

THE POLITICS OF DELEGATION IN EUROPEAN BANKING UNION: BUILDING THE ECB SUPERVISORY OVERSIGHT CAPACITY

ABSTRACT

The nature and scope of the European Central Banks’s (‘ECB’) oversight mandate over the supervision of smaller and medium banks by national supervisors has been one of the most debated aspects of the newly created European Banking Union. In particular, the issue whether the ECB should influence already established national supervisory practises and standards was not immediately straightforward. This paper applies the Principal-Agent (‘PA’) approach to explore the extent of the ECB supranational agency governing the supervisory oversight policies in the Single Supervisory Mechanism (‘SSM’). Notably, one of the important features of the SSM institutional design is the contractual incompleteness of supranational delegation. The ECB has been granted discretion to fill-in the agency contract concluded with the Member States. A brief analysis of the practical operationalization of the ECB oversight role suggests that the ECB could exploit this contract condition to pursue own policy goals (agency hold-up problem) and situate itself in “bureaucratic drift” vis-à-vis the Member-State principals. However, under slightly relaxed Principal-Agent assumptions which assume proactive role of the agent in reducing information asymmetries vis-à-vis its principal, it is also possible that the ECB managed to influence the Member States’ stance, and, in doing so, exercised effective bureaucratic entrepreneurship.

INTRODUCTION

On 3 November 2013, the Council Regulation establishing the Single Supervisory Mechanism entered into force (‘SSM Regulation’). It delegated to the European Central Bank (‘ECB’) a number of supervisory tasks related to prudential supervision of credit institutions in the newly created Banking Union (‘BU’)ⁱ. In doing so, it set up the first and key pillar of the Banking Union – a common supervisory framework for banks headquartered in the Euro Area (‘EA’) Member States and those non-EA Member States which opt-in to join (Howarth and Quaglia 2016b). The Single Supervisory Mechanism (‘SSM’) is a new multi-level governance structure to carry out prudential tasks in the BU which is characterized by obligatory supervisory cooperation between European and national policy-making levels. In this framework, the ECB directly supervises large and systemically important banks referred to as significant institutions (‘SIs’). According to Article 6(5)(c) of SSM Regulation, it also performs oversight over the whole supervisory system by monitoring the conduct of direct supervision of smaller and medium sized banks (less significant institutions, ‘LSIs’) which remain in the scope of national competence (National Competent Authorities, ‘NCAs’). In this capacity, it does not act as a direct supervisor but rather as a supervisor of national supervisors (Lackhoff 2013).

Insights derived from the Principal-Agent and contract theories offer to shed some light not only on the institutional complexities of the European integration but also on activism of supranational institutions, agencies and other bodies in the EU. In this context, the PA literature assumes that supranational institutions (agents) will carry out delegated tasks in line with the Member States’ governments policy preferences (Pollack 1997). Such a delegation of tasks is perceived as an agency contract concluded between rationally oriented actors: the principal(s) and the agent(s).

However, in contractual relations ‘contingencies inevitably arise that have not been planned for and, when they do, the parties must find ways to adapt’ (Milgrom and Roberts 1992: 128). This implies that any contract is inherently incomplete in its nature (i.a. Williamson 1985; Cooley and Spruyt 2009). The fact that the Member States are a collective rather than a unitary principal, with possibly differing policy preferences, adds another twist to the analysis of delegation between the Member-State principals and their supranational agents.

This paper looks at the institutional design of the Single Supervisory Mechanism in terms of incomplete delegation contract between the Council (collective principal) and ECB (agent). Indeed, Article 6(7) of SSM Regulation leaves the ECB with discretion to define a framework for its cooperation with the NCAs when carrying out different supervisory functions in the SSM. This applies not only to the ECB direct supervision, but also to its oversight role over the functioning of the system.

My contribution focuses on second of the abovementioned features of the SSM institutional design. It discusses the process of the operationalization of the ECB’s oversight role in the SSM (‘oversight policies in the SSM’). The ECB direct supervision of significant banks is out of the scope of this paper. Oversight policies in the SSM are perceived in terms of filling-in the incomplete delegation contract between the ECB and Council which was framed in the SSM Regulation. I argue that in shaping its oversight role, the ECB pushed its own policy objectives and went beyond the initial stance formulated by the Council. In light of the Principal-Agent framework, this can be seen as stretching the boundaries of the original mandate, possibly implying a form of ‘bureaucratic drift’/‘agency slack’. However, under slightly relaxed Principal-Agent assumptions this situation could be also contemplated as a genuine form of “bureaucratic entrepreneurship” resulting from the ECB’s proactive attempts to reduce original information asymmetries vis-à-vis its Member-State principals concerning highly complex and intricate matters related to banking supervision.

In doing so, I seek to contribute to the studies on the activism of supranational institutions by exploring cases of the agency’s hold-up. This term describes situations, in which the agent thoroughly uses gaps in incomplete contracts — in which all future positions are not specified — to pursue own preferences (Gilardi 2001). My research ultimately aims to support the claim that contractual incompleteness tends to increase the agent’s discretion and hence its autonomy vis-à-vis its political principal(s) (Rittberger, Leuffen & Schimmelfennig 2012).

The remainder of the paper is structured as follows. The first section introduces the theoretical underpinnings to analyse the dynamics of supranational policy-making through the Principal-Agent and contract theory lens. The second section applies this analytical framework to explore the delegation of the oversight policies in the SSM, both from the principal and agent perspective. It investigates the development of the Member States’ and ECB’s initially differing stances on the SSM oversight policies and explains them in terms of the ECB’s wide discretionary powers in the BU’s supervisory policy-making.

SUPRANATIONAL POLICY-MAKING AND PRINCIPAL-AGENT APPROACH

Delegation theory and rational choice

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, designated the agent, acts on behalf of or as representative for the other, the principal” (Ross 1973: 134).

