



The ECBs half-baked supervision mandate or, how to get serious about shadow banking again

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Abstract

Over the last couple of years, there has been considerable debate on the need to “complete” the banking union. In this debate there has been little attention, however, to the omission of shadow banks from the supervision mandate given to the European Central Bank in and through the Single Supervisory Mechanism (SSM). The European Systemic Risk Board’s (ESRB) – confined to monitoring, as opposed to supervising – recently documented that Europe’s banking and non-banking financial institutions are as interconnected as ever. There cannot be any such thing as a completion of Europe’s banking union, we argue, without the establishment of formal European supervision of all non-banking institutions. We identify four potential, explanatory factors for the omission of shadow banking from the SSM mandate. This examination of factors that may help explain the SSM’s narrow supervision mandate, allows us to reflect on strategies – discursive as well as organizational – towards establishing pan-European supervision of all non-banking financial institutions.

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EXECUTIVE SUMMARY

The Banking Union was the cornerstone in the efforts to deepen the Economic and Monetary Union (EMU) that were undertaken by the Commission and EU member states from 2012 onwards (EC 2012). Such reform efforts were widely considered to be crucial for breaking the “doom loop” between banks and sovereigns in the euro-area. Over the last couple of years, there has been considerable debate on the need to “complete” the banking union, which soon came to be seen as half-baked. In this debate, there has been little attention, however, to what is arguably the most glaring, gaping hole of the Banking Union: the omission of shadow banks from the supervision mandate given to the European Central Bank in and through the Single Supervisory Mechanism (SSM).

The European Systemic Risk Board's (ESRB) – which is confined to monitoring, as opposed to supervising – recently documented that Europe's banking and non-banking financial institutions are as interconnected as ever (ESRB 2019). There cannot be any such thing as a completion of Europe's banking union, we argue, without the establishment of formal European supervision of all non-banking institutions.

Addressing the current lack of research, we identify four potential, explanatory factors for the omission of shadow banking from the SSM mandate, in addition to a generalized preference in many member states to opt for limited rather than comprehensive reform whenever possible:

- The positive reframing of shadow banking, that was ongoing in parallel, stressing its potential as funding source for SME's and hence its potentially important contribution to economic recovery
- A preference for avoiding disruption of prior decisions and institutional constructs pertaining to Europe's shadow banking institutions
- The predominance of a concern with breaking the 'doom loop' between banks and sovereigns, and a concomitant forgetfulness of systemic risks when banking union was conceived and negotiated
- The reluctance, on the part of the ECB, to assume formal supervisory responsibilities for non-banking institutions, for fear that this could potentially compromise or complicate its dedication to its primary objective of price stability

In a theoretical reflection on these explanatory factors, we associate each of them with one of the four main types of institutional theory (historical, sociological, discursive and rational choice). This careful examination of factors that may help explain the SSM's narrow supervision mandate, allows us to reflect on strategies – discursive as well as organizational – towards establishing pan-European supervision of all non-banking financial institutions. Going forward, we outline four different ways in which comprehensive European supervision of shadow banking could be institute. In fact, we identify a fifth option too, but dare only mention it in the very last paragraph.

1. INTRODUCTION

In November, a new Commission will take office. One of the political processes that has been on hold for the better part of a year – which one can expect soon to be resumed – is the Commission's efforts to compel member states to “deepen” the Economic and Monetary Union (EMU), not least to “complete” the banking union. It goes for the global as well as the European economy, that growth is weak and recession a real risk, so matters of euro resilience to adverse shocks certainly are no less acute than they were in spring 2018, when policy-makers and analysts sounded alarm about the urgency of these reforms.

In past debates about what it takes to “deepen” the EMU – such that the euro becomes more resilient – a crucial topic has been sorely missing, we argue; the establishment of comprehensive European supervision of all non-banking financial institutions. When the establishment of a Single Supervisory Mechanism was agreed by member states in October 2013 (to become operational a year later), only banks were included in its remit. This was contrary to the US, where the Dodd-Frank Act established the Financial Stability Oversight Council (FSOC), with an explicit mandate to supervise shadow banking institutions and prevent the build-up of systemic risk. In Europe, an agency dedicated to issues of systemic risk was created too, in the form of the European Systemic Risk Board (in 2010), but it was given authority only to monitor, not to supervise, the shadow banking sector, and hence were given no compelling tools to combat systemic risk. Confined to monitoring, the ESRBs warnings about adverse developments and its recommendations to address them are non-binding.

But what are the ramifications of locating shadow banking supervision at the national rather than the supranational level, as Europe did? Will it necessarily lead to less forceful supervision of non-banking institutions? To cut a long story short, the core problem is that with fragmented oversight of shadow banking activities, national supervisors are susceptible to industry pressures to be lenient with their domestic institutions, so as not to disadvantage them in international competition (Thiemann 2018: 229).¹

Over the summer, the ESRB published its most recent monitoring report on non-banking institutions, documenting that interconnectedness between banks and shadow banks have not decreased at all over the past five years (ESRB 2019). This is despite the fact that interconnectedness was identified in the Liikanen report (2012) as one of the key problems in the European banking system, which needed to be urgently addressed. If this core problem has not been ameliorated in the least, may we infer that the ESRBs mandate is indeed too weak, to the detriment of the resilience of Europe's financial system? Does it stress the need for a form of financial oversight that supervise the financial system in its totality, and that an institution is invested with authorities that go considerably beyond monitoring?

We answer these questions in the affirmative. There is every reason to worry about the lacking European supervision of its shadow banking institutions. Hence, it is of paramount importance that the new Commission – in collaboration with member states and the new European Parliament – establishes an effective European supervision of all non-banking institutions, especially those deemed systemically important. At the end of our essay, we outline four different ways in which this task can be approached organizationally.

