

# Controlling the controllers: the institutional design of Europe's new Single Supervisory Mechanism

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## Abstract

This paper examines the institutional design of the Single Supervisory Mechanism and views the relation between the European Central Bank (ECB) and the National Competent Authorities (NCAs) as a principal-agent relation in which the NCAs are carrying out supervision of the less significant banks on behalf of the ECB. From a principal-agent perspective, the institutional design is understood as the 'art' of choosing appropriate *ex ante* and *ex post* mechanisms of control by the ECB over the activities of the NCAs. Therefore, the focus of the paper is on (1) identifying the appropriate control mechanisms consisting of the 'ex-ante' and the 'ex-post' controls, as suggested by the principal-agent model, which the ECB may use to ensure that its policy preferences are enforced by the NCAs within the SSM and (2) assessing whether they may possibly cover all of the NCAs 'zone of discretion' relating to supervision of less significant banks on the ECB's behalf. The working hypothesis is that the NCAs zone of discretion cannot be fully controlled by the ECB. It is argued that existence of such 'black holes' constitute challenges for the ECB to ensure its policy preferences are enforced to a full extent by the NCAs. The application of a principal-agent approach in the context of the SSM raises interesting theoretical questions: (1) with regard to the approach's applicability within the context of what is, in legal terms, a single system; given that the agents (NCAs) precede the principal in question (the ECB / Supervisory Board) and have more established expertise; and (2) that both the principal and agents must operate in other principal-agent relationships with other institutions and, notably, democratically elected governments.

**Keywords:** supranational banking supervision, Single Supervisory Mechanism, European Central Bank, principal-agent, mechanisms of control

## 1. Introduction

This paper seeks to contribute to the studies of European Union by applying the principal-agent (P-A) model to institutional complexities of newly created Single Supervisory Mechanism (SSM), which builds the first pillar EU's future Banking Union – supranational banking supervision. From a political science perspective, the P-A approach is a useful device to explore the dynamics of European integration because it examines (1) the kind of powers are delegated and for what reasons, (2) who delegates these powers to whom and ultimately (3) how to ensure that policy preferences of the delegating party (the principal) are respected and not undermined by its delegates' (the agents') actions and behavior.

This paper aims to gain insight into the institutional design of the SSM by applying a P-A model in its third dimension. Institutional design is perceived here as "*an exercise in choosing from a menu of both 'ex ante' and 'ex post' controls*" (Thatcher, Stone Sweet 2002: 5). Therefore, the focus of the paper is directed on (1) to identifying the proper control mechanisms consisting of the 'ex-ante' and the 'ex-post' controls, as flourished and theorized in the context of the P-A analysis (ex. Weingast and Moran 1983, Kiewiet and McCubbins 1991, Pollack 1997) which the European Central Bank (ECB) may use to ensure that its policy preferences are enforced by the National Competent Authorities (NCAs)<sup>1</sup> within the SSM and (2) assess whether they may possibly cover all of 'zone of discretion'<sup>2</sup> the NCAs have with regard to supervisory tasks<sup>3</sup> having been carried on the ECB's behalf. The working hypothesis is the following: the NCAs 'zone of discretion' may

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<sup>1</sup> The National Competent Authorities (the NCAs) is a term used in the supervisory *acquis* to refer to national authorities responsible for banking (depending on given bank supervision arrangements at the national level in different EU Member States). For an overview of (pre-crisis) EU national supervisory architectures, see e.g. Masciandaro, D. (2004), Masciandaro, D.; Pellegrina, L. (2008).

<sup>2</sup> To define a 'zone of discretion' this paper employs understanding developed by Thatcher and Stone Sweet (2002). The zone of discretion is "the sum of delegated powers (policy discretion) granted by the principal to the agent, minus (b) the sum of control instruments, available for use by the principals to shape (constrain) or annul (reverse) policy outcomes that emerge as a result of the agent's performance of set tasks" (ibid: 5)

<sup>3</sup> For the sake of brevity, 'supervisory tasks' are understood in this paper as specific tasks concerning policies relating to the prudential supervision of credit institutions in accordance with the SSM Regulation (Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions). Available at <http://bit.ly/1dJpPy9>, accessed on 31 March 2014.

be not fully covered by the ECB's mechanisms of control in the light of P-A framework. I will argue that existence of such 'black holes' of the NCAs discretion may be challenging to ensure upon them the observance of the ECB's policy preferences to the full extent.

This paper is structured into five sections. Firstly, the rationale for employing a principal-agent framework to the EU supranational banking supervision is provided (2) and the framework is subsequently applied to the Single Supervisory Mechanism (3). The main part of the paper identifies the principal's control mechanisms encapsulated in the SSM common supervisory *acquis* (4).<sup>4</sup> This will be followed by an assessment whether these, previously identified, control mechanisms possibly expose all the NCA's discretionary area relating to supervisory tasks they carry out on the ECB's behalf (5). In other words, the challenges to ensuring ECB's policy preferences within the SSM will be highlighted. The final section draws general conclusions on the Single Supervisory Mechanism viewed through the lens of a P-A model (6).

## **2. Rationale for applying a principal-agent perspective to the SSM**

In the last 20 years, a principal-agent model has become an increasingly attractive tool for the analysis of EU policy-making dynamics in different areas. It has already been employed to EU studies to explain why the EU Member States decided to confer tasks on the EU institutions and to understand institutional design of the EU economic governance. It was applied to study the relations between the EU Commission and the EU Member States and their capacity to control it (Pollack 1997) as well as to the relations between the Euro Area Member States and the European Central Bank, with the focus on how the ECB ensures the Euro Area policy choices in monetary affairs (Elgie 2002). Furthermore, it was also used to explain the relations between the ECOFIN and the EU Member States in the area of the EU fiscal governance (Schuknecht, 2004 and Hodson, 2009).

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<sup>4</sup> The primary sources of common supervisory *acquis* are the SSM Regulation and the future SSM Framework Regulation. The SSM Framework Regulation shall be enacted six months before the SSM becomes operative, that is until 4 May 2014 at the latest. The current draft of the SSM Framework Regulation is available here: <http://bit.ly/1gfCI7E>, accessed on 31 March 2014.