In the past 20 years, the Principal-Agent model has become an increasingly attractive tool for the analysis of EU policy-making dynamics in different areas (see for example: Tallberg 2002; Kassim and Menon 2003; Pollack 1997, 2007). Depending on the policy area covered, the nature and scope of delegated mandate may vary: starting from agenda-setting, information collection, representation, decision-making, to monitoring of compliance and

enforcement. It has been applied to explain multiple relations between the EU Member States and EU institutions in many public policies, including such areas as judicial policy-making (Garrett 1995), trade policy (Elsig 2007), central banking (Elgie 2002) economic governance (Hodson 2009).

There exists a vast body rational choice literature analysing the motivations that lead the Member-State principals to confer authority upon supranational agents. Delegation is explained in functional terms driven by a desire to minimize transaction costs (Hall and Taylor 1996) and ensure credible interstate commitments (Tallberg 2002), in particular by overcoming problems of collective action (Axelrod 2006), improving the quality of policy in technical areas (Egan 1998) and limiting regulatory competition between interdependent states which have incentives to treat their own firms leniently (Majone 1994; Egan 1998). The latter reason seems to be of a particular relevance in the context of recent integration of banking supervision in the EU. As pointed out by de Larosière report, inconsistent implementation of EU banking regulation across Member States’ jurisdictions and together with often nationally biased supervisory treatment of home banks facilitated the spread of the financial crisis across the EU (De Larosière et al. 2009).

Nonetheless, the use of the Principal-Agent framework to explain dynamics between supranational and national actors in financial (banking) supervision has been limited so far. Among one of notable exceptions is of an analysis conducted by Martin Schüler, who investigated the Member States’ incentives to delegate banking supervision to the European level (Schüler 2003). As a matter of fact, the majority of Principal-Agent work on banking supervision was rather concentrated on relations between elected policymakers and independent regulatory in context of delegation taking place at national levels. Notably, it explored the policymakers choices on the institutional design of bank supervision in the EU and around the world (Masciandaro 2004), 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 and Pellegrina 2008).

Uneasy dynamics of Principal-Agent relations

A Principal-Agent relation is created when the Member-State principals renounce direct exercise of a particular function or a set of tasks and transfer it/them to a European/supranational agent (often an EU institution, agency or a body). The latter is expected to carry them in line with the preferences expressed by the Member-State principals in the agency contract. Such an arrangement involves however certain risks for the principal. Even when the principal’s policy preferences are explicitly articulated, one cannot assume that the agents are likely to pursue them at all times. This difficulty is known in the classic delegation theory as the ‘principal’s problem’ (Ross 1973). It treats agents as opportunistic actors who may develop their own preferences, which may diverge from those of their principal once the agency contract has been concluded (Kiewiet and McCubbins 1991). The agents’ perverse incentives to pursue their own policy objectives are stimulated by another key assumption of the 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).

Under certain conditions, the principal’s problem may escalate to the so-called ‘bureaucratic drift’ or ‘agency slack’, both describing the ability of an agency to enact outcomes different from the policies preferred by those who originally delegated power. It may happen when the supranational agent pursues policies closer to its goals rather than those enacted by its principal and/or attempts to bypass its control by going beyond boundaries of delegated authority (Horn and Shepsle 1989; McCubbins and Schwartz 1984). These policy objectives

may be related to its power and welfare maximization (Niskanen 1975) as well to the improvement of its non-majoritarian policymaking legitimacy (Carpenter 2001).

Additional layer of complexity occurs when the principal consists of multiple actors, as in the case of Member-State principals acting in the Council (Hodson 2009). Such a collective principal may exhibit divergent policy preferences which can be exploited by an opportunistic agent and give him more leeway (Tallberg 2002).

Insights derived from the contract theory add another twist to the principal’s problem. Any ex-ante contract between the principal and the agent is invariably incomplete in its nature since it would be extremely costly, if not impossible, to spell out in explicit detail all future positions and precise obligations (Williamson 1985). Rather than designing complete contingent contracts, the principal-agent relations are embedded in an “incomplete contracting framework” (Grossman and Hart 1986; Hart 1995; Hart and Moore 1999;) with an option to fill in the details of such an incomplete contract left to either the principal, agent or a third party. In particular, a very structure of political delegation in which the supranational agent is left with the possibility to fill-in the incomplete contract may embolden him to use it as a window of opportunity to advance integration in certain policy field (Chalmers, Jachtenfuchs, Joerges 2016). Such centripetal activism may not be however in the line with its Member-State principals’ original preferences. In the transaction cost politics literature, a situation in which the agent exploits incompleteness of contract to pursue its own preferences is known as the agency hold-up problem (Epstein & O’Halloran 1999).

However, information asymmetry may also become detrimental for the agents under the conditions of incomplete contracting (Coremans and Kerremans 2016) if the policies pursued by the agent considerably deviate from the ones preferred by the principal (Kerremans 2006). The vast majority of Principal-Agent literature does not however contemplate a possibility of

reducing information asymmetries between the principal and the agent by means other than principal-induced controls (“anti-agent bias”). Against this backdrop, a rationally bounded agent could be expected to become a policy entrepreneur who proactively seeks to reduce information asymmetries vis-à-vis its principal. As a result this kind of the agent’s activism, the principal’s preference on the scope of the agent’s discretion may evolve over time.

Striking a balance between the principal’s control and the agent’s autonomy

The principal has to find ways to limit the bureaucratic drift/agency slack by encouraging the agent’s compliance with the principal’s policy choices and accommodate the agent’s incentives to develop preferences contrary to those of its principal. The Principal-Agent theoretical toolbox equips the principal with two groups of mechanisms to mitigate the possibility of the transgression of the agent’s side. These are administrative (ex-ante) and oversight (ex-post) procedures of political control. However, these are not costless measures.

The ex-ante administrative procedures are put in place to 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 mandate and its autonomy related to the execution of discretionary powers are granted by its principal. The design of administrative procedures aiming to establish criteria for decision-making in unforeseen circumstances seems to be of particular importance in the context of the problem of incomplete contracting. As noted by Moe, leaving as little as possible to discretionary judgment of bureaucratic agents in highly complex and technical areas of public policies is not a solution for establishing effective organisations since ‘cumbersome, complicated, structures may undermine their capacity to perform their jobs well’ (Moe 1990: 228).

