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The ECBs half-baked supervision mandate

Or how to get serious about shadow banking again

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THE ECBS HALF-BAKED SUPERVISION MANDATE

Or, how to get serious about shadow banking again

By Jakob Vestergaard and Stine Quorning

Abstract: In debates on the need to “complete” the banking union, there has been little attention to the omission of shadow banks from the supervision mandate given to the European Central Bank with the establishment of the Single Supervisory Mechanism (SSM). We argue that there can be no completion of the banking union without dedicated pan-European supervision of all non-banking financial institutions. We identify four explanatory modalities for the omission of shadow banking from the SSM mandate and discuss organizational options for institutionalizing European supervision of its shadow banking sector.

Keywords: financial supervision; banking union; single supervisory mechanism (SSM); European Central Bank (ECB); shadow banking; systemic risk.

1. Introduction

The recession caused by the corona lockdown has thrown the Eurozone into yet another existential crisis (D’Erman et al 2020; Gros 2020). Matters of euro resilience are even more acute today than they were in spring 2018, when policy-makers and analysts sounded alarm about the urgency of “completing” the banking union (BU) (Donnelly 2018b; Howarth and Schild 2019; Howarth and Quaglia 2018). In past debates on what a completion of the BU would take, a crucial topic has been missing, however. There has been no attention to the establishment of comprehensive European supervision of non-banking financial institutions.

When the establishment of a Single Supervisory Mechanism (SSM) was agreed by member states in October 2013, only banks were included in its remit. This was contrary to developments in the US, where the Dodd-Frank Act established the Financial Stability Oversight Council (FSOC) with a mandate to supervise shadow banking institutions and prevent the build-up of systemic risk. In Europe, an agency dedicated to issues of systemic risk was created too, in the form of the European Systemic Risk Board (in 2010), but it was given authority only to monitor, not to supervise. Hence, the ESRB has no compelling tools to combat systemic risk, but is confined to issuing warnings and recommendations that are non-binding.

There are two main reasons why the omission of shadow banks from the SSM mandate is troubling. First, several scholars suggest that much financial sector risk have migrated from the banking to the shadow banking sector in the aftermath of the crisis (Rogoff 2019; Thiemann 2018).[1]

Second, banking and shadow banking remain so interconnected, that excluding the latter from the supervision mandate amounts to supervising European banks with eyes half-closed. The interconnectedness of banks and shadow banks stems from securitisation and collateral intermediation (Pozsar et al. 2010). Several scholars have shown how the business models of banks changed over the course of the 1990s and 2000s (see for instance Gabor 2018; Liikanen 2012; Hardie et al 2013). Hardie et al (2013) conceptualised the trend as a shift from bank-based to market-based finance, whereby banks became dependent on financial markets, in several ways. In terms of lending, banks went from an originate-to-hold towards an originate-to-distribute model, ie., selling loans

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[1] Rogoff (2019) recently warned that “risky debt... has migrated to the shadow financial system”, noting that these debts “can inflate quite quickly”.

as securitised financial products. Banks, however, were interlinked with shadow banks not only through securitisation but also through collateral intermediation (Gabor 2018; Thiemann 2018). European banks have been shown to be key nodes in European collateral networks, with European sovereign bonds used as prime collateral (Gabor 2018; Gabor and Ban 2016). The latest reports from FSB and ESRB show that banks and shadow banks have not reduced their interconnectedness (ESRB 2019; FSB 2019). Given this interconnectedness, it makes little sense to supervise only banks.[2]

It may be objected that shadow banking is in fact thoroughly supervised in Europe, not by the ECB but by the national supervisory authorities of member states. But the decision to keep shadow banking supervision a national affair has fragmented the supervision of systemic risk in Europe to the detriment of its effectiveness. Moreover, national authorities are known to be more susceptible than supranational ones to industry pressures, not to disadvantage them in international competition (Thiemann 2018, 229; Mayes 2018, 134).

