking failures in the past, the most common questions that come to light are, how did nobody see it coming? Why did the external audit firms and credit rating agencies fail to point out the risk of sophisticated financial products? Why did not supervisors take timely corrective actions to forestall bank failures? Why did the high level of risk assumed by the banks were not generating any kind of alarm? Although some of these may seem obvious, the general response emphasises the use of soft rules that did not ensure due risk management diligence of the bank transactions under supervision. In this way, the lack of powers or lax regulation intended to achieve effective banking supervision ends up causing negative spillover effects on the real sector of the economy.

Moreover, highly interconnected financial network at an international level highlighted the need for a superintendent with sufficient powers at a supranational level in the European Union. These repeated events led to a build-up of more efforts to establish a much stronger supervisory structure with a more active role in understanding and evaluating changes in the business of banking. In the same line, Van Rompuy et al. (2012) underlines the need of well-unified banking supervision with supranational

powers in the eurozone to ensure long-run stability in the single market in terms of financial issues.

The following lines will discuss the new regulations issued after the financial crisis of 2008 in the European Union, and will specifically focus on those that give the European Central Bank (ECB) supervisory power under the Single Supervisory Mechanism (SSM). We will also examine the principal actors in the application of prudential and conduct-of-business supervision under the new framework and identify whether both pillars have been equally strengthened.

In this context, the paper endeavours to answer the following question: Should the ECB also supervise the relationship between banks and customers in the Eurozone to achieve harmonization in terms of effective protection of consumers and at the same time allow for more comprehensive supervision at a supranational level? Following this, an appropriate balance between the scope of action for prudential and conduct supervision has been broadly discussed in different supervisory models and applied in different ways with the objective to perform the best comprehensive supervisory model that ensure financial stability in the banking business in the long term.

This work is organised in seven sections. After this introduction, section 2 briefly presents the main supervisory models and the role of the prudential and conduct supervision. In section 3 the main changes in the supervisory framework in the euro area after the financial crisis in 2008 are addressed. On the other hand, section 4 analyses the rationale behind and the crucial innovation with the establishment of the single supervisory mechanism and discusses the transformation of the scope of action in terms of prudential and conduct supervision, followed by section 5, which identifies the tasks that have been accomplished and those that are still pending in terms of conduct supervision at the supranational level. Finally, section 6 pinpoints some experiences on the impact of poor bank-consumer relationship and how this also provide substantial elements that should be examined by the prudential supervision and section 7 summarizes the main results.

ii. Is there any balance between the sphere of banking prudential supervision and conduct supervision?

Alexander (2019) describes the four main supervisory models of financial regulation on which states develop their institutional structures of financial regulation and supervision: functional, institutional, integrated and Twin Peaks approaches. The classification outlined is shown in Figure 1.