The ex-post oversight procedures allow the principal to monitor its agents’ behavior and react in case bureaucratic drift/agency slack is detected. Conventionally, they are divided into

‘police patrols’ and ‘fire-alarms’ (Kiewet 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. ‘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’.

The control mechanisms installed by the Member-State principals over their supranational agents may vary from one policy to another policy area and also depend on the nature of scope of delegated powers. As such, they may be more or less restrictive which reflects a trade-off between the flexibility and comprehensiveness of the agent’s activities (McCubbins and Page 1987; McCubbins, Noll and Weingast 1987). It follows that a degree of the agent’s autonomy is primarily a function of the control mechanisms established by the Member-State principals to check on their supranational agents (Pollack 2007). Whether or not the agents have a discretion to fill-in the incomplete contact directly influences their autonomy vis-à-vis their political principals (Rittberger, Leuffen & Schimmelfennig 2012) as well as their incentives to pursue own preferences, such as pro-integrationist agenda (Stone Sweet 2010).

CASE STUDY: THE SUPERVISORY OVERSIGHT POLICIES IN THE SSM

This section draws inspiration from the work conducted by Robert Elgie who investigated the delegation of monetary policymaking by the Member-State principals to the ECB (Elgie 2002). In doing so, it goes one step further and applies the Principal-Agent model between

those two actors but to investigate the dynamics inside the newly created Single Supervisory Mechanism. In this context, it exclusively focuses on one of the delegated tasks: the nature of scope of the ECB’s oversight function over the supervision of less significant banks carried out by the NCAs.

Identifying principal-agent dynamics in the SSM

In the SSM, the delegation of multiple tasks related to prudential supervision of credit institutions takes place between the Member States acting as a collective principal in the Council and the European Central Bank which is an EU supranational institution. The agency contract between both parties is laid down in the SSM Regulation, which stipulates supervisory tasks conferred upon the ECB. Among them, the Member-State principals delegated to the ECB a very particular and somewhat vague task – the oversight over the whole SSM supervisory system (Article 6(5)(c) of SSM Regulation).

{Figure 1}

In this capacity, the ECB acts as the supervisor of national supervisors (Lackhoff 2013) who remain responsible for the prudential supervision of less significant banks. The part of the agency contract between the ECB and Council regulating the ECB’s oversight function over national supervisors (NCAs) provides however only very general principles of ECB-NCA relations in this regard. It stipulates that they are governed by a duty of cooperation in good faith and an obligation to exchange information (Article 6(2) of SSM Regulation). It follows that the delegation contract does between the ECB and CON is incomplete in its nature, with the discretion to define a framework of the ECB-NCA relations left to the former (Article 6 (7) of SSM Regulation).

The Member States’ stance on the oversight policies in the SSM

The primary sources to extract the Member States’ original policy preference may be sought in the legal text of the agency contract and official policy statements on the SSM formulated by the Council. It shall be however noted that the official documents reflect rather a political compromise among diverse positions of individual Member States as of a collective principal acting in the Council. Indeed, the range of the Member States’ preferences on the extent of the ECB oversight over smaller and medium-sized banks varied from a ‘fully-fledged’ supervision as initially proposed by the Commission to more ‘light-touch’ oversight dimensions. On one side, some Member States, including France and Netherlands, reported to favour a more intrusive oversight function (Howarth and Quaglia 2016a). On the other side, there existed also a group of countries, notably Germany, which was opposing the ECB strong oversight powers over the conduct national supervision ([Schäuble 2012](#), Lombardi and Moschella 2016).

The outcome was that the ECB’s scope of supervision in the SSM was to be ‘differentiated’ ([CON 2012](#)). The SSM Regulation confers upon the ECB direct supervision of credit institutions considered as “significant” ones whereas other credit institutions (“less significant”) remain in the scope of direct national supervisory competence. National supervision is however carried out under the ECB oversight which should include at least notification of material supervisory procedures and decisions in order to let the ECB express its views on them (Article 6 (7)(c) of SSM Regulation). It was however provided that in exceptional circumstances the ECB could escalate the intrusiveness of its oversight mandate and take over direct supervision of a less significant bank (Article 6(5)(b) of SSM Regulation).

Furthermore, the Council did not initially provide for a clear ECB’s role as regards promotion of the convergence and consistency of different national supervisory practices. This task was to remain within the responsibility of the European Banking Authority ([CON 2012](#)). All in all, one may therefore contend that the initial aggregated preference of the Member-State principals on the nature and extent of the ECB oversight function reflected a rather ‘light-touch’ and ‘backward-looking’ than ‘intrusive’ and ‘forward-looking’ dimension, notably by remaining silent on the ECB’s role in fostering the convergence of national supervisory approaches.

To ensure its preferences and cope with a possible bureaucratic drift/agency slack on the ECB side, the SSM Regulation equips the Council with certain mechanisms of control. These appear to be however limited. In line with the Core Principles for Effective Banking Supervision developed by the Basel Committee of Banking Supervision (BCBS), the ECB shall be politically independent (but accountable) when carrying out its supervisory tasks (Article 19 and Recital 55 of SSM Regulation). Relatively limited control mechanisms on the principal side are reflected in certain ECB accountability arrangements vis-à-vis the Council (and the European Parliament). The ECB accountability on supervisory matters is governed by Interinstitutional Agreement (‘IIA’) (2013/694/EU) regulating practical aspects the ECB’s accountability vis-à-vis the European Parliament and the Memorandum of Understanding (‘MoU’) from 29 October 2013 setting the ECB’s accountability arrangements towards the Council and the Euro group.

The Member States’ involvement in appointment of the SSM leadership can be regarded as an important ‘ex-ante’ accountability arrangement. As provided by the delegation contact, SSM chief supervisors (Chair and Vice-chair of the Supervisory Board) are appointed by the Council on the proposal of the Supervisory Board (largely consisting of national

representatives) and after the approval of the European Parliament (Article 26(3) SSM Regulation).