In debates about the proper role of the ECB in euro governance matters it is often a concern whether proposed initiatives would violate the Treaties that define the perimeters of its legitimate activities. In this case, there are no grounds for such concern, however. The Treaty explicitly defines the remit of the ECB as encompassing "credit institutions" and "other financial institutions".[3] This scoping could easily accommodate non-banking financial institutions.

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[2] Some argue that the most substantive issues is contagion not interconnectedness (Scott 2016). Our stance is that both issues are important and that comprehensive pan-European financial supervision can contribute on both registers.

[3] See Article 127(6) of the Treaty on the Functioning of the European Union

If the Treaties allow for the inclusion of non-bank financial intermediaries, maybe the decision to exclude them from the ECB supervision mandate simply reflected that regulators and policy-makers were unified in finding their inclusion irrelevant, one might ponder. There is ample evidence to the contrary, however. A letter sent in September 2012 from José Manuel Barroso, then President of the Commission, to Martin Schulz, then President of the European Parliament, is indicative of the attention to the issue at the highest echelons of European financial regulation. Discussing the BU, Barroso argued that it was important to consider "legislation to address systemic risks related to non-banks and shadow banking" (Barroso 2012).

An understanding of the factors that explain the exclusion of shadow banks from the SSM mandate is of paramount importance for a qualified discussion of how such supervision may be instituted going forward. But despite the burgeoning literature on EMU reforms and BU, only a few studies analyse the constitution and operation of the SSM.[4] A couple of these mention that the SSM mandate exclude non-banking institutions, but none of them explore the potential reasons why that was the case.

In this paper, we identify four explanatory modalities. Our ambition is not to adjudicate between the different types of explanations – asserting which were the more decisive – but to produce an account that is as exhaustive as possible. This strategy best informs a debate about discursive and organizational strategies that can be deployed in order to promote the establishment of pan-European supervision of Europe's shadow banking.

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[4] See Thiemann (2018), Angeloni (2015), Angeloni and Beretti (2015), Ferran and Babis (2013) and Wymeersch (2014).

The omission of shadow banks from the mandate of the SSM is by far the only shortcoming of post-crisis developments in Europe's tackling of systemic risk, of course. To effectively address systemic risk establishment of a more firmly and formally institutionalized lender of last resort function at the European level is crucial. But we argue that supervision of non-banks is sufficiently important in its own right to merit focused attention, not least because it constitutes a core aspect of a serious problem in Europe, namely the "under provision of the public good of financial stability" (Quaglia 2013, 27).[5]

The remainder of our essay is organized as follows. First, we review the existing literature on the omission of shadow banks from the SSM mandate and outline our approach. We then discuss the four main explanatory modalities, showing how they relate to the four main types of institutional theory (Schmidt 2010). Finally, this typology of explanations helps us identify four different ways to institute comprehensive European supervision of shadow banking going forward.

2. Background and analytical approach

The starting point for post-crisis reforms of financial supervision in Europe was the high-level report published in 2009, named by its convener, Jacques de Larosiére, former governor of the French central bank (de Larosiére 2009). The report's two main proposals for institutional reform were the establishment of a European Systemic Risk Board (ESRB) and the transformation of three pan-European advisory committees into

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[5] Many post-crisis regulatory initiatives require strengthening (Howarth and Schild 2019; Howarth and Quaglia 2018; Mayer 2018; Salter 2017).

independent supervisory agencies; the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). The ESRB began operations in late 2010 and the three ESAs in early 2011.

Both ESMA and EIOPA perform supervisory tasks pertaining to parts of the shadow banking sector. However, they do so only in partial ways, with limited mandates (Quaglia 2013; Busch and van Rijn 2018).[6] The creation of the three European Supervisory Agencies (ESAs) constituted a formal upgrading of pre-existing committees, but did not reflect a concerted effort to institute comprehensive supervision of European shadow banking.

Although the establishment of the BU was decided upon in 2012, shortly after the ESRB and the three ESAs had been created, the scholarly literature on the BU have engaged only in limited ways with these closely linked institutional developments. The literature has focused on how the BU came about rapidly in a highly politicised climate (De Rynck 2016; Véron 2015; Howarth and Quaglia 2018; Schild 2018; Donnelly 2018b) and how the regulation of the BU works in practice (Howarth and Schild 2018; Schoenmaker and Véron 2016; Schoenmaker 2016; Donnelly 2018a).

