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The lack of ECB's conduct supervisory power

An analysis of the architecture and application of supervision.

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Abstract

The architecture of supervision is currently based mainly onto two pillars: the prudential and the conduct type of supervision; whose powers are conferred to different competent authorities. Due to the separate responsible institutions and to the financial crisis of 2008, the banking regulatory sector is highly fragmentated. Fragmentation is indeed the main cause of pitfalls of the banking sector, and it makes arise the need of a more unified system.

This paper, after giving a general overview of the current supervisory structure in Europe, tries to point out the problem related to the conduct supervision and its lack of an institution responsible for. Even if it is argued that the European Central Bank should be in charge of checking conduct requirements, the ECB is actually focused on different tasks, such as monetary policies.

Key Words: Supervisory structure, banking regulation, prudential supervision, conduct supervision, authorities, financial crisis

Summary

INTRODUCTION

The banking sector is one of the most deeply regulated industry and its worldwide harmonization has always been an important topic to deal with. It continues to face challenges and it keeps on being subject to reforms. Especially after the financial crisis of 2008, which caused the collapse of the entire system, there has been the need of having a more unified industry and common rules in order to prevent further negative events. Indeed, the failure of Lehman Brothers and the consequent bank crash showed that the financial system of regulation and supervision[1] were clearly inadequate and inaccurate[2]. As the financial crisis made come to light this problem, which basically is the realization of the fragmentation and the lack of homogeneity among rules of the different countries, also the fulfilment of other consequent issues arose. For example, it came up the ineffectiveness or the non-compliance of practices concerning checks on banks, when they were actually put into practice.

However, by trying to tackle all the problems relating to the regulation and supervision framework, more attention to the now-so-called prudential supervision has been paid. You might think of the reforms applied when Basel II was implemented in Basel III[3]; while conduct supervision cases, which basically deal with mis-compliance of behaviour of banks towards clients and consequent sanctions by supervisory authorities, were neglected.

This paper will try to analyse the current situation by starting from consulting the juridical literature. The Twin Peaks model of supervision is taken into consideration into the European framework and the consequent division of power that this model implies is also analysed. It will try to emphasize the differences between the two types of

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[1] To clarify, "regulation" deals more with rulemaking and it essentially responds to distinct market failure; while "supervision" has to do with checking whether rules have been applied with consistency.
To better analyze this distinction, please see Wymeersch E., "The future of financial regulation in Europe", 42 Common Market L.R. (2005), 987-1010-

[2] In order to deepen and analyze the causes of the crisis, consult Roy S., Kemme D. M., (2012), "Causes of banking crises: deregulation, credit booms, asset bubbles, then and now" and Klomp J., de Haan J., (2012), "Banking risk and regulation: does one size fit all?"

[3] For further information consult Miu P., Ozdemir B., Giesinger M., (2010), "Can Basel III work? Examining the new capital stability rules by the Basel Committee: a theoretical and empirical study of capital buffers".

supervisions, which are then taken into consideration into the current architecture of supervision. The paper focuses also on the role of the Single Supervisory Mechanism and on the powers conferred to the European Central Bank, which is more based on prudential supervisory tasks, showing how it is actually missing an authority competent for the conduct side of supervision and the protection of the consumer. This is due mainly because of the problem of fragmentation that characterize even nowadays financial system. This paper purpose is not trying to point out the most appropriate institution for this task, but it would rather attempt to justify the fact that, even though the European Central Bank misses being responsible for conduct supervision, it should not be the one in charged for it.

LITERATURE REVIEW AND HYPOTHESIS

Architecture of supervision

Financial regulation has been historically differentiated according each country and its institutional design. There are four main supervisory models, which consist in the functional, institutional, integrated and Twin Peaks approaches, but for the purposes of this paper we are going to analyse only the last one.