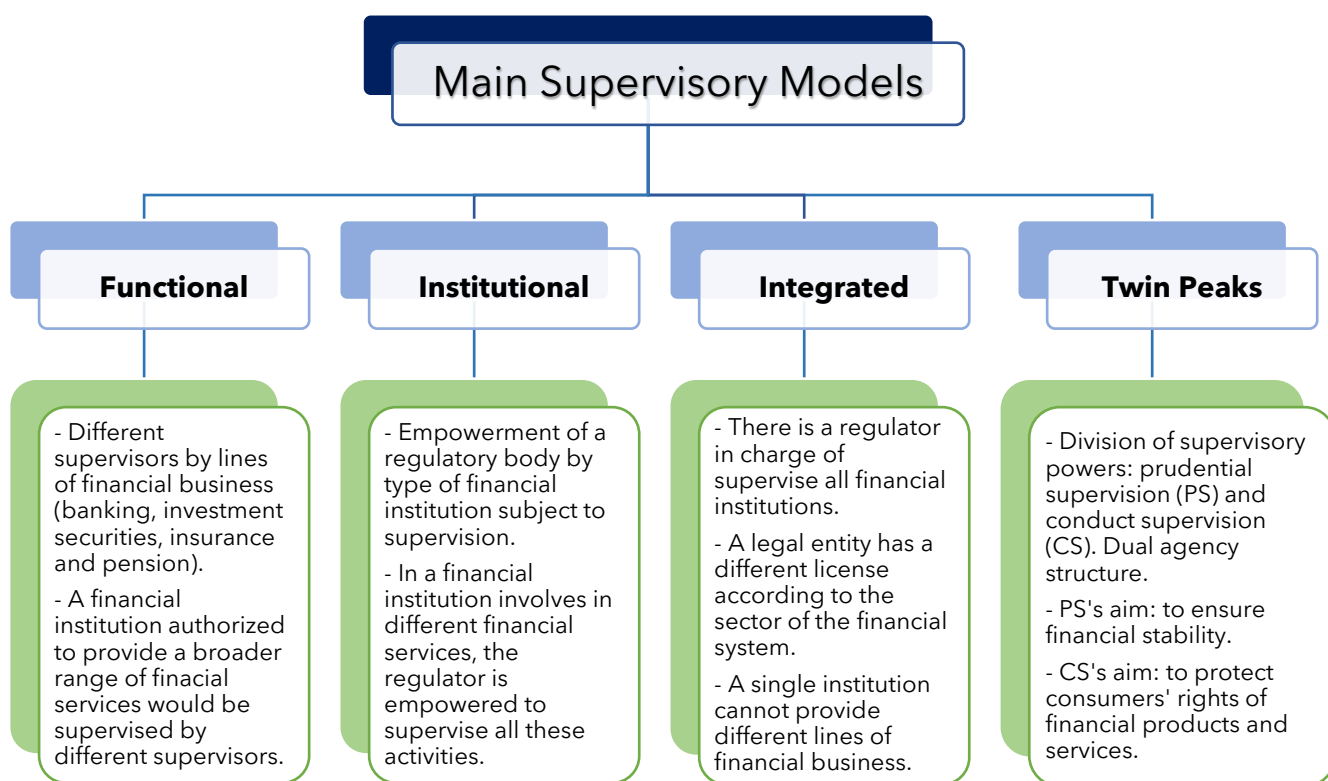


Figure 1. Source: Author's description based on Alexander (2019)

Alexander (2019) argues that these models have evolved as a result of financial crises complexity, and that the Twin Peaks approach is the most popular model mainly because it seeks to establish a better balance in the supervision of the relationship between supervisors vs. banks and banks vs. customers. Moreover, in some regulatory system, the prudential supervision under the latter approach has been separated in two subgroups: micro-prudential and macro-prudential supervision in order to oversee with a higher level of detail.

However, in practical terms, the application of hybrid models has been commonly accepted. Before the financial crisis of 2008, the majority of European countries follows a hybrid Twin Peaks approach, including aspects of other models, in which the prudential and conduct supervision was generally managed by a single competent authority, under the same roof, but independently in the pursuit of their objectives. Under the new institutional architecture of the European Banking System, prudential supervision climbed to a higher level of importance for the Eurozone countries. In other words, the prudential supervision is considered the most important peak and the legislator constantly establishes new measures to strengthen it at the euro area level, while conduct-of-business supervision seems to have been underrated.

On the other hand, it is relevant to mention the case of United Kingdom. As a result of the same crisis, the single financial regulatory body that existed at the time, FSA, was replaced by two different authorities in 2013, one in charge of the conduct-of-business supervision: the Financial Conduct Authority (FCA), and the other agency responsible for the prudential supervision: Prudential Regulation Authority (PRA). This division better ensures that both objective under the Twin-Peaks approach are equally weighted in the struggle to maintain a stable financial system (Alexander, 2019).

At the international level, the production of recommendations, global regulatory standards and guidelines issued by Basel Committee or FSB aimed at financial stability have focused on prudential supervision, basically reinforcing only one of the peaks. Basel Committee on Banking Supervision (2012) shows that the core principles for effective banking supervision are centred on prudential supervision. Regarding to customers, it only includes guidelines about the correct application of the principle know your customers which is relevant for AML purposes. Hence, these principles do not consider insights concerning effective supervision in the relationship between banks and customers.

iii. The main changes in the EU banking supervisory approach in the post-financial crisis stage

After a major banking failure, policymakers begin to focus their efforts in creating initiatives or hard regulations as a way to prevent such events from happening in the future and to control negative externalities coming from the banking system and boosted through by the higher level of connectivity in banking transactions around the World. An example of this is that due to the financial crisis of 2008, a series of reports and recommendations have been developed, such as the "Larosière Report", with the aim of seeking a more comprehensive regulatory perspective for the euro-area countries.