In terms of the three pillars of the BU – the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the common European Deposit Insurance Scheme (EDIS) – only a modest amount of literature have focused on the SSM (Ferran and Babis 2013; Angeloni 2015; Angeloni and Beretti 2015; Wymeersch 2014). But the

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[6] ESMA, for instance, have "no legal authority over domestic regulations and no real power in terms of supervision or rulemaking"; it is little more than a forum for national supervisors to monitor and coordinate actions (Thiemann 2018, 229).

few studies that exist notes that shadow banking institutions were omitted from the SSM mandate:

Schoenmaker (2016, 46) stresses that the SSM is "constrained to banking supervision only, which means that the ECB cannot extend towards shadow banks or other relevant intermediaries if necessary"; Mayes 2018 notes how the exclusion of shadow banks "precludes a total coverage of the financial sector"; Busch and van Rijn (2018, 338) observes that "the exclusion of market infrastructure, insurers, investment firms and other shadow banking entities is puzzling from the perspective of financial stability"; Wymeersch (2014, 27) posits that the exclusion of "several categories of financial institutions" from the SSM mandate will likely "raise eyebrows as some of these institutions are clearly significant and may even be systemically relevant"; Posen and Veron (2014) notes that the exclusion of "non-banks could lead to harmful regulatory arbitrage"; and Ferran and Babis (2013, 259) are concerned that "SSM will not have the flexibility found in both the US and the UK systems for non-banks to be brought within the purview of the ECB if they are deemed to be systemically significant".

Despite the awareness of the problems entailed in omitting non-banking financial institutions from the SSM mandate, there has been no systematic effort to explore potential explanatory factors.

Based on extensive engagements with post-crisis financial supervision and regulation in Europe, we have identified several explanatory modalities in a process best captured by Charles Sanders Peirce's notion of *abduction*. None of the explanatory modalities have been deducted from specific theories, nor are they the result of induction

based on specific empirical analyses. Rather, they are the result of a "process of forming explanatory hypotheses" (C.S Peirce, Collected Papers, 5.172).[7]

In our efforts to explain the omission of shadow banks from the SSM mandate, we are not interested in identifying a supposedly decisive or superior explanation, but in multiplying explanatory modalities so as to arrive at the fullest possible account.[8] To inform our abductive effort, we have drawn upon Vivien Schmidt's (2010) typology of institutional theories.

Each of the four main explanatory modalities identified may be said to constitute an explanatory configuration, characterized by a distinct logic and object of explanation (Schmidt 2010): one of path dependency, focusing on established institutional structures; one of communication, focusing on the role of dominant ideas and discourses; one of appropriateness, focusing on the normative setting and framing; and finally, one of calculation, emphasizing the incentives of a key actor.

But we aim not only at multiplying explanatory modalities, but also at continuously stressing the hypotheses generated, by reflecting on the potential limitations of their explanatory potential. We look, in other words, at how the omission of shadow

[7] In Peirce's seminal account, the logic of abduction proceeds as follows: "The surprising fact, C, is observed; But if A were true, C would be a matter of course; Hence, there is reason to suspect that A is true" *(Peirce, Collected Papers, 5.189).*

[8] Here we take inspiration from Nietzsche's perspectivism: "There is only a perspective seeing, only a perspective 'knowing'; and the more affects we allow to speak about one thing, the more eyes, different eyes, we can use to observe one thing, the more complete will our 'concept' of this thing, our 'objectivity', be *(Nietzsche, On the genealogy of morals III, §12).* For introduction to Nietzchean perspectivism, see Welshon (2009: 28-29).

banks from the SSM can be explained in terms of different but overlapping institutionalist frameworks, while examining the extent to which these are coherent with the evidence base. We put forward the four identified explanatory modalities as an abductively generated theory of a specific occurrence in European post-crisis financial supervision, which explains the omission of shadow banking from the SSM mandate as the combined cause of several, supplementary factors.