The Twin Peaks model of supervision has started to be adopted among the European states approximately during the nineties, and it has been more and more applied especially during the post-financial crisis period. According to this approach, there is a separation of supervisory tasks and, consequently, of its powers, which are conferred to two different regulatory authorities. In fact, when it comes to financial stability in general, or to the relationship between financial intermediaries and public authorities, or, more specifically, to financial institutions requirements, we are dealing with prudential supervision. On the other hand, as far as the relationship between financial intermediaries and costumers or consumer protection are concerned, we have to do with conduct supervision. As already mentioned, the Twin Peaks model has been increasingly used in Europe, as during the crisis it has been showed the weakness and inadequacy of national regulatory bodies. Also, it has seen the involvement of experts trained in economics, finance and accountancy with different skills and approaches. Consequently, it is extremely important "having one regulatory authority solely devoted to financial stability and other prudential oversight issues, and another regulator with responsibility for investor and consumer protection in the light of scandals involving mis-selling of investments and financial products"[4].

For what concerns the authority responsible for checking the compliance, it depends on the type of supervision examined. More specifically, the country control principle states that the home competent authority has prime competence and it is responsible to supervise a market actor or to regulates its activities. Nevertheless, when it comes to prudential supervision, the home country control principle rules and it is up to the national competent authority where the market actor originally belongs to provide to potential mis-compliance. On the other hand, when dealing with conduct supervision, the principle applied is the host country control one, which means that the national authority where, for example, the bank is established has to act and solve. The main problem connected to this rule is the fact that it indirectly creates fragmentation and heterogeneity into the system. In fact, there might be a lack of incentive for authorities to operate in case of cross-border operations, which is often the case. This problem has been tried to be tackled by reforming the whole architecture of supervision and regulation.

The European architecture of supervision, which is defined as "the allocation of supervisory powers to different policy institutions, have actual implications for policy conduct and for the economic and financial environment in which these policies are implemented"[5]. The organization of financial regulation and supervision have been subject to regulatory reforms, aimed at solving the problem of fragmentation. In fact, systematic risk might also be caused by supervisory fragmentation. So, in order to prevent further collapses of the entire financial system, it was necessary to reorganize the institutional design.

[4] Kern A., (2019), "Principle of banking regulation", Cambridge University Press
[5] Ampudia M. et al., (2019), "Working paper series: the architecture of supervision", European Central Bank

ECB's responsibilities

In order to pursue this main objective, there have been established two institutions, to which different objectives have been assigned as well, by the European Union in the attempt to institutionally restructuring the financial regulation: the European System of Financial Supervision (ESFS) and the European Systemic Risk Board (ESRB). They both deal with prudential supervision, but the difference stands in the scope of action: a more micro level for the first institution, and a more macro level for the second one. In fact, ESRB is responsible for preventing or mitigating systemic risks due to macroeconomic developments in order to maintain financial stability[6]. On the other hand, the ESFS is composed of three supervisory authorities (ESA), which are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational and Pension Authority (EIOPA). As suggested by their names, they all operate in different sectors, specifically the banking sector, the financial markets and investment sector and the insurance one; and they are conferred by real and concrete powers[7]. This linkage between the ESAs and the ESRB was an attempt to establish a and a more coherent institutional framework aimed at a more harmonized implementation.

Always with the perspective of tackling the problem of fragmentation among EU laws, it has been established the Banking Union, which is composed of three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Deposit Guarantee Scheme (DGS). They are all focused on supervisory tasks, but for the purposes of this paper, we are going to focus only on the SSM.

