Banking Regulation and Banking Supervision: Current Structure and Challenges

Andreas Pfingsten and Corinna Woyand

1 Introduction

Since the global financial crisis, the issue of regulating and supervising banks adequately has gained increasing attention. In their role as financial intermediaries, banks provide important transformation functions, whereby taking comparably high risks (Hartmann-Wendels, Pfingsten, & Weber, 2014, p. 11). In particular, banks are exposed to a certain bank run risk (Diamond & Dybvig, 1983). At the beginning of the financial crisis, the British bank Northern Rock made their own first-hand experience as concerned customers rushed to withdraw their deposits, because they lost trust in the bank's liquidity. As a consequence of this bank run, Northern Rock was indeed unable to repay its liabilities and finally taken into state ownership to avoid its bankruptcy (Shin, 2009).

Unlike most other industries, a bankruptcy of a single bank can have severe consequences for the whole economy, especially in case of a spillover on further banks or even on other financial systems. Actually, this so-called contagion effect occurred after the investment bank Lehman Brothers collapsed in September 2008. As a result, several banks around the globe needed governmental support (Hartmann-Wendels et al., 2014, p. 310). Due to the high economic importance of the banking system and the demonstrated consequences in case of bankruptcy, banks are generally regulated much stricter than other corporations. The regulation and supervision of banks through a governmental oversight body aims to ensure the stability of the financial system in general (Hartmann-Wendels et al., 2014, p. 309).

The Basel I accord, introduced in 1988 by the Basel Committee of Banking Supervision (BCBS), lays the foundation for international banking regulation (Basel

A. Pfingsten (✉) · C. Woyand
University of Münster, Münster, Germany
e-mail: Andreas.Pfingsten@wiwi.uni-muenster.de

C. Woyand
e-mail: Corinna.Woyand@wiwi.uni-muenster.de

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Committee on Banking Supervision (BCBS), 1988). Since then, the structure and scope of banking regulation and supervision has been constantly developed. The subsequent Basel II and Basel III capital adequacy frameworks substantially raised the complexity for banks as well as for supervisors since the compliance with a large number of rules and requirements needs to be assessed appropriately (Basel Committee on Banking Supervision, 2004, 2017). The Basel framework provides comprehensive guidelines to be applied by each BCBS member country, while it is no legislative act. Instead, these guidelines need to be translated into national policies and actions (Deutsche Bundesbank, 2013, p. 57).

In order to achieve an integrated financial framework at a European level, the two-layer structure of banking regulation and supervision in the EU differing from non-EU Basel member states, must be observed. Thus, the Basel frameworks are implemented into EU-law first before being translated into national law. Moreover, responsibilities for the prudential supervision of credit institutions are conferred on the European Central Bank (ECB). Hence, the pure national task of banking oversight has become an overall European task (European Central Bank (ECB), 2014). This comparably complex structure of European supervisory practices results in new conflicts of interest. Therefore, several EU-specific problems and challenges are currently apparent.

In this context, this paper aims to structure international banking regulation and supervisory practices with a particular focus on the European banking market. We point to current challenges resulting from the specific structure of European banking regulation and supervision and discuss consequences and policy implications. In detail, we consider the lack of separation between monetary policy and supervisory functions of the ECB, discuss the affected competitive conditions, and illustrate limitations for the intended European level playing field.

In doing so, we firstly give a short overview of the general objectives and the current structure of international banking regulation in Sect. 2. In a similar manner, we present the objectives and current structure of banking supervision in Sect. 3, focusing on the specific characteristics of European supervisory practices. In Sect. 4, we finally present and discuss current challenges for European supervisors and regulators and derive specific policy implications. Section 5 concludes.