Among two main ‘ex-post’ control arrangements, which are closer to ‘police-patrolling’, one may list the ECB’s annual reporting on its supervisory activities to the Council/Euro group (and the European Parliament) which must cover a range of fields, including the conduct of its oversight function (Article 20(2) of SSM Regulation). Furthermore, the Chair of the Supervisory Board may be invited to participate in ‘exchange of views’ on the execution of supervisory tasks in the SSM with the Euro group in banking union composition (Article 20(3) of SSM Regulation). More specifically, the Chair must attend at least two such hearings and the information exchanged must remain confidential. The Euro group may also request additional ‘ad-hoc exchange of views’ (Section I, Paragraph 2 of MoU). The ECB must also respond to questions posed by the Euro group (Article 20(6) of the SSM Regulation). Ideally, they should be addressed as promptly as possible, and in any event within five weeks of their submission (Section I, Paragraph 3 of MoU).ⁱⁱ

The ECB’s stance on the oversight policies in the SSM

To identify the ECB’s policy preference on the nature and scope of its oversight function, it may be useful to study the way how the originally incomplete delegation contract was filled-in and subsequently applied in day-to-day supervisory policymaking by the ECB.

As it was already noted, the SSM Regulation left to the ECB discretion to define practical modalities of the supervisory cooperation between the ECB and NCAs in the SSM, both with regard to the ECB direct supervision of significant banks and its oversight over the NCAs. To fill in the details of the SSM Regulation, the ECB notably adopted three specific acts: the legally binding SSM Framework Regulation (‘FR’)ⁱⁱⁱ and the SSM Regulation on reporting of

supervisory financial information (‘SRR’)^{iv} as well as the SSM Supervisory Manual (‘SM’) which is an ‘internal staff document’ ([ECB 2014a](#)).

The FR stipulates the rules and procedures governing the cooperation between the ECB and NCAs ([ECB 2014b](#)). From the perspective of the ECB objectives on its oversight policies, two chapters of the FR are of particular significance: Part IV provides the methodology to determine significance of SSM credit institutions and Part VII regulates the ECB-NCAs relations on the supervision of less significant banks. In the framework of its oversight function, the ECB monitors the SSM’s entire banking sector and identifies ‘significant’ banks and ‘high-priority’ less significant banks. Furthermore, Part VII of the FR develops key preventive and retrospective oversight mechanisms: NCA ex-ante notifications on financial deterioration of banks under their supervision and material decisions/procedures (Articles 96-98 of FR) and NCA ex-post regular reporting obligations on the conduct of their supervision (Articles 99-100 of FR).

Under EU-wide supervisory legislation drafted by the EBA^v, financial reporting is mandatory for credit institutions applying international accounting standards - International Financial Reporting Standards (IFRS). It consists of two components – financial (FINREP)^{vi} and common reporting (COREP)^{vii}. The SRR extends these reporting obligations in a proportionate way to BU-headquartered credit institutions using country-specific reporting standards (nGAAP). For less significant banks, it introduces ‘simplified’, ‘over-simplified’ financial reporting and ‘supervisory financial reporting data point’ with corresponding reduced sets of templates to be used by banks. It also sets out rules related to the submission of information by the NCAs to the ECB^{viii}. The information collected from the NCAs provides the ECB with first-hand qualitative and system-wide input necessary to exercise efficient oversight over the entire SSM supervisory system.

Finally, the ECB further specifies operational aspects and policy objectives of its oversight function in the SSM Supervisory Manual. In the public version of this document – *Guide to banking supervision* ([ECB 2014c](#)), the ECB lays down organisational arrangements governing its oversight function and develops very specific dimensions of this function. The ECB oversight function, now officially referred to as the ECB indirect supervision, is located at a separate ECB business line – Directorate General Micro-Prudential Supervision III. This directorate performs indirect supervision over LSIs understood as supervisory oversight, institutional and sectoral oversight, and methodological support (*ibid*: Paragraph 89). For the ECB, the exercise of its oversight responsibility goes hand-in-hand with maintaining ‘effective and consistent functioning of the SSM primarily by ensuring that the supervisory activities carried out by the NCAs are of the highest quality and that supervisory requirements on all credit institutions covered by the SSM are consistent’ (*ibid*: Paragraph 88). To meet this objectives, the Directorate General Micro-Prudential Supervision III oversees ‘NCAs’ supervisory approaches vis-à-vis less significant institutions’, ‘applies supervisory approaches developed by the Directorate General Micro-Prudential Supervision IV for significant credit institutions in a proportional manner’, ‘classifies less significant banks’, ‘monitors individual institutions’, ‘organises thematic reviews’ and develops methodologies for Risk Assessment System (‘RAS’) and Supervisory Review and Evaluation Process (‘SREP’) for less significant banks (*ibid*: Paragraph 89).

The abovementioned non-exhaustive enumeration of the Directorate General Micro-Prudential Supervision III’s responsibilities hints at a more proactive and ‘forward-looking’ approach regarding the nature and scope of the ECB’s oversight function when compared to the preference initially expressed by the Council. But more importantly, it seems to suggest that the ECB sees itself as a driving force promoting the convergence and consistency of different supervisory practices across the SSM. The recent SSM policy statements and

activities seem to confirm this assumption. As boldly stated by the ECB, ‘ensuring the consistent application of high supervisory standards across the SSM is the primary goal of indirect supervision and supervisory oversight’ ([ECB 2016a](#): 42) which is to be achieved by development of joint supervisory standards and common methodologies for NCAs. In 2015, two sets of harmonized supervisory standards binding to the NCAs were developed. One of them relates to the supervisory planning process at NCA, through which they prioritize, plan and monitor the execution of key on-site and off-site supervisory activities for less significant institutions (*ibid*: 42). Another joint standard developed was focused on recovery planning (*ibid*: 43) and defines a framework to assess the eligibility of less significant institutions for simplified obligations under the BRRD regime.^{ix}

In comparison to the Member States’ preference to leave to the EBA the work on supervisory convergence ([CON 2012](#)), the ECB’s interpretation and subsequent operationalization of its oversight mandate seems to go beyond the original policy objectives formulated by the principal.

