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"The Effects of European Central Bank's Single Supervisory Mechanism on Corporate Governance Practices in European Banks"

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DECLARATION OF AUTHORSHIP

I confirm that this thesis is my own work and I have documented all sources and material used. This thesis was not previously presented to another examination board and has not been published.

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TABLE OF CONTENTS

LIST OF FIGURES

1. Introduction

"Good governance is good for everyone.
Consequently, European banking supervision has made internal governance one of its top supervisory priorities."

Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, (ECB – Banking Supervision, 2016a)

The recent financial crisis of the years 2007-2009 showed that a deregulated financial sector can be dangerous for the world economy. So, politicians and regulatory authorities around the world took appropriate steps to increase regulation. The member states of the European Union have chosen a very centralized approach by establishing the European Banking Union.

In addition to the failing of credit institutions, the financial crisis revealed severe shortcomings in Corporate Governance (CG), e.g. in risk management and executive remuneration, especially in financial services companies.

This thesis combines the two aspects, stricter regulation and improved CG, in order to assess on the one hand the impact of the new legal framework and the regulatory set-up for European banks in general and on the other hand the changes, consequences and next steps with specific regard to corporate governance practice in detail.

The topic is of high practical relevance, because these changes affect all banks, from multinational corporations to small regional banks. Thus, this work provides a general overview about the European Banking Union considerable for all actors in the financial industry and a detailed analysis of Corporate Governance issues informative for members of the management body, compliance officers, internal auditors, risk managers, corporate governance specialists, compensation managers and other employees of financial institutions that are affected by the regulations. Further potential readers can be those managers and key function holders in banks whose qualification is assessed in course of the supervisory authorities' fit and proper tests, which are analyzed in detail in this paper.

The European Banking Union comprises three pillars. The first pillar relates to banking supervision, the second to resolution and the third to deposit insurance. As the Single Supervisory Mechanism (SSM), the first pillar, is fully operational since November 2014 and has the most correlation to corporate governance topics the work concentrates on this pillar. Hence, it is the objective of this thesis to determine what has changed with respect to Corporate Governance in European banks after the European Central Bank (ECB) established the Banking Union and has implemented the first part – the Single Supervisory Mechanism – and what are the consequences for financial institutions. Much attention is given to the main tool of ongoing supervision, the Supervisory Review and Evaluation Process (SREP).

Further objectives of the paper are to

- describe the recent changes in European banking regulation following the financial crisis in 2008,
- identify the status quo of regulation in the financial industry in the euro area,
- analyze recently issued Corporate Governance policies and the practical consequences for European banks and
- discuss challenges faced by banks and supervisors caused by the stricter supervision regime.

Due to the topicality and the extensive changes in the last years, the academic base needs to be refreshed on this topic. Some scientific papers and books exist on both topics, banking regulation and corporate governance in financial institutes, but a combined analysis of both aspects exists rarely, nor are the majority of the published works up to date considering the rapidly changing environment.

The chosen method of the paper is a literature study with critical discussion of practical implications. The literature study comprises

- existing academic papers and books,
- legal texts, e.g. regulations and directives
- official information provided by competent authorities (EBA, ECB, EC,…), e.g. guidelines, transcripts of speeches, reports, etc., and

- publications from business consultants, for evaluating the practical impact.

This theoretical method is chosen over an empirical analysis, because at this stage building a profound scientific basis with practical aspects is seen to make more sense than assessing the short-term developments empirically. The regulatory change and the implementation in daily business life are still ongoing and not yet completed. In future, some years after the process of regulatory movement in the banking sector has come to an end, a quantitative study of the outcomes of the change from a less regulated environment to very strict regulation is deemed as desirable. This research can then be performed based on the huge amount of statistical data ECB collects during supervision as well as through benchmarking exercises and stress tests.

The paper is arranged in two main parts. After this introductory chapter the evaluation will start with an overview about the European Banking Union analyzing the legal framework, the authorities involved, and the set-up of the three pillars. The second main part concerns corporate governance in the banking sector focusing on the peculiarities with respect to the banking sector. Furthermore, it combines the analysis of the corporate governance regulations and the related supervisory practice in the light of the European Banking Union. The last section provides a discussion of the key findings of this research and concludes with a brief summary of points of attention.

2. THE EUROPEAN BANKING UNION

2.1. Theory of Banking Regulation

Before analyzing the practical achievements and the current set-up of European banking regulation the following subsection will provide insights into regulation theory with focus on banks.

As a general definition, Ogus (2009) states that regulation is “designed to induce individuals and firms to outcomes which they would not voluntarily reach. Regulation is largely enforced by public officials and compliance is aided by the threat or imposition of some sanction.”

Dragomir (2010) analyzes regulation theory in the context of European prudential banking regulation and supervision and starts by referring to Majone (1996) who differentiates between the terms economic and social regulation. All regulatory activities which have the purpose to limit market powers, e.g. when natural monopolies exist, are subsumed under economic regulation. Whereas social regulation refers to consumer protection and safety. Traditionally, Economic banking regulation was more common in the US than in Europe. Regulators were afraid that banks may become too powerful in terms of their economic strength especially following the deregulation phase in the 1980s.

Generally, regulation in all industries is imposed because of market failures like externalities, market power or information asymmetries (Santos, 2000). In the past there was not always general agreement among practitioners and theorists whether banks need to be regulated at all (Santos, 2000), but the recent financial crisis is the best example why regulation is absolutely necessary. Santos (2000) provides two arguments for the existence of banking regulation: systemic risk and the protection of depositors’ interests. Freixas and Santomero (2003) further differentiate between three types of market failure: The first reason is monetary liquidity costs. Central banks have the responsibility to assure that enough liquidity is provided in the monetary system. Hence, they have the duty to oversee the banks’ assets and liabilities management. Costs of bank failure which relates to the systemic risk factor is stated as the second type of market failure. Trust between the counterparties in the banking system is vital, because the failure of one bank may have negative externalities for others too. The third kind of market failure is not specifically related to the banking sector. It relates to inefficiencies caused by market power. Efficiency in the financial sector depends on confidence in the financial institutes and transparency of information to all market participants. When it comes to regulation itself, higher levels of efficiency are achieved by cost-benefit analysis for each new regulation.

Also banking regulation differs from other sectors from the perspective of their goals and how they make use of instruments in order to achieve their targets. Contrary e.g. to the energy market, regulation in the financial sector is more focused on safety of the system and not so much on price (Cao, 2014). The most important instruments of banking regulation are capital requirements, deposit insurance, disclosure requirements and bank examination (Mishkin, 2001). Bank examination refers to the duty of the regulator to check whether the respective entities comply with the regulatory framework and to impose actions in case of non-compliance. Banking supervision goes one step further by conducting qualitative and quantitative analysis regarding the soundness of the banks management. Mishkin (2001) defines these two different tasks as “regulatory” and “supervisory” approach.

As previously just briefly addressed, one of the most important parts of regulation is to ensure that all market participants comply with the defined rules. This is the reason why the attention on banking supervision rapidly increased over the past eight to ten years, too. The picture of this first theoretical part is completed by presenting banking supervisory theory in relation to the underlying regulation.

Davis and Obasi (2009) elaborate on different aspects which have to be considered when designing efficient banking supervision. First, it has to be decided who shall be the supervisory authority: the central bank or another agency. Central banks have the advantage that they have most of the important information at hand and that they are used to adopt a macroeconomic and systemic view. But, the disadvantage is that the central banks may be exposed to a conflict of interest because of their different duties. A compromise is a set-up with the central bank being responsible for macro-oversight and another agency undertaking all other duties of supervision. However, Pichet (2014) shares the opinion that macro-regulation and micro-supervision have to be much better aligned, which he thinks would be one solution that could have reduced the extent of the financial crisis. A further aspect regarding the design of supervision concerns independency. It is important that the entrusted bank supervisors are independent from politicians during their appointment phase and form the supervised entities at any time (Davis and Obasi, 2009). The assigned powers to supervisory authorities are a further mentioned integral part of the supervisory framework.

The evolution of banking regulation and the related supervisory practice are outlined in the next part. In this regard, it can be observed that regulatory convergence became more important with the increase of cross border banking (Davis and Obasi, 2009).

2.2. Motivation for a Banking Union in Europe

Regulation has a dynamic character. It has to be adapted to a changing environment, loopholes have to be identified and closed and the regulatory framework has to be adapted to the established scientific theory. Therefore, to better understand the current situation and developments in the past years, a brief excurse into the history of banking regulation makes sense.

Penikas (2015) analyses the past 40 years of Basel Committee of Banking Supervision (BCBS) and the related regulatory and supervisory framework and its development. The Basel Committee of Banking Supervision was installed in 1974 and has to be understood as a setter of global regulatory standards for the banking sector. Even though BCBS regulation is not legally binding, the principles, guidelines and remarks have worldwide importance and can be seen as the business standards of best practice. The history of BCBS banking regulation can be subdivided into five periods.

1) The Basel Committee of Banking Supervision started its first regulatory wave with the publication of the first document called ‘Concordat’. The Concordat was a basic report stressing the importance of cooperation between national authorities for cross-border operating banks.

2) From 1987 to 1998, the second regulatory wave brought new aspects to banking supervision. ‘Basel I’ has set new standards by introducing quantitative elements with a risk-weighted approach for credit and market risk. Also, the operational risk was addressed reacting to the emergence of computer and telecommunication systems, however a quantitative assessment for operational risk was not intended at that time.

3) The period from 1999 to 2008, the third regulatory wave, stands in the context to ‘Basel II’. The amendments compared to Basel I were significant. On the one hand, Basel II included internal models for credit risk with the so called internal ratings-based (IRB) approach. On the other hand, a further improvement was the introduction of the pillar-framework. Pillar I refers to minimum capital requirements, pillar II is called supervisory review and pillar III should ensure market discipline.

4) The financial crisis necessitated a fundamental revision and brought ‘Basel III’ in the fourth regulatory wave of BCBS. The major innovations of Basel III are the quantification of liquidity risk, the revision of capital and introduction of capital buffers, the parallel monitoring of unweighted and risk-weighted capital ratios as well as a proposal for harmonization of remuneration rules for risk taking employees.

5) The fifth regulatory wave, ‘Post-Basel III’ starting in 2012, includes new proposals and revisions that are not directly associated with Basel III regulation, but complete the regulatory framework. Danièle Nouy, Chair of the ECB’s Supervisory Board, stated that “Basel III, the centrepiece of regulatory reform, is about to be finalized in 2016. There will be no significant further increases in capital requirements and we are not discussing Basel IV. Regulatory reform is coming to an end.” (ECB – Banking Supervision, 2016b). In November 2016 the European Commission published a regulatory package which aims to complete the process of the banking reform (EC, 2016a). The regulatory changes that were proposed to the European Parliament and the Council include further capital and liquidity requirements, reduced burden for smaller, less complex banks pursuant to the proportionality principle as well as support for the creation of a Capital Markets Union. In addition, an update of the Basel framework is still under

discussion at the current time (Magnus, Duvillet-Margerit and Mesnard, 2017).

Penikas (2015) outlines that the number of publicized pages concerning BCBS banking regulation increased significantly over the period from 1974 to 2014 and finds in a much generalized way correlation between the number of pages published by the BCBS and the trend of economic activity indicated by S&P 500. This relation shows one of the most fundamental discussions in the banking regulation. Nowadays, the banking sector is highly regulated and supervised in comparison to other sectors, as the energy market, where the trend went in the direction of more liberalization. What makes banks so special in the global economy? The answer to this question is discussed by Eken, Kale and Selimler (2013) who state that "banks are special for the fact that they transform risk, maturity and liquidity for generating investments (liabilities) and funding (assets) instruments that meet the taste of a wide range of individuals and corporations." The relation between banks and individuals is a principle-agent problem with strong influence of asymmetric information. In addition, the connection between banks and globalized markets justifies the special treatment of financial institutions, because of the systemic risk. The recent financial crisis is an expressive example for the systemic risk thematic. It has been shown that a shock in one location or asset class may have tremendous implications for markets and institutions world-wide (Cerutti, Claessens and MGuire, 2012). Bullard, Neely and Wheelock (2009) argue that financial companies are more exposed to systemic risk than non-financial firms, caused by the high interconnections of banks, high leverage, and because banks tend to use short-term debt to finance long-term assets. This was more the case in times of weak liquidity management, which was broadly improved through the last five year.

The answer to minimize or decrease systemic risk of banks is stricter regulations. However, a globalized world with interconnected markets and a large number of financial institutes that are 'too-big-to-fail' require macroprudential regulation and supervision (Galati and Moessner, 2011). It is important to note that the Basel principles are not binding law, but have recommendation character for regulators around the world to ensure similar standards.

In the European Union, the solution for facing the risks of interdependencies – learning from the failures in the recent financial crisis – was to create the European Banking Union (EC, 2014). In June 2012, the European Commission (EC, 2012) proposed the general concept of the European Banking Union. Beck (2015) names several reasons for the necessity of a centralized European Banking Union, for example that in a decentralized system local regulators' priority lies on the stability of the national stability interests neglecting the interdependencies and that governance structures of the national authorities are enhanced.

It is clear that the financial crisis was the trigger event for the creation of the banking union in Europe. During the crisis several individual national states in Europe, e.g. Hungary and Iceland, were overwhelmed by the challenges, which were then faced on the European level. A bank rescue plan in 2008 was the starting point for further cross-border cooperation including the idea of stronger and more harmonized financial services regulation and the promotion of European integration. (Hodson and Quaglia, 2009)

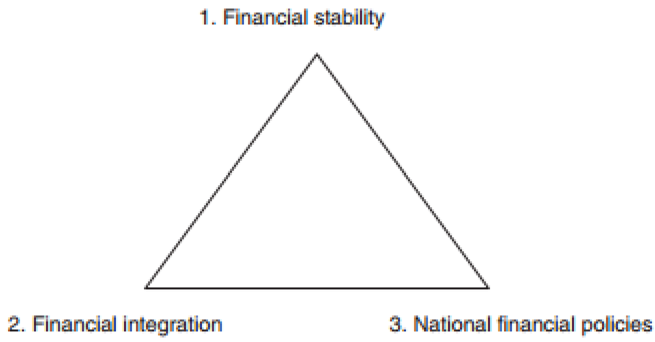
Another approach for analyzing the motivation for a banking union in the EU is a comparison with a similar economic area, the United States of America. Of course, the framework of the two economies is quite different, yet, it is interesting how the USA coped with the recent crisis. The US set-up of banking regulation and supervision differed from the setup in the EU at that time. In general, the crisis hit the US and the EU in a similar way. However, because of different regulatory set-up the US reacted much faster to the deficiencies, since it was possible to delay the implementation of financial reforms due to sovereign layers in the EU (Eubanks, 2010). Also Breuss (2013) indicates that the difference in how the two areas cope with the challenges was that the US already had a well-functioning monetary union. Gros (2012) compares two economic entities with almost identical statistics and effects during the crisis – Ireland and Nevada. In both entities the banks suffered during the crisis with huge losses and also many banks became bankrupt. However, the big difference was that in Ireland the banks' failure resulted in a financial crisis for the country, whereas in Nevada the problems were taken on a federal level, because the US is and already was a banking union at that time, and the Federal Deposit and Insurance Corporation (FDIC) stepped in and managed the treatment of failed banks without using taxpayers' help.

2.3. Legal Framework of the European Banking Union

The European Banking Union is a complex construct, because it requires the harmonization of laws, responsibilities, supervisory practices and principles across all the member states. The current challenge of this endeavor is to find and define best practice and to minimize the amount of national options and discretions (NODs). However, at the height of the financial crisis, thus before the beginning of the regulatory revolution in Europe, the challenges were much greater. The persons responsible had to take important decisions in order to model a system that is more stable, transparent and viable.

Schoenmaker (2011) shows two different options for the European banking system at that time. The considerations originate from the model of financial trilemma (Fig. 1). The model claims that it is not possible to combine financial stability, financial integration and national, i.e. decentralized, financial policies. The financial crisis has shown that a higher degree of financial integration, meaning cross-border business in the banking sector, combined with regulatory powers in the hand of the single national authorities, resulted in negative consequences for financial stability. The two options that were proposed by Schoenmaker are either reducing financial integration by stemming cross-border linkages, which does not comply with the European Union's principles, or to integrate the duties for regulation and supervision at the higher EU level, too.

Figure 1: The financial trilemma



Source: Schoenmaker (2011)

But thinking a step further, what happens if financial integration increases even more? The implication of the model would suggest an extension of the scope of financial regulation to even higher levels. The currently ongoing discussions about free trade agreements, e.g. Transatlantic Free Trade and Investment Partnership, TTIP, or Comprehensive Economic and Trade Agreement, CETA, exposed new challenges. If the markets for financial services become more liberalized, the regulations have to be harmonized again. Puccio (2015) raises the issue of regulatory fragmentation in case of those free trade agreements. The divergence of regulation between the European Union and the United States would either result in an increased regulatory burden for affected financial institutions or would require a complex procedure of convergence with years of negotiations.