Based on our account and analysis of the four main explanatory modalities, we venture into a discussion of conceivable policy options for addressing the lacking supranational supervision of shadow banking in Europe, reflecting on their respective strengths and weaknesses in terms of feasibility and effectiveness.

3. Why were shadow banks excluded from the supervision mandate?

Before exploring the full range of explanations why non-banking institutions were not included in the SSM mandate, one might ask if we need anything other than the generalized majority preference, amongst member states, for a "limited reform approach" to European post-crisis reforms of financial regulation and supervision (Quaglia 2013, 24) to account for it? Our answer is the affirmative. Even if shadow banks had been included in the SSM mandate it would still have constituted a "limited reform approach" against the benchmark of regulatory proposals for international minimum haircuts that were circulated by the Financial Stability Board (FSB) in the aftermath of the financial crisis (Gabor 2018). The question therefore becomes why the approach to shadow banking in Europe was reduced to the bare minimum of merely monitoring?

The account of the four explanatory modalities follows shortly, but first a brief overview charting their alignment with the four main types of institutional theory (Schmidt 2010):

- From a discursive institutionalist perspective, the omission of shadow banking may be understood as intimately related to the concurrent ideational reframing of shadow banking. With shadow banks being framed no longer as a serious threat to financial stability but as essential to economic recovery, it didn't seem important or even desirable to subject them to pan-European supervision
- From a historical institutionalist perspective, the path dependency created when the ESRB was established played a key role. With a designated institution for oversight of SBs already in place, and a decision only to monitor having already been taken, there was little scope for including shadow banking institutions in the SSM supervisory mandate
- From a sociological institutionalist perspective, the omission of shadow banks from the SSM mandate appears a matter of appropriateness. The SSM was conceived and negotiated in the context of the launching of the BU, an effort to break the bank-sovereign doom loop in the context of the sovereign debt crisis. In this political context, it was natural to focus on banks rather than shadow banks.
- Finally, from a rational choice institutionalist perspective the omission of shadow banks from the SSM mandate could be seen as resulting from resistance by the ECB. In this interpretation, shadow banks were excluded from the SSM mandate, because one of the most powerful actors, the ECB, didn't want to risk that its primary mandate for price stability would be compromised by formal, supervisory responsibilities for shadow banks.

Positive reframing of shadow banking

In the period from 2012 to 2015, European shadow banking underwent a process of discursive reframing (Engelen and Glasmacher 2018; Engelen 2018). The conjunction of weak economic performance and commitment to austerity in most EU member states

meant that policymakers had to look elsewhere for strategies to promote economic growth and job creation. The solution identified featured shadow banks as an alternative source of credit for SMEs. By mobilizing non-banking institutions in the provision of credit to SMEs, it would be possible to circumvent the post-crisis contraction in funding from banks, it was argued. Shadow banks came to be seen as primarily a crucial source of business funding, economic growth and job creation, and much less as a source of systemic risk and financial instability (Braun and Hübner 2018; Engelen and Glasmacher 2018).

While the emergence of the new discourse on shadow banking has been linked mainly with the Capital Markets Union (CMU) initiative, launched in July 2014, we suggest that the political rationalities that informed the reframing of shadow banking were at play several years before. Policymakers were preoccupied with identifying a low-cost, job-creating growth strategy already as they were negotiating the BU in 2012.[9] The same preoccupation loomed large in the Commission's Green Paper on Long-Term Financing (LTF) of the European Economy, released in March 2013, that is, in parallel with the negotiation of the SSM mandate from September 2012 until October 2013. In the LTF Green Paper, SMEs were singled out as one of the most important sources of long-term economic growth, and the lack of funding for them was identified as a major impediment to growth (see also Braun and Hübner 2018).

Thus, as the SSM mandate was negotiated, shadow banking was already being reframed as a solution rather than a problem. A plausible interpretation of the omission

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[9] While the reframing of shadow banking was brewing from 2012 onwards, the shift from the Barroso to the Juncker Commission in November 2014, and the launch of the CMU, reinforced and accelerated it.

of shadow banks from the SSM mandate, from this perspective, would be that policymakers and regulators did not want to interfere with shadow banking at this critical moment for fear of inhibiting economic recovery (Braun and Hübner 2018; Engelen and Glasmacher 2018).