As for banking supervision, the principal-agent studies have already been conducted on the incentive problems of the bank supervisors in the EU acting as agents of national taxpayers (Schuler 2003), on explaining the policymakers choices on the institutional design of bank supervision in the EU and around the world (Masciandaro 2004) and on the financing of banking supervision where the society acts as the principal and banking supervisory authority as the agent (Masciandaro, Nieto, Priast 2007) as well as to address the degree of consolidation of powers in financial supervision (Masciandaro, Pellegrina 2008).

Both application of a principal-agent model to the EU studies and banking supervision indicate that a large number of principal-agent relationships focusing on different institutional complexities may be conceivable. The supranational banking supervision in the EU is no exception. One may apply a principal-agent model between the European Council (the principal) and the European Central Bank (the agent) or between the European taxpayers as a collective principals and the Single Supervisory Mechanism (as a collective agent). Yet, given the collective nature of the Single Supervisory Mechanism which consists of two types of actors – the ECB and the NCAs, another principal-agent relation is possible: between the ECB acting as the principal and the NCAs acting as its agents, which carry certain supervisory tasks on behalf of the ECB.

As the European Central Bank (ECB) is solely responsible for efficient functioning of the Single Supervisory Mechanism, its relations with the NCAs are pivotal, in particular with regard to ensuring the ECB's supervisory policy preferences within the system. Therefore, the relevance of the ECB's mechanisms of assuring control over the NCAs in the SSM legitimizes the application of a P-A framework to examine relations between them.

### 3. The Single Supervisory Mechanism as a principal-agent model

This section applies a principal-agent model to the Single Supervisory Mechanism. It builds a framework to perceive the ECB as a principal and the NCAs as its agents with regard to execution of (specific) supervisory tasks within the SSM. It sketches a nature and objectives of the SSM (3.1), identifies principal-agent relations in the SSM (3.2), suggests the ECB's policy preferences as the principal (3.3) and envisages difficulties which the ECB faces in relations with its agents (principal's problems) from a principal-agent perspective (3.4).

#### 3.1. The nature and the objectives of the SSM

The nature of the Single Supervisory Mechanism is described in its founding act<sup>5</sup> (hereinafter: the SSM Regulation). In light of the SSM Regulation, the SSM is a primarily<sup>6</sup> Euro Area banking supervisory system (regime) consisting of the European Central Bank and National Competent Authorities (of Euro Area Member States) as bank supervisors.<sup>7</sup> The overarching objective of the SSM, for which the ECB is solely responsible,<sup>8</sup> is to ensure that all banks of the countries participating in the system are subjected to supervision of the highest quality implemented in a coherent and effective manner.<sup>9</sup>

#### 3.2. The principal-agent relations between the ECB and the NCAs

The principal-agent model, according to Ross' celebrated definition, is a mean of understanding the relationship "between two (or more) parties when one of these,

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<sup>5</sup> See Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. Available at <http://bit.ly/1dJpPy9>, accessed on 31 March 2014.

<sup>6</sup> The SSM Regulation provides a possibility for non-Euro Area Member States to opt-in in a framework of a "close cooperation". The modalities of the 'close cooperation' regime are detailed in Part IX of the draft Framework Regulation.

<sup>7</sup> Art. 6.1 of the SSM Regulation: (...)The ECB shall carry out its tasks within a single supervisory mechanism composed of the ECB and national competent authorities (...).

<sup>8</sup> Ibid.: (...)The ECB shall be responsible for the effective and consistent functioning of the SSM (...).

<sup>9</sup> Recital 12 of the SSM Regulation: (...) a single supervisory mechanism should ensure that the Union's policy relating to the prudential supervision of credit institutions is implemented in a coherent and effective manner (...).

*designated the agent, acts on behalf of or as representative for the other, the principal"* (Ross, 1973: 134). The SSM Regulation provides for two supervisory procedures relating to the Euro Area banks in the SSM framework: the direct ECB's supervision of the significant banks (art. 6.4 of the SSM Regulation) and the direct NCAs' supervision of the less significant banks. (art. 6.5 of the SSM Regulation) under the ECB's oversight (indirect ECB supervision). Delegation of supervisory tasks on the less significant banks applies to the relation between the ECB and the NCAs in a following way:<sup>10</sup>

As the ECB is solely responsible for effective and consistent functioning of the SSM, all the supervisory tasks carried out within the SSM are ones carried out on the account and on behalf of the ECB. Thus, it follows that all the supervisory tasks, notably supervision of the less significant banks, are executed by the NCAs in the SSM on behalf of the ECB.

### **3.3. The ECB's policy preferences in the SSM**

The sole, not shared, responsibility of the ECB for efficient and consistent functioning of the SSM also suggests that the ECB's policy preferences as a principal are inextricably related to the SSM main objectives. As indicated in previous subsections, the essence of the SSM objectives is to ensure that all banks of the countries participating in the system are subjected to supervision of the highest quality implemented in a coherent and effective manner (single supervisory approach). Yet, while distinguishing possible policy preferences of the ECB, it may be supportive to appeal to the causes which led to the empowerment of the ECB with banking supervisory tasks. These were twofold: national fragmentation of financial supervision (together with light-touch supervision) across the European Union, which had led to the recent financial crisis, and subsequent national supervisory bias (tendencies to support 'national champions') among the EU Member States during the recent crisis. Therefore, if one sees the foundation of the Single

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<sup>10</sup> It should be pointed out here that the case of the SSM is one of rare ones where a political delegation is not formally followed by a legal delegation of tasks. In the legal terms, no delegation between the ECB and the NCAs *de iure* occurs and the SSM is treated as a ECB's 'separate business line' only with two different supervisory approaches: a direct one to significant banks and indirect one to less significant banks. Yet the issue remains controversial even in the legal academic community. See e.g. legal analysis of Ferranini and Chiarella (2013) who describe the ECB-NCAs relations in terms of delegation, and on the other hand, rather skeptical non-delegation position of Wymersch (2014).

Supervisory Mechanism as a decisive EU anti-crisis measure, it suggests that the ECB policy preference in the SSM framework would be to mitigate the factors which contributed to the recent crisis, namely to ensure the highest supervisory quality by reducing the scope of national supervisory divergences and gradually eradicating the remaining national bias among the National Competent Authorities.