Coming back to the current situation, this chapter analyses the structure of the European Banking Union at the present point in time by analyzing the legal framework, the authorities in charge, the affected financial institutions and the general framework with three pillars for supervision, resolution and deposit insurance.

As mentioned before, the Basel III framework has no binding character. It can be seen as a recommendation or a collection of best practice in banking regulation. However, EU legislators and also legislators from other countries transpose these rules and principles to their own frameworks. In the European Union, Basel III was adopted with the 'CRD IV package', comprising the European Capital Requirements Regulation (CRR, Regulation (EU) No 575/2013) and the European Capital Requirements Directive (CRD IV, Directive 2013/36/EU). Both became effective as of 1 January 2014. From this point in time onwards, banking regulation is managed on the European level with more harmonized rules for all EU member states. Some divergence in the regulatory requirements occur because of national options and discretions.

The CRR is directly a binding law and has to be entirely enforced by all EU member states. The capital requirements are oriented on Basel I and Basel II standards, but these standards have been revised, improved and extended learning from the lessons that the financial crisis taught. The most important requirements refer to own funds for credit risk, market risk and liquidity risk as well as newly implemented rules with respect to leverage.

Contrary to the CRR, the regulations in the CRD IV are not binding per se, but the goals that were set in the directive have to be achieved. The member states have to implement their own laws in order to reach the targets. In the CRD IV it is described how the competent authorities have to cooperate to ensure proper supervision and supervisory powers and penalties are defined. Furthermore, in section II some general principles regarding internal governance and remuneration are stipulated.

The basis for the three pillars of the European Banking Union are divided into separate regulations and directives. SSM Regulation (SSMR, Regulation (EU) No 1024/2013) and SSM Framework Regulation (SSMFR, Regulation (EU) No 468/2014) were introduced to build the legal basis for the first pillar, the Single Supervisory Mechanism. In these two regulations ECB's tasks for prudential supervision of credit institution in the European Union (Article 1 SSMR) are determined. Aspects that are highlighted are the cooperation between ECB and NCAs (Article 6 and 33 SSMR). The SSMFR is an ECB regulation in which the practical arrangements for the cooperation within the SSM are implemented. For the second element, the Single Resolution Mechanism (SRM), the Bank Recovery and Resolution Directive (BRRD, Directive 2014/59/EU) builds the framework for planning the proceeding with failed banks. A further part of the legal framework of the European Banking Union is the Directive on Deposit Guarantee Schemes (DGSD) that makes it compulsory for the member states to ensure that EUR 100 000 are protected for each depositor if the bank fails and is not able to refund deposits (Article 6 DGSD).

All of the stated regulations and directives are part of the Single Rulebook, which aims at the harmonization of the legal framework in order to avoid loopholes and ensure that all rules apply for all banks in the European Union. The European Banking Authority (EBA) is responsible for contributing to the establishment of the Single Rulebook by publishing Binding Technical Standards (BTS) and allowing for interchange of information through a “question and answers” (Q&A) tool (Enria, 2015). Enria (2015) further states that the biggest problem of the Single Rulebook is the existence of national options and discretions.

An option is defined as “a situation in which competent authorities or Member States are given a choice on how to comply with a given provision selecting from a range of alternatives set forth in Community legislation.” (Margerit, 2016) and a discretion “refers to a situation in which competent authorities or Member States are given a choice whether to apply or not to apply a given provision in EU Law.” (Margerit, 2016). The problem with ONDs is already addressed by the European regulators. ECB Regulation (EU) 2016/445 on the exercise of options and discretions available in Union law harmonizes the execution of 35 horizontal NODs of the CRD IV package. In addition, ECB published a Guide on options and discretions available in Union law that refers to case-by-case NODs (Margerit, 2016). ECB conducted an impact assessment on NODs, finding that the harmonization of national options and discretions will not immediately result in a quantitative change, but in the long term consistency, simplification and enhancement of the legal framework will be beneficial to the safety and soundness of the European banking sector (ECB, 2016a).

2.4. Authorities in the European Banking Union

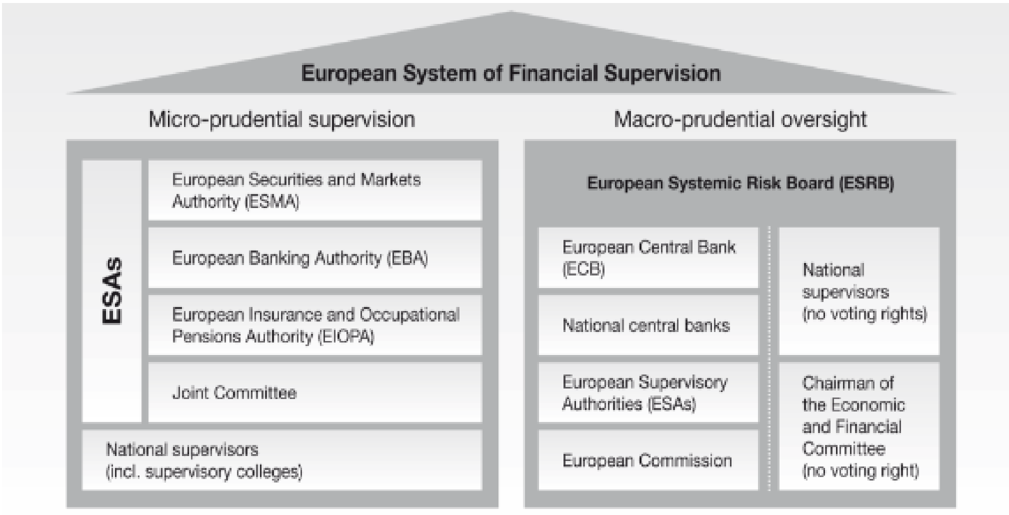
A number of authorities are involved in the functioning of the European Banking Union. The first agency is the European Commission (EC), which is responsible for making the rules and proposing policies that are adopted by the European Parliament and the Council of Ministers.

The most important authority for the operational execution in the European Banking Union is the European Central Bank with its head office in Frankfurt. Within the first pillar of the banking union – the Single Supervisory Mechanism –

the ECB is, together with National Competent Authorities (NCAs) (ECB, 2014a), responsible for a major part of the supervisory tasks. NCAs are the responsible authorities, usually the National Central Banks (NCBs) in all member states of the SSM, which were responsible for banking supervision prior to the establishment of the European Banking Union and take over clearly defined responsibilities. The structure of the SSM and the distribution of duties are covered in chapter 2.5. Moreover, the National Central Banks fulfill at the time of writing this paper the function of ‘lender of last resort’. This objective is planned to be transferred also under the responsibility of the ECB in the future. Goodhart and Schoenmaker (2014) support ECB’s takeover of the ‘lender of last resort’ function, because this would ensure incentive compatibility of the governance framework. ECB has an incentive to perform better supervision, since they would have to pay in case of failures of banks.

Another important agency for the banking union is the European Banking Authority that was established in 1 January 2011 and is based in London. The main task of the EBA is to complete the European Single Rulebook. The authority publishes Binding Technical Standards and guidelines in order to harmonize the legal framework in Europe. Furthermore, EBA engages as advisor for the European Commission, European Parliament and the Council and as mediator in cross-border conflicts between NCAs (EBA, 2016a). Schoenmaker (2015) points out that the scope of the EBA are European countries, whereas the European Banking Union is just relevant in euro area countries and non-euro area countries that decide to participate in this union. Some other institutions were established after the financial crisis in order to increase the safety and soundness of the financial system, but are not directly responsible for dealing with banks. The European Securities and Markets Authority’s (ESMA) objectives are investor protection and stability as well as orderliness of financial markets (ESMA, 2016). For achieving these goals as effectively as possible, ESMA performs activities to assess the risk to investors, to complete the single rulebook for EU financial markets, increase supervisory convergence through sharing best practice and completing the single rulebook and to directly supervise credit rating agencies and trade repositories. The European Insurance and Occupational Pensions Authority (EIOPA) is responsible for insurance supervision and regulation also targeting consumer protection, a harmonized single rulebook and financial stability (EIOPA, 2016). Solvency II regulation for insurance companies is comparable to Basel III for banks as it also defines capital requirements for credit and market risks. Laas and Siegel (2015) compare the two regulations and find that the goal of financial supervisory consistency is not met, because Basel III capital requirements for the same amount and type of risk are higher than those under Solvency II. The inconsistencies can lead to regulatory arbitrage that can be exploited by financial conglomerates which can shift risks to the less regulated legal entities to reduce capital burden. EBA, ESMA and EIOPA are part of the European System Risk Board (ESRB) that completes the framework of financial supervision in Europe with macro-prudential oversight, as depicted in Fig. 2.

Figure 2: EU's framework of supervision and oversight

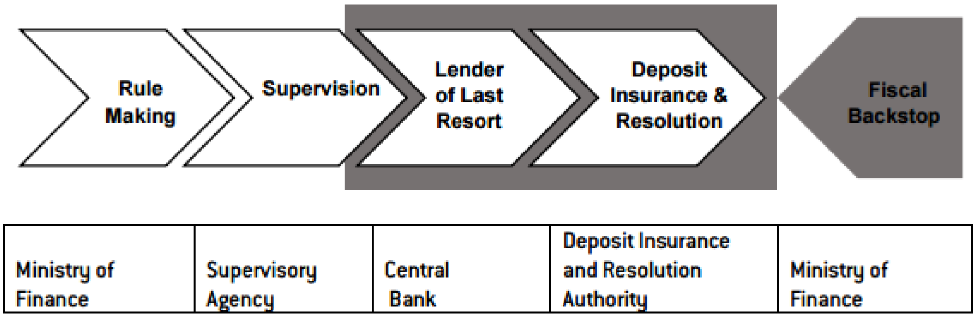


Source: Kontkanen (2011)

Besides the SSM, the European Banking Union comprises of a second pillar, the Single Resolution Mechanism. The authority responsible for the SRM is the Single Resolution Board (SRB) together with the National Resolution Authorities (NRAs) aiming at being prepared for and conducting resolution of failing banks (SRB, 2015).

The last part of the European banking framework is the European Stability Mechanism as a tool for recapitalization. Schoenmaker (2015) summarizes, as depicted in Fig. 3, the governance framework in the European Banking Union, from policy-making over supervision, lender of last resort and resolution to fiscal backstop.

Figure 3: Governance framework of the European Banking Union

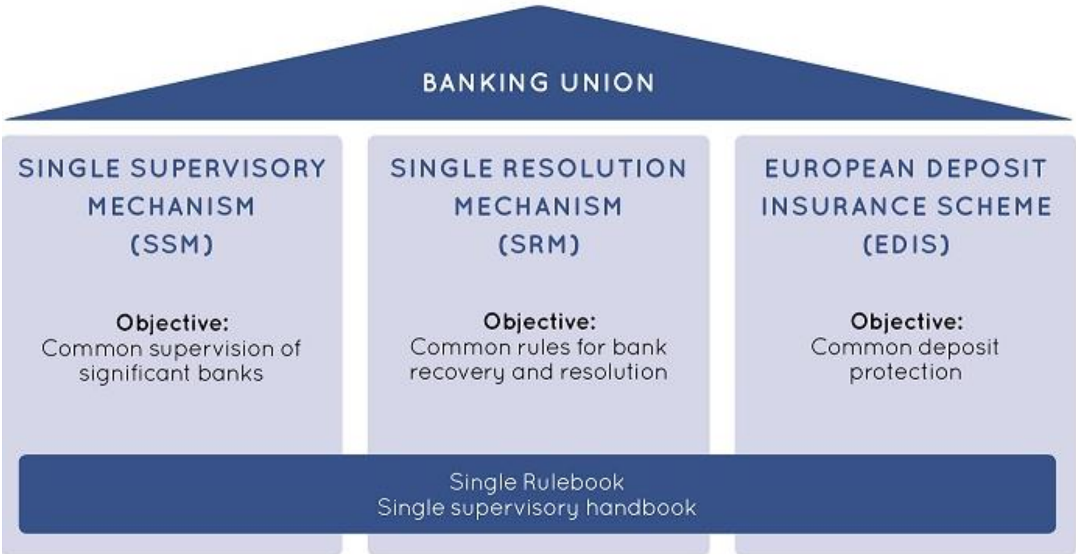


Source: Schoenmaker (2015)

2.5. Three Pillars of the Banking Union

This part of the description of the European Banking Union's structure goes into more detail. The three pillars – Single Supervisory Mechanism, Single Resolution Mechanism and the European Deposit Insurance Scheme (EDIS) – together with the Single Rulebook build the fundament of the banking union (see Fig. 4).

Figure 4: The structure of the European Banking Union



Source: OeNB – Austrian National Bank (2017a)

2.5.1. Single Supervisory Mechanism

2.5.1.1. Set-up of the SSM

The Single Supervisory Mechanism became operational on 4 November 2016. From this point on the ECB took over responsibility for prudential supervision together with the National Competent Authorities of all credit institutions in the participating member states (ECB – Banking Supervision, 2014).

According to the guide to banking supervision (ECB – Banking Supervision, 2014) the ECB defined the following nine supervisory principles that should be considered by the supervisors of ECB and the NCAs:

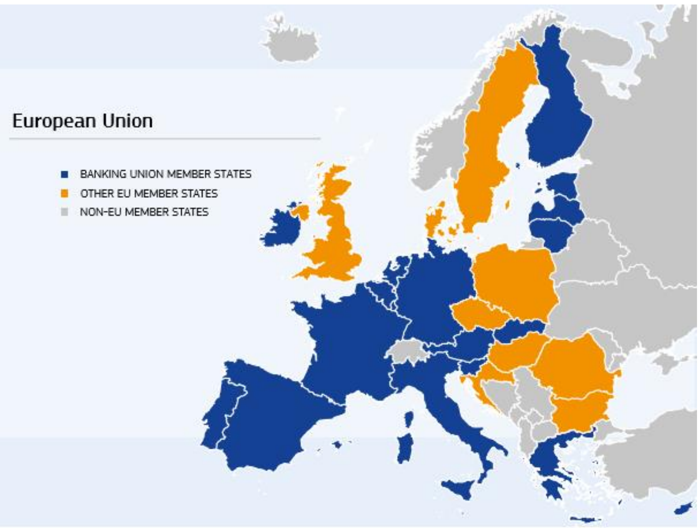
1) Use of best practices
2) Integrity and decentralization
3) Homogeneity within the SSM
4) Consistency with the Single Market
5) Independence and accountability
6) Risk-based approach
7) Proportionality
8) Adequate levels of the supervisory activity for all credit institutions
9) Effective and timely corrective measures

By adopting the supervisory principles, the ECB wants to "ensure safety and soundness of the European Banking system, increase financial integration and stability and ensure consistent supervision" (ECB – Banking Supervision, 2014).

The SSM is responsible for the oversight of all banks in the euro area. The types of banks are credit institutions, financial holding companies, mixed financial holding companies and branches of credit institutions established in non-participating Member States. Also, EU countries with currencies other than the euro can join to participate in the European Banking Union and therefore, also in the SSM by close cooperation agreements (Deutsche Bundesbank, 2016). Up to now, not a single EU country that is not part of the Eurozone decided to opt in. The members of the European Banking Union and the other EU member states which decided to not take part are depicted in Figure 5. The EU member states which currently do not take part in the European Banking

Union are Great Britain (until the finalization of the Brexit agreement), Denmark, Sweden, Czech Republic, Poland, Hungary, Croatia, Romania and Bulgaria.

Figure 5: Participating and non-participating EU member states



Source: SRB (2016)

The potential benefits of joining the SSM are increased European integration and attraction of foreign investors due to better coordination (Kosior and Rubaszek, 2015). For example, if a German bank decides to expand its business to Poland, which is currently not in the SSM, the German bank faces two different regulatory and supervisory schemes. However, if Poland decided to opt in and adopt the legal requirements, the German bank is subject to the same regulation and can be supervised in Germany on consolidated level including the activities in Poland. The major disadvantage of the SSM for those states is that the role of the financial safety net is limited and that close cooperation does not imply that the states which opted in have the same powers, especially in the decision-making process, like Eurozone countries (Kosior and Rubaszek, 2015). UK, Sweden and the Czech Republic decided to definitely not opt in, whereas others, i.e. Romania, Denmark and Bulgaria, expressed their general willingness to join the SSM, and other EU Member states, like Poland and Hungary, have chosen a “wait and see” approach (Shearman & Sterling, 2014).

Darvas and Wolf (2013) outline the chances of the EU member states not participating in the SSM. They analyze the example of Denmark in more detail, explaining the factors that are important for the decision whether to participate in the European Banking Union or not. Denmark and Sweden have established different supervisory practices, which results in a competitive disadvantage for Danish banks. If both countries would join the SSM with a harmonized supervisory approach, Danish banks would have to operate a level playing field. Additionally, this example explains why Sweden might not want to be a part of the SSM. Furthermore, the largest Danish bank, Danske Bank, has a major subsidiary in Finland, meaning that opting to participate in the SSM would make it easier to design the cross border supervisory process for the supervisory authorities and hence, also facilitate the banks' fulfillment of the requirements. In this context, it is interesting to observe that Danske Bank recently suggest the possibility to change the strategic approach for the Finnish subsidiary to reduce supervisory burden. It is planned to merge the subsidiary and the branch in Finland into one single branch as outlined in their Annual Report 2016 (Danske Bank Group, 2016). Increased efficiency of cross border supervision and financial integration can also be beneficial in CEE countries, where the banking market is dominated by foreign companies. In addition, Darvas and Wolf (2013) point out that the ambiguity about the exact structure of the pillars of the European Banking Union are a reason for not immediately opting in at that time. Up to now, the creation and development of the elements of the SSM, SRM and EDIS are not fully finalized yet, which is a reason for the countries to wait with the agreement for a participation in the European Banking Union.