There exist several reasons which might be driving the ECB’s push for more convergence of supervisory practices on the supervision of less significant banks across different NCAs, notably financial stability concerns. It is now widely believed that national supervisors tend to favour domestic banking markets and develop ‘light-touch’ supervisory standards boosting competitive positions of national champions in the single market (see *i.a.* Spendzarova 2012, Howarth and Quaglia 2016b) or more ‘generous treatment of banks closely associated with the political world’ (Wymeersch 2014: 2-3) .

Furthermore, despite of a widespread agreement in the literature on limiting direct ECB supervisory competence to the largest and significant banks (see *i.a.* Garicano and Lastra 2010, Ferran and Babis 2014), there exists however compelling reasons to subject all the

Eurozone headquartered banks to the supranational supervision. As suggested by Goyal et al., in a banking union ‘a larger number of small banks with correlated exposures can threaten systemic stability’ and the ‘ultimate goal should therefore be to supervise all banks, not just systemic or vulnerable ones’ (Goyal et. al 2013).

In these circumstances, it would seem plausible to expect from the ECB as of a rationally bounded actor that it would develop over time a policy preference for more proactive and ‘forward-looking’ oversight of less significant banks in order to ‘ensure (...) the stability of the financial system of the Union’ (Recital 30 of SSM Regulation).

Coping with potentially mismatching positions on the SSM oversight policies

The analysis of the way how the ECB has operationalized its oversight function in the SSM until this very moment points out at the existence of diverging policy objectives when compared to the initial position of the Council formulated in December 2012 ([CON 2012](#)), both with regard to its nature and scope.

One way to approach this situation would be to declare that the ECB has gone beyond the original preferences of its Member-State principals and interpret this excess in terms of a bureaucratic drift/agency slack. In line with this argument, one may contend that the ECB has been efficiently using its discretion to complete the agency contract which results in overstretching its oversight mandate in the SSM by adding to it a more proactive and forward-looking dimension. Indeed, there exist very weak control mechanisms over the ECB action and its supranational autonomy has been widely recognized.

However, one may also assume that while filling in the complex details of the incomplete agency contract, the ECB has managed to influence the initial preferences of the Council or at least of some of its Member-State principals by actively cooperating in order to reduce information asymmetries inherent to the Principal-Agent settings. Although the Principal-

Agent framework, although it asserts that the policy objectives of rational actors are rather fixed and immune to pressures, does not exclude the possibility that the agents may transform the preferences of the configuration of the principals (Zito 2013). In this sense, rather than finding itself in a position of bureaucratic drift vis-à-vis their principal(s), the agent actions are still in line with its principal’s broad policy preferences. Insights provided by Delreux seem to indicate that ‘the functional benefit of delegation does not disappear when principals and agents cooperate, and it increases the possibility for the principals to remain active players in the task that is delegated to the agent’ (Delreux 2009: 205).

There are two components of the SSM institutional design – a formal and an informal one – which provide stable platforms for improving the degree and quality of complex supervisory information exchange between the Member-State principals (more specifically: their supervisory high-level representatives) and the ECB. The formal component has to do with the composition of the Supervisory Board which is the most important decision-making body in the SSM. At the moment, it gathers 32 high-level members, including the Chair, the Vice chair, four ECB delegates and 26 representatives of 19 NCAs.^x Therefore, it may be perceived as a venue which brings the principal and the agent together and gives them the opportunity to exchange their policy objectives and seek solutions on complex issues related to supervisory policy-making. The member of the SB shall meet regularly according to the agenda set by the Chair (Article 2.1 of Rules of Procedure, ‘RoP’).^{xi} Given that all ECB decisions related to supervisory-policymaking in the SSM have to be endorsed by the SB, it is an important yardstick to gauge whether pursued policy solutions are in line with the Member-State principal preferences. Despite of being a part of the agent’s institutional structure with legally enshrined guarantees of political independence (Article 26 of SSM Regulation), the Supervisory Board may be also perceived to a certain degree as the Member-State principals’ proxy. That is because national backgrounds of the Member States’

representatives at the Supervisory Board tend to influence their policy-making orientations, as widely reported by various European and international bodies in the context of the SB’s ‘older sister’ - the EBA Board of Supervisors ([COM 2014: 9](#); [EP 2013: 34](#); [IMF 2013: Paragraph 25](#); [EP 2014: Paragraph AU](#)).

Furthermore, the Chair of the Supervisory Board may be invited to participate in ‘exchange of views’ on the execution of supervisory tasks in the SSM with the Euro group in banking union composition (Art. 20(3) of SSM Regulation). More specifically, the Chair must attend at least two such hearings and the information exchanged must remain confidential. The Euro group may also request additional ‘ad-hoc exchange of views’ (Section I, par. 2 MoU). In 2015, the Chair attended two meetings of the Euro group in banking union composition: on 24 April the Chair presented the 2014 ECB Annual Report on supervisory activities and on 7 December (ECB 2016AR).

The informal component, which sets another specific channel to reduce information asymmetries between the Member States (more specifically: their high-level representatives) and the ECB, is the Senior Management Network. This network is hosted by the Directorate General Micro-Prudential Supervision III and is exclusively dedicated to the ECB indirect supervision. It is chaired by the Director General and gathers ECB and national high-level experts who work together on various issues relating to LSI supervision, ranging from the technical aspects of day-to-day supervision to policy discussions ([ECB 2015: 66](#)).