### **3.4. The ECB and the principal's problem**

Under political delegation, the agents are granted discretion to carry out certain tasks in line with the principal's policy preferences. Such an arrangement involves however certain risks for a principal. In a principal-agent relation, even when the principal's policy preferences are clearly articulated, one cannot assume that the agents are likely to enforce them at all times at their discretion. This difficulty is known in the classic political delegation theory as the 'principal's problem' (Ross 1973). It treats agents as rational and opportunistic actors who may develop their own preferences, which may diverge from those of their principal, once the agency relation is set up (Kiewiet, McCubbins 1991).

In addition, the agents' perverse incentives to pursue their own preferences are stimulated by another key assumption of political delegation theory which is an inherently asymmetrical distribution of information in a principal-agent relation that favors the agent (Holmstrom 1979, Kiewiet and McCubbins 1991). In case agents succeed in developing their own preferences, which diverse from those of their principal, an 'agency loss' occurs and agent 'shirks'. The likelihood of agent 'shirking' increases by 'agent slippage', which takes place when the very structure of political delegation emboldens an agent to do so (Pollack, 1997). Therefore, the principal has to find ways to limit the 'agent's shirking' by encouraging the agent's compliance with the principal's policy choices and discouraging the agent's incentives to develop preferences contrary to those of its principal.

The principal-agent relation between the ECB and the NCAs in the SSM relating to supervision of less significant banks is likely to foster the NCA's slippage, because the SSM

Regulation confers on the ECB only the responsibility for its efficient and consistent functioning. Furthermore, the future nature of the ECB-NCAs relations – which are principally designed as “*relations of information*” in words of the SSM Framework Regulations drafters<sup>11</sup> as well as the fact that ECB puts emphasis on its direct supervision of significant banks<sup>12</sup> and makes from it the core of new supervisory system suggests its lower interest in its indirect supervision of less significant banks.

#### 4. The ECB's mechanisms of control over the NCAs

A principal who is endangered by ‘agency loss’, both the first level ‘agency slippage’ and the second level ‘agency shirking’, is however not stripped of the means of counteraction. The classical political delegation theory developed two groups of mechanisms to mitigate the ‘agent’s shirking’ and align the principal’s policy preferences. These are the ‘ex-ante’ and the ‘ex-post’ controls. However, it should be noted that they are not costless measures. Thus, the usage both mechanisms is ultimately a trade-off between higher agency costs against limiting of the ‘agency loss. The following subsections explain the nature of both controls and investigate whether the ECB has been equipped with such the ‘ex ante’ and the ‘ex post’ controls over the NCAs as to their supervision of the less significant banks within the SSM framework.

##### 4.1. The ECB's ‘ex-ante’ controls over the NCAs

The principal’s ‘ex-ante’ controls, known also as administrative procedures, define a scope of agency, legal instruments available for the agency and the set of procedures the agents must follow (Pollack, 1997). They delineate agent’s zone of discretion and their

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<sup>11</sup> Eduard Fernandez-Bollo (Chairman of the ECB's work stream (WS2) on the SSM legal framework and Ignazio Angeloni (Chair of DG Macro-Prudential Policy and Financial Stability at the ECB) at the ECB's Public Hearing on the SSM Framework Regulation, 19 February 2014, Frankfurt.

<sup>12</sup> Such a conclusion may be drawn after an overview of the SSM global governance structure in the ECB: two DGs (DG Micro I and II with around 15 Divisions for direct supervision of the significant banks and one DG (Micro III) with only 3 Divisions for indirect supervision of the less significant banks. See a tentative organigramme of the SSM governance in the ECB in the Letter of the ECB President Draghi to ECON Chairwoman Bowles – ‘Re: Your letter of 6 December 2013’, L/MD/14/18, 10 January 2014, Frankfurt: ECB. Available at <http://bit.ly/1lxNggC>, accessed 31 March 2014.

'room of maneuver' as to the execution of discretionary powers they are granted to carry out certain tasks in line with the principal's policy preferences.

The institutional design of the Single Supervisory Mechanism provides a number of the ECBs' 'ex-ante' controls over the NCAs. Among them, one can identify such as the SSM's Framework Regulation with the SSM's Supervisory Manual<sup>13</sup> (4.1.1), the SSM common supervisory procedures (4.1.2), the NCAs 'ex-ante' reporting on 'material' decisions and procedures (4.1.3). The ECB's power to issues regulations, guidelines and general instructions for the NCAs an example of the ECB's 'ex ante' control, yet it may be also regarded as a mechanism situated in between the 'ex ante' and the 'ex post' controls. For these reasons, they will be described in a separate section (5). Below, the three of the ECB's 'ex-ante' controls over the NCAs are identified.

#### **- 4.1.1. The SSM's Framework Regulation with the SSM's Supervisory Manual**

According to art. 6 (7) of the SSM Regulation, the ECB is obliged to set our practical arrangements of relations between the ECB and the NCAs. In February 2014, the ECB proposed a draft of the SSM Framework Regulation (hereinafter: the draft SSM Framework Regulation)<sup>14</sup>, in which modalities of the ECB-NCAs relations are clarified, including the division of the supervisory tasks within the SSM. The SSM Framework Regulation will be accompanied by a detailed SSM's Supervisory Manual, in which the modalities of the ECB-NCAs relations will be further specified, most notably the ECB-NCAs working, non-public and confidential relations setting supervisory policies. Both the SSM Framework Regulation and the SSM Supervisory Manual are crucial in developing a single supervisory approach, which will not be affected by different, national supervisory practices. Viewed in this light, the SSM Framework Regulation with the SSM's Supervisory Manual set limits on the NCA's discretion and may be

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<sup>13</sup> The ECB Supervisory Manual will be an internal (partially) confidential ECB/SSM document addressed to the NCAs, covering all the tasks and supervisory processes of the SSM. As such, it will complement both the SSM Regulation and the future SSM Framework Regulation and constitute an important part of common supervisory *acquis*. On the supervisory *acquis*, see *supra* n.4.