One of the earliest initiatives was the establishment of the European Systemic Risk Board (ESRB) in 2010 in accordance with Regulation (EU) 1092/2010. This regulation states that the ESRB shall be responsible for the macro-prudential oversight of the financial system in the European Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union, so as to avoid periods of widespread financial distress.

The second step in the formation of the new supervisory structure was the establishment of European Supervisory Authorities by the transformation and greater recognition of three existing Committees whose financial business lines were banking, securities and insurance sector, respectively. The European Supervisory Authorities (ESAs) were born at the end of 2010 and began operations in 2011 as independent EU agencies with different legal personalities. The main purpose of these agencies was to fill in the gaps of technical regulation through more detailed technical measures dealing with micro-prudential supervision and to govern the formulation of regulatory technical standards, guidelines, and recommendations (European Court of Audits, 2014).

The ESAs (EBA, ESMA and EIOPA) in collaboration with the national competent authorities (NCAs) and the ESRB form the supervisory architecture in Europe, the European System of Financial Supervision (ESFS). Despite these efforts, the powers of this team were still considered incomplete to ensure a strong supervisory structure in

the EU, which led to the emergence of new assessment reports within this framework and some key roles of each participant were restructured (Demarigny et al., 2013). As a result, in September 2012, the European Commission announced a proposal for a single supervisory mechanism (SSM) for all banks in the euro area and in October of the following year came into effect the regulation (EU) No 1024/2013 which represents the first pillar of the Banking Union.

A relevant aspect to highlight in the supervision model prior SSM it that each NCA applies different models of supervision in the EU. This approach proved to be inadequate in the context of more dynamic and multinational banks. According to European Court of Audits (2014), the supervision of complex cross-border banks was carried out through the synergy and cooperation among home and host regulators that meet periodically, together with representatives of EBA, at the colleges of supervisors.

But with the introduction of the SSM regulation, the ECB has been invested with greater attributes that allow it to play a central and active role in the prudential supervision of credit institutions and other financial institutions (on the basis of art. 127.6 TFEU). In this sense, the ECB became an integral part of the ESFS and maintain a strong cooperation with the other actors of this framework. Given these new attributions for the ECB, the SSM regulation pinpoints the independency of the two objectives: 1) maintaining price stability as part of its monetary policy, and 2) to protect the safety and soundness of credit institutions and the stability of the financial system as part of its supervisory task.

According to the SSM supervisory manual, the core function of the ECB on prudential supervision has a threefold classification: 1) a direct micro-prudential supervision of the largest credit institutions and financial groups in the euro area 2) a micro-prudential supervision at the euro zone level for performing common assess and procedures and 3) specific support with analytical tools to the ESRB, which has macroprudential interests in the European Union.

As noted in ECB (2018), the conformation of four Directorates General (DGs) was essential to execute the ECB' micro-prudential tasks in an effort to develop a better risk profile of the largest banking groups, as well as to ensure consistency in the

supervisory approach of small institutions managed by the NCAs. The DGs Microprudential Supervision I and II are responsible for the direct day-to-day supervision of significant institutions, the DG Microprudential Supervision III has to oversee the supervision of less significant institutions performed by NCAs and for all common procedures related to them, and the DG Microprudential Supervision IV performs horizontal and specialised tasks in respect of all credit institutions under the SSM framework.

Basically, DG Microprudential Supervision level III and IV respond to the ECB's responsibility for ensuring effective and consistent functioning of the SSM that requires assessing the supervisory activities carried out by the NCAs and its compliance with the best supervisory practices according to the SSM (European Central Bank, 2018). The rationale behind not only concentrating the attention of ECB on the big banks, but also reducing the heterogeneity in the scheme of supervisory and monitoring systems for the small institutions. This latter is based on the latent risk that a relatively small bank can provoke a systemic effect.

iv. What was sought with the establishment of the SSM? What did this change mean in terms of prudential and conduct supervision?