¹ In Thiemann's phrase, it seems likely that the problem of international regulatory competition regarding financial services have merely “migrated from one segment of financial markets to others” (ibid).

First, however, we explore what factors may potentially have contributed to the omission of non-banking institutions from the SSM mandate. Despite the burgeoning literature on EMU reforms and banking union, there are few studies analysing the constitution and operation of the SSM.² And while a few studies mention that the SSM mandate exclude non-banking institutions, none of them explore the potential reasons why that was the case.

A key feature of many debates about what the ECB could and should do, or not, often entails disputes on whether proposed initiatives would violate the strictures of the Treaties that defines the perimeters of its legitimate activities. In our case, such an argument would not apply, however. The Treaty explicitly refers not to banks but to “credit institutions” and “other financial institutions” (Article 127(6) of the Treaty on the Functioning of the European Union), a concept that could easily accommodate several non-banking financial institutions, including those encompassed by the ESRB’s monitoring reports.

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

Our point of departure is that an understanding of the factors that can explain the exclusion of shadow banks from the SSM mandate, is of paramount importance for a qualified discussion of how such supervision may be constituted in the not too distant future. We identify four explanatory factors, all of which have likely played an important role. Our ambition is not to adjudicate between the different types of explanations – asserting which were the more decisive of them – but to produce an account that is as exhaustive as possible. This strategy is what best informs a qualified debate about the discursive and organizational strategies that can be deployed in order to promote the establishment of genuine, pan-European supervision of Europe’s shadow banking institutions.

The remainder of our essay is organized as follows. First, we establish the case that interconnectedness of banks and shadow banks constitute a considerable challenge for European financial stability. Then we discuss the four factors that we have identified as potential contributors to an explanation why shadow banks were excluded from the SSM mandate, briefly highlighting the strengths and weakness of each. This is followed by a theoretical reflection that associate each of the four explanatory factors with one of the four main types of institutional theory (historical, sociological, discursive and rational choice). This typology of explanatory narratives helps us identify four different ways a comprehensive European supervision of shadow banking could be constituted going forward.

² The notable exceptions are Mathias Thiemann’s (2018) recent work, Angeloni (2015), Angeloni and Beretti (2015), Ferran and Babis (2013) and Wymeersch (2014).

2. THE INTERCONNECTEDNESS OF BANKS AND SHADOW BANKS

Over the summer, the European Systemic Risk Board (ESRB) released the most recent of its shadow banking monitoring reports, which seek to capture the developments within the shadow banking sector, focusing particularly on risks and vulnerabilities related to interconnectedness, liquidity and leverage (ESRB 2019).³ The report shows that there has been no reduction of overall interconnectedness over the past five years, but also that the last years' trend exhibits increased interconnectedness between banks and shadow banks, particularly in and through transactions in the repo market. In aggregate, repo and reverse repo transactions increased by 37% over the course of the last two years (ESRB 2019).

The interconnectedness between banks and shadow banks has been a key concern for financial stability since the financial crisis. The outbreak of the financial crisis showed how the interconnectedness between banks and shadow banking entities led to an unforeseen level of risk and spill overs across sectors and national borders. Given that shadow banks are constituted by complex intermediation chains, the workings of shadow banks were characterised by a lack of transparency prior to the crisis (Abad et al. 2017).⁴

A key finding of the Liikanen report, released in 2012, was that the European banking sector had developed prior to the financial crisis to encompass a diverse set of bank business models, such that labels referring to “retail banks” versus “investment banks” were deemed too simplistic. A consequence of the diversified business models amongst European banks was that banks were increasingly engaging in lengthened intermediation chains increasing the level of interconnectedness between banks and the shadow banking system (Liikanen 2012).⁵ On this basis, the Liikanen report proposed structural reforms in banking, recommending a separation of the activities of deposit banks and trading entities. “Separate legal entities within a group”, the report noted, would be “the most direct way of tackling banks’ complexity and interconnectedness” (Liikanen 2012: ii).⁶

Since shadow banking involves a broad range of different activities, the interconnectedness between traditional banks and shadow banks are visible in heterogeneous ways, and can be direct as well as indirect. The direct interconnectedness between banks and shadow banks can be seen in the way banks rely on shadow banks as a source for wholesale funding, and in the way banks provide loans and credit lines to shadow banks. Another example is the way banks act as counterparties in derivative transactions. The indirect exposure between banks and shadow banks arise through common membership of a corporate group where the guarantees provided by the banks are important to the functioning of shadow banks (Abad et al. 2017; ESRB 2019; Financial Stability Board 2011). As was seen during the financial crisis, these guarantees may take the form of so-called step-in risks, where the sponsoring banks step in and provide liquidity to the securitisation vehicles, thereby bringing those shadow banking entities back into the banks’ balance sheets. It is important to

³ What was known as “shadow banking” in the early post-crisis policy discourse, has later been relabeled as “non-bank financial intermediation”, both by the Financial Stability Board (FSB) and the ESRB.

⁴ The intermediation chain describes the process in which long-term assets such as mortgages are transformed to short-term liquid assets, through processes of maturity and liquidity transformation. See Pozsar and Singh (2011).

⁵ This is what Hardie and Howarth (2013) have framed as the turn from bank-based to market-based banking.

⁶ Reducing the interconnectedness between banks and shadow banks was one out of five objectives in separating deposit banks from trading entities. The other four objectives being limiting a banking group’s incentives and ability to take excessive risks with insured deposits, prevent the coverage of losses incurred in the trading entities by the funds of the deposit bank, avoid excessive allocation of lending from the deposit bank to other financial activities, and level the playing field in investment banking activities between banking groups and stand-alone investment banks (see Liikanen 2012: vi).

continuously assess and estimate the interconnectedness between banks and shadow banks, because it is such an important indicator of potential contagion (Financial Stability Board 2019).