<sup>14</sup> See *supra* n. 4.

considered as the ECB's 'ex-ante' controls (procedures) on the NCAs supervisory policies, aiming at ensuring the ECB's policy preference: reducing national divergences in supervisory approaches and eradicating the remaining national bias in supervisory practices of the NCA's.

- **4.1.2. The SSM common supervisory procedures**

The Single Supervisory Mechanism is designed as a supervisory system in which the ECB executes directly its supervisory powers with regard to the significant banks, while the NCAs do the same with regard to the less significant ones, but on behalf of the ECB. Yet, the draft SSM Framework Regulation stipulates a number of specific supervisory powers which are at direct and exclusive competence of the ECB with relation to all banks, regardless whether they are significant or less significant ones. These are listed in Part V of the draft SSM Framework Regulation and described as 'common procedures'.

The SSM common supervisory procedures encompass: (1) bank authorization,<sup>15</sup> (2) withdrawal of bank authorizations<sup>16</sup> and (3) assessment of the acquisition of a qualifying holding<sup>17</sup>. The role of the NCAs in these procedures is limited to serving as an 'entry point', as in the case of bank authorizations, or to initiating the procedure and non-binding consultations, as with regard to withdrawals of bank authorizations and assessments of the acquisitions of qualifying holdings.

The SSM common supervisory procedures are an example of the principal's involvement in important decision-making on the less significant banks and as such constitute 'ex-ante' controls on the agents' discretion in key supervisory policies.

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<sup>15</sup> See art. 73-79 of the draft Framework Regulation, available at <http://bit.ly/1gfCi7E>, accessed on 31 March 2014.

<sup>16</sup> See *ibid.* art. 80-84.

<sup>17</sup> See *ibid.* art. 85-87.

- **4.1.3. The NCA's 'ex-ante' reporting on 'material' decisions (procedures)**

The draft SSM Framework Regulation obliges the NCAs to report on 'material' supervisory procedures concerning the less significant banks.<sup>18</sup> The NCAs are required to provide the information *ex ante* or, exceptionally, simultaneously to opening of a procedure. The ECB is empowered to provide opinions on the draft material decisions and procedures. The draft Framework Regulation lists two examples of material supervisory procedures: (1) removal of member of management boards and appointment of a receiver (art. 97 (2a) of the draft SSM Framework Regulation), (2) the procedures which have a significant impact on a less significant banks (art. 97 (2b) of the draft SSM Framework Regulation). The ECB shall define the general criteria for the significance, basing on the risk situation of the entity and its impact on the domestic financial system.

As these NCA's 'ex-ante' reporting requirements on 'materiality' impose a burden on the execution of their discretionary powers, they may be perceived as the principal's 'ex-ante' controls, which enables the ECB to oversee the NCA's actions.

In addition to the abovementioned procedures, in which 'materiality' feature is defined either by law or at the ECB's discretion, the draft SSM Regulation envisages another NCA's 'ex ante' reporting procedures, which initialization is however at the NCA discretion. In case a NCA considers a procedure as (1) a 'material' one and which may be of supervisory interest for the ECB<sup>19</sup> or (2) which may negatively affect the reputation of the SSM<sup>20</sup>, the NCA on its own initiative notifies the ECB on such. According to drafters'<sup>21</sup> own interpretation, this procedure should be treated as a 'catch-up' clause for other of the NSA supervisory decisions which "do not fulfill the

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<sup>18</sup> See *ibid.* art. 97.

<sup>19</sup> See *ibid.* art. 97 (4a).

<sup>20</sup> See *ibid.* art. 97 (4b).

<sup>21</sup> See *supra*, n. 11.

'materiality' premises, but should be assessed by the NCAs with regard to the quantitative criteria".<sup>22</sup>

In light of a P-A framework, such a competence of a NCA may be problematic and may generate 'leaks' in the principal's control of its agents 'zone of discretion' as it leaves to the NCA the power to delineate a border between 'material' and 'non-material' procedures, that is to decide which supervisory procedures shall be of interest for the ECB and carry the burden of the *ex-ante* oversight and which not. This issue will be further tackled in the section on the institutional challenges for ensuring the ECB's policy preferences (5.1).

#### **4.2. The ECB's hybrid ('ex ante'/'ex post') controls over the NCAs**

According to art. 6 (5a) of the SSM Regulation, the ECB has a power to issue regulations, guidelines and general instructions to the NCAs with regard to all supervisory tasks carried out by them within the SSM, with exception of the common supervisory procedures. From a principal-agent view, these instruments may be prudently regarded as both 'ex-ante' and 'ex-post' ('hybrid') controls depending on given circumstances and as such this paper treats them. The role of the ECB's guidelines would be principally to inform the NCAs how certain provisions of the supervisory *acquis* should be interpreted and applied or how to use their discretionary powers on the ECB behalf. The ECB's regulations and general instructions, in turn, would principally seek to steer the NCA's supervisory actions. For example, the Supervisory Manual which is, in substance, a guideline on the supervisory policies within the SSM could be described as an 'ex-ante' control, while an instruction directed to a NCA based on the ECB's oversight of the SSM would be an example of the 'ex post' control.<sup>23</sup> Given the sensitivity of bank supervisory policy and its possible impact on the financial markets, many of the ECB's regulations, guidelines and instructions directed to the NCAs will be of confidential nature, which are likely to be (partially) disclosed only

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<sup>22</sup> Eduard Fernandez-Bollo, see *supra*, n. 11.

<sup>23</sup> See e.g. art. 108 of the draft SSM Framework Regulation.

after a certain period of time (early interviews, CSSF<sup>24</sup>, Luxembourg, February/March 2014).