While appearing compelling at first, there are several limitations of this explanatory modality. First, no firm evidence establishes that the role of shadow banks as a potential source of funding and economic growth played a role in motivating the omission of shadow banks from the SSM mandate. Second, subjecting shadow banks to supervision would not necessarily impede their ability to fund SMEs and hence nor their contribution to economic growth. All things considered, we are not convinced that the positive reframing of shadow banks, in and of itself, can explain the omission of non-banking institutions from the SSM mandate.

Avoiding disruption of prior decisions and institutional constructs

Another plausible candidate for an explanation of the omission of shadow banks from the SSM mandate is that a European institution had been created only two years earlier with the explicit mandate of monitoring shadow banks, namely the European Systemic Risk Board (ESRB). If the SSM mandate had included supervision of shadow banks, it would have caused disruption in the ecology of post-crisis European financial regulation (Mayes 2018). Having one institution responsible for monitoring and another responsible for supervision would be awkward, at best. So the implication of giving the SSM a mandate for shadow banks would likely have been to subsume the ESRB under the SSM. Such institutional disruptions often meet resistance from the institutions that would potentially be subject to dislocation and reorganization.

A first note of caution, however, with respect to this explanatory modality, would be that a similar logic could be applied to the supervision of banks. The year before the

banking union idea was first floated by Herman van Rompuy (2011), the EU had decided to establish a supervisory body for banks; the European Banking Authority. If it was possible to include banks in the SSM mandate – despite the prior existence of EBA – why would it not be possible in the case of shadow banks, despite the prior existence of the ESRB?

Here one might add that the ESRB has been criticized from the outset for having limited power and being slow on its feet. Its complex institutional configuration – with 28 national central banks, all three ESAs participating, and with the attendance of financial authorities from all member states – rendered its processes of issuing recommendations "cumbersome" (Thiemann 2018; Lombardi and Moschella 2017; Salter 2019). Lombardi and Moschella (2017) reflected that the institutional constitution of the ESRB showed that policy-makers were more concerned with symbolic, signalling effects than with the efficiency of European financial supervision.

Perhaps the difference between banking and shadow banking – with regard to the SSM mandate – was not so much organizational as political then. The EBA was one of three advisory committees that had been transformed into a supervisory agency. In the case of the banks, a decision had already been taken to in fact supervise them, whereas for shadow banks the opposite was the case; a political decision *not* to supervise had been taken several years earlier (contrary to what was the case for the three ESAs). Hence, including shadow banks in the SSM mandate was never really on the negotiating table.

Again, a balanced account must note a key weakness of the suggested explanation. Why would the decision to monitor rather than supervise be politically irreversible? In the climate of political urgency that characterised the period when these institutional innovations took shape, surely a change of approach, from monitoring to supervision, would have been possible (if widely considered important)? The entire BU process was

considerable institutional rupture, as was the ECB's venture into the OMT programme, so maybe this explanatory modality also is not enough, in itself, to explain the omission of shadow banking from the SSM mandate.

Focused on breaking the doom loop, forgetful of systemic risk

It was discussed several times throughout the Commission's Green Paper and Communication on shadow banking, published in March 2012 and September 2013 respectively, that shadow banks ought to be subject to supervision. In the Communication from September 2013 it was argued that such supervision could be linked to the Single Supervisory Mechanism (SSM). Yet, there were no traces of this kind of reasoning in the SSM files; neither in the original Commission proposal nor in the final legislative text. Not even in official documents aiming to pre-empt burning questions and reservations stakeholders might have about the SSM, was there any mention of shadow banks (EC 2012a, 2013b).[10]

Instead, the SSM documents were alluding to a different set of concerns, centred on the bank-sovereign 'doom loop' and its potential ramifications for euro resilience. Barroso, then Commission President, stated that the aim was to "to break the vicious link between sovereigns and their banks" (EC 2012b). "The role of the ECB is to make sure that banks in the euro area stick to sound financial practices", Commissioner Barnier elaborated (ibid.). Beyond these acute policy concerns, official documents also stressed that the Council decision to create an SSM for banks was "part of a longer term vision for economic and fiscal integration" (ibid.).