In the aftermath of the financial crisis in 2008, it became clear that maintaining EU monetary integration is not enough just to transfer monetary policy powers to a supranational authority. The transfer of powers in terms of the financial system supervision is required so as to avoid instability of the Euro over the long term and enhanced the level of law harmonization in financial supervision matters. As the preamble, recital 2 of the SSM regulations said,

“...the integrity of the single currency and the internal market may be threatened by the fragmentation of the financial sector. It is therefore essential to intensify the integration of banking supervision in order to bolster the Union, restore financial stability and lay the basis for economic recovery.”

One of the principal reasons for this reorganization was also underpinned by the largest number of multinational banks and a high degree of interconnectivity with

different institutions in the eurozone, which makes them more vulnerable to cross-border financial spillover. In this context, the creation of SSM lays the foundations for the transfer of prudential supervisory tasks from national supervisors to the ECB in the euro area, while the NCAs remain with the conduct-of business supervision tasks. In addition, the ECB will be responsible for the whole well-functioning of the SSM (European Central Bank, 2018).

The SSM focuses its actions in the improvement of harmonized prudential rules, giving prudential supervision a wider scope with respect to conduct supervision. Under this mechanism, the protection of consumers' rights is outside the scope of the ECB's responsibilities and the NCAs are solely responsible for this mission.

On top of that, there are some legal limitations before the creation of a competent authority for significant institutions performing both prudential and conduct supervision. According to the legal basis in TFEU art. 127.6, the ECB is only empowered to perform prudential supervision of credit institutions and other financial institutions in the Eurozone members.

As far as consumer protection is concerned, under the new framework, the SSM has played an essential role in prudential supervision while pushing conduct supervision into the background. The ECB is in charge of the direct prudential supervision of the significant institutions from across the euro area, whereas conduct supervision of the same institutions is relegated to the national competent authorities. Therefore, the lack of a single and integrated conduct supervision in the euro area may undermine the ECB regulator's ability to grasp a global picture of the largest banking groups, especially taking into account that just the analysis of prudential requirements has proved to be too limited to perform a comprehensive oversight.

Although the objective of prudential supervision is to ensure financial stability and the aim of the conduct supervision looks at the protection of the weaker party in the bank-consumer relationship, the two objectives are not completely unrelated given that the analysis of conduct supervision can provide elements or initial triggers of other failures in the structure of the institution. For instance, sales malpractices and other unfair patterns performed by banks are part of the scope of the conduct supervision, and the analysis of this tendency and specific way of proceeding can be symptoms of unsound

or weak governance and internal control mechanisms which is part of the analysis of the prudential supervision.

v. What has been accomplished and what tasks lay ahead in terms of conduct supervision at the supranational level?

As part of legislation level II and III (non-legislative acts), the consumer protection in the banking sector is part of the EBA's remit. Under the regulation 1093/2010, EBA was entitled of different tasks related to micro-prudential supervision and conduct-of-business supervision. Concerning this latter, article 9 describes the tasks related to consumer protection and financial activities. According to this, EBA has a leading role in promoting transparency, simplicity and fairness in the market for consumer financial products or services across the European Union.

With regard to the progress made on this area at the legislation level I (legislative acts), the European Parliament and the Council have only made isolated endeavours in establishing regulations or directives aimed at improving transparency rules on the products that banks offer to their clients. As EBA et al. (2019) said,

“There is no general Level I text harmonizing the conduct rules that are applicable to the provision of banking activities. While a number of directives include conduct rules for specific banking activities and products, i.e. PSD2, the MCD, the PAD and the Consumer Credit Directive 27 (CCD), or only for specific circumstances, such as the Distance Marketing of Financial Services” (p. 22).

This course of action suggests a production of Directives based on specific products without a comprehensive and generalized vision of conduct-of-business supervision.