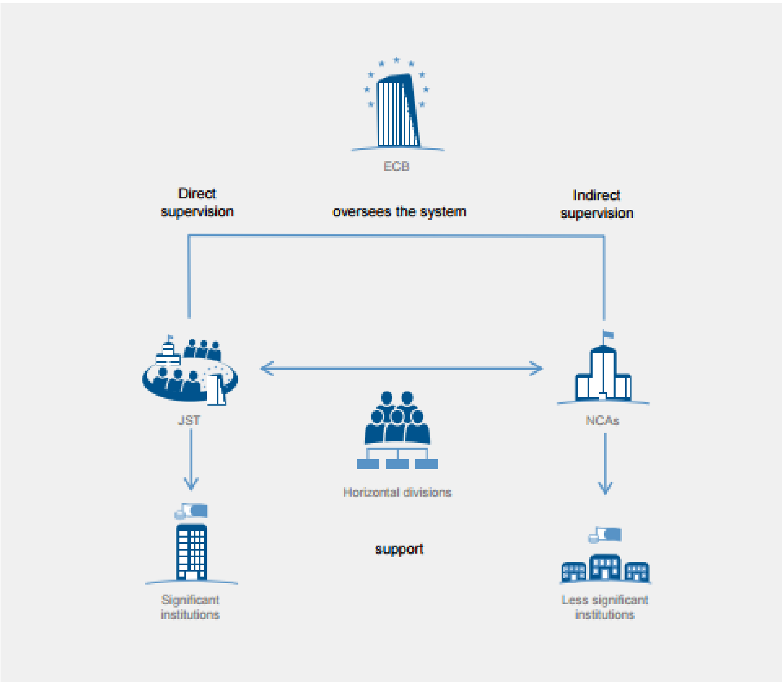
Within the scope of the SSM banks it is differentiated between Significant Institutions (SI) and Less Significant Institutions (LSI). Credit institutions in the member areas are regularly assessed whether they fall under the classification significant or not. The criteria for the type of classification are determined in Art. 6 para. 4 SSMR as size of the institution, importance for the economy and significance of cross-border activities. The limits for being defined as a significant institution according to the three classification criteria are defined in the SSMR as follows:

- "the total value of the institution's assets exceeds EUR 30 billion;
- the ratio of the institution's total assets over the GDP of the participating member state of establishment exceeds 20%, unless the total value of its assets is below EUR 5 billion;

- ECB decision following a notification by the institution's NCA that it considers such an institution as significant with regard to the domestic economy; ECB decision to consider an institution as significant if it has established banking subsidiaries in more than one participating Member States."

All the institutions that fulfill these criteria of a Significant Institution are directly supervised by the ECB with the use of Joint Supervisory Teams (JSTs), whereas all other institutions, defined as Less Significant Institutions, are supervised by the NCAs and are subject to the oversight of ECB (see Fig.6). Furthermore, if in a participating member state fewer than three institutions fulfill the criteria for significance, the three most significant institutions are subject to direct supervision. Also, institutions that receive assistance from the European System of Financial Supervision (ESFS) or the European Stability Mechanism (ESM) cannot be seen as less significant, thus are subject to direct ECB supervision.

Figure 6: The distribution of Tasks within the SSM



Source: ECB – Banking Supervision (2014)

As of 1 January 2017, 125 banking groups, which are accounting together for almost 85% of total banking assets in the euro area, are classified as significant and are therefore directly supervised by the ECB (ECB – Banking Supervision, 2017a). These groups comprise in total about 1200 supervised entities. All of these entities are subject to direct supervision because it is stated in the SSMR Art. 6 para. 4 that applies at the highest consolidated level, which means that subsidiaries of significant institutions are also directly supervised (Tröger, 2013). In contrast, 3500 entities are specified as LSIs and are still supervised by the local NCAs (ECB, 2014a). However, the oversight function of the ECB that provides coordination and guidance developed and still develops the supervisory approach also in the NCAs (Tröger, 2013). The ECB gives the NCAs direction in form of regulations, guidelines or general instructions and is entitled to step in and undertake direct supervision for one or more credit institutions by exerting supervisory power through requests for information, investigations and on-site inspections (Art. 6 para. 6 SSMR).

For the day-to-day tasks of direct supervision the ECB installed Joint Supervisory Teams for each significant institution, which are assembled with supervisors from ECB and NCAs from states where the credit institution, its subsidiaries or significant cross-border branches of a given banking group are established. Each JST comprises three levels. On the first level operates the JST coordinator, who is the chair of the JST, is usually not from the country where the supervised entity is established and is appointed for a period from three to five years. The second level, the core JST, is composed of sub-coordinators from NCAs who take responsibility for certain specified areas of supervision. The core team can be supported by expertise divisions from ECB and assists the JST coordinators. The basis of the JSTs build teams of experts from both ECB and NCAs, which can be consulted according to the actual scope and priorities of JST's supervision. The composition of JSTs varies depending on the nature, complexity, scale, business model and risk profile of the supervised credit institution. (ECB, 2014a)

The elements of supervision in the Single Supervisory Mechanism are multilayered. The banks in the participating member states are stressed, controlled and evaluated from many perspectives and with various instruments. Starting with a stress test and Asset Quality Review (AQR) the supervisors established practices as the Supervisory Review and Evaluation Process, on-site inspections in specific risk areas and model investigations. Furthermore, the

ECB is responsible for granting authorization of credit institutions and taking fit and proper decisions by assessing the suitability of the management body of significant banks within the SSM.

A stress test was conducted before the ECB took over the operational supervisory responsibility for the banks in the euro area and stands for the starting point by evaluating the initial situation. A dedicated Asset Quality Review was performed as a second component together with the stress test in 2014 and both are summarized under the term Comprehensive Assessment. The AQR was undertaken by the ECB, whereas the stress test was carried out by EBA (De Groen and Lannoo, 2014). The two parts of the Comprehensive Assessment have different samples of evaluated banks, however, the 93 most significant banks in the SSM at that time participated in both the ECB AQR and the EBA stress test (De Groen and Lannoo, 2014). The AQR assessed the balance sheets of the banks as of 31 December 2013 and is focused on the proper specification of carrying values of the banks' assets (ECB, 2014). De Groen and Lannoo (2014) speak about a "test of the fairness and transparency of banks' balance sheets". While the AQR assessed the status quo of banks' healthiness and capital adequacy, the EBA stress test followed a forward looking approach by evaluating the resilience of the participating banks in certain macroeconomic scenarios (ECB, 2014). A further EBA stress test was conducted in 2016 with a reduced sample of 51 EU banks and included some slight adjustments in relation to the 2014 stress test (EBA, 2016b). The results showing how the banks' capital is affected from macroeconomic shocks in a three-year time-horizon are fed into the SREP (EBA, 2016b), which is the instrument for ongoing supervision and will be discussed in the following section. The ECB has mentioned positive development comparing the 2014 comprehensive assessment and the 2016 stress test, pointing out that the overall resilience of the European banking sector has improved (ECB, 2016b).

2.5.1.2. The Supervisory Review and Evaluation Process

The Supervisory Review and Evaluation Process is the main tool that summarizes most of the supervisory activities that are performed over the year by the JSTs (ECB, 2014a). The general objectives of the SREP are defined in CRD IV Article 97 by stating that "the competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the institutions and evaluate:

(a) risks to which the institutions are or might be exposed;
(b) risks that an institution poses to the financial system and
(c) risks revealed by stress testing taking into account the nature, scale and complexity of an institution's activities."

In addition, the EBA published on 19 December 2014 the Guidelines on common procedures and methodologies for the SREP (EBA/GL/2014/13), in short SREP-Guidelines, where it is specified in over 200 pages how the SREP process has to be conducted in order to "promote common procedures and methodologies" (EBA, 2014).

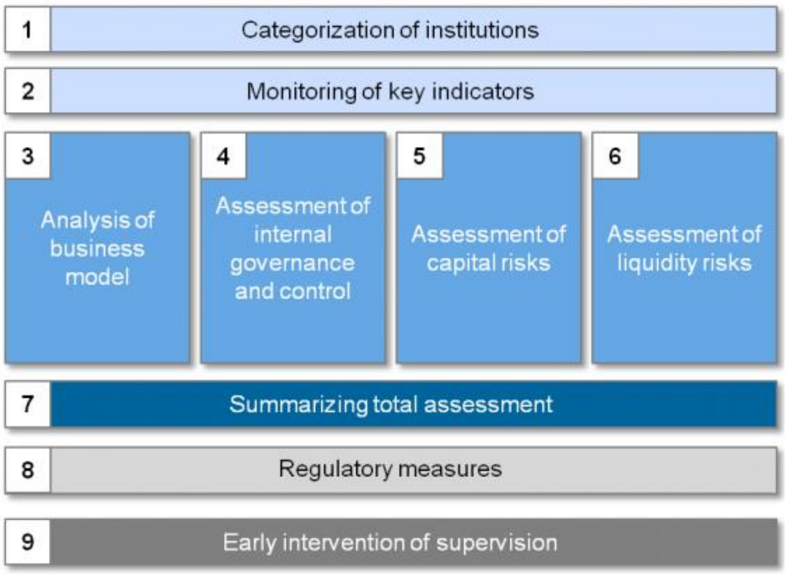
The process is divided into 3 phases: Preparation, Evaluation and Decision, and each cycle lasts for one year. The preparation phase foresees first collections of supervisory reporting and relevant information. In the second phase the actual evaluation through assessments, analyzes and meetings by the supervisors takes place. In the third phase the supervisors draft their decision based on their previous assessment trying to adopt a forward looking approach. In the fourth phase of each year the banks are notified about the draft SREP decision and can comment on the findings of the assessment in the "right to be heard"-phase. In the end of the SREP period the banks can expect the final SREP decision that builds the basis for the assessment of the following year. (ECB – Banking Supervision, 2015a)

The SREP is nothing totally new. The concept was introduced in course of the Basel II framework in 2004 and was performed by the national supervisors under the term Supervisory Review Process (SRP). However, through the harmonization of the processes by the establishment of the SSM and the publishing of the EBA SREP guidelines the SREP was developed and adjusted to best practice. Especially for big cross-border banking groups the new setup should bring simplification, because they just have to follow one unified process for all legal entities in all participating EU countries. In addition to the quantitative SRP the SREP also focuses on qualitative input to supervision.

The first full cycle was performed in 2015 (ECB – Banking Supervision, 2015a). After the finalization of the second full cycle in 2016, banks should be able to define internal processes to suit the new requirements. Wagner and Stoll (2014) propose to install a responsible function for the SREP in each institute. The so called Single Point of Contact (SPOC) steers the process and ensures that the supervisors receives the documents, reports and further required information. This employee or – in larger institutions – unit, can be labeled as 'SREP task force' and should also be responsible for guiding the bank through supervisory authorities' on-site inspections, organizing meetings with representatives of ECB or NCAs and reporting to the management body (MB) about important activities in course of the SREP. By doing this, the SPOC, as centralized function, gains an overview about the regular requests and can try to anticipate the next actions by the supervisors following the SREP's forward looking character. Including analysis of the yearly published SSM Supervisory Priorities (ECB – Banking Supervision, 2015b, 2016c and 2016f), the bank should then be able to introduce and pursue measures to be better prepared for the subsequent SREP assessment and achieve better results. The reason why the SREP results are important is that the banks have to build capital buffers depending on the SREP score (ECB – Banking Supervision, 2015a).

The SREP framework follows a 9 step approach as outlined by the EBA (2014) and shown in Figure 7:

Figure 7: The 9 elements of the SREP



Source: Wagner and Stoll (2014), EBA (2014)

In a first step, the institutions subject to the SREP assessment are categorized. The intensity of supervision depends on size, structure and internal organization of the institutions in order to comply with the proportionality principle (ECB – Banking Supervision, 2015c). The ECB clearly states that "the frequency and intensity of the Supervisory Review and Evaluation Process (SREP) should be proportionate to the size, systemic importance, nature, scale and complexity of the activities of the institution concerned".

Banks under the first category with the most intensity of supervision are the systemically important institutions, followed by institutions of medium to large size, small to medium and others. The fourth category 'others' refers to small non-complex domestic institutions. The minimum level of engagement of supervision ranges from ongoing engagement including annual assessment of all SREP elements for category 1 institutions to full SREP assessment at least every three years for category 4 banks.

The second step refers to continuous assessment of the Key Performance Indicators (KPIs). Financial and risk indicators, regulatory reporting, market indicators and recovery plan indicators are monitored on a quarterly basis testing for anomalies or deficiencies.

The steps three to six depict the core processes of the SREP: Business Model Analysis (BMA), assessment of internal governance and control, assessment of risks to capital and assessment of liquidity risks. During the BMA, ECB analyses the short, medium and long term profitability of the banks assessing how profits are made today and will be made in the future as well as the current and prospective key drivers of profitability. The banks business models are evaluated comprehensively on their viability, i.e. less than one year, sustainability, less than 3 years, and cycle profitability. The BMA within ECB's supervision can also be seen from a critical perspective. The supervisor does indeed not have the power to directly regulate the strategic business model of the single banks. But, through the comprehensive evaluation, judgment and indication of detected insufficiencies the ECB can indirectly influence the business models of European banks and thus, acts as a superordinate bank manager aiming for unification of banks' strategies and business models as kind of 'SSM optimized' (Binder, 2015). The vice-chair of the Supervisory Board of the ECB gives an indication on ECB's thoughts about the business models of the supervised banks in her speech about a résumé of the first two years of SSM and an outlook of the remaining challenges for the future by giving the following answer to the critics that the supervisory regime is too strict and imposes too high costs for the banks:

> "European banks are suffering from weak earnings, the causes of which go far beyond stricter regulation and low interest rates. Banks must clear their balance sheets of legacy assets and get their costs under control. But most of all, they need to adjust their business models. […] Banks' business models continue to be one of the most important topics for us as supervisors. We are also of the view that some institutions urgently need to adjust their business models." (ECB – Banking Supervision, 2016e)

The fourth step, standing for the second core process of the SREP, refers to internal governance and institution wide controls. Under this pillar, the supervisors assess the appropriateness of elements of governance and controls, e.g. governance of the management body, risk management, remuneration and internal control system, and evaluates whether the existing setup complies with standards set out in the EBA Guidelines on Internal Governance. The SREP requirements with respect to corporate governance and the mentioned BCBS principles as well as other guides issued by the EBA and ECB will be discussed in detail in the next part of this thesis, as one 2015 SREP result was that the corporate governance processes were in some cases noticed as inadequate (Bonomo, Schneider, Turchetti and Vettori, 2016). In the fifth and sixth step the SREP assessment include assessment of risks to capital, as credit and counterparty risk, market risk, operational risk and interest rate risk in the banking book, as well as risks to liquidity and funding.

In step seven the combined score of the evaluation of the four SREP elements is calculated and the results are converted in additional capital requirements for covering the regulatory own funds. The assessment of each of the four elements is based on scoring on a scale from 1-4, ‘1’ standing for no risk identified, ‘2’ for low level of risk, ‘3’ medium risk level and ‘4’ meaning high level of risk. Additionally, also the score ‘F’ is feasible, representing failing or likely to fail. The results are communicated to the credit institutions in the form of a SREP decision.

The step eight is specified as supervisory measures, summarizing quantitative capital or liquidity measures and other supervisory measures, that may be necessary for certain banks depending on the SREP result. The supervisory measures are regulated in Article 16 SSMR and include powers as the reinforcement of the arrangements, processes, mechanisms and strategies, additional reporting requirements, removal of members of the management board, restriction or limitation of business and others. Under step nine early intervention measures are envisaged which are regulated in Article 27 BRRD. In case of imminent timely breach of regulatory key figures or for example dramatic deterioration of the financial situation, ECB can inter alia conduct additional on-site inspections, request action plans to solve the problems as well as change the organizational and strategic set-up of a credit institution.

The full SREP is currently only performed for Significant Institutions. However, it is planned to expand the scope also to Less Significant Institutions. In this case, the NCAs will be assigned to perform a SREP process under indirect supervision of the ECB and have also to take into account the European Union’s proportionality principle.