The legal status of the ECB's regulations, guidelines and general instructions directed to the NCAs remains however ambiguous. In light of art. 288 TFEU<sup>25</sup>, in order to exercise the Union's competences, the EU institutions adopt legally binding regulations, directives, decisions, and non-binding recommendations and opinions. Regulations are legally binding in their entirety as well as generally and directly applicable in all Member States and by its administrative bodies. Directives are legally binding to Member States only and with regard to the policy result to be achieved, leaving to national authorities free choice as to forms and methods. Decisions are legally binding in their entirety, but only to those whom they address. All five of the abovementioned acts are known as EU 'typical acts'. All the other decision-making instruments of the EU institutions, not expressly listed in art. 288 TFEU, are generally referred to as EU 'atypical acts'.<sup>26</sup> The catalogue of decision-making atypical acts available to the EU institutions is open-ended and covers such instruments as inter-institutional agreements<sup>27</sup>, guidelines<sup>28</sup>, or guiding directives<sup>29</sup>. It follows that ECB's regulations, guidelines and general instructions directed to the NCAs with regard to supervision of less significant banks may be considered as the EU atypical acts. This issue, and particularly the problem of their enforceability<sup>30</sup>, will be further explored in the section on the institutional challenges for ensuring the ECB's policy preferences.

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<sup>24</sup> Commission de Surveillance du Secteur Financier (CSSF) is a Luxembourgish national authority competent for banking supervision in the light of the SSM.

<sup>25</sup> Treaty of Functioning of the European Union – one of the EU constitutional treaties. Available at Available at <http://bit.ly/P99UhB> accessed 31 March 2014.

<sup>26</sup> See e.g. Snyder (1993); Bawn (1997); Cosma and Whish (2003); Grosse Ruse-Khan, H., Jaeger, T., Kordic, R. (2011).

<sup>27</sup> For e.g., see art. 177, 287(3), and 295 TFEU.

<sup>28</sup> For e.g. see *ibid.* art. 121(2), 148(2), or 171(1).

<sup>29</sup> For e.g., see *ibid.* art. 218(2).

<sup>30</sup> The public, non-confidential regulations, guidelines and instructions directed to the NCAs with an intention to produce legal effects will, of course, be enforceable by the Court in accordance with art. 263 TFEU. It remains however problematic how the Court could enforce confidential and undisclosed acts of the ECB directed towards the NCAs (and which are likely to constitute the majority of the ECB's supervisory acts).

#### **4.3. The ECB's 'ex post' controls over the NCAs**

The principal's 'ex post' controls, known also as oversight procedures, allow the principal's to monitor its agents behavior and impose sanctions on them in case 'agency shirking' is detected. While the principal's 'ex ante' controls draw borders of the agents' discretionary zone, the 'ex post' controls may be described as the principal's "Great Eye", gazing at the agent's discretionary actions in search of its possible shirking. The principal's 'ex-post' controls are conventionally divided into 'police patrols' and 'fire-alarms' (Kiewiet and McCubbins, 1991).

'Police patrols' consist of an active surveillance of a sample of the agent's behavior by the principal with the aim of detecting any of their non-compliance with the principal's policy preferences. In a classic form they include public hearings, studies, field observations and examinations of regular agency reports (Pollack, 1997).

'Fire alarms' may be described as the principal's indirect 'ex post' controls because while monitoring agents' activities the principal relies on the support of third parties. The 'fire alarms' are less costly but in the same time, they are also less centralized and tend to be more superficial than the 'police patrols'.

##### **4.3.1. The ECB 'police patrols' over the NCAs**

Among the 'police patrols', which the ECB's has at its disposal to oversee the NCAs compliance with its policy preferences, one may distinguish the NCAs "ex-post" reporting (A), the ECB's power to request supervisory information from any less significant banks (B) and to conduct general investigations and send on-site inspections to any less significant bank (C), and ultimately the ECB's power to take over the supervision of the less significant bank from the NCA(D). Aforementioned 'police patrols' may be differentiated into the 'intrusive' (case A) and the 'non-intrusive' ones (cases B, C, D). The group of the 'intrusive ones' may, in turn, be

tentatively divided into 'yellow police patrols' (cases B, C) and 'red police patrols' (case D).

- **4.3.1.1. The ECB's 'non-intrusive police patrols' – (A) the NCAs 'ex post' reporting**

The NCAs 'ex-post' reporting requirements may be considered as the instruments of the ECB's 'non-intrusive police patrols' and also as classic and well-established example of a principal's 'ex post' controls. The draft SSM Framework Regulation<sup>31</sup> obliges the NCAs to submit regular reports on their supervisory activities regarding the less significant banks on the basis of which the ECB will assess the degree of the NCAs compliance with its policy preferences. Furthermore, except of this general 'ex post' reporting requirements, the NCAs may be requested to provide information, both on *ad hoc* or on continuous basis, on their supervisory activities within the SSM.<sup>32</sup>

- **4.2.1.2 The ECB's 'intrusive police patrols'**

- **'Yellow police patrols' (B, C)**

The 'yellow police patrols' constitute the first level of the ECB's 'intrusive police patrols'. This paper offers to perceive a usage of such ECB's 'police-patrols' as giving a yellow card on a NSA performance relating to supervision of less significant banks. In other words, by means of 'yellow police patrols' the ECB may send a message to a particular NCA that it is not satisfied with the way it supervises less significant bank(s) on its behalf.

Under the Section 'Investigatory Powers' of Chapter Three, the SSM Regulation stipulates three procedures which can be classified as field observations (both on- and offsite) in the traditional meaning of 'police patrols' and which are treated as the examples of 'yellow police patrols' by the author of this paper. These are: the ECB's power to request supervisory information directly from any less significant banks (B);<sup>33</sup>

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<sup>31</sup> See art. 99 and 100 of the draft SSM Framework Regulation.

<sup>32</sup> See art. 6 (5e) of the SSM Regulation.

<sup>33</sup> See *ibid.* art. 10.

and the ECB's powers to carry out general investigations<sup>34</sup> as well as on-site inspections (C).<sup>35</sup> These procedures are completely autonomous and independent from the NCA's 'ex ante' reporting on less significant banks and remain at the exclusive disposal of the ECB.

- **The ECB's power to request supervisory information from any less significant banks (B)**

The ECB is empowered to request from a less significant bank all information which may be necessary to carry out its tasks within the SSM, including data on supervisory policies not delegated to the ECB level (such as consumer protection, money laundering issues). The request can be issued after having taken account of information available to the NCAs. After receiving requested information from a less supervisory bank, the ECB shall share it with the relevant NCA.