2 The Objectives and Structure of Banking Regulation

As presented in the introduction, banks play a major role for the economy as a whole. They act as financial intermediaries and thereby provide important transformation functions, namely lot size transformation, risk transformation and term transformation (Hartmann-Wendels et al., 2014, p. 11). Regulators argue that the resulting risks, such as default risk, interest rate risk or liquidity risk, need to be monitored to guarantee the financial stability of the banking system (Basel Committee on Banking Supervision (BCBS), 2004). However, because of its complexity, the banking industry is characterized by comparably high informational asymmetries and resulting

agency problems. Due to their limited liability, bank owners and bank managers are incentivized to take higher risks at the costs of their debtors, especially in a poor earnings situation (so-called gambling for resurrection) (Dewatripont & Tirole, 1994, p. 123). Particularly private depositors are neither willing nor able to monitor banks by themselves to prevent such a behavior. Therefore, banking regulation provides official rules and guidelines to be fulfilled in order to safeguard the overall financial soundness by ensuring the adequacy of each bank's capital and risk structure to protect private investors and to restore their confidence (Hartmann-Wendels et al., 2014, p. 309).

In this paper, we look at international banking regulation with a particular focus on European features. Thereby, regulation can be structured into three main levels. Firstly, international policy makers of the BCBS of the Bank of International Settlements (BIS) establish certain rules and guidelines, commonly referred to as the Basel Capital Adequacy Framework. Secondly, at a European level, authorities transfer such guidelines into EU-law, which, thirdly, may have to be implemented at a national level as applicable law. In the following, we present each level in more detail.

At the international level, the BCBS sets the main standards and develops specific regulatory requirements and capital adequacy guidelines. The BCBS consists in total of 28 member countries, including the European Union, which is institutionally represented by the ECB. Because banking regulation is an evolving process, the Basel Committee verifies steadily the usefulness of established rules, adjusts existing guidelines, and provides new rules if gaps are detected (Basel Committee on Banking Supervision (BCBS), 1988, 2004, 2017). Since the introduction of Basel I in 1988, the Basel capital adequacy framework underwent two major revisions and was extended by several additional standards. The finalization of Basel III (sometimes referred to as Basel IV) was recently published in December 2017 and aims to correct shortcomings of previous frameworks, which became apparent during the financial crisis (Basel Committee on Banking Supervision (BCBS), 2017).

With the introduction of Basel II, the Basel framework was structured into three main pillars. The first pillar—*minimum capital requirements*—deals with the regulatory capital for credit risk, market risk, and operational risk. The second pillar—*supervisory review process*—aims to ensure an Internal Capital Adequacy Assessment Process (ICAAP). In contrast, the purpose of the third pillar—*market discipline*—is to enable the monitoring by external market participants and specifies disclosure requirements in order to increase the transparency and comparability across bank reports (Basel Committee on Banking Supervision (BCBS), 2004).

However, standards and requirements established by international policy makers need to be implemented as national law. Due to the ongoing integration of the European banking market, the Basel guidelines are not directly transferred into German law, but adjusted beforehand at the European level. The European Parliament and the European Council aim to establish consistent standards across all European countries. Therefore, the third Basel Accord was implemented into European law via two legal acts. The first element is the Capital Requirements Directive (CRD IV) and the second element is the Capital Requirements Regulation (CRR).

At the national level, the German Parliament, the Federal Council and the Ministry of Finance have to transform EU-directives into German law, while EU regulations apply directly. The German Banking Act (Kreditwesengesetz, KWG) contains most rules regarding capital requirements and definitions. The German Solvency Regulation (Solvabilitätsverordnung, SolvV) further specifies the rules of §§ 10 KWG on banks' minimum capital requirements (pillar I of the Basel framework) and also contains the disclosure requirements of the third pillar. Finally, the minimum supervisory requirements for risk management (Mindestanforderungen an das Risikomanagement, MaRisk) spell out the requirements on banks' internal risk controlling (pillar II of the Basel framework) (Hartmann-Wendels et al., 2014, p. 336).

These rules are legally binding. Banks incur effort and costs to fulfil such a large number of regulatory requirements. In particular, strict banking regulation might constrain banks in their business activities. Hence, the incentive to comply voluntarily with such rules and minimum requirements is rather low. Therefore, it is necessary that a governmental oversight body monitors and verifies the compliance with regulatory standards. The next section presents and discusses the objectives and structure of banking supervision, again with a focus on the European banking market.