When presenting the different phases, steps and consequences the comprehensive SREP assessment implicates, it is obvious that banks have to prepare for this exercise, because poor preparation results in poor scoring which results in higher capital requirements. Hence, banks are well-advised to implement measures to cope with these challenges. Actions can include impact assessment, setting up a task force, increase coordination as SREP requires information from several departments and competence lines and develop internal reporting in association with SREP in order to increase awareness and ensure an overview about all the supervisory activities. Above all, it has to be stressed again that it is of particular importance to implement a central unit as Single Point of Contact for supervisory issues and especially for the SREP. (KPMG, 2014)

2.5.1.3. On-site inspections

Further important parts of JSTs supervisory activities are on-site inspections and model investigations. On-site inspections are inevitable in a strong banking supervision regime. The term “on-site” indicates that the investigation is conducted to a major extend in the premises of the bank that is subject to the inspection (Hafeman and Randle, 2009). The legal basis of this duty is to be found in Article 12 of the SSM Regulation, where it is explicitly stated that the persons that were authorized by the ECB are allowed to enter the business premises of the inspected bank and can request any information which has to be provided. Furthermore, in Articles 143-146 SSM Framework Regulation it is written down that specific on-site teams have to be formed individually for each inspection. The inspection teams are composed of staff from ECB and NCAs and is led by a head of mission that is appointed by ECB also in cooperation with NCAs, but must not be a JST member to ensure independency (ECB – Banking Supervision, 2014). In 2015, about 95% of the deployed inspectors were NCA staff and just the remaining 5% came from ECB’s Centralised On-site Inspections Division (ECB – Banking Supervision, 2016d). Another vital benefit of the SSM is the diversity of banking supervisors, which allows views from outside and a mix of supervisory cultures. This aspect can be seen in a statistic from the SSM Annual Report 2016 (ECB – Banking Supervision, 2017b). In 2016, 40 % of all on-site inspections were conducted in so called “mixed/cross border teams”, meaning that one or more members of the inspection team are not nationals of the home country of the investigated bank. For the purpose of promoting this concept, a tool was installed where inspectors from NCAs can apply for participating in planned on-site inspections (ECB – Banking Supervision, 2017b). On the other side a negative implication of this concept could be that inspectors may not be familiar to the bank’s peculiarities and local regulations, but this drawback can be eased through the other inspectors who are more familiar to the supervision of banks in the specific country.

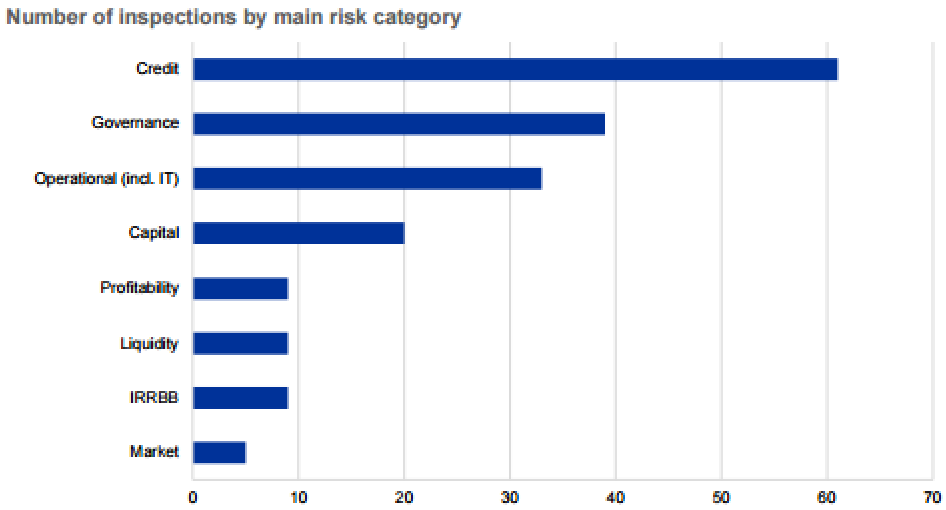
ECB defines (ECB- Banking Supervision, 2014) that “in general, the purpose of on-site inspections is to:

- examine and assess the level, nature and features of the inherent risks, taking into account the risk culture;
- examine and assess the appropriateness and quality of the credit institution’s corporate governance and internal control framework in view of the nature of its business and risks;
- assess the control systems and risk management processes, focusing on detecting weaknesses or vulnerabilities that may have an impact on the capital and liquidity adequacy of the institution;
- examine the quality of balance sheet items and the financial situation of the credit institution;
- assess compliance with banking regulations;
- conduct reviews of topics such as key risks, controls, governance.”

If analyzing the purposes for conducting an on-site inspection stated by ECB, it is crucial to mention that the inspections are not only intended to evaluate the banks’ dealing with risks, but also to focus the attention on corporate governance practice implemented in the banks. The elements of banking supervision with regard to corporate governance will be discussed in the second part of the present work in detail.

In its Annual Reports on supervisory activities for the years 2015 and 2016 (ECB – Banking Supervision, 2016d; ECB – Banking Supervision, 2017b), ECB provides an overview of performed inspections in 2015 and 2016 (see Figures 8 and 9).

Figure 8: On-site inspections: breakdown per risk



Source: ECB – Banking Supervision (2017b)

As depicted in Figure 8, 185 inspections were conducted in total in 2016 and the inspection teams focused on the areas of Credit Risk, Governance and Operational Risk. The table in Figure 9 shows how the number of inspections was broken down in six clusters depending on the size of the significant credit institutions in 2015. Segment 1 categorizes the largest banks and segment 5 the smallest. It clearly reflects that for the largest institutions the average number of inspection is higher with six than for the smallest banks with about one inspection per credit institution per year.

Figure 9: On-site inspections: breakdown per cluster of banks

Cluster	Total	1	2	3	4	5
Number of significant institutions	118	7	7	28	27	49
Total number of inspections	250	42	35	69	54	50

Source: ECB – Banking Supervision (2016d)

The inspection process is outlined in ECB's guide to banking supervision (ECB – Banking Supervision, 2014) and the corner stones are summarized in Figure 10. In general, the supervised entity has to be notified about an upcoming on-site inspection. The bank then has to submit requested data material and prepare for the visit in the premises of the bank. After the on-site phase with workshops and further document requests the inspection team drafts a report which is signed by the head of mission and sends it to JST. The JST establishes recommendations for the inspected institute to remedy the detected findings that are presented to the credit institute in a closing meeting. Usually, the bank has to define an action plan with agreed deadlines and has to report about the proper fulfillment of the Action Plan (Hafeman and Randle, 2009), which is monitored by the JST (OeNB, 2017b).

Figure 10: ECB's on-site inspection process

Source: Own illustration, ECB – Banking Supervision (2014)

The JST decides about the scope and frequency of on-site inspections for the banks individually based on the overall supervisory strategy and characteristics of the bank (i.e. size, nature of activities, risk culture, weaknesses identified) (ECB – Banking Supervision, 2014). This means that the supervisors take the proportionality principle into account, which indicates that larger banks imposing more risk to the economy have to be supervised on a higher level than institutes that are only to a lesser extent system relevant (ECB – Banking Supervision, 2016e). The application and exercise of the proportionality principle in banking supervision is highly debated, as smaller banks complain about the efforts that have to be made to comply with the regulatory requirements and satisfy the supervisors (Hackethal and Inderst, 2015). As discussed in a previous section, the ECB is only responsible for direct supervision of Significant Institutions. Hence, it is also valid for the inspection process that the NCAs perform on-site inspections for Less Significant Institutions with similar standards and procedures. However, the ECB has the right to step in at any time and also conduct on-site inspections also for LSIs (ECB – Banking Supervision, 2014). Gren (2014) analyzes the interaction between ECB and NCAs with regard to supervision of LSIs from a principal-agent perspective, where the ECB (principal) 'police patrols' over the NCAs (agents). The power of the ECB to take over or newly announce on-site inspections in LSIs is one of several mechanisms identified in this paper to ensure NCAs' compliance with the requirements and to avoid agency shirking. On the other side, it is stated that the application of the proportionality principle imposes a risk for the proper exercise of the policy standards from a principal-agent perspective, if ECB leaves to much room for interpretation and maneuver for NCAs.

Internal models of banks were introduced with Basel II under the terms Internal Rating Based approach for credit risk, Advanced Measurement Approach (AMA) for operational risk and Internal Models Approach (IMA) for market risk and are used to calculate risk parameters based on own estimations. For the evaluation of these models two different kinds of inspections are performed. One the one hand, ECB conducts model validations on application of the bank. Banks have to apply for using internal models instead of calculation with the standard approach or for material model changes, which has to be assessed and approved by the supervisors. On the other hand, ECB is authorized to perform model investigations on its own initiative, which follow a similar approach and process than common on-site inspections, but are conducted by ECB's Internal Models Division together with NCAs' model experts and the JST (IMF, 2016, p. 171; Baglioni, 2016, p. 45-46). ECB announced that they will concentrate on model investigations during the years 2016 and 2018 (or 2019) within their Targeted Review of Internal Models (TRIM) (ECB – Banking Supervision, 2016c). The goal of TRIM is to increase comparability and transparency through higher harmonization of the internal models used in SSM banks. A guidance paper for the validation of internal models in general and the TRIM in particular was published in February 2017 (ECB –Banking Supervision, 2017b).

2.5.1.4. Authorization

A further duty of the ECB under the Single Supervisory Mechanism is authorization. The ECB together with the NCAs is responsible for granting and withdrawing banking licenses, authorize acquisitions of qualified holdings and other decisions like passporting procedures as well as management and supervisory appointments (ECB – Banking Supervision, 2016d). These tasks are not to be underestimated: In 2016 (2015), ECB was notified about around 3180 (3400) authorization procedures and was confronted with time problems during processing (ECB – Banking Supervision 2016d; ECB Banking Supervision, 2017a). One example of the obstacles occurred are the short deadlines for licensing procedures. According to Article 14 SSM Regulation, the ECB has 10 working days to approve and adopt the proposed draft decision of the NCA regarding a licensing authorization. With respect to acquisitions of qualified holdings the period is extended to 15 working days. ECB admitted that the short deadlines were difficult to meet. (ECB – Banking Supervision, 2016d)

Also for the authorization of management and supervisory board appointments some adjustments were necessary to better manage the large number of the so called fit and proper assessments. These assessments are "dealing with the requirements for managers of good repute, knowledge, skills and experience" (ECB – Banking Supervision, 2016d). In 2016, ECB's processes were developed based on the lessons learnt in the previous year and achieved a significant reduction of the backlog and a 98% rate of fit and proper procedures completed in case of national legal deadlines. EBA published its Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA, 2012) defining the "process, criteria and minimum requirements for assessing the suitability of members of the management body and key function holders of a credit institution". The content of these guidelines as well as a more concrete analysis of fit and proper assessments are discussed in section 3.5.5.

2.5.2. Single Resolution Mechanism

In order to display the full picture of the European Banking Union, even though not fully implemented, the other two pillars are presented and discussed in the following paragraphs. The second pillar of the European Banking Union is the Single Resolution Mechanism. The SRM is based on the legal framework set out in the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation (SRMR, Regulation 806/2014). The designated authority, the Single Resolution Board, is operational since 1 January 2015. After a transitional phase of one year, the SRM became fully operational as of 1 January 2016 (SRB, 2016).

The mission of the SRB is stated in SRB's (2016) Introduction to Resolution Planning:

> "The SRB is the resolution authority for significant banks and other cross-border groups within the Banking Union. Together with NRAs, it forms the SRM. The NRAs play a key role within the Banking

Union. The mission of the SRB is to ensure the orderly resolution of failing banks with minimum impact on the real economy and public finances of the participating Member States of the Banking Union."

The SRB has to draft resolution plans for significant banks in the scope of the European Banking Union, assess the banks' resolvability and adopt resolution schemes when a credit institution is subject to severe financial problems and has to be either winded up under usual insolvency proceedings or use resolution. Apart from these main tasks the SRB also manages the Single Resolution Fund (SRF), which is the last resort built by contributions of the banking sector. (SRB, 2016)

Breuss (2012) evaluates the costs and benefits of the Single Resolution Mechanism and concludes that the benefits are unequally distributed between the participating member states. Germany is stated as the biggest loser, whereas Spain and the Netherlands are titled as the main winners. This is the case because the 'bail-in' approach disadvantages countries with a sound banking system, which have to bail for countries with a poorer established system. However, Breuss, Roeger and in't Veld (2015) find that if the European Banking Union would have been effective at the time of the financial crisis, GDP losses could have been reduced by 30-40% for periphery countries, i.e. the less developed, and by 10-40% for core countries depending on which resolution mechanism was in place. Three different options for recapitalization of periphery banks are evaluated: Through the SRM or through loans of the European Stability Mechanism (ESM), or through direct recapitalization by the ESM. Again, the results are that the SRM is more favorable for banks in poorer position than for core banks, whereas ESM loans are more attractive to core banks but less attractive for periphery ones. The third option, direct recapitalization, is the best option with respect to the minimization of GDP losses, but morally questionable because of tax payers' involvement and its implications for moral hazard. This incentive dilemma of 'too big to fail' is made concrete by Calciano, Fiordelisi and Scarano (2015). It is pointed out that it would be the most helpful if banks would hold the optimal leverage ratio on their own. The regulator could influence the behavior with the use of incentives. The market-participation incentive is the simplest mechanism in this case. The banks that are not able to keep the bank specific optimal leverage ratio are likely to fail at a certain point in time. However, at the current setup with the SRM aiming to save a failing bank and to even refinance it with the help of the SRF is not incentive-compatible.

2.5.3. European Deposit Insurance Scheme

The third pillar alongside supervision and resolution is the European Deposit Insurance Scheme. The reason why this concept is not operational yet, is that it is highly controversially discussed and the implementation was blocked by some member states. Especially Germany has raised major concerns and rejection regarding the planned mechanism for deposit insurance (German Federal Government, 2015). The current set-up with national deposit guarantee schemes is criticized as "promoting liquidity ring-fencing and market fragmentation in times of stress" (Wruuk, 2015). Furthermore, locally concentrated problems would have higher impact on each individual deposit guarantee scheme, which could be avoided more easily after the implementation of EDIS. In promoting a unified deposit insurance scheme the European Commission published a proposal on EDIS in November 2015 (EC – European Commission, 2015). In addition the European Parliament also released a draft report on EDIS in November 2016 (EP – European Parliament, 2016). According to the initial EC proposal the final implementation is planned until 2024 following a three-stage approach.

As EDIS is not of primary relevance for this thesis, it will not be further elaborated here.

3. Corporate Governance in Banks

3.1. Theoretical Approach in Corporate Governance Literature

The first part of this thesis concentrated on the general framework of the European Banking Union and the elements of banking supervision. The topic of corporate governance was touched on during the discussion of the SREP, which dedicates a pillar to internal governance and control, fit and proper assessments and specific passages in the legal frameworks. The next part goes into detail analyzing the status quo of CG practice as well as by illustrating the lessons learnt during the recent financial crisis with regard to corporate governance in banks and the respective adaption of the supervisory framework in the Single Supervisory Mechanism.

Academic corporate governance studies can be divided into different streams. The Agency theory and stakeholder theory are the most prominent opinions in corporate governance theory. The *agency theory* follows the traditional principal-agent situation (Jensen and Meckling, 1976) which can be easily applied to the banking context. The stockholders are the principals who appoint the CEO (the agent) to manage the company. The problem of asymmetric information between the principal and the agent exists in this set-up, but the theory implies that mechanisms exist~~s~~ to align the agent's interest to the principal's. The most common solution to the principal-agent problem is alignment through the link of executive compensation to firm performance (Nyberg and Gerhart, 2010). Freeman (1994) is an advocate of *stakeholder theory* which states that the management's interest shall be aligned with all stakeholders. Himaj (2014) adds that agency theory has its origins in the Anglo-American CG model and stakeholder theory was grounded in Continental Europe. One peculiarity of banks is that more stakeholders are involved in the banking business than in most of the other industries. Additionally to the usual kinds of stakeholders, banks have to pay special attention to depositors and creditor as well as regulators. This is the reason why the traditional agency theory cannot be applied in the context of banks (Kern, 2004).

Before analyzing corporate governance in the banking sector in detail, it is important to point out the difference between financial institutions and non-financial institutions with respect to CG. Mehran, Morrison and Shapiro (2011) identify two major differentiation criteria: the amount and multitude of stakeholders and complexity of banking business. Macey and O'Hara (2003) claim that banks cannot be compared easily. The set-up of banks varies not only in size, but also regarding the kind of banking business, complexity and cross-border operations. So, a one-size-fits-all corporate governance approach cannot be applied. CG practice in banks and its regulation have to pay attention to proportionality and adapt to the respective structure, but this does not mean that smaller or less complex banks can automatically be more lax in defining an executing their CG framework. Another aspect that must be considered is the fact that financial institutions have to follow shareholders' interest by maximizing the profits, on the one hand, but, on the other, have to act according to public interest (Mehran and Mollineaux, 2012). This dual demand obliges banks to be both safe and innovative at the same time. It was argued before that the traditional agency theory cannot be applied and that the stakeholder theory provides more consistency with corporate governance in banks. The banking environment differs also from other industries because of the existence and strictness of regulation and supervision, which has high influence on the corporate governance in practice in banks (Mehran, Morrison and Shapiro, 2011). Both, Regulation as well as deposit insurance, intend to protect one of the weakest stakeholders, the depositors. The aspect of the influence of regulation and supervision on corporate governance will be discussed in section 3.4 of the present work. Mehran and Mollineaux (2012) explain further on that decisions taken by financial institutions resulting in failures and financial crisis are caused by wrong incentives. Corporate governance is the mechanism to align incentives in a way that those negative results can be avoided. Himaj (2014) sums up the three most prominent reasons for the difference between banks and other types of companies when it comes to CG: "The broader range of stakeholder, including depositors and creditors; (ii) The opacity and complexity of banks business,[…]; and, (iii) The unique system of oversight in the form of bank supervisors, deposit insurers and a comprehensive body of banking laws and regulations […]."