In a working paper for the ESRB, Abad et al. (2017) sought to map the interconnectedness between banks and shadow banks. Their study showed that UK banks' exposure to shadow banks amounted to €284 billion, corresponding to 76% UK banks' aggregate eligible capital. German and French banks' exposure to shadow banks amounted to €106 billion and €78 billion, respectively, corresponding to 108% of eligible capital for German banks and 62% French banks (Abad et al. 2017: 12). Their analysis also demonstrate how several banks are linked to the same shadow banking entities, which increase interconnectedness and systemic risk.

The ESRB monitoring report shows that wholesale funding provided by shadow banks to traditional banks increased by 4.2% in 2018 to €2.31 trillion (up from €2.22 trillion in 2017). It can be observed that the growth rate in wholesale funding, year-on-year, has been increasing since 2011. Another measure of the interconnectedness between banks and shadow banks is ownership of asset management companies by banks. The ESRB report states that 14 of the top 25 asset management companies in the EU are owned by European banks which according to the report creates "additional channels of contagion", resulting from "reputational spillovers, credit lines and contingency arrangements between banks, their asset management arms and the investment funds that they manage" (ESRB 2019: 18-19).⁷

A key indicator of an increasing level of interconnectedness is recent developments in the repo market. The ESRB reports that balance sheet data for euro area banks shows a 21% increase in liabilities with other entities, rising to €254 billion through the use of repo transactions and the gross amount of repo and reverse repo transactions have increased by 37% for the past two years (ESRB 2019). The report notes that the increasing use of repo transactions in and of itself have increased interconnectedness between banks and shadow banks in 2018.

The high level of interconnectedness between banks and shadow banks underlines that traditional banks are by no means insulated from developments in the shadow banking sector. Indeed, one of the key lessons of the global financial crisis was that problems in the non-banking segments of the financial system can be expected to substantially impact the banking sector, precisely because the distinction banks and shadow banks makes more sense analytically than as a clinical, empirical distinction between supposedly separate entities of the financial system. In light of all this, the exclusion of non-bank financial intermediaries from the SSM's supervision mandate was unfortunate and indeed somewhat strange.

3. WHY WERE SHADOW BANKS EXCLUDED FROM THE SUPERVISION MANDATE?

The scholarly literature on the banking union mostly address how the banking union came about rapidly in a highly-politicised climate (De Rynck 2016, Epstein and Rhodes 2016, Epstein and Rhodes 2018, Véron 2015) and how the supervision works in practice (Schoenmaker and Véron 2016; Schoenmaker 2016). In terms of the three pillars of the banking union, there have been only a few in-depth analyses of the single supervisory mechanism (Ferran and Babis 2013; Angeloni 2015; Angeloni and Beretti 2015; Wymeersch 2014). The omission of shadow banks from the SSM mandate has been noted in several studies, however:

⁷ This figure has remained stable over the past couple of years (ESRB 2017, ESRB 2018).

Schoenmaker (2016: 46) stresses that the SSM is “constrained to banking supervision only, which means that the ECB cannot extend towards shadow banks or other relevant intermediaries if necessary”; Busch and van Rijn (2018: 338) notes that “the exclusion of market infrastructure, insurers, investment firms and other shadow banking entities is puzzling from the perspective of financial stability”; Wymeersch (2014: 27) posits that the exclusion of “several categories of financial institutions” from the SSM mandate will likely “raise eyebrows as some of these institutions are clearly significant and may even be systemically relevant”; Posen and Veron (2014) observes that the exclusion of “non-banks could lead to harmful regulatory arbitrage”; and Ferran and Babis (2013: 259) are concerned that “the ECB’s initial remit will not extend to insurers, investment firms, central counterparties, other market infrastructure providers or entities engaged in shadow banking activities, notwithstanding that it is now firmly recognised that it is not only banks that can pose a threat to the stability of the financial system” and they stress that the “SSM will not have the flexibility found in both the US and the UK systems for non-banks to be brought within the purview of the ECB if they are deemed to be systemically significant”.

Despite the considerable body of literature that notes with concern that the ECB, did not get a mandate to supervise non-banking financial institutions, there has been no systematic effort to explore potential explanatory factors. Before we proceed to an account of the main factors that may explain the omission of shadow banks from the SSM mandate, a few remarks on key, prior developments pertaining to European post-crisis financial supervisory reform is warranted.

The starting point for post-crisis reforms of financial supervision in Europe was the high-level report published in 2009, named by its convener, Jacques de Larosi re, the former governor of the French central bank (de Larosi re 2009). The report’s two main proposals for institutional reform were the establishment of a European Systemic Risk Board (discussed below) and the transformation of three pan-European advisory committees into independent supervisory agencies; the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), eventually located in London, Paris and Frankfurt, respectively.⁸

Both ESMA and EIOPA may be depicted as performing supervisory tasks pertaining to parts of the shadow banking sector. However, they do so only in very partial ways and with quite limited mandates (Quaglia 2013, Busch and van Rijn 2018). In terms of institutional structure, the three European Supervisory Agencies (ESAs) reflected what they were – the result of a transformation of pre-existing committees so as to have more formal authority and responsibility, more than a concerted effort to institute comprehensive supervision of the shadow banking sector.⁹

Needless to say, the omission of shadow banks from the mandate of the SSM is not the only shortcoming of post-crisis reforms of financial supervision in Europe, but we surmise that it is a sufficiently important one to merit focused attention, especially as it can be considered a core aspect

⁸ The committees were originally established as a result of the recommendations of the [Lamfalussy report](#), adopted in 2001, to function as coordinating bodies consisting of national regulators. Two years before the publication of the de Larosi re report, the IMF had published a review asserting that “the Lamfalussy framework was too slow and lacked institutional capacity to respond effectively to a cross-border financial crisis within the European Union” (Ferran and Alexander 2011: 17).