3 The Objectives and Structure of Banking Supervision in Europe and Particularly in Germany

To make sure that banks satisfy the rules and guidelines established by regulators, national supervisory authorities are required to oversee each bank in the respective country. The main task of the supervisor is to monitor banks' capital adequacy and to verify the correct and sufficient application of national law (Deutsche Bundesbank, 2017a, p. 129). Due to the specific structure of the integrated European banking market, European banking supervisory practices deviate from the standard case of a pure national oversight body. In the following, we present the current structure of European banking supervision.

The EU member states agreed upon a European Banking Union being subject to the so-called Single Rulebook. In order to create a set of harmonised prudential rules, the European Banking Authority (EBA) develops specific technical standards and guidelines (Regulation (EU) No 1093/2010). The intended Banking Union can be structured into three core elements. The first core element—*Single Supervisory Mechanism (SSM)*—plays a key role for this paper and is therefore explained in more detail hereafter. Just for completeness, the second core element—*Single Resolution Mechanism (SRM)*—and the third core element—*European Deposit Insurance Scheme (EDIS)*—are also briefly mentioned (European Central Bank (ECB), 2014, p. 21). The SRM complements the SSM and aims to establish adequate mechanisms to manage banking failures. As part of the EDIS, the European Commission sets up a deposit insurance scheme in the Euro area to protect bank deposits up to 100,000 € (European Union, 2018, Art. 6(1)).

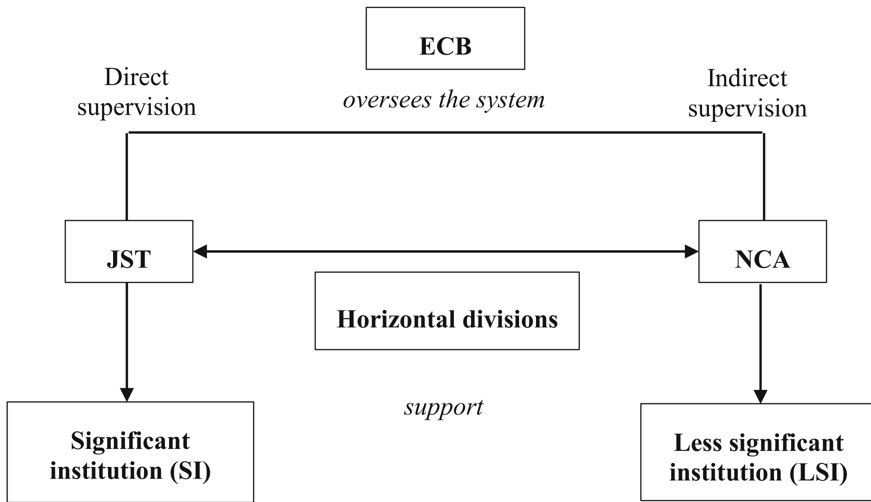

Fig. 1. The distribution of tasks within the SSM (Source: ECB, 2014, p. 11)

Figure 1 visualizes the distribution of tasks within the SSM and illustrates the key role of the ECB for the prudential supervision of banks in the Euro area. The ECB is responsible for the oversight of all significant institutions, while only indirectly supervising less significant institutions in the Euro area. Instead, the national competent authorities (NCAs), in some cases the national central banks themselves and in others in collaboration with the national central banks, still directly supervise these less significant banks. In Germany, "*BaFin and the Deutsche Bundesbank share banking supervision […]. Their cooperation is governed by Sect. 7 of the German Banking Act […], which stipulates that, among other things, the Deutsche Bundesbank shall, as part of the ongoing supervision process, analyse the reports and returns that institutions have to submit on a regular basis and assess whether their capital and risk management procedures are adequate.*" (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), 2016).

Banks are classified into significant and less significant institutions according to different criteria. In particular, a bank is categorized as a significant institution if the total value of its assets exceeds 30 billion Euro or if the bank is one of the three largest credit institutions in a country (European Central Bank (ECB), 2014, p. 10).