Walker (2009) analyzed the corporate governance arrangements in UK banks at that time in depth and issued recommendations in his 'Walker Report'. The findings are generally applicable to all comparable countries and provided a comprehensive conceptual framework for corporate governance practice. He states regarding discussion in the board room that the optimal process would be presentation, challenge, decision, execution. But, especially the second part of the process – challenge – lacks implementation in most banks. The quoted reasons for the underrepresentation of constructive discussion with the aim to challenge proposed new strategies before taking a joint decision are lack of time commitment and inadequate level of collective board capabilities. Both aspects are incorporated in the new regulatory requirements regarding fit and proper assessment which will be discussed later on. Walker's further recommendation concerns the risk management framework in banks. He believes there is still plenty of room for improvement when it comes to risk oversight activities at the highest level. He deems it necessary that decisions on topics such as the risk appetite and monitoring activities shall be made on board level with the executive responsibility given to the CRO who should be able to act independently. Furthermore, it is recommended to revise the existing remuneration frameworks, because a board oversight in this matter was missed in most cases. Also, the establishment of remuneration committees were demanded to ensure that compensation of the management functions is aligned with the risk strategy of the banks. Walker brought also the matter of disclosure up, expecting that information regarding the compensation of the management functions – not only board members – shall be disclosed to the major shareholders. He calls this concept "disclosure of high end remuneration on a banded basis".

3.2. Corporate Governance and the banking crisis

One of the major goals of the SSM is to increase the governance in European banks including the fitness and propriety of the management and key function holders. The following studies provide evidence for the assumption that weak CG influenced the impact of the financial crisis and explain why the responsible people behind the creation of the Banking Union put their focus on the topic.

Kirkpatrick (2010) supports his analysis regarding the causes of the banking collapse by stating that “the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements.” Incentives for excessive risk taking, insufficient accounting standards and regulatory requirements as well as weak remuneration systems are mentioned as reasons for the failures. Acharya et al. (2009) add the underestimation of systemic risk by regulators to the list of reasons and Dermine (2011) highlights that also banking supervisors and regulators have to follow and implement strict corporate governance principles. This aspect is discussed in paragraph 3.4, evaluating the recent changes in the corporate governance framework.

Several academic studies analyzed the impact of corporate governance practice in banks on the change of specific parameters during the financial crisis. In the following, the findings are summarized clustered into three CG categories – risk management, boards and compensation.

3.2.1. Risk management

Risk Governance – Corporate Governance related to Risk Management – plays an important role for the banks, because it enables the managing bodies to “authorize, optimize and monitor risk taking in an enterprise” (Peddada, 2014). Risk oversight has to be ensured by the whole board, but the operational responsibility has the Chief Risk Officer (CRO). The integration of the CRO in the organizational structure varies in the different institutions. Mikes (2009) adopts four different risk management types: compliance champion, modelling expert, strategic advisor, and strategic controller. Furthermore, the use of risk committees is an important part of the governance set-up. (Peddada, 2014).

Aebi, Sabato and Schmid (2011) concentrate in their research on how risk management-related CG mechanisms influenced banks’ performance during the crisis. The first argument they pointed out is that risk management as part of the CG practice is an important differentiation criterion between financial and non-financial institutions. The results of their analysis show that banks which have a Chief Risk Officer who directly reports to the board of directors significantly outperform those banks, where the CRO reports to the Chief

Executive Officer (CEO). This finding implicates that if a CRO is part of the executive board, risk management receives more attention especially when the CEO and CRO have conflicting interests. In a crisis scenario, this approach clearly has a positive impact on the company performance, but in a normal market environment this constellation may have negative impact on the company performance. Afanasyeva, Lapina and Scherbina (2013) add that the installation of a Risk Management Committee has also positive effects on the firm performance. Apart from the influence of the CRO in a financial institution, Kirkpatrick (2010) also highlights that risk management practices in many banks were not sufficiently developed before the crisis. In this thesis, analyzing risk management techniques is not in scope, but the fact that board members and other responsible committee members were not informed about the shortcomings and the upcoming problems is a corporate governance issue. Kirkpatrick (2010) provides evidence that in many banks the personnel attributed to make management decisions and oversee the banks' control systems was informed too late about changed market conditions and problems in the companies' performance. After the crisis regulators put high attention to increase the banks' risk management. The chosen approaches comprise on the one hand increasing the legal requirements with respect to risk management practices also considering a forward-looking approach with e.g. stress testing and, on the other hand, strictly observing compliance with the rules through supervision. A major part that the supervisory framework emphasizes is risk governance.

3.2.2. Boards and Committees

With regard to board composition of banks, aspects as number, busyness and age of board members, CEO duality, etc. are investigated. Firstly, for CEO duality, i.e. that CEO holds also the position of the chairperson of the board, it was found as having a negative effect on firm performance during the crisis situation (Grove, Patelli, Victoravich and Xu, 2011). Kirkpatrick (2010) raises the issue of performance of board members as part of the reasons for the negative impact on firm performance during the crisis. For suitability of board members some examples are mentioned in the area of corporate governance. First, the existence, frequency and seriousness of committees like the risk or audit committee is under the influence of the board members. Second, all board members have to take risk management serious and should be up-to-date with respect to new regulations and techniques. This was not always the case as risk management was considered as “too specialist for meaningful oversight by the whole board” Kirkpatrick (2010) admits that measuring board member’s competence is very difficult. The fit and proper assessments which are part of the new regulatory and supervisory regime in the European Banking Union are a mechanism to make sure that board members and other key managers have a suitable background and experience. This does not only apply for executive board members, but also for non-executive board members. The Chartered Institute of Management Accountants (CIMA, 2012) found for the non-executive board room for improvement regarding the formalization of the recruitment process, the independency and the range of selection criteria. Another highly important finding was raised in a European Commission report (2010) addressing the lack of challenging capacity of non-executive board members, supervisory board members in a two-tier board structure, respectively. The term challenging capacity refers to the objective of the non-executive board members to check decisions, raise questions and maybe also express disagreement on certain topics. Apart from expertise, non-executive directors have to show sufficient time commitment for fulfilling their duty.

3.2.3. Remuneration

Another aspect which has been investigated very intensively after the financial crisis is executive compensation and its impact on firm performance during the crisis. The reason for the interest in this topic is that excessive risk taking caused by wrong remuneration incentive systems is blamed as one of the main reasons for the financial crisis from a corporate governance perspective. In the 1990s, famous scholars found that it is important to align executives’ and shareholders’ interest to increase firm performance. Holmström and Tirole (1993) developed a model that shows that the best incentive for CEOs to be conform to shareholders’ goals is to reward them with stock-based compensation. Becht, Bolton and Röell (2012) confirm that this opinion gained acceptance during the past two decades and that as a consequence the stock price of a company has been approved as a benchmark for CEO performance. Fahlenbracht and Stulz (2011) provide evidence that the concept of alignment of shareholders' and CEOs' interest did not sustain in the financial crisis. Based on their research they found no evidence that better aligned CEOs performed better during the crisis. They even go one step further by arguing that shareholder-CEO alignment was a reason for worse performance. The evolution of research outlined in this thesis can be summarized as follows: It was seen beneficial for firm performance to align CEOs' interest with the shareholders'. The best way to achieve this is to provide incentives in the form of performance pay with stock. As a consequence, these kind of incentive resulted in excessive risk taking by the CEOs which was in line with shareholders' interest. But, during the crisis the higher risk turned out to be not beneficial showing higher losses for companies with higher CEO and shareholder alignment. In the following sections of this thesis it is discussed which measures have been developed by regulators to reduce risk taking incentives and increase incentives for long-term stability of the company through compensation as well as increasing transparency. Hüttenbrink, Kaserer and Rapp (2014) analyzes the correlation between financial regulation and incentives for the management of banks and finds that shareholders tend to offer higher incentives in countries where regulation tends to be stricter.

3.3. The difference in Corporate Governance practices between financial and non-financial companies

The examples from the last section show that bank governance is different and more complex than for non-financial companies. Becht, Bolton and Röell (2012) give one of the most important examples for why bank governance is different. Banks' business models are designed for taking and managing risk. It is undisputed that also non-financial companies face several risks in their course of business, but the big differences are, on the one hand, the systemic importance that lies in the nature of banking and, on the other hand, that the risk does not only have impact on shareholders, but also on other stakeholders, as for example depositors, creditors, counterparties and as the financial crisis has shown also taxpayers.

Haan and Vlahu (2013) underline that in general corporate governance academic papers, the assessment of financial firms is often left aside. Another aspect which increases the complexity of corporate governance in banks is the "too-big-to-fail" commitment of governments and policy makers (Haan and Vlahu, 2013). Especially for big banks it is unlikely that governments let them break due to their systemically important role, which can be an incentive for banks to take higher risk.

Another stakeholder which has to be taken into account when discussing corporate governance topics in banks are regulators. Regulators have a serious effect on internal governance practice. As banks are highly regulated and supervised these days, CG practice differs immensely between financial and non-financial firms because of the regulatory influence. (Haan and Vlahu, 2013)

The next difference pointed out by Haan and Vlahu (2013) refers to ownership concentration. In corporate governance theory, concentrated ownership correlates with better monitoring and control, because the more stock one shareholder holds the more incentives it has to take care about the well-being of the company. Large shareholders are more interested to be informed about the company's business and make better use of the voting rights. It is stated that, mostly in the US, the likelihood of large shareholders is higher in financial firms than in non-financial firms. In Europe differences exist between UK and continental Europe with respect to ownership concentration. While in continental Europe ownership is concentrated in the UK, the share of the largest blockholding is much lower on average (Köhler, 2009). Concentrated ownership has the advantage that the management's and large shareholders' interests can be better aligned. However, another agency problem can occur between large and minority shareholders.

With respect to compensation, the following difference is highlighted apart from the previously mentioned aspect of alignment of the executives' to the shareholders' interest. Whereas it is more common for executives in non-financial firms to lead the company through reorganizations in times of financial distress, it is often the case that in financial firms the executive management is exchanged in negative times. (Haan and Vlahu, 2013)

Furthermore, general CG literature usually refers to the concept of market for corporate control, which is based on the assumption that the threat of hostile takeovers disciplines the executives of a company to increase firm performance. The theory suggests that executives fear to be substituted by the acquirers. Hence, as it is mentioned that the market for corporate control plays no role in banks' corporate governance (Haan and Vlahu, 2012), this topic will not be further discussed in the present thesis.

3.4. Bank Governance from a supervisory perspective

The new supervisory regime was described in the first section of this thesis, followed by a more general part about corporate governance in banks. In this section, both topics will be combined by laying the focus on supervisory aspects in banks' corporate governance and providing introductory messages for the next part where recent regulatory and supervisory initiatives will be analyzed in depth.

Mehran, Morrison and Shapiro (2011) describe the relation between supervisors and bank's corporate governance as difficult, because "there are no hard and fast rules, and just when a practice becomes widely accepted as best practice, exceptions of the rules emerge in precisely those firms most in need of good governance." Furthermore, they point out that the priority of regulators and supervisors should be to bring awareness of safety and soundness into the banks' board rooms. Engagement, expertise and independence are mentioned as the key principles of board members best practice with respect to governance. In addition, supervision shall investigate and increase the challenging capacity of the executive board members to challenge the management as well as the supervisory board to challenge the decisions and actions of executives. All of these elements are part of EC's Guide to fit and proper assessment, which will be discussed in the next part of the present paper. Mehran, Morrison and Shapiro (2011) raise a point that is crucial for the whole functioning of the framework of bank governance and its dependence on regulation and supervision: Whereas the board may feel only responsible for acting in the interest of shareholders, the authorities have the objective to add other stakeholders like creditors, depositors and taxpayers to the board's consideration.

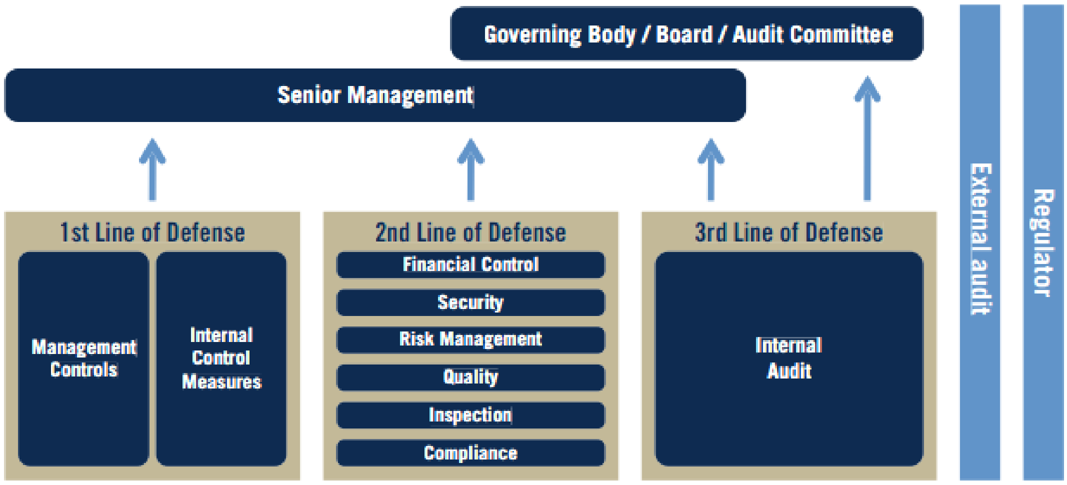
Dermine (2011) presents a slightly different view on this topic by proposing a separation of accountability between the board, who guarantees shareholder's value maximization, and the supervisory authorities, who shall defend the safety and soundness of the banking system. The interest of the other stakeholders is automatically defended, when the banks are forced by the rulemakers to act according to a safe and sound banking environment.

If banking supervision should play an increasingly important role, it has to be considered that supervisors have to be more integrated into the governance systems of banks. Arndorfer and Minto (2015) provide an approach to further supervisory integration into banking systems by establishing the 'four lines of defence' model of financial institutions, which is a development of the common 'three lines of defence' model. The 'three lines of defense' model refers to the internal control system of banks which is a key component of corporate governance. According to the EBA Draft Guidelines on internal governance, "the internal control framework of an institution should ensure:

a. effective and efficient operations;
b. prudent conduct of business;
c. adequate identification, measurement and mitigation of risks;
d. reliability of financial and non-financial information reported, both internally and externally;
e. sound administrative and accounting procedures; and
f. compliance with laws, regulations, supervisory requirements and the institution's internal policies, processes, rules and decisions." (EBA, 2016c)

The 'three lines of defense' model constitutes the core element of the internal control system and was formulated by the Institute of Internal Auditors (IIA, 2013). A general visualization of the three lines of defense is depicted in figure 11.

