

The Institutional Developments of the European Banking Supervision

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Abstract: In response to the negative impact of the financial crisis on the stability of the banking sector the architecture of the banking supervision in Europe has fundamentally changed. The European Central Bank started to take additional tasks in the banking supervision. Thus, there arise conflicts of interest with its role in monetary policy. The Central Bank's activities should be controlled, that may lead to the loss of its independence.

Zusammenfassung: In Reaktion auf die negativen Auswirkungen der Finanzkrise auf die Stabilität des Bankensektors ist die Architektur der Bankenaufsicht in Europa grundlegend verändert worden. Die Europäische Zentralbank hat Aufgaben in der Bankenaufsicht übernommen. Dadurch entstehen aber Interessenkonflikte mit ihren geldpolitischen Aufgaben. Sie müsste kontrolliert werden und könnte so ihre Unabhängigkeit verlieren.

Keywords: Central bank independence, banking supervision, financial market.

Stichwörter: Unabhängigkeit der Zentralbank, Bankenaufsicht, Finanzmarkt.

Introduction

The still continuing financial market and banking crisis has shown since 2007 that such crises are able to influence the functioning of market economy and democratic systems substantially in its entirety. But even outside of crisis scenarios, the financial markets and the banking system have a significant impact on the economic development and prosperity of the economy [1, 81-83] - which in turn radiates on political processes. Conversely, the actors on the financial markets and financial institutions are also significantly influenced by the relevant political conditions; probably „political institutions [are] the most important determinants of financial institutions“ [2, 288].

The interrelationships are quite complex. Generally most feared are violations of the principles of creditor protection and system protection through banks and other institutional financial market participants. Logically, exactly these potential hazards provide the most important motives for the far-reaching oversight and regulation of banks [3, 27]. The achievement of these objectives, in turn, depends on how the prudential rules as well as those organizations responsible for its implementation and enforcement are designed by the democratically elected legislature. The issue of adequate institutional structure of European Banking Supervisors has currently obtained a new momentum by the reorganization of responsibilities between national and European institutions. This contribution therefore focuses on the institutional developments of the banking supervision in Europe.

European Banking Supervision

Confidence in the functioning of financial markets and the stability of the European banking system will continue to depend crucially on the independence of the European Central Bank (ECB) and in addition on the existing (European and national) Banking Supervisors. Central bank independence is generally regarded as a guarantor of the stability of a currency and the stability of a financial system.

Within the discussion on ensuring and maintaining a politically and economically independent central bank and banking supervision is divided into:

- goal independence,
- instrument independence, - financial independence and
- Personal independence [4, 151].

In these multiple ways, the independence of the ECB is secured by the freedom from instructions of any government institutions, by prohibiting the public finance (including the ban on the purchase of government debt securities) and by the autonomous choice of strategies and activities. It remains to ask whether the new institutional structures of European Banking Supervisors influence the objectives and developments in the regulatory and monetary policy.

Further, we pursue the following hypotheses.

1. The independence of the ECB is very strongly influenced by their participation in banking supervision.
2. The independence of the ECB as an institution of banking supervision is very limited.

It is quite clear that, through its operational supervisory functions, the ECB will promptly receive information on the solvency of (foremost systemically important, but also other) banks, which otherwise only a competent national authority would have available [5, 412-427]. If, at the same time, the ECB can support the liquidity of banks by different instruments such as by the Emergency Liquidity Assistance (ELA), conflicts of interest arise in the regulation, but also in the field of monetary policy. On the one hand, the moral hazard problem may lead to the fact that some regulatory measures are not enforced in the necessary degree of consistency or banks are treated differently in the supply of liquidity [6, 285-315]. On the other hand, a massive provision of liquidity via the expansion of money supply in turn may be opposed to monetary policy objectives.