Both the Supervisory Board and the Senior Management Network create opportunities for the ECB to influence dynamics of its Principal-Agent relation with the Member States and to reshape their policy stances on the nature and extent of the SSM oversight policies. It seems that so far the ECB has been successful in complementing its agency contract in line with its policy objectives. Crucially, it managed to get the Member States’ consent to adopt a

harmonized SSM-wide policy stance on the national exercise of overwhelming number of options and national discretions (‘OND’) vis-à-vis to less significant banks ([ECB 2016b](#)). They provide the competent (supervisory authorities) and the Member States’ legislatures with possibilities to choose how (‘an option’)^{xii} and whether (‘a discretion’) to apply certain prudential requirements to credit institutions stipulated in European supervisory legislation (mainly CRR/CRDIV). The ONDs were the result of bargaining between the EU and Member States during the process of Basel III implementation and reflect the Member States’ interests in lowering the transaction costs (originating from *ia.* imposing tougher regulatory capital ratios) for their domestic banking sectors to the new regulatory environment (Howarth and Quaglia 2013, 2015). They are indeed of a very sensitive nature and high domestic political salience. Therefore, the ECB’s success in getting the Member States’ endorsement for their harmonisation is a notable example of the ECB ‘forward-looking’ and ‘proactive’ oversight activism. It also may be perceived in terms effective bureaucratic entrepreneurship resulting from the agent’s side, especially given their specific national interests and the initial reluctance in accepting the ECB’s policy mandate in the field of harmonisation.

CONCLUSION

This contribution applied the Principal-Agent framework to explain the oversight policies in the SSM. It demonstrated that the Member States (collective principal) and the ECB (agent) initially manifested differentiated policy stances on the nature and scope of the ECB oversight over NCA supervision of less significant banks. This partially accounts for an inherently incomplete nature of their agency contract which left the ECB a window of opportunity to set out technical details. From this angle, the discretion to fill-in the agency contact exercised by the ECB apparently went beyond the Member States’ preference formulated in the Council position on SSM ([CON 2012](#)).

However, rather than seeing it as an example of the agent’s transgression implying a form of bureaucratic drift/agency slack, what this paper offers is to follow a slightly relaxed approach to the main PA assumptions. From such a perspective, this development can be also perceived as a successful attempt to influencing the principal’s preferences by the agent.

The explanation I put on table asserts that the ECB has used the contractual incompleteness (agency hold-up) to engage in two-side interaction with its principal by using different formal and informal channels of communication. This has reduced the information asymmetries on the national experts and policymakers’ side and allowed the ECB to indirectly steer the policy preferences of the Member States governments which they represented.

Against this background, this case can be contemplated as an interesting and sophisticated form of effective bureaucratic entrepreneurship in highly complex and technical area of shared policy-making which ultimately expands the scope of supranational delegation but without inducing any manifest form of a bureaucratic drift/agency slack.

The findings presented by this contribution largely confirm the earlier Principal-Agent insights on the politics of delegation in the realm of EU monetary policy, notably including the research conducted by Robert Elgie (Elgie 2002). The institutional design of the SSM may serve as the support for both arguments in favour and against shirking applied to the ECB’s NCA oversight policies. However, when analysed under assumption that the ECB, as a rationally bounded supranational agent, does have incentives to proactively reduce information asymmetry vis-à-vis its Member-State principals, this paper provides a useful insight to illuminate the relations between the principal and the agent under the incomplete agency contract once delegation has taken place.

REFERENCES

Axelrod, R. M. (2006). *The evolution of cooperation*. Basic books.

Carpenter, D. P. (2001). *The forging of bureaucratic autonomy: Reputations, networks, and policy innovation in executive agencies, 1862-1928*. Princeton University Press.

Chalmers, D., Jachtenfuchs, M. and Joerges, C. (2016). *The End of the Eurocrats' Dream*. Cambridge University Press.

COM [European Commission] (2014). ‘Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS) {SWD(2014) 261 final}’, COM(2014) 509 final, available at http://ec.europa.eu/finance/general-policy/docs/committees/140808-esfs-review_en.pdf (accessed on 26 June 2016).

CON [Council] (2012). ‘Council agrees position on bank supervision’, 17739/12 PRESSE 528, Brussels, 13 December, available at http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/134265.pdf (accessed on 26 June 2016).

Cooley, A. and Spruyt, H. (2009). *Contracting states: Sovereign transfers in international relations*. Princeton University Press.

Coremans, E., and Kerremans, B. (2016). ‘Agents as information asymmetry managers in EU trade policy’, paper presented at the 8th Pan-European Conference on the European Union, Trento (Italy), 15-18 June 2016, available at <https://ecpr.eu/Filestore/PaperProposal/e36bef92-e930-49cb-accc-6e0b6917b964.pdf> (accessed on 25 September 2016).

De Larosière, J. et al. (2009). ‘The High Level Group on Financial Supervision in the EU – Report of the de Larosière Group’, available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (accessed on 26 June 2016).

Delreux, T. (2009). ‘Cooperation and Control in the European Union The Case of the European Union as International Environmental Negotiator’, *Cooperation and conflict*, 44(2), pp. 189-208.

ECB [European Central Bank] (2014a). ‘Hearing at the Committee on Economic and Monetary Affairs of the European Parliament’, Introductory statement by Danièle Nouy, chair of the Supervisory Board, Single Supervisory Mechanism, ECB, Brussels, 18 March, available at <https://www.bankingsupervision.europa.eu/press/speeches/date/2014/html/se140318.en.html> (accessed on 26 June 2016).

ECB [European Central Bank] (2014b). ‘ECB publishes SSM Framework Regulation’, Press release, 25 April, available at <https://www.bankingsupervision.europa.eu/press/pr/date/2014/html/sr140425.en.html> (accessed on 26 June 2016).

ECB [European Central Bank] (2014c). ‘Guide to Banking Supervision’, November 2014, available at www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf (accessed on 26 June 2016).

ECB [European Central Bank] (2015). ‘ECB Annual Report on supervisory activities 2014’, available at <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmar2014.en.pdf?c50e4de7ccc030381567868a76b97e1d> (accessed on 26 June 2016).

ECB [European Central Bank] (2016a). ‘ECB Annual Report on supervisory activities 2015’, available at <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmar2015.en.pdf?76bfa705d9eb131ceed673b36b94079a> (accessed on 26 June 2016).

ECB [European Central Bank] (2016b). ‘First ordinary hearing in 2016 of the Chair of the ECB’s Supervisory Board at the European Parliament’s Economic and Monetary Affairs Committee’, Introductory statement by Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, Brussels, 13 June, available at <https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se160613.en.html> (accessed on 26 June 2016).