[10] The two FAQ's released by the Commission had no Q&A on why shadow banking institutions were not included in the SSM mandate (EC 2012a, 2013b).

In conceiving the SSM, policy-makers, regulators and member states were acutely concerned with breaking the bank-sovereign doom loop. This was the core *raison d'étre* of the BU – not a concern with addressing systemic risk – and hence banks were seen as the crucial entities to target, not shadow banks. As a consequence, the main political battle of the BU was not whether or not to include non-banking institutions in the supervisory effort, but rather how many banks to subject to supranational rather than national supervision.[11]

While this explanatory modality is compelling in highlighting how the legislation was shaped by the framings that dominated in the specific conjecture, we nevertheless hesitate to rely fully on it. Shadow banks do in fact play a key role in the dynamics of the bank-sovereign doom loop. It would not have been too difficult to articulate a concern with shadow banks that related them specifically to the dominant agendas of the BU effort and the establishment of the SSM. We suspect, therefore, that a fourth and final explanatory modality must be drawn upon to complete our account of the omission of non-banking institutions from the SSM mandate.

Too much of a bad thing? The ECB's reluctance

Maybe a key reason why shadow banks were excluded from the SSM was that the ECB didn't want them included? We noted that while the EBA was invested with formal, supranational supervisory powers (Donnelly 2010, 8) the ESRB was given only an advisory one. If it was controversial to anchor the monitoring of shadow banks in an

[11] For the division of labour between national and supranational authorities, instituted with the SSM, see Donnelly (2014, 99) and Quaglia (2013, 25).

institution designed to concern itself, first and last, with price stability, it would obviously be even more so, if new supervisory powers had included non-banking institutions.

A plausible reason why it was decided that shadow banks were not to be subject to European-level supervision was that there were strong forces at work to keep the ECB 'at-a-distance' from formal responsibilities pertaining to financial stability, for fears that this could potentially compromise its commitment to price stability. Willem Buiter was quick to sound alarm over the potential "clashing demands of price stability and financial stability" that could result from locating the ESRB within the ECB (Buiter, cited in Treasury Committee 2009, 18). In fact, concerns were raised by many, notes Ferran and Alexander, "about the wisdom of vesting responsibility for macroprudential supervision in a central-bank dominated body given the potential for the demands for price stability and financial stability to pull in opposite directions and thus to give rise to conflicts of interest" (Ferran and Alexander 2011, 28).

These concerns links to a wider academic debate about how to best organize the potentially conflicting objectives of financial stability and price stability. In this literature, it is a widespread notion that the two policy objectives should ideally be pursued by two different modes of policy – macroprudential and monetary policy, respectively.

Whether the ECB was to be assigned responsibility for both monetary and financial stability, is a debate that dates back to its inception, with the Germans advocating separation and the British integration (Goodhart and Schoenmaker, 1995). Eventually, the German model prevailed, such that the ECB was assigned responsibility only for monetary policy, whereas financial stability remained a national responsibility.[12]

[12] It was left to the discretion of member states, whether to attribute the financial supervision responsibility to its national central bank or to a separate supervisory entity.

This has engrained a deep resistance in the ECB against policy changes compromising its price stability mandate. Hodson argues that the position of the ECB is generally supportive of efforts to bestow greater competences on itself or other EU institutions, except when such changes "are perceived as a threat to price stability (e.g., by interfering with its mandate or political independence)", in which case it will strongly "[prefer] status quo to further integration" (Hodson 2011, 37).