Prudential supervision of SIs is a major competence of the ECB. So-called Joint Supervisory Teams (JSTs), comprising ECB members and national supervisors, conduct the direct oversight of such institutions and are supported by horizontal and specialised expertise divisions regarding the micro-prudential supervision (European Central Bank (ECB), 2014, p. 11). The collaboration has the objective to reach consistent supervisory practices across the EU member states. Moreover, this structure intends to ensure a more reliable supervision for all systemically relevant institutions in a country to assure that violations of rules and significant risks are recognised and

evaluated at an early stage. This is thought to lead to more financial soundness in general (European Central Bank (ECB), 2014, p. 5). As a consequence of this complex supervisory structure, European banking supervision is currently exposed to several problems and challenges. We will discuss three key issues in more detail in the next section.

4 Current Challenges for European and National Supervisors

In the following, we discuss three major issues resulting from the current structure of European banking supervision. First of all, the ECB's key role for both banking supervision and monetary policy induces certain conflicts of interest. Secondly, we point to differences in supervisory practices between European authorities and national authorities, each representing its specific interests. Thirdly, we illustrate problems with respect to the intended European level playing field across all member states resulting from differences in supervisory stringency across the EU member states.

4.1 Combination of Supervisory and Monetary Policy Functions

In general, central banks play a key role for the financial system as they are mandated to ensure price stability. However, the additional assignment of major supervisory tasks to the ECB implies a strong concentration of power. There has been an ongoing discussion on the usefulness of combining both functions under the ECB. Some countries even withdrew their central banks mandate for supervising banks (e.g., UK, Japan or Canada) (European Central Bank (ECB), 2001, p. 4). In Germany, we observe a mixed form since staff of the German central bank are involved in supervisory tasks. In general, there are two opposing views on the combination of monetary policy and supervisory functions.

On the one hand, opponents of the conferral of prudential supervisory tasks on a central bank argue that this aggregation results in severe conflicts of interest. In particular, the ECB might be incentivized to perform its monetary policy function as to ensure the stability of banking markets and therefore may adjust the interest rates not purely according the main objective, price stability. This was observed in the USA during the Savings and Loans crisis (Ioannidou, 2005, pp. 63). Hence, monetary policy might be "misused" to avoid bank failures and especially spillover effects on further banks. Some critics even argue that the ECB largely exceeded its mandates (Matthes & Demary, 2013). Furthermore, because Euro area banks heavily rely on ECB liquidity, the combination of these two functions may increase the link between sovereigns and banks (House of Lords, & European Union Commitee, 2012, p. 16).

On the other hand, proponents of a combination of these two functions argue that the ECB seems to be the most appropriate institution to undertake the role as a European supervisor for the Banking Union (European Central Bank (ECB), 2001, p. 3). Especially, not refraining from separating those tasks allows to link both functions related to the overall objective of financial stability. In this double role, the central bank could gather useful information from banking supervision to enhance its monetary policy function (Ioannidou, 2005, p. 61). Moreover, the ECB is therefore able to decide reasonably whether to act as a lender of last resort for specific banks or not (e.g., it would not be reasonable if a bank is nearly insolvent anyway) (Ioannidou, 2005, pp. 61). As stated above, the ECB could nevertheless be incentivized to rescue certain banks to ensure the overall financial soundness. However, the ECB clearly states that price stability is the major aim (European Union, 2016, Art. 127(1)).

Overall, we can conclude that the combination of monetary policy and prudential supervision functions at the ECB leads to certain conflicts of interest. However, changing the European supervisory structure by withdrawing the ECB's supervisory task might not be a reasonable solution either. It would instead be necessary to ensure a clear separation of staff members of both divisions and to define tasks in case of a crisis. Hence, it is important to guarantee that the ECB acts independently in its role as price stabilizer (Great Britain et al., 2012, p. 18).

4.2 Differences Between European and National Supervisory Practices

As presented in the previous section, JSTs are required to supervise all significant institutions of each EU member state, while national supervisors still oversee all other institutions. However, it has to be taken into account that each country's banking system has its own specific national characteristics and is affected by different economic conditions. With the increasing number of regulatory requirements and rules, an overall harmonized regulatory standard across all banks is therefore frequently criticized (Hackethal & Inderst, 2015). For example, the German banking system is characterized by a three pillar structure comprising savings banks, cooperative banks, and commercial banks. Savings banks and cooperative banks mainly act regionally. Such smaller, local banks are less complex and less risky, whereas the business models of commercial banks, in particular the largest bank holding companies, are internationally oriented and often categorized as systemically important (Hartmann-Wendels et al., 2014, pp. 28).