- **The ECB's power to conduct general investigations and to send on-site inspections to any less significant bank (C)**

The ECB's power to initiate general investigations and conduct on-site inspections of less significant banks are other examples of its 'yellow policy patrols'. In particular the latter one is a straightforward and standard example of an on-site field observation 'police patrol'. Both the ECB's general investigations and on-site inspections are initiated by the ECB decision, and an ECB decision may also initiate both general investigations and on-site inspections if the purpose and scope of them is the same.<sup>36</sup>

An on-site inspection team is composed of the ECB (chair) and NCA staff (or persons authorized by them). The NCA part of the team shall originate from a NCA that has jurisdiction over a less significant bank concerned.<sup>37</sup>

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<sup>34</sup> See *ibid.* art. 11.

<sup>35</sup> See *ibid.* art. 12.

<sup>36</sup> See art. 143 (3) of the draft Framework Regulation

<sup>37</sup> See *ibid.* art. 144 in conjunction with art. 12 of the SSM Regulation.

An ECB's on-site inspection shall be notified to the relevant NCA at least one week prior to the notification of a less significant bank concerned.<sup>38</sup> Yet the ECB may determine that a less significant bank should not be informed about a planned on-site inspection if it could jeopardize the efficiency and proper conduct of an on-site inspection.<sup>39</sup> In such a case, a relevant NCA shall be notified "as soon as possible" before the start of an inspection.<sup>40</sup>

The detailed procedures relating to the ECB's on-site inspections will be further described in the SSM Supervisory Manual and will cover: scope and objectives of different types of on-site inspections together with their organization, techniques and typical life cycle.<sup>41</sup> Now, I will revert upon what this paper proposes to call the ECB's 'red police patrols'.

- **'Red police patrols' (D)**

The 'red police patrols' constitute the second level of the ECB's 'intrusive police patrols'. This paper offers to perceive a usage of such ECB's 'police-patrols' as giving a red card on a NSA performance relating to supervision of less significant banks. To put it differently, by means of 'red police patrols' the ECB intervenes directly with the zone of discretion of a particular NCA, with a view to reverse and improve the outcomes of their supervisory policies.

The SSM Regulation provides the ECB with such a control mechanism. According to art. 6 (5b) when it is necessary to ensure consistent application of high supervisory standards, the ECB may on its own initiative<sup>42</sup> decide to take over from a NCA direct supervision of a particular less significant bank ('take-over' clause). As the wording of the premise for enabling the take-over clause suggests that a particular NCA might

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<sup>38</sup> See *ibid.* art. 145 (1).

<sup>39</sup> See *ibid.* art. 145 (2)

<sup>40</sup> *Ibid.*

<sup>41</sup> See ECB (2014) p. 12 (4.6). Available at <http://bit.ly/1e3wMVM> accessed 31 March 2014.

<sup>42</sup> But, noteworthy, also upon request by a NCA. See *ibid.*

not have followed the ECB's supervisory preferences, this ECB's police patrol has a clearly remedial character. From a principal-agent model, it is an instructive example of how the principal's may still reshape the agents' zone of discretion after the moment of delegation. Having identified a set of the ECB's 'police patrols', the following subsections will focus on the 'fire alarms' at the ECB disposal.

#### 4.3.2. The ECB's 'fire alarms' over the NCAs

This paper proposes to distinguish the ECB's 'internal' and 'external fire-alarms'. The ECB's power to horizontally relocate the national supervisory personnel between the different NCAs across the SSM forms an 'internal fire alarm' (A). On the other hand, the EBA's power to identify the breaches of the EU law by national competent authorities (B) and the power of national parliaments to request public hearings on banking supervisory policies in the SSM from the ECB's supervisory arm, but also accompanied by the National Competent Authorities (C) are treated as the ECB's 'external fire alarms'.

- 4.3.2.1. The ECB's 'internal fire alarms' (A)

In the context of this paper, the 'internality' of a 'fire alarm' means that a 'fire alarm' procedure is foreseen with the borders of the system and no external institutions are engaged. I argue that the ECB's power to horizontally relocate the national supervisory personnel between the different NCAs constitutes an (internal) 'fire alarm' however with some elements of 'police patrol' control.

In light of the SSM Regulation, the ECB may find appropriate to involve staff from one NCA into supervisory teams of another NCA as regards to direct supervision of less significant banks.<sup>43</sup>

As the wording of enabling clause for this ex-post control is relatively vague and prone to interpretations, one may imagine that the notion of appropriateness allows to use it

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<sup>43</sup> See art. 31 (2) of the SSM Regulation.

also in such situations when the ECB cannot be certain whether a particular NCA ensures its policy preferences to an acceptable extent, but simultaneously does not want to make an use from its more centralized 'police patrols' controls. In such a case, the NCA personnel, coming from one NCA monitors how the another NCA carries out its supervisory tasks within the SSM. Therefore, by these means the ECB acquires a decentralized source of information on possible agency transgressions on the part of the NCAs. The possible difficulty with treating this mechanism as a 'fire-alarm' originates from the fact that, in the end it is an agent (not a third party) who engages in monitoring. Therefore, it is offered to treat it as an 'internal fire alarm' as opposed to 'external fire alarm' in which the third party (outsider) carries out the oversight over an agent.

Yet, given the fact that the SSM operates in setting consisting of multiple agents (NCAs) and single principal (the ECB), it seems to be justified to treat national supervisory staff of one NCA involved in work of the another one as an equivalent to a 'third party' in this context. As the NCAs may compete among themselves for reputational reasons and for favors of their principal, it should not be assumed that they are likely to engage into monitoring forbearance while being engaged in the supervisory work of the fellow NCAs. This suggests that perceiving the ECB's power to horizontally relocate the national supervisory personnel between the different NCAs as an (internal) 'fire alarm' finds its justification when applying a principal-agent framework to the SSM.

- **4.3.2.2. The ECB's 'external fire alarms'**

This paper treats the ECB's 'external fire alarms' as the traditional 'fire alarms' previously theorized by the school of congressional dominance (e.g. Kiewiet, McCubbins 1991). Thus, they are considered as means of the NCA's decentralized oversight exercised by the SSM outsiders only. Among them, two procedures are highlighted: the EBA's power to identify the breaches of the EU law by national

competent authorities (B), the power of national parliaments to request public hearings on banking supervisory policies (C).