The ECB became the first amongst the EU institutions to actively promote establishment of a banking union, following a realisation that it had to step in to guarantee the sustainability of the euro and ensure the transmission of its monetary policy throughout the eurozone. The ECB thus became an important entrepreneurial advocate of the creation of a BU (De Rynck 2016, 132) and a key player in an intergovernmental negotiation process dominated by the bigger member states, in particular Germany (Donnelly 2014; Howarth and Quaglia 2015; Schäfer 2016; Schimmelfennig 2015, Schoeller 2018).[13]

If the ECB resisted a broader SSM mandate, it would not have been the first time it advocated a light-touch approach to European shadow banking. Gabor (2016) has demonstrated that the concerted effort by the Commission to establish a European financial transaction tax collapsed to large extent on account of the ECB's insistence that repos, an important segment of the shadow banking sector, had to be excluded from any such initiative.

A technocratic objection might be, however, that the ECB resolved the issue of dual objectives organizationally, in and through the way it operationalized its banking supervision mandate. The SSM was created within the ECB, but at arms-length from

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[13] For the role of the European Parliament, see Rittberger (2014).

monetary policy-making. Commissioner Barnier stressed this point when the SSM legislation was released; "We have proposed a mechanism", he said, "to separate supervision from monetary policy within the ECB" (EC 2013a). In so doing, "potential conflicts of interest" could be avoided (EC 2012c):

> Conflicts of interest could for instance emerge in a situation where in order to meet the monetary policy objective of price stability, interest rates need to be raised, while this might at the same time have adverse effects on the solvency and profitability of the banking sector (EC 2012c).

But one thing is organizational charts and assignment of different objectives to different departmental chiefs, another is the realities of central banking controversies over conflicting objectives. Yves Mersch, member of the executive board of the ECB, insists that the ECB should always put price stability before financial stability; whatever responsibility the ECB may have with regard to financial stability, it can only ever be secondary, at best.[14]

One might say that the original decision to go with the German model of separating the two responsibilities has been gradually and partially undermined with the integration of first the ESRB and then the SSM within the organizational and jurisdictional boundaries of the ECB – such that the current state of affairs is a hybrid of the two original models of separation or integration, although with a clear hierarchy of goals and mandates, giving priority to monetary policy and the pursuit of price stability. The organisational picture only gets more complicated by the fact that the ESRB in principle can address recommendations and warnings to the ECB itself (Ehrmann and Schure 2019). The important point here is that it is not unlikely that this hybrid solution –integrated, but internally separated and hierarchized – is in fact less effective than both of its constituent alternatives would be.

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[14] Yves Mersch's comments were quoted by Bloomberg in September 2018.

Beyond the ECB itself, we cannot help briefly mentioning that it is certainly imaginable that high-ranking executives of the banking industry sensed that an SSM oriented exclusively towards banks would be much less disruptive of the business models of large global banks than an SSM with supervisory powers over non-banking institutions and a concomitant concern with systemic risk. If indeed they had such premonitions, it is likely that they imparted them on their high-ranking colleagues in the ECB.

4. Policy alternatives

Looking forward, we see four options for instituting enhanced European supervision of shadow banking, each of which we now outline and assess in terms of feasibility and effectiveness. The two most straightforward ways in which European supervision of shadow banking can be strengthened, is to either upgrade the existing mandate of the ESRB to encompass not just monitoring but also supervision, or to expand the mandate of SSM to include all financial institutions.[15] A major problem with both of these options is that they would increase the ECB's formal responsibilities for financial stability and hence would likely meet intensive internal resistance for fear of eroding the primacy of the ECB's commitment to price stability. In the absence of a revision of the mandate of the ECB itself – formally putting financial stability and price stability on equal footing – these two options don't seem practicable.

A third option would be to create one or two new supervisory bodies targeting specific activities in the shadow banking sectors where supranational supervision would be particularly important. As a case in point, one might establish a European Repo Agency, to complement the supervisory work of ESMA and EIOPA. In many ways, such

[15] The Articles exempt only insurance companies.

a mushrooming strategy likely would be the path of least resistance. But it would also be the least compelling. The supervisory mandates of the existing ESAs are known to be weak and the danger that coordination efforts would be unable to compensate for the disadvantages of fragmented supervisory agency is considerable.