⁹ As has been noted by Thiemann, ESMA “has no legal authority over domestic regulations and no real power in terms of supervision or rulemaking”; it is little more than a forum for national supervisors to monitor and coordinate actions (Thiemann 2018: 229).

of a rather serious, general problem in Europe, namely the “under provision of the public good of financial stability” (Quaglia 2013: 27).

Although there has been little explicit analysis of the omission of shadow banks from the ECBs supervision mandate, we suggest that the vast literature on other aspects of post-crisis financial regulation in Europe can be mobilized to identify factors that may help explain why were non-banking institutions not included in the SSM mandate.

We identify the following four such factors: the positive reframing of shadow banking that was accelerating in parallel; a concern with avoiding institutional over-layering and the political difficulties of challenging a decision to monitor rather than supervise shadow banks that had been instituted only two years earlier; a primary preoccupation with breaking the doom loop between banks and sovereigns, as opposed to combating systemic risk; and strong resistance from the European Central Bank (ECB), the most powerful European institution in issues of macrofinancial governance, against assuming formal supervisory responsibilities for non-banking institutions.

These four factors are all supplementary, we stress, to what we might term the generalized majority preference, amongst member states, for a “limited reform approach” to more or less each and every item on the agenda for European post-crisis reforms of financial regulation and supervision (Quaglia 2013: 24).¹⁰

Positive reframing of shadow banking

In the period from 2012 to 2015, shadow banking was undergoing a process of discursive reframing (Engelen and Glasmacher 2018; Engelen 2018).¹¹ Since many European economies suffered from protracted recession or very weak and slow recoveries from the crisis – and since the strictures of austerity excluded policies of fiscal expansion – policymakers had to look elsewhere for strategies to promote economic growth and job creation. One of the key elements of the solution that was identified involved shadow banks as an alternative source of credit for SMEs. By mobilizing non-banking institutions in the provision of credit to SMEs, it would be possible to circumvent the funding contraction in the traditional banking sector funding, it was argued. Since the traditional banks were set to consolidate after the financial crisis, and state spending were restricted from austerity measures, the only viable option seemed to be to look to the shadow banking sector.

The combination of protracted economic weakness, low levels of bank lending to businesses, and a political commitment to austerity, instigated a fundamental reframing of shadow banking in Europe. Shadow banks came to be seen as a crucial source of business funding, economic growth and job creation, and much less as a source of systemic risk and financial instability (Braun and Hübner 2018, Engelen and Glasmacher 2018).

This logic was stated clearly by Vítor Constâncio, then Vice-President of the ECB (Constâncio 2013). In a speech given in December 2013, he argued that it is important to revive the Asset Backed Securities

¹⁰ One of the ways in which the generalized preference for a limited reform approach found expression was in a reluctance to give too much power to the ECB over supervisory matters; “national efforts to admit only a limited role to the ECB”, notes Donnelly, “ignored complaints, from the European Commission and others, that national supervisors had not done their job properly for political reasons” (Donnelly 2013: 994).

¹¹ Engelen (2018) identifies a footnote in a FSB report on shadow banking from April 2012 saying that the term shadow banking is not intended to cast a ‘pejorative tone’ on this part of the financial system as marking the beginning of the reframing. He identifies the culmination of this reframing to take place in July 2014, where Mark Carney, then Chairman of the FSB, in an op-ed piece in the Financial Times argued for a need to re-focus on shadow banking.

(ABS) markets in Europe precisely in order to improve access to funding for SMEs. According to Constâncio, more variegated financial markets would lead to financial stability, because SMEs would have better access to finance and thereby become more resilient and less prone to lay-offs, also during a period of recession.

While the emergence of this discourse has so far been linked mainly with the CMU initiative, launched in July 2014 – when Juncker as incoming President of the European Commission presented his political plan to the European Parliament – we suggest that the political rationalities that informed the reframing of shadow banking were at play several years before. Perhaps the exclusion of shadow banking institutions from the SSM mandate testified to this exactly?

Policymakers were preoccupied with identifying a low-cost, job-creating growth strategy already as they were negotiating the Banking Union in 2012. The same preoccupation loomed large in the Commission's Green Paper on Long-Term Financing of the European Economy, released in March 2013, that is, in parallel with the negotiation of the SSM mandate from September 2012 until October 2013. In the Green Paper on Long-term financing of the European Economy, SMEs were identified as one of the most important sources of long-term economic growth, and the lack of funding for them was identified as a major impediment to growth (see also Braun and Hübner 2018).

While we argue that the more positive framing of shadow banking was brewing from 2012 onwards, the shift from the Barroso to the Juncker Commission in November 2014, and the new agendas and priorities of the latter, very likely reinforced the positive reading and resulted in a shift of balance in the competing framings of shadow banking.

To sum up, as the SSM mandate was negotiated, shadow banking was being reframed as a solution rather than a problem; a crucial source of funding for SMEs in the context of constrained bank funding. So a plausible interpretation of the omission of shadow banks from the SSM mandate would be that policymakers and regulators did not want to interfere with shadow banking at this critical moment for fear of inhibiting economic recovery.