- **The EBA's power to identify the breaches of the EU law by national competent authorities (B)**

The EBA has substantial powers to ensure enforcement of the EU rules by banking supervisory authorities in the EU. According to art. 17 of the EBA Regulation<sup>44</sup>, the EBA shall counteract the breaches of EU law by competent authorities which means that the EBA is competent to examine the conformity of actions of the NCAs (and the ECB) with the SSM Regulation, the future SSM Framework Regulation and other EU legal acts (regardless of its hard or soft law nature; or whether they address supervisory or regulatory matters). This competence may occur to be particularly significant once the European Single Rulebook for EU banking regulation is established.

- **The national parliaments oversight over the NCAs' (C)**

With regard to the supervision of less significant banks in the SSM, the NCAs may be called to account by national parliaments in two ways.

Firstly, a representative of a NCA may be invited together with a Chair or a member of the SSM Supervisory Board to participate in 'exchange of views' on the supervisory policies in that Member State.<sup>45</sup> Therefore, such an 'exchange of views' may also address the supervision of less significant banks in various contexts. This mechanism may be useful for the ECB to assess in an *ad hoc* manner the supervisory approach of a particular NCA and its conformity with its policy preferences.

Secondly, the SSM Regulation maintains national parliaments oversight on the NCAs, even with regard to their tasks carried out within the SSM. The SSM Regulation stipulates that "*it is without prejudice to the accountability of national competent*

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<sup>44</sup> See Regulation (EU) No. 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority). L 331/12. Available at <http://bit.ly/1pFzW7h>, accessed on 31 March 2014.

<sup>45</sup> See art. 21 (3) of the SSM Regulation

*authorities to national parliaments in accordance with national law (...) for the performance of activities carried out by them in accordance with Article 6."*<sup>46</sup> This 'fire-alarm' may be particularly supportive for the ECB, especially before the establishment of the Single Rulebook when it has to base on at least 18 different national legal orders, although harmonized but far from ideational regulations, when pursuing its policy preferences in the SSM.

It may be therefore contended that two of above-mentioned oversight instruments fulfill the role of encouraging the elected policymakers to bring agency discretion to the attention of principals, and as such comply with the underlying idea behind 'fire-alarms' as the principals' 'ex post' controls.<sup>47</sup>

## 5. The institutional challenges for ensuring the ECB's policy preferences

This section aims to assess whether the ECB's mechanisms of control, as identified by the present paper, may possibly cover all the 'zone of discretion', the NCAs enjoy when carrying out the direct supervision of the less significant banks on behalf of the ECB. It is not to say that in order to avoid 'agency loss', the whole of the agents' 'zone of discretion' must be covered by the principal's control mechanisms. The control *per se* over the agents 'zone of discretion' is not the point in ensuring their compliance with the principal's policy preferences (or aligning their incentives to do so) in each and every case. It is even claimed that when principal waives the control over some areas of agent's discretion, the agent is provided with greater incentives to use its superior information (expertise) in the delegated sector of policy-making (Gailmard, 2012).

Notwithstanding these considerations, this paper will follow the orthodox approach to the agency institutional design and assert that the existence of 'black holes' in the ECB's mechanisms of control may constitute institutional challenges from a P-A perspective. It

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<sup>46</sup> See *ibid.* art. 21 (4) of the SSM Regulation. Art. 6 of the SSM Regulation assigns to the NCAs direct supervision of the less significant banks.

<sup>47</sup> To paraphrase Elgie (2002): 193.

means that at least partial incapacity of the principal to examine whether its policy choices are enforced by the NCAs in all possible "states of the world" may be encouraging for the agents to develop their own policy preferences, not necessarily compatible with those of their principal. This section recognizes three challenges for ensuring the ECB's preferences stemming from the SSM current institutional design: the NCAs discretion on 'materiality' reporting (in particular the usage of the 'catch-up clause') (5.1), the legal status of the ECB's regulations, guidelines and instructions directed to the NCAs (5.2) and the 'proportional' application of the SSM Regulation and the draft Framework Regulation to the supervision of the less significant banks (5.3).

### **5.1. The NCAs discretion on 'materiality' reporting (in particular the usage of the 'catch-up clause')**

As already pointed out, the NCAs shall also 'ex ante' notify to the ECB on a supervisory procedure which they consider as (1) a 'material' one and which may be of supervisory interest for the ECB<sup>48</sup> or (2) which may negatively affect the reputation of the SSM<sup>49</sup>. This provision was intended to play a role of 'catching-up' by the ECB with the current developments on the less significant banks. The challenge here is that these are the NCAs which determine whether the ECB shall 'catch-up' with a given (possibly important from a view of ensuring its policy preferences) procedure or not. Thus, it may be possible that ECB remains uninformed on the certain 'material' actions the NCAs take on the supervision of less significant banks, which may be in turn of interest for the ECB. As such, it paper offers to classify the 'catch-up' clause of art. 97 (4) of the draft Framework Regulation as a potentially challenging to the current SSM institutional design.

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<sup>48</sup> See art. 97 (4a) of the draft Framework Regulation.

<sup>49</sup> See *ibid.* art. 97 (4b).

## 5.2. The legal status of the ECB's regulations, guidelines and instructions directed to the NCAs

The subsection on the ECB's hybrid 'ex ante'/'ex post' controls over the NCAs (4.2) has described the ECB's regulations, guidelines and instructions directed to the NCAs as the legal acts out of the scope of art. 288 TFEU. Such acts are commonly referred to as 'atypical acts'.

From a principal-agent perspective the challenge arises from the fact that either the SSM Regulation or the draft SSM Framework Regulation provides the ECB's with direct instruments to enforce its regulations, guidelines and general instructions directed to the NCAs.<sup>50</sup> Although, their legally binding nature (hard legal obligations) is evident in the light of the SSM supervisory policy objectives which the ECB is obliged to pursue, it is difficult to imagine how a confidential regulation, guideline or instruction could be considered a legal act enjoying direct or hard enforcement mechanisms.<sup>51</sup>

Therefore, it follows that they cannot be considered as 'hard law'. 'Hard' law describes a legal situation where a hard legal obligation is followed by hard enforcement mechanism (Terpan 2013: 13). In this case, the NCA's hard legal obligations are not formally accompanied by coercive mechanisms of their enforcement. There is no provision neither in the SSM Regulation nor in the draft SSM Framework Regulation which allows the ECB to undertake enforcement actions directed to the NCAs, except of the 'take-over clause'.<sup>52</sup> In light of aforementioned considerations, it seems prudent to treat the ECB's regulations, guidelines and general instructions as 'soft law' or 'soft atypical acts' lacking hard enforcement mechanisms in a full scope.<sup>53</sup>

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<sup>50</sup> See Wymersch (2014): 41.