The Single Supervisory Mechanism was assigned with the responsibility of checking on significant financial institutions settled in the euro zone by the ECB. In fact, according to the Article 1 of SSM Regulation, it contributes "to the safety and soundness of credit

[6] According to Art. 3 Regulation (EU) No 1092/2010 of the European Parliament and of the Council, on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.
[7] To deepen the topic of ESAs' powers, consult for example Art. 17 to 19, ESA Regulation. They basically enact legally binding administrative acts, such as the power to intervene in case of policing breaches of EU law, or mediate and settle disputes between national authorities.

institutions and the stability of the financial system within the Union [...] with full regard and duty of care for the unity and integrity of the internal market". What basically the SSM does is to check daily whether banks comply with capital requirements, liquidity ratios, corporate governance rules etc... for purposes of prudential supervision. Its powers have been conferred by the European Central Bank, which according to the Article 127.6 TFEU[8] is endowed also with supervisory powers.

In order to better understand the involvement of the ECB in the framework of supervision, first we are going to explain its function. In fact, "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 European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119. 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"[9].

Basically, the ECB is focused on maintain price stability through the application of monetary policies and all the consequent manoeuvres involving inflation, exchange rates and management of the Euro. Moreover, the paragraph 6 of this Article opens up to the possibility for the ECB to have supervisory power, in detail concerning prudential supervision. "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings".

[8] Consolidated version of the Treaty on the European Union and Treaty on the Functioning of the European Union 2012/C 326/01
https://eur-lex.europa.eu/eli/treaty/tfeu_2012/oj
[9] Art. 127 published in 2016 in the Official Journal of the European Union
https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12016E127&from=IT

This paragraph is extremely important because it clearly states that the ECB has power to make banks comply with the law; it is the legal basis for it to enact. At the same time, it is an attempt to harmonize, unify and create consistency among EU countries. The main reason why prudential supervisory powers have been conferred to the ECB is because monetary policies, which the Central Bank is competent for, and supervision are actually interconnected, and they also help improving market discipline[10]. As a matter of fact, there is a direct interaction between the objectives of price and financial stability, since monetary policy affects price stability, which in turn impacts the aggregate demand of banks. These last subjects are forced to change their characteristics and behaviour in order to comply and create consistency. For instance, when the ECB changes policy rates, intermediation margins and banks funding conditions are directly affected and thus force banks to adapt risk taking decisions and distress probability[11]. So, for what concerns prudential supervision, having a single institution carrying out both monetary policies and supervision, seems to benefit and provide a better framework.

As already mentioned, the SSM provides direct help for the ECB to carry out its objectives as central supervisor. Despite the elements of cooperation and delegation provided, there is still the possibility for possible conflicts of interests and asymmetries of information to arise (Ferrarini G., Chiarella L., 2013).

ECB lack of power

It has been debated and criticized the fact that ECB lacks powers relating to conduct supervision and it would be ideal to confer to the Central Bank also the capability to control financial institutions in case of relationship with their clients. However, we might consider two pitfalls into this type of institutional organization. First of all, there is a clear distinction between prudential and conduct supervision, and currently the ECB's powers include only the first one. It actually seems more coherent, given the fact that the actions of the ECB influence indirectly the structural standards of banks. Secondly,

[10] For further information, consult Carrillo J.A., Mendoza E.G., Nuguer V., Roldán-Peña J., (2017), "Tight money-tight credit: coordination failure in the conduct of monetary and financial policies"
[11] In this paper it will not be analyzed in details how monetary policies affects banks behavior, since of course there are more aspects to be examined.

the ECB scope of action relates only the Eurozone, which means the countries which actually have adopted the Euro as a currency. Similarly, the powers of the SSM, acting as delegator for the ECB, will be confined to the Eurozone, making in this way the Banking Union failing to provide the degree of financial integration that it was actually expected. Consequently, as far as conduct supervision is concerned, we have confirmed the fact that the host country control principle applies. In the case of a cross-border situation, when a possible mis-compliance towards clients happens and the national competent authority does not act to solve the situation, if the country where the breach occurred does not belong to the euro zone, then the scope of action of the ECB will not reach that country.