Compelling as it sounds, at first glance, there are a few weaknesses to this explanatory modality that must be noted. First, there is no firm evidence that has established that the role of shadow banks as a potential source of funding, economic growth and job creation was in fact a rationale that motivated the omission of shadow banks from the SSM mandate. There was no explicit mention of shadow banks in the Commission's original proposal and the extent to which their inclusion was an active consideration in the negotiating process has yet to be investigated. A point of scepticism, however, with regard to according a key role to the positive reframing of shadow banking in explaining the omission of shadow banks from the SSM mandate would be that subjecting shadow banks to supervision would not, in and of itself, impede their funding for SMEs. And hence the contribution of shadow banks to economic growth and job creation also likely would not be much affected. Of course, such finer details may easily get lost in acute political processes, but all things considered, we find it hard to believe that an ongoing effort to reframe shadow banks positively, in and of itself, could explain the omission of non-banking institutions from the SSM mandate.

Avoiding disruption of prior decisions and institutional constructs

Another plausible candidate for an explanation of the omission of shadow banks from the SSM mandate is that another European institution had been created only two years earlier with the explicit mandate of monitoring shadow banks, namely the European Systemic Risk Board (ESRB). If

the SSM mandate had included supervision of shadow banks, it would have caused considerable disruption in the ecology of post-crisis European financial regulation. It would be difficult to imagine having one institution responsible for shadow banking monitoring and another responsible for shadow banking supervision. So, the implication of giving the SSM a mandate for shadow banks too would likely have been to subsume the ESRB under the SSM. Those kinds of institutional disruptions, often meet resistance, not least from the already existing institutions threatened by destabilization and reorganization.

A first note of caution here might be that a similar logic could be applied to the supervision of banks. The year before the banking union idea was first floated by Herman van Rompuy (2011) – and hence also before a Single Supervisory Mechanism was seriously considered – the EU had decided to establish a supervisory body for banks; the European Banking Authority (located in London). If it was possible to include banks in the SSM mandate – despite the prior existence of EBA – why would it not be possible in the case of shadow banks, despite the prior existence of the ESRB, one might object?

Following this line of reasoning one might add that the ESRB had not exactly hit the ground running. On the contrary, it had faced rather intense critique for having limited power and being slow on its feet. Its main task was collection of data and issuance of warnings and recommendations, without any formal authority to back efforts to insist on their adoption. And the institutional set-up with the 28 participating national central banks and three ESAs, with the attendance of relevant financial authorities of all member states, led observers to describe its processes of issuing recommendations as “cumbersome” (Thiemann 2018, Lombardi and Moschella 2017). Indeed, Lombardi and Moschella (2017) asserts that the particular constitution of the ESRB showed that policy-makers were at least as concerned with symbolic, signalling effects to the public, as there were with the efficiency of European financial supervision.

Perhaps the difference between banking and shadow banking – with regard to the SSM mandate – was not so much organizational as political. The EBA was one of three advisory committees that in 2011 had been transformed into supervisory agencies (along with ESMA and EIOPA). Perhaps the key difference between banks and shadow banks was that in the case of the former, a decision had already been taken to supervise them, whereas for latter the opposite was the case; a political decision not to supervise had been taken several years earlier.

To sum up; the decision how to deal with shadow banks at the European level had been taken several years earlier, when the ESRB was formed – and the decision was to monitor, not to supervise (contrary to what was the case for the three ESAs; EBA, ESMA and EIOPA).¹² Hence, including shadow banks in the SSM mandate was never really on the negotiating table.

Here too a balanced account, must note a key weakness of the suggested explanation. Why would the decision to monitor rather than supervise be politically irreversible? In the climate of political urgency that characterised the period (2012-), surely a change of approach, from monitoring to supervision, would have been possible (if widely considered necessary or important)? The entire BU process was in and of itself a considerable institutional rupture, as was the ECB's venture into the OMT programme, so maybe this too is not enough to explain the omission of shadow banking from the SSM mandate.

¹² While the three ESAs were given formal supervisory mandates, critics have argued that it was not particularly strong ones (Qualia 2013; Busch and van Rijn 2018; Thiemann 2018).

Focused on breaking the doom loop, forgetful of systemic risk

It was discussed several times throughout the Commission's Green Paper and Communication on shadow banking, published in March 2012 and September 2013 respectively, how shadow banks ought to be subject to supervision. In the Communication from September 2013 it was explicitly mentioned that such supervision could be linked to the Single Supervisory Mechanism (SSM). Yet, there were no traces of this kind of reasoning in the SSM files; neither in the original Commission proposal nor in the final legislative text. It was striking that not even in official documents aiming to pre-empt burning questions and reservations stakeholders and citizens might have had about the SSM, was there any mention whatsoever of shadow banks (EC 2012c, 2013c).¹³

Instead, the SSM documents were alluding to a different set of concerns, centred on the bank-sovereign nexus and its ramifications for euro resilience. Barroso, then Commission President, stated that the aim was to “to break the vicious link between sovereigns and their banks” such that in the future “bankers' losses should no longer become the people's debt, putting into doubt the financial stability of whole countries” (EC 2012b). Commissioner Barnier elaborated that it would be “the role of the ECB to make sure that banks in the euro area stick to sound financial practices. Our ultimate aim is to stop using taxpayers' money to bail out banks” (ibid.).¹⁴ Beyond these acute policy concerns, official documents also stressed that the Council decision to create an SSM for banks was “part of a longer term vision for economic and fiscal integration” (ibid.).

The ECBs supervision mandate was originally intended to encompass all banks, as there was a dual concern, both with banks that were too-big-to fail and with smaller banks that were too-interconnected-to-fail (Donnelly 2013: 99). Eventually, the SSM did indeed assume formal responsibility for all banks, but a careful division of labour with national supervisors was agreed (see Quaglia 2013: 25).