<sup>51</sup> Hard enforcement mechanism is a legal situation in which the rules compliance is ensured by judicial or (exceptionally) administrative review. For an exhaustive overview on this matter, see Terpan (2013).

<sup>52</sup> See *supra*, n. 48.

<sup>53</sup> At least with regard to confidential and undisclosed regulations, guidelines and instructions directed to the NCAs with an intention to produce legal effects.

While remaining a challenge, it may be worth pointing out that such a state of affairs must necessarily impede the effectiveness of these 'hybrid' controls. Indeed, under certain institutional arrangements, the 'soft law' measures with steering potential mechanisms are even preferred to classic 'hard law' ones. The 'soft law' instruments are widely regarded as adequate means for institutions to prepare the launch of new policies and test their impact and effects.<sup>54</sup> They allow for a "*carefully tailored differentiation of those effects on the part of the addressees, affording maneuvering space for both the adopting institutions in terms of self-binding effect and intensity of enforcement and the addressees in terms of compliance*" (Grosse Ruse-Khan, Jaeger, Kordic 2011: 906). Given the fragmented financial regulation (at least until creation of a truly EU Single Rulebook for banking sector) and the necessity to build an unified approach to banking supervision in the newly created Single Supervisory Mechanism, the 'soft' legal nature of the ECB's steering instruments towards the NCAs, although a challenge when it comes to enforcing it, may not necessarily produce detrimental effects such as departure by a NCA from pursuing the ECB's policy preferences.

### **5.3. The 'proportional' application of the SSM Regulation and the draft Framework**

#### **Regulation to the supervision of the less significant banks**

According to art 5 of TEU<sup>55</sup>, the exercise of the Union's competences shall be governed by the principle of proportionality. Within the SSM, both the ECB and NCAs will be executing the Union's competences and this principle shall apply. It has already been signalized by the drafters of the SSM Framework Regulations<sup>56</sup> that the less significant bank will have different and simplified reporting requirements in comparison to the significant ones. Also the risk management standards enshrined in the supervisory *acquis* will be proportionally applied to the less significant banks. As

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<sup>54</sup> See Cini (2000): 4.

<sup>55</sup> That is the Treaty of European Union, the second of the EU constitutional treaties. Available at <http://bit.ly/1jPqlYV>, accessed on 31 March 2014.

<sup>56</sup> Eduard Fernandez-Bollo (Chairman of the ECB's work stream (WS2) on the SSM legal framework) at the ECB's Public Hearing on the SSM Framework Regulation, 19 February 2014, Frankfurt.

explained by one of top SSM's officials "*proportionality does not mean that lower standards are applied. The proportionality means that a proper approach taking into account risks and business models of less significant banks is ensured. Thus, the objective of high quality supervision consistently applies to whole banking sector.*"<sup>57</sup>

Although such a differentiation is legitimate in light of the objective to simplify the supervision in the Banking Union<sup>58</sup>, it may be challenging to ensure the ECB's overarching policy preferences of ensuring single supervisory approach, at least from a principal-agent perspective.<sup>59</sup> From this perspective, the proportional application of supervisory *acquis* by the NCAs to supervision of the less significant banks leaves them 'margin of discretion' as to the interpretation of supervisory standards. Therefore, it is crucial for the ECB to define necessary *ex ante* templates and guidelines for the NCAs on how to interpret the common supervisory *acquis*. Leaving too much 'room for maneuver' for the NCAs in this respect may result in the supervisory outcomes not necessarily desired by the ECB.

## 6. Conclusions

This paper has applied a principal-agent framework to the relations between the ECB (the principal) and the NCAs (multiple agents) which are carrying out the supervision of the less significant on the ECB's behalf in the SSM. The P-A approach offers a toolkit to cope with so-called 'principal's problem' when a political delegation of certain tasks occurs – a possibility of agency loss by the principals ('agency slippage' or 'agency shirking'). It focuses on the agency institutional design, which is understood as "*an exercise in*

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<sup>57</sup> As grasped by Jukka Vessala (Director of DG Micro III) at the ECB's Public Hearing on the SSM Framework Regulation, 19 February 2014, Frankfurt.

<sup>58</sup> Ignazio Angeloni (Director of DG Macro-Prudential Policy and Financial Stability of the ECB) at the ECB's Public Hearing on the SSM Framework Regulation, 19 February 2014, Frankfurt

<sup>59</sup> The ECB policy preferences in the SSM were presented in details in the subsection 3.3. It was argued that single supervisory approach consisting of reducing the scope of national supervisory divergences and gradually eradicating the remaining national bias among the National Competent Authorities is the overarching policy preference of the ECB in the SSM.

*choosing from a menu of both ex ante and ex post controls*" (Thatcher, Stone Sweet 2002) over the agents' actions by the principals.

By applying a principal-agent model to the SSM institutional design, this paper has tentatively identified 11 mechanisms of the ECB's control over the NCAs supervisory actions directed to the less significant banks. This indicates that the ECB has a set of measures at its disposal to ensure the NCAs compliance with its policy preferences and reduce a possibility of the NCAs shirking. Due to the timing and lack of empirical evidence, this paper did not seek to evaluate the effectiveness of their functioning. Instead, certain challenges for the institutional design of the SSM were highlighted.

To sum up, this paper suggests a negative answer to the question whether the NCAs zone of discretion may be fully controlled by the ECB's mechanisms of control in the light of principal-agent framework. As underlined in the section on the challenges to the SSM's institutional design, 'black holes' in the ECB's controls over the NCAs relating to supervision of less significant banks have a potential to occur. Therefore, the working hypothesis of this paper is confirmed.

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