The example of the regulation of banks before the financial crisis has shown that instability in the banking system cannot be fundamentally prevented. The state was bound to help during the crisis and to intervene with massive use of financial resources in order to stabilize the system. It is expected that this will not be excluded in the future. The state intervenes therefore, if necessary, in the interests of the ECB as an institution of banking supervision. Its independence in this area is therefore already limited in practice. In addition, the actions of the ECB in the regulation of banks will probably affect its reputation as a whole and therefore also touch upon their reputation in monetary issues.

Below we will critically discuss some of the new core elements of the European institutional structure of banking supervision. Since 1 January 2015 bank restructuring is added by an EU-wide regulation for banking resolution (Bank Recovery and Resolution Directive - BRRD) [7, 337]. According to BRRD all banks and other credit institutions within the 28 EU Member States are obliged to internally define measures for crisis prevention and to draw up recovery plans.

In Germany, the Federal Agency for Financial Market Stabilization (FMSA) has taken over the function of a resolution authority for banks. Banking supervision and banking resolution were in the national responsibilities of the member states of the European monetary union up to 2014. Iceland and Ireland, for example, has overwhelmed the rescue of their banks during the financial market and banking crisis. The new institutional structure of the European banking union is intended to prevent from recurring such problems. For the banking union three pillars are provided:

- a common banking supervision (Single Supervisory Mechanism, SSM),
- a common bank resolution (Single Resolution Mechanism, SRM) and - common standards for the deposit guarantee.

All three pillars are connected by a common set of rules (Single Rule Book).

All this means that, under the single supervisory mechanism, the ECB is the top authority of banking supervision for all banks in SSM-Member States. But its responsibility is divided into two different regulators – a direct and an indirect one. Under the direct supervision the ECB is responsible for the supervisory review and evaluation process. With regard to indirect supervision, the role of the ECB is limited to the fact that the competent national authorities ensure the demands of justice of the SSM and guarantee the coherent implementation of regulatory needs [8, 16]. Whether the ECB may ever fully fulfill its role of top banking supervision under these conditions, will have to be proved in the future.

According to the Lisbon Treaty, the primary objective of the Central Bank is to maintain price stability. There can also be transferred specific functions to the central bank related to the prudential supervision of credit institutions [9]. This dual function already creates the risk of conflicts of interest between the ECB monetary policy and its tasks in banking supervision, how they were worked out

above. Because of the governance structure of the ECB, there is no complete separation between the two areas. The deputy chairman of the Supervisory Board is also a member of the Executive Board. Thus, a leading proponent of banking supervision decides on monetary policy in the Governing Council. To avoid moral hazard the ECB would have to be subject to a specific monitoring, which ultimately, of course, would put their independence into question.

According to the Lisbon Treaty, the ECB is independent in carrying out its tasks in banking supervision. In addition to the ECB as the top banking supervision authority the national supervisory authorities remain in place. Currently there exist national bank regulators in 10 out of the 18 member countries of the Euro zone [10, 39-49]. This results not only in the question of how closely the ECB and the national supervisory authorities should cooperate in the micro-prudential banking supervision and in the monitoring of ongoing business operations. The result is mainly the question of to what extent the political independence of the ECB is respected in banking supervision, because the national supervisory authorities are regularly subordinated to government agencies. In Germany, for example, the Federal Financial Supervisory Authority (BaFin) is subject to the supervision of the Federal Ministry of Finance. Therefore, not only at macro-prudential supervision but also in the field of micro-prudential issues common European rules are necessary to ensure the independence.

Conclusions

The independence of the ECB, not only in its monetary policy but also in banking supervision, is of the utmost importance for the political and economic

stability of the EU as well as for the stability of the banking system. When it wants to agree on its monetary policy decisions with their tasks in banking supervision the ECB, however, is exposed to conflicts of interest and target in the current architecture of the European supervisory mechanism. To observe these conflicts, the ECB would have to be controlled, but this instantly would limit its independence. Institutionally, therefore, a strict separation between monetary policy and prudential tasks of the ECB must be ensured. In banking supervision there must be recognized unambiguous rules to safeguard the ECB's independence at European level.

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