To sum up, policy-makers, regulators and member states were acutely concerned with breaking the bank-sovereign doom loop. This was the core *raison d'être* of the banking union, not a concern with addressing systemic risk, and hence banks were seen as the crucial entities to target, not shadow banks. As a consequence, the main political battle of the banking union was not whether or not to include non-banking institutions in the supervisory effort, but rather how many or how few banks were to be subject to supranational supervision, and how authority would be distributed between the supranational and the national.

While this explanatory modality is compelling in terms of how the legislation was shaped by the framings that dominated in the specific conjecture, we nevertheless hesitate to rely fully on this explanation. Shadow banks actually play a key role in the dynamics of the bank-sovereign doom loop, and in any case, the banks and the shadow banks are so interconnected that their separation in supervisory affairs is artificial in the first place.¹⁵ It wouldn't have been too difficult, in other words, to articulate a concern with shadow banks that related them specifically to the dominant agendas of the banking union effort and the establishment of the SSM. We suspect, therefore, that a fourth and

¹³ The two FAQs included questions and answers on a range of concerns, but there was no Q&A on why shadow banking institutions were not included in the SSM mandate”.

¹⁴ Member states decided to make the establishment of the SSM a “precondition for the possible direct recapitalization of banks by the European Stability Mechanism” (Quaglia 2013: 24).

¹⁵ Further, Thiemann (2018) notes how regulatory competition amongst national regulators merely moves from the banking sector to the shadow banking sector.

final explanatory factor must be drawn upon to complete our account of the omission of non-banking institutions from the SSM mandate.

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

Maybe a key reason why shadow banks were excluded from the SSM was that the ECB didn't want them there? To explore this explanatory modality, let us first revisit the establishment of the ESRB, a few years earlier. Why was the ESRB given only a monitoring role? When EBA was created a year after, it was invested with formal, supranational supervisory powers (Donnelly 2011: 8). Why was EBA given a supervisory role and the ESRB only an advisory one? Why would microprudential supervision of banks have strong supranational features, whereas authority on the most important aspects of macroprudential supervision remained national? From an academic point of view, if a division of labour were to be instituted, it would have made more sense the other way around; for the macroprudential to be supranational, and the microprudential to be national.

A plausible reason why it was decided that shadow banks were only to be subject to monitoring was that there were strong forces at work to keep the ECB 'at-a-distance' from formal responsibilities pertaining to financial stability, for fears that this could potentially compromise or complicate its commitment to price stability. Such concerns were prevalent inside the ECB as well as amongst academics. Willem Buiter was among the most prominent academics to sound alarm over the potential conflicts between the objectives of financial stability and price stability that could result from locating the ESRB within the ECB.¹⁶ Questions were raised at the time, noted Ferran and Alexander, "about the wisdom of vesting responsibility for macroprudential supervision in a central-bank dominated body given the potential for the demands for price stability and financial stability to pull in opposite directions and thus to give rise to conflicts of interest" (Ferran and Alexander 2011: 28).

These concerns links to a wider academic debate about how to best organize the potentially conflicting objectives of financial stability and price stability. In this literature, it is a widespread notion that the two policy objectives should ideally to be pursued by two different modes of policy – macroprudential and monetary policy, respectively. Whether the ECB was to be assigned responsibility for both tasks, is a debate that dates back to its inception, with the Germans advocating separation and the British integration (Goodhart and Schoenmaker, 1995). Eventually, the German model prevailed, such that the ECB was assigned only responsibility for monetary policy and financial responsibility remaining a national responsibility.¹⁷

If it was controversial to anchor the monitoring of shadow banks in an institution designed to worry first and last about price stability, not financial stability, it would obviously be even more so, if formal supervisory powers were implied, as would have been the case if the SSM mandate had included

¹⁶ Buiter was quoted at length in a UK Treasury Committee report on proposals for European financial supervision: "Professor Buiter was one of the most vociferous critics of the composition of the ESRB, describing the institution as being "ludicrously lopsided in favor of central banks in general and of the ECB in particular". He argued that it was difficult to see why central banks should be given such a prominent role given that "the ECB, the Eurosystem NCBs and the rest of the EU NCBs have not exactly covered themselves with glory in the area of macro-prudential supervision and regulation during the past decade". Professor Buiter also brought home some of the tensions that could emerge, for example, from whether central banks in control of the ESRB would be "conflicted" in the use of policy instruments by the "potentially clashing demands of price stability and financial stability"" (Treasury Committee 2009: 18).

¹⁷ It was left to the discretion of member states, whether to attribute the financial supervision responsibility to its national central bank or to a separate legal entity, such as the British Financial Services Authority (FSA).

non-banking institutions. If anchoring the ESRB within the ECB was delicate, including shadow banks in the SSM mandate would be even more so.

A technocratic objection here might be that the ECB has already dealt with and organizationally resolved this issue of dual objectives, in and through the way it operationalized its banking supervision mandate. The SSM was created within the ECB, but at arms-length from monetary policy-making. Commissioner Barnier stressed this point when the SSM legislation was released; “We have proposed a mechanism”, he said, “to separate supervision from monetary policy within the ECB” (EC 2013a) and in other official documents released by the Commission the same point was stressed:

Within the ECB an operational separation between monetary policy tasks and supervisory tasks is necessary to eliminate potential conflicts of interest between these two tasks. Conflicts of interest could for instance emerge in a situation where in order to meet the monetary policy objective of price stability, interest rates need to be raised, while this might at the same time have adverse effects on the solvency and profitability of the banking sector (EC 2013: 5).