Egan, M. (1998). ‘Regulatory strategies, delegation and European market integration’, *Journal of European Public Policy*, 5 (3), pp. 485-506.

Elgie, R. (2002). ‘The politics of the European central bank: Principal – agent theory and the democratic deficit’, *Journal of European Public Policy*, 9 (2), pp. 186–200.

Elsig, M. (2007). ‘The EU’s choice of regulatory venues for trade negotiations: A tale of agency power?’, *Journal of Common Market Studies*, 45 (4), pp. 927-948.

EP [European Parliament] (2013). ‘Review of the New European System of Financial Supervision (ESFS)’, Part I. IP/A/ECON/ST/2012-23, available at [http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507446/IPOL-ECON_ET\(2013\)507446_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/etudes/join/2013/507446/IPOL-ECON_ET(2013)507446_EN.pdf) (accessed on 26 June 2016).

EP [European Parliament] (2014). ‘Resolution of 11 March 2014 with recommendations to the Commission on the European System of Financial Supervision (ESFS) Review’, 2013/2166(INL) P7_TA (2014) 0202a, available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P7-TA-2014-0202+0+DOC+PDF+V0//EN> (accessed on 26 June 2016).

Epstein, D., and O’halloran, S. (1999). *Delegating powers: A transaction cost politics approach to policy making under separate powers*. Cambridge University Press.

Ferran, E., and Babis, V. S. (2013). ‘The European single supervisory mechanism’, *Journal of Corporate Law Studies*, 13(2), pp. 255-285.

Gandrud, C., and Hallerberg, M. (2015). ‘Does banking union worsen the EU’s democratic deficit? The need for greater supervisory data transparency’, *Journal of Common Market Studies*, 53 (4), pp. 769-785.

Garicano, L., and Lastra, R. M. (2010). 'Towards a new architecture for financial stability: Seven principles', *Journal of International Economic Law*, 13(3), pp. 597-621.

Garrett, G. (1995). 'The politics of legal integration in the European Union', *International Organization*, 49 (1), pp. 171-181.

Gilardi, F. (2001). 'Principal-agent models go to Europe: Independent regulatory agencies as ultimate step of delegation', paper presented at the ECPR General Conference, Canterbury (UK), 6-8 September 2001, available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.2258&rep=rep1&type=pdf> (accessed on 26 June 2016).

Goyal, R., et al. (2013). 'A banking union for the euro area', IMF Staff Discussion Note, SDN/13/01, February, International Monetary Fund.

Grossman, S. J., and Hart, O. D. (1986). 'The costs and benefits of ownership: A theory of vertical and lateral integration', *The Journal of Political Economy*, pp. 691-719.

Hall, P. A. and Taylor, R. C. (1996). 'Political science and the three new institutionalisms', *Political studies*, 44 (5), pp. 936-957.

Hart, O. (1995). *Firms, contracts, and financial structure*. Clarendon Press.

Hart, O., and Moore, J. (1999). 'Foundations of incomplete contracts', *The Review of Economic Studies*, 66 (1), pp. 115-138.

Hodson, D. (2009). 'Reforming EU economic governance: A view from (and on) the principal-agent approach', *Comparative European Politics*, 7, pp. 455-475.

Holmstrom, B. (1979). 'Moral hazard and observability', *Bell Journal of Economics*, 10, pp. 74-91.

Horn, M. J., and Shepsle, K. A. (1989). 'Administrative process and organizational form as legislative responses to agency costs', *Virginia Law Review*, 75 (2), pp. 499-508.

Howarth, D., and Quaglia, L. (2013). 'Banking on stability: the political economy of new capital requirements in the European Union', *Journal of European Integration*, 35 (3), pp. 333-346.

Howarth, D., and Quaglia, L. (2015). 'The Comparative Political Economy Basel III in Europe', Edinburgh School of Law Research Paper, 2015/19, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2630555 (accessed on 26 June 2016).

Howarth, D., and Quaglia, L. (2016a). 'Internationalised banking, alternative banks and the Single Supervisory Mechanism', *West European Politics*, 39 (3), pp. 438-461.

Howarth, D., and Quaglia, L. (2016b). *Political economy of European Banking Union*. Oxford: OUP, forthcoming (September 2016).

IMF [International Monetary Fund] (2013). 'European Union: Publication of Financial Sector Assessment Program Documentation -Technical Note on Issues in Transparency and Accountability', IMF Country Report No. 13/65, available at <https://www.imf.org/external/pubs/ft/scr/2013/cr1365.pdf> (accessed on 26 June 2016).

Kassim, H., and Menon, A. (2003). 'The principal-agent approach and the study of the European Union: promise unfulfilled?', *Journal of European Public Policy*, 10(1), pp. 121-139.

Kerremans, B. (2006). 'Proactive policy entrepreneur or risk minimizer? A Principal-agent interpretation of the EU's role in the WTO' [in] Egström, O., and Smith, M. (eds.) *The European Union's roles in international politics: Concepts and Analysis*, Abingdon, Routledge, pp.172-188.

Kiewiet, D.R. and McCubbins, M.D. (1991). *The Logic of Delegation: Congressional Parties and the Appropriations Process*. Chicago: University of Chicago Press.

Kuile, G. T., Wissink, L., and Bovenschen, W. (2015). 'Tailor-made accountability within the Single Supervisory Mechanism', *Common Market Law Review*, 52 (1), pp. 155-189.

Majone, G. (1994). 'The rise of the regulatory state in Europe', *West European Politics*, 17 (3), pp. 77-101.

Lackhoff, K. (2013). 'How will the Single Supervisory Mechanism (SSM) function? A quick overview', *Journal of International Banking Law and Regulation*, 29 (1), pp.13-28.

Lombardi, D., and Moschella, M. (2016). 'Domestic preferences and European banking supervision: Germany, Italy and the single supervisory mechanism', *West European Politics*, 39 (3), pp. 462-482.