In the same line, the aforementioned report highlighted as a recommendation for EU co-legislators the importance of harmonization at a supranational level:

“The ESAs note that there is no general Level 1 text harmonising the conduct rules applicable to institutions carrying out business, especially in the banking sector. The ESAs are of the view that this situation might create differences in the level of

regulation at national level due to insufficient harmonisation, thereby creating the risk of regulatory arbitrage. The ESAs encourage the EU co-legislators to consider reinforcing the harmonisation of the Level 1 provisions governing conduct of business rules in the banking sector and clearly setting out and allocating responsibilities between the home and the host CAs with regard to the application of consumer protection and conduct of business provisions. This would promote cross-border business, increase consumer welfare, simplify the legal framework and facilitate supervision, as financial institutions would have to comply with similar rules in all EU MSs” (p.25).

Although EBA has been given a key role in promoting consumer protection in the banking sector across the EU, there are still certain constraints to perform comprehensive conduct supervision. The EBA’s tasks in this field are defined in the regulation (EU) No. 1093/2010, art. 9(1): a) collecting, analysing and reporting on consumer trends; b) reviewing and coordinating financial literacy and education initiatives by the competent authorities; c) developing training standards for the industry; d) and contributing to the development of common disclosure rules.

The European Court of Auditors (ECA) underlined on its report about the EBA and its changing context in 2014 that consumer protection was not given a high priority by the EBA. Its position was based on the fact that a small number of people were allocated to this activity and that during the first year of operation there was no discussion on consumer protection issues on the Board of Supervisors. Additionally, ECA mentioned that the priority target of the EBA during the first two years was focus on systemic risk, and until 2012 started to put a little more work on consumer protection. (European Court of Audits, 2014). Indeed, the EBA began to publish the consumer trends report until 2013 (two years after the agency started operations).

In the fulfilment of its tasks, the EBA has to assess the convergence in the application of supervisory measures by each NCAs and inform, broadly speaking, the issues arising from specific banking products and services identified by the NCAs that can lead to significant consumer detriment. These consolidated results are compiled in the consumer trends report issued by the EBA in collaboration with the NCAs. It is worth mentioning that the frequency of evaluation of this report is much broader than that required for prudential performance reports. In fact, prior to the last consumer trends

report in 2019 (corresponding to the performance of 2018-2019), the frequency of publication used to be on an annual basis and since then, it began to be carried out every two years (European Banking Authority, 2019).

More precisely, the EBA tackles consumer protection supervisory matters in a cursory manner, and its reports do not go into detail about in which regions there is more evidence of sale practices violation, whether an institution falls into recidivism or whether the same institution shows the same conduct when it is present in the other Member States; and all this in order to identify behavioural patterns that allow for a more in-depth analysis of the situation and to take corrective actions.

On the other hand, European Court of Audits (2014) also indicated that there is still a gap between the performance of consumer protection across the European Union because the broad range of domestic arrangements for consumer protection makes it difficult for EBA to harmonize rules in a more straightforward direction.

vi. Lessons learned in banking conduct supervision

The main premise that it has been established with the intention of achieving the safety and soundness of the financial system was the creation of banking regulatory and supervisory system orientated to micro- and macro-prudential approach. This perspective has overlooked the production of conduct-of-business guidelines since it is not considered relevant to achieve the primary goal. Even so, there have been a number of cases in recent year evidencing high-risk exposure by banks not identified through prudential supervision but rather through conduct supervision.

At its simplest, a bank can generate negative externalities only with the deterioration of its reputation risk due to mismanagement in its relationship with the client. These types of events can be observed at first sight by performing conduct supervision when one or more clients point out consumer protection violations coming from the deficiencies or mismanagement that a bank has in any product or service offered.

Large institutions in the U.S. such as Wells Fargo and Bank of America give us lessons about the consequences of consumer protection violations and the impact in their

reputational risk. One of the best-known scandals in 2016 was the Wells Fargo fake accounts scandal, which was also followed by sales practices violations in credit cards accounts, and auto and mortgage lending. According to Tayan (2019), many factors led to diverse abusive and out of order practices, such as engaging in aggressive tactics to meet their daily cross-selling targets, excessive pressure on low level employees, the chairman and CEO roles were not separated, and a decentralized mechanism for internal risk supervision. During 2011-2016, the scam was being committed and nobody outside the bank knew about this situation, the value of the stocks increased as well as a senior-executive bonus (Bishop, 2018).