But one thing is organizational charts and assignment of different objectives to different departmental chiefs, another is the harsh realities of central banking controversies over conflicting objectives. Every so often, one witnesses central bankers debating these issues in the public domain. Last year, Yves Mersch, member of the executive board of the ECB, felt compelled to insist that the ECB should always put price stability before financial stability; whatever responsibility the ECB may have with regard to financial stability, it can only ever be secondary, at best.¹⁸

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

We should be careful to stress that the ECB is by no means in one mind with respect to the question of whether non-banking institutions should be supervised supranationally or not, nor that it is a *cold case* in any way. Several figures within the ECB establishment in fact called for shadow banking supervision over the years. One example will suffice. At a presentation given in November 2014, Sabine Lautenschläger, then newly appointed Vice-Chair of the Supervisory Board of the ECB, discussed how a possible improvement of the macro-prudential toolkit of the ECB would be to extend the regulatory perimeter to “systemic non-bank institutions and activities” (Lautenschläger 2014).

So, there have been and presumably still are contending perspectives on the matter within the ECB, but so far resistance to assuming formal, supranational responsibilities for shadow banking supervision has prevailed.¹⁹ Hodson has argued that the position of the ECB is generally supportive of

¹⁸ Yves Mersch’s comments were [quoted](#) by Bloomberg in September 2018.

¹⁹ Further research would be needed to investigate in more detail the views of the different members of Governing Council of the ECB on the matter of its role vis-à-vis non-banking institutions – first, when the ESRB was established and second, when the SSM legislation took form.

efforts to bestow greater competences on itself or other EU institutions, except when such changes “are perceived as a threat to price stability (e.g., by interfering with its mandate or political independence)”, in which case it will strongly “[prefer] status quo to further integration” (Hodson 2012: 37). We suspect that the majority of the Governing Council of the ECB actually were not keen at all on getting a formal supervision mandate for shadow banking, because this would considerably enhance its role and responsibility in matters of financial stability, and thereby might potentially compromise its primary (and precious) mandate for price stability.

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

Summary

The four explanatory modalities laid out in the preceding sections should be seen as complementary; we are not interested in adjudicating between them, but in multiplying, so as to arrive at the fullest possible account. Each of the four main explanations laid out in the preceding sections can be condensed in the form of an explanatory configuration, characterized by a distinct logic and object of explanation, drawing upon Vivien Schmidt's (2010) typology of institutionalisms: one of path dependency, focusing on established institutional structures; one of communication, focusing on the role of dominant ideas and discourses; one of appropriateness, focusing on the normative setting and framing; and finally, one of calculation, emphasizing the incentives of a key actor. By way of summarizing, we can identify four narratives that align with the four main types of institutional theory (ibid.):

Table 1 Typology of explanations based on varieties of institutional theory

	<i>Historical institutionalist</i>	<i>Discursive institutionalist</i>	<i>Sociological institutionalist</i>	<i>Rational choice institutionalist</i>
<i>Account of missing SB mandate</i>	There was already a designated institution for oversight of SBs (i.e., the ESRB), and the decision had already been taken only to monitor, i.e. not to supervise. In other words: SBs not relevant for SSM mandate	SB was undergoing a dramatic ideational reframing, from outright dangerous to essential for economic recovery – it simply didn't seem important to include them in the SSM mandate	The SSM was conceived in the context of the BU, itself a response to the euro crisis – and its shape reflected this frame; reflected what was appropriate in that specific context. An SSM of a Banking Union, should focus on banks, of course	SBs were deliberately excluded from the scope of the SSM mandate, because the most powerful actor, the ECB, didn't want to risk that its primary mandate would be compromised
<i>Logic of explanation</i>	Path-dependency	Communication	Appropriateness	Calculation
<i>Object of explanation</i>	Structures and practices	Ideas and discourse of sentient agents	Norms and cultures of social agents	Behavior of rational agents
<i>Definition of institutions</i>	Macro-historical structures and regularities	Meaning structures and constructs	Cultural norms and frames	Incentive structures

4. POLICY ALTERNATIVES

Reflections on policy change

From the analysis and typology devised above we can draw several inferences with regard to the conceivable conditions of possibility of a process leading towards the establishment of comprehensive European shadow banking supervision.

First, it seems likely that a discursive reframing of shadow banking must take place, such that the activities of non-banking institutions are no longer seen as overwhelmingly benign, as is currently the case. Such reframing could result from a less optimistic view of their crucial contribution to growth and job creation (perhaps in relation to the rise of other more effective strategies of growth and jobs promotion), or from a renewed awareness of the risks and costs that they may give rise to. Second, it is likely that a 'critical juncture' of some kind is required to break the pattern that European supranational attention to shadow banking should take the form of monitoring rather than supervision. Failing that, Europe will likely remain reliant on the ESRB's rather weak hand in crucial matters of systemic risk. Thirdly, this 'critical juncture' would need to unfold in a manner that would render supervision with non-banking institutions the obviously most appropriate response, in the eyes of a wide range of the central actors. Last but not least, a further condition of possibility would likely be that the ECB could be circumvented or transformed. Circumvention here would entail that supervision with shadow banks was located outside the ECB, in a separate legal entity. Transformed so as to be fit for purpose, on the other hand, would mean that the ECB was given a proper mandate for financial stability (as opposed to its currently rather ragged one). A genuine mandate for financial

stability would give equal priority to price and financial stability, such that the ECBs incentive structure would be fundamentally altered.

What might constitute a 'critical juncture' to such effect? An obvious candidate for a critical juncture that would likely satisfy all the stated criteria would be a new financial crisis, stemming from shadow banking segments of the financial system. Perhaps renewed speculative pressure on the euro and/or significant trouble and losses in parts of the shadow banking sector with real economy ramifications. But our account is not meant to inspire pessimism and laissez-faire. On the contrary, we stress that progressive scholars and policy-makers should unite in efforts to reframe and reform the way we think about and supervise shadow banking and engage in speculative efforts, such as ours, to draw up institutional templates readymade for better times.