Masciandaro, D. (2004). 'Central banks or single financial authorities? A political economy approach', University of Lecce Economics Working Paper No. 47/25, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=493483 (accessed on 26 June 2016)

Masciandaro, D., Nieto, M. and Prast, H. (2007). 'Financial governance of banking supervision', Documentos de Trabajo N. 0725. Banco de España 2007, available at <http://www.bde.es/f/webbde/SES/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosTrabajo/07/Fic/dt0725e.pdf> (accessed on 26 June 2016).

Masciandaro, D. and Pellegrina, L. (2008). 'Politicians, central banks, and the shape of financial supervision architectures', *Journal of Financial Regulation and Compliance*, 16 (4), pp. 290-317.

McCubbins, M. D., and Schwartz, T. (1984). 'Congressional oversight overlooked: Police patrols versus fire alarms', *American Journal of Political Science*, pp. 165-179.

McCubbins, M. D., and Page, T. (1987). 'A theory of congressional delegation' in Congress: Structure and policy, 409, pp. 411-13. New York: Cambridge University Press.

McCubbins, M. D., Noll, R. G., and Weingast, B. R. (1987). 'Administrative procedures as instruments of political control', *Journal of Law, Economics, & Organization*, 3 (2), pp. 243-277.

Milgrom, P. and Roberts, J. (1992). *Economics, organization and management*. New York: Prentice-Hall International.

Moe, T. (1990). 'Political institutions: the neglected side of the story', *Journal of Law, Economics and Organizations*, 6, pp. 213–66.

Niskanen, W. A. (1975). 'Bureaucrats and politicians', *The Journal of Law & Economics*, 18 (3), pp. 617-643.

Pollack, M. A. (1997). 'Delegation, agency and agenda setting in the European Community', *International Organization*, 51 (1), pp. 99–134.

Pollack, M. A. (2007). 'Principal-Agent Analysis and International Delegation: Red Herrings, Theoretical Clarifications, and Empirical Disputes', paper presented at the Workshop on Delegating Sovereignty, Duke University, 3-4 March 2006, available at <https://www.law.duke.edu/publiclaw/pdf/workshop06sp/pollack.pdf> (accessed on 26 June 2016).

Rittberger, B., Leuffen, D., and Schimmelfennig, F. (2012). *Differentiated integration: Explaining variation in the European Union*. Palgrave.

Ross, S. (1973). 'The economic theory of agency: The principal's problem'. *American Economic Review*, 12, pp. 134–139.

Schäuble, W. (2012). 'ECB should only supervise big banks', Reuters, 3 September, available at <http://www.reuters.com/article/us-eurozone-banks-schaeuble-idUSBRE88204U20120903> (accessed on 26 June 2016).

Schüler, M. (2003). 'Incentive problem in Banking Supervision: the European case', ZEW Discussion Papers, No.03-62, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=467840 (accessed on 26 June 2016).

Spendzharova, A. (2012). 'Is More 'Brussels' the Solution? New European Union Member States' Preferences about the European Financial Architecture', *Journal of Common Market Studies*, 50, pp. 315–334.

Stone Sweet, A. (2010). 'The European Court of Justice and the judicialization of EU governance', Living Reviews in EU Governance, 2010, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1583345 (accessed on 26 June 2016).

Tallberg, J. (2002). 'Delegation to supranational institutions: why, how, and with what consequences?', *West European Politics*, 25 (1), pp. 23-46.

Williamson, O. E. (1985). *The economic institutions of capitalism*. New York: Free Press.

Wymeersch, E. (2014). 'The Single Supervisory Mechanism or 'SSM', Part One of the Banking Union', National Bank of Belgium Working Paper, (255).

Zito, A. R. (2013). *Learning and governance in the EU policy making process*. Routledge.

LIST OF FIGURES

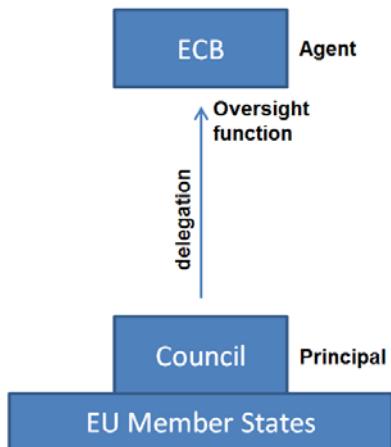


Figure 1 – PA view on oversight policies in the SSM

ⁱ Cf. [Council Regulation \(EU\) of 15 October 2013 No 1024/2013](#) conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

ⁱⁱ On the ECB accountability arrangements in the context of the SSM, see Gandrud and Hallerberg (2015) for a political analysis and Kuile, Wissink and Bovenschen (2015) for a legal one.

ⁱⁱⁱ Cf. [Regulation \(EU\) No 468/2014 of the European Central Bank of 16 April 2014](#) establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17).

^{iv} Cf. [Regulation \(EU\) No 468/2014 of the European Central Bank of 17 March 2015](#) on reporting of supervisory financial information (ECB/2015/13).

^v Cf. [Commission Implementing Regulation No 680/2014](#) laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.

^{vi} Financial reporting obligation for credit institutions takes place at consolidated level, and includes forbearance and non-performing exposures.

^{vii} Common reporting obligations for credit institutions cover own funds, capital requirements, large exposures, liquidity and stable funding, as well as leverage.

^{viii} Together with the [ECB decision](#) on the provision to the European Central Bank of supervisory data reported to the national competent authorities by the supervised entities pursuant to Commission Implementing Regulation (EU) No 680/2014.

^{ix} Cf. [Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014](#) establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

^x See ECB Banking Supervision website - <https://www.banksupervision.europa.eu/organisation/whoiswho/supervisoryboard/html/index.en.html> (accessed on 26 June 2016).

^{xi} Cf. The Rules of Procedure of the Supervisory Board of the European Central Bank, available at https://www.ecb.europa.eu/ecb/legal/pdf/en_rop_sb_f_sign.pdf (accessed on 26 June 2016).

^{xii} This could include a specific choice from alternative treatments of credit institutions.