Even though prudential and conduct supervision might seem connected at first sight, and you might think to the fact that safeguarding institutions and the financial system as a whole - which relates to prudential supervision objectives - have an indirect influence also on the protection of the single consumer, it would be best to keep the authority responsible for checking the two different types of supervision separated. First of all, for the reasons already mentioned: the distinction of targets is clearly underlined; second of all, the ECB might not be the proper authority for controlling also the issued related to consumers.

Also, having prudential and conduct supervisory powers in the same institution might not be the best solution, as possible conflict of interest might arise. As already explained, these types of supervision have different objectives and targets and it is important to keep them separated. In fact, there might be situations, for example in case of crisis, where the purposes of prudential supervision, and therefore financial stability, might overcome and seem more important than those relating to conduct; causing then neglecting duties towards customers.

Even though conduct supervision rules are a more recent topic, managing policing different types of behaviour has become an increasingly important matter for the functioning of markets. You might think of conflict of interest cases, which clearly concern the conduct supervision scope of action.

One of the possible solutions that has been proposed is to confer to the EBA the power to supervise the relationship between financial institutions and customers. Initially, it might appear that the problem of the reachability is solved, because the EBA scope of action covers the entire European Union. Also, the EBA is already fulfilled with supervisory and regulatory powers, as the Article 8 of the EBA regulation states: "The Authority shall have the following tasks: to contribute to the establishment of high-quality common regulatory and supervisory standards and practices, in particular by providing opinions to the Union institutions and by developing guidelines, recommendations, and draft regulatory and implementing technical standards which shall be based on the legislative acts referred to in Article 1"[12]. However, what the EBA does is to coordinate national supervisory authorities, while potential disputes concerned with conduct supervision arise directly in singles financial firms, which are actually controlled by the national authorities. So, adding to the EBA the responsibility for supervising conducts would simply turn into lack of incentive to act, as it would focus on its main tasks, which relate for example to intervention in case of emergency situations or again policing breaches.

As a result, cross-border operations remain subject to substantial supervisory fragmentation and in general the issue of conflict of interests becomes more problematic when trying to put in charge the prudential supervisor also for protecting the relationship between banks and clients.

Once ascertained the fact that the EBA should not be responsible also for conduct supervision, it might be argued that different authorities can be put in charge for it according the sector in which they operate. In fact, it is stated in the International Monetary Fund Reports that, when considering the wholesale market activities, it would benefit more allocating the responsibility for conduct supervision to the ESMA, conferring to it a stronger power and role. Indeed, the current bilateral cooperation between the various national competent authorities, which are responsible for checking that relationship with clients is fairly respected, might not be sufficient to ensure the degree of supervision that there is supposed to be. However, even if there were more authorities responsible according the banking sector, the problem of fragmentation and heterogeneity within the system would remain, if not enhanced.

[12] EU Regulation No 1093/2010 of the European Parliament and of the Council of 24th November 2010 establishing a European Supervisory Authority (EBA).
For further information on the powers conferred to the EBA, check:
https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32010R1093&from=IT#d1e892-12-1

CONCLUSION

After having analysed the European institutional design of financial regulation, it clearly can be deduced that there still are problems related to the fragmentation and heterogeneity of the system as a whole. The reforms that have been already realized have brought substantial benefits, but the financial system still needs to be harmonized fully. Due to the fact that the reforms applied were focused more on the prudential aspects of supervision while the ones relating the conduct supervision have been neglected, the market cannot be efficient as in theory.

ECB, which is already invested of a lot of tasks, is not the appropriate authority that should supervise the client and financial institution relationship. As a matter of fact, the protection of customers and his interests would actually obstruct the primary objectives of the European Central Bank as an institution responsible for prince stability.

It was also suggested that the EBA might not be the best authority that should be appointed for checking the conduct compliance, as it already has more important objective to pursue and that could be in conflict with one another.

Finally, it is also not recommended to have multiple authorities dealing with this kind of supervision, but it would rather be more coherent establish an institution, which is able to operate in the entire European Union and that it has to deals only with conduct supervision.

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