Such a diversified and decentralized system requires a differentiated regulation among banks (Deutsche Bundesbank, 2017b, p. 45). Nevertheless, all EU banks are subject to the same Single Rulebook leading to a high administrative burden for locally oriented and less risky banks that are too small to implement own regulatory departments. Therefore, small banks are faced with comparably high bureaucratic expenditures to comply with all regulatory standards and disclosure requirements

(Hackethal & Inderst, 2015). In this context, the proportionality principle determined in the CRD states that the internal governance "*shall be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the institution's activities.*" (European Union, 2013, Art. 74 (2)). Hence, the proportionality principle refers to the second pillar of the Basel framework (ICAAP, see Sect. 2). However, Andreas Dombret, former member of the Executive Board of the German central bank, recently suggested to elaborate a so-called Small Banking Box containing a separate set of rules for smaller, locally oriented, and less risky institutions (Dombret, 2017).

Apparently, national supervisory authorities are typically aware of the specific characteristics of their country's banking system and therefore consider the interests of their own domestic banks. As presented in Sect. 3, the largest banks are supervized by JSTs, while smaller, mainly regional banks, are overseen by the national supervisory authorities. As a result, the competent national supervisor might be incentivized to be laxer at some points taking into account the specific national characteristics to protect the own system. For example, Brown and Dinç (2011) find that regulatory forbearance is more likely in weaker banking systems. Hence, prudential supervision might be affected by local political and economic considerations. A laxer oversight of domestic banks finally results in a biased competitive environment among large and small institutions in a specific country.

As a conclusion, it is particularly difficult to establish an adequate Single Rulebook to address all specific national conditions of the EU member states. The consequence is that small, locally oriented and less risky banks are currently regulated too strictly at EU level, but might be less stringently monitored by national supervisors. This unequal treatment finally leads to a biased competitive environment within a country. However, going back to a pure national supervision is not suitable when establishing a European Banking Union, whereas a Small Banking Box could be a step in the right direction. Resulting from this key challenge, the intended European level playing field might be affected, too. We discuss this in further detail in the following.

4.3 Limitations of the European Level Playing Field

Directly linked to the challenges regarding national banking competition, we observe further problems with respect to distortions of competition at a European level. One major objective of the European Banking Union is to create a level playing field (European Parliament, 2009, p. 1). This might be harmed due to the specific structure of banking supervision in Europe.

As stated above, a "one size fits all" mentality is problematic because banking systems substantially differ across countries. In Germany, the three pillar system is relatively less concentrated compared to other systems (European Central Bank (ECB), 2016). The large number of small banks requires a different regulatory treatment. Hence, prudential supervision needs discretion at the national level. However, several studies find that national differences in supervisory practices signif-

icantly affect banks' balance sheets and risks (González, 2005). As one of many examples, overseeing and verifying the implementation of internal risk models, which are recently strongly criticized, is a national task for all less significant institutions. Mariathasan and Merrouche (2014) find significant variations of internally estimated risk-weights across jurisdictions depending on the stringency of national supervisors. Hence, banks in less strict supervisory regimes can engage in regulatory capital arbitrage more easily by using the leeway provided by internal risk models to minimize their own funds requirements. Thus, the level playing field might be affected by different regulatory treatments across EU member states.

In conclusion, not only the national competitive environment, but the level playing field at the European level is harmed by the current supervisory structure. A uniform supervision at the European level without any national discretion would be a structural approach alleviating both conflicts at the national level as well as at the European level. Such a solution might increase overall welfare, however discriminating specific bank types at the same time since banking systems are not fully homogeneous. Thus, there may be no overarching structural solution at all.

Instead, it might be reasonable to "correct" incentives for bank owners and management. The recent financial crisis required several bank bail-outs underlining the need for banking regulation and leading to the assumption of implicit state guarantees most of all for large, systemically important banks (so-called too-big-to-fail-phenomenon) (Kaufman, 2014). It seems to be necessary to make it credible that equity as well as debt investors will participate in the loss in case of bankruptcy. The recent Minimum Requirement for Own Funds and Eligible Liabilities (MREL) aims to provide an alternative by establishing a bail-in procedure where holders of non-subordinated debt instruments are exposed to bank losses, too. This procedure purposes a resolution of all banks, including systemically important banks, without endangering the overall financial soundness or the need to finance bail-outs by taxes (Deutsche Bundesbank, 2016, pp. 63). Such a resolution does not systematically discriminate a specific bank type and simultaneously re-establishes effective market discipline (Mikosek, 2016). Therefore, a credible bail-in tool might mitigate agency problems and conflicts of interest.

5 Conclusion

This paper examines the structure of banking regulation and supervision, focusing on the European banking market. In particular, we present the objectives and current structure at three levels, namely at the international level, at the European level and at the national level. Due to the integration of the European banking market, European supervisory tasks and national authorities are strongly interconnected. As a result, certain conflicts of interests and agency problems arise from the specific

structure of the European Banking Union. This paper discusses three key challenges in more detail.

First of all, new conflicts of interests arise from a missing separation between the monetary policy function and the supervisory function of the ECB. In this double role, the ECB might adjust interest rates according to supervisory objectives and may violate price stability. However, changing the structure of European banking supervision by withdrawing the ECB's supervisory task might not be reasonable either. Instead, a clear separation of tasks between supervisory and monetary policy divisions is necessary. Secondly, the Single Rulebook might systematically disadvantage smaller, only locally active and less risky banks by imposing too strict requirements on such banks. However, taking this into account, national supervisors might be less strict in overseeing domestic banks, leading to a biased competitive environment between large and small banks. Establishing a Small Banking Box as recently suggested by German supervisory authorities could therefore be useful. Directly connected to this issue, thirdly, is the main objective of the European Banking Union, namely to establish a European level playing field, which might be affected by diverging national supervisory practices. The characteristics of each banking system can differ significantly among EU member states justifying certain discretions for national authorities. However, several studies find that differences in supervisory stringency across countries affect banks' balance sheets and risks. Primarily, when banking markets are weak, regulatory forbearance seems to be higher. However, an overarching structural solution might not be possible either. It is rather necessary to adjust incentives such that investors participate in losses in case of bankruptcy. The recently introduced bank recovery and resolution regime might be a step in the right direction.

It remains to be seen whether agency problems in the banking market are reduced through the new bank recovery and resolution regime introduced in Europe in 2015. Future research is necessary to analyze whether this bail-in procedure is credible and therefore changes the behaviour of bank owners and management. A credible bail-in procedure should enhance the incentives for debt holders to monitor banks. Working as a complement to state regulation, an effective market discipline could mitigate some of the key problems arising from conflicts of interest and agency problems in the European banking market, too.

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Andreas Pfingsten has been Professor of Business Administration and head of the banking area at the University of Münster since 1994. Formerly, he was Professor of Economics at the University of Siegen. As a visiting professor, resp. visiting scholar, he worked at universities in Austria, Canada, and the US. His professional experience includes employment with a bank and an IT services firm as well as consulting activities. He publishes, among others, in *Journal of Banking & Finance*, *Journal of Business Finance & Accounting*, *Journal of Economic Theory*, *Journal of Public Economics*, *Mathematical Social Sciences*, *International Tax and Public Finance*, and *Journal of Risk*. Current fields of research include the credit business, securitization, risk management, regulation, and bank accounting. He is a member of the North Rhine-Westphalian Academy of Sciences, Humanities and the Arts, various other academic as well as professional associations, and former president of the German Finance Association.

Corinna Woyand is a research assistant at the Finance Center of the University of Münster since 2015. Her main research interests lie in the area of banking regulation, risk management, and corporate governance. She obtained her bachelor's degree in business administration from the University of Hamburg in 2012 and her master's degree with the major in finance from the University of Münster in 2014. During her studies, she completed different internships in research and consultancy.