Figure 11: The ‘three lines of defense’ Model



Source: IIA – Institute of Internal Auditors (2013)

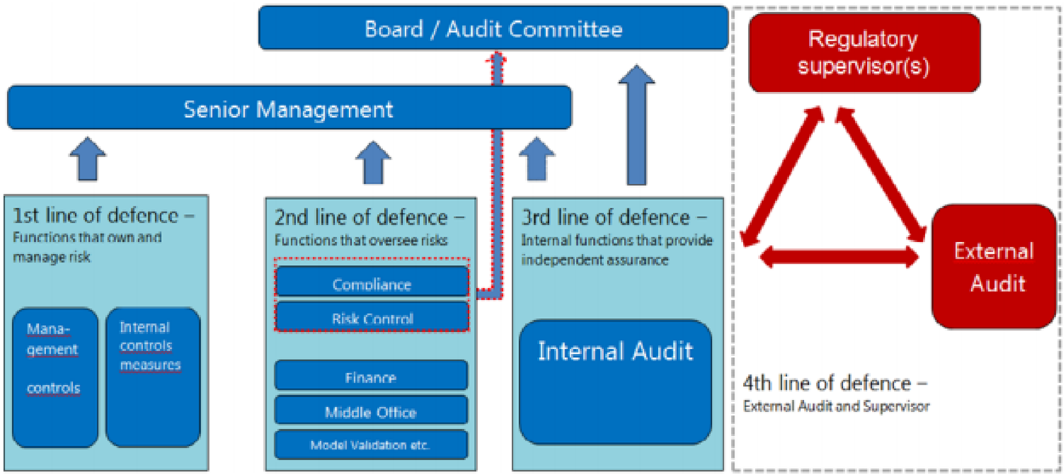
The *first line of defense* consists of the units responsible for revenue generation like traders, asset managers, sales persons and relationship manager. The idea behind this concept is that the internal control system should start at the basis of the value chain which is intuitive, because the business units are the originators of risk. Risk takers should be aware of the risk which they produce and the behavior of risk takers can be controlled by setting incentives. At this stage it has to be pointed out that taking risk is part of the banking business and therefore the production of risk should not be seen as negative in this context. However, the risk should be in line with the risk strategy and the risk appetite the bank is willing to take and should not hurt the regulatory requirements. A component of variable remuneration could be dependent on the control activities of the risk taker, to give the business units incentives to fulfill their tasks as first line of defense. But clearly, generating revenues should be the key priority and control mechanisms are contrary interests. (Arndorfer and Minto, 2015)

The *second line* of the internal control system consist of Compliance and risk management functions (RMF). They have to step in when the first line of defense are not capable of performing their control duties effectively, which can happen, because the core duty of business units is to generate revenues. The Compliance and risk functions objectives are to monitor the controls conducted in the first line and additionally to provide the risk framework which has to be adhered to in the first line. The second line of defense has been strengthened considerably after the financial crisis, because of the increased regulatory requirements. The Compliance and risk functions are not any longer only engaged in adapting the internal control system to best practice, but also have to provide the supervisory authorities with information which is needed to perform their oversight duties. (Arndorfer and Minto, 2015)

The core criterion of the *third line of defense*, the Internal Audit Function (IAF), is independency. A strong Internal Audit department is important for banks, because it signalizes a strong internal governance and control system and shows that it can act as an 'extended arm' of supervisors. EBA guidelines (2016c) require the audit functions to plan the activities on an annual basis and according to a risk-based approach. In practice, the risk assessment should identify the functions and processes with the highest remaining risk after consideration of the activities of the internal control system. An adequate evaluation of the risks is vital for the functioning of the Internal Audit framework, which implies that a poor risk assessment implies that overall risk can increase, because the bank trusts the Internal Audit department's work. (Arndorfer and Minto, 2015)

Arndorfer and Minto (2015) try to enhance the 'three lines of defense' model by considering the peculiarities which come along with the complexity of financial institutes and the aspect of strong external regulation and supervision. Their proposal for a new model including a fourth line of defense, depicted in Fig. 12, foresees an integration of external auditors and regulatory supervisors in the control system of banks. It has to be mentioned that while the 'three lines of defense' model has a general scope of application in any kind of company, the enhancement to the fourth line is only designed for financial institutes. The goal of this model is to increase the closeness of relationship between external supervisors and banks. Better coordination can only be achieved by communication, which is needed to reduce asymmetric information and regain the public's confidence in the financial sector. The major reason for the occurrence of information asymmetry and moral hazard is the high level of complexity related to the banking business and to its control activities. The 'four lines of defense' model should not be misunderstood in the way that it stipulates a formal integration of external auditing and supervisory functions into the banks' organizations, but as a framework that should induce a communication environment for internal and external control systems. Under optimal conditions it should allow a fruitful exchange of information and ensure a win-win situation. Too much integration and involvement in banks' operative control system would have negative impacts on the independence of supervisors.

Figure 12: The 'four lines of defense' Model



Source: Arndorfer and Minto (2015)

Considered in detail, the interactions within the triangle Internal Audit – External Audit – Supervision provide potential for increased efficiency for the internal control system of banks. A trustful relationship is the basis for the establishment of a comprehensive flow of information and best practice. The increased amount of information obtained by the supervisory authorities would enable an enriched environment for benchmarking not only of Internal Audit practices and the internal control system in general, but also of all audited processes and methods in the banks.

Firstly, the increased interaction between external auditors and banking supervisors in the 'four lines of defense' model can be beneficial for both sides because they have different views on the audited/supervised entity. Whereas the external auditor is responsible for the review of financial statements and the internal control framework, the supervisory authorities have a broader scope, because they have to reveal risks which could impose a threat to the stability and soundness of the banks. Arndorfer and Minto (2015) propose a regular exchange of experiences and views in bilateral or even trilateral (with the chair of the Audit Committee) meetings.

Secondly, the relation between Internal Audit and supervisors has attracted most attention in regulatory and political discussions after the financial crisis. It is clear that supervisors rely on the work of Internal Audit departments, because they do not have resources to perform the amount of investigations in all the supervised banks. It is common practice to ask for several audit reports to learn if any major risks were identified. In the 'four line of defense' model this interaction would be extended in a way that the supervisors would receive information as they would be part of the organization. But, the model also foresees that the benefit should be experienced in both directions. Supervisors shall provide IAFs with information that could increase the effectiveness and performance of their activities. A positive effect of this two-sided information exchange could be that Internal Audit functions would report certain observations proactively and voluntarily, because they receive trust and appreciation. However, supervisors are also responsible to assess the adequacy of the internal control system, and by doing this, is also investigating the Internal Audit function. Arndorfer and Minto (2015) further express their opinion that it is possible to combine the conflicting types of interaction in a vertical and horizontal relationship. A proposal to overcome these obstacles is to identify different teams in the supervisory authority; one for relationship management and one for assessing the work of the Internal Audit function. It is also recommended to formalize the interactions by holding regular meetings, but also to retain flexibility to allow the banks ad-hoc disclosure of information.

Thirdly, internal and external auditors have overlapping areas of responsibility to some extent, although the Internal Audit function has a much broader scope. A closer relationship would avoid duplication and could help the external auditor to define the work which they need from internal auditors as a basis for their assessment. The benefit for the Internal Audit function can be that the external auditor may have more experience from other banks and hence can provide more of an outside view. (Arndorfer and Minto, 2015)

Summarizing the ideas behind the 'four lines of defense' model formulated by Arndorfer and Minto (2015) it has to be stated that this model proposes increased communication between the third line of defense, i.e. the Internal Audit function, and external control functions, i.e. external auditors and supervisory authorities. The rationale behind this concept is to reduce information asymmetry and, as a result, to increase the safety and soundness of the financial system.

The ‘four lines of defense’ model implies that supervisory authorities are part of the governance system of banks. In doing so it has to be ensured that also the corporate governance mechanisms of regulatory and supervisory authorities have to be enhanced according to the demands of the complex banking environment (Dermine, 2011). According to Article 19(3) of the SSM Regulation, ECB is obliged to implement a Code of Conduct. This code taken into force in 2015 regulates the expectations towards ECB’s staff regarding independence, standards of professionalism, private financial transactions, dignity at work and use of ECB resources (ECB, 2015a). Based on the Ethics Framework (ECB, 2015b) the NCAs are required to report on an annual basis about the progress of implementing the guidelines and complying with them. Moreover, an Ethic Committee is installed as part of the corporate governance framework of the ECB. (ECB – Banking Supervision, 2017b)

3.5. Recent changes in the ECB Corporate Governance framework

The positive aspects of corporate governance on banks’ stability are unquestioned, but it has to be applied with the guidance of the regulatory and supervisory bodies. Keeping this message in mind, the following section shows what regulators and supervisors undertook to develop CG practices in line with strong supervision in the recent years.

3.5.1. New Corporate Governance rules as answer to the financial crisis

It was often and explicitly stated by regulatory as well as supervisory representatives that weak corporate governance was playing a big part in the emergence of the recent financial crisis. For this reason, one of the first reactions to the weaknesses in bank governance from a European regulatory point of view, the CRR and CRD IV were precedent-setting. Articles 88-96 of the final CRD IV version of 26 June 2013 – see Fig. 13 – build the corner stones of ECB's corporate governance framework. Whereas Article 88 outlines the general requirements regarding internal governance, Article 91 refers to the suitability of the management body, and Articles 92-95 set out rules for remuneration. The other mentioned articles contain expectations concerning public disclosure. The three main parts of the CRD IV Internal Governance package are addressed in the

- EBA Draft Revision of the Guidelines on Internal Governance,
- Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders, and
- EBA Guidelines on sound remuneration policies.

Figure 13: CRD IV - Articles related to Governance topics

Article	Title	EBA Guidelines
Article 88	Governance arrangements	EBA Guidelines on Internal Governance
Article 89	Country-by-country reporting	–
Article 90	Public disclosure of return on assets	–
Article 91	Management body	Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders; ECB Guide to fit and proper assessments
Article 92	Remuneration policies	EBA Guidelines on sound remuneration policies
Article 93	Institutions that benefit from government intervention	
Article 94	Variable elements of remuneration	
Article 95	Remuneration Committee	
Article 96	Maintenance of a website on corporate governance and remuneration	–

Source: Own illustration, CRD IV.

Hopt (2013) analyzed the Draft Capital Requirement Directive of 20 July 2011, which remains almost unchanged in the final version with regard to the previously mentioned articles and found that the focus of the regulators was on increasing internal bank governance, but the strengthening of shareholder and debtholder governance was addressed to a minor extent.

3.5.2. SSM Supervisory Statement on Governance and Risk Appetite

In 2016 the ECB published a report regarding Governance and Risk Appetite (ECB – Banking Supervision, 2016g) which summarizes the results of an in-depth assessment of institutions management bodies and their Risk Appetite Frameworks (RAF).

The principles for the RAF were outlined by the Financial Stability Board (2013) and require banks to implement a “strategic tool to reinforce a strong risk culture in financial institutions” (ECB – Banking Supervision, 2016g). The RAF should help banks to clearly define the level of risk tolerance, i.e. the risk appetite, which the bank is “willing to assume within its risk capacity to achieve its strategic objectives and business plan” (Financial Stability Board, 2013). By doing this, the banks have to take into account not only the interest of the shareholders, but also of other stakeholders like depositors and policyholders (Financial Stability Board, 2013).

Part of the Risk Appetite Framework is a regularly monitoring of the main key performance indicators accompanied by the reporting of a risk appetite dashboard to the management body at least in quarterly frequency for larger institutions. The risk appetite dashboard provides an overview about defined KPIs in the dimensions of liquidity and funding, capital adequacy, profitability, market risk, credit risk, etc. and should compare the risk exposure and agreed risk limits which are calibrated according to the risk appetite of a bank. An escalation plan in case of breaches of the set limits must also be included in the RAF. (ECB – Banking Supervision, 2016g)

A functioning RAF can only be achieved with the existence of strong corporate governance rules for all involved stakeholders (i.e. board, senior management, risk function, business lines, legal entities, etc.). Especially board members are requested to take an active part in definition, validation and monitoring of the Risk Appetite Framework. In addition, the Internal Audit function shall review the effectiveness of the framework in general and the proceeding in case of limit breaches on an annual basis. (ECB – Banking Supervision, 2016g)

With respect to the second central point of the SSM report, governance, the ECB outlined their “supervisory expectations regarding board composition as well as the functioning and effectiveness of boards (ECB – Banking Supervision, 2016g).

In the first point of their analysis about board composition the supervisors focused on the boards’ size and structure and found that in some institutions the amount of board members has a negative impact on the possibility and effectivity of interactive discussions. Furthermore, ECB showed up some weaknesses in the area of independency of board members highlighting the opinion that independency in the board room promotes the challenging and oversight capacity vis-à-vis the senior management. Room for improvement was also considered on the topic of collective knowledge of the board, especially in areas as IT and accounting. The last highlighted issue refers to the formalization of the succession planning process. (ECB – Banking Supervision, 2016g)

Regarding the quality of debate and board's challenging capacity, the report highlighted some room for improvement in the reviewed credit institutions. Firstly, the time and documentation of debates were found to be inadequate in all banks. The amount of information asymmetry between individual board members or groups of board members was identified as another obstacle to a fruitful debate in the board room. The last recommendation of the report with respect to governance arrangements refers to the internal control framework, which showed the need to be strengthened. Especially the reporting channels of the risk management function, the Internal Audit function and the Compliance function to the board were investigated in this regard. (ECB – Banking Supervision, 2016g)

This report shows that the dialogue between the supervisors and the boards of the banks is an integral part of the new European banking supervision regime. By clearly expressing the expectations for the governance arrangements and capability in the board room and by showing up insufficiencies in the reviewed banks, the ECB clearly gave the message that internal governance is a key supervisory priority in the SSM (ECB – Banking Supervision, 2016a). In addition, Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, emphasizes this statement and goes even one step further by also demanding pro-active contact seeking from board members with the supervisors to discuss strategies, risk management frameworks and about the set-up of the board's oversight function (ECB – Banking Supervision, 2016a).

3.5.3. Governance as key element of the Supervisory Review and Evaluation Process

The general concept of the Supervisory Review and Evaluation Process was introduced in section 2.5 as the tool of daily supervision combining quantitative and qualitative assessment. Besides qualitative statements in the final SREP decision showing up the findings from the supervisory assessment the supervisors also impose additional capital requirements, in the form of the so-called Pilla r 2 Requirement and the Pillar 2 Guidance, based on the scoring of the SREP evaluation (EBA, 2014). Pillar 2 Guidance was newly established in 2016 and states the amount of expected capital which banks are expected to hold above all other capital requirements and buffers (ECB – Banking Supervision, 2016h). A violation of this limit does not automatically trigger any supervisory action, but ECB decides individually on the measures for facing the limit breach.

The SREP assessment is divided into four categories:

1. business model analysis
2. internal governance and institution-wide controls,
3. risks to capital and
4. risk to liquidity and funding.

The second, so-called SREP element, is now described and analyzed in detail. Under Title 5 of the Guidelines on common procedures and methodologies for the supervisory review and evaluation process, EBA (2014) defines the framework which has to be followed by ECB and the NCAs regarding the assessment of internal governance in banks. The SREP guidelines are directly addressed to the competent authorities. In general, it is stated regarding the assessment of internal governance that the supervisors have the objective to analyze the internal governance and risk management arrangements within an institution-wide assessment. In case the evaluation reveals weaknesses in the internal governance and control mechanisms, the bank has to provide additional capital reserves for the associated risks labeled as Pillar 2 Requirement. (EBA, 2014)

Throughout the SREP, one supervisory field of attention lies on the underlying policies and regulation. Hence, the ECB and NCAs have the responsibility to check the supervised entities' compliance with the Guidelines on Internal Governance, the EBA Guidelines on the assessment of the suitability of members of the management body and key function holders as well as the EBA Guidelines on sound remuneration policies. The mentioned guidelines and respective SREP investigatory duties of the supervisory authorities will be part of the next paragraphs in the present paper. Further areas which fall under this SREP category include risk management framework, IT systems and business continuity as well as recovery planning. The implementation and appropriateness of the Risk Appetite Framework and the associated Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP) frameworks with respect to soundness, effectiveness and comprehensiveness as well as stress testing are key inputs to the supervisory assessment of the risk framework. Regarding information systems, it is of high importance to have accurate, reliable, aggregated and up-to-date risk data in a timely manner in order to be ready to provide internal stakeholders, i.e. primarily the management body and the supervisors with the needed information. The appropriateness of recovery and business continuity plans complete the broad area of SREP inputs in the category regarding internal governance. All of these governance arrangements are also assessed in the context of institution-wide controls. (EBA, 2014)

As for all categories, the findings of the assessment phase are graded on a scale from 1 – 4. Score 1 means that the detected deficiencies "pose no discernible risk to the viability of the institution" and score 4 indicates a high level of risk. This scoring combined with the results of the assessments of the other SREP categories to the overall SREP score determine the SREP capital add-on. In addition, other quantitative supervisory expectations are formulated in the SREP decision, which should be tackled by the banks in order to improve SREP results in the following cycle. (EBA, 2014)

In addition to this aspect of an external view on the governance arrangements in a bank, the internal exploitation of synergies should also be considered. It is a challenge for the management body to use these regulatory requirements to improve internal processes and seek to maximize efficiency in the organization from a managerial perspective. Many of the tools which are required by supervisors, as for example the RAF or internal models, can be used for steering, control and monitoring purposes. Also, the regulatory bodies should take this aspect into account in defining the regulatory requirements wherever possible in a way that they can also be used in a managerial context. (Jankowiak, 2016)

3.5.4. Internal Governance

The core policy of the framework regarding the corporate governance framework in banks is the EBA Guideline on Internal Governance, which has to be read in conjunction with other related guidelines on remuneration policies, on the assessment and suitability of the members of the management and key function holders, the CEBS Guidelines on outsourcing arrangements, EBA Guidelines on SREP, and on disclosures.

The ultimate goal of the EBA Guidelines on Internal Governance, which is addressed to the competent authorities and credit institutions, is to establish a strong risk culture. This version of the guidelines albeit currently being only in draft status substitutes the version published in 2011. (EBA, 2016c)

EBA elaborates in the press release on 28 October 2016 (EBA, 2016d) on the main corner stones of the revision. The framework is strengthened with regard to risk oversight function of the management body, the risk management function, “know-your-structure”, business conduct and the establishment of a risk culture, a code of conduct and the management of conflict of interest.

The draft guidelines are clustered into 5 parts: role of the management body, internal governance policy, proportionality, internal control framework and transparency (EBA, 2016c).

Firstly, with regard to the role of the management body regarding internal governance it is stipulated that, on the one hand, the organizational structure has to have clear lines of responsibility and processes to identify, manage, monitor and report risks. On the other hand, the management body has the responsibility for the implementation of arrangements in the area of overall business and risk strategy, the internal control framework, internal and regulatory capital, remuneration, individual and collective suitability assessment of the management body, selection of key function holders, functioning of the committees, risk and corporate culture as well as ensuring the integrity of the accounting and financial reporting systems. Regarding the structure of the management body it is generally required that a chair leads the management and is responsible for the overall functioning of the organization in an effective way. The management body is divided into two separate objectives: the management and the supervisory function. (EBA, 2016c)

The segregation in the MB as well as distribution of duties between these two functions is highly discussed as the documentation of the consultation period shows. The European Banking Federation (EBF), which represents the interest of the European banking sector, states in their response to the consultation paper that the wording in the present draft version of the guidelines may fail to meet the demands of regulating all kinds of organizational structures in the same appropriate way. It seems that the guidelines are designed for two-tier boards making the application of the rules problematic for one-tier systems and other hybrid models. (EBF, 2017a)

The second part outlines the guideline’s rules and expectations regarding the implementation of an internal governance policy as well as a sound and consistent risk culture and a code of conduct. Whereas the third part prescribes the proportionality principle meaning consistency of the internal governance arrangements with the individual risk profile and business model, the fourth part deals with the internal control framework. (EBA, 2016c)

The ‘three lines of defense’ model, which was already introduced in section 3.4, builds the basis for the internal control framework as depicted in the guidelines on internal governance. The internal control function in a bank has to consist of the risk management function, the Compliance function and the Internal Audit function. It is allowed that risk management and Compliance can be combined in some cases, but the IAF has to be completely independent from other control functions. It is crucial for the functioning of the internal control framework that direct access to the management body is provided to the control bodies. Furthermore, adequate staffing and training of the personnel responsible to conduct the controls in either of the three control functions has to be ensured and is evaluated by the supervisory authorities in a consistent manner. The RMF shall be independent from the business lines, responsible for elaborating the risk strategy, involved in all material risk management decisions and ensures proper identification, assessment, measurement, monitoring, mitigation and reporting of all risks. The Compliance function assumes advisory tasks to the MB related to laws, rules, regulations and standards and has to conduct compliance monitoring by evaluating the impact of new regulatory changes. A close cooperation with the risk management function is very important. The Compliance function has to be independent from business lines and other internal units apart from the risk management function. The major tasks of the Internal Audit function as regulated in the Guidelines on internal governance are to check "whether the quality of the institution's internal control framework […] is both effective and efficient" and it should "verify, in particular, the integrity of the processes ensuring the reliability of the institution's methods and techniques" (EBA, 2016c). To perform those and other tasks access to any information has to be granted and guaranteed by the audited areas. The methodology of the IAF foresees the establishment of an audit plan on an at least yearly basis. This audit plan has to be brought to the attention of the management body in its supervisory function. Moreover, the MB has to be informed about the fulfillment of measure implementation regarding Internal Audit findings and recommendations. The respective follow-up procedure lies also under the responsibility of the Internal Audit function.

Geiersbach (2010) analyzes the IAF as part of the corporate governance framework from a theoretical perspective. The connection between the management body and the hierarchically subordinated departments and units can be designed as a principal-agent problem. The MB (principal) grants rights of disposal to the agents, which usually results in asymmetric information and the problem of moral hazard. The agents can use the information advantage for their own benefit and/or reduce their input to the least acceptable minimum, which is the so-called problem of shirking. The Internal Audit function is installed as a monitoring tool in order to reduce information asymmetries by assessing and verifying the information which is provided by the agents. The degree of information asymmetry within an institution can be seen as indicator for the proportionality principle. The higher the information asymmetry between the MB and the subordinated departments is the more comprehensive should the assessment of the Internal Audit function be planned and conducted. A further special element of the monitoring activity of the Internal Audit function is the fact that the IAF is also an agent of the MB. This situation is described as a multiple agency model. Solutions for this problem are the implementation of elaborated incentive systems and the establishment of further control instances as the external auditor and supervisory authorities.

Richter (2014) developed a reference model with the purpose of giving an overview about the principal agent relations in financial institutions concerning risk governance. The first step of the model refers to the external corporate governance function for banks. In the banking context, the usual shareholder (principal) – management (agent) relation is extended by the depositors whose corporate governance role is performed by the banking supervisory authorities. The supervisory function of the management body is considered additively in step two. This internal governance function as supervisor appointed by the shareholders is exerted through committees, as e.g. the audit committee and the risk committee. The third and fourth step show different allocations of control duties between the managing bodies in its operative function. The role of the Internal Audit function as monitoring mechanism in combination with supervisory investigations, e.g. through the SREP, and regular controls conducted by the external auditors. In addition to these governance systems, it is mentioned that remuneration systems are also a valuable mechanism for contributing to the reduction of moral hazard.

In the SREP assessment the supervisory authorities are required by the EBA SREP Guidelines to check the overall internal governance framework in line with the EBA Guidelines on Internal Governance. In more detail this means that the expectations towards the supervised entities comprise the robustness and transparency of the organizational structure and the governance framework, policies regarding risk management, avoidance of conflict of interest and outsourcing, as well as a clear distribution of responsibilities in the organization, especially in the management body and the committees. Furthermore, regarding corporate and risk culture, the management body is constrained to perform its duties regarding the setting of the risk strategy, the governance principles, corporate values and appropriate standards. It is also reviewed in the SREP whether the communication of the strategy and policies to the relevant employees was sufficiently ensured. Additionally, the SREP assessment concentrates on the existence and functioning of the entire internal control framework. It has to be evaluated whether the policies in place reflect the rules set-out in the Guidelines on Internal Governance in all its facets. Also, the internal control functions are assessed with special attention to the Internal Audit function which should serve the institution as an effective and independent third line of defense.

EBA (2017) announced that they will update the SREP Guidelines, which are in place since 2014, in order to bring them to the newest status of regulation. Also, for the section about internal governance and institution-wide controls, it is stated that the SREP Guidelines will be enhanced in order to be consistent with the update of the EBA Guidelines on internal governance. The timeframe foresees publishing of the final revised SREP guidelines in 2018.

3.5.5. Fit and Proper assessment

One of the requirements set in the SREP Guidelines with regard to internal governance refers to the organization and functioning of the management body. Some of the rules related to this point are set out in the Guidelines on Internal Governance, but the majority have reference to the Joint ESMA and EBA Guidelines on assessment of the suitability of members of the management body and key function holders (EBA, 2016e) which are currently in a draft status. Furthermore, ECB has also published a guide to fit and proper assessment (ECB – Banking Supervision, 2017e).

The interaction between the EBA Guidelines and the ECB guide was outlined in a public consultation (ECB – Banking Supervision, 2017d) following the draft version of the guide to fit and proper assessment (ECB – Banking Supervision, 2016i). Whereas the EBA provides the regulatory basis in the single rulebook, the ECB tries to transpose the rules into practice with this guide and express their stance on the interpretation. But, the practical implementation can also give input for regulation in the other way around. Nevertheless, ECB’s intention of the guide to fit and proper assessments is to ensure compliance with the legal framework across the participating member states. As a consequence, the ECB guide is more detailed, explains the process which has to be followed and gives an indication on which type of information is needed by the ECB to conduct fit and proper assessments.

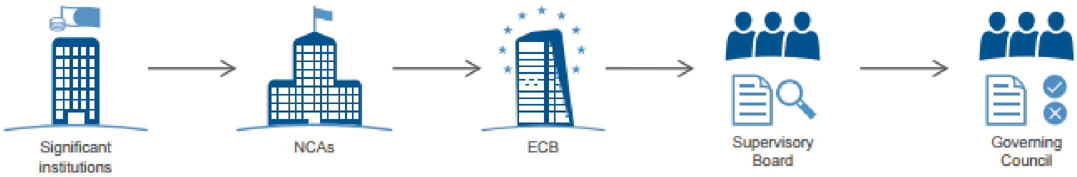
Hence, as the present work concentrates more on the supervisory aspect of corporate governance than on the regulatory, the ECB guide will be in the center of attention. Nonetheless, reference is also made to the EBA Guidelines where necessary.

It is undisputed that the quality of the top management in the banks contributes to the safety and soundness of the banking sector. It was one of the claims resulting from the recent financial crisis that some of those responsible in the banking institutions were not able to adequately conduct all necessary tasks for a proper management of their banks. ECB in its supervisory role puts high requirements on the suitability of the supervised banks especially on the significant institutions. As regulated in the SSM Regulation under Article 6 para. 4, fit and proper assessments in less significant institutions are fully under responsibility of national competent authorities. (ECB – Banking Supervision, 2016j)

The legal basis for the fit and proper powers of the ECB provides Article 91 CRD IV. As the CRD IV is a directive, which had to be transposed to national law, the fit and proper regulation is not uniform in all 19 Euro area countries. ECB’s guide to fit and proper assessments, as well as the related EBA guidelines, seek to harmonize the rules and have the aim to increase consistency in practice. Furthermore, it is stipulated in Article 4 para. 1 that ECB has the assignment to conduct the task of fit and proper assessments. (ECB – Banking Supervision, 2017e)

The process of fit and proper assessments is depicted in Fig. 14 from an operational point of view. In general cases, the supervised entity has to notify the appointment of changes in the management body and of key function holders. For significant institutions, it is foreseen that the notification is provided to the NCAs in the usual national form. The NCA informs ECB about the notification and fulfills all further data gathering and assessment tasks in collaboration with ECB. The responsibility of the final decision relies on the Supervisory Board of the ECB and the Governing Council based on the proposal of the ECB and NCA.

Figure 14: Involved stakeholders in fit and proper assessments



Source: ECB – Banking Supervision (2016i)

As a practical guide, ECB further concentrates on explaining its understanding and interpretation of the respective legal basis and EBA Guidelines by elaborating on its principles and the assessment criteria. The first principle – *primary responsibility of credit institutions* – stipulates ECB's expectations that the credit institutions have the responsibility to appoint only new members to the management body who comply with the suitability criteria. Moreover, it is clearly the obligation of the banks and the appointee to provide all the required information. The second principle defines the ECB's role as a *gatekeeper*. It elaborates that ECB has the objection and the right to intervene in case the suitability requirements are not met by new or active members of the management bodies of its supervised entities. Thirdly, as already touched, ECB seeks to unify the fit and proper practices in the participating member states. This *harmonization* by defining best practice is important, because the Article 91 CRD IV was transposed into national law in an inconsistent way. The fourth principle is called *proportionality and case-by-case assessment*. Regarding the proportionality principle, it is mentioned that the standards for suitability by itself are not subject to any indulgence, but the process by the competent authorities is adequately chosen to the size of the entity, scale and complexity of its activities. In addition, the application process depends also on the role the appointee is designated to fulfill. Meaning that plain vanilla cases in low risk institutions are prioritized in a different way during the fit and proper assessment than CEOs of the biggest credit institutions. The fifth principle guarantees the supervised entity and the appointee a *due process and fairness*. The sixth and last principle takes into consideration the *interaction with ongoing supervision*. This interaction is two-sided. One the one hand, the fit and proper assessment benefits from input from the ECB in its supervisory role and, on the other hand, the outcome of the fit and proper assessment can have implications for the ongoing supervision. It is conceivable that the JSTs have additional information regarding the practical performance and experience of an appointee from their ongoing interaction with the supervised entities. (ECB – Banking Supervision, 2017e)

The assessment criteria follow the expectations in Article 91 para. 12 CRD IV instructing EBA to define notions which was done in the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body. It is distinguished between five criteria for the fit and proper assessment:

- experience,
- reputation,
- conflicts of interest and independent mind,
- time commitment, and
- collective suitability (ECB – Banking Supervision, 2017e).

The *experience* of an appointee is evaluated from a practical and theoretical perspective by following a two-stage approach. In a first step the adequacy of knowledge, skills and experience is assessed against thresholds. Sufficient fitness is presumed for a managing MB with ten years “recent practical (senior) managerial experience” for the CEO and five years for other directors. In a supervisory function the timeframes for the chairman is also ten years and for other members of the MB in its supervisory function three years. However, not meeting the thresholds does not automatically trigger a negative decision, because the lack of experience can be whitewashed by several indicators. One of these indicators can be that the collective suitability of the MB is assured or that the new member brings in a new important aspect to the MB’s collective suitability, e.g. IT knowledge. Furthermore, training plans can be established to ensure the remediation of the lack of experience. Regarding the second assessment criterion on *reputation* which relates to the properness of an appointee, it is highlighted that in this case the proportionality principle has definitely no applicability. Good repute of an appointee is considered by applying the presumption of innocence. However, it is stated in the ECB guide that also pending legal proceedings can have influence on the fit and proper assessment which contradicts to constitutional rights in several member states where it is regulated that one should be seen as not guilty until the final sentence (EBF, 2017b). The third criterion regarding *conflicts of interest and independence of mind* were also under controversial discussions in the consultation phase. Conflicts of interest are divided into four categories with respect to its materiality: personal, professional, financial and political. The assessment of independence of mind is unrelated to conflicts of interest and has to be evaluated by the JST indicating previous behavior. In the consultation period, it was argued that the requirements concerning the independence criteria of the members of the MB will make it difficult to find enough suitable and independent candidates (EBF, 2017b). Moreover, it is stressed that national peculiarities and other factors as big banking Groups or family ownership, have to be taken into account. In general, it is criticized that the independence criterion is not required in the CRD IV and thus, it should also not be binding in the proposed form in the EBA Guidelines (EBF, 2017b). *Time commitment* refers to the amount of mandates or positions of an appointee that has to be provided and estimated in a self-declaration. The last criterion on the *collective suitability* of the management body requires the supervised entity to provide information on the idea behind the new appointment. The status quo shall be declared and in a further step also the impact of the new member of the MB to the collective suitability. (ECB – Banking Supervision, 2017e)

A tool for ECB to conduct the fit and proper assessments is interviewing the applicants. Fit and proper interviews are mandatory for new CEOs and chairpersons at stand-alone banks and the top banks of groups. In all other cases the necessity of interviews is decided on a case-by-case basis. The informative interview comprises information gathering and verification in all assessment categories. A second interview is unusual but can be required in case of concerns in some fields. (ECB – Banking Supervision, 2017e)

Another topic of discussion in the consultation phase of the EBA Guidelines is the timing of the fit and proper assessment. At the current stage, it is not yet decided whether an ex-ante or ex-post approach should be used. In the ECB Guide this topic is completely excluded, leaving the decision to the EBA. Ex-ante assessment means that the new candidate for the position will be assessed and decided as suitable prior to the appointment. The positive aspect of this approach is that the risk of refusal of appointees after already being in operative charge is eliminated for the banks. On the contrary, the bank has to arrange enough time for a new appointment, because the fit and proper assessment process normally takes between three and four months. This aspect has to be included into succession planning. EBF states that a neutral formulation allowing both approaches is favored by the institutions. This regulation would allow either ex-ante or ex-post assessment also considering national laws. (EBA, 2016e; EBF, 2017b)

One interesting take-away from the guide to fit and proper assessment and its related consultation phase is the opinion of the ECB regarding CEO duality. ECB clearly expresses its opinion that the CEO and the Chairman position of one institution must not be represented by the same individual. It is only granted by the ECB in exceptional cases. (ECB – Banking Supervision, 2017d)

3.5.6. Remuneration

Unlike as for the previously introduced EBA or ECB guidelines, this EBA guideline on sound remuneration policies are already available in its final version. Moreover, the guidelines are even in force and have to be applied since 1 January 2017 by the member states. The legal basis of the EBA Guidelines are set out in Article 75 CRD IV, where the EBA is instructed to issue guidelines complying with Article 92 to 95 CRD IV. (EBA, 2015)

Excessive risk taking incentivized by unreasonable remuneration arrangements in banks were identified as main reasons for the recent financial crisis. In summary, the newly introduced concepts in these guidelines concern the relation of fixed and variable compensation. This ratio is limited to 100% in general and in case of shareholders' approval to 200%. Further aspects are stricter requirements regarding malus and clawback as well as requirements regarding the type of instruments used for buying out the variable part of remuneration. (EBA, 2015)

As the subject of the present thesis is focusing on corporate governance topics, the passages in the EBA guideline regarding remuneration governance will be outlined in more detail. The core concept of the remuneration governance principles is the remuneration committee (RemCo). Significant institutions and its subsidiaries are obliged to install a RemCo consisting of members of the supervisory function of the management body and a majority of independent people. Apart from the general duties concerning the assistance in the design and oversight of the remuneration policy the new EBA Guidelines define two additional tasks that should be performed in the RemCo. The reaction of the arrangements in the remuneration policy and practices to external and internal events will be assessed with the aid of scenarios. Further, the remuneration of the senior managers in the internal control functions, i.e. risk management, Compliance and Internal Audit function, should be subject to the oversight activities by the RemCo. A bonus cap is introduced in case variable remuneration exceeds fixed remuneration. Upon shareholders' approval, it is possible to extend the ration from 1:1 to maximum 1:2. (EBA, 2015)

The set-up and the adequate functioning of the remuneration policies, the RemCo and the practice of shareholders' approval is also subject to the regular SREP assessment. Furthermore, the alignment of the remuneration schemes to the risk appetite, risk profile and business strategy as well as the avoidance of excessive risk taking and the proper consideration of a long-term approach have to be investigated by the supervisors. (EBA, 2014)

Murphy (2013) analyzes the setting of the bonus cap to a ratio of 1:1 and in exceptional cases to 1:2 from an economic perspective. He criticizes that the new cap system has the tendency to lead to behavior that is contrary to the originally intention of this policy. He predicts that the introduction of the new cap leads to an increase in the fixed amount of remuneration. This increase is set to be equal to a decrease of the amount which would be lost in case of a downside event, which can lead to more risk taking as the penalty is reduced. Furthermore, it is stated that the employees will stop with their performance and even save it for the next year if the cap is reached. An additional aspect is the competitive disadvantage for SSM banks, which is implied through this cap regulation. Young talented individuals can flee to companies in countries where performance is rewarded in an uncapped way.

An answer to the criticism was given by the European Commission in a delegated external study (EC, 2016b). The study indeed confirms the trend to more fixed remuneration, but also invalidates the above arguments by presenting empirical evidence showing that the decision to take more risks is barely related to the ratio of fixed and variable remuneration and that job changers did not include the remuneration regulation in their decision as a main reason. In addition, the importance to improve governance arrangements is stressed. They found room for improvement in two areas regarding remuneration governance. First, the involvement of the CRO in the review of the performance is considered as too much in many surveyed banks and second, the involvement of the remuneration committee is perceived as too low. Transparency either through public disclosure or through supervisory investigations is a further important point for risk reduction, which is highlighted in the review. However, the harmonization of the detail of disclosure shall be harmonized, which may improve due to the EBA Guidelines.

4. DISCUSSION AND CONCLUSION

4.1. Policy Implications

In order to follow the concept of this work, this part will also be divided into two separate discussion topics, general thoughts on the European Banking Union and corporate governance practice in banks, and then be evaluated in interconnection. Fields of further research, which can build on this study, are described and demanded in the conclusion.

Regarding the set-up and functioning of the European Banking Union and its Single Supervisory Mechanism, Schoenmaker and Véron (2016) published a blueprint offering an in-depth evaluation of the supervisory practice in the first one and a half year of the existence of the European Banking Union. The key findings of their study are generally positive, but also highlighting some room for improvement. First, the establishment of the European Banking Union is deemed to be an effective improvement in contrast to the former dispersed structure of national responsibilities. But, the goal of a level playing field is not yet reached in all aspects. The concept of establishing Joint Supervisory Teams for each banking Group is considered to be positive, because it ensures a clear line of command and decision making and gives the possibility of independent supervision in specialized key areas as for example internal governance. They agreed with the banks' complaints that the new banking supervision regime is tough, but they also state that it seems mostly fair. Nonetheless, negative aspects are also addressed, like overlapping or redundant data requests or deficiencies regarding the use of delegation for some decisions. Lack of transparency is a further topic touched on in the study. More information regarding the determination of SREP scores is demanded.

A perceived overshooting of the newly imposed requirements since the publishing of the Basel III rules is a further highly recurrent criticism. Inevitably, there is a conflict between high regulation to reduce risk, but leading to high capital costs, and the expectations to adopt the business models to increase efficiency. A further complicating point for banks' profitability is the currently pursued low-interest monetary policy. All in all, it can be said that on the cost side the burden to comply with regulatory requirements are challenging managers in the banking sector, whereas the low interest rate environment is impeding banks' profitability on the revenue side. On the contrary, there are also voices which claim that the actual level of banking regulation does not go far enough. Admati and Hellwig (2013) stipulate that the share of equity has to be much higher as it is currently required by banking regulation. A uniform leverage ratio of at least 20 to 30 % for all banks is proposed by them. In return, the financial burden caused by comprehensive risk calculation – e.g. through internal models – disappears, because in this concept no difference is made between banks with respect to the impact of the risk situation to the required capital ratio. Nobel Laureate Roger Myerson (2013) positively underlines the work of Admati and Hellwig and adds that the complexity of the banking business – also due to the regulatory aspects – can be lowered by applying the proposed approach. In this context, Myerson further expresses his opinion that the basics of regulatory reforms should be formulated in a way that they are understood by all citizens which are affected by them. Admati and Hellwig's work was controversially discussed and picked to pieces in the recent years. Also a representative of the ECB joined the discussion and clearly stated that uniformity of capital requirements is not the key solution, but that there is an individual optimal level for each bank which depends on measurement of risks (ECB –Banking Supervision, 2017f). Of course it has to be ensured that the calculation of capital requirements with the use of internal models is adequate and reliable. This is the reason why ECB puts its focus on assessing risk modelling in its Targeted Review on Internal Models.

With respect to the goal of a level playing field for banks it can be claimed that the intention to accomplish this target is seen for banking regulation, but is missing for other related fields, e.g. taxation. Bénassy-Quéré, Trannoy and Wolff (2014) argue that a unified corporate tax shall be paid by all significant banks in the SSM on the European level. In application of the goal of harmonization, a uniform tax rate would have to be applied as a consequence.

To bring the discussion back to corporate governance, a dangerous aspect of the harmonization ambitions of the regulators is raised by Binder (2015). The objectives of the European Banking Union are, on the one hand, defining best practice and promote consistency and, on the other hand, to consider the proportionality principle with regard to the diversity in the market structures and business models. The intuitive perception of these goals is that they seem to be conflicting. Over the course of time, it can happen that the ECB's intention of convergence will lead to more unified and streamlined business models and governance schemes in supervised banks. The discussion regarding the revision of the Basel III framework indicates this perception. The possibility of calculating regulatory capital requirements with internal models could be reduced by applying more standardized approaches or floors. (Magnus, Duvillet-Margerit and Mesnard, 2017)

Apart from the addressed disagreement regarding the bonus cap in the field of regulation of remuneration and the need of refinements for the Guidelines on Internal Governance and regarding fit and proper assessment, the general opinion about the European corporate governance framework, as outlined in this study, is quite positive. Richter (2014) supports this opinion by concluding his paper with the statement that the adaptions in the field of risk governance "can be seen as positive". At the same time, he brings the issue of proportionality on the table. However, the competent authorities seem to have understood this general recurring topic of criticism and refer to this point in several discussions during consultation phases and revise some guidelines with more focus on the proportionality principle. Regarding the remuneration principles in the CRD IV, respective EBA guidelines and respective supervisory oversight it is stated that their impact on risk management can be seen as significant. As the linking of remuneration regulation to risk governance was a main goal, it can be viewed as successful in this first review. The practice regarding transparency is a field where room for improvement is noted in this study. (EC, 2016b)

One topic which is very much under public attention at the moment is the sector of financial technologies (FinTech). The consideration by regulators and supervisors are currently at an early stage in this field, so are the governance requirements for those firms. It is the objective of the regulatory bodies to make sure that the dealing with every relevant risk in the financial sector – irrelevant if originated in traditional banks or FinTechs – is regulated (Dombret, 2016). But the question is if this trend towards digitalization cannot be utilized for governance processes as well. Regulatory technologies (RegTech) seem to appear and develop in a comparable manner as FinTechs. RegTech have the potential to promote innovation, improve the data quality for regulatory reports and reduce compliance costs with regulatory requirements (EY, 2016). All of these benefits can be incorporated and coupled with existing governance arrangements. Thus, emerging new types of IT and outsourcing risks have to be adequately considered in the governance framework. Much more analysis in this field also in academic research is essential for enhancing efficiency and safety in the banking sector.

But, coming back to more general implications for future policy in the European Banking Union, it will be very important that the involved agencies better cooperate when drafting new regulations, technical standards, guidelines, etc. At the current set-up too many stakeholders are involved in the processes regarding the definition of the regulatory framework for the European banking sector. There are discussions on the international level regarding an update of Basel III and at the same time European legislators decide on a revision of the CRR/CRD IV package. It should be possible to react faster to detected weaknesses in the regulatory framework and to adopt improved rules more efficiently than in the current set-up. This kind of two-track issue is also observed in connection with the guidelines setting approach in the European banking industry. EBA and ECB, both are issuing guidelines stating their opinion on certain topics. In case of the guides concerning Fit and Proper assessment, it is noticeable that the proceeding of both authorities seems to be not coordinated neither in terms of content nor in terms of timing. This concern was also raised by some respondents in the respective public consultation processes. ECB states in their feedback document (ECB – Banking Supervision, 2017) that the two guides are aligned indeed, but the repeated occurrence of the claim by the respondents raises doubt about this statement.

A further issue which is also connected to the regulatory practice concerns the stability of regulation. Now, eight years after the financial crisis, the regulatory change seems to come slowly but surely to an end. It is important that the regulatory environment in the banking sector remains stable in the upcoming years, so that ~~the~~ banks and the supervisory authorities can adopt and define best practices in all related fields. A new wave of deregulation, which was brought to the table in the US, would make most of the efforts of the past years obsolete. But currently, it can be assumed that the envisaged new policy changes do not include the intention to weaken the corporate governance regulations in the US (McLucas and Murphy, 2017). Hence, European legislators are not forced – because of the need of international harmonization – to think about adaptations of the European rules in this field. The current corporate governance regulatory framework is well established and accepted. Saying that, directors shall not make the mistake to misinterpret the current mood in the direction of deregulation – especially in the US – and believe that also corporate governance issues are pursued more loosely (McLucas and Murphy, 2017).

To conclude this section about policy implications and ideas for the future treatment of governance in the banking sector from the supervisory perspective, the already introduced 'four lines of defense' model is brought back to attention. This concept – introduced by Arndorfer and Minto back in 2015 – seems to have met only with little response in both, the academic and the practical scene, although it was established in connection with the BCBS. The idea of an ongoing information flow between the Internal Audit function, which is on top of the bank internal governance pyramid, the external auditors and the supervisory authorities can generally be seen as positive. On one hand, the implementation of this concept would reduce asymmetric information for the supervisors and on the other hand the banks would ideally also receive information in the other direction in a very transparent way. Of course, the implementation of this triangle information flow needs a sophisticated framework including the set-up of new processes and rules. But, at the end of the story the benefits of better coordination and alignment, i.e. reduction of information asymmetry and more efficient risk control systems, have high potential to outweigh the costs of setting up the communication framework. This kind of combination of internal and external governance would also increase the incentives for the external authorities to care more about the performance and well-being of the audited and supervised banks, because they are far more linked to the banks. Anyway, the ‘four lines of defense’ concept deserves to be taken seriously into consideration and to be implemented in a structured and dedicated manner.

4.2. Conclusion

The following concluding remarks are intended to provide a brief summary of the study. It has shown that the field of banking governance was in strong motion during the past years because of the changes that were necessary in the aftermath of the financial crisis. The Guidelines on internal governance, fit and proper assessment and remuneration were identified as the core principles of the new corporate governance framework. The linkage to banking supervision is drawn with the use of the SREP where the importance of internal governance is represented through the dedication of internal governance and institution-wide controls as one of the four SREP categories. The qualitative SREP assessment of internal governance forces the supervised entities to improve their governance arrangements and practice, because all detected weaknesses directly lead to higher prudential capital requirements. It will be interesting to trace how the banks will adapt to the regulatory expectations and how the supervisory assessment will continue as soon as the regulatory changes are completed.

Apart from this general answer to the research question what has changed after the SSM was introduced, the following interesting findings came up in the current study. With respect to the ‘three lines of defense’ model which is a central concept in internal governance practice an interesting idea of development was raised. The introduced ‘four lines of defense’ model seeks to increase the cooperation between the Internal Audit function and the external stakeholders in the control process, i.e. supervisors and external auditors. Moreover, the SREP was presented as the central supervisory tool. It has the objective to investigate whether the relevant regulations and guidelines are adequately implemented by the supervised entities. In the light of the qualitative and quantitative results which trigger higher capital requirements, the banks have to find solutions to adopt their internal processes to this intense approach to supervision. The implementation of a SPOC function for the bank internal SREP coordination and relationship management towards supervisory authorities as well as the investment in RegTech are two illustrated possibilities for banks. ECB on the other side has to take care that its intention of harmonization and convergence does not lead to an over-unification of banking business models and governance structures. The level playing field should be proportional not only regarding the size and complexity of the banks, but also considering the variety of the banking business and cultures.

The study can build the basis for future work in this field, for example a review after a couple of years or an analysis of the development of key performance indicators over time. In the future, it would also be important for the European Central Bank to establish profound considerations with academic background in order to support their practical views by theoretical evaluations in a consistent manner. Hopt (2013) raises a similar issue by claiming that regulatory activities and academic research should be far more interconnected. The topic of governance of FinTechs and the impact of RegTech were briefly touched in the conclusive discussion, however, much more interdisciplinary research to support practitioners is definitely needed.

In the end, the following quote from Laeven and Ratnovski (2014) perfectly summarizes the coherence of banking supervision and corporate governance:

> *"However, corporate governance cannot substitute for strong supervision: it can at best provide a helping hand."*

5. ABBREVIATIONS

AMA	Advanced Measurement Approach
AQR	Asset Quality Review
BCBS	Basel Committee of Banking Supervision
BMA	Business Model Analysis
BTS	Binding Technical Standards
CEO	Chief Executive Officer
CG	Corporate Governance
CRD IV	European Capital Requirements Directive
CRO	Chief Risk Officer
CRR	European Capital Requirements Regulation
DGSD	Deposit Guarantee Scheme Directive
EBA	European Banking Authority
EBF	European Banking Federation
EC	European Commission
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FinTech	Financial Technologies
FDIC	Federal Deposit and Insurance Corporation
IAF	Internal Audit Function
ICAAP	Internal Capital Adequacy Assessment Process
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
IMA	Internal Models Approach
IRB	Internal-Rating Based
JST	Joint Supervisory Team
KPI	Key Performance Indicator
LSI	Less Significant Institution

MB	Management Body
NCA	National Competent Authority
NCB	National Central Bank
NOD	National Option and Discretion
OeNB	Austrian National Bank
RAF	Risk Appetite Framework
RegTech	Regulatory Technologies
RemCo	Remuneration Committee
RMF	Risk Management Function
SI	Significant Institution
SPOC	Single Point of Contact
SREP	Supervisory Review and Evaluation Process
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation
SRP	Supervisory Review Process
SSM	Single Supervisory Mechanism
SSMFR	Single Supervisory Mechanism Framework Regulation
SSMR	Single Supervisory Mechanism Regulation
TRIM	Targeted Review of Internal Models

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7. APPENDIX

7.1. Abstract English

Corporate governance is one of the key priorities of banking supervision, because one of the takeaways of the financial crisis was that weak governance arrangements in financial institutions have been a contributing factor. The thesis gives an overview about the newly established European Banking Union and about its structure focusing on the first pillar, the Single Supervisory Mechanism (SSM). In a second step, the focus is laid on the recent regulatory changes regarding corporate governance, the related supervisory practice and implications for European banks.

The guidelines on internal governance, fit and proper assessments and remuneration are identified and analyzed as the core principles of the enhanced corporate governance framework of banking regulation.

The link to banking supervision is drawn with an illustration of the Supervisory Review and Evaluation Process (SREP), where internal governance is represented as one of the main elements of the supervisory assessment.

Overall, the conducted changes in the regulatory framework, especially regarding corporate governance, seem to meet the objective of ensuring safety and soundness of the European Banking system. Room for refinements is detected regarding proportionality and transparency of the supervisory practices as well as its influence on banks' profitability.

7.2. Abstract German

Corporate Governance ist eine der Hauptprioritäten der Bankenaufsicht, da schwache Governance-Vorkehrungen in Finanzinstituten als Ursache für die Finanzkrise angesehen werden. Diese Arbeit gibt einen Überblick über die neue eingerichtete Europäische Bankenunion und deren Aufbau, insbesondere über die erste Säule, den einheitlichen Aufsichtsmechanismus (Single Supervisory Mechanism, SSM). In einem weiteren Schritt wird der Schwerpunkt auf die Anpassungen der Regulierung bezüglich Corporate Governance, die damit

verbundenen Aufsichtspraktiken und die Auswirkungen auf europäische Banken gelegt.

Die Leitlinien zur internen Governance, Fit and Proper Beurteilung und Vergütungspolitik werden als bedeutende Grundsätze des regulatorischen Rahmenwerks hinsichtlich der Corporate Governance in Banken identifiziert und analysiert.

Der Bezug zur Bankenaufsicht wird durch den Supervisory Review and Evaluation Process (SREP) hergestellt. Der Begutachtung der internen Governance wird durch die Zuordnung eines Hauptelements im SREP große Bedeutung zugesprochen.

Grundsätzlich werden die vorgenommenen Änderungen im regulatorischen Rahmenwerk insbesondere im Bereich der Corporate Governance als geeignet angesehen um das Ziel eines sicheren und soliden europäischen Bankensystems sicherzustellen. Kleine Anpassungen in Bezug auf Proportionalität und Transparenz der Aufsichtsaktivitäten sowie deren Einfluss auf die Profitabilität von Banken sind noch vorzunehmen.