The four main options: getting serious about shadow banking supervision

Looking forward, the two most straightforward ways in which comprehensive European supervision of shadow banking could be organized would be to either upgrade the existing mandate of the ESRB to encompass not just monitoring but also supervision, or to expand the mandate of SSM to include all financial institutions.²⁰ A major problem with both of these options is that they would increase the ECB's formal responsibilities for financial stability and hence would likely meet intensive internal resistance for fear of eroding the primacy of the ECB's commitment to price stability. In the absence of a revision of the mandate of the ECB itself – formally putting financial stability and price stability on equal footing – these two options don't seem practicable.

A third option would be to create one or two new supervisory bodies targeting specific activities in the shadow banking sectors where supranational supervision would be preferable to mere monitoring. As an important case in point, one might establish a European Repo Agency, to complement the supervisory work of ESMA and EIOPA, and institute enhanced mechanisms of cross-agency coordination. In many ways, such a mushrooming strategy likely would be the path of least resistance. But it would also be the least compelling. The supervisory mandates of the existing ESAs are known to be rather weak and the danger that coordination efforts would be unable to compensate for the disadvantages of fragmented supervisory agency is considerable.

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

The main obstacles to such a construction would likely be popular sentiment that it would represent yet another bureaucratic overreach from technocrats in Brussels – yet another infringement of national autonomy – and the predictable resistance on the part of the European banking industry, which will much prefer to see financial liberalization continue to go hand in hand with a mode of supranational, European financial supervision that is fragmented, weak and partial, at best.

²⁰ The articles that defines the legitimate scope of ECB activities talks of "credit institutions" and "other financial institutions", but there is an exemption for insurance companies. See Ferran and Alexander (2011) for a discussion.

5. CONCLUSION

Apart from being considered a cornerstone of efforts to “deepen” Europe’s Economic and Monetary Union (EMU), the banking union has been praised by scholars and policymakers for having paved the way for the European Central Bank (ECB) to actively engage in the resolution of the European sovereign debt crisis (Schoenmaker and Véron 2016; Van Rompuy 2014). Mario Draghi identified the commitment to European banking supervision by the political leaders of EU member states as the “game-changer” that the ECB needed to “step up its role in the crisis” (van Rompuy 2014).²¹ In this interpretation, the banking union decision was what made Draghi’s public assurance that the ECB “would do whatever it takes to save the euro” possible. Draghi’s assurance was soon followed by the launch of the ECB’s Outright Monetary Transactions (OMT) programme a few months after, cementing the ECBs commitment to the cause.

While the Banking Union has no doubt played an important role as political precondition for the ECBs ability to dissolve the sovereign debt crisis, it has also inadvertently sowed the seeds for the next crisis, we argue, by excluding shadow banks from the supervisory mandate of the Single Supervisory Mechanism (SSM), the first of the three pillars of the Banking Union. The exclusion of shadow banks from the SSM has dealt a double blow to systemic risk regulation in Europe. First, it maintained supervisory authority at the national level in sections of the financial markets where cross-national supervision were most acutely needed. Second, it inadvertently but inevitably (further) weakened the position of the ESRB in the ecology of post-crisis European financial regulation.

In this policy paper, we have discussed the factors underlying this strategic *faux pas* and suggested remedies going forward. First, we briefly sketched the interconnectedness of banking and shadow banking in Europe, drawing upon the ESRB’s recently published monitoring report for empirical detail. Second, we documented that the Maastricht treaty could easily have accommodated a specification of the ECB’s supervision mandate that included non-banking credit institutions and that several key players in the regulatory community were acutely aware of the importance of doing so. Third, we accounted for the main reasons why Europe’s financial governance elite have so far abstained from insisting on a broad supervision mandate for the ECB. Finally, we argued that to complete the banking union, it is essential to establish comprehensive European supervision of shadow banking, in a manner that measures up to the realities of the business models of Europe’s international banking industry.

We have suggested four options for instituting comprehensive European supervision of shadow banks. The most straightforward options are either to expand the mandate of the ESRB to give it formal, supervisory powers, or to expand the supervisory mandate of the SSM to include shadow banks. A third option would be to establish one or two new supervisory boards for specific shadow banking activities, supplementing ESMA and EIOPA, such as for instance a European Repo Authority. The fourth option we see is to fundamentally reform the system of European financial supervision by

²¹ Van Rompuy’s account in full: “[I] will never forget, a couple of hours later on that Friday [the press conference where it was presented that a banking union would be created, red.], Mario Draghi walking into my office, right before the start of the summit’s last working session. A man under huge pressure, for the first time in the eight months during which I’d seen him at work, he now looked relieved. “Herman,” he said, “Do you realize what you all did last night? This is the game-changer we need.” The commitment of political leaders to European banking supervision created the opening he needed for his own institution to step up its role in the crisis – with words, now famous words, and with action, the OMT, which both came that summer” (van Rompuy, 2014: 3).

creating a new institution of financial oversight, merging the existing pan-European institutions into one, with enhanced authority.

We believe that this latter option – the German model, in the terminology of Goodhart and Schoenmaker (1995) – would likely be the most efficient solution, but one that would call for considerable courage on the part of European policy-makers, given the fundamental rupture with the existing institutional framework that it would require. The fifth and final option – which we haven't discussed – would be to fully integrate all financial supervision into the ECB; that is, to have a Single Financial Supervision Authority within the ECB. But for the supervisory functions not to be treated step-motherly, as a secondary concern, the mandate of the ECB would have to be changed such that the two objectives were put on equal footing.

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