This leads us to the fourth option, to create a new institution of financial oversight that merges all of the existing pan-European supervisory and monitoring agencies into one – organized as an independent institution, separate from the ECB. At first glance, it may seem the least realistic of the four options. But it has several strong features that merit attention. First and foremost, it would bring an end to institutionally fragmented financial supervision and likely lead to enhanced supervisory coherence and consistency across various segments of European finance. But even more importantly, perhaps, it would address a key problem exposed by the financial crisis that post-crisis reforms have still not tackled, namely "the complete lack of any clear institutional responsibility for overseeing the safety and soundness of the financial system as a whole" (Ferran and Alexander 2011, 18).

Table 1 summarises the four options on two dimensions; the level of integration achieved by the reform and its institutional appropriateness, in terms of the match between the new mandates and their respective institutional anchoring.

< INSERT TABLE 1 HERE >

Two potential sources of resistance to such a construction can be foreseen. First, popular sentiment might see it as yet another bureaucratic overreach from technocrats in Brussels – yet another infringement on national autonomy. Second, Europe's financial industries will likely prefer to see a continuous process of financial integration going hand in hand with a mode of financial supervision that is fragmented, partial and weak.

In any case, it is likely that a significant political and economic rupture in European finance would be required to pave the way for pan-European supervision of shadow banking (Mayes 2018). Maybe the recession caused by the corona lockdown and the stress that it has created in European financial governance will prove to fit the bill?

5. Conclusion

Apart from being considered a cornerstone of efforts to "deepen" Europe's Economic and Monetary Union (EMU), the banking union (BU) has been praised for having paved the way for the ECB's active engagement in the resolution of the European sovereign debt crisis (Schoenmaker and Véron 2016; Van Rompuy 2014). Mario Draghi identified the commitment to European banking supervision by the political leaders of EU member states as the "game-changer" the ECB needed to "step up its role in the crisis" (van Rompuy 2014). In this interpretation, the BU decision was what made Draghi's public assurance that the ECB "would do whatever it takes to save the euro" and the subsequent launch of the Outright Monetary Transactions (OMT) programme possible.

While the BU may have played an important role as political precondition for the ECB's ability to dissolve the sovereign debt crisis, it has also sowed the seeds for future financial crises, we argue, by excluding shadow banks from the supervisory mandate of the Single Supervisory Mechanism (SSM). The exclusion of shadow banks from the SSM has dealt a double blow to systemic risk regulation in Europe. First, it maintained supervisory authority at the national level in segments of the financial markets where cross-national supervision were most acutely needed. Second, it inadvertently but inevitably (further) weakened the position of the ESRB in the ecology of post-crisis European financial regulation.

We have discussed the factors underlying this strategic *faux pas* and suggested remedies going forward. We noted that the Maastricht treaty could easily have

accommodated a specification of the ECB's supervision mandate that included non-banking credit institutions and that several key players in the regulatory community were acutely aware of the importance of doing so. However, a plurality of factors help explain why Europe's financial governance establishment have so far abstained from insisting on a broad supervision mandate for the ECB.

We have suggested four options for instituting comprehensive European supervision of shadow banks going forward. The most straightforward options are either to expand the mandate of the ESRB to give it formal, supervisory powers, or to expand the supervisory mandate of the SSM to include shadow banks. A third option would be to establish one or two new supervisory boards for specific shadow banking activities, supplementing ESMA and EIOPA, such as for instance a European Repo Authority. The fourth option would be to creating a new system-wide institution of financial supervision, merging the existing pan-European institutions into one, with enhanced authority.

We believe that this latter option – the German model, in the terminology of Goodhart and Schoenmaker (1995) – would likely be the most effective. The fifth and final option – which we haven't discussed – would be to fully integrate all financial supervision into the ECB; that is, to have a Single Financial Supervision Authority within the ECB. But for the supervisory functions not to be treated step-motherly, as a secondary concern, the mandate of the ECB would have to be changed such that the two objectives of monetary and financial stability were put on equal footing. Many in the European central banking community, we suspect, would take a bullet before allowing that.

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