The consequences for Wells Fargo, beyond paying a multi-million dollar fine to government regulatory agencies, and compensation and refunds to customers, are significant because this kind of pitfall in the long-term can jeopardize the financial institution stability due to the lack of credibility, which results in a sharp decline in the value of the stock, reduction in the number of clients (not only in the affected banks but in their subsidiaries in other countries), and consequently lower level of profits.

It is worth mentioning that, it is part of prudential supervision's tasks to check whether the controls are adequate, to analyse the practices in the governing structure, and to examine the business model of the bank and its vulnerabilities. However, neither internal and external audit nor prudential supervisor managed to foresee the potential risks as a result of the company's sales system, management practices, organizational culture and deficiencies in the structure of its corporate governance on time.

Indeed, the first signs started with the investigation of the conduct-of business supervision in the US, Consumer Financial Protection Bureau (CFPB), due to complaints from several customers regarding the opening of unauthorized accounts, and later other violations of consumer rights were committed in other products and services from the same institution (Bishop, 2018).

Unfortunately, there are other important institutions with significant fines for bad practices in the relationship between financial entities and clients. For instance, Consumer Financial Protection Bureau (2016) pointed out an ample list of well-known credit and financial institutions that were fined for illegal practices, deceptive marketing, unfair billing, illegal overdraft fee, among others in July 2016.

For these reasons, in the period between 2011- July/2016, the Consumer Financial Protection Bureau (CFPB) had collected \$11.7 billion from its supervised entities as compensation to customers, other consumer relief as a result of enforcement activity and supervisory activity. This kind of experience should not be considered as an outlier event that does not transcend borders or that are not replicated by its branches and subsidiaries in other countries, in words of Sabine Lautenschläger, “we need to learn from each other’s experiences. Other countries’ risks can quickly become our own.”

An overarching lesson from a supervisory perspective is that competent authorities should take mitigation measures as a means to minimize the impact of the “too big to manage problem”. In this context, to achieve an effective, suitable and comprehensive oversight of a large financial institution, it is necessary to have a full perspective of the bank operations and potential high-risk exposure so as to understand the banking business and its economic environment that evolves and changes as time goes by. For instance, at first glance, bad practices and potential risks may not be visible in the analysis of prudential requirements but that it could be very well complemented with the analysis of conduct-of-business supervision.

vii. Conclusions

From this analysis, it can be inferred that in order to fulfil a consistent model of supervision, it is required to perform a well-balanced prudential and conduct supervision. However, the current supervisory framework in the European banking system has shown a greater focus on prudential supervision, while conduct oversight has become side-lined to the national level because there is still poor coordination and consistency in terms of customer protection for the SSM countries.

Disagreements and abuse of powers that arise from the relationship between the bank and the client do not seem to be considered as a potential cause of specific or systemic instability. However, the lack of transparency and accountability plays a counterproductive role in terms of long-term relationships with clients, limiting the growth of the institution and increasing the level of risk exposure. From that

perspective, it is a key element to achieve the goal of financial stability in the long run through confidence and reputation. In this sense, whether a bank provides incomplete and/or unclear information about financial products, this fact can adversely affect their reputation as well as customer loyalty and confidence, that in turn can expose the bank to financial losses.

Therefore, the European Central Bank, which is responsible for the SSM, has a global role in maintaining the stability of the financial system and should include the conduct-of-business supervision as a part of its spectrum. Although there are some legal constraints to endorse conduct supervision to the ECB, as a second-best option in the short-term could be to improve the existing tasks of the EBA on consumer protection.

During the last years, sales practices violations have also showed to be a key point for analysing other management failures that increase institutions' risk exposure, resulting in instability. For this reason, efforts must be made for better integration between both types of supervision, especially since conduct supervision can provide sufficient elements to carry out better prudential supervision.

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