

Risky gap in the control of European banking supervision

In response to the euro crisis, the EU Member States transferred the supervision of systemically important banks to the European Central Bank (ECB). Since the Single Supervisory Mechanism (SSM) took effect in November 2014, the ECB is responsible for early detection of emerging threats to the financial system so as to be ready to respond swiftly and decisively, if necessary. But who supervises the supervisors?

Recently, the Italian government had to support three banks with public funds. They encountered some difficulties; in 2014 two of these banks had passed their respective stress tests without reservation, one bank passed the stress test with reservation. Further, the ECB assessed one Spanish bank that had also previously passed the stress test as "failing or likely to fail". The Santander bank ultimately stepped in to take it over in a watershed deal. All four aforementioned banks are supervised by the ECB under the recently established SSM. Overall, the ECB is responsible for supervising 129 large banks in the euro area holding assets of some €21 trillion.

For the performance of its supervisory role the ECB is accountable to the European Parliament and the European Council by way of self-reporting. This represents a risky gap in the control of the banking supervision function. Self-reporting alone is not enough. Although the ECB is subject to an external audit by the European Court of Auditors (ECA), the ECA's audit scope is restricted to the "operational efficiency of the management of the ECB." This means that how the ECB is exercising banking supervision is not scrutinised.

These are the findings set out in a report published jointly by several Supreme Audit Institutions (SAIs), including the German *Bundesrechnungshof* and the Dutch *Algemene Rekenkamer*. In its first audit of the SSM, the ECA encountered a major obstacle. It could not obtain relevant documents. Arguing that the ECA's audit mandate is limited, the ECB largely denied the ECA access to documents on supervisory activities. As a result, the ECA was not even able to audit as to whether the ECB efficiently managed the SSM with regard to governance, off-site supervision and on-site inspections. This happened although banking supervision goes beyond the traditional function of central banks and must therefore be subject to external audit. As a banking supervisor, the ECB is not covered by the same degree of independence as in its role as a central bank.

Prior to November 2014, a number of national SAIs had comprehensive audit mandates in this field, including the *Bundesrechnungshof* in Germany and the *Algemene Rekenkamer* in the Netherlands. The two SAIs even audited and assessed the supervisory review and evaluation process. In other words their audit scope went far beyond what the ECA is able to exercise today under the SSM.

The European Commission seems to be well aware of this gap in audit coverage concerning banking supervision. In its recently published review of the SSM, the Commission confirms that the scope of the SAIs' audit mandates varies significantly. However, the Commission concludes from this that the problem can be solved if the ECA and the ECB sign an inter-institutional agreement specifying the modalities of the information exchange. The Commission did not consider clarifying the legal framework. As a result, an opportunity has been foregone to ensure the ECA is given full access to relevant ECB documents.

As public law entities, supervisory bodies must be subject to audit by independent SAIs. Accountability and transparency of the SSM do not follow from self-reporting by the ECB alone: Instead they thrive on the basis of audit evidence collected by an independent body – something that should be a matter of course in a democratic system based on the rule of law and with a functioning balance of powers. Against the background of striking imbalances faced by large banks in Italy and Spain and their potential impacts on the euro area, banking supervision needs to be subject to comprehensive audit by an independent external authority.

The joint effort undertaken by ECA and ECB to conclude an inter-institutional agreement, that regulates their information exchange, is a first step in the right direction. However, clearly defined audit rights should continue to be an aim worth striving for. Ultimately, what is required is greater legal certainty. There is therefore an urgent need to clearly and explicitly determine the ECA's audit mandate vis-à-vis the ECB in its capacity as supervisory body.

Furthermore, even small and medium-sized banks can trigger economic and financial crises. Within the SSM, such banks are indirectly supervised by the ECB - in conjunction with national supervisory bodies. Our joint report highlights another alarming trend in this respect: The ECB increasingly subjects this part of banking supervision to its confidentiality regime. As a result, national SAIs are denied access to important documents. This infringement is not acceptable and

impedes national SAIs in exercising their statutory audit mandates. It is important to restore confidence in banking supervision. To achieve this, it is essential that banking supervision becomes more and not less transparent.

Seen from the national audit perspective, the SSM in its current form represents a step backwards. Banking supervision essentially becomes a "black box" posing a risk